A Case For A Monetary Rule: It's Time To End The Fed's Discretion

By James Dorn
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The Federal Reserve has long been the world's most powerful central bank and has become even more so since the 2008 financial crisis. The Fed chairman not only has wide discretion over the course of monetary policy but also over financial regulation. With a Congress that has abandoned its constitutional duty to safeguard the value of money, the Fed chairman is more powerful than the President.

In an uncertain world, rules are necessary to limit power and bring about order. The institutional and property rights structure comprise the rules of the game. To be effective, rules must be enforced and widely accepted. This is as true for rules of the road and sports as it is for monetary rules.

The classical gold standard was successful because the rules were generally accepted and the convertibility principle was enforced. Trust in contracts with the promise of redeeming currency and deposits for specie meant that people had confidence in the long-run value of money. There was no need for fancy macro models or for a data-dependent monetary policy. Sound money, free trade, and the absence of capital controls helped produce a harmonious international monetary order.

Today we live in a pure fiat money world. The Fed has a dual mandate to promote price stability and full employment, but there is no monetary rule. Monetary policy depends on forecasting the real economy—and the Fed's forecasting record is dismal. Not one of the Fed's large staff of top university PhD economists forecast the Great Recession. The Fed chairman did not predict the subprime crisis or the Great Recession, and the Fed's army of sophisticated models didn't predict it either.

Actual data is always backward looking, no one knows the future. Yet, Fed Chairwoman Janet Yellen and her Federal Open Market Committee base their decisions about the course of monetary policy—that is, their stance on the benchmark federal funds rate—on guesses about the path of the economy.

Interest rate projections from different Fed officials range from 0.375 percent to 4 percent for year-end 2016, indicating a wide variation in expectations about inflation and the real economy. Of the 17 officials who submitted forecasts at the recent FOMC meeting, most predicted short-term rates to edge up by mid-2015, with a median estimate of 1.125 percent by the end of 2015. The median estimate for 2017 was 3.625 percent. Such spuriously precise predictions—using three digits to the right of the decimal point—impart a sense that Fed officials have superior information. Yet, in reality, their diversity of views indicates that they have no real idea of the true state of the economy or what interest rates should be: “the emperor has no clothes.”

Charles Plosser, president of the Federal Reserve Bank of Philadelphia, has been critical of prolonging near-zero rates and using the term “for a considerable period” in the FOMC’s statement. He has pointed to the limits of monetary policy and is sympathetic to guiding policy by a rule rather than pure discretion (e.g., see his article in the spring/summer 2014 Cato Journal).

The Fed could implicitly adopt a monetary rule without any action from Congress but is unlikely to bind itself. Thus, Congress needs to reconsider the benefits and costs of activist monetary policy as opposed to a non-activist monetary rule. Indeed, it is the constitutional duty of Congress to “regulate the value” of money—that is, to safeguard the purchasing power of the dollar. When Congress created the Federal Reserve it did not give up its responsibility for sound money to a discretionary central bank. The United States was still tied to the gold standard, but that has long since disappeared and given way to a pure discretionary fiat money system.

The Fed will have to map out its exit strategy and begin raising rates in 2015. The longer the FOMC waits to normalize rates, the more costly the final adjustments will be, and the higher the risk of inflation and another financial crisis.

Given the Fed’s poor history, now is the appropriate time to have a national debate on the issue of rules versus discretion in the conduct of monetary policy, to consider the limits of monetary policy, and to explore alternatives to the current regime. That is why it is essential to reintroduce the “Federal Reserve Accountability and Transparency Act” (H.R. 5018) in the new Congress and for Jeb Hensarling (R-TX), chairman of the House Financial Services Committee, to continue his “Federal Reserve Centennial Oversight Project.”

With Rep. Bill Huizenga (R-MI) heading the Financial Services Subcommittee on Monetary Policy and Trade in January, there is an opportunity to have a meaningful discussion on the role of the Fed, its powers as delegated by Congress, and the case for a rules-based approach to monetary policy.

Currently all the leading central banks are more concerned about the risk of inflation being too low rather than too high. The Fed has led the way for other major central banks to adopt quantitative easing and to put their balance sheets on steroids. But that experiment is likely to end in tears. Pumping up the supply of high-powered or base money while suppressing real interest rates and misallocating credit is a recipe for failure not long-run economic growth.

Central bankers apparently still believe in a tradeoff between inflation and unemployment, even though the stagflation of the 1970s should have dispelled that notion. They seem to think that as an economy approaches “full employment,” inflationary pressures will rise—and since there is still slack in the labor market, there is little risk of inflation. The problem with that presumption is that inflation is a monetary phenomenon, with excess money growth as the fundamental cause of a sustained rise in the general level of money prices.

The Fed and other central banks cannot determine equilibrium levels of employment, real interest rates, or output; but they can create chaos—and are creating chaos—via erratic monetary policy.

The substitution of monetary rules for pure discretion would lend greater certainty to the future path of nominal variables and anchor the purchasing power of the dollar. Markets would operate more smoothly under a rules-based regime, and the allocation of capital would be more efficient. Real interest rates would be positive and savers would be rewarded for postponing current consumption to increase future consumption through productive private investment. Government borrowing would be more prudent under a regime of market-based interest rates that were not suppressed by a politicized central bank.

The Federal Reserve’s job is not to encourage risk by engaging in financial repression (i.e., negative real interest rates) or to incentivize big government by holding rates near zero “for a considerable time.” Markets should be free to set rates and to make individuals responsible for their choices. The Fed’s job is not to support financial asset prices but to provide a framework for stable-valued money and let private markets allocate credit.

A stable government by law means a limited government that protects persons and property, including the property right citizens have in sound money. It is time for Congress to step up to the plate and reclaim its constitutional mandate to safeguard the value of money rather than delegating that responsibility to a non-elected government central bank board and bureaucrats, no matter how smart they think they are.

In doing so, Congress should heed the words of James Madison, the chief architect of the Constitution: “The only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie. . . . I am sensible that a value equal to that of specie may be given to paper or any other medium, by making a limited amount necessary for necessary purposes; but what is to ensure the inflexible adherence of the Legislative Ensurers to their own principles & purposes?”

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