Rule it out

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Rule or judgement?

- Should experts in the public service follow rules, or rely on their own judgment (discretion)?
- The answer is crucial for many areas of public policy, including criminal sentencing, immigration and education
- Is setting interest rates according to a fixed formula a bad idea?

Discretion

- Central bankers usually have discretion over how to use interest rates to achieve their goals
- Yet it is easy to see the problems that result, as analysts pore over every word any central banker utters and markets see-saw in response
- Some Republicans in Congress think it would be better if the central bank's actions were more predictable, or using a simple formula (rule)

Rule vs. discretion

- The debate about rules versus discretion is an old one
- Kydland and Prescott (1977) shows too much tinkering with interest rates can be harmful

The model

- Two things determine inflation: the expectations of workers, who must decide how much pay to ask for, and the interest rate (money supply)
- If policymakers prefer lower unemployment than is natural, they will be tempted to cut rates when wage growth is moderate
- Foreseeing this, workers expect high inflation to begin with

High inflation

- Most economists reckon this cycle helps to explain the high inflation of the 1970s
- Policymakers would do better if they could credibly promise to sit on their hands (rule)

Taylor rule

- John Taylor (1993) showed that the Fed typically behaves as if it follows a simple rule
- This formula is remarkably good at predicting the Fed's behaviour

Transparency

- Monetary policy based on rules has one main advantage: transparency
- When making saving decisions, people care about tomorrow's interest rate as well as today's
- The more they can predict how the central bank will act, the better they can plan—and the more likely they are to behave in the way that the central bank wants.

Forward guidance

- The benefit of transparency explains the policy of "forward guidance"—pledges by central banks
- Yet central bankers do not like having their hands tied
- The Bank of England, for instance, listed no fewer than four reasons why it might abandon its own guidance, including runaway inflation and financial instability