

Towards an Exit Strategy: Discretion or Rules?

Discorso Bruno Leoni 2011

John B. Taylor
Stanford University

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I want to thank the Istituto Bruno Leoni for inviting me to Milan to give the 2011 Discorso Bruno Leoni. I have enjoyed being here to see firsthand all the good things that the Institute is doing to promote economic and political freedom under Alberto Mingardi's leadership. I've also enjoyed the chance to learn about the great Piedmont wines and the wonderful hospitality of your city. So thank you, Alberto, for being such a gracious host and for that kind introduction. And thank you all for coming tonight.

This beautiful room—the Galleria—as well as the whole Palazzo Clerici has so much history behind it. I've already learned that the ceiling was painted by Tiepolo in 1741, 35 years before my country was founded, and I'd like to learn more. (See photo below)..

To answer the question about exit strategies posed in this lecture —where do we go, rules or discretion?—I want to talk about history. I'm going to go back in time—not to the 1740s, but to the 1960s—to tell you about the amazing history of rules and discretion, an old, but important, topic in economics, and very relevant today.

I'm going to focus on the United States. I'll discuss some corroborating history from Europe, but I know the United States the best, and that's where I most clearly see the remarkable historical developments, which help us, I think, understand where we should be going now.

If you look back over the past fifty years or so, you see some striking trends in which policy moves toward more discretion and intervention, and then moves back again toward more rules-based policy, and then back again. It's a cycle between the balance of rules and discretion.

The period of the sixties and seventies, for example, is characterised by interventionist policies, and I'll talk about that in a minute. There were quite a bit of interventions on both the fiscal and monetary side. And then in the 1980s and 90s we saw a period where there was much less interventionist policy; it was more rules-based, as I call it. And then in more recent years—it's hard to know exactly where you pinpoint the beginning—there was a move back towards more intervention and discretion. It's also interesting to me that as you look at these trends, it's quite remarkable that they occur for both monetary and fiscal policy. But it's not just monetary policy, it's not just fiscal policy, even though I'll focus on those. It's broader than both.

When I use the terms “rules-based” versus “discretionary”, I don't necessarily insist on the academic distinction, though it is very important in research. I am not talking

specifically here of the distinction—which sometimes comes out of game theory—between discretionary policies, defined as sub-optimal solutions to a game, and rules, defined as optimal solutions to a game. Rather than this more technical definition, I'm going to think of discretionary policies as simply policies that are less predictable, more interventionist, more fine-tuning type policies, and, if you like, more short-term oriented policies. Whereas rules-based policies are more predictable, more systematic over time and don't involve a lot of intervention. It's a distinction which emerges very clearly from the data, as I'll indicate in a minute. You can think—from an economic perspective—of a variable X that might measure whether policy is rules-based or not. Higher values of X could represent more rules-based policies; lower values of X could represent more discretionary policies. I want to look at the ups and downs in X over time.

I want to examine what causes those ups and downs, but more important for this talk, I want to see what their impact is. You can think, especially in the case of monetary and fiscal policy, about the impact on the overall state of the economy. How high unemployment is, how high inflation is, how strong economic growth is, how frequent recessions are, how long expansions are. Those are all measures of economic performance that are affected by the degree of discretion versus rules in monetary policy and fiscal policy. You can think of a measure of that performance in terms of another variable, say Y. So I want to look at how X affects Y.

Are high values of X for rules-based policies associated with high values of Y for better performance? Or is it the other way around? We should be able to tell from the swings back and forth over time. And then we can ask—given what we find, given that relationship, given those trends—does this history suggest a particular way forward, if you like, an exit strategy from the sub-par economic performance of the last few years?

The first policy swing in the United States occurred in the sixties and the seventies, when we had a move towards more interventionist discretionary policy. It's sometimes referred to as the "Keynesian revolution." It began, of course, with Keynes, but really took force in the United States in the 1960s. It began in the Kennedy administration and then in the Johnson Administration. A remarkable document was written in 1962—*The Economic Report of the President*. In that document, distinguished economists at the President's Council of Economic Advisers made the case for Keynesian intervention, explaining that it was needed to keep the economy stable. And their persuasive arguments resulted in a lot of Keynesian interventions in practice, such as the investment tax credit, a tax surcharge, temporary tax rebates, and many other stimulus packages. Well into the seventies we would see the federal government sending stimulus grants to the states so that they'd start spending, start building infrastructure, to get the economy going.

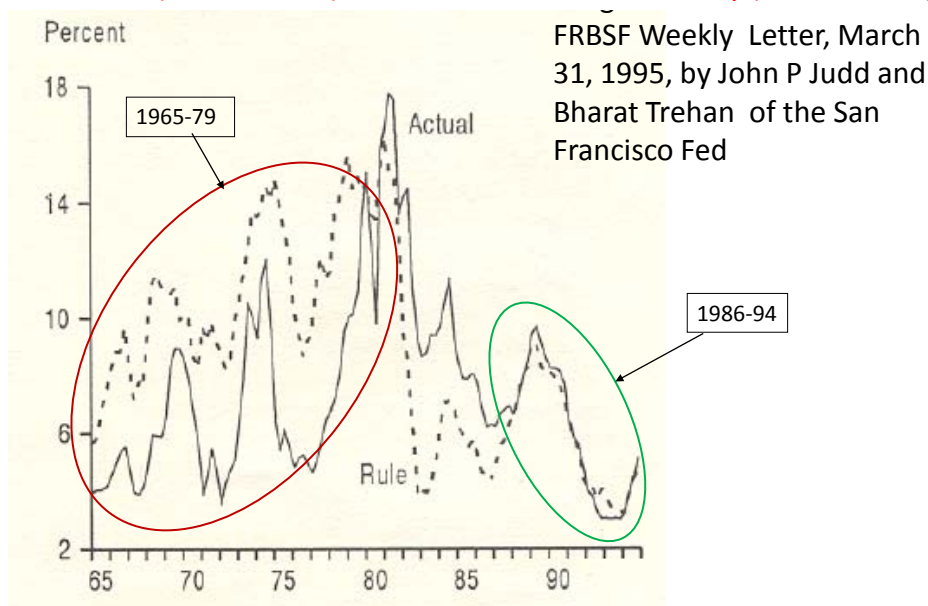
So in the sixties and seventies we saw a move towards these kinds of Keynesian interventionist, discretionary policies, which appeared to be rationalised by solid economic arguments made in a very persuasive way.

And then simultaneously we witnessed the same phenomenon on the monetary side. People were beginning to learn how powerful monetary policy was. Milton Friedman wrote in the 1960s about how powerful it was. But he also wrote in a famous speech to the American Economic Association in 1968 that you shouldn't try to tinker too much with it. Set some policy rules for money growth and try to keep the economy stable, "don't fine tune." He warned that fine-tuning would cause higher inflation or higher unemployment in a

boom-bust cycle. But those warnings were not heeded. And indeed the United States moved to a monetary policy which tried to stimulate the economy, raise money growth, and then cut money growth. We had a very turbulent 1970s. Inflation reached double digits in the United States; unemployment rates reached double digit as well. The times were undoubtedly bad from an economic standpoint, but the point I am making now is that interventionist policies were at work.

You can document this interventionist policy in many ways, including with a few charts which I would like to share with you. This first chart shows how un-rule-like and interventionist policy was in the late sixties and seventies. As you can see there's an oval in the chart labelled "1965 to 1979" which denotes the discretionary period. The short-term interest rate, the federal funds rate in the United States, is the solid line. The dashed line is the so-called Taylor Rule which describes a systematic response of this interest rate to changes in inflation and real GDP. This chart was originally created by the Federal Reserve Bank of San Francisco back in 1995. The gap between the actual interest rate and this policy rule is a measure of how discretionary the policy was. Interest rates were held too low throughout this period, but time after time they moved up and down, as the Fed tried to halt inflation, but then gave up too soon and gunned it again. So you can see this tendency for policy to be un-rule-like or discretionary at that time. But you don't have to look at a chart, you can just remember the many boom bust periods in the economy and interventionist policies to deal with rising inflation such as wage and price controls.

Chart from Federal Reserve Bank of San Francisco Showing Discretion (1960s-1970s) and Shift to Rules-Based Policy (1980s-1990s)



So, to sum up so far, we had a lot of interventions both in monetary policy and in fiscal policy in the 1960s and 1970s. That's the first move towards this discretion.

In the eighties and nineties we experienced a complete change in policy. And I'll start with fiscal policy. The Keynesian-type temporary stimulus policies of the late 1970s pretty much ended in the early eighties. By the mid-nineties they were gone completely. For example, in 1992 President George H.W. Bush proposed a fiscal stimulus, but it was minuscule. He only wanted to move forward some government purchases by a few months,

ten billion dollars' worth, very tiny by today's standards, but even that was rejected by the US Congress. So we didn't have a stimulus package. And in 1993 President Bill Clinton also proposed a minuscule stimulus; it was sixteen billion dollars, but that was rejected by the Congress as well. So there weren't any Keynesian policies throughout this period.

If you had to characterise an economic consensus in the late nineties in America, and in other countries for that matter, it would be that Keynesian interventionist policy does not work; it's not feasible. That was really the consensus at that time, so we had moved completely away from Keynesian policies of the seventies both in theory and in practice. We basically could think about fiscal policy as almost entirely due to the so-called automatic stabilisers. When the economy would go into recession, tax revenues would decline; it would mean tax payments were smaller, and that would tend to be stimulative, but it's automatic, rule-like. It does not require the enactment of a piece of legislation to do that. So, it was a big change.

And the same thing happened with monetary policy and in fact, this was even more dramatic. You had a new chairman of the Fed come in, Paul Volcker. He quickly moved away from these highly inflationary monetary policies, and instead focused on getting inflation down. He was followed by Alan Greenspan who continued that through most of the eighties and nineties. And I think that their characterisation of what they did, well, maybe not using the exact terminology that I'm using, "rule-like", etc., was to focus on this goal of price stability. That was their most important objective, and they argued that price stability would lead to more economic stability. This single-minded focus would create its own predictability.

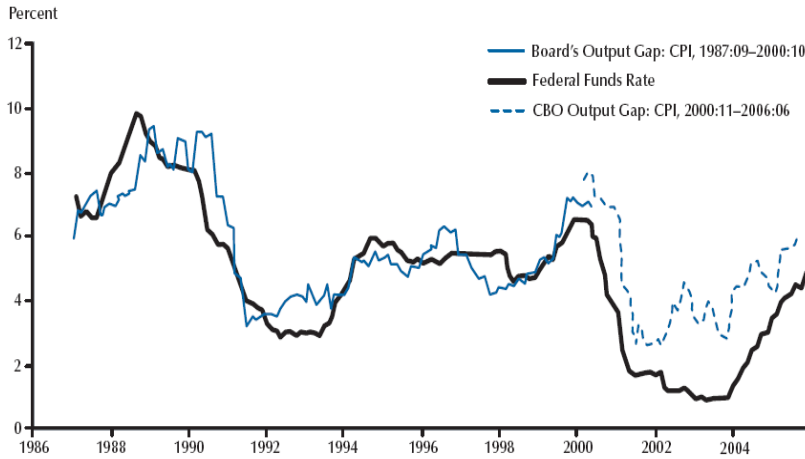
You can see this move in monetary policy in many other ways. It was at that time that central banks began to try to be more transparent about their policies; the idea of the "mystique" of a central bank kind of disappeared. The Fed started announcing when it changed the interest rate. Before that the Fed wouldn't even announce such a change, so, we ended up with much more transparency. And there were many more efforts to describe what interest rates would be in the future, to announce what policies will be in the future. You can now go back and look at the transcripts or the minutes of the Federal Open Market Community (FOMC), the deliberative body of monetary policy in the United States, and you can see many, many references to policy rules that would be guiding policy, making things more predictable. Financial market participants were now using policy rules to figure out what was happening with policy.

So, there's evidence all over the place. You can also see it in the data. Go back to the first chart I was referring to a few minutes ago, and you can see, I think, this pretty clearly. I mentioned the oval for '65-'79. Well compare that with the next oval, and you can see that the behaviour of monetary policy corresponds to a more rule-like way of thinking. So the chart is a demonstration of a shift in policy.

Here is another chart which takes you closer to the present. The chart was created by another district bank of the Fed, the Federal Reserve Bank of St. Louis. The dark solid line is the actual interest rate set by the Fed. The lighter line (dashed for part of the period) is what would be recommended by a policy rule. So, for much of the eighties and nineties, policy continued to be more rule like, and apparently close to a good, sensible policy rule that was working well.

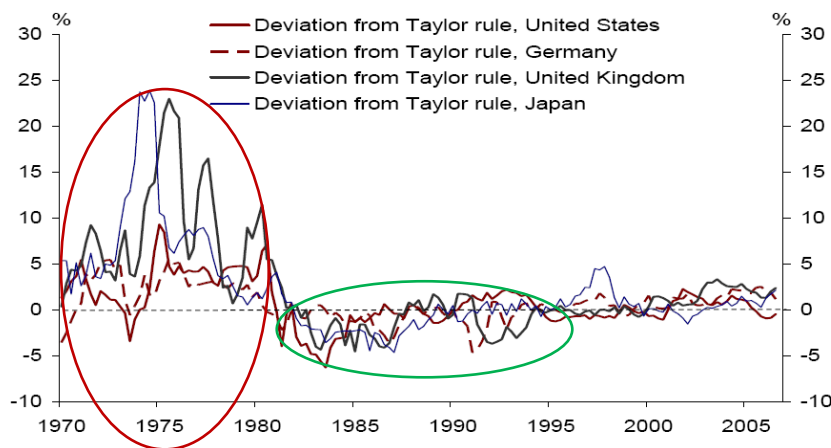
Chart from Fed, St. Louis *Review*, William Poole (Jan/Feb 2007)
 Showing Shift Back Toward Discretion

Greenspan Years: Federal Funds Rate and Taylor Rule
 (CPI $p^* = 2.0$, $r^* = 2.0$) $a = 1.5$, $b = 0.5$



This shift toward more rule-like monetary policy is also evident in other countries. The next chart is from research by Steve Cecchetti, now at the BIS, and his colleagues. It shows the gaps between actual monetary policy and rule-like policy in several countries: Germany, Britain, Japan, as well as the United States. You can see very clearly that the 1970s were highly discretionary. And then you see this shift, just like the one I mentioned for the United States—shown with the flat oval—to more systematic types of policies. So there's definitely something there.

Chart from Research by Stephen Cecchetti and Others
 Showing Large Shift in Several Countries at End of 1970s

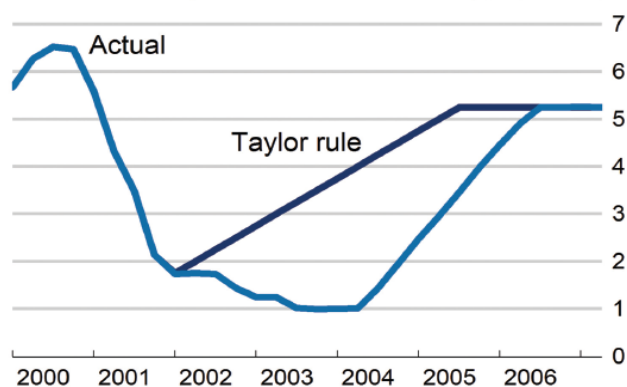


So that brings me to the third, more recent, period in which we can begin to see significant departures from these kinds of rule like policies. You actually see it clearly in the chart from the St Louis Fed which I was just showing you. You can see a gap forming between the actual interest rate and the policy rule in the period around 2002-2005—a deviation from rule-like policy towards more discretionary policy. To make this clearer, take a look at the next chart which focuses on the gap. This is a chart from *The Economist* magazine; it's simpler than the St. Louis Fed chart, but it's basically the same kind of evidence that monetary policy was getting more discretionary.

Chart from *The Economist*, October 18, 2007 Showing Swing Toward Discretion

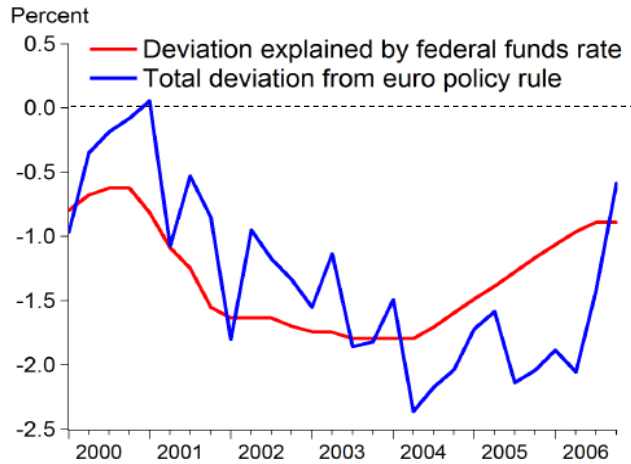
Loose fitting

Federal funds rate, actual and counterfactual, (in percent)



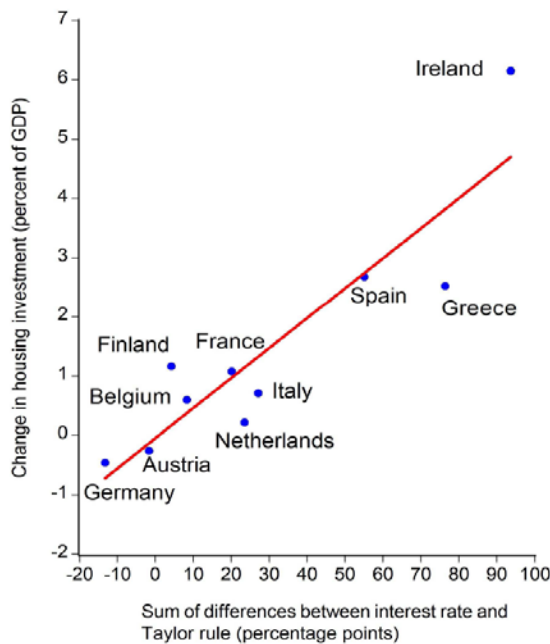
The next chart shows you the same kind of deviations at the ECB. The line that wiggles a little bit is the deviation of the actual policy in Europe from the policy rule for Europe. Interest rates appear to have been too low here too. The deviation is as much as two percentage points too. The line that doesn't wiggle too much is how much I think those low rates were probably related to the fact that the Fed had rates too low. Central banks do tend to move together, and we don't know for sure whether that happened in this case, but we do know that rates were extremely low in Europe too.

Meanwhile in Europe



These low interest rates in the euro zone had differential impacts in different countries within the zone. The next chart shows you what was happening in different countries in Europe at this time. Within Europe, the horizontal axis shows you the move towards discretionary policy. The points toward the right on the chart represents big gaps between ideal monetary policy, based on policy rule considerations and what actually took place. The vertical axis represents the extent to where there was a housing boom. And you see, and I think it is quite amazing, that Ireland, Spain and Greece are up there in the upper right part of the picture. This is a chart produced several years ago by the OECD based on the arguments that I had made, so that was before we saw these problems.

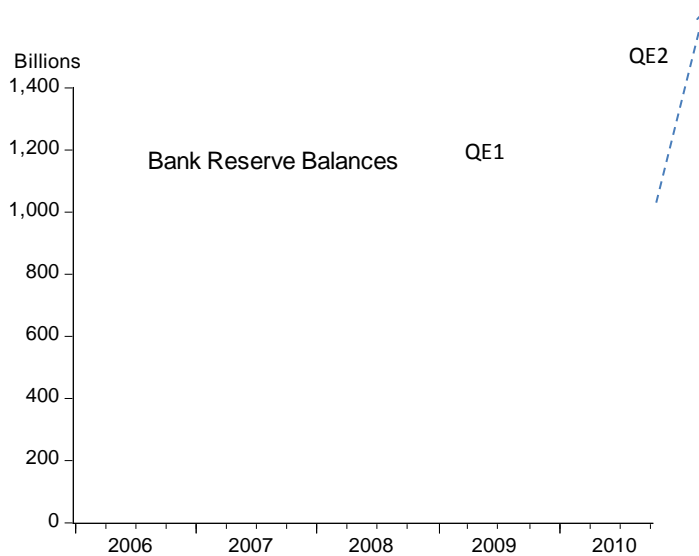
Chart from OECD Showing Impact (2001-06) in Euro Zone



So it's pretty clear that you can document a shift away from rules-based policy. And it goes deeper on the monetary policy side, because—at least in the Federal Reserve—we had many other interventions. The Fed used its balance sheet and created money in order to bail out the creditors of Bear Stearns. It then decided not to use its balance sheet to bail out creditors of Lehman Brothers. It then went in and helped the creditors of AIG and then it stopped again. These are discretionary policies by any definition. I'm not judging their impact just yet. I'm just saying that they are not rules-based, but rather discretionary.

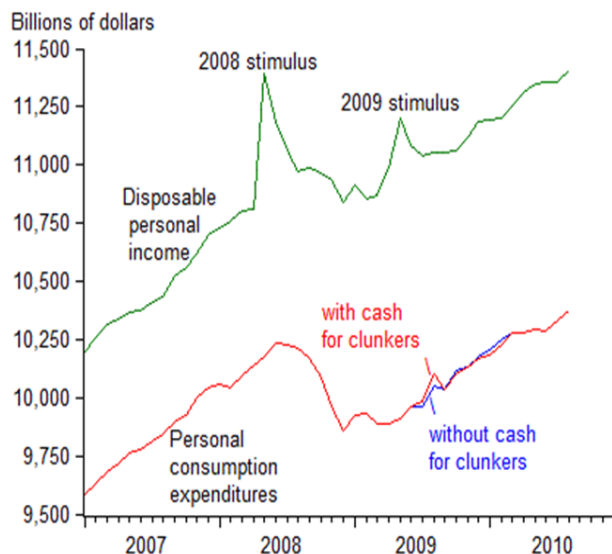
And then, after the panic in the autumn of 2008, which took place after many of these interventions, you saw even more interventions. In the United States we've had the quantitative easings, QE1 and QE2. This next chart shows the amazing impact of these policies on reserve balances—or central bank money sometimes called high-powered money. QE1 was mainly the purchase of 1.25 trillion dollars of mortgage-backed securities. QE2 is the purchase of another 600 billion of medium-term Treasury bonds. Those are financed by printing money, or by crediting banks with the reserves which explodes the Federal Reserve's balance sheet as shown in the picture. So again this is discretionary intervention rather than rule-like behaviour.

Quantitative Easing: QE1 and QE2



Now let's consider fiscal policy. We certainly have had a lot of stimulus packages, not just in the United States, but in other countries too, unlike anything seen in the eighties and nineties. The next chart illustrates these policies. It shows disposable personal income in the United States; you can see some of these gigantic blips as discretionary stimulus payments are sent from federal government to individuals, hoping that they'll spend more to stimulate the economy. Those are the so-called Keynesian stimulus packages. There's a big one in 2008 and another one in 2009.

Return of Discretionary Fiscal Packages



We've also had a rash of other interventions in the US economy, such as the "Cash for Clunkers" program where the Federal Government gave cash to car dealers if people came and exchanged their gas guzzling car for a new car. The hope was that this would stimulate consumption. But as shown in the picture of consumption, it certainly didn't stimulate the economy by much.

The 2009 stimulus package in the United States also aimed to stimulate spending at the state and local level. Grants were sent to the states from the federal government. The idea is that the states would spend those grants on infrastructure, but in fact, they didn't. All they did was to borrow less or save the funds. So it didn't stimulate infrastructure spending at all.

So there you have the history. This is the cycle I'm talking about. It's irrefutable that X measure of rules-discretion balance has moved up and down. Now what about Y, what's happened to economic performance? Well, this is clear too. The sixties and seventies were a terrible period. We had high inflation, high unemployment, high interest rates. We had a recession that lasted three or four years. We had really, a distressing economy. So, those discretionary policies certainly didn't do any good, quite the opposite: when it got more discretionary, when X when down, economic performance deteriorated.

The next episode, the eighties and nineties, was less discretionary, more rule-like, and the performance was completely different. The economists called this, "The Great Moderation Period". We had long expansions, low inflation, much lower unemployment.

And then finally, the recent discretion that we've seen has been associated with unquestionably sup-par performance. It's now called "the Great Recession". And this poor performance is continuing with high unemployment in the United States.

So, there's this relationship. Now, as everyone knows, correlation doesn't mean causation, so you need to think about this correlation a little bit. Is there evidence of causation from policy to performance? We would be surer that the answer is yes, if we could rule out reverse causation.

Does a reverse causation make any sense here? Well, I think not. In the first instance, you'd have to argue that the poor economic performance in the late sixties and seventies brought on interventionist policy. But this makes no sense because the poor performance followed the interventionist policies. In the second period, when there was a swing towards rules-based policies, you'd have to argue that low inflation, long expansions, good economic performance brought on the policies of Paul Volcker, etc. That doesn't make any sense either. It would be an insult to Volcker, that's for sure.

Now, finally in this recent period, maybe it is slightly more plausible to think that this highly interventionist policy was brought on by the bad performance as policy makers reacted. But still it doesn't fit the data. Remember that my first example of a move towards discretion—the 2003-05 monetary policy—occurred long before the bad times started. And the move towards highly discretionary fiscal policy in the United States began in February 2008, before this panic period in the fall of 2008. Yes, some of the interventions occurred after the panic, and you could argue that they were brought on by the panic, but the basic shift towards discretionary policy preceded the poor performance.

You also have some basic economic theory that supports the view that these changes in policies have driven performance. A vast economic literature in the past thirty or forty years demonstrates the importance of rules for policy. In fact, any decent economic model where people look forward in the future, where they take time to adjust, shows the benefits of having rules-based policy. Finn Kydland and Edward Prescott got a Nobel prize for showing the advantages of rules-based policies. And another Nobel prize was given to Robert Lucas for showing that you can't evaluate discretionary policies very well, implying that rules are better. There are thousands, literally thousands of papers written showing this connection.

I got interested in policy rules before this recent literature developed because I thought that policy rules are more predictable. These were the kinds of ideas that Milton Friedman developed. Policy rules help fend off special interests, which get policy off track. They help communicate what policy is. So there are these advantages which indicate that policy would be better in those rules-based periods.

And then, finally, in terms of empirical evidence, if you look carefully at all these interventions or these moves towards rules and evaluate their impacts, I think you can see a story quite consistent with what I'm saying. In the United States there were studies such as by Alan Blinder, saying that the temporary tax changes had very little impact, or that wage and price controls did very little good to affect inflation. And then there was the study of the stimulus packages, the Keynesian stimulus packages in the late seventies where we sent grants to the states in the United States so that they would spend more. That didn't work, and we had studies back then showing that that they didn't work. And then in the 1980s and 90s there are studies showing that the specific shifts to different types of monetary policy made the difference for stability.

I have spent a good chunk of the last three years looking in detail at a lot of these interventions, and I think they basically didn't work. Sending checks to people to stimulate consumption didn't stimulate consumption. You can go back and look at the graphs and see that very clearly. Sending money to the states did not stimulate infrastructure spending, as I mentioned a few minutes ago. If you look at most of the interventions in the financial sector, the bailouts, I don't think they helped. I think they made it worse, with an important

exception: During the worst of the panic central banks got together and they intervened in the money markets with swaps between themselves, which I think was quite constructive in stemming the panic. Not every specific discretionary intervention was harmful. But the overall shift in this direction was very harmful.

Now with this evidence in hand, what about the exit strategy? First, we need to consider what might be causing these cycles in policy. One possibility is that they are driven by economists and their theories. It is true that the economics profession made the case for rules in the 1970s and a move of policy away from discretion toward rules followed. But what about the move back to discretion? I am not aware of a shift in economic research that would have predicted the recent move towards discretion.

Another possibility is that the underlying shift to more rules-based policies is motivated by people who prefer a rule of law, a limited power approach to government. The political philosophy of limited government and individual freedom calls for a rule of law approach to government policy, and that is consistent with rules-based monetary and fiscal policy. Rules-based monetary and fiscal policies are good on their own right, but they may need to be supported by the political philosophies of government.

There may also be an endogenous cyclical process going on here in which poor economic performance generates policies that are better. People got sick of that high inflation and high unemployment in the 1970s, and they effectively said “these policies are terrible.” So then we moved towards better policies in the eighties and nineties. And then perhaps the better performance makes policy-makers too complacent. That good economic performance in the eighties and nineties made people say, “we know about those political pressures on us all the time to do something with a short-term focus, but maybe we can succumb to those pressures a little bit because economic performance is so good.” So they moved away from the good policy.

Now this endogenous view of the cycle suggests we can ride this wave. The exit will occur naturally as the continuing dismal economic performance of the past few years drives people back towards sound monetary policy and sound fiscal policy. But here I think we would be relying too much on hope. And besides it may take too long. I mentioned that in 1968 Milton Friedman made the case for not going to these discretionary policies. It took twelve years of going the wrong way before policy heeded that advice. We had twelve years of terrible performance, and we don't want that to happen.

So we need to find, in my view a way to speed up the cycle, and here there are things that can be done. In the United States, for example, I've been arguing for a reform of the Federal Reserve Act that will require the Fed to be more rule-like. They are actually pretty simple reforms. One is to change the Fed's mandate to focus on price stability within a context of overall economic stability. Right now it has two or three mandates. That alone would create the kind of rule-like focus that we saw during Paul Volcker's and much of Alan Greenspan's terms. The Federal Reserve Act could be restored to require specific reporting by the Fed. In the year 2000 the Federal Reserve was required to report to Congress about its strategy for money growth and, if it deviated from it, to say why it deviated. Those reporting requirements were removed in 2000. They could be put back in again, modified, modernised, if you like, to have rules-type reporting, strategic-type reporting. There's an effort that's going on in the US Congress now to try to move in those directions; it's just beginning. It is

an example of what we can do to exit from this period more rapidly than just waiting for the natural forces of history. There are similar examples in the case of fiscal policy.

So, let me wrap up with a quick summary. What I've tried to do here tonight is outline what I think is an amazing history of swinging back and forth between discretion and rules. That history is irrefutable. I've also shown a correlation between that type of policy and performance. That correlation is also irrefutable. I've also tried to argue that the correlation is causal; policy is causing that performance. That's a debate we can have, but I think I've given you a lot of evidence that argues for the causality from the policy to the events. And then finally I've outlined some theories of why we have these cycles, including that they are endogenous and that the swing of the policy pendulums will play itself out if left alone. But by sensible actions, using our democratic system, we can check that swing of the pendulum, pull it back towards more rules-based policies, tie it down, and prevent it from swinging back again.

Thank you very much.

The Galleria at the Palazzo Clerici

