

XI. *Federal Reserve Monetary Policy and The Taylor Rule*

A. Introduction

The Federal Reserve System (“Federal Reserve” or “Fed”) requires flexibility when it adjusts interest rates, rather than restricting itself to any specific interest rate rule.¹ Proponents of the Fed’s current adjustable policy—including former Chairs of the Board of Governors of the Federal Reserve Alan Greenspan and Ben Bernanke—argue that any mechanical formula, even if useful as a general policy guideline, could prove ineffective during especially tumultuous or unusual economic times.² For example, in response to the 2008 recession the Federal Reserve instituted a policy of discretionary stimulus spending, which significantly increased the U.S. national debt.³

Opponents of the current policy seek several changes to the Federal Reserve.⁴ A recent bill titled the “Federal Reserve Accountability and Transparency Act of 2014,” approved by the House Committee on Financial Services in July 2014, would require the central bank’s policy-setting Federal Open Market Committee (“FOMC”) to detail its strategy for adjusting interest rates.⁵ The FOMC could later change its policy rule, but any changes would be subject to Government Accountability Office (“GAO”) audits.⁶ The bill proposes

¹ Rich Miller, *Bernanke, Greenspan Voice Doubts About Tying Fed to Policy Rule*, BLOOMBERG (Aug. 5, 2014, 11:49 AM), <http://www.bloomberg.com/news/2014-08-05/bernanke-greenspan-voice-doubts-about-tying-fed-to-policy-rule.html>, archived at <http://perma.cc/YS9-QRLR>.

² *Id.*

³ Chriss W. Street, *Federal Reserve Moves Closer to Abandoning Keynesianism*, BREITBART (Aug. 20, 2014), <http://www.breitbart.com/Big-Government/2014/08/20/Federal-Reserve-Moves-Closer-to-Abandoning-Keynesianism>, archived at <http://perma.cc/K3NQ-ZELW>.

⁴ Press Release, H. Comm. on Fin. Servs., Committee Approves Legislation to Bring Accountability, Transparency to the Federal Reserve (July 30, 2014), available at <http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=390084>, archived at <http://perma.cc/Z8V4-ZHL8>.

⁵ Federal Reserve Accountability and Transparency Act of 2014, H.R. 5018, 113th Cong. § 2C (2014) (requiring the submission of a detailed “Directive Policy Rule” after FOMC meetings to various congressional committees as well as the Comptroller General); *id.*

⁶ See H.R. 5018 § 2(f)(2) (describing the GAO audit process, which empowers the Comptroller General to audit any changed monetary policy upon request of the appropriate congressional committee).

implementation of the “Taylor Rule,” a quantitative algorithm which stipulates that, “for every one-percent increase in inflation, the Fed should raise the nominal interest rate by more than one percentage point to take the steam out of inflation.”⁷

This Article questions whether implementing the Taylor Rule makes macroeconomic sense, and traces the debate over Federal Reserve monetary policy by analyzing the workings of our current system against the proposed Taylor Rule. Part B explores current monetary policy and congressional oversight of the Federal Reserve, while Part C examines the Taylor Rule. Finally, Part D details the 2014 proposed legislation endorsing the Taylor Rule, and Part E discusses whether the Taylor rule should become law.

B. Federal Reserve Monetary Policy and Congressional Oversight

The Federal Reserve System was created in 1913 through the Federal Reserve Act⁸ to serve as the central bank of the United States, and to provide the U.S. with “a safer, more flexible, and more stable monetary and financial system.”⁹ While the Federal Reserve serves several different purposes,¹⁰ one of its central roles is the formulation of monetary policy, which involves “influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.”¹¹ To further its monetary policy goals, the Federal Reserve engages in open market transactions, which involve “the purchase and sale of government securities in the secondary market”¹² The Fed employs such operations in order to keep inter-bank lending rates—known as the “federal funds rate”—near the FOMC targets.¹³

⁷ Street, *supra* note 3.

⁸ Federal Reserve Act, 12 U.S.C. § § 221–252 (2012).

⁹ *What is the purpose of the Federal Reserve System?*, FED. RES. SYS., http://www.federalreserve.gov/faqs/about_12594.htm (last updated Feb. 4, 2014), *archived at* <http://perma.cc/F3AM-W9RN>.

¹⁰ *Id.* (stating the functions of the Fed as “[c]onducting . . . monetary policy . . . supervising and regulating banks . . . maintaining the stability of the financial system . . . providing . . . financial services . . . [and] operating and overseeing the nation’s payments systems.”).

¹¹ PAULINE SMALE, CONG. RESEARCH SERV., RS20826, *STRUCTURE AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM 2* (2010).

¹² *Id.*

¹³ *Id.*

Today, the Federal Reserve keeps interest rates low in order to achieve its long-term goals of optimal employment levels and stable inflation at 2%.¹⁴ These low lending rates “help households and businesses finance new spending and help support the prices of many other assets.”¹⁵ The current federal funds rate is set at 0.25%.¹⁶ The FOMC, however, has outlined its intent to raise the federal funds rate over the long run, and thereby “normalize” monetary policy.¹⁷ In deciding when to raise these interest rates, the FOMC reviews whether it has been able to advance its goals of optimal employment and stable inflation by analyzing factors such as inflation, the employment of the American workforce, and any new changes in the economy.¹⁸ Further, the FOMC has predicted that, even after achieving these main goals, the state of the economy may demand maintaining the inter-bank lending rate below a “normal” rate.¹⁹ Critics of current Federal Reserve policy say that the institution has failed to improve employment and stabilize inflation since 2008, and that setting a very low interest rate is actually part of the problem.²⁰

¹⁴ *Why are interest rates being kept at a low level?*, FED. RES. SYS. [hereinafter FED. RES. SYS. LOW INTEREST RATES], http://www.federalreserve.gov/faqs/money_12849.htm (last updated Nov. 3, 2014), *archived at* <http://perma.cc/8997-2AP4>.

¹⁵ *Id.*

¹⁶ *FED Federal Funds Rate, American central bank's interest rate*, GLOBAL-RATES.COM, <http://www.global-rates.com/interest-rates/central-banks/central-bank-america/fed-interest-rate.aspx> (last visited Oct. 8, 2014), *archived at* <http://perma.cc/ZK8U-T6K9>.

¹⁷ *What does the FOMC mean by “monetary policy normalization”?*, FED. RES. SYS., <http://www.federalreserve.gov/faqs/what-does-the-fomc-mean-by-monetary-policy-normalization.htm> (last updated Sept. 18, 2014), *archived at* <http://perma.cc/QL99-JKMM>.

¹⁸ *How will Federal Reserve policymakers judge when the economy is ready for the start of monetary policy normalization?*, FED. RES. SYS., <http://www.federalreserve.gov/faqs/how-will-fed-policymakers-judge-when-the-economy-is-ready-for-start-of-monetary-policy-normalization.htm> (last updated Oct. 30, 2014), *archived at* <http://perma.cc/CJ73-WJAZ>.

¹⁹ FED. RES. SYS. LOW INTEREST RATES, *supra* note 14.

²⁰ See James Dorn, *The Fed Needs Truly Radical Reform, not a Timid Taylor Rule Fix*, FORBES (July 31, 2014, 4:32 PM), <http://www.forbes.com/sites/jamesdorn/2014/07/31/the-fed-needs-truly-radical-reform-not-a-timid-taylor-rule-fix/>, *archived at* <http://perma.cc/VR8Q-6MPE>.

Congress established the Federal Reserve as a statutorily independent agency in order to insulate the institution from politics.²¹ The central bank is, however, also answerable to Congress.²² Presidential appointment of Federal Reserve board members requires Senate confirmation,²³ and Congress routinely checks the Federal Reserve through various oversight mechanisms.²⁴ Congressional oversight is nonetheless limited, because Congress is not permitted to audit the Federal Reserve's decisions with respect to monetary policy.²⁵ On the other hand, the Federal Reserve regularly publishes reports,²⁶ and upon congressional request, testifies on banking and economic-related topics.²⁷

C. Analysis of the Taylor Rule

The Taylor Rule is a formula that mandates the “nominal interest rate” based on the inflation rate and the gap between the economy's potential and actual level of output.²⁸ Devised by Stanford University professor and economist John Taylor in 1992,²⁹ “the Taylor [R]ule has revolutionized the way many policymakers at central banks think about monetary policy.”³⁰ The Taylor Rule itself specifies how much the monetary policy tool—in this case, the “federal funds rate”—

²¹ See Federal Reserve Act, 12 U.S.C. § 242 (2012) (declaring that the President can only remove members of the Board of Governors of the Federal Reserve System “for cause”); SMALE, *supra* note 11, at 1.

²² § 247; SMALE, *supra* note 11, at 5–6.

²³ § 241.

²⁴ SMALE, *supra* note 11, at 5–6 (providing examples of congressional oversight, such as analyzing the “monetary policy reporting system” codified in 12 U.S.C. § 225b, conducting statutorily scheduled committee hearings, and requiring reports on monetary policy twice per year).

²⁵ *Id.* at 5.

²⁶ *Id.*

²⁷ *Id.*

²⁸ See Street, *supra* note 3; see generally THE TAYLOR RULE AND THE TRANSFORMATION OF MONETARY POLICY (Evan F. Koenig et al. eds., 2012) (presenting various viewpoints about the theory and effects of the Taylor Rule).

²⁹ John B. Taylor, *Discretion versus Policy Rules in Practice*, 39 CARNEGIE-ROCHESTER CONF. SERIES ON PUB. POL'Y 195, 199–210 (1993).

³⁰ George A. Kahn, *The Taylor Rule and the Practice of Central Banking*, in THE TAYLOR RULE AND THE TRANSFORMATION OF MONETARY POLICY, *supra* note 28, at 63, 63.

should rise in connection with various macroeconomic pressures.³¹ The Taylor Rule also includes the Taylor Principle, which involves boosting the “federal funds rate” by more than a one-to-one ratio in response to high inflation rates of over two percent.³²

Proponents of the Taylor Rule say the rule has been utilized effectively with great success from 1985 to 2007,³³ acknowledging some key deviations marked by (1) the 1997 Asian crisis and the Long-Term Capital Management bailout; and (2) the 2002-06 recovery from the downturn in the early millennium.³⁴ Critics of the Taylor Rule lament these same extraordinary economic periods as illustrative of the rule’s imperfections.³⁵ For example, Alan Greenspan, who headed the Fed from 1987 through 2006, has stated that the Taylor Rule is too uncertain to work on a consistent basis.³⁶ Ben Bernanke has also asserted that the Taylor Rule “would have been no assistance whatsoever since 2008”³⁷ Bernanke remarked that because interest rates had been reduced to near zero percent in December 2008, the Taylor Rule’s formula would not have generated prudent economic policy.³⁸ Instead, the Fed tried to revamp the economy by purchasing bonds in the open market, and by comforting investors that it would keep the money supply expanded and accessible.³⁹ Today, however, the Federal Reserve has slowed open market operations by winding down its bond-buying.⁴⁰ On the other hand, Bernanke has emphasized that he does not oppose the Taylor Rule as a guidepost for prudent monetary

³¹ Taylor, *supra* note 29, at 202 (proposing the first iteration of the Taylor Rule in the following formula: “ $r = p + .5y + .5(p - 2) + 2$, where r is the federal funds rate, p is the rate of inflation over the previous four quarters, [and] y is the percent deviation of real GDP from a target.”).

³² Kahn, *supra* note 30, at 69.

³³ See Street, *supra* note 3.

³⁴ George A. Kahn, *Taylor Rule Deviations and Financial Imbalances*, FED. RES. BANK KAN. CITY ECON. REV., Apr. –June 2010, at 63, 69–70.

³⁵ See *infra* notes 38–41 and accompanying text (explaining the responses of current and former Federal Reserve Chairs Alan Greenspan, Ben Bernanke, and Janet Yellen).

³⁶ See Miller, *supra* note 1.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ Jon Hilsenrath, *Fed Closes Chapter on Easy Money*, WALL ST. J., <http://online.wsj.com/articles/fed-ends-bond-buys-sticks-to-0-rate-for-considerable-time-1414605953> (last updated Oct. 29, 2014, 7:19 PM).

policy; rather, he opposes “applying [it] in a mechanical way.”⁴¹ The current Fed Chair, Janet Yellen, also opposes strict adherence to the Taylor Rule.⁴²

The Taylor Rule’s systematic and relatively straightforward approach has numerous advantages, such as (1) serving as a useful guide to the FOMC when it sets monetary policy;⁴³ (2) helping set reliable parameters for people and businesses involved in the financial industry;⁴⁴ and (3) allowing the Fed proactively send signals to the global public.⁴⁵ On the other hand, the Taylor Rule’s simple approach to interest rate adjustments presents various constraints, such as (1) choosing a single measure of inflation from a variety of potential indices;⁴⁶ (2) formulating interest rates based on extrapolated data;⁴⁷ (3) using a few select variables when more variables may be required to significantly influence policy;⁴⁸ and (4) failing to adequately account for risk-reduction goals.⁴⁹

D. Details of the Proposed Legislation Endorsing the Taylor Rule

The Federal Reserve Accountability and Transparency Act of 2014⁵⁰ was approved by the House Committee on Financial Services in July 2014.⁵¹ This bill not only mandates the Federal Reserve to conduct a cost-benefit analysis when it adopts new rules, it requires the Federal Reserve to explain any deviation from the Taylor Rule.⁵² Technically,

⁴¹ See Miller, *supra* note 1.

⁴² *Id.*

⁴³ See Donald L. Kohn, *It’s Not So Simple*, in THE TAYLOR RULE AND THE TRANSFORMATION OF MONETARY POLICY, *supra* note 28, at 173, 175.

⁴⁴ *Id.* at 176.

⁴⁵ *Id.*

⁴⁶ *Id.* at 176–77 (conveying inconsistent measures when the formula measured inflation by the “GDP price deflator . . . price index for personal consumption expenditures . . . [or] consumer price index.”).

⁴⁷ *Id.* at 177.

⁴⁸ *Id.*

⁴⁹ *Id.* at 177–78.

⁵⁰ Federal Reserve Accountability and Transparency Act of 2014, H.R. 5018, 113th Cong. (2014).

⁵¹ Press Release, H. Comm. on Fin. Servs., *supra* note 4.

⁵² H.R. 5018, § 2(c)(6) (requiring not only an official statement if the Fed’s policy rule has changed and a “detailed justification” for such change, but also a description of how the rule may be changed in the future).

the FOMC could deviate from the Taylor Rule, but the GAO—a congressional agency—would assess any such deviations.⁵³

The Directive Policy Rule (“DPR”) refers to any rule promulgated by the FOMC that satisfies certain specified requirements.⁵⁴ Such requirements include “identify[ing] the Policy Instrument the [DPR] is designed to target . . . [providing] the coefficients of the [DPR] that generate the current policy instrument target . . . [and using] a calculation that describes with mathematical precision the expected annual inflation over a 5-year period.”⁵⁵ Though the bill does not explicitly mention the Taylor Rule as the prescribed DPR, the aforementioned requirements and the bill sponsor’s own commentary all but require it.⁵⁶

The bill’s Republican sponsors—notably Michigan’s Bill Huizenga and New Jersey’s Scott Garrett—tout the bill as bringing “openness” to the Federal Reserve.⁵⁷ Huizenga additionally stresses the legislation’s benefit in bringing “predictability to how monetary policy is conducted in the United States.”⁵⁸ The House Committee on Financial Services approved House Bill 5018 along partisan lines, with staunch Republican backing.⁵⁹ The bill would not only require more congressional oversight, but would mandate the Federal Reserve Chair “to testify before Congress quarterly, instead of twice a year as the law now specifies.”⁶⁰ Additionally, the bill requires the Federal Reserve to

⁵³ *Id.* § 2(d) (setting out the process by which the GAO would inspect any changes as follows: “The Comptroller General of the United States shall compare the Directive Policy Rule submitted under subsection (b) with the rule that was most recently submitted to determine whether the Directive Policy Rule has materially changed. If the Directive Policy Rule has materially changed, the Comptroller General shall, not later than 7 days after each meeting of the Federal Open Market Committee, conduct an audit of the Rule and submit a report to the appropriate congressional committees specifying whether the Rule submitted after that meeting and the Federal Open Market Committee are in compliance with this section.”); Miller, *supra* note 1.

⁵⁴ H.R. 5018 § 2(c).

⁵⁵ *Id.*

⁵⁶ Bill Huizenga, Section by Section Breakdown H.R. 5018, http://huizenga.house.gov/uploadedfiles/section_by_section_5018.pdf, archived at <http://perma.cc/SJ6Z-LBAN>.

⁵⁷ See Press Release, H. Comm. on Fin. Servs., *supra* note 4.

⁵⁸ *Id.*

⁵⁹ See Miller, *supra* note 1.

⁶⁰ *Id.*; H.R. 5018 § 5(a)(1).

disclose the salaries of highly paid employees and makes them conform to the same ethical requirements as other federal financial regulators.⁶¹

E. Should the Taylor Rule Become Law?

Implementation of the Taylor Rule may be an unwise restriction on monetary policy.⁶² Our nation's complex economic history shows that outside disturbances may call for unforeseen Federal Reserve action.⁶³ While allowing the Federal Reserve to employ a flexible monetary policy approach is prudent, regulators and economists have nevertheless accepted the Taylor Rule's use as an economic guideline rather than a strict mandate.⁶⁴ Although Janet Yellen has opposed efforts to make Federal Reserve monetary policy adhere to the Taylor Rule,⁶⁵ she has nevertheless promoted the rule as a "check" on the Federal Reserve's policy judgments, in order to "prevent[] the FOMC from overreacting to shocks."⁶⁶ Other influential economists have lavished similar praise upon the Taylor Rule, including ex-Fed Chair Alan Greenspan.⁶⁷

Although critics have decried the Federal Reserve's opacity,⁶⁸ the Federal Reserve is already audited to a great extent—it is accountable through GAO reviews, audits of its own financials, congressional hearings and examinations.⁶⁹ With respect to setting monetary policy, however, allowing the Federal Reserve to operate as a largely independent governing body is critical to achieving its various economic goals, including its statutorily mandated employment and inflation objectives.⁷⁰ Finally, enacting House Bill 5018, which

⁶¹ H.R. 5018 § 8(u)–(v).

⁶² See FED. RES. SYS. LOW INTEREST RATES, *supra* note 14.

⁶³ *Id.*

⁶⁴ See Janet Yellen, *The View from Inside the Fed*, in THE TAYLOR RULE AND THE TRANSFORMATION OF MONETARY POLICY, *supra* note 28, at 281, 284.

⁶⁵ See Miller, *supra* note 1.

⁶⁶ Yellen, *supra* note 64.

⁶⁷ Miller, *supra* note 1 (reiterating Greenspan's sentiments that the Fed's policy should generally "track" with the results dictated by the Taylor Rule, as the Fed's monetary policy showed between 1987 and 1993).

⁶⁸ See Press Release, H. Comm. on Fin. Servs., *supra* note 4.

⁶⁹ FED. RES. SYS., *Does the Federal Reserve Ever Get Audited?* FED. RES. SYS., http://www.federalreserve.gov/faqs/about_12784.htm (last updated Feb. 3, 2014), archived at <http://perma.cc/4AR3-L6BV>.

⁷⁰ 12 U.S.C. § 225a (2012).

mandates the implementation of the Taylor Rule, has the potential of politicizing an independent organization.⁷¹

F. Conclusion

The Taylor Rule certainly has its merits, particularly for improving the clarity of FOMC decisions and helping increase the reliability of financial industry forecasts.⁷² Although the Taylor Rule's formulas can certainly help guide monetary policymakers, the Federal Reserve should nonetheless retain its ability to operate flexibly to achieve its employment and inflation goals.⁷³ Ultimately, directing the Federal Reserve to automatically employ the Taylor Rule in response to macroeconomic changes may result in politicization of the Federal Reserve's decision-making authority.⁷⁴ In addition, the Taylor Rule may unfortunately constrain our central bank's effectiveness in dealing with unexpected economic events.⁷⁵ Thus, the FOMC should use the Taylor Rule as an important persuasive guideline for setting interest rates, rather than as a required mandate.⁷⁶

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⁷¹ See SMALE, *supra* note 11, at 1 (discussing the organization of the Fed as an independent agency).

⁷² Kohn, *supra* note 43, at 173–76.

⁷³ See Kahn, *supra* note 30, at 64.

⁷⁴ Miller, *supra* note 1.

⁷⁵ See *supra* notes 33–42 and accompanying text (discussing financial disruptions which called for deviations from the Taylor Rule).

⁷⁶ See Yellen, *supra* note 64.

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