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# Federal Reserve: Legislation in the 115<sup>th</sup> Congress

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## Summary

The Federal Reserve (Fed) is the subject of legislation being considered in the 115<sup>th</sup> Congress. The bills contain wide-ranging changes that can be grouped into five broad categories:

**Fed governance.** Some proposals would change the Fed's institutional structure. H.R. 10 as passed would increase the voting weight of regional Fed presidents on the Federal Open Market Committee (FOMC) at the expense of the Fed's Board of Governors and the New York Fed, and it would create a congressional commission to recommend reforms to the Fed.

**Oversight and disclosure.** Some proposals aim to make the Fed more accountable to Congress by increasing congressional oversight or requiring the Fed to disclose more information to Congress and the public. H.R. 24 as reported and H.R. 10 would require Government Accountability Office (GAO) audits of the Fed that are not subject to current statutory restrictions that prevent GAO from performing policy evaluations of the Fed's monetary policy. H.R. 10 would subject the Fed's rulemakings to cost-benefit analysis requirements and require the Fed to publicly disclose information on international negotiations and the salaries and personal finances of certain officials and employees. It would also require the FOMC to publicly release meeting transcripts and increase requirements to periodically report to and testify before Congress. H.R. 10, H.R. 3280 as reported, and H.R. 3354 as passed by the House would subject the Fed's nonmonetary policy functions to the congressional appropriations process and require the Fed to levy assessments to offset them.

**Monetary policy rules (the Taylor Rule).** H.R. 10 and H.R. 4270 as reported would require the Fed to compare its monetary policy decisions to those prescribed by a policy rule (e.g., the Taylor Rule) and report those findings to Congress. Under H.R. 10, policy deviations from the rule would trigger GAO audits and congressional testimony.

**The Fed's emergency lending powers.** H.R. 10 and H.R. 4302 as reported would reduce the Fed's discretion to make emergency loans under Section 13(3) of the Federal Reserve Act. The Fed used this authority to extend credit to nonbank financial firms during the financial crisis.

**The Fed's balance sheet.** H.R. 4278 as reported would limit the types of securities that the Fed may acquire through open market operations to gold, coins, or the direct obligations of the federal government, foreign central banks, or the International Monetary Fund. It would require the Fed to swap any other assets (namely, its holdings of mortgage-backed securities) for federal debt with the Treasury Department.

The proposals reviewed in this report are wide ranging and diverse; many are united by the goals of increasing the Fed's accountability to Congress and decreasing Fed discretion. Although some provisions make minor changes, taken together the proposals would arguably somewhat reduce the Fed's independence from Congress. The Fed is more independent than most other agencies, which has traditionally been justified by its monetary policy responsibilities. Most research has found a positive relationship between monetary policy independence and economic outcomes. (Research is more divided on whether there is a positive relationship between Fed discretion and economic outcomes.) To some extent, a tradeoff between independence and accountability is unavoidable. For example, Congress can require the Fed to follow a policy rule to reduce discretion, but Congress can only ensure compliance with the rule if there are negative consequences for noncompliance that would reduce independence.

This report analyzes Fed bills that have seen committee or floor action and the policy debate surrounding them.

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## Introduction

The Federal Reserve's (Fed's) responsibilities as the nation's central bank fall into four main categories: (1) monetary policy, (2) provision of emergency liquidity through the lender of last resort function, (3) supervision of certain types of banks and other financial firms for safety and soundness, and (4) provision of payment system services to financial firms and the government.<sup>1</sup>

The 115<sup>th</sup> Congress is considering a number of bills that would affect the Fed's monetary policy, lender of last resort, and regulatory responsibilities. Although these bills contain numerous wide-ranging changes, most provisions can be grouped into five broad categories:

- **Fed governance.** Some proposals would change the Fed's institutional structure—how officials are selected, how policy decisions are reached, and so on.
- **Oversight and disclosure.** Some proposals aim to make the Fed more accountable to Congress by increasing congressional oversight or requiring the Fed to disclose more information to Congress and the public.
- **Policy rules (e.g., the Taylor Rule).** Some proposals would require the Fed to compare its monetary policy decisions to those prescribed by a policy rule such as the Taylor Rule and report those findings to Congress.<sup>2</sup>
- **The Fed's emergency lending powers.** Some proposals would reduce the Fed's discretion to provide emergency assistance under Section 13(3) of the Federal Reserve Act.
- **The Fed's balance sheet.** Some proposals would alter the types of assets that the Fed is allowed to purchase and hold on its balance sheet.

This report analyzes these provisions and the policy debate surrounding them. It does not cover legislation that would change Fed-administered regulation of depository institutions, systemically important financial institutions, and financial market utilities.

## Legislative Activity

The following bills affecting the Federal Reserve have seen committee or floor action in the 115<sup>th</sup> Congress:<sup>3</sup>

- The Financial CHOICE Act (H.R. 10) passed the House on June 8, 2017.<sup>4</sup>
- Parts of the Financial CHOICE Act, including a provision that would place the Fed's nonmonetary policy functions under appropriations, were included in the

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<sup>1</sup> For background on the Federal Reserve (Fed), see CRS In Focus IF10054, *Introduction to Financial Services: The Federal Reserve*, by (name redacted)

<sup>2</sup> The Taylor Rule is defined and discussed in the section below entitled "Rules-Based Monetary Policy (The Taylor Rule)."

<sup>3</sup> All discussions of provisions of the bills in this report are based on the version most recently amended, unless otherwise noted. For Fed legislation considered or enacted in the 114<sup>th</sup> Congress, see CRS Report R44273, *Federal Reserve: Legislation in the 114th Congress*, by (name redacted)

<sup>4</sup> The Financial CHOICE Act also has a number of provisions affecting the regulatory process for all financial regulators that is beyond the scope of this report. For more information, see CRS Report R44839, *The Financial CHOICE Act in the 115th Congress: Selected Policy Issues*, by (name redacted) et al.

FY2018 Financial Services and General Government Appropriations Act (H.R. 3280), as reported by the Appropriations Committee on July 18, 2017, and an omnibus appropriations act (H.R. 3354), as passed by the House on September 14, 2017.

- The Monetary Policy Transparency and Accountability Act (H.R. 4270), the Independence from Credit Policy Act (H.R. 4278), and the Congressional Accountability for Emergency Lending Programs Act (H.R. 4302) were ordered to be reported by the House Financial Services Committee on November 14, 2017.
- The Federal Reserve Transparency Act (H.R. 24) was ordered to be reported by the House Oversight and Government Reform Committee on March 28, 2017.

## **Governance Proposals**

### **Background**

The Federal Reserve Act (12 U.S.C. §221 et seq.) created the Fed as the nation’s central bank in 1913. The basic governance structure is largely unchanged in recent decades. The Fed is composed of 12 regional Federal Reserve banks overseen by a Board of Governors in Washington, DC. The board comprises seven governors nominated by the President and confirmed by the Senate. The President selects (and the Senate confirms) a chair and two vice chairs for the Board from among the governors. The governors serve nonrenewable 14-year terms, but the chair and vice chairs serve renewable 4-year terms. Board members are chosen without regard to political affiliation.

In general, the board formulates policy and the regional banks carry it out. Monetary policy decisions, however, are made by the Federal Open Market Committee (FOMC), which is composed of the seven governors, the president of the New York Fed, and four other regional bank presidents. The Chair of the Board is also the Chair of the FOMC. Representation for these 4 seats rotates among the other 11 regional banks. Thus, the governors have more votes on the FOMC than the regional bank presidents when all board positions are filled; however, the board has experienced frequent vacancies in recent years. The FOMC meets at least every six weeks to set monetary policy.

Aside from its permanent seat on the FOMC, the New York Fed has no special role in the Federal Reserve Act compared with other Fed regional banks. Nevertheless, it has taken on certain prominent roles within the system. It carries out the open market operations that implement the FOMC’s monetary policy decisions. During the financial crisis, the New York Fed ran many of the Fed’s emergency programs (discussed in the “Emergency Lending” section below). It supervises many of the largest banks because they are headquartered in the New York Fed’s District. The New York Fed is responsible for conducting foreign exchange transactions on behalf of the government and storing the gold of foreign central banks and international agencies. In all of these instances, it is executing, not formulating, policy. By tradition, the FOMC elects the New York Fed president to be vice chair of the FOMC, a position with no formal powers.

The Fed’s capital comprises paid-in capital issued to member banks and retained earnings deposited in its surplus account. Private banks regulated by the Fed buy stock in the Fed to become member banks. Membership is mandatory for national banks, but optional for state banks. To finance the creation of the Fed, the Federal Reserve Act required member banks to purchase Fed-issued stock. Member banks are required to purchase (“pay in”) stock equal to 3%

of their capital, and the Fed has the option to call in an additional 3%. The stock can be thought of as a risk-free investment; it pays dividends, which was fixed by statute at 6% from 1913, until modified in 2015. Ownership of stock in the Fed confers more limited rights than common stock in a private corporation. For example, stockholders have no control over Fed policy.

Stockholders choose two-thirds of the board of directors at the regional Fed banks, however. Each regional Fed bank has a board that is composed of three Class A directors, required to be representatives of the banking industry chosen by member banks; three Class B directors, representatives of the public chosen by member banks; and three Class C directors, representatives of the public chosen by the Board of Governors. A chairman and deputy chairman of the board are selected from among the Class C directors. The other main difference between the classes of directors is their role in choosing the regional bank presidents. Regional bank presidents are chosen by the Class B and C directors of their boards—not by the President—and must be approved by the Board of Governors.

## Policy Proposals

**Voting on the FOMC.** H.R. 10 would change the FOMC’s voting membership to increase the number of regional bank presidents from five to six and allow them each to vote every other year.<sup>5</sup> To accomplish this, it would reduce the frequency of the New York Fed’s voting rights from every year to every other year and increase the frequency of voting rights for 9 of the other 11 banks from every third year to every other year.<sup>6</sup>

**Interest Paid on Reserves.** H.R. 10 would shift responsibility for setting the interest rate paid to banks on reserves from the Board of Governors to the FOMC. Congress granted the Fed the authority to pay interest on reserves in 2008 (P.L. 110-343). The Fed uses this interest rate to help it achieve its federal funds rate target, which is set by the FOMC, in the presence of the Fed’s large balance sheet.<sup>7</sup>

**Staff for Governors.** H.R. 10 would allow each board member to hire at least two personal staff. Currently, the board and its governors share professional staff.

**Congressional Commission.** H.R. 10 would create a commission whose voting members are composed of four Members of the House from the majority party, two Members of the House from the minority party, four Members of the Senate from the majority party, and two Members of the Senate from the minority party. The commission would examine and make recommendations on monetary policy, the dual mandate,<sup>8</sup> macroprudential regulation, and lender of last resort functions. The commission is authorized to be funded through congressional appropriations.

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<sup>5</sup> Although the Fed’s Board of Governors members would still have more seats on the Federal Open Market Committee (FOMC) than the Fed presidents, because of the frequent vacancies on the board, this change would make it more likely that the presidents would outnumber FOMC board members at any given time.

<sup>6</sup> Under current law, the Federal Reserve Banks of Chicago and Cleveland presidents already vote on the FOMC every other year.

<sup>7</sup> For more information on the Fed’s balance sheet, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by (name redacted)

<sup>8</sup> Under what is popularly known as the dual mandate (12 U.S.C. §225a), the Fed is required to “maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

**Conflict of Interest.** H.R. 10 would add ethics standards and conflict of interest rules on investments, outside employment, and outside publications for board governors and staff. Fed employees are currently subject to government-wide conflict of interest standards (18 U.S.C. 208) and employees of the Board of Governors are subject to ethics standards (5 C.F.R. 6801).

## Oversight and Disclosure Proposals

### Background

Critics of the Federal Reserve have long argued for more congressional oversight, Fed transparency, and Fed disclosure. Criticism intensified following the extensive assistance that the Fed provided during the financial crisis.

Some critics have downplayed the degree of oversight and disclosure that already takes place. For congressional oversight, since 1978, the Fed has been statutorily required to report to and testify before the House and Senate committees of jurisdiction semiannually. At these hearings, which take place in February and July, the Fed chairman presents the Fed's *Monetary Policy Report to the Congress*, testifies, and responds to questions from committee members.<sup>9</sup> In addition, these committees periodically hold more focused hearings on Fed topics. On January 25, 2012, the Fed began publishing forecasts for its federal funds rate target and announced a longer-run goal of 2% for inflation. According to the Fed, it hopes greater transparency about its intentions will strengthen financial market participants' understanding of its actions, thereby making those actions more effective.<sup>10</sup>

Contrary to popular belief, the Government Accountability Office (GAO) has conducted audits of the Fed's regulatory and payment activities regularly since 1978, subject to statutory restrictions. In addition, private-sector auditors audit the Fed's financial statements and the Fed has an Office of Inspector General. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) required an audit of the Fed's emergency activities during the financial crisis, released in July 2011, and an audit of Fed governance, released in October 2011. The effective result of the audit restrictions remaining in law is that GAO can audit the Fed's monetary policy decisions or operations, transactions with foreign central banks and governments, discount window operations, or policies related to bank reserves or securities credit for waste, fraud, and abuse, but cannot evaluate the economic merits of these actions.<sup>11</sup>

The Fed's budget is not subject to congressional appropriations, limiting congressional oversight compared with appropriated agencies. Although Congress still sometimes attaches Fed "policy riders" to appropriations acts, in the absence of agency appropriations, Congress cannot prescribe the size or uses of the Fed's budget. The Fed is self-funded by fees and the income generated by securities it owns. Its income exceeds its expenses, and it remits most of its net income to the Treasury, where it is used to reduce the federal debt. The Fed uses a small portion of its net income to pay dividends to member banks and to add to its surplus when necessary.

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<sup>9</sup> These hearings and reporting requirements were established by the Full Employment Act of 1978 (P.L. 95-523, 92 Stat 1897), also known as the Humphrey-Hawkins Act, and renewed in the American Homeownership and Economic Opportunity Act of 2000 (P.L. 106-569).

<sup>10</sup> Ben Bernanke, "Communication and Monetary Policy," speech at the National Economists Club, Washington, DC, November 19, 2013, at <http://www.federalreserve.gov/newsevents/speech/bernanke20131119a.htm>.

<sup>11</sup> 31 U.S.C. §714.



For Fed disclosure, the Fed has publicly released extensive information on its operations, mostly on a voluntary basis. It is statutorily required to release an annual report and a weekly summary of its balance sheet. The expanded scope of the Fed's lending activities during the financial crisis eventually led it to release a monthly report that offered more detailed information. In December 2010, the Fed released individual lending records for emergency facilities, revealing borrowers' identities and loans' terms, as required by the Dodd-Frank Act. Going forward, individual records for discount window and open market operation transactions have been released with a two-year lag.

More recently, some Members of Congress have sought greater disclosure of information related to regulation (including international agreements), and salary and financial information about Fed officials and employees. In its rule-making, the Fed follows the standard notice and public comment process and must consider the burdens and benefits for depository institutions,<sup>12</sup> but is not required to conduct formal or quantitative cost-benefit analysis. The Fed has an ombudsman and an appeals process for its supervisory decisions, such as exam results. The Dodd-Frank Act created a vice chair for supervision who is required to testify before the committees of jurisdiction semiannually; that position has not yet been filled, however.

For more information, see CRS Report R42079, *Federal Reserve: Oversight and Disclosure Issues*, by (name redacted)

## Analysis

Although oversight and disclosure are often lumped together, they are separate issues and need not go together. Oversight relies on independent evaluation of the Fed; disclosure is an issue of what internal information the Fed releases to the public. Contrary to a common misperception, a GAO audit would not, under current law, release any confidential information identifying institutions that have borrowed from the Fed or the details of other transactions.

A potential consequence of greater oversight is that it could undermine the Fed's political independence. Most economists believe that the Fed's political independence leads to better policy outcomes and makes policy more effective by enhancing the Fed's credibility in the eyes of market participants. The Fed has opposed legislation removing remaining GAO audit restrictions on those grounds. Disclosure helps Congress and the public better understand the Fed's actions. Up to a point, this makes monetary and regulatory policies more effective, but too much disclosure could make both less effective because they rely on market-sensitive and confidential information. The challenge for Congress is to strike the right balance between a desire for the Fed to be responsive to Congress and for the Fed's decisions to be immune from political calculations and pressure.

A different standard of oversight and independence for monetary policy and the Fed's regulatory role might be conceptually desirable, but difficult to disentangle in reality. For example, if the Fed's regulatory budget were subject to congressional appropriations, Congress could potentially adjust that budget in response to disagreements about the Fed's monetary policy decisions.

## Policy Proposals

**GAO Audit.** H.R. 10 would remove statutory restrictions on GAO audits of monetary policy and would require an annual audit that is not subject to current statutory provisions, such as

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<sup>12</sup> P.L. 103-325.



confidentiality requirements. H.R. 24 would remove statutory restrictions on GAO audits of monetary policy and require a one-time GAO audit of the Fed that is not subject to statutory restrictions. Effectively, this would expand GAO's powers to allow it to evaluate the economic merits of the Fed's policy decisions.

**Blackout Period.** H.R. 10 would mandate a media blackout period lasting from one week before to one day after an FOMC meeting, in which monetary policy decisions are made.<sup>13</sup>

**Testimony and Report to Congress on Monetary Policy.** H.R. 10 would increase the frequency of the Fed's required monetary policy reports to Congress from semiannually to quarterly and would require the chair to testify on monetary policy before the committees of jurisdiction quarterly instead of semiannually.

**Vice Chair of Supervision.** The Dodd-Frank Act created the position of vice chair of supervision on the Board of Governors and required the vice chair to testify on Fed supervision semiannually. H.R. 10 would change the frequency of testimony to quarterly and require a written report on ongoing rulemaking to accompany that testimony. It would also require the Chair to testify in place of the Vice Chair if the latter position is vacant.

**Release of FOMC Transcripts.** H.R. 10 would require FOMC transcripts to be made publicly available. Currently, the Fed voluntarily releases the transcripts to the public with a five-year lag and FOMC meetings minutes with a six-week lag.

**Appropriations.** H.R. 10 would subject the nonmonetary policy functions of the Fed's Board of Governors and 12 privately owned regional banks to the congressional appropriations process. It would require the Fed to assess fees to cover the costs of appropriations, which would become offsetting collections to these appropriations in the federal budget. Expenses are currently financed primarily out of income earned on the Fed's securities holdings. Because the Fed remits most of its net income to the Treasury, CBO estimated that the new fees would increase federal revenues.<sup>14</sup> A similar provision was also included in the FY2018 Financial Services and General Government Appropriations Act (H.R. 3280), as reported, and an omnibus appropriations act (H.R. 3354), as passed by the House.

**Disclosure of Supervisory Information.** H.R. 10 would require the Fed to determine its stress test scenarios through the public rulemaking process and provide those scenarios to GAO and CBO's Panel of Economic Advisers. Currently, the scenarios are not disclosed to the banks or the public, but the stress test process was publicly described through the standard rulemaking process.

**Cost-Benefit Analysis Requirements.** H.R. 10 would subject all federal financial regulators, including the Fed, to quantitative cost-benefit analysis when issuing new rules and retrospectively five years after a final rule is issued.

**Disclosure of International Negotiations.** H.R. 10 would require the Fed (and other federal banking regulators) to notify the committees of jurisdiction and the public and solicit public comment at least 30 days before it enters into and at least 90 days before it completes international negotiations on financial standards.

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<sup>13</sup> The Fed has voluntarily adopted a similar policy. See Federal Open Market Committee, *FOMC Policy on External Communications of Federal Reserve Staff*, amended January 31, 2017, [http://www.federalreserve.gov/monetarypolicy/files/FOMC\\_ExtCommunicationStaff.pdf](http://www.federalreserve.gov/monetarypolicy/files/FOMC_ExtCommunicationStaff.pdf).

<sup>14</sup> Congressional Budget Office, *Cost Estimate for the Manager's Amendment to H.R. 10*, June 6, 2017, at <https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/hr10managers.pdf>.

**Disclosure of Salaries and Financial Information.** H.R. 10 would require the public disclosure of salary and personal finances for all Fed governors, officers, and employees of the Federal Reserve Board of Governors with a salary above the equivalent of GS-15 on the government scale.

## Rules-Based Monetary Policy (The Taylor Rule)

### Background

Congress has granted the Fed broad discretion to conduct monetary policy as it sees fit as long as it strives to meet its statutory mandate. This discretion includes autonomy over what policy tools to use (e.g., whether policy should be carried out by targeting the federal funds rate) and what the stance of monetary policy should be (e.g., at what level should the federal funds rate target be set?).

Some Members of Congress, dissatisfied with the Fed’s conduct of monetary policy, have looked for alternatives to the current regime. Some opponents of Fed discretion argue for a rules-based regime. One example of a monetary policy rule is the Taylor rule, which was developed by Economist John Taylor to describe and evaluate the Fed’s interest rate decisions.<sup>15</sup>

Normally, the Fed carries out monetary policy primarily by setting a target for the federal funds rate, the overnight inter-bank lending rate.<sup>16</sup> The Taylor rule is a simple mathematical formula that, in the best-known version (described in the text box below), relates interest rate changes to changes in the inflation rate and the output gap. These two factors directly relate to the Fed’s statutory mandate to achieve “maximum employment and stable prices.”

Taylor rules are currently used in economic analysis to explain the Fed’s past actions or to offer a baseline in an evaluation of what the Fed has done or should do in the future. A Taylor rule (although with different parameters from this example) has been demonstrated to track actual policy relatively well for the period lasting from after inflation declined in the 1980s to the beginning of the financial crisis in 2007.<sup>17</sup> Thus, it can be used in an economic model (which offers a simplified version of the actual economy) to represent the Fed’s decisions under normal economic conditions.

A limitation of the Taylor rule is that it was designed only to be used with the federal funds rate, which was the Fed’s primary monetary policy instrument from roughly the early 1990s to late 2008. From December 2008 to October 2014, the Fed did not use the federal funds rate as its primary policy tool because the rate was at the “zero lower bound”—it was set near zero, and thus could not be lowered further. Instead, the Fed created new policy tools such as “quantitative easing” (QE) to stimulate the economy.<sup>18</sup> The Taylor rule cannot make policy prescriptions at the zero lower bound—different combinations of deflation (falling prices) and output gaps would

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<sup>15</sup> John Taylor, “Discretion vs. Policy Rules in Practice,” *Carnegie-Rochester Conference Series on Public Policy*, 1993, p. 195.

<sup>16</sup> For an overview, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by (name redacted) Monetary Policy and the Federal Reserve: Current Policy and Conditions, by (name redacted).

<sup>17</sup> Charles Carlstrom and Saeed Zaman, “Using an Improved Taylor Rule to Predict When Policy Changes Will Occur,” Federal Reserve Bank of Cleveland, *Economic Commentary*, March 2014.

<sup>18</sup> For more information, see CRS Report R42962, *Federal Reserve: Unconventional Monetary Policy Options*, by (name redacted)

prescribe a negative federal funds rate under the Taylor rule, but that prescription would not be actionable because the federal funds rate is a market rate.<sup>19</sup> The Taylor rule was devised at a time when interest rates had never fallen to the zero bound before, and it arguably seemed reasonable at the time to assume that the rule would not need to cover this contingency.

### The Traditional Form of the Taylor Rule

The best-known version of the Taylor Rule is:

$$FFR = (R + I) + 0.5 \times (\text{output gap}) + 0.5 \times (I - IT)$$

where:

*FFR* = federal funds rate

*R* = equilibrium real interest rate (assumed here to equal 2)

*output gap* = percent difference between actual GDP and potential GDP

*I* = inflation rate

*IT* = inflation target (assumed here to equal 2)

If actual GDP is equal to potential GDP and inflation is equal to its target, this rule calls for the federal funds rate to be 2% above the current inflation rate (because  $R = 2\%$ ). This is assumed to be the “neutral” interest rate, at which monetary policy is neither stimulative nor contractionary.

The goal of achieving maximum employment is represented by the factor  $0.5 \times (\text{output gap})$ . The output gap is the difference between actual and potential GDP. Potential GDP is the level of output that would be produced if all of the economy’s labor and capital resources were being used. In economic downturns, actual GDP falls below potential because some resources are idle; likewise, the economy can temporarily be pushed above a level of output that is sustainable. In this rule, when the economy is below full employment, the output gap is expressed as a negative number, calling for lower interest rates. This Taylor rule states that when actual GDP is, say, 1% below potential GDP, the federal funds rate should be 0.5 percentage points below the neutral rate.

Changes in inflation enter the Taylor rule in two places. First, the nominal neutral rate rises with inflation (in order to keep the inflation-adjusted neutral rate constant). Second, the goal of maintaining price stability is represented by the factor  $0.5 \times (I - IT)$ , which states that the FFR should be 0.5 percentage points above the inflation-adjusted neutral rate for every percentage point that inflation (*I*) is above its target (*IT*), and lowered by the same proportion when inflation is below its target. Unlike the output gap, the inflation target can be set at any rate desired. For illustration, it is set at 2% inflation here, which is the Fed’s longer-term goal for inflation.

The variables in the same formula can also be rearranged to be expressed as:

$$FFR = R + 0.5 \times (\text{output gap}) + 1.5 \times I - 0.5 \times IT$$

Although a specific example has been provided here for illustrative purposes, a Taylor rule could include other variables, and any of the parameters (*R*, *IT*, and the weights on the output gap and inflation) could be set at any level.

## Analysis

Economists and policy analysts have debated whether basing monetary policy decisions on a Taylor rule would lead to better economic outcomes than the status quo. The Fed already uses the Taylor rule as a reference tool to help inform its policy decisions.<sup>20</sup> Proponents would like the Taylor rule to have a more formal role in policymaking, either requiring policy to be set by a Taylor rule or requiring the Fed to explain its decisions relative to a Taylor rule.<sup>21</sup> Under current

<sup>19</sup> A few foreign central banks have recently set their equivalent of the interest rate that the Fed pays on bank reserves slightly below zero, but economists assume that interest rates could not fall much lower than this in practice because of the incentive for private actors to switch their holdings to currency, which cannot have a negative nominal rate of return.

<sup>20</sup> See, for example, Janet Yellen, “Perspectives on Monetary Policy,” speech at the Boston Economic Club Dinner, June 2012.

<sup>21</sup> See, for example, John Taylor, “Legislating a Rule for Monetary Policy,” speech at the Cato Institute, November 18, 2010.

law, if the Fed desired, it could arguably adopt these proposals voluntarily (e.g., the FOMC could agree to base their vote on a Taylor rule's prescription). Legislative changes would be needed to require the Fed to adopt these proposals, however.

The desirability of basing policy on a Taylor rule (whether it takes the form presented above or an alternative form) can be viewed through the prism of the economic debate about the superiority of rules versus discretion in policymaking.<sup>22</sup> Economists who favor the use of rules argue that policy is more effective if it is predictable and transparent. They argue that unpredictable policy results in financial and economic instability. For example, there can be large movements in financial prices when the Fed makes a policy change that "surprises" financial markets. In addition, a formal role for a Taylor rule could potentially help Congress in its oversight capacity by providing a clear benchmark against which the Fed's decisions could be evaluated.

Economists favoring discretion argue that policymakers need flexibility to manage an inherently complex economy that is regularly hit by unexpected shocks. For example, rules might have hindered the Fed's ability to respond to the housing bubble and the financial crisis in the late 2000s. In principle, a Taylor rule need not be limited to inflation and the output gap, but making it more complex would reduce the perceived benefits of transparency and predictability. Likewise, periodically modifying the form that the Taylor rule takes in response to unforeseen events would reduce predictability and increase discretion. Further, how could a Taylor rule incorporate amorphous concerns about, say, financial stability or asset bubbles when there is no consensus on how to quantify them? A Taylor rule requires data points that are easy to measure and accurately embody a larger economic phenomenon of concern. Using forecasts would probably be preferable to using actual data in the Taylor rule because monetary policy affects the economy with lags, but would potentially reintroduce policy discretion (because the Fed would produce the forecast). Furthermore, if perceived policy errors were mainly caused by forecasting errors (e.g., the failure to identify the housing bubble), then using a Taylor rule based on forecasts would probably not have prevented them. Any of these issues could be addressed by modifying the Taylor rule, but this would arguably reduce the perceived benefits of a rules-based regime.

Other practical challenges with formalizing the use of the traditional Taylor rule in policymaking include (1) the requisite data are released with lags and later revised; (2) the neutral rate of interest and potential output growth cannot be directly observed and may vary over time, making them difficult to estimate accurately in real time;<sup>23</sup> (3) a FFR based only on inflation and the output gap would make it more volatile; (4) public comprehension; and (5) how to address the zero bound issue.

Originally, rules were favored by economists who believed that Fed discretion was responsible for high inflation, but inflation has been low since the 1990s and below 2% by the Fed's preferred measure since 2013. Recently, Taylor rules have been used to support criticism that the Fed has engaged in too much stimulus.<sup>24</sup> Policy rules in general do not inherently have a pro- or anti-

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<sup>22</sup> Milton Friedman, "Monetary Policy: Theory and Practice," *Journal of Money, Credit, and Banking*, vol. 14, 1982, p. 98.

<sup>23</sup> Recent research suggests that the neutral rate has fallen since the financial crisis, in which case the traditional Taylor rule would have set interest rates too high. See, for example, William Dupor, "Liftoff and the Neutral Rate," Federal Reserve Bank of St. Louis, *Economic Synopses*, no. 12, June 2015, at <https://research.stlouisfed.org/publications/economic-synopses/2015/06/05/liftoff-and-the-natural-rate-of-interest/>.

<sup>24</sup> See John Taylor, "Monetary Policy Rules Work and Discretion Doesn't," *Journal of Money, Credit, and Banking*, vol. 44, no. 6, September 2012, p. 1017. Taylor uses a Taylor rule to argue that there has been too much monetary stimulus since 2003. The traditional Taylor rule was not designed to prescribe unconventional policies, but it does not follow that the adoption of a Taylor rule would prevent unconventional policy because, in principle, a new version of (continued...)

stimulus bias, however, as their parameters can be adjusted to meet policymakers' goals. Policymakers who emphasize price stability could put a relatively high weight on the inflation parameter. Alternatively, policymakers who want the Fed to be responsive to (high or low) growth could put a relatively high weight on the output gap parameter. Because the form that a Taylor rule takes involves, in part, value judgments about the goals of monetary policy and the best way to achieve those goals, choosing its form involves political tradeoffs and economic modeling.

As mentioned above, as long as the Fed prefers discretionary policy, it can only be forced to adopt rules-based policy through legislation. It would arguably be difficult, however, for Congress to determine what would be the best form of Taylor rule for the Fed to follow or when the Fed should be allowed to deviate from the rule's prescription. It needs the Fed's cooperation to devise and implement a rules-based policy, but the Fed has little incentive to "tie its own hands." If Congress wanted the Fed to adhere to both the spirit and letter of any law that reduced the Fed's discretion, it may need to find legal carrots or sticks to succeed. But exposing the Fed to negative consequences when it does not follow the monetary policy that Congress prefers would be antithetical to the Fed's independence from Congress. It would provide Congress a new avenue to potentially apply political pressure on the Fed's monetary policymaking, even if that is not the proponents' intent. Thus, the challenge for proponents of rules-based policy is how to ensure less discretion without compromising the Fed's independence.

## Policy Proposals

H.R. 10 would require the Fed to formulate a mathematical rule (called the "Directive Policy Rule") that would instruct it how to set monetary policy (e.g., prescribe the current level of the federal funds rate) that would achieve its mandate of stable prices and maximum employment based on macroeconomic variables. The Fed would be required to publish a five-year projection of inflation under its rule. H.R. 10 would also require the Fed to calculate a traditional Taylor rule (called the "Reference Policy Rule" in the bill), as described in the text box, and compare it to the Directive Policy rule. Within 48 hours of a policy decision, the Fed would be required to submit the prescription of its rule to GAO and the committees of jurisdiction. GAO would report to Congress if the Fed was in compliance with the act's requirements, and if it was not, it would trigger a GAO audit that was not subject to the normal statutory restrictions (described "Oversight and Disclosure Proposals" section above) and the Fed chair's testimony before the committees of jurisdiction.

H.R. 4270 would require the Fed to annually publish a monetary policy strategy laying out its expectations for monetary policy that year. It would require the Fed to adopt 1-3 mathematical policy rules intended to represent how monetary policy reacts to changes in the economy. The Fed would be required to issue a report to the committees of jurisdiction semi-annually on how the Fed's strategy or monetary policy decisions differ from the policy rules.

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(...continued)

the rule could be designed to base unconventional policies on, say, data on inflation and the output gap.

# Emergency Lending

## Background

Under normal authority, the Fed faces statutory limitations on whom it may lend to, what it may accept as collateral, and for how long it may lend. If the Fed wishes to extend credit that does not meet these criteria, it can turn to emergency lending authority found in Section 13(3) of the Federal Reserve Act.

The worsening of the financial crisis in 2008 led the Fed to revive this obscure provision to extend credit to nonbank financial firms for the first time since the 1930s. Using this authority, the Fed created six broadly based facilities (of which only five were used) to provide liquidity to *primary dealers* (i.e., certain large investment firms) and to revive demand for commercial paper and asset-backed securities. More controversially, the Fed provided special, tailored assistance exclusively to four firms that the Fed considered “too big to fail”—AIG, Bear Stearns, Citigroup, and Bank of America.

Credit outstanding (in the form of cash or securities) authorized by Section 13(3) peaked at \$710 billion in November 2008. At present, all credit extended under Section 13(3) has been repaid with interest and all Section 13(3) facilities have expired. Contrary to popular belief, under Section 13(3), the Fed earned income of more than \$30 billion and did not suffer any losses on those transactions. The transactions exposed the taxpayer to greater risks than traditional lending to banks through the discount window, however, because in some cases the terms of the programs had fewer safeguards.

The restrictions in Section 13(3) placed few limits on the Fed’s actions in 2008. However, in 2010, the Dodd-Frank Act added more restrictions to Section 13(3), attempting to ban future assistance to failing firms while maintaining the Fed’s ability to create broadly based facilities. It also attempted to limit taxpayer’s risk, prevent the Fed from removing assets (as was done in assistance to Bear Stearns and AIG), and terminate assistance in a timely fashion.<sup>25</sup> The Dodd-Frank Act also required records for actions taken under Section 13(3) to be publicly released with a lag and required GAO to audit those programs for operational integrity, accounting, financial reporting, internal controls, effectiveness of collateral policies, favoritism, and use of third-party contractors.

For more information, see CRS Report R44185, *Federal Reserve: Emergency Lending*, by (name redacted)

## Analysis

The Fed’s use of Section 13(3) in the financial crisis raised fundamental policy issues:

- Should the Fed be lender of last resort to banks only or to all parts of the financial system? Is this a more appropriate role for the Fed or Treasury?
- Should the Fed lend to firms that it does not supervise?

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<sup>25</sup> The Fed issued a final rule implementing Dodd-Frank changes to Section 13(3) on November 30, 2015. See Federal Reserve, “Extensions of Credit by Federal Reserve Banks,” RIN 7100-AE08, November 30, 2015, at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20151130a.htm>.



- How much discretion does the Fed need to be able respond to unpredictable financial crises?
- Do emergency lending benefits, such as quelling liquidity panics, outweigh the costs, including moral hazard?
- Should Fed emergency lending be approved by Congress? Would the need for Congressional approval create market uncertainty that caused financial instability? Would Congress act fast enough to maintain financial stability?
- How can Congress ensure that taxpayers are not exposed to losses?
- How can Congress ensure that Section 13(3) is not used to “bail out” failing firms?
- Should the Fed tell Congress and the public to whom it has lent? Would that result in a stigmatizing effect that made firms in need of liquidity unwilling to borrow from the Fed?

Fed governor Jerome Powell has opposed further reducing the Fed’s discretion under Section 13(3) on the grounds that the Fed needs “to be able to respond flexibly and nimbly” to future threats to financial stability.<sup>26</sup> Although Section 13(3) must be used “for the purpose of providing liquidity to the financial system,” some Members of Congress have expressed interest in—while others have expressed opposition to—the Fed using Section 13(3) to assist financially struggling entities, including states, municipalities, and territories of the United States.

## Policy Proposals

Some Members of Congress believe that the Dodd-Frank Act did not sufficiently limit the Fed’s discretion. H.R. 10 and H.R. 4302 would amend Section 13(3) to limit the Fed’s discretion to make emergency loans. Changes can be divided into a few categories:

**Preconditions for Use.** H.R. 10 and H.R. 4302 would limit 13(3) to “unusual and exigent circumstances that pose a threat to the financial stability of the United States.” H.R. 10 would require “the affirmative vote of not less than nine presidents of Federal reserve banks” in addition to the current requirement of the affirmative vote of five Fed governors, while H.R. 4302 would require “the affirmative vote of not less than two-thirds of the members of the FOMC.”<sup>27</sup>

**Collateral.** H.R. 10 and H.R. 4302 would forbid the Fed from accepting as collateral equity securities issued by a borrower. The bills would also require the Fed to issue a rule establishing how it would determine sufficiency of collateral, acceptable classes of collateral, any discount that would be applied to determine the sufficiency of collateral, and how it would obtain independent appraisals for valuing collateral.

**Eligibility.** H.R. 10 and H.R. 4302 would eliminate the current language permitting the Fed to establish a borrower’s solvency based on the borrower’s certification and would specify that before a borrower may be eligible for assistance, the Fed’s board and any other federal banking regulator with jurisdiction over the borrower must certify that the borrower is not insolvent. The bills would limit assistance to institutions “predominantly engaged in financial activities” and

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<sup>26</sup> Governor Jerome H. Powell, ““Audit the Fed’ and Other Proposals,” speech at the Catholic University of America, Columbus School of Law, Washington, DC, February 9, 2015, at <http://www.federalreserve.gov/newsevents/speech/powell20150209a.htm>.

<sup>27</sup> As noted above, the FOMC is composed of the 7 Fed governors and 5 of the 12 Fed regional bank presidents.



preclude assistance to federal, state, and local government agencies and government-controlled or -sponsored entities.

**Lending Rate.** H.R. 10 and H.R. 4302 would require the Fed to issue a rule establishing a minimum interest rate on emergency loans based on the sum of the average secondary discount rate charged by the Federal Reserve banks over the most recent 90-day period and the average of the difference between a distressed corporate bond index (as defined by a Fed-issued rule) and the Treasury yield over the most recent 90-day period.

**Congressional Approval.** H.R. 4302 would require a joint resolution to be enacted into law within 30 days of congressional notification or else a lending facility created under Section 13(3) would automatically terminate. The joint resolution would be considered under special expedited (“fast track”) parliamentary procedures.

## The Fed’s Balance Sheet

### Background

Before the financial crisis, the Fed balance sheet predominantly consisted of Treasury securities that it acquired through open market operations (financial transactions in secondary markets to implement monetary policy). In response to the financial crisis, the Fed acquired over \$1 trillion of mortgage-backed securities (MBS) and other debt issued by the government-sponsored enterprises (GSEs). The Fed is now gradually reducing its holdings of MBS with the goal of eventually returning to a Treasury-only balance sheet. In the meantime, the Fed will continue to hold large amounts of MBS for the next several years under current plans.<sup>28</sup>

In addition, the Fed acquired more exotic private securities through some of its 13(3) lending facilities during the financial crisis. These securities matured or were sold off relatively quickly after financial conditions stabilized, and only residual holdings have remained since 2012.<sup>29</sup>

### Analysis

The types of assets that the Fed can purchase through open market operations are relatively limited under current law. It is limited to reduce the riskiness of the Fed’s portfolio and to limit the Fed’s influence on the allocation of credit—were the Fed to purchase securities issued by specific private firms, it could have an outsized effect on those firms’ cost of credit relative to their competitors.

The Fed may purchase any type of security fully guaranteed by the federal government or a federal agency, however. As a practical matter the Fed has not held most agencies’ securities because there are few federal agencies that issue publicly traded securities in large amounts or at all. For the purposes of this statutory provision, notable exceptions are the GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks) and Ginnie Mae. Although this authority far predates the financial crisis, it enabled the Fed to accumulate over \$1 trillion in MBS issued by these entities in an attempt to help stabilize housing markets. Unlike 13(3) lending, there are no

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<sup>28</sup> For more information, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by (name redacted)

<sup>29</sup> For more information, see CRS Report R44185, *Federal Reserve: Emergency Lending*, by (name redacted)

comparable statutory restrictions or requirements on its ability to acquire or hold MBS through open market operations.

Outside of open market operations, the Fed's authority is largely limited to lending. Borrowers from the Fed post collateral to back loans, and the Fed could wind up acquiring this collateral if the loans are not repaid, however. The Fed allows a broader range of collateral to be posted than the types of securities it may purchase through open market operations. Furthermore, the Fed acquired some private securities during the financial crisis under 13(3) by lending to limited liability corporations that it created and controlled so that those LLCs could purchase assets that the Fed was not permitted to purchase through open market operations. In a joint announcement in March 2009, the Treasury and Fed stated a desire to transfer some of these assets to the Treasury in the long run, but never followed up on this announcement.<sup>30</sup>

## **Proposals**

H.R. 4278 would limit the types of securities that the Fed may acquire through open market operations to gold, Treasury currency (e.g., coins), or the direct obligations of the federal government, foreign central banks (e.g., foreign currency), or the International Monetary Fund (e.g., special drawing rights). This would eliminate the Fed's authority to purchase short-term municipal tax anticipation notes,<sup>31</sup> foreign government bonds, and securities guaranteed by federal agencies (e.g., agency MBS). It would require the Fed to swap any other assets (that it already holds or subsequently acquires) for federal debt of equal market value with the Treasury Department. Currently, that would require it to swap its large MBS holdings and residual 13(3) holdings. The Treasury would issue new debt to swap with the Fed. Presumably, the Treasury Department's ability to issue debt to swap with the Fed would be limited by the debt limit, which the bill does not raise, unless Treasury sold the securities it received from the Fed immediately. The bill would also remove current statutory restrictions on the Fed's ability to buy debt directly from Treasury; this restriction is intended to prevent the Fed from "printing money to fund the budget deficit."

The bill would also repeal the Fed's authority to make emergency loans to groups of banks, a power that has not been used because the Fed also has the authority to lend to individual banks. The bill would also limit the use of mortgages as collateral backing discount window loans.

## **Concluding Thoughts**

The proposals in this report are wide ranging and diverse but are united by the goals of increasing the Fed's accountability to Congress and decreasing Fed discretion. Whereas some provisions make minor changes, taken together the proposals would arguably somewhat reduce the Fed's independence from Congress. There is a long-standing policy debate about how independent regulatory agencies should be from Congress and the President, with proponents for independence arguing that it will lead to more technocratic decisionmaking and opponents arguing it leads to opaque, undemocratic, and unresponsive decisionmaking. For decades, the Fed has enjoyed an unusual degree of independence from Congress and the President compared with other government agencies, which has typically been justified in terms of insulating its monetary

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<sup>30</sup> Federal Reserve and U.S. Treasury Department, "The Role of the Federal Reserve in Preserving Financial and Monetary Stability," joint press release, March 23, 2009.

<sup>31</sup> The Fed has not used its authority to purchase tax anticipation notes.

policy decisions from political pressures.<sup>32</sup> To some extent, a tradeoff between independence and accountability is unavoidable. Besides the Taylor Rule, few of the provisions reviewed in this report directly relate to monetary policy, but may indirectly influence monetary policy through changes in how decisions are made, who makes decisions, and Congress's oversight of those decisions.

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<sup>32</sup> For more information, see CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by (name redacted), (name redacted), and (name redacted)

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