

Monetary Policy Rules for Efficiency and Liberty¹

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In these remarks I endeavor to answer the question presented for consideration by this panel: “what kind of monetary policy is (1) *most efficient* and (2) *consistent with liberty*?” My answer—perhaps not surprisingly—is, on both counts, a *rules-based* monetary policy. I first explain why that’s the best answer, and I then argue that the answer holds regardless of the type of monetary system in play. While some rules-based policies are better than others, rules are superior to the pure discretion of authorities. I also show that a rules-based approach has significant advantages in the international economy, not only in a single country or region.

Rules-Based Monetary Policy is Efficient

I have found in my research over many years with many models that rules-based monetary policy is more efficient than discretion in the sense that it leads to a more stable economy with sustainable economic growth. In recent years, model-based policy research has improved greatly, and it has incorporated robustness to different modelling assumptions through the development of macro model data bases, such as the one developed by Volker Wieland with more than 100 models (see Wieland, Volker, E. Afanasyeva, M. Kuete, and J. Yoo (2016)).

Historical and direct econometric evidence also points to a close connection between adherence to policy rules and superior economic performance. Allan Meltzer (2012) provided historical evidence for the United States, Nikol'sko-Rzhevskyy, Papell, Prodan (2014) provided econometric evidence for the United States, and Teryoshin (2017) provided econometric for other countries.

To summarize, policy rules are efficient for the following reasons (see Taylor 2019)):

Time inconsistency. The time inconsistency problem calls for the use of a policy rule in order to reduce the chance that the monetary policy-makers will change their policy after people in the private sector have taken their actions.

Clearer explanations. If a policy rule is simple, it can make explaining monetary policy decisions to the public or to students of public policy much easier. It is difficult to explain why a specific interest rate is being chosen at a specific date without reference to a method or procedure such as would be described by a policy rule. The use of a policy rule can mean a better educated public and a more effective democracy. It can help to take some of the mystique out of monetary policy.

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Less short-run political pressure. A policy rule is less subject to political pressure than discretionary policy. If monetary policy appears to be run in an ad hoc rather than a systematic way, then politicians may argue that they can be just as ad hoc and interfere with monetary policy decisions. A monetary policy rule which shows how the instruments of policy must be set in a large number of circumstances is less subject to political pressure every time conditions change.

Reduction in uncertainty. Policy rules reduce uncertainty by describing future policy actions more clearly. The use of monetary policy rules by financial analysts as an aid in forecasting actual changes in the instruments would reduce uncertainty in the financial markets.

Teaching the art and science of central banking. Monetary policy rules are a good way to instruct new central bankers in the art and science of monetary policy. In fact, it is for exactly this reason that new central bankers frequently find such policy rules useful for assessing their decisions.

Greater accountability. Policy rules for the instrument settings allow for more accountability by policymakers. Because monetary policy works with a long and variable lag, it is difficult simply to look at inflation and determine if policymakers are doing a good job. Today's inflation rate depends on past decisions, but today's settings for the instruments of policy—the monetary base or the short-term nominal interest rate—depend on today's decisions.

A useful historical benchmark. Policy rules provide a useful baseline for historical comparisons. For example, if the interest rate was at a certain level at a time in the past with similar macroeconomic conditions to those of today, then that same level would be a good baseline from which to consider today's policy actions.

In contrast to rules-based policy, discretionary policy raises problems in each of the above areas. And there are other problems: Those who benefit directly from discretionary interventions, even at the expense of overall benefits to the economy, have incentive to help officials who favor such interventions advance. Industries and firms that benefit from discretionary bailouts will favor officials who are comfortable with such bailouts. Even academic research on economic policy can become biased toward such interventionism.

Keynes recognized some of these problems saying that he wanted only *beneficent* interventionists. In a letter to Hayek he wrote: "I should therefore conclude your theme [in *The Road to Serfdom*] rather differently. I should say that what we want is not no planning, or even less planning, indeed I should say we almost certainly want more. But the planning should take place in a community in which as many people as possible, both leaders and followers, wholly share your own moral position." (See Keynes (1944)). Milton Friedman later cited this letter from Keynes to Hayek in his criticism of views favoring discretionary government interventions with too little concern for who would take those positions. (See (1997)).

Some have tried to make an economic efficiency case for discretion. Summers (2013) argues in favor of relying on an all-knowing expert—like a good doctor who knows just what to

do. But much progress in medicine has come from “checklists” by which doctors follow reliable procedures, as described by Atul Gawande. Of course, doctors need to exercise judgement in implementing checklists, but empirical studies show that checklist-free medicine is as problematic as rules-free monetary policy.

Some also argue that all that is needed for efficient outcomes is a goal such as an inflation target, rather than a rule for the policy instruments. But simply having a numerical goal leads to a discretionary approach to choosing the policy instruments, and it ends up being all tactics with the disadvantages mentioned above. Experience over the years, including policy actions taken in advance of the global financial crisis, indicates that this approach has not worked for monetary policy.

Rules-Based Monetary Policy is Consistent with Liberty

Policy rules are also attractive because they protect liberty. As Hayek quotes John Locke: “The end [meaning the purpose] of the law is, not to abolish or restrain, but to preserve and enlarge freedom...where there is no law there is no freedom,” See Hayek (1960). Rules constraint the power of government officials and thereby protect and preserve freedom. Rules thus have two purposes prosperity and freedom.

I tend to focus on economic freedom or on the basic idea that people are free to decide what to produce, what to buy, where to work, how to help others and that they make these choices within a *predictable policy framework*, based on the *rule of law*, with strong *incentives*, emanating from a *reliance on markets*, and a *limited role for government*.

The first two of the five characteristics— policy predictability and the rule of law—have not been stressed as much in economics as have been the other three—markets, incentives, and a limited role of government, but they are very important. Hayek wrote in *The Road to Serfdom*, “nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law. Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty...and to plan one’s individual affairs on the basis of this knowledge.” Hayek (1944)

The dual advantage of rules can be seen in their absence. Consider wage and price controls. Controls are arbitrary, requiring decisions by people at the top. They also screw up the economy, distorting signals and incentives and creating shortages and surpluses.

How can monetary policy rules work in practice when politicians and government officials are so often called on to “do something, anything,” and feel strong pressure to do so. Rules sound good, skeptics say, but rules mean you do nothing, and that is impossible.

Monetary policy rules, however, do not mean that the central bank does not take actions to change the instruments of policy (interest rates or the money supply) in response to events. Rather it means that they take such actions in a predictable manner. And inaction can mean that

one has deviated from a rule or a strategy. A decision by government regulators not to act when financial institutions take on risk beyond the limits of the rules and regulations is inaction and certainly is not observing the rule of law. It is important for policymakers to be able to explain that a policy strategy involves a series of actions.

Some claim that crises force policy makers to deviate from rules. But a crisis may be the worst time to deviate from rules. In a crisis, increased clarity about the strategy rather than increased unpredictability is needed. This was clear following the first bailout of the recent crisis—the Bear Stearns intervention, when few knew what to expect the next time because no strategy was put forth. The sooner people can make their decisions with knowledge of the rules, the sooner recovery from a crisis will come.

Even those who support the ideas of freedom can get off track. During the 1970s, Hayek (1975) seemed to say that discretion in monetary policy was needed, and others began saying the same thing. Friedman (1975) objected saying: “I hate to see you come out as you do here for what I believe to be one of the most fundamental violations of the rule of law that we have, namely discretionary activities of central bankers.”

Alternative Rules and Changing Technologies

There have long been discussions and disagreements about what kind of monetary policy rule would work best and these discussions and disagreements have continued today with a focus, for example, on money growth (Belognia and Ireland (2017)), nominal GDP (Sumner (2012, 2014), Koenig (2013), Sheedy (2014), Bullard (2019)), or the interest rate (Taylor (1993) Federal Reserve Board (2019, table A. p 37)).

Some of the disagreement have to do with different modelling assumptions. For example, as Koenig (2013) points out “In economies with nominal debt contracts, importantly, it is not just price and output variability that matter for performance (as is assumed in “Taylor curve” analysis), but also the correlation between price and output fluctuations.” This is another reason to consider a range of models and emphasizing robustness of rules to these different models.

Recently there has been much research on how to modify interest rate rules to deal with the effective lower bound on the interest rate, as exemplified in the research by Mertens and Williams (2019). Lilley and Rogoff (2019) argue that the “tools presently available to monetary authorities at the zero bound make it difficult to conform to rules...” and for this reason their paper proposes reforms which allow negative interest rates to be more effective. In this context they advocate and strengthen the case for policy rules.

Bordo and Levin (2017) propose “central bank digital currency (CBDC) which would be “fixed in nominal terms, universally accessible, and valid as legal tender for all public and private transactions.” And they then consider a benchmark for adjusting the interest rate in response to economic activity and prices “as in the Taylor rule.”

While there are differences between these policy rules, I think the similarities could be stressed more as in Koenig (2012) or Taylor (1999). Moreover, most of the efficiency and liberty arguments mentioned thus far in these remarks apply to any sensible rule for the policy instruments.

New technologies such as blockchain may enable economies to operate in the future without central banks as we know them, and it is good that economists and entrepreneurs are studying and experimenting with such technologies. Depending on how the technology evolves, new technologies could well provide more protections of liberty, but it is likely that policy rules—perhaps simpler than current rules, perhaps more like a gold standard—would be necessary to gain the most economic efficiency.

A Rules-Based International Monetary and Financial System

As one considers monetary policy within a global monetary and financial system one must also consider international capital markets and exchange rates. I have previously argued that the *most efficient* system conducive to a stable global economy with strong growth is one that with (1) open capital markets, (2) flexible exchange rates between countries or blocs and (3) a rules-based, monetary policy. (See Taylor (2019)).

When policy moves closer to those three attributes, as in the 1980s and 1990s for the advanced countries and more recently for emerging market countries, the economy does well, growing in a stable manner. When policy deviates from these three, as U.S. monetary policy did in the period leading up to the global financial crisis, the economy does poorly. And continued deviations will likely lead to poorer performance, competitive devaluations of exchange rates, and complaints of currency manipulation.

Here I argue that the same three attributes are also most *consistent with liberty*. The first attribute—open capital markets—of course means that there are no cross-country capital controls or government restrictions on people’s decisions to loan and invest abroad. This was just recommended as a long-term goal in a Report by the G20 Eminent Persons Group (EPG) on Global Financial Governance on which I served. The idea of open capital markets has implications for freedom more generally as it can be applied intellectually and practically to goods markets. In contrast an emphasis on “capital flow management measures” or restrictions on capital flows at the IMF easily carries over to restrictions on goods flow which should be reduced and avoided.

The second attribute presumes that government does not interfere with the workings of the foreign exchange market. In the case of a fixed exchange rate or single currency, this lack of interference is clear, but in the case of flexible exchange rate it means that government avoids intervention in the exchange market.

The advantages of the third attribute—rules-based monetary policy in each country—is simply a repeat of what I have already argued above.

How do we get from here to there? We need an international policy framework in which each central bank follows its own rules-based monetary policy, and in doing so contributes to a global rules-based system. There is no need for one central bank to tell another central bank what to do except to be transparent about its strategy or rule.

The most practical way forward is for one or more central banks to “just do it,” to start to move in a rules-based direction. It appears that the Fed began to normalize in the past year and a half in actions, appointments, publications, and speeches. Other central banks need to follow in a global normalization. It will not be easy, so it is important to be predictable and gradual.

In sum, although we are not there yet, an international monetary policy framework will be most efficient and consistent with liberty if it is based on these three attributes: Rules-based monetary policy at each central bank, flexible exchange rates between countries or blocs, and open capital markets.

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