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## Summer Policy Boot Camp

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## Monetary Policy Making: A Case against Discretion

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**Background**

The Founding Fathers were more than skeptical of central banking and paper money. Alexander Hamilton, the first Treasury secretary for the United States, warned that fiat currency—by its very nature—is subject to abuse.[1] Thomas Jefferson, the author of the Declaration of Independence, went so far as to write to John Taylor, a political theorist at the time of the American Revolution, that "banking establishments are more dangerous than standing armies."[2]

America's central bank, the Federal Reserve System, has held interest rates arbitrarily low for the majority of the current century.[3] In light of the COVID-19 pandemic, government-implemented lockdowns gave rise to an economic shutdown, leading to the furtherance of easy money and intense quantitative easing by the Fed. By official measures, the rate of inflation in the United States hit a forty-year high as a result.[4] The methodology for calculating the consumer price index has changed—in order to account for substitution and hedonics—but if the original methodology is applied, today's annualized inflation rate exceeds that of many years during the Great Inflation of the 1970s.[5]

The Fed controls the money supply primarily by the utilization of price controls on interest rates—the price of borrowing, to be sure—in accordance with its dual mandate of balancing employment and price stability. In principle, this is central planning enacted through the power of the state. As evidenced by history and economic theory, governments too often create egregiously suboptimal outcomes in the way of utility and—from some normative perspective—liberty. To that end, the abuse of printing money has even been cited as a major cause for the decline of some of the world's most powerful civilizations for its damage to real productivity growth and distortions to the natural functioning of the market.[6]

There are, of course, those who proclaim a new paradigm vis-à-vis the nature and causes of inflation, but the recent price increases at the very least demonstrate the improbability of so-called modern monetary theory's validity. The era of low interest rates being inconsequential to price stability is over. Furthermore, efforts have been made to convince the public that high inflation can actually be something positive on egalitarian grounds even though it diminishes the purchasing power of the consumer.[7] To the contrary, inflation is effectively a regressive tax, as price increases disproportionately affect the welfare of middle-class consumers while the expansionary monetary policies that beget a rise in the price level appreciate asset prices—in short order, a positive for those with significant financial assets who spend a negligible portion of their income on consumption.

It follows that tolerating high inflation becomes a slippery slope. While there is considerable disagreement among economists on the proper form of monetary policy making, empirical evidence suggests serious limitations to the Fed's ability to increase employment in the short run.[8] In the long run, that ability is still more limited, if it even exists at all.[9] As such, constraints need to be placed on the central bank to greatly limit its discretion with respect to policy making, given the reality—however rasping—of actual market dynamics and the severity of what is at stake.

**Recommendations**

A few centuries after Thomas Jefferson delivered his aforementioned remarks to John Taylor, a different John Taylor offers a credible solution to rein in the Fed's discretionary monetary policy: a rules-based approach for setting the federal funds rate's target range, the interest rates of foremost importance to the economy. The period from 1985 to 2003 was arguably characterized by rules-based monetary policy that considered both the rate of real productivity growth and the rate of change in the price level, while the 1960s and 1970s, along with the period following 2003, saw central-banking practices that were largely discretionary in nature. The age of rules-based monetary policy was a time of enhanced economic performance, and analysis has suggested this relationship was causal.[10]

It is endlessly proclaimed that supply-chain bottlenecks are largely to blame for the current inflation. Other inflation scapegoats, discussed ad nauseum in international media, range from corporate greed in the form of intense price gouging to Russian president Vladimir Putin's policies. The main driver of this unprecedented inflationary pressure, however, is irresponsibly low interest rates that constitute an expansion of the money supply and a staunch deviation from what is practical. The Fed failed to raise interest rates at the appropriate time (per the rate that should be targeted deriving from the Taylor Rule derived by rigorous academic studies) for fear of inducing a deep recession. Although not entirely misaligned with political incentives and human nature as it relates to time preference, such fear is ungrounded: a greater amount of damage in the way of a recession might arise from inaction to the extent that the Fed holds rates below an appropriate level.[11]

It should come as no surprise that the national debt is incredibly high by historic standards and compared to what is permitted, so to speak, in a healthy market economy. The Fed cannot, however, accommodate reckless fiscal policy: monetizing the debt is not just improper on theoretical grounds, it violates the legal mandate of political independence established by Congress. In a world wherein discretionary monetary policy making is permitted or even encouraged, it is all too easy for a central bank to become hostage to the short-run performance of the economy as opposed to remaining a steward of the optimization of long-run productivity and the resultant living standards.

Naturally, the Fed does not outright claim the intention of a serious deviation from policy making that achieves its dual mandate of maximizing employment and minimizing inflation. It therefore follows that an adherence to interest rates set through the formula prescribed by the Taylor Rule helps to uphold the credibility of the central bank. Indeed, there is a correlation between the aforementioned period of rules-based monetary policy and the Fed's credibility.[12] When the Fed has less credibility, it needs to take more intense action to achieve its policy goals against the backdrop of worsened expectations: in other words, greater rate hikes and thus a deeper recession are requisite to address heightened inflation.[13]

**Expected Results**

If Congress reins in the Fed with an alteration to its dual mandate that requires interest rates to be set to levels implied by the Taylor Rule or at least levels significantly closer—with some explicitly stated error band—than has been recent precedent, greater price stability should arise along with a higher rate of real GDP growth than the alternative. And, of course, inflation crises the likes of which we are experiencing should occur less often. The Fed's credibility should increase as a result, which would make its job significantly easier and the business cycle's road less bumpy.

The world does not behave like simple economic models, which are dependent on a myriad of highly unrealistic assumptions. We cannot simply conclude that less economic growth and higher inflation relative to historical growth levels and inflation rates imply that the policy prescription of rules-based central banking is unsuccessful if implemented. Nor can we assume that more economic growth and lower inflation—again, relative to historical growth levels and inflation rates—indicate the success of implementing the Taylor Rule in an effort to subdue discretionary power. Rather, econometrics needs to be used against the backdrop of theoretical contextualization to assess the policy's legitimacy.

Empirical methods of linear regression that compensate for the fact that all factors are not held constant are of critical importance. The methodology used by economist John Taylor to analyze the period of relatively rules-based monetary policy and that of more ad hoc decision making in the way of setting interest rates is highly lauded and serves as a prime model for evaluating policy implementation. As would be expected, a more expansive time series should provide more conclusive results.

While the future is characterized by radical uncertainty and the great difficulty of making perfectly accurate economic forecasts, rules-based monetary policy is a promising policy goal. The most thought-out frameworks that describe the world, not as it ought to be, but rather as it truly is, lead to the ideas discussed in this policy proposal. Nobel laureate Milton Friedman famously asserted that a computer could assume the role of central banker.[14]

While the implementation of rules-based monetary policy suggested by Taylor is not entirely aligned with Friedman's ideally functioning macroeconomy, the essence is all but the same: individuals are incapable of centrally planning the direction of the economy. Arbitrary interest rates, which are intrinsic to discretion-based central banking, necessarily lead to an arbitrary allocation of resources.

Banking institutions, if left under the sole direction of a central planner, may well be as dangerous as Jefferson believed them to be more than two hundred years ago. From the events of the past century, history teaches us that it would be unwise to allow the Fed to gamble with America's great civilization in a deviation from the way of the market.

**Endnotes**

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