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Fed Needs Rule To Avert Financial Instability

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There is a strong case for a rule-based monetary policy in a world of pure fiat money where the U.S. dollar and other major currencies are not convertible into specie (i.e., gold or silver). The Federal Reserve is supposed to maintain the value of the dollar and maximize employment, but has failed to do so on many occasions since it was founded in 1913.

Indeed, the purchasing power of the dollar has fallen by 95% since the founding of the Fed and there have been persistent lapses from full employment during periods of monetary instability. Such a lapse was the Great Depression, when the Fed allowed the money supply to decline by nearly 30 percent in the early 1930s. The 2008 financial crisis is merely the latest Fed failure.

Some experts will say that discretionary policy — in the form of ultralow interest rates, quantitative easing, credit allocation, and forward guidance — helped end the Great Recession and restored real economic growth. That is debatable, however, and in any case the Fed cannot *permanently* increase economic growth and employment. The only way to do that is through pro-market policies that reduce onerous regulations, cut marginal tax rates, and safeguard property rights.

The absence of a credible monetary rule makes Fed policy unpredictable — and that uncertainty undermines private investment, slows economic growth, and reduces future wealth.

Fed Chairwoman Janet Yellen has firmly opposed making the Fed "follow a simple mathematical rule that fails to take account of many things that are very important in making monetary policy."

But a rules-based monetary regime need not be tied to a "simple mathematical rule." The key is to have a rule that adheres to Article 1, Section 8 of the U.S. Constitution, giving Congress — and only Congress — the power "to coin Money (and) regulate the Value there of."

In a constitutional republic, the Fed cannot and should not be independent. It must be subject to the rule of law — and policymakers must be held responsible for monetary and financial stability. The best way to do that is by choosing among alternative monetary rules. Possible choices include a commodity standard, a demand rule such as nominal GDP targeting, or a quantity rule designed to control the growth of some monetary aggregate in line with real economic growth.

The Fed should not be allowed to manipulate interest rates, which are relative prices that affect asset prices and the allocation of resources. Those rates should be set by market forces (e.g., consumers' preferences for present and future consumption, and factors that affect the marginal productivity of capital). In a rules-based regime uncertainty would decrease, and investors would invest more and have greater confidence in their investment decisions.

The passage of the Financial CHOICE Act of 2017 by the House of Representatives is a signal that a growing number of legislators are concerned not only with the problem of "too big to fail" but also with the need to reign in the Fed by requiring audits and having the Fed comply with a monetary rule.

There is also support for a Centennial Monetary Commission to examine the Fed's performance and explore alternative monetary regimes that would deliver sound money and financial stability.

With the probable appointment of Randall Quarles (assistant secretary for international affairs at the U.S. Treasury in 2005) as vice chairman for supervision on the Fed's Board of Governors, there will be renewed interest in the case for monetary rules in preference to pure discretion. Mr. Quarles has argued that the Fed's low interest rate policy has increased speculation and inflated asset prices. He has stated his support for "a monetary policy rule, such as the Taylor rule, that would normalize interest rates and reduce the incentive for big banks and even smaller institutions to take dangerous risks."

The Fed's recent *Monetary Policy Report* reflects the thinking of many Fed officials on the adoption of a money rule: "The U.S. economy is highly complex, and these rules, by their very nature, do not capture that complexity."

In fact, it is the complexity of the economy that makes rules beneficial and more likely to bring about monetary and financial stability than pure Fed discretion. As Karl Brunner, a co-founder of the Shadow Open Market Committee, remarked in 1980, "A nonactivist (rules-based monetary) regime . . . does not assure us that economic fluctuations will be avoided. But it will assure us that monetary policymaking does not impose additional uncertainties."

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