

How to Improve Fed Accountability and Transparency

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In recent years, there has been increased interest in making the Federal Reserve (Fed) more accountable to Congress and the public. One recent congressional proposal would have made the Fed subject to occasional audits by the Government Accountability Office (GAO).¹ Another proposal called on the Fed to create an explicit monetary policy rule.² Thus far, these efforts have not been successful, partly owing to opposition from within the Fed.

In this paper, I'll propose an alternative approach to accountability and transparency, which I believe is both more useful and more politically acceptable. In this regime, the Fed would first set specific quantifiable goals, then conduct annual evaluations of past policy decisions. The Fed would then tell Congress whether, in retrospect, the previous year's policy stance had been too expansionary or too contractionary, and it would also provide specific metrics to justify this appraisal. In order to see the advantages of this accountability system, it is first necessary to understand the Fed's current policy goals and flaws in the structure of Fed policymaking.

THE DUAL MANDATE AND POLICY EVALUATION

Congress has given the Fed a mandate to produce stable prices and high employment, as well as moderately high long-term interest rates.³ Fed policymakers believe they have only a very limited ability to control long-term interest rates, mostly through their control of inflation expectations. Thus, as a practical matter, the Fed has typically interpreted the law as giving it a *dual mandate* (i.e., stable prices and high employment), under the assumption that low inflation will indirectly help to stabilize long-term rates. Because some fluctuations in inflation are inevitable, and because many economists view mild deflation as more costly than mild inflation, in 2012 the Fed officially announced a target for personal consumption expenditures (PCE) inflation of 2 percent. Employ-

ment is considered high when unemployment is at the natural rate, which is generally assumed to be 4.0 to 4.6 percent, but there's some uncertainty on this point.⁴

For the preceding reasons, the dual mandate is currently interpreted to keep unemployment in the 4.0 to 4.6 percent range and inflation at 2 percent. That's not to say that Fed officials have identical views on the appropriate policy goals, but the bigger controversies revolve around the question of how to achieve this dual mandate. For instance, in 2009 most Fed officials agreed that inflation (near zero) was too low and unemployment (near 10 percent) was too high.

What should Congress make of situations where the Fed fails to hit its targets? As of today, Congress is not very good at evaluating Fed policy, partly because this is a highly technical field and most representatives and senators are not professionally trained macroeconomists. It's not even clear if the Fed should be seen as having in some sense failed in 2009—was there an alternative policy that would have done better?

I will argue that there is a way of making Fed policy more accountable, which achieves two goals at once. One goal is to make it easier for elected representatives to understand what the Fed is trying to do and exercise appropriate oversight of this critically important policy area. A second goal is to help the Fed itself make more effective policy.

Professional macroeconomists see the Fed as the institution that controls aggregate variables such as inflation and nominal spending. You might think of the metaphor of a captain steering a giant ship that is continually buffeted by “shocks” such as wind and waves. For many economists, the high inflation of the 1970s and the severe deflation of the 1930s represent failures of Fed policy.⁵ Elsewhere I've argued that the Fed will eventually be blamed for an overly contractionary monetary policy during 2008–2013.

In contrast, many noneconomists see the Fed as just one of many factors that influence inflation, along with oil shocks, fiscal policy, labor union wage demands, house price bubbles, and many other factors. In this view, monetary policy can be seen as a series of “gestures” that might nudge inflation up or down but don't necessarily have a decisive impact on the path of the price level. For the most part, Congress did not blame the Fed for either the Great Depression of the 1930s or the Great Inflation of the 1970s.

Many economists, myself included, do blame the Fed for these undesirable outcomes. If the Fed were not responsible for the inflation rate, then it's not clear why inflation has averaged 2 percent since 1990, nor is it even clear why Congress would assent to the Fed setting an inflation target.⁶

More specifically, the accountability mechanism I propose should make it easier for those involved in congressional oversight to recognize how inflation and employment outcomes reflect the success or failure of Fed policy.

If the Fed had a single mandate of 2 percent inflation (like some other central banks) it would be relatively simple for Congress to hold it accountable to that goal. Unfortunately, the dual mandate makes things a bit trickier. It's not always possible to hit the inflation and employment targets at the same time, so how should we evaluate any discrepancies? Again, any system of accountability should make it easier for policymakers facing a highly complex macroeconomic environment to come to a simple and straightforward evaluation of the effectiveness of Fed policy.

AGGREGATE DEMAND AND THE DUAL MANDATE

Although the Fed's dual mandate involves two policy goals, both inflation and employment are affected by a single macroeconomic variable: *aggregate demand* (AD), sometimes called nominal GDP. The Fed periodically adjusts policy with the goal of influencing the total amount of nominal spending (i.e., aggregate demand) in the economy. This variable is the sum of all spending on consumption, physical investment, and government goods and services, plus net exports. The Fed tries to "steer" aggregate demand to a position consistent with roughly 2 percent inflation and reasonably full employment (i.e., an actual unemployment rate that is close to the estimated natural rate).

Thus, although the Fed has a dual mandate, it affects both variables by impacting a single macroeconomic aggregate: nominal spending. Because AD affects both inflation and employment, any evaluation of previous Fed decisions boils down to a determination of whether previous Fed decisions led to too much or too little aggregate spending. To evaluate Fed policy, Congress needs to know whether past policy decisions by the Fed were too expansionary (too much AD) or too contractionary (too little AD).

Congress could choose to make this sort of evaluation on its own. However, given the complexity of these issues, a more effective oversight would involve collaboration between Congress and the Fed. The Fed would explain what it was trying to do as specifically as possible, then provide Congress with an evaluation of whether the previous year's policy setting had been excessively expansionary or excessively contractionary, combined with a summary of the data used to make that determination. For instance, the Fed might cite the near-zero inflation and the roughly 10 percent unemployment of 2009 as evidence that previous policy decisions (during 2008) had been, in retrospect, too contractionary. The 10.2 percent inflation of 1979, a time of near-normal unemployment, might be cited as evidence that previous policy decisions (in 1978) were too expansionary.⁷

The current form of oversight is highly unsatisfactory. Congress does not seem to understand the role of monetary policy in steering nominal spending, and hence it has no framework for evaluating the effectiveness of past monetary policy decisions. The Fed needs to provide Congress with that framework, and the best way of doing so is to have the Fed self-report whether previous decisions were too expansionary or too contractionary.

Large bureaucracies tend to be self-protective, and some might worry that the Fed will be reluctant to admit previous mistakes. This is why I favor a regime where the Fed also provides the metrics for its evaluation of past policy decisions. This would force a greater degree of honest self-reflection than might be apparent at first glance. Once Congress understands that the Fed’s job is to steer aggregate demand, they will not accept bland assurances that past decisions were fine in an environment where things are clearly off course. Imagine the Fed saying “there is no inflation problem” back in 1979 as evidence that AD was not too expansionary. How would Congress have reacted? Or suppose that in 2009 the Fed indicated that aggregate demand was just fine and that a stronger economy would be undesirable. Obviously, this sort of report would attract a great deal of skepticism.

While transparency and accountability sound nice in the abstract, it’s not clear how this proposal would actually improve the economy. Would it simply lead to more acrimonious discussions when Fed officials appear before Congress, without improving policymaking?

I see two ways by which more accountability and transparency can actually make policy more effective. Both are aimed at overcoming political problems associated with the ambiguity of the current dual-mandate policy approach. One political problem is caused by splits within the Fed—between the so-called hawks and doves. I’ll begin, however, with the problems that occur when the Fed is forced to take actions that are unpopular with Congress and the general public in order to achieve its mandate.

BETTER COMMUNICATION BETWEEN THE FED AND THE PUBLIC

During the 1960s and 1970s, there were a number of occasions where the Fed refrained from tightening monetary policy despite rising inflation. One factor may have been the political unpopularity of higher interest rates. Conversely, during the recovery from the Great Recession, some Fed officials expressed frustration with the pushback they received from various expansionary policy initiatives, such as ultra-low interest rates and quantitative easing. Indeed, some suggested that these political headwinds explained why the Fed did not adopt an even more aggressive policy stance to promote a faster recovery. Both of these problems—resistance to needed contractionary steps during the 1970s as well as resistance to needed expansionary policy actions during the Great Recession—can be mitigated with a clear system of accountability.

If during the 1960s and 1970s the Fed had been required to evaluate whether past policy decisions had been too contractionary or too expansionary, they would probably have mostly been reporting that, in retrospect, policy should have been tighter. They would presumably have cited high rates of inflation to back up that conclusion. If a bureaucracy has been honestly reporting that they erred in excessively expansionary policy, it’s pretty hard for Congress to respond, “Then keep repeating the same mistakes.” Thus, a policy of honest self-reflection would have actually provided more political cover for a tightening of policy.

Of course, Congress might have pressed the Fed to raise its inflation target in order to make policy more expansionary, but higher inflation is also not politically popular. A policy of improved transparency forces Congress to more honestly evaluate the tradeoffs in policymaking and think seriously about what it actually wants the Fed to accomplish.

In Ben Bernanke's memoir, he indicates that he was occasionally frustrated by the reaction on Capitol Hill to Fed policy initiatives.⁸ During the period from July 2008 to July 2016, the Fed almost continually missed its targets. Policy was too contractionary to achieve the dual mandate of roughly 2 percent PCE inflation and high employment.⁹ And yet, despite these consistent policy misses of a policy objective set by Congress, Bernanke complained that most of the criticism from Congress and the public was that monetary policy was actually *too expansionary*. It seems plausible that this criticism led the Fed to refrain from even more aggressive policy initiatives, which might have led to a faster recovery.

Now suppose that Bernanke had to provide an annual report on the effectiveness of past Fed policy decisions. At first glance this might seem like a major problem for the Fed—who wants to go before a congressional committee five years in a row, each time admitting that the previous year's policy stance had been too contractionary to hit the target? In this case, however, accountability might actually help the Fed. This sort of annual report would be an implicit rebuke to those who complained that Bernanke was doing too much. The Fed could say to Congress, "Look, if you don't like our interpretation of the dual mandate, then feel free to change it. But this is what we need to do to achieve the targets that you've asked us to achieve."

The problems I've discussed here are even worse than they appear at first glance. It's not just that certain Fed actions may be politically unpopular; at a deeper level the public often doesn't understand that the Fed controls AD. Much of the discussion of stabilization policy is oddly disconnected from the actual issues. Thus, monetary policy is often discussed as something that determines inflation, whereas fiscal policy is viewed as a factor that influences growth. This is wrong. Both monetary and fiscal policy influence aggregate demand, and AD influences both inflation and growth. This confusion explains why people found it odd when, in 2010, Bernanke indicated that inflation was too low and that the Fed was trying to increase inflation.

At the time Bernanke spoke of the need for higher inflation, he was actually trying to boost AD in the *hope* that it would lead to higher growth and the *expectation* that it would lead to higher inflation. Suppose instead that in 2010 there had been an accountability system in place where Bernanke could have reported that the policy setting in 2009 had been too contractionary, citing data on both inflation and employment, and then indicated that, henceforth, policy would become more expansionary with the goal of boosting aggregate demand high enough to create jobs and also lead to a stable 2 percent inflation rate. To a noneconomist, that sounds much better than simply calling for higher inflation.

CREATING A MORE UNIFIED POLICY APPROACH WITHIN THE FED

Fed officials are often labeled either “doves” (those favoring more expansionary policies) or “hawks” (those favoring more contractionary policies.) This sort of dichotomy only makes sense in a world where the policy objectives are ambiguous. In a world where there was a single mandate of 2 percent inflation, for instance, there would be no room for hawks or doves.

To illustrate this point, consider the following analogy. Two drivers might have a different view on where they’d like to drive their cars. But if they both agree to drive from New York to LA, it makes no sense to talk about a right steer bias or a left steer bias. The mutually agreed upon destination constrains their path, at least in the long run. Similarly, with 2 percent inflation as a goal, monetary policy becomes a technical problem of how to steer aggregate demand, not an ideological debate between hawks and doves about whether the economy would be better off with 0 percent inflation or 4 percent inflation.

Unfortunately, the dual mandate makes things a bit more complicated. While the recent adoption of a 2 percent inflation objective has reduced the gap between hawks and doves, there are still some mild differences owing to the fact that employment is also part of the mandate, and it’s not clear how these two goals should be balanced.

A system of accountability would force the various policymakers at the Fed to come together and embrace a single vision as to how the dual mandate should be interpreted. Each year, the Fed would vote on the question of whether previous policy had been too expansionary or too contractionary. Then the Fed would put together a joint statement pointing to the metrics they used to make this determination. *Importantly, these metrics would indirectly shed light on the actual meaning of the dual mandate.*

If this all sounds rather utopian, you might be surprised to learn that a process very much like what I’ve described occurred between 2006 and 2012. Ben Bernanke had long been a proponent of inflation targeting, but many at the Fed were skeptical of the idea of an explicit inflation target. There was concern that the Fed might be blamed when inflation deviated from the target, perhaps owing to transitory factors such as oil shocks.

Bernanke came up with an ingenious solution. After being appointed chair of the Federal Reserve Board, he first created a system wherein each Federal Open Market Committee (FOMC) policymaker would forecast certain key variables, such as inflation and employment. Importantly, he asked policymakers to make their forecasts under the assumption of “appropriate monetary policy.”¹⁰ For each official, their long-run inflation forecast then revealed their actual policy preference. If a Fed official thought inflation would be 2 percent in the very long run, *assuming optimal policy*, then it was pretty clear that the official favored 2 percent inflation. Over time, it became clear that 2 percent inflation was indeed close to the consensus preference of Fed policymakers.

After operating for a number of years under this regime, the media began to view 2 percent as the implicit Fed inflation target. That made it easier for Bernanke to later get Fed officials to agree to make official an inflation target of 2 percent (in 2012).

Today, there are diverse views within the Fed as to what sort of growth in aggregate demand would best address the dual mandate. Over time, an annual reappraisal of past decisions would help to make the Fed's policymaking process more transparent. Thus, one year the Fed might report that previous policy had been too tight during a period where growth in aggregate demand ended up being 3 percent. On another occasion, they might report that the previous policy stance had been too expansionary during a period where growth in demand was 7 percent.

Congress could also ask the Fed to report any shortfalls or overshoots, no matter how small, to make it easier to pinpoint exactly how the Fed interprets the dual mandate. By insisting that even tiny undershoots or overshoots get reported as policy errors, Congress would also reduce the risk that the Fed would reflexively keep insisting that previous policy decisions had been exactly right.

CONCLUSION

While previous proposals to “audit the Fed” have been fiercely resisted by the Fed leadership, this proposal for boosting transparency and accountability is likely to be uncontroversial, with appeal to both political parties. No institution can seriously argue that its performance leaves no room for improvement or that it cannot learn from past mistakes. Indeed, the proposal has several features that might actually be attractive to the Fed chair. First, it will help Congress to better understand the Fed's motives when unusual policy steps are needed. Second, it will tend to unify the Fed's own decision-making process. The Fed chair will be less likely to feel like a person “herding cats” with differing views on how to make the dual mandate operational.

Unlike other reform proposals, the Fed will retain its current level of independence under this proposal. It will continue to be free to decide how to interpret the meaning of its dual mandate, to decide which policy instrument settings are best able to implement its vision of the dual mandate, and it will also be given the discretion to decide for itself how to evaluate whether past policy settings were too expansionary or too contractionary. That's an enormous amount of independence for such a key policymaking institution. As a result, it's hard to imagine the Fed putting up much resistance to the proposal.

ABOUT THE AUTHOR

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NOTES

1. Patrick Gillespie, “Yellen Battles Congressman over Fed Independence,” *CNN*, July 12, 2017.
2. Harriet Torry and Josh Zumbrun, “Yellen Reiterates Opposition to Taylor Rule in Letter to Ryan, Pelosi,” *Wall Street Journal*, November 17, 2015.
3. The law passed by Congress to this end is the Humphrey-Hawkins Full Employment Act of 1978. See Full Employment and Balanced Growth Act, Pub. L. No. 95-523, 98 Stat. 1887 (1978).
4. All economic data in this brief are from the Federal Reserve Economic Data (FRED) data site, produced by the Federal Reserve Bank of St. Louis.
5. Indeed, even former Fed Chair Ben Bernanke blames the Fed for these two policy failures.
6. PCE inflation averaged 1.94 percent from July 1990 to July 2018. This is the inflation rate targeted by the Fed. CPI inflation has averaged closer to 2.3 percent.
7. PCE inflation was 10.2 percent from December 1978 to December 1979.
8. Ben S. Bernanke, *The Courage to Act: A Memoir of a Crisis and Its Aftermath* (New York: W. W. Norton and Co., 2015).
9. PCE inflation averaged only 1.14 percent, and the unemployment rate was above 6 percent during most of that period.
10. See a recent example of the Fed minutes for an explanation of this process. Federal Open Markets Committee, *Minutes of the Federal Open Market Committee June 12–13, 2018*, July 5, 2018.