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POLICY BRIEF

Enhancing FOMC Transparency: Making Implicit Monetary Policy Rules Explicit

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Building on the implications of modern macroeconomic models with forward-looking actors, Robert Lucas exposited the argument for a rules-based monetary policy. At the same time, he ended his argument with what appears to be a conundrum. The Federal Reserve System (Fed) ignores the advice of such models and conducts a discretionary monetary policy. This paper explains the conundrum as a disconnect between the actual behavior of the Federal Open Market Committee (FOMC), which imposes a consistency over time on its behavior, and its communication to the general public, which uses the language of discretion. If correct, the explanation only raises additional questions. How should the FOMC communicate the nature of its monetary policy—as rules-based or discretionary? Given the need for transparency and accountability, how should the FOMC communicate to the public?[1]

Lucas wrote:

> Our ability as economists to predict the responses of agents rests, in situations where expectations about the future matter, on our understanding of the stochastic [policy] environment agents believe themselves to be operating in. In practice, this limits the class of policies the consequences of which we can hope to assess in advance to policies generated by fixed, well understood, relatively permanent rules (or functions relating policy actions taken to the state of the economy). . . . Analysis of policy which utilizes economics in a scientific way necessarily involves choice among alternative stable, predictable policy rules, infrequently changed and then only after extensive professional and general discussion, minimizing (though, of course, never entirely eliminating) the role of discretionary economic management.[2]

Lucas also noted:

> I have been impressed with how noncontroversial it [the above argument for rules] seems to be at a general level and with how widely ignored it continues to be at what some view as a "practical" level.[3]

Section 1 of this paper reproduces Milton Friedman's classic argument that a discretionary monetary policy is a source of instability. At the same time, given the prevalence of inflation-targeting central banks, one must explain why his argument—that a price-level target would be destabilizing—is wrong. Section 2 reproduces quotations that illustrate the consensus among economists on a rules-based monetary policy. Section 3 challenges the FOMC to acknowledge that, in the past, it has followed different strategies (rules).[4] Learning about the design of a stabilizing monetary policy requires evaluating which strategies (rules) have stabilized the economy and which have destabilized it. Policymakers can—and should—then ask how the strategy (rule) has changed over time and which strategies (rules) have stabilized or destabilized the economy.

Section 4 illustrates how to organize communication to the public using the rules-based monetary policy developed in the Volcker–Greenspan era. Section 5 reviews the arguments that using the language of discretion in communication gives the FOMC chair flexibility to defend Fed independence. Section 6 challenges FOMC chairs to evaluate their implicit assumption that the language of discretion is the best way for them to defend Fed independence. The transparency produced by explicitness about the strategy (rule) followed by the FOMC would provide widespread public support for Fed independence when the Fed is confronted with political pressure. Section 7 summarizes and concludes.

1. Milton Friedman and Rules

Friedman wrote:

> The granting of wide and important responsibilities that are neither limited by clearly defined rules for guiding policy nor subject to test by external criteria of performance is a serious defect of our present monetary arrangements. It renders monetary policy a potential source of uncertainty and instability. It also gives greater power to the men in charge for good or ill, greater "flexibility" to meet problems as they arise, to use the phrase the Reserve System likes to emphasize. . . . Experience suggests that eliminating the danger of instability and uncertainty of policy is far more urgent than preserving "flexibility." The major need in reforming our present control of monetary policy is, therefore, to provide some definite guides to policy and more satisfactory criteria of performance.
>
> One way to do so that has frequently been urged is to adopt price level stability as simultaneously the specific goal for monetary policy, the immediate guide to policy, and the

> criterion of performance. . . . The key difficulty is that the link between price changes and monetary changes over short periods is too loose and too imperfectly known to make price level stability an objective and reasonably unambiguous guide to policy.[5]

2. Modern Macroeconomic Models Assume a Rules-Based Monetary Policy

Michael Woodford wrote:

> Because the key decision-makers in an economy are forward-looking, central banks affect the economy as much through their influence on *expectations* as through any direct, mechanical effects of central bank trading in the market for overnight cash. As a consequence, there is good reason for a central bank to commit itself to a systematic approach to policy, that not only provides an explicit framework for decision making within the bank, but that is also used to explain the bank's decisions to the public.
>
> The signals that have been given thus far through the post-meeting [FOMC] statements all attempt to say something about the likely path of the funds rate for the next several months. . . . They do not speak of the way in which future policy should be *contingent* on circumstances that are not already evident. If the statements are interpreted as *commitments* to particular non-state-contingent paths for the funds rate . . . then they are likely to constrain policy in ways that are not fully ideal. For while an optimal policy commitment will generally imply that policy should be *history-dependent* . . . , it will also generally imply the policy should be *state contingent* as well. (italics in original)[6]

Commentary from the Greenspan era reflects the importance of consistency in FOMC behavior to shape expectations constructively. As a governor in the Greenspan FOMC, Ben Bernanke said:

> The Fed controls very short-term interest rates quite effectively, but the long-term rates that really matter for the economy depend not on the current short-term rate but on the whole trajectory of future short-term rates expected by market participants. Thus, to affect long-term rates, the FOMC must somehow signal to the financial markets its plans for setting future short-term rates. . . . FOMC talk probably has the greatest influence on expectations of short-term rates a year or so into the future, as beyond that point the FOMC has very little, if any, advantage over market participants in forecasting the economy or even its own policy actions. . . . First, to the extent practical, the FOMC strives to be consistent in how it responds to particular configurations of economic conditions and transparent in explaining the reasons for its response. By building a consistent track record, the FOMC increases its own predictability as well as public confidence in its policies. Second, more generally, comments by FOMC officials about the Committee's general policy framework, including the Committee's economic objectives and members' views about the channels

> of monetary policy transmission and the structure of the economy, help the public deduce how policy is likely to respond to future economic circumstances.[7]

Stanley Fischer said:

> It has been increasingly acknowledged that monetary policy implementation relies importantly on the management of market expectation. . . . Clarity about the central bank's reaction function . . . helps meet the central bank's policy targets, with the result that the markets are working in alignment with the policymaker's goals. . . . Clear communication of the Federal Open Market Committee's (FOMC's) views on the economic outlook and the likely evolution of policy is essential in managing the market's expectations.[8]

The essence of Fischer's remark is that the FOMC should "avoid unintended surprises in the conduct of policy." He argues for consistency in and explicitness about monetary policy strategy.

In the spirit of the Lucas quotation previously mentioned, Fischer made the case for implementation of a policy based on rules when he talked about the Board of Governors' staff model, FRB/US. Fischer also said:

> [A]n increase in the federal funds rate affects expectations of future values of that rate, which in turn affect interest rates on longer-term bonds, equity prices, and the exchange value of the U.S. dollar. Households and firms are forward looking. . . . [They] set out a plan—a contingency plan—for consumption, savings, and employment for the future. . . . So the expectations of decisionmakers, be they households, firms, or investors, are at the center of how monetary policy works—both in the real world and in FRB/US.[9]

These quotations pose a conundrum. They make the point that a stabilizing monetary policy must be rules based. However, implicit in the FOMC chair's use of the language of discretion with no mention of a strategy (rule) is that the argument for a rule is wrong. The FOMC does better with the discretionary implementation of monetary policy. Specifically, period by period, the FOMC appraises the near-term behavior of the economy and then evaluates what priority to assign to either its maximum employment or stable prices goal. If maximum employment is the priority, the FOMC lowers the funds rate. If stable prices are the priority, the FOMC raises the funds rate.

The unstated assumption is that the FOMC has solved the simultaneity problem of disentangling the two-way causation between the behavior of the economy and the behavior of the FOMC. It understands the one-way causation going from its individual policy actions to the behavior of households and firms. The next section argues that, in actual practice, the FOMC finds ways to communicate to markets the strategy (rule) that provides consistency to monetary policy. The argument for discretion, then, is disingenuous.

3. Learning Requires Evaluating How Different Strategies (Rules) Performed in the Past

One defense by the FOMC for the use of discretion is that it needs to follow in real time any changes in the evolution of the economy. However, the FOMC has never offered a history of how that real-time learning worked in the past and how the FOMC then presumably stabilized the economy. The fact that FOMC chairs communicate in terms of discretion—that is, by avoiding the defense of the current policy action in terms of a strategy (rule)—in no way changes the reality that financial markets are forward looking. One indication that the FOMC communicates the underlying consistency in its policy to financial markets is the recent appearance of its Statement on Longer-Run Goals and Monetary Policy Strategy.

The first statement was released in 2012 in the context of concern about the consequences of and the message conveyed by quantitative easing (QE). The FOMC at the time wanted to confirm to markets that it remained committed to the Volcker–Greenspan policy of price stability. The FOMC remained committed to the policy of preemptive increases in the funds rate to prevent the emergence of inflation. It was no coincidence that in January 2012 the FOMC announced an inflation target.

In contrast, the statement released in August 2020 informed markets that the FOMC had abandoned the policy of preemptive increases in the funds rate. The policy, called flexible average inflation targeting, committed the FOMC to QE and a funds rate maintained at the zero lower bound until inflation rose for an undefined period of time above the 2 percent inflation target. The FOMC abandoned the earlier policy of monetary neutrality with its focus on maintaining price stability in favor of an activist policy of aggregate demand management with the two independent competing goals of low inflation and a socially desirable low rate of unemployment. Policy would remain strongly expansionary until the unemployment rate had declined at least to its prepandemic value of 3.5 percent.

The contrast in the language of the two statements reveals the change in the strategy (rule) of monetary policy. The Statement on Longer-Run Goals and Monetary Policy Strategy released January 25, 2012, included the language:

> The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. . . . The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment.[10]

The clear nominal/real distinction pointed to the continued influence of the Volcker–Greenspan policy with its preemptive increases in the funds rate marking the primacy of price stability.

The language of the 2020 statement is more convoluted, but the Board of Governors press release summarizing the new statement made clear to markets that the FOMC implicitly rejected the former policy of preemption:

- The FOMC emphasized that maximum employment is a broad-based and inclusive goal and reports that its policy decision will be informed by its "assessments of the *shortfalls* of employment from its maximum level." The original document referred to "*deviations* from its maximum level." (italics in original)
- On price stability, the FOMC adjusted its strategy for achieving its longer-run inflation goal of 2 percent by noting that it "seeks to achieve inflation that averages 2 percent over time." To this end, the revised statement declares that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."[11]

The first bullet point emphasizes that declines in the unemployment rate would not precipitate an increase in the funds rate. The second bullet point states that the FOMC would not raise the funds rate until after an increase in inflation for some unspecified period of time. Although unclear at the time, the new policy was asymmetric in that the FOMC would compensate for undershoots of inflation from 2 percent but not for overshoots. Moreover, there was no attempt to limit the overshoot to just the amount of inflation required to return to an extrapolated price-level target.

As explained in the remainder of this section, these dual contrasting statements of policy define the two basic choices made by the FOMC in the post-1951 Treasury–Fed Accord period. Modern macroeconomic models with their forward-looking agents imply that consistency in policy shapes the expectations of agents, and those expectations are what transmit monetary policy to the behavior of the public. This insight can give content to the basic monetary policy followed in the post-accord period, which former Fed chairman William McChesney Martin Jr. characterized as "leaning against the wind" (LAW). As LAW evolved by the early 1960s, it captured two elements of forward-looking expectations. With LAW, the FOMC raised the funds rate (earlier, short-term Treasury bill rates) in a measured, persistent way in response to evidence that the economy was growing unsustainably fast, with a converse characterization in the event of weakness. The objective of the policy was to stabilize the economy's rate of resource utilization.

With that objective, the price system maintains growth in real output in line with growth in potential output. In particular, sustained growth above potential indicates that the real rate of interest lies below the natural rate of interest and that the real rate of interest must rise. The natural rate of interest is the interest rate that distributes aggregate demand intertemporally so that contemporaneous aggregate demand equals potential output. Sustained growth above potential indicates that the real rate of interest is too low to offset the optimism about the future that makes households want to move consumption from the future to the present to smooth their consumption.[12]

As LAW had evolved in the early 1960s, a characteristic of it was the preemptive changes in the funds rate to maintain price stability. The FOMC raised the funds rate significantly at signs of stress in rates of resource utilization in general and overheating in labor markets in particular, and similarly lowered it significantly at signs of weakness. This strategy (rule) conditions the behavior of bond markets to move the term structure of the risk-free rate of interest embodied in the yield curve in response to incoming information in a continual way to maintain stability in the economy's rate of resource utilization. Financial markets assume that persistent changes in the funds rate will cumulate to whatever degree required to maintain stability in the rate of resource utilization and the price level. I term these procedures "LAW with credibility."[13]

Why does LAW with credibility explain how central banks can target price stability without running into Friedman's long-and-variable-lags critique? A credible rule that shapes expectations separates the behavior of relative prices from the determination of the price level by causing firms that set prices for multiple periods not to incorporate an inflation premium.[14] The FOMC then is free to implement policy in a way that causes the funds rate to track the natural rate of interest and turn the behavior of real variables (output and employment) over to the stabilizing properties of the price system. Contrary to the assumption made by Friedman, the FOMC is not following a feedback rule in which it moves money (or the funds rate) in response to deviations of the price level from a constant value. Friedman's critique, however, remains valid for evaluating activist aggregate demand policies that target some tradeoff between low unemployment and low inflation.

In the early 1960s, the Walter Heller Council of Economic Advisors challenged the Martin strategy (rule) of LAW with credibility with its preemptive interest rate increase by setting a 4 percent rate of unemployment as a national goal for full employment. Paul Samuelson and Robert Solow provided empirical estimates for the United States using the newly invented Phillips curve, purportedly showing that a 4 percent unemployment rate would generate only moderate inflation, which could be offset by wage and price guidelines.[15] The political pressure on the FOMC, especially after President Johnson pushed through the Kennedy tax cut in early 1964, was for the FOMC to abandon preemptive increases in the funds rate until the unemployment rate fell to 4 percent. Although Martin remained committed to price stability, he temporized in raising the funds rate despite unsustainable growth in output and money in an attempt to influence budget negotiations. Martin hoped to persuade Congress to balance the budget by offering the prospect of avoiding the need for a sharp increase in interest rates.[16] The FOMC stumbled into the go/stop monetary policy that dominated in the 1970s. LAW with tradeoffs and its cyclical inertia in funds rate changes replaced LAW with credibility with its preemptive changes. The discipline imposed on monetary policy in the Volcker–Greenspan era (intended to restore the stable nominal anchor in the form of the expectation of price stability lost in the 1970s) reinstated Martin's LAW with credibility and its preemptive funds rate changes.[17]

Reliance on a rule that makes use of the stabilizing properties of the price system implicitly assumes that the working of the price system imposes a discipline on monetary policy that makes possible a rule. The language of discretion, which is justified by the presumed need to continually follow changes in the structure of the economy, implicitly rejects the ability of the price system to stabilize the economy in the absence of monetary disturbances. In the spirit of rules, George Stigler wrote:

> The elements of an economic system which economists believe to be basic have been present for a long time. The nature of economic systems has changed relatively little since [Adam] Smith's time. . . . A discipline which was in intimate and continuous dependence upon the current output of events . . . would simply not be a discipline; it would be a temporary collection of subjects. It could have no specialists—who would be pathetically obsolete in a few years—nor any accumulated theoretical corpus, for its theory would change with each new liaison or external development. It would not be a science.[18]

4. Communicating a Rules-Based Monetary Policy to the Public

This section illustrates how the FOMC could communicate a rules-based monetary policy to the public.[19] The illustration assumes that, in its next Statement on Longer-Run Goals and Monetary Policy Strategy, the FOMC rejects the strategy (rules) implicit in its 2020 formulation in favor of its 2012 formulation. In the terminology used here, the FOMC rejects LAW with tradeoffs in favor of LAW with credibility—that is, the earlier strategy (rule) that characterized the Volcker–Greenspan era. The first step would be to make explicit the nature of the rule by giving it numerical content. The difference Taylor rule shown in formula (1) expresses the nature of the rule (strategy) developed in that era:[20]

$$i_t = i_{t-1} + 0.5(\pi_{t+3|t} - \pi^*) + 0.5(\Delta^4 y_{t+3|t} - \Delta^4 y^*_{t+3|t}) \quad (1)$$

where i_t is the funds rate for quarter t, $\pi_{t+3|t}$ is forecasted inflation three quarters ahead, π^* is the inflation target, and $(\Delta^4 y_{t+3|t} - \Delta^4 y^*_{t+3|t})$ is the forecasted (three quarters ahead) annual average GDP growth relative to potential.[21]

A check on whether the FOMC is implementing formula (1) in a way that consistently provides for price stability is to examine its forecasts in the Summary of Economic Projections (SEP). Price stability requires that the FOMC consistently align the rate of growth of nominal output with the rate of growth of potential output. Orphanides provided empirical support for that condition by fitting a difference rule over the period starting in the early 1990s, when the FOMC basically maintained price stability.[22] His rule, which he termed "the natural growth rule," makes explicit the discipline imposed by maintenance of price stability. Empirically, during this period of price stability, the FOMC did align the growth of nominal output with the growth of potential output.

Orphanides explained: "In real time, the natural growth rule employs short-term forecasts to check whether nominal income grows in line with the economy's natural growth rate." Orphanides defined the "natural growth rate" to equal growth in potential output plus 2 percent, the FOMC's inflation target. Orphanides described the rule:

> According to this rule, the change of the federal funds rate from the previous quarter can be guided by the difference between the projected growth of nominal income, n, and the natural growth rate, $n*$, defined as the sum of the Fed's inflation goal, $\pi*$, and the growth rate of real potential GDP, $g*$. The rule takes the difference form:
>
> $$\Delta i = \theta(n - n*)$$
>
> where Δi is the rule's prescription for the quarterly change of the funds rate from the previous quarter, and θ is a parameter governing how responsive policy should be to the projected imbalance.[23]

(Orphanides used the real-time forecasts from the Survey of Professional Forecasters published by the Federal Reserve Bank of Philadelphia.)

To provide for easy verification, the FOMC should formulate a consensus SEP that provides the forecasts used in the variables on the right-hand side of the reaction function shown in formula (1).[24] Note that there is nothing "mechanical" about the rule in that the forecasts require judgment. In FOMC debate, participants would explain how their forecasts differ from those of the Board staff's Tealbook and the funds rate that the Board staff provides based on formula (1).[25] The role of the FOMC chair would be to guide FOMC debate in a way that provides the consensus SEP forecast yielding the funds rate, i_t, expressed in formula (1).

A consensus SEP would differ from the current SEP provided quarterly by FOMC participants. As Fischer explained about the current SEP:

> [SEP] projections are based on *each individual's* assessment of appropriate monetary policy. Each FOMC participant writes down what he or she regards as the appropriate path for policy. *They do not write down what they expect the Committee to do*. . . . "Appropriate monetary policy" is Fedspeak for a policy that delivers on the Committee's interpretation of its legislated mandate. The fact that FOMC participants' forecasts are conditional on each participant's conception of the appropriate monetary policy . . . means that their forecasts will tend to converge over time to the Committee's 2 percent inflation objective and to each individual's interpretation of maximum employment. (italics in original)[26]

As Fischer noted, the current SEP records the forecasts of individual FOMC participants on a number of macroeconomic variables based on an assumption of "appropriate monetary policy." Unfortunately, the term "appropriate monetary policy" is without content. All participants simply

choose a funds rate path that makes their individual forecasts converge to the FOMC's inflation target and puts unemployment at their assumed full-employment level. Which model and strategy (rule), if any, that conditions those forecasts are not reported.

There is no way to separate the forecasts made by individual FOMC participants, much less evaluate them for internal coherence. The individual forecasts are jumbled together as separate forecasts of real GDP, prices, the unemployment rate, and the funds rate. There is no identifiable, common set of conditioning variables (such as behavior of the exchange rate or the stock market). There is no way to associate a participant's funds rate path with that participant's forecast of the economy. Fed watchers cut through the disconnected mass of information presented in the SEP by looking at median values under the assumption that the values portray the consensus views of the FOMC achieved by the chair.

If adopted, the rule expressed in formula (1) would make monetary policy transparent. Accountability for the consistent pursuit of price stability would come from the consensus SEP presented by the FOMC chair at the post-FOMC meeting press conference. If the FOMC is faithfully following the rule, its consensus SEP forecast would show that the forecasted rate of growth of nominal output aligns with the forecasted rate of growth of potential output. There would be accountability in that the FOMC chair would need to defend forecasts that differed from market consensus forecasts.

5. Political Economy Arguments for Discretion

At present, the language of discretion the FOMC chair uses characterizes policy in terms of individual policy actions, each one of which is made independently in the context of the contemporaneous state of the economy. Phrased alternatively, the FOMC communicates in terms of forward guidance but not a reaction function. Given forward-looking markets, however, modern macroeconomic models require a consistency in policy imposed over time to ensure a stable nominal anchor while allowing the price system maximum latitude to stabilize the economy. The language of discretion obscures that consistency.

Is obscurity about the strategy (rule) that underlies the required consistency of monetary policy a price that has to be paid for the Fed to maintain its independence? An argument against making explicit the strategy (rule) is that the language of discretion gives the FOMC chair more latitude to defend Fed independence. One explanation for the use of the language of discretion by FOMC chairs is that they believe the required discipline imposed on the format of discussion for FOMC meetings would limit their ability to control the choice of individual policy actions. They do not want a strategy (rule) "looking over their shoulders."

FOMC chairs may also be concerned that they would lose the flexibility to control the timing of funds rate changes and their verbal packaging in a way designed to counter populist attacks on

increases in the funds rate. For example, the FOMC imposes unidirectionality on changes in the funds rate over long periods. A reason is that Fed critics would seize on a short-term reversal in the funds rate as a mistake. An explicit rule would prompt more short-term reversals. Although they would average out over time, leaving the stance of monetary policy unchanged, critics would still pounce. More fundamentally, in the event of a recession, the chair now can package funds rate reductions as mitigating the recession. An explicit rule would make the defense more complicated by highlighting whether the rate reductions that occurred were timely.

To defend Fed independence, FOMC chairs also like to portray monetary policy decisions as reflecting widespread consensus limited to a small number of dissents just sufficient to indicate a healthy diversity of opinion. The reason is that politicians do not understand the arcana of monetary economics and monetary policy. However, they do understand a catfight. Critics of the Fed could exploit any division within the FOMC for their own political purposes. To achieve this public posture of internal consensus, the chair restricts FOMC decision-making to individual policy actions, thereby avoiding the divisive issues within monetary economics about which macroeconomic variables the central bank can control and how it exercises that control.

6. Why a Strategy (Rule) Would Help Preserve Fed Independence

There are counterarguments in favor of making explicit the FOMC's strategy (rule) as a way to preserve its independence. One argument for a rule, which is simple and widely understood, is that it would insulate the Fed from the temptation of a president to use political appointees to promote "easy" money and "low" interest rates. Abandonment of the rule would flag political interference, causing an adverse reaction in financial markets. Also, learning requires knowledge of how the strategy (rule) has changed over time. Only with that knowledge can one ask whether a particular policy is stabilizing or destabilizing. FOMC debate would then deepen because potential candidates for members of the Board of Governors and presidents of regional Fed banks would need to be well versed in which strategies (rules) worked well and which did not.

Explicitness about the strategy (rule) would also more effectively allow the Fed to counter pressures to offset the adverse consequences of harmful fiscal policies through undesirable expansionary and ultimately inflationary monetary policy. For example, at present, both presidential candidates have advocated aggressive use of tariffs to rally political support. Neither expresses concern for a balanced budget. The resulting potential harm to the economy and stability in financial markets could in the future create political pressure on monetary policy to abandon its price stability goal.[27] With the United States leading the world into protectionism and abandoning the support for free trade that it showed in the post–World War II period, a trade war could arise that would throw the world into recession. Further, if Congress and the administration wait for a crisis before addressing the unstainable increase in debt now built into the federal budget, Treasury yields could rise dramatically, disrupt financial markets, and set off a banking crisis.

A recession caused by a trade war would share characteristics with the 2020 COVID-19 recession. Both would exhibit a reduction in potential output. Both would exhibit a rise in prices due to supply disruptions and an increase in unemployment. Would the FOMC then respond as it did during the COVID-19 recession with a highly expansionary monetary policy, which would interact with the supply disruptions to raise inflation?—that is, would it continue with a policy based on the 2020 Statement on Longer-Run Goals and Monetary Policy Strategy? Alternatively, would it concentrate on keeping underlying inflation low and stable while allowing the price system to reallocate resources away from exports and toward domestic production? In other words, would it follow a policy based on the 2012 Statement on Longer-Run Goals and Monetary Policy Strategy? The FOMC should make its policy explicit in advance so that markets will be able to forecast the behavior of inflation.

7. Concluding Comment

FOMC chairs use the language of discretion in their communication with Congress and the public. That language ignores the standard arguments for a rules-based monetary policy. First, financial markets are forward looking. The behavior of the yield curve depends not only on how the FOMC responds to new information on the economy as it arrives but also on how markets believe it will take account of that new information in its future actions. In actual practice and despite the language of discretion, the FOMC does impose an underlying consistency on policy and finds ways to communicate that consistency to markets. The transparency required for accountability, however, requires articulation of this strategy (rule) to the general public and to Congress.

Second, the Constitution assigns responsibility for monetary policy to Congress. Congress has delegated that responsibility to the Fed. It has done so with a mandate that amounts to no more than the instruction to do "all good things." At the same time, the language of discretion used by the Fed to communicate monetary policy makes understanding monetary policy so complex that, realistically, members of Congress and their staffs cannot critically monitor it. Without such monitoring, the risk is that the Fed becomes like a fourth branch of government not subject to the checks and balances of the other branches. Again, clear communication of the underlying strategy (rule) that organizes the period-by-period policy actions of the FOMC would allow Congress to fulfill its responsibility to monitor policy.

A rules-based monetary policy that provides for a stable nominal anchor and allows the stabilizing properties of the price system to work and that is communicated to the public would not only make the Fed part of the constitutional framework in a way that ensures its long-run independence but would also guarantee a stabilizing monetary policy.

About the Author

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Notes

1. For a discussion of the need for the accountability of monetary policy, see Andrew T. Levin and Christina Parajon Skinner, "Central Bank Undersight: Assessing the Fed's Accountability to Congress" (Economics Working Paper 23120, Hoover Institution, February 8, 2024).
2. Robert E. Lucas Jr., "Rules, Discretion, and the Role of the Economic Advisor," in *Studies in Business-Cycle Theory*, ed. Robert E. Lucas Jr. (Cambridge, MA: MIT Press, 1981), 255.
3. Lucas, "Rules, Discretion," 255.
4. In the past, at times, FOMC participants have identified a rule with a formula that would not allow them to respond to the variety in the new information that arrives on the economy. A rule would be "mechanical." For that reason, this paper uses the expression "strategy (rule)" to refer to the underlying consistency in monetary policy.
5. Milton Friedman, *A Program for Monetary Stability* (New York: Fordham University Press, 1960), 86–87. Taylor in "Discretion versus Policy Rules" has taken up the baton from Friedman as the foremost proponent of a rules-based monetary policy. See John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy* 39 (December 1993): 195–214.
6. Michael Woodford, "Central Bank Communication" (NBER Working Paper No. 11898, National Bureau of Economic Research, Cambridge, MA, 2005), 401, 436–37.
7. Ben S. Bernanke, "Implementing Monetary Policy," Remarks at the Redefining Investment Strategy Education Symposium. Dayton, Ohio, March 30, 2005, 5.
8. Stanley Fischer, "Monetary Policy Expectations and Surprises," Speech at the Columbia University School of International and Public Affairs, New York, NY, April 17, 2017, 1.
9. Stanley Fischer, "I'd Rather Have Bob Solow Than an Econometric Model, but . . . ," Remarks at the Warwick Economics Summit, Coventry, England, February 11, 2017, 6–7.
10. Board of Governors of the Federal Reserve System, "Statement on Longer-Run Goals and Monetary Policy Strategy," Federal Open Market Committee Meeting, January 24–25, 2012.
11. Board of Governors of the Federal Reserve System, "Federal Open Market Committee Announces Approval of Updates to Its Statement on Longer-Run Goals and Monetary Policy Strategy," press release, August 27, 2020.
12. Marvin S. Goodfriend, "Monetary Policy in the New Neoclassical Synthesis: A Primer," *Federal Reserve Bank of Richmond Economic Quarterly* 90 (Summer 2004): 3–20.
13. Robert L. Hetzel, *The Monetary Policy of the Federal Reserve: A History* (Cambridge, MA: Cambridge University Press, 2008); Robert L. Hetzel, *The Great Recession: Market Failure or Policy Failure?* (Cambridge, MA: Cambridge University Press, 2012); Robert L. Hetzel, *The Federal Reserve System: A New History* (Chicago, IL: University of Chicago Press, 2022).

14. Kosuke Aoki, "Optimal Monetary Policy Responses to Relative-Price Changes," *Journal of Monetary Economics* 48, no. 1 (2001): 55–80.

15. Paul A. Samuelson and Robert Solow, "Analytical Aspects of Anti-Inflation Policy," *American Economic Review* 50, no. 2 (1960): 177–94.

16. Hetzel, *The Monetary Policy of the Federal Reserve*, chapter 7.

17. Hetzel, *The Monetary Policy of the Federal Reserve*, *The Great Recession*, and *The Federal Reserve System*.

18. George J. Stigler, "The Influence of Events and Policies on Economic Theory," in *Essays in the History of Economics*, ed. George J. Stigler (Chicago, IL: University of Chicago Press, 1965), 16–30.

19. This material draws on Robert L. Hetzel, "Rules vs. Discretion Revisited: A Proposal to Make the Strategy of Monetary Policy Transparent" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, June 25, 2019) and "What Is Monetary Policy?" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, forthcoming).

20. Board of Governors of the Federal Reserve System, *Report to the FOMC on Economic Conditions and Monetary Policy* (Tealbook, Book B, "Monetary Policy: Strategy and Alternatives," August 4, 2011), 43.

21. For a discussion of the rule, see Athanasios Orphanides, "Historical Monetary Policy Analysis and the Taylor Rule," *Journal of Monetary Economics* 50 (July 2003): 983–1022.

22. Athanasios Orphanides, "Enhancing Resilience with Natural Growth Targeting" (IMFS Working Paper Series No. 200, Institute for Monetary and Financial Stability, Frankfurt, Germany, 2024). The rule flags restrictive monetary policy in the 2008–2009 Great Recession, when the FOMC imparted inertia to changes in the funds rate while the economy weakened after April 2008. It also flags expansionary monetary policy during the inflation of 2001 and 2002.

23. Orphanides, "Enhancing Resilience," 7, 9.

24. Robert L. Hetzel, "A Proposal to Clarify the Objectives and Strategy of Monetary Policy," *Journal of Macroeconomics* 54, Part A (December 2017): 72–89.

25. The formal name for the Tealbook is *Report to the FOMC on Economic Conditions and Monetary Policy, Book A: Economic and Financial Conditions: Outlook, Risks, and Policy Strategies*.

26. Fischer, "I'd Rather Have Bob Solow," 2.

27. The current bipartisan political support for protectionism shows in the way that President Biden followed the lead of former President Trump in this respect. Lea Skene wrote:

> As president, Donald Trump imposed a 25% tariff on foreign steel. . . . Biden largely preserved Trump's tariffs—on steel, aluminum and a mass of goods from China. . . . The two candidates have ditched a U.S. commitment to relatively frictionless trade . . . that was a bedrock of American policy for decades after World War II. . . . Trump has vowed more of the same in a second term. He's threatening to impose a 10% tariff on all imports—and a 60% tax on Chinese goods. . . . A report . . . from Kimberly Clausing and Mary Lovely of the Peterson Institute for International Economics estimates that for families in the middle of the U.S. income distribution, Trump's tariff proposals would amount to a tax of at least $1,700 a year. ("Trump or Biden? Either way, US Seems Poised to Preserve Heavy Tariffs on Imports," Associated Press, May 21, 2024)

Pinelopi Koujianou Goldberg wrote:

> President Joe Biden's administration has just announced 100% tariffs on electric vehicles (EVs) manufactured in China, prompting Donald Trump to promise a 200% tariff on Chinese cars made in Mexico if he is elected in November. . . . Apart from the direct consequences for GHG [greenhouse gas] emissions, tariffs on EVs also expose the hypocrisy of some climate-change advocates, further undermining the cause. . . . It will be much harder to pressure less affluent countries, such as India, to adopt green policies that may be costly in the short run. If the US and Europe are not willing to put the environment ahead of their short-term economic interests, why should anyone else? ("The High Costs of the New US Tariffs on Chinese EVs," Project Syndicate, May 30, 2024)

On the fiscal deficit, Romina Boccia and Dominik Lett wrote:

> Here are key highlights from CBO's [Congressional Budget Office's] 30-year forecast report. As a percentage of the country's yearly economic output, federal public debt (the debt borrowed from credit markets) is currently 99 percent of GDP—about $103,000 for every person in America. In just four years (2028), public debt is projected to surpass its all-time World War II high of 106 percent. By 2034 (ten years from now), public debt will reach 116 percent of GDP. By 2054 (30 years from now), public debt is projected to reach 166 percent of GDP. Such high debt levels have never before been recorded in U.S. history. Between 2024 and 2054, interest costs are projected to grow from 3.1 percent to 6.3 percent of GDP. ("CBO Warns of Fiscal Crisis in Long-Term Budget Outlook," Debt Dispatch, May 21, 2024, debtdispatch@substack.com)

One example shows the lack of restraint with respect to budget deficits. Nat Malkus wrote that the American Enterprise Institute's tracking of the debt forgiven under the Trump and Biden administrations' student loan forgiveness program has amounted to $405 billion. That amount adds directly to the deficit. ("Biden's Unending Student Loan Forgiveness Run," American Enterprise Institute, Washington, DC, May 30, 2024).