Anne Sibert

Talk prepared for the Federal Reserve Bank of Boston's 61st Economic Conference, "Are Rules Made to Be Broken: Discretion and monetary policy," 13–14 October 2017.

I do not like the rules of the type proposed in the Fed Oversight Reform and Modernization (FORM) Act. I will discuss why, but I will mostly focus on how it was that the House could actually pass such a poor law. I will argue that it had nothing to do with the subtleties of how monetary policy is conducted and everything to do with a widely held view that — in its current form — the Fed is not democratically legitimate. I will argue that rules such as those proposed in the FORM act will not enhance legitimacy. I suggest two legislative changes that might.

Among other things, the FORM Act of 2015 — passed by the House of Representatives— proposed a benchmark policy rule for the Fed.[1] The Fed can choose not to follow this rule, but if it does not it must come up with its own reference policy rule, subject to constraints imposed by the bill. And, within 48 hours of the FOMC meeting at which it chose a new rule, it must provide a detailed explanation of why it did so, a description of the circumstances in which the new rule might be amended in the future and a calculation of expected inflation over the next five years. If the GAO views either the new rule or the explanation as unsatisfactory, the Fed chairman can be forced to testify before Congress. The stated idea is to enable investors and consumers to form more accurate expectations and to make better decisions.

[1] Fed Oversight Reform and Modernization Act of 2015, H.R. 3189, 114th Congress, 2015–2016.

The type of rules embedded in the FORM Act were applauded by 24 distinguished economists, including Robert Lucas, Edward Prescott, Allan Meltzer and John Taylor. They claimed that monetary policy works best when it follows a clear, predictable rule or strategy.[2] However, there are many reasons to oppose such a rule. It can depend on unobservable variables and it ignores relevant state variables. When the structure of the economy changes, a rule can become obsolete and the proposed legislation makes the cost of change high. As a result, the Fed might choose to follow its prevailing rule for longer than it should. Furthermore, it diverts discussion from what really matters: what policy rate best ensures target inflation. It also might reduce collegiality in a committee by attempting to force a common view of how the economy works on members with divergent opinions. It might also suggest to the public that the Fed has more understanding of how the economy works than it actually does.

In my view the Fed should not want to bind itself to a particular rule and it should definitely not want to have a rule imposed on it, with the GAO deciding if it has behaved properly and Congress being allowed to interrogate the chairman for real and imagined infractions. So, how did the Fed get in a situation where so many Congressmen distrust it that the FORM Act could pass in the House? In is interesting to ask why Congress has become so interested in constraining and overseeing the Fed.

Rick Mishkin argues that since the 1980s, monetary policy in the United States has been quite good and I agree — certainly it has not been so bad as to incur as much

[2] Lars Peter Hansen et al., "Statement of Policy Rules Legislation," (n.p., n.d., unpublished note).

Congressional displeasure as it has. As Rick points out, inflation has been low and I share his view that monetary policy was not a key factor in the housing bubble and that monetary policy mistakes have been minor. Moreover, I suspect that most economists would probably say that the Fed did a reasonably good job in helping to contain the financial crisis. So, why was the FORM Act proposed and why did it pass in the House?

While improving forward guidance is desirable, one might wonder if there are more pressing concerns for Congress than legislating Taylor-type rules. The sponsor of the bill is Congressman Bill Huizenga and in a video on his website he explains what drove him to propose it.[3] He says, "With the Federal Reserve having more power and responsibility than ever before, it is imperative the Fed changes its opaque structure and becomes more accountable and transparent to the American people." He complains that the Fed is "opaque" and "shrouded in mystery" and that he wants to "pull back the curtain." In the three-minute video he uses the word "transparency" six times. Bill Huizenga's video suggests that the FORM Act and the distrust of the Fed have nothing to do with the Fed doing a bad job or with subtle arguments about how best to conduct monetary policy.

Instead, many members of Congress have come to doubt the *legitimacy* of the Fed in a democratic society. How does an institution get such legitimacy? Political scientists offer a framework. An institution can get such legitimacy in two ways. The first is input legitimacy; this is related to how an institution is designed and operates. Does the public approve of how the institution came into being and was given its roles and of how its policymakers are

[3] Bill Huizinga, "It's Time to Bring the Federal Reserve Out of the Shadows," *Congressman Bill Huizinga*, (Bill Huizinga, 3 Aug. 2015, video).

appointed? And, is the institution accountable? Accountability exists when an institution informs the citizenry about its actions explains and justifies them and submits to pre-determined sanction. Accountability is thus seen as being achieved in two ways. An institution can be formally accountable if it is transparent about its past, current and planned future actions future actions: about what it does and why. It is substantively accountable if its policymakers can be punished for incompetency or misconduct.

The second type of legitimacy is output legitimacy and this has to do with the institution's performance. Two things contribute to output legitimacy. The first is its perceived competency. Does the public think that the institution is doing its job well? The second is not usurping roles it was not given. That is, if an institution does not want to damage its output legitimacy it should not take on tasks that it was not assigned, even if it can do these tasks well.

Consider the period between the 1980s and the onset of the financial crises. Financial stability issues were in the background and monetary policy was concerned with choosing policy rates. Output legitimacy was not a problem for the Federal Reserve: it produced low and stable inflation and its routine lender-of-last resort actions attracted little attention. The Federal Reserve also had some input legitimacy as central banks are viewed as the natural institutions to make monetary policy. If policymakers are appointed, rather than elected, this is probably viewed as acceptable because choosing policy rates in normal times is a technocrat's job. Unfortunately, having Federal Reserve Bank presidents appointed by the Federal Reserve's Class B and C directors is not universally viewed as acceptable. Most of the problems that the Fed might have had with being perceived as legitimate, however, revolved around accountability.

It is probably understood that the monetary policy makers need to be independent — in the sense that they should not be too substantively accountable — if they are to escape political pressure and to be less susceptible to a time-inconsistency problem. Indeed, the Fed is far more substantively accountable than the Eurosystem and may even be insufficiently independent for the purposes of picking policy rates. Its chair serves a four-year renewable term and there is always the threat of Congress further limiting its independence.

Monetary policy makers are, however, expected to display formal accountability and here the Fed may appear somewhat worse than some other advanced central banks, say, the Bank of England. It is not transparent about how decisions are made (or about what subset of the FOMC makes these decisions); serious discussions do not take place at its meetings (as it is too large and as it releases transcripts rather than minutes); its individual voting records are rather meaningless if it is conventional for members to vote with the chair, even if they do not necessarily support an action.

Despite its input legitimacy being somewhat questionable, during normal times, as long as it does its job well, the Fed's output legitimacy should guarantee it enough overall legitimacy that Congress will not have an incentive to rewrite its rules. Unfortunately, however, the financial crisis expanded the Fed's role from the provision of low and stable inflation to the provision of financial stability and inevitably damaged its legitimacy.

During the crisis, the Fed got some output legitimacy because it was generally perceived as doing a good job. In contrast to the Eurosystem, the Fed came into being as a result of a series of financial panics and therefore, it was viewed as having a legitimate role to play in the provision of financial stability. Unfortunately, it woefully lacked the formal accountability to play such a fiscal role; fortunately, a Manhattan court judge and Bloomberg have largely fixed this problem. Unfortunately, also, the Fed was forced to take on fiscal tasks that it was viewed as absolutely not supposed to do.

Nevertheless, the hostility toward the Fed seems on balance unwarranted. But, as David Brooks has pointed out in a recent column, a hundred years ago monetary policy was a proxy fight in a larger conflict between agricultural and post-industrial America.[4] That is, it was not just monetary policy that was at issue but also that one's views on monetary policy became an identify marker: a way of distinguishing one group of people from another. Unfortunately, after the financial crisis and with the rise of the culture wars, it appears that attacking the Fed become an identity marker. Many may oppose the Fed in its current form, or oppose it more than they otherwise would, because doing so identifies them as being a supporter of the Tea Party, and holding the values that it espouses. It is indicative of this that, while the Tea Party appears to detest the Fed, it is not entirely sure why it does. Some have accused it of trying to monetize the debt (Mike Lee, R-UT); some have accused of being to cozy with private business interests (Ken Buck, R-CO); some believe it is devaluing

[4] David Brooks, "Guns and the Sole of America," *New York Times*, (New York Times, 6 Oct. 2017, online article).

the dollar (Rand Paul, R-KY). Most, however, appear to feel that the Fed lacks accountability and thus it appears that many do not view it as legitimate.

Would the FORM Act improve matters? I try to imagine how this legislation would work in practice. In my view, the proposed rule is a bad idea for a committee. I was a member of a monetary policy committee — a pipsqueak one, but I imagine that there are similarities. A monetary policy committee has to solve a complex technical problem and agree upon its communication in a short period of time. Choosing a policy rate to hit an inflation target focuses the discussion.

The Icelandic monetary policy has only five members: real discussion is possible. But, even in a small committee, deciding whether or not to change a rule and if the rule is to be changed, what it is to be changed to would be very difficult when members have distinctly different views about how the economy works.

A vast social psychology literature documents that the output of committees is not as good their composition might suggest it would be. And, output losses increase with the size of the committee: not everyone can speak at once, less information is shared its members and less effort is exerted by its members. The FOMC is way too large a group to decide whether the prevailing rule needs to be changed, and if so, to then reformulate the rule and possibly to come up with new estimates of the inputs within the confines of an FOMC meeting. The requirement that the proceeds be taped and that transcripts be made of the tapes would put an additional damper on any meaningful discussion. The likely result is that a subset of the FOMC would choose the rule outside of the FOMC meeting. Then, there is the matter of the unobserved variables. Does the Fed staff estimate them? Would an obliging Fed staff with career concerns come up with estimates that would ensure the chairman's most preferred policy rate was chosen? Or, might the staff try to sabotage an unpopular appointee? The result of the uncertainty over who does what and why would cause monetary policy to become even more opaque and be moved further behind the curtain.

What legislative acts might improve matters? Here are my two suggestions and they both involve reducing or eliminating the quasi-fiscal or fiscal roles of monetary policymakers with the intent of increasing the Fed's perceived legitimacy.

The Treasury has the ultimate responsibility for foreign exchange intervention while the Federal Reserve executes it. I have the impression that when it was routine to intervene in small amounts to calm disorderly markets that the Treasury mostly delegated intervention to the Fed. And, if a disaster occurred and an appropriate Treasury official could not be located, the Fed would have gone ahead without approval. A similar division of labor might work for lender of last resort activity. In this scenario, routine lending in normal times might be effectively delegated to the Fed and if AIG has to be bailed out, it will be absolutely clear to the public that it is at the Treasury's behest and not on the initiative of the Fed.

Another option might be to separate monetary policy, narrowly defined as choosing a policy rate and perhaps the size (but not the composition) of the Fed's balance sheet, to a committee that it is otherwise distinct from the central bank. This is what Iceland does. The committee could be populated entirely or mostly by people with no other relation to the central bank. This has the allure of separating two jobs (monetary policy and the provision of financial stability) that require different interests and skills and different amounts and types of accountability. The rest of the central bank, having a fiscal role, should be subject to substantial substantive accountability while the monetary policy committee, not having a fiscal role, could have the freedom from substantive accountability that would protect it from political influence.