THE CENTER FOR POPULAR DEMOCRACY

THE NATIONAL CAMPAIGN FOR A STRONG ECONOMY FED UP

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Dear Representative,

On behalf of the Center for Popular Democracy's Fed Up coalition, we are writing to express concerns about the Financial CHOICE Act, and urge you to oppose the measure. The Fed Up coalition consists of economists, low-wage workers, labor groups, and community leaders throughout the country, and partners with economic justice organizations in each of the 12 Federal Reserve districts. Our coalition's mission is to make the Federal Reserve's policymaking decisions more responsive to the economic interests of low-wage workers and communities of color. As such, we are not wedded to the status quo at the Fed, and in fact have proposed sensible reforms to the Fed's governance and structure that would make the Fed more accountable and publicly representative. We believe a fully public Federal Reserve would enact monetary and regulatory policies that facilitate a full employment economy while protecting our financial system from Wall Street excess.

Unfortunately, the proposed Federal Reserve reforms in the Financial CHOICE Act would achieve none of these goals. Instead, the Financial CHOICE Act would constrain Fed policymakers' ability to pursue its full employment mandate by eliminating Fed policymakers' discretion, allowing intrusive reviews of Fed decision-making, and increasing the number of monetary policy decision-makers who are private officials serving corporate and financial interests, rather than the public.

The Financial CHOICE Act would hamper policymakers' discretion to respond to changes in economic conditions by mandating a so-called "Taylor Rule" that the Fed must follow when setting interest rates. Estimates that guide the Taylor Rule (estimates of inflation and the current output gap, or unemployment gap) are just that: estimates. They can change rapidly over time. For example, given actual growth in gross domestic product (GDP) since the Great Recession, estimates of trend GDP growth made in 2008 by the Congressional Budget Office would indicate that the output gap today was over 10 percent of potential GDP. But since 2008, estimates of trend GDP growth have been rapidly reduced, so the actual output gap as measured by the CBO today is under 3 percent. Judgment and discretion are needed to know when and by how much to discount the mechanical prescriptions of any monetary policy rule.

If a strict Taylor Rule like the one mandated by the Financial CHOICE Act was followed during a period of time when the "neutral" real interest rate was secularly changing, it would lead to very large policy errors. The neutral real interest rate is the federal funds rate consistent with the economy growing at trend with stable inflation. However, extensive research indicates exactly that the neutral real interest rate in the

United States (and likely globally as well) has indeed been changing significantly in recent years (see Laubach and Williams (2015), for example).[1] Put simply, if the Financial CHOICE Act's Taylor Rule mandate had been in effect over the past decade and had been followed, monetary policy would have made very large policy errors that would have led to millions of fewer Americans working today. Indeed, a recent analysis by economists Carola Binder and Alex Rodrigue found that "requiring the Fed to follow a Taylor rule would likely be detrimental to the full employment goal." Binder and Rodrigue concluded that the Taylor Rule's measures were insufficient to capture how far the economy is from full employment, and point to numerous examples where flexibility and discretion by the Fed has enabled faster recovery from economic downturns. [2] The Minneapolis Federal Reserve Bank recently confirmed Binder and Rodrigue's conclusion, estimating that 2.5 million fewer jobs would have been added to the economy had the Fed followed the prescriptions of the Taylor Rule over the past five years.[3]

It is also not clear what problem the Financial Choice Act is meant to solve. Inflation has been running consistently below the Fed's 2.0 percent target. If the Fed had followed a more contractionary policy, as would be implied by this measure, presumably it would be even further undershooting its inflation target.

To keep Fed policymakers on the prescribed Taylor Rule pathway, the Financial Choice Act allows any congressional committee to initiate a full and immediate GAO audit of the Fed's monetary policy if the GAO determines that a specific FOMC decision hasn't strictly followed the mathematical rule. While proponents of the bill insist that the Fed would have discretion to develop its own rule, language in the bill requiring that the Fed explain how and why it has strayed from the Taylor Rule makes it clear that the bill's intent is to constrain the Fed's ability to pursue policy outside the Taylor guidelines. Allowing abrupt, congressionally-mandated second-guessing of monetary policy decisions would exert strong pressure for the Fed to mechanically follow a simple rule, which is fundamentally inconsistent with the way that the creator of the rule himself has characterized the purpose of these benchmarks:

"...in my view, a policy rule need not be a mechanical formula...A policy rule can be implemented and operated more informally by policymakers who recognize the general instrument responses that underlie the policy rule, but who also recognize that ***operating the rule requires judgment and cannot be done by computer****."*

Stanford economist John Taylor[4]

Any increased oversight of the Fed should be independent and nonpartisan, and should be aimed at improving management and operations, not at constraining the operational independence of Fed officials to set monetary policy. Specific commentary on monetary policy should remain outside of the purview of

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[1] Thomas Laubach and John Williams, *Measuring the Natural Rate of Interest Redux* (October 31, 2015), http://www.frbsf.org/economic-research/files/wp2015-16.pdf

[2] Carola Binder and Alex Rodrigue, *Monetary Rules and Targets: Finding the Best Path to Full Employment* (September 1, 2016), http://www.cbpp.org/research/full-employment/monetary-rules-and-targets-finding-the-best-path-to-full-employment

[3] Neel Kashkari, *Taylor Rule Would Have Kept Millions Out of Work* (January 5, 2017), https://www.minneapolisfed.org/news-and-events/messages/taylor-rule-would-have-kept-millions-out-of-work

[4] John Taylor, *Discretion versus policy rules in practice* (1993), https://web.stanford.edu/~johntayl/Papers/Discretion.PDF

the GAO. GAO reviews of the Fed, if authorized, should be undertaken by the nonpartisan officials at the GAO itself, not triggered by Congress. GAO oversight should be aimed at ensuring effective management, protection against fraud, proper maintenance of Federal Reserve units that interact with the international financial system, and efficient use of taxpayer resources. GAO audits should not be used as a partisan tool to question the monetary policy course of Fed decision-makers.

The Financial CHOICE Act would also undermine decision-making at the Fed by expanding the number of unaccountable, private officials on the Federal Open Market Committee. The FOMC was created with the intention of ensuring that the Federal Reserve Bank presidents—as heads of private institutions—would only constitute a minority of the voting members of the FOMC. In recent years, however, the Fed's Board of Governors has regularly experienced multiple vacancies, reflecting a more extensive timeframe for vetting potential nominees as well as a more protracted duration of the Senate confirmation process. Thus, the members of the Board of Governors have constituted a voting majority at only half of the FOMC meetings from 2001 to 2008 and less than one-third of the FOMC meetings since then.[5] In effect, increased political gridlock has expanded the influence of the Federal Reserve Bank presidents in setting the nation's monetary policy. By expanding the number of Reserve Bank presidents sitting on the FOMC from five to six, the Financial CHOICE Act would lock this dynamic in permanently, increasing the likelihood that private Reserve Bank presidents will control the FOMC. Indeed, if the Financial CHOICE Act became law today, Reserve Bank presidents would further increase the majority they hold on the current FOMC due to vacancies at the Board of Governors.

The Financial CHOICE Act purports to strengthen the Federal Reserve's accountability to the public. It is hard to imagine a worse way of achieving that than by increasing the policymaking power of private officials with no public accountability. Despite the crucial role of Reserve Bank presidents in determining the nation's monetary policy, the process for selecting them takes place entirely behind closed doors. Recent Reserve Bank presidential selections and re-appointments have revealed a process that is opaque, inbred, and largely *pro forma*.

Reserve Bank presidents are chosen by each Reserve Banks' board of directors. Reserve Banks' boards are disproportionately white and male, and come largely from corporate and financial backgrounds, despite the Federal Reserve Act's requirement that directors "represent the public."[6] Consequently, directors tend to choose longtime Fed insiders and bankers who share their economic perspectives and background. In 2015, three straight individuals with strong ties to Goldman Sachs were chosen to lead the Reserve Banks of Philadelphia, Dallas, and Minneapolis. In Dallas and Philadelphia, the individuals chosen were involved in their own selection, and the selection processes contravened the spirit of a Dodd-Frank Act reform intended to limit commercial bankers' influence on the selection process. Retiring Dallas Fed president

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[5] Peter Conti-Brown, *The twelve Federal Reserve banks: Governance and accountability in the 21st century* (March 2, 2015), https://www.brookings.edu/research/the-twelve-federal-reserve-banks-governance-and-accountability-in-the-21st-century/

[6] Connie Razza and Jordan Haedtler, *To Represent the Public: The Federal Reserve's Continual Failure to Represent the American People* (February 5, 2016), http://populardemocracy.org/news/represent-public-federal-reserves-continued-failure-represent-american-people

Richard Fisher convened his own advisory committee to undertake the search for his successor.[7] Philadelphia Fed President Patrick Harker was a banker-elected, Class B director at the Philadelphia Fed, and cleared the way for his selection by stepping down as chair of the search committee tasked with finding a new president.[8]

The cozy relationship between the financial sector and Reserve Bank presidents was highlighted dramatically by the resignation of Richmond Federal Reserve President Jeffrey Lacker just a few weeks ago. Lacker admitted to leaking market-sensitive information to the hedge fund advisor Medley Global.[9] Federal officials investigating the leak had informed the board of the Richmond Federal Reserve that they were interested in speaking with Lacker about his role in the leak as early as May 2015, yet the Richmond Fed's board enthusiastically and unanimously recommended Lacker's re-appointment to a five-year term at the end of 2015.[10] All Reserve Bank presidents are FOMC participants with access to market-sensitive information and influence over important decisions affecting the economy. Yet as the Lacker incident demonstrates, Reserve Bank presidents are private officials accountable only to oversight and *pro forma* re-appointment by their corporate boards.

The Financial CHOICE Act's apparent lesson from the Lacker scandal is that Reserve Bank presidents should be given more power, while Fed policymakers' overall discretion to consider labor market data like the quits rate, involuntary part-time work, and wage growth should be limited. This is the wrong lesson to take. The Federal Reserve can and has made helpful interventions in the economy, and Reserve Bank presidents can contribute to this by bringing insights about labor market conditions in their region to FOMC meetings. Instead, at least one Reserve Bank president has just admitted to essentially the opposite: bringing insights from FOMC meetings to the financial services industry. Currently, the process for selecting Reserve Bank presidents is an opaque and publicly exclusive process, and the individuals chosen have not demonstrated sufficient independence from the financial sector they are supposed to oversee and regulate. Until and unless Reserve Bank presidents are made more publicly representative and accountable, they must not be given a larger role in setting monetary policy.

The *status quo* of the Federal Reserve should not persist. Governance should become more transparent and representative and policy should in turn weigh the economic interests of low and middle-wage workers more highly. But the reforms proposed in the Financial CHOICE Act go in precisely the wrong direction. We urge you to oppose them.

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[7] Jonathan Spicer and Ann Saphir, *Efforts to replace Fed hawks Plosser, Fisher pick up speed* (October 30, 2014), http://www.reuters.com/article/us-usa-fed-plosser-fisher-idUSKBN0IJ26X20141030

[8] Christopher Condon, *Not far to look: New Fed President Searched, Found Himself* (June 3, 2015), http://www.bloomberg.com/news/articles/2015-06-03/not-far-to-look-fed-s-newest-president-searched-found-himself

[9] Jeff Cox, *Richmond Fed President Lacker says he was involved with Medley leak, announced resignation* (April 4, 2017), http://www.cnbc.com/2017/04/04/richmond-fed-president-lacker-says-he-was-source-of-medley-leak-announces-immediate-resignation.html

[10] Chris Condon, *Lacker's Exit Leaves Mystery at Fed Over 2016 Reappointment* (April 6, 2017), https://www.bloomberg.com/news/articles/2017-04-06/lacker-s-exit-from-fed-leaves-mystery-over-2016-reappointment

Thank you for your consideration. For more information, please contact Fed Up's Campaign Manager Jordan Haedtler at jhaedtler@populardemocracy.org.

Sincerely,

Center for Popular Democracy