



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

November 16, 2015

The Honorable Paul Ryan
Speaker of the House of Representatives
House of Representatives
Washington, D.C. 20515

The Honorable Nancy Pelosi
Democratic Leader
House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker and Madam Leader:

I am writing regarding the House of Representative's consideration of H.R. 3189, the Fed Oversight Reform and Modernization (FORM) Act. The FORM Act would severely impair the Federal Reserve's ability to carry out its congressional mandate to foster maximum employment and stable prices and would undermine our ability to implement policies that are in the best interest of American businesses and consumers. This legislation would severely damage the U.S. economy were it to become law.

There are a number of harmful provisions in the FORM Act, but the provisions concerning the conduct of monetary policy are especially troubling. Section 2 of the bill would require the Federal Reserve to establish a mathematical formula or "directive policy rule" that would dictate how the Federal Open Market Committee (FOMC) adjusts the stance of monetary policy at every FOMC meeting. The Government Accountability Office (GAO) would be responsible for determining whether the rule adopted by the FOMC met all the criteria in the legislation. Any time the FOMC was judged not to be in compliance with the GAO-approved rule, the GAO would be required to conduct a full review of monetary policy and submit a report to the Congress. Moreover, the GAO would also be required to conduct a full review of monetary policy and report to the Congress any time the FOMC changed its policy rule.

These provisions are significantly flawed for a number of reasons. Most importantly, the provisions effectively cast aside the bipartisan approach toward monetary policy oversight developed by the Congress in the late 1970s. Under that approach, the Congress establishes the long-run objectives for monetary policy but affords the Federal Reserve a considerable degree of independence in how it goes about achieving those statutory goals, thus ensuring that the conduct of monetary policy is insulated from political influence. This framework is now recognized as a fundamental

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principle of central banking around the world. The provisions of the FORM Act, in contrast, would effectively put the Congress and the GAO squarely in the role of reviewing short-run monetary policy decisions and in a position to, in real time, influence the monetary policy deliberations leading to those decisions.

Conducting monetary policy by strictly adhering to the prescriptions of a simple rule would lead to poor economic outcomes. There is no consensus among economists or policymakers about a simple policy rule that is best suited to cover a wide range of scenarios. For example, even during the period known as the Great Moderation, in the 1980s and 1990s, when a simple rule might have been expected to work well, the actual level of the federal funds rate often diverged substantially from the level prescribed by the reference rule included in the FORM Act. Indeed, for much of this period, monetary policy was actually tighter than what would have been the case under that rule.

Even more tellingly, no simple policy rule has yet been devised that would adequately address the effective lower bound on the policy rate--a constraint that has been binding in the United States since late 2008. Had the FOMC been compelled to operate under a simple policy rule for the past six and a half years, the unemployment experience of that period would have been substantially more painful than it already was, and inflation would be even further below the FOMC's 2 percent objective. Indeed, a recent study by Federal Reserve economists suggests that the current unemployment rate would still be above 6 percent and inflation would now be running somewhat below zero, if the FOMC had not taken the actions it did but rather had followed the reference rule and made it clear that it would do so in the future.¹ In other words, millions of Americans would have suffered unnecessary spells of joblessness over this period, generating enormous amounts of personal and collective damage that could have been avoided--and, in fact, was avoided because we had the latitude to use our available tools responsibly and forcefully.

In addition to allowing the GAO to conduct a review specifically related to the "directive policy rule," Section 13 of the FORM Act also allows GAO to more broadly review and analyze the monetary policy decisions of the Federal Reserve at any time. This provision would politicize monetary policy and bring short-term political pressures into the deliberations of the FOMC by putting into place real-time second guessing of policy decisions. Such action would undermine the independence of the Federal Reserve and likely lead to an increase in inflation fears and market interest rates, a diminished status of the dollar in global financial markets, and reduced economic and financial stability.

¹ Engen, Eric M., Thomas Laubach, and David Reifschneider (2015). "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," Finance and Economic Discussion Series 2015-005. Board of Governors of the Federal Reserve System (U.S.).
<http://dx.doi.org/10.17016/FEDS.2015.005>.

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The provision is based on a false premise--that the Federal Reserve is not subject to an audit. To the contrary, under existing law, the financial statements of the Federal Reserve System are audited annually by an independent accounting firm under the supervision of the Inspector General for the Board. These audited financial statements are made publicly available and provided to Congress annually. The GAO may also conduct an audit of the Board's financial statements and of transactions that the Federal Reserve conducts in the course of its lending and other activities. In addition, each week the Federal Reserve publishes its balance sheet and charts of recent balance sheet trends, as well as every security the Federal Reserve holds, along with each security's CUSIP number. Moreover, as specified in the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Reserve now releases detailed transaction level information for all open market operations and discount window lending with a two-year lag.

I am concerned about other provisions in the FORM Act as well, including the debilitating restrictions on the Federal Reserve's emergency lending authorities. In the face of a future crisis--where the collapse of the financial system is on the scale of the Great Depression or the recent financial crisis--I believe it is essential that the Federal Reserve have the emergency lending powers necessary in those circumstances to support the flow of credit to households and businesses and mitigate harm to the U.S. economy. The FORM Act would essentially repeal the Federal Reserve's remaining ability to act in a crisis. I am also deeply troubled by provisions related to the Federal Reserve's supervisory responsibilities, particularly those that would undermine the strength and effectiveness of our stress tests and impede our ability to advocate internationally for standards that are in the best interest of U.S. businesses and consumers.

Throughout my career and certainly during my many years working within the Federal Reserve System, I have been an advocate for greater openness and transparency. As Chair, I remain committed to these important issues. Accountability and transparency of public institutions are critical in a democratic society. Unfortunately, the FORM Act attempts to increase transparency and accountability through misguided provisions that would expose the Federal Reserve to short-term political pressures. For these reasons, I urge the House not to adopt the FORM Act. The bill would severely impair the Federal Reserve's ability to carry out its congressional mandate and would be a grave mistake, detrimental to the economy and the American people.

Sincerely,



Cc: The Honorable Jeb Hensarling
The Honorable Maxine Waters