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Hutchins Center
on Fiscal & Monetary Policy
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Comment on John Taylor:

Rules Versus Discretion: Assessing the Debate over the Conduct of Monetary Policy

October 13th, 2017

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Primacy of Objectives

- Policymakers should be held accountable primarily for achieving legislated objectives.
- Granted high degree of instrument independence in how to do so:
 - Enables longer-term perspective relative to elected representatives.
 - Central bank needs to explain how its instrument setting relates to legislated objectives.
 - What should be the role of “rules” in fostering progress toward objectives and in explaining instrument choices.

Kohn and Taylor Differences

“[Rules] tend to use formulas or equations for the policy instrument, at least as a guide when making decisions. And the decisions about the policy instruments can be described reasonably well by a stable relationship which shows a consistent reaction to observable events...” (pp.19-20).

▪ **Degree of Presumption; Role of Prediction:**

○ **Taylor:**

Look first to an algebraic rule, usually based on a small number of variables, that doesn't vary over time; deviations from the algebra—or new formulations—are unusual (otherwise it wouldn't be a rule) and require very strong rationale. Rely mostly on current estimated values of output and inflation gaps and r^* .

○ **Kohn:**

Algebraic rules are reference points to be used in thinking about and explaining policy strategy, but in a complex, ever changing and poorly understood economy, the presumption for following an algebraic rule closely is weak and the appropriate reference rule can change. Prediction using all information is essential to good policy.

○ **Mike Tyson and Dwight Eisenhower**

The Golden Age of Rules: 1985-2003

- **Irony**: Policymakers weren't trying to follow a rule.
- **What were they doing**:
 - Focusing on containing and reducing inflation— following Taylor principle but not in a rule-based manner.
 - Paying close attention to output and employment and their relationship to inflation, with some skepticism about gap measurement.
 - Conscious of policy lags, they were trying to anticipate the future, using every scrap of information, and employing “risk management”.
 - Making allowance for shifting relationships of policy rate to financial conditions affecting output gaps.
 - Bringing diverse views to their deliberations.

Stability and utility of stable relationship of instrument settings to observable events requires knowledge and stability of underlying values and relationships.

- **Values of the unobservables:** y^* , u^* , r^*
- **Relationships:** r and $y-y^*$; $y-y^*$ and π .

1985-2003

- Great Moderation; NICE period

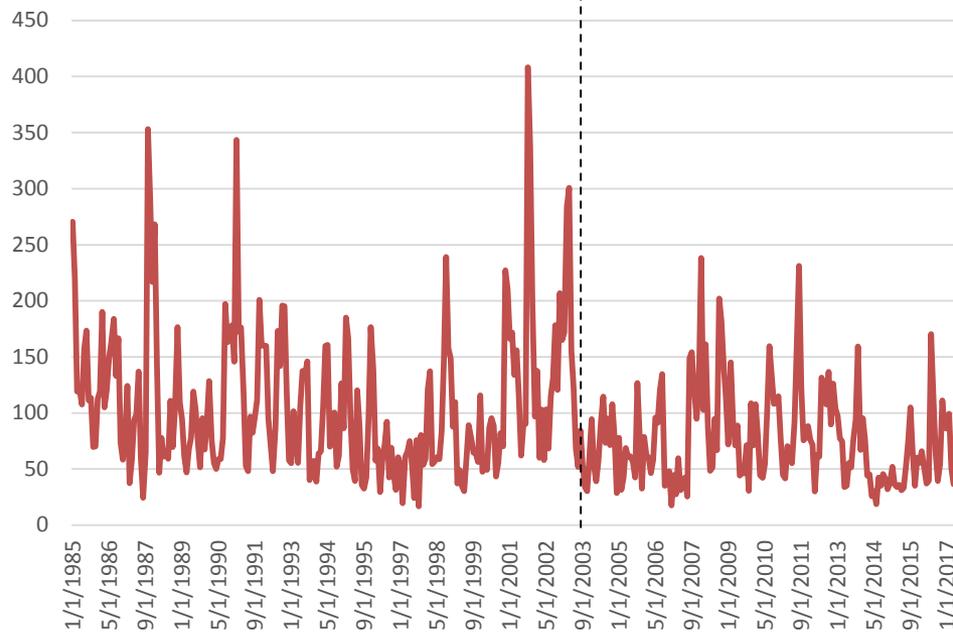
2003-

- Falling productivity and labor force growth.
- Declining r^* and damped response to accommodation.
- Very low inflation, threat of deflation, changing relationship of π to $y-y^*$.
- Huge changes in the financial system that transmits policy impulses.
- Long stretches with policy rates constrained by ELB.

What are the problems rules advocates are trying to solve?

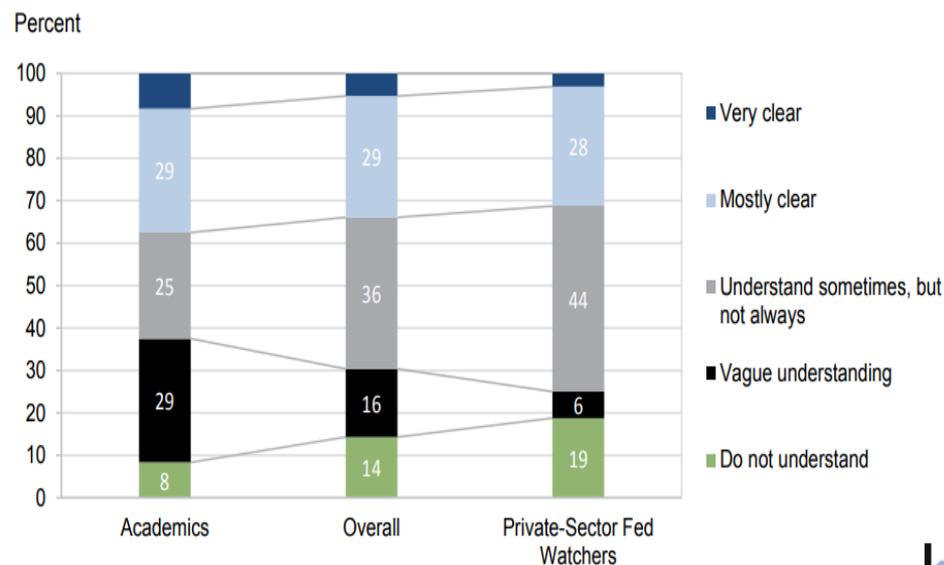
- **Poor Outcomes**: Slow recovery, low inflation.
- **Accountability**: Improving congressional oversight.
- **Uncertainties**: Helping people understand Fed actions.

Monetary Policy



Source:
Economic Policy Uncertainty. 2017. "US Policy Categories - Categorical EPU Data".
Retrieved from: http://www.policyuncertainty.com/categorical_epu.html

How Well Do You Understand the Fed's Reaction Function?



Note: N = 56 (24 academics, 32 private-sector Fed watchers).

Source:
Olson, Peter and David Wessel. 2016. "Federal Reserve Communications: Survey Results". Hutchins Center on Fiscal and Monetary Policy at Brookings. Retrieved from: <https://www.brookings.edu/wp-content/uploads/2016/11/fed-communications-survey-results.pdf>

Enhanced Role for Rules: Align Public with Private Use

- **Not the FORM Act:**
 - Strong presumption of following an algebraic rule.
 - Involving GAO arm of Congress for changes or deviations.
 - If FOMC's hands had been tied by FORM Act and its sand in the gears of responding to unprecedented economic and financial developments, outcomes would have been further from legislated objectives.

- **Can have a strategy without following a rule:**
 - How expect to achieve objectives; how might respond to shocks under different circumstances.
 - 1985-2003
 - But need to explain as well as possible.

- **Rules can be useful for explication of strategy to enhance understanding and accountability:**
 - Another way to articulate strategy rationale:
 - Where is policy setting relative to suite of rules (MPR box)?
 - Why? (not in box)
 - Could help understanding and evaluation of policy decisions.