Monetary Policy and the Financial CHOICE Act

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The Financial CHOICE Act is a comprehensive piece of legislation that, if enacted, will eliminate many of the provisions of the 2010 Dodd-Frank Act, thus changing the financial regulatory structure profoundly. The CHOICE Act will also affect the operations of the Federal Reserve and alter its ability to fulfill its core functions to conduct monetary policy and act as the lender of last resort. The focus on the Fed is not surprising, given the view taken by the writers of the CHOICE Act:

> *"Dodd-Frank rewarded the governmental entity arguably most responsible for the financial crisis – the Federal Reserve – with expansive new regulatory powers, lending credence to the adage that at least in Washington, nothing succeeds like failure."*[122]

In this section, we discuss how the CHOICE Act affects the conduct of macroeconomic policy and the use of the lender of last resort facility. We conclude that the rules imposed and the oversight over the conduct of monetary policy will hamper the Fed's ability to conduct monetary policy independent of political interference. The limits placed on the lender of last resort are likely to constrain the Fed's ability to react quickly in a crisis situation to maintain financial stability. The CHOICE Act will make the Fed's monetary policymaking less effective and will hamper its ability to respond to financial crises.

[122] **http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf** The House Committee on Financial Services, Comprehensive summary of the act, p.56.

Background

Central banks are venerable institutions with roots that date back almost 400 years. However, both the goals of central banks and the scope of their activity have changed dramatically over time. The Federal Reserve System is very different today from the institution that was created just over 100 years ago. The Federal Reserve emerged from one crisis, the Panic of 1907, and has been shaped by subsequent crises, the Great Depression and the recent financial crisis of 2007-2009. Today, the Fed is most closely associated with the conduct of monetary policy—a role that simply did not exist 100 years ago.

The main goal of the Fed, at the time of its founding, was to provide financial stability ("furnish an elastic currency" in the words of the legislation), and its principal tool was discounting or lending to the banking system. The Fed's role in making macroeconomic monetary policy developed after World War II, as policymakers and the economics profession began to understand the potency of changes in interest rate and credit aggregates. The Employment Act of 1946 added the goal of "maximum employment" to the traditional goal of price stability, thus creating the Fed's "dual mandate."[123] By the end of the 20th century, the Fed was primarily associated with its macroeconomic policy role, although it continued to have significant regulatory responsibilities.

Traditional thinking about central bank functions is usually associated with the 19th century British journalist, Walter Bagehot, who articulated the idea that a central bank should act as the lender of last resort to the financial system. By providing liquidity, the central bank can prevent crises and preserve stability. The lending functions of the Federal Reserve diminished in importance

[123] The dual mandate was implicit in the Employment Act and spelled out in 1977 legislation that gave the Fed the mandate to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" (that makes three mandates but the last is usually subsumed into the first two).

through the latter half of the 20th century.[124] However, the financial crisis of 2007-2009 brought a renewed emphasis on the Federal Reserve as the lender of last resort and on its role in using its lending to ensure that financial institutions are safe and the financial system is stable. Financial stability became the Fed's implicit third mandate.

Central bank lending in a crisis is controversial because the central bank should not be engaged in the bailout of insolvent institutions. The lender of last resort facility exists to support solvent but illiquid institutions. The facility would be less useful if there were stigma attached to the borrower. Access to the lender of last resort by insolvent institutions introduces an element of moral hazard, as banks would count on a bailout facility being available. Further, lending to an insolvent borrower does not end its need for support, and it can subordinate private creditors in any bankruptcy. These concerns were clear to Bagehot years ago, but are hard to maintain in contemporary crisis situations where it can be difficult to determine whether an institution is insolvent or merely illiquid.

As a result, a 21st century central bank has three complex and closely related functions: (i) setting monetary policy to attain its goals of price stability and maximum sustainable growth; (ii) providing a lender of last resort facility to financial institutions, which leads to an involvement with regulation and supervision; and (iii) maintaining the stability of the financial system as a whole. This broad remit and the high expectations of success place the Fed under intense scrutiny.

[124] The eminent monetary historian, Anna J. Schwartz, concluded in 1992 that "A Federal Reserve System without the discount window would be a better functioning institution," p.68, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis, *Review,* September/October 1992. The Fed did not follow her advice but took several steps in the 1990s to strengthen the discount window and encourage bank borrowing.

The CHOICE Act is a reaction to the expanded role of the Fed over time. Monetary policy became the principle tool of macroeconomic management since the Volcker and Greenspan Feds tamed inflation. Fed lending and regulatory actions took center stage during the financial crisis. As a principal player with a degree of independence, the Fed attracts criticism from all quarters. Critics find it easy to blame this powerful institution for all that is wrong with the economy and the financial sector and are eager to place it under tight control. The CHOICE Act pretends to introduce greater clarity to the role of the Fed and its conduct of monetary policy, but in reality, it shifts control over the central bank to Congress.

The CHOICE Act goes much further than earlier legislation, which set out broad goals or objectives for the central bank—the dual mandate of monetary policy. The legislation specifies exactly how policy should be determined and conducted. As a result, it contradicts a tenet of modern central banking that is universally supported: the independence of the central bank to conduct monetary policy.[125] This independence is valued for three reasons, all linked to the problem of time consistency (the incentive for a policymaker to renege on a long-term commitment).

- It insulates policymaking from political cycles and the temptation to pump up economic activity in advance of an election.[126]

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[125] For a central banker's explanation of the importance of the Fed's independence, see Timothy Geithner, "Perspectives on Monetary Policy and Central Banking," March 30, 2005, a speech given at Central Bank of Brazil, a country that has suffered the consequences of non-independence **https://www.newyorkfed.org/newsevents/speeches/2005/gei050329** . See also, the empirical evidence in the *Annual Report, 2009* of the Federal Reserve Bank of St. Louis, **https://www.stlouisfed.org/annual-report/2009/central-bank-independence-and-inflation**

[126] Of course, even an independent central banker might be subverted by politics. Board Chairman Arthur Burns has been criticized for the role that the Fed played in the 1972 re-election of Richard Nixon.

- Central bank independence protects against the age-old temptation that governments have to finance their activities by printing money.
- Independence gives the central bank the ability to ignore criticism and maintain policies that are consistent with its long-run objectives of stable prices and sustainable growth. That is, central bank independence promotes policy credibility, which helps keep inflation expectations low without sacrificing long-run economic growth.

Indeed, central bank independence has relevance beyond the conduct of monetary policy. The lender of last resort function that is needed to maintain financial stability is essentially a banking function. The central bank is lending to a customer, and just like any bank, it needs to know its customers. Thus, the central bank has a role in bank supervision partly because it should be familiar with the condition of its potential loan customers. Further, the Fed should be able to maintain some secrecy regarding lending so that solvent banks that access the discount window are not stigmatized or subject to runs. To conduct its banking functions, particularly in a crisis, the Fed needs to operate independently and out of the public eye.

Central bank independence does not mean that it should be unaccountable or free from scrutiny. Accountability and transparency are also important objectives, but the mechanisms for achieving these goals should not *and need not* interfere with the ability to make policy. The CHOICE Act crosses the line between legislative oversight and the central bank’s ability to independently pursue its mandate.

These issues are not new. Populist attacks on the Fed have been around for years, and there have been many legislative efforts to rein in the central bank. We will examine a few earlier efforts where Congress passed legislation that affected the Fed’s operations and goals. Specifically, we look at the Federal Reserve Reform Act of

1977, the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act) and the 2010 Dodd-Frank legislation. Although this legislation changed the way in which the Fed conducts and communicates policy, these laws did not interfere with the Fed's ability to make monetary policy. We will show that the Financial CHOICE Act is fundamentally different.

The 1970s Legislative Initiatives

Hubert Humphrey, the liberal Democratic Senator from Minnesota, sought to place monetary policy under closer, even direct, Congressional supervision, because he thought that the Fed paid too little attention to the full employment mandate set out in 1946.[127] At the same time, the Fed was criticized for being unable to rein in inflation, which accelerated through the 1970s. The 1970s also saw the intellectual ascendancy of monetarism and its emphasis on the rate of growth of the money supply. These different forces came together and led to legislative changes to clarify the goals of the Fed (the formal establishment of the dual mandate) and to increase the Fed's reporting to Congress regarding its policymaking. The earlier statements of goals were vague, and the Fed, along with other central banks, largely operated in secret. Secrecy about short-term intentions—and even about actual policy changes—was thought to preserve the Fed's discretion and influence over financial markets. Importantly, the legislative initiatives of the 1970s did not constrain the Fed's ability to make monetary policy or direct its policy actions. As we will see, the CHOICE Act proposals are very different.

The Reform Act of 1977 increased Congressional oversight by requiring the Fed to "consult with Congress at semiannual hearings about the Board of Governors' and the Federal Open Market

[127] It is ironic that in the 1970s, the most liberal wing of Congress was eager to control the Fed, while 40 years later, it is the rallying cry of the most conservative elements. In fact, populist elements on both sides the aisle—from Rand Paul to Bernie Sanders—are often critical of the Fed's independence.

Committee's objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates for the upcoming twelve months, taking account of past and prospective developments in production, employment, and prices." Congress specified a policy approach, a monetarist emphasis on growth targets and formalized accountability for the first time. However, it went on to add "Nothing in this Act shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions."[128] A year later, the Humphrey Hawkins Act called for a broader written report, the semiannual Monetary Policy Report to Congress on both monetary policy and macroeconomic performance. It also gave the committees an opportunity to respond and required the Fed to report on any revisions to or deviations from its objectives and plans. These reports continue today, long after monetary growth targets were abandoned.

Another element of Congressional oversight introduced in the 1977 Reform Act was that it made the designation of the Chairman and Vice Chairman of the Federal Reserve Board (from among the Governors) as Presidential designations that are subject to Senate confirmation, with a four-year term. This tied the appointment of the leading policymakers to the political structure. It did not alter the membership of the policymaking body, the Federal Open Market Committee, which includes all of the Governors (who are Presidential appointees, with 14-year terms) and the Presidents of the regional Federal Reserve Banks (who are not Presidential appointees).

The semiannual reporting to Congress had provided mixed benefits. In his history of the Fed, Allan Meltzer suggested that the semiannual reporting led the Fed to give more attention to

[128] Section 2A of the Act from https://www.govtrack.us/congress/bills/95/hr9710/text .

medium-term objectives.[129] However, a central feature of the Humphrey-Hawkins bill was the specific requirement for the presentation of "the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted…"[130] One result was a constant and excessive focus on target growth ranges for an array of aggregates (M1, M2, M3 and Total Credit). The target ranges were often very wide and of little value because of the problem of base drift, i.e., growth rate targets do not reflect prior growth that determines the base. Moreover, by the time the procedures were put in place, confidence in the efficacy of a strict monetarist approach was waning. The relationships between money aggregates and economic performance started to fall apart because of structural changes in the financial system at just the time that Congress enshrined the money growth targets in law. Even Meltzer, a monetarist, argued that by "the time President Carter signed the legislation, a common belief was that the act would not achieve its stated goals" (p. 991).

The Fed dutifully voted on and presented monetary growth targets until the Humphrey Hawkins legislation expired in 2000. There is a lesson to be learned from this experience: With a dynamic financial system, it is a mistake to define the way monetary policy should be conducted by legislating a particular approach. The experience with money growth targets was benign, because the legislation did not require the Fed to do anything more than provide an explanation when targets were not met. As we will see below, some 40 years later, the CHOICE Act includes a new attempt to legislate how policy should be conducted.

[129] Allan H. Meltzer, *A History of the Fed: Volume 2, Book 2, 1979-1986*, U. of Chicago Press, 2009, pp. 985-992.
[130] Sec. 108, **https://www.gpo.gov/fdsys/pkg/STATUTE-92/pdf/STATUTE-92-Pg1887.pdf**

In 1994, a Treasury proposal aimed to control the powers of the Fed by consolidating all financial regulation in a single new executive branch commission. The Greenspan Fed fought the proposal on the grounds that it would diminish the influence of the Fed, especially the regional Federal Reserve Banks that are deeply involved in bank supervision. Much financial sector regulation is conducted by other agencies, such as the Securities and Exchange Commission, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation; it does not have to be in the central bank. However, there is an important reason why the central bank needs to maintain some engagement with bank supervision: The Fed needs to know its loan customers if the lender of last resort function is to be used effectively in a crisis. The Clinton era proposal was made at a time when discount lending was inconsequential, and the importance of a customer relationship was overlooked.[131]

Dodd-Frank and Monetary Policy

The 2010 Dodd-Frank Act introduced extensive changes to financial regulation but did not address the way monetary policy is conducted. The goals of monetary policy—stable prices, maximum employment and moderate long-term interest rates—which had been codified earlier, were left unchanged. Early drafts of the Act included an additional goal—maintaining financial stability—but it is not part of the Act. However, the Act introduced new Fed functions and responsibilities that make such a goal implicit, and the Fed's own mission statement does include "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets." [132]

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[131] The United Kingdom did consolidate regulation in a single authority outside the central bank and regretted it during the crisis. The Bank of England had to make emergency lending decisions without having detailed knowledge of the condition of its customers. These were supervised by the Financial Supervisory Authority, which was abolished after the crisis.
[132] https://www.federalreserve.gov/aboutthefed/mission.htm

Dodd-Frank made no explicit changes to either the goals of monetary policy or the way in which monetary policies are determined or enacted, but it did place serious limitations on the lender of last resort function. Federal Reserve lending was the original tool of the central bank, but its importance diminished over time with the development of the Fed Funds market. However, the Fed started making vigorous use of its lending authority as the financial crisis began to emerge in 2007. Many new lending facilities were put in place to provide liquidity to the financial system, and lending once again became a tool of aggregate economic policy. As the crisis deepened, the Fed made use of emergency lending authority under Section 13(3) of the Federal Reserve Act, which then stated that "In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may …" lend to just about any institution.[133]

This unusual lending authority was added to the Federal Reserve Act in the Depression, subsequently repealed, and then reinstated in 1991. The lending authority was not used in the post-Depression era until the Fed invoked section 13(3) in connection with the purchase of Bear Stearns in March 2008. The Fed used 13(3) for some of its broad-based lending programs and for tailored assistance to four firms that the Fed considered too-big-to-fail. These four instances generated a great deal of controversy about the willingness of the Fed to bail out Wall Street, while it was accused of doing nothing for Main Street, where mortgage foreclosures created enormous dislocation. The proper scope of emergency lending by the central bank and whether it should extend to nonbank entities is a difficult question that has been the subject of much debate.[134] The negative public reaction to the Fed's

[133] Federal Reserve Bank of Minneapolis, "Lender of More than Last Resort," 2002. https://www.minneapolisfed.org/publications/the-region/lender-of-more-than-last-resort

[134] See Marc Labonte, *Federal Reserve: Emergency Lending*, Congressional Research Service, January 6, 2016. **https://fas.org/sgp/crs/misc/R44185.pdf**

actions resulted in provisions in Dodd-Frank designed to rein in emergency lending.

The Dodd-Frank Act sought to eliminate bailouts, in part by restricting the use of section 13(3). It restricts emergency lending to nonbanks to those participating in a broad-based program. The provision was specifically designed to prohibit the extension of credit to individual nonbanks. It also introduced some external oversight of Fed lending. The original provision only required the approval of not less than five members of the Board of Governors, while Dodd-Frank requires prior approval by the Secretary of the Treasury. In addition, the Act requires reporting to Congressional committees within seven days of the use of 13(3) and allows for Government Accountability Office (GAO) auditing. Dodd Frank also requires full public disclosure, with a time delay, of the terms and details of *all* Fed transactions. While transparency is valuable, the detailed disclosure policies (even with a lag) might inhibit the Fed's willingness to use its lending authority in a crisis.

The original section 13(3) lending provision was very open-ended. Dodd-Frank restricted the Fed and introduced some additional oversight; proponents argue that the restrictions on emergency lending were mitigated by other provisions of the Act. The orderly liquidation authority and the systemically important financial institution (SIFI) designation by the newly formed Financial Stability Oversight Council were designed to eliminate the dangers of too-big-to-fail. The ability of these provisions to do so in a crisis has not been tested. Moreover, the Financial CHOICE Act would eliminate these structures.

In summary, Dodd-Frank reflected anger with perceived bailouts by restricting 13(3) emergency lending. It introduced other mechanisms for responding to a crisis so the ability of the Fed to conduct monetary policy was not seriously affected. Importantly, Dodd-Frank mandates that financial crisis response is not the exclusive purview of the central bank. The Financial Stability

Oversight Council (FSOC) has an awkward structure that includes executive branch representatives, as well as the leadership of the Federal regulators and others. This structure runs the risk of delaying and politicizing decision making—just the opposite of what would be desirable in a crisis. Until such a test occurs, it remains hard to gauge whether these new structures, along with the Fed's limited emergency lending powers, will be an adequate substitute for 13(3) in a crisis.

The Financial CHOICE Act

The Financial CHOICE Act would dramatically change the way that macroeconomic monetary policy is conducted in the United States. Although it does not change the goals of monetary policy, it provides detailed instructions regarding the choice of policy targets and how the appropriate target value should be determined. In addition, the Fed will have to adhere to strict reporting and accountability standards should policy deviate from the rules in the law. The CHOICE Act provisions would restrict the Fed's independence and constrain its flexibility to respond to economic conditions.

From start to finish, the CHOICE Act provisions that relate to monetary policy reflect an anger at the Fed's history and practice. There is an underlying motif that the Fed consistently does the wrong thing and needs to be admonished and controlled; it is an institution that cannot be trusted. Short of replacing it with some other institution, the Act attempts to place monetary policy on a short leash and under a degree of scrutiny that will clearly compromise the independence of policymakers. Not only is the leash short, the direction that policy should take is made explicit. These changes, as we outline below, would move the United States away from the model of central bank independence and commitment to politically determined mandates. In its place, monetary policy would be subject to greater oversight and influence from the political sphere. The Act potentially takes

governance of the world's most important central bank down to a political level that is found today only among failed or failing states.

To be clear, the independence of a central bank does not mean that it should be extra-legal or not subject to criticism or able to deliberate in secrecy. The public and its political representatives set the goals for monetary policy.[135] The central bank should clearly state how it intends to meet those goals and should be transparent in what actions it is taking to do so. Transparency is necessary to allow elected officials to hold the central bank accountable for its actions.

However, the central bank should have the independence to analyze economic and financial conditions and to determine what policy actions should be taken to reach its mandated goals and what operational instruments to use to get there. Put differently, it should have *instrument independence*, not *goal independence*. The goals are set legislatively in the form of the dual mandate, but the Fed should be free to choose which instruments to use (the Fed Funds rate or something else) and how they should be set.

All previous legislation has been consistent with these principles: It specified the dual mandate, required reporting and left the decision making and operational details to the Fed. Moreover, since the 1990s, the Fed has steadily enhanced its communications regarding policy and policymaking. It was only in 1994 that the Fed began to announce the numerical value of its Fed Funds rate target and only in 2011 that the Board Chair began to hold a press conference after the Federal Open Market Committee (FOMC) meeting. The FOMC now regularly publishes forecasts for key economic variables, along with projections for the policy interest rate. Like most central banks, its communications efforts remain a work in progress, with room for improvement.

[135] There is also some direction given to the Fed regarding the tools it can use to conduct policy. For example, legislation specifies a narrow range of assets that the Federal Reserve is authorized to acquire.

The CHOICE Act takes a drastically different approach. It specifies a fixed reference rule as a benchmark for assessing monetary policy and introduces complex procedures for GAO and Congressional oversight of the Fed's policymaking or adherence to that rule. While the Fed can set its own policy rule, its performance will be assessed against the CHOICE Act's reference rule in a way that can diminish the Fed's incentive to set policy optimally. The Act reflects the view that, as currently structured and staffed, the Fed is not making the right choices and therefore needs to be reined in and given explicit direction.

The Taylor Rule

The heart of the CHOICE Act's approach to monetary policy is the legislation's specification of the Taylor rule; it spells out the equation term by term in section 701. A strong argument can be made for the use of rules in guiding monetary policy and policy communication, but the CHOICE Act does more than guide policy by rule. It constrains policymakers and introduces a structure for second-guessing and criticizing the *instrument-setting* by Fed policymakers, rather than assessing the Fed's effectiveness in achieving its mandated objectives.[136] The GAO will be responsible for providing a "compliance report" to Congress within seven days of any material change in policy.

[136] The CHOICE Act does not comment on the goals set out earlier or on the Fed's ability to meet them, perhaps because the average inflation rate (using the Fed's preferred PCE deflator) for the past 20 years has been 1.74%.

There is a long history of economists who support the use of policy rules for monetary policy.[137] In broad terms, a rule provides the public with a context for understanding policy decisions and interpreting the intermediate-term objectives of policy. A publicly known rule makes the central bank's objectives clear and shows how it will use its policy targets to achieve those objectives. Importantly, a rule also helps the policymaker to maintain a stable policy designed to achieve long-term objectives. In an ideal world, the rule guides policy and provides the public with a full understanding of policy decisions, thus enhancing economic stability and confidence. Monetary policy should be systematic, predictable and focused on its long-run objectives; a rule can be useful as part of the communication strategy.

In a less than ideal world, the challenge is how to specify a rule and how to address economic conditions that might warrant deviations from the rule. The CHOICE Act is very specific about both of these issues and would introduce procedures that would unduly constrain the conduct of monetary policy.

In 1993, John Taylor offered a rule of thumb for determining the appropriate level for the Fed's target interest rate.[138] The Taylor Rule specifies that the target for the policy interest rate should be equal to the sum of:

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[137] In 1977, Finn Kydland and Edward Prescott introduced the idea of time inconsistency, showing that the short-term and long-term objectives of the central bank might be at odds. This led to much discussion of policy rules as a way of solving the problem. They were awarded the Nobel Prize for this contribution in 2004. For a brief discussion see **https://www.stlouisfed.org/publications/regional-economist/january-2003/rules-vs-discretion-the-wrong-choice-could-open-the-floodgates** . Also pp. 64-67 of the House Committee on Financial Services, Comprehensive Outline for a summary of recent views **http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf**

[138] Taylor, John B. (1993). "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy. **39**: 195–214.*

- The real or natural rate of interest,
- The inflation rate,
- One-half of the percentage deviation of real Gross Domestic Product (GDP) from its potential level, and
- One-half the deviation of inflation from its target (2%).

Interestingly, over a long period of time, Taylor's specification tracks the Fed's actual policy rate rather closely—except for several periods when the Fed pursued a consistently tighter or looser policy than the rule would have dictated. Such deviations from the simple rule can arise frequently when policy decisions are influenced by considerations that are not reflected in the rule, such as financial conditions or international issues.

Policy observers and policymakers often find the Taylor Rule a useful construct for discussing the stance of policy or policy options; it provides a useful measuring stick that makes policy understandable. Although it is not used explicitly in Fed policy statements, many economists within the Federal Reserve System make reference to it, and estimates of the Fed Funds rate target based on the rule can be found on the websites of more than one Federal Reserve Bank.

However, to enshrine a particular equation into law overlooks all the uncertainties that surround such a simple rule. The CHOICE Act mandates that the Fed issue a 'policy directive rule' that specifies its plans to adjust the policy instrument (the Fed Funds rate), while it spells out the Taylor Rule in the legislation as the reference rule that is to be used to assess Fed policy setting. There are several problems with this rigid use of the Taylor Rule:

- The Taylor rule starts with the unobservable equilibrium real rate of interest; the legislation specifies it as 2%, which happens to be the number chosen by Taylor 20 years ago. The possibility that it has declined in recent decades has

been suggested in recent academic work.[139] In any case, there is a wide range of uncertainty about the choice of 2%. It could be higher or it could be zero. The uncertainty from this source alone indicates that any Taylor Rule specification of policy necessarily would be of too wide a range to be useful in assessing the Fed's decisions regarding its policy instrument.

- The Taylor rule specifies that the policy interest rate target should adjust to one-half the percentage deviation of GDP from its potential and one-half the deviation of inflation from its target of 2%. These coefficients are not physical constants, but rather they are judgments regarding the appropriate response. These values were chosen because they appear consistent with the mandate to attain price stability and maximum sustainable output, and lead to a rule that tracks actual policy fairly well. Yet there might be situations when the Federal Reserve might want to respond to deviations more quickly or less quickly, and the appropriate responses might not be symmetric.[140]

- Finally, there are many measurement issues that need to be addressed before the rule can be applied. There is more than one measure of the GDP gap, and inflation measures can

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[139] K. Holston, T. Laubach and J. Williams, "Measuring the Natural Rate of Interest: International Trends and Determinants," December 2016 **http://www.frbsf.org/economic-research/files/wp2016-11.pdf** . Also, "The fall in Interest Rates: Low Pressure," *The Economist,* September 24, 2016, **http://www.economist.com/news/briefing/21707553-interest-rates-are-persistently-low-our-first-article-we-ask-who-or-what-blame**

[140] Ben Bernanke suggested that the slack response coefficient should be one, which brings the rule's specification for the Fed Funds rate since the crisis much closer to the actual policy rate; see "The Taylor Rule: A Benchmark for Monetary Policy?" The Brookings Institution, April 28, 2015. **https://www.brookings.edu/blog/ben-bernanke/2015/04/28/the-taylor-rule-a-benchmark-for-monetary-policy/** .

differ. For example, which price index and what time horizon should be used to calculate inflation?

The Taylor Rule policy rate target at the end of 2016 was 3.04%, considerably higher than the actual rate of 0.45%.[141] If the response coefficient is increased to one, the rule-driven Fed Funds rate falls to 2.51%. And, if the real rate estimates suggested by Laubach and Williams in their research at the Federal Reserve Bank of San Francisco is used, the target Fed Funds rate is just about where the rate is now. A reasonable range of uncertainty about the rule parameters spans the difference between the Fed's critics and its policy.[142]

The CHOICE Act would force policy communications to focus on the relationship between the rule and policy decisions. Given the uncertainty arising from various specifications of the Taylor Rule, it might do more to reduce the clarity of policy communication than it does to increase transparency. The rule and the procedures in the CHOICE Act to monitor adherence to the rule might make the FOMC reluctant to implement policy changes that they perceive as desirable. In this case, the rule could lead to less effective policy.

From 1977-2000, the Fed was required by law to set growth targets for monetary aggregates. It was soon apparent that the relationship between any definition of money and economic performance was unstable. The ranges for money growth became so wide that the targets soon played little if any role in policymaking, although they continued to appear in FOMC communications. Once the legislation expired, the Fed abandoned any mention or use of money growth targets. A more prominent role for the Taylor Rule in policymaking

[141] Using the Federal Reserve Bank of Atlanta, Taylor Rule utility with the parameter values specified in the CHOICE Act.

[142] Janet Yellen discusses the value of a Taylor Rule in an uncertain world in "The New Normal Monetary Policy," March 27, 2015, **https://www.federalreserve.gov/newsevents/speech/yellen20150327a.htm**

could have a similar fate, with limited usefulness in providing a uniform framework and, ultimately, with little influence.

The CHOICE Act procedures that would be put in place to force adherence to the rule are particularly troubling. The legislation has a complex structure: The reference policy rule (the Taylor Rule equation in the law) is used to prepare a directive policy rule (which appears to be a replacement for the Policy Statement released after each FOMC meeting, though it is not clear whether it would also be a pubic document).[143] Within two days of an FOMC meeting, the directive policy rule is submitted to the appropriate committees of Congress and to the GAO. It includes a statement of whether the directive policy rule conforms with the reference policy rule, and if not, it provides an explanation and justification. It also includes a certification by the Fed Chair that the directive policy rule is expected to support the Fed's goals of stable prices and maximum employment over the long term. Whenever there is a material change in policy, the GAO submits a "compliance report" to the Congressional Committees. In the event of noncompliance, the Chairman of the Board testifies before Congress within a week, and the GAO can be asked to audit the conduct of monetary policy.[144]

The legislation specifies that "Nothing in this Act shall be construed to require that the plans with respect to the systematic quantitative adjustment of the Policy Instrument Target … be implemented if the Federal Open Market Committee determines that such plans cannot or should not be achieved due to changing market conditions." However, in the event of such a determination by the

[143] There are some additional specifications of what must be in the directive policy rule; for example, it must "include a calculation that describes with *mathematical* precision the expected annual inflation rate over a 5-year period" (my emphasis).
[144] These policy audits by the GAO are distinct from the annual audits of all the activities of the Board of Governors and the regional Federal Reserve Bank that are introduced elsewhere in the CHOICE Act.

FOMC, it has to submit, with an explanation, an updated directive policy rule, which is subject to further review by the GAO.

These complex procedures are designed to constrain the discretion of the FOMC. Embedding the Taylor Rule in legislation elevates it to more than its current role as a useful policy guide, giving it enhanced status as a policy benchmark. It reflects a particular school of thought that believes that the zero interest rate policy followed by the Fed (and all other major central banks) after the crisis was a serious mistake. It attempts to put into law a rule that Congressional overseers could have exploited to influence Fed instrument setting.

Oversight and Transparency

Congressional oversight of Fed policymaking is not particularly new: the Chairman of the Board of Governors testifies regularly before Congress and is unlikely to refuse to do so if asked more often. The CHOICE Act requires appearances when the GAO determines that there has been noncompliance. The Act also mandates that the Chairman appear before Congress four times a year, up from twice a year currently.

What is new is the introduction of the GAO as an auditor. It will be asked to judge compliance and audit monetary policy and make formal reports. In a very real sense, the GAO becomes a shadow FOMC. The public may wonder whether it should look to FOMC statements or GAO compliance reports to determine the direction of monetary policy.

Most important is the difference in the type of oversight. It does not focus on holding the Fed accountable for achieving its long-run objectives mandated by law. Instead, it introduces oversight and influence over instrument-setting itself, encouraging second-guessing of every policy decision. How should the Fed respond to a critical GAO compliance report? To what extent will Congress

pressure the Fed to alter instrument setting? There is a clear risk that the Fed's hard-earned credibility as an independent policymaking institution would be surrendered to Congressional committees.

Transparency—the prompt publication of additional information about monetary policy—is generally viewed as a positive thing. Today, the FOMC provides an enormous amount of information about its policy setting. It has steadily increased the amount of information shared since it began announcing the Fed Funds target more than 20 years ago. Its regular communications now include useful, forward-looking information about the distribution of economic forecasts made by FOMC members, as well as their individual assessments for the interest rate instrument over a three-year horizon. As a result, the public now has considerable access to the policymaking process. The FOMC's economic forecasts and judgments regarding the appropriate policy responses indicate how it would respond to economic and financial developments. This information about the policy path and, implicitly, the Fed's 'reaction function' makes monetary policy more transparent than ever before and probably more effective. The Fed is already providing far *more* information than what is included in a simple policy rule.

The CHOICE Act does not mandate any improvement in the amount of information that the Fed already shares. It does set up a mechanism for public Congressional criticism of monetary policy decisions. A report to Congress within 24 hours of an FOMC meeting, a GAO determination of compliance, and the possibility of a policy audit will reduce Fed independence and potentially shift policymaking to Congressional committees. These complex procedures also could add to uncertainty about monetary policy, by raising doubts about the finality of FOMC decisions.

Summary and Conclusions

Our concern about the CHOICE Act's procedures for the direction and oversight of monetary policy is threefold: First, it creates an apparatus for monitoring and second-guessing the policy instrument setting in a way that diminishes central bank independence. Second, the existence of this apparatus would diminish the incentive of monetary policymakers to choose what they believe to be the optimal policy setting if it deviates from the simple benchmark rule. Third, the CHOICE Act procedures could increase, rather than reduce, uncertainty about policymaking.

With regard to discount lending, the CHOICE Act goes beyond Dodd-Frank, which seriously restricted the Fed's emergency lending authority. By eliminating the Systemically Important Financial Institution (SIFI) designation, the CHOICE Act will hamper the Fed's ability to address crisis situations. Specifically, the Act eliminates the Financial Market Utilities (FMUs) designation, which would deny access to the Fed discount window for solvent, but illiquid clearinghouses. Because that is unlikely to make these institutions less systemic, it may contribute to an unnecessary panic in a period of financial distress.

Finally, toward the end of Title VII (Fed Oversight Reform and Modernization), there is a section that calls for the establishment of a Centennial Monetary Commission (a little late since the Federal Reserve System started operations in 1914). There is nothing wrong with a commission examining the complex structure for financial system oversight that includes supervision of the financial industry, monetary policy and systemic risk regulation. The Fed is already very different from its 1914 incarnation, and some fresh thinking about the structure of the central bank might be beneficial. The proposed Commission would have just one year to examine some fundamental issues: the efficacy of different monetary policy operating regimes (including a gold standard); the value of macroprudential policy; the use of the lender of last resort; and the

dual mandate. Furthermore, the appointment process would encourage partisanship, as all the voting Commission members will be appointed by the Congressional leadership, with two-thirds of the seats appointed by the majority party.

In conclusion, the CHOICE Act will impinge on the ability of the Fed to use its authorized tools to conduct monetary policy independently and without interference. The proposed oversight of instrument setting is more likely to boost, than to reduce, uncertainty. The Act would further limit the ability of the Fed to act as the lender of last resort for solvent, but illiquid, intermediaries in a crisis. With the elimination of SIFI and FMU designations, and the removal of the Orderly Liquidation Authority, it is not clear that the United States will have the institutions needed to prevent or contain a future financial crisis.