MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

RESEARCH SUMMARY

AN INTRODUCTION TO MONETARY POLICY RULES

As policymakers seek to prevent another financial crisis, they are scrutinizing the role the Federal Reserve (Fed) played before and during the 2008 crisis. The Fed currently exercises a great deal of discretion in monetary policy. A key point of debate is whether requiring the Fed to follow a specific rule would be preferable to the Fed's current broad discretion.

In a new study for the Mercatus Center at George Mason University, scholar Alexander William Salter examines several different proposed rules that the Fed could follow. Salter provides a framework to help policymakers better understand how incentives and information can affect monetary policy and discusses discretion-based and rule-based approaches to monetary policy. He concludes that a rule-based approach is superior and may have been able to prevent the 2008–2009 financial crisis. While Salter does not advocate a particular rule in his study, he presents a framework for policymakers to use as they strive to choose the best monetary policy rule.

BACKGROUND

Monetary policy seeks to offset changes in the demand for money by changing the supply of money. Monetary policy that effectively manages the money supply helps ensure that prices for goods and services accurately reflect changes in supply or demand for those goods and services. The Fed currently adjusts the money supply by buying and selling government bonds and other assets, such as mortgage-backed securities.

RULES VS. DISCRETION

Academics and policymakers debate whether central banks should follow a predetermined, fixed rule or should have discretion in monetary policy. Proponents of central bank discretion argue that a simple monetary policy rule is incompatible with the complexity of the US economy. A closer look, however, suggests that a rules-based approach is superior.

For more information, contact
Kate De Lanoy, 703-993-9677, kdelanoy@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

- A good monetary policy rule specifies a plan of action which the central bank cannot later ignore, while discretion allows central bankers to react—and often overreact—to economic indicators as they see fit.

- The rules-based approach has been criticized for being too rigid, but it provides certainty in the market that the central bank will not sacrifice long-term stability for short-term gain.

- While discretion affords central bankers the flexibility to respond to the economy's complexity, they lack the perfect knowledge and untainted motives that would enable them to exercise this discretion appropriately. Central banks are bureaucracies, and bureaucracies are not adept at processing new information and making changes to policies in response.

- In sum, a simple and easily communicated rule is better able to manage the complexity of the economy than a central bank operating with discretion.

WHICH RULE?

Having established the superiority of a rules-based approach, the study looks at the pros and cons of several popular proposed rules. The proposed rules are divided into two categories: targeting rules and market-based proposals.

Targeting Rules

A number of scholars recommend a rule that includes a particular target. Among these are the following:

- *Friedman's k-percent rule.* This rule would increase the supply of money by a certain fixed percentage per time period, which cannot be changed by the central bank. One of the problems with this rule is its inability to adjust to sudden and unexpected swings in the economy, especially changes in money demand. The result may be abrupt "shocks" to income and employment.

- *Taylor's interest rate rule.* This rule would set a target for the short-run interest rate. Whenever inflation or output in the economy is above the desired rates, the monetary authority would raise the target rate by contracting the supply of money. If inflation and output are below desired levels, the monetary authority would increase the supply of loanable funds, thus lowering the interest rate.

- *McCallum's feedback rule.* This rule takes Friedman's rule and attempts to apply macroeconomic variables, such as changes in employment and income, to determine the target rate for the monetary authority. However, similarly to the above rules, McCallum's rule is costly in that it would require the accurate and timely measurement of such variables.

- *Inflation targeting rule.* This rule would set an inflation target—for example, 2 percent—and adjust the money supply every predetermined time period by 2 percent. This does not require the same measurement as the other rules, but could destabilize the economy if income and employment are reduced due to other factors in the economy, thus increasing inflation at a faster rate than the target. This would raise prices of goods and services without a corresponding increase in the quantity of money.

Market-Based Proposals

The following three market-based proposals are "institutional" changes that could lead to greater stability in the market than either discretion or the rules discussed above.

- *Market-based nominal income targeting*. This proposal would restrict the central bank to buying and selling an unlimited amount of a derivative financial instrument. Its market value would be dependent on the actual level of nominal income, set in advance, controlling the actual price at which the monetary authority would buy or sell the contract. This rule would harness the diffuse knowledge of the market and the profit-seeking incentives of individuals.

- *Commodity standards*. This proposal would make money take the form of a commodity, such as gold, with all prices of other goods and services listed in units of that commodity. The political and institutional inertia against returning to a commodity standard may be too high of a cost to overcome, however, despite the self-correcting and stabilizing nature of a commodity standard.

- *Free banking*. In this system, anyone could open a bank and issue notes and checkable deposits. These would serve as liabilities against the bank's assets, which historically were backed by gold held by the bank. A bank would have a financial incentive to regulate itself by issuing notes relative to the demand for money by customers. This would create a stabilizing force similar to what nominal income targeting would create. However, despite its appeal from a macroeconomic stability standpoint, it is unclear whether the benefits of moving toward such a system would be worth the transition costs.

CONCLUSION

The correct way of thinking about issues in monetary theory and policy is not to work within these fields only, but to include broader political-economy considerations as well. Abstract monetary theory is both good and necessary, but without engaging issues of political economy little can be said about whether a particular monetary policy is desirable. When considering monetary policy, it is important to remember that central bankers are self-interested and lack access to perfect information. Because policymakers cannot know everything about the economy at one time and their incentives as public actors remain the same as their incentives as private actors, establishing rules for their decision-making is preferable to prolonging the current discretion-based policymaking at the Fed.