

COMMITMENT, RULES, AND DISCRETION

Charles I. Plosser

The debate regarding rules versus discretion in the conduct of monetary policy is an old one dating back at least to Henry Simons (1936). His famous paper in the *Journal of Political Economy*, entitled “Rules versus Authorities in Monetary Policy” is a classic. Simons’s view stressed the importance of establishing the “rules of the game” as opposed to the “delegation of legislative powers,” that granted “authorities” to central banks. Today we would characterize authorities as discretionary powers in contrast to rules. He rightly struggled with these concepts and their implications for a free society in the classical liberal sense. His conclusion was that establishing rules of the game was clearly preferable and the lesser of two evils when it came to monetary policy.

The modern version of the debate surrounding rules versus discretion is best captured in the work of Finn Kydland and Edward Prescott (1977), again in the *Journal of Political Economy* and titled “Rules Rather than Discretion: The Inconsistency of Optimal Plans.” They showed that a regime that precommits policymakers to behave in a particular way is preferable to a regime that allows policymakers pure discretion—that is, to choose a policy independently at each point in time.

The idea is very counterintuitive to most people and particularly unappealing to many policymakers. After all, the policymaker could choose the same set of actions under discretion as he could

Cato Journal, Vol. 36, No. 2 (Spring/Summer 2016). Copyright © Cato Institute. All rights reserved.

Charles I. Plosser is the former President and CEO of the Federal Reserve Bank of Philadelphia.

under commitment. So it would seem that a discretionary policy can certainly be no worse than a policy that entails precommitment. Therefore, the argument goes, there is value in retaining “flexibility,” or as some monetary policymakers I know used to say, “optionality,” so that decisions can respond “appropriately” to current events. Thanks to Kydland and Prescott and others, we now know that this argument is flawed. The fatal flaw in this conventional wisdom stems from its failure to recognize the important role played by expectations of future policy in economic decisions made today.

Expectations, Commitment, and Discretion

Expectations of the future play a crucial role in all sorts of decisions. This is particularly evident in financial markets, where investment decisions and the valuation of securities depend importantly on assessments of future economic outcomes. But it is equally true for individuals buying a home or a car, and for businesses considering capital expenditures.

Before going further, it is useful to be a bit more precise and define what I mean by “commitment” and “discretion.” Commitment essentially means that policymakers deliver on past promises about future actions. Discretion, on the other hand, means the policymaker is not bound by previous actions or plans and thus is free to make an independent decision every period.

Discretion means the policymaker may find it preferable to change his or her mind, or re-optimize, and do something other than what was promised. The temptation to renege on previous promises or plans is what economists refer to as the time-inconsistency problem, and it has surprisingly troublesome consequences. In particular, it can mean that outcomes under a discretionary regime are likely to be worse than those under a regime where the policymaker is constrained to follow through on previous commitments.

To illustrate the issue, consider the case of patent protection. Research and development (R&D) by the private sector is an important source of innovation in our economy. From new drugs to computers, research has led to new products that have enhanced our health and productivity. Thus, investment in research generates important returns that contribute to the improvements in living standards both here and around the world.

To encourage such investment, governments often seek to ensure that private returns to innovation are sufficient to elicit the socially optimal amount of investment in new ideas. In practice, governments often give temporary monopoly rights to companies and individuals, in the form of a patent, as a means of assuring that the private inventor can earn a sufficient rate of return on what may be a very costly and risky research endeavor. In one sense this is assuring property rights to new inventions.

Suppose, however, that after the discovery, the discretionary policymaker decides to make the new product's design freely available to all. The result would be more competition and lower prices, making society better off. The policymaker thus reoptimizes to do the best thing at the time and reneges on past promises. We all know the problem of such a discretionary strategy—while achieving short-term benefits, it is likely to have devastating effects on future investments in research and inventive activity. Thus, removing the discretion of the policymaker to revoke the patent protection raises overall welfare. The expectations of future policies and behaviors have important implications for decisions today and, thus, future welfare.

Commitment, or the lack thereof, also has important implications for monetary policy. Just as firms' R&D decisions are affected by their expectations about the future of patent protection, many economic decisions are affected by their expectations about the future course or path of monetary policy. The stance of monetary policy is, after all, not simply the current level of the policy instrument, but includes its expected path over time. As a result, the central bank faces a time-inconsistency problem. That is, it will be tempted to pursue policies that deliver temporary economic benefits that may be inconsistent with longer-term goals. Realizing that the central bank will have the latitude, or discretion, to give in to this temptation, people will make decisions today that drive the economy to a suboptimal outcome.

Thus, in a wide range of cases, a policy governed by commitment dominates one of discretion. The challenge is: How do we get commitment? Are there institutional arrangements that would make it easier for policymakers to honor their commitments?

Looking back, societies have employed various means to try to pre-commit to a policy path and thereby produce better outcomes. None are perfect. Indeed, in a democratic society it is impossible to obtain

full commitment. Legislation is one mechanism for supporting commitment. But, of course, laws can and do change. Nonetheless, it can be difficult and costly to do so. So laws can and do enhance the credibility of a commitment as in Simons's rules of the game.

Institutional Design

More generally, institutional design can be a useful means to enhance commitment. Creating institutions that align the incentives of the policymaker to behave in a more rule-like or committed manner also can be helpful.

For example, at Cato's 2013 monetary conference, I gave a paper entitled, "A Limited Central Bank," which appeared in the *Cato Journal* (Plosser 2014). I argued that there were other ways to strengthen commitment and limit discretionary behaviors in a central bank. I suggested that designing an institution with a more limited purpose and fewer authorities can improve the ability of policymakers to both commit to future behaviors and be held accountable for the outcomes. In particular, I suggested designing the central bank with a more narrow mandate as a way to focus the activities of the policymakers. The narrow mandate also improves transparency and enables the public to hold the policymakers accountable. Broad and expansive mandates that are accompanied by broad authorities and powers invite discretion and shifting priorities. Along these lines, I also argued for limiting the range of assets that the central bank can purchase and thus the markets in which it is allowed to directly intervene. This also can help limit the scope for discretion and better align the authorities with the more narrow mandate.

A monetary regime that is based on the gold standard provides a form of commitment. In principle, there is very little room for discretionary monetary policy under a gold standard. Indeed, a metallic standard of some form has served as a form of standard and commitment on and off for centuries. Although, in the end, the system was far from perfect. Economic forces and the incentive of governments, politicians, to be discretionary, especially during wars, eventually led to the abandonment of the discipline of the gold standard. Nevertheless, it does illustrate that the importance of commitment is not a new one and how difficult it can be to sustain.

Many countries have adopted fixed exchange rate regimes as means to attain credibility and ensure commitment. Certainly, the

Bretton Woods system that eventually replaced the gold standard after World War II was a commitment device, although it, too, eventually broke down.

Some countries have chosen to peg their exchange rate to the dollar as a means of restricting the ability of their central bank to create inflation. Doing so, however, simply puts monetary policy in the hands of another country.

Other approaches to strengthen credibility and commitment include rule-based strategies. Rules are a means of limiting discretionary behavior by constraining policy choices. For example, Milton Friedman, who was highly critical of discretionary monetary policy-making, suggested adopting a rule that required constant growth of the money supply—the so-called *k*-percent rule (Friedman 1960).

More recently, rules have been developed that specify a feedback mechanism from, say, inflation and an output gap measure, for setting the funds rate. The most well-known version of such a rule is the one proposed by John Taylor. There are a number of variations of such feedback rules that have been proposed and investigated for their robustness properties. That is, do they perform well in different models? The general result is these simple rules often produce good results in a wide variety of models, which is quite encouraging. This is an important development because it means that complete agreement on a model is not necessary to adopt a rule that enhances credibility and is likely to work well over time, even as models are improved.

Rules also improve communication and reduce instability caused by surprise discretionary actions by the central bank. A rule, in essence, provides a reaction function that helps the public and markets understand how monetary policy will react to incoming data. It thus provides the right kind of forward guidance and reduces uncertainty and surprises when it comes to monetary policy. This then contributes to a more stable and efficient economy. Had the Fed been operating under a transparent, well-understood rule prior to the crisis, the efforts at forward guidance in the face of the zero lower bound might have proved to be more helpful rather than mostly confusing.

Many central banks around the world have adopted inflation targeting frameworks as a means to strengthen credibility and commitment. Under inflation targeting, the central bank announces a numerical target or target range for a specific inflation measure and

commits to keeping inflation in that range over a specified period. The Fed finally joined most of the other major central banks around the world in quantifying an inflation target in January 2012 after nearly two decades of debating the issue. Inflation targets are a step in the right direction, but are not very specific about the monetary policy strategy that will lead to that outcome. Thus, they allow a wide range of discretionary actions.

Monetary Policy Strategies

So where do we go from here. My discussion highlights the fact that full commitment is hard to attain in practice. Moreover, policy-makers are very reluctant to give up discretion. The attempt by the Federal Open Market Committee (FOMC) to make statements about the future path of policy recognizes the importance of expectations and a desire to influence them. But at the same time, the Committee tried to retain complete discretion to change its policy as circumstances change. But the Committee did not, and still does not, provide much guidance as to how that would be done. This tension between rules and commitment versus the desire to be discretionary has loomed large over the past several years and created significant challenges in communication and clarity of a monetary policy strategy.

However, that does not mean that progress cannot be made. There are people inside the Fed who value the importance of a more systematic approach to policy even if there is no agreement on the precise form that such a strategy might take. A more systematic strategy would make monetary policy more predictable, it would make communication easier, and it would improve transparency. In doing so, it would make the Fed more accountable.

Paul Volcker once said to me that Montagu Norman, the long-time Governor of the Bank of England (1920–44), once told him that a basic prescription for all central bankers should be, “Never explain and never apologize.” While I don’t know whether the quote or its attribution is accurate, I do know that the message is one that captures the attitude and practice of central bankers through much of the 20th century.

But as we know, times have changed. Transparency has replaced secrecy, and openness and communication have replaced mystery. While there are those who long for the mystique and thrilling days of

yesteryear and wish for a little more mystery and a little less openness, I don't think the clock can be turned back—nor should it be.

Indeed, I give a lot of credit to the Fed for its efforts to become more open and transparent, but I think the desire to maintain absolute discretion has seriously interfered with that agenda. It is very difficult to communicate clearly a monetary policy strategy, or to use forward guidance as part of that strategy, when the fundamental approach to policy is discretion. I would go so far as to argue that discretion is not a strategy but the absence of a strategy.

So how might the FOMC move to a more systematic way of articulating given that they are not yet ready to adopt a single rule? I think there is a path forward that is really quite simple, and, although far from perfect, puts monetary policy and the Fed on a better trajectory.

To move an entire institution from one that values discretion over commitment is challenging. One strategy is legislation. As I mentioned, I have proposed one such approach that creates a more narrow central bank with limited objectives and limited powers or authorities. In such a framework, I believe that a more systematic or rule-like approach to monetary policy is more likely to flourish. I believe the design of the institution is important, because it helps shape the incentives and activities of the policymakers.

Another legislative approach is to mandate a rule or policy strategy that policymakers must pursue. This approach, too, has its merits and is closely aligned with proposed legislation in the House. The disadvantage, from my perspective, of this legislation is that it gets Congress deeply involved in the technical aspects of monetary policy and invites greater politicization of monetary policy choices. I am not convinced at this point that as a society it would be the best way to proceed. I would prefer an approach that focuses on the limits of the institution's goals and objectives and its authorities rather than on micromanaging the tactical arrangements and policy prescriptions. More generally, I am concerned that any legislative approach in the current environment would lead to compromises that are likely to lead to less independence and greater politicization of the Fed and monetary policy. I do not think this is wise.

My suggestion, which requires no legislative action, and the risks it entails, is for the Fed to take the initiative and implement a shift toward a more systematic monetary policy strategy. It has the authority to do so if it chooses.

The approach is quite simple, is mostly in place, and one I have stressed before. As I mentioned, there are many within the Fed that understand and value the importance of a more systematic implementation of policy. This is evidenced by the fact that the staff regularly calculates the implications of various robust rules and reports on them to the FOMC. The basic model used by the Fed, affectionately known as FRB/US, incorporates and relies, to a great extent, on rule-like behavior for monetary policy. This work provides a good starting point to move forward.

The FOMC could begin to reshape its policy communication in a way that emphasizes the usefulness of these various rules in the formulation of policy. Publishing the outcomes and implications of the various rules on a timely basis as part of a quarterly monetary policy report would be an important step forward. More useful would be for the Committee to discuss its policy choices in the context of such guideposts provided by the rules. At times, these rules may give a wide range of options. If so, that leaves some latitude for the Committee to exercise judgment and discretion as to the best policy choice. But such an approach would require, almost demand, the Committee explain why its decision differs from the guideposts. This practice would improve the communication and transparency of the monetary policy strategy at work.

I believe that this approach could accomplish several desirable objectives. First, it would force the Committee to directly confront the implication of the rules and to justify its policy choices should it choose to significantly deviate from the guideposts. Second, such a process would change the nature of the discussion by the Committee in important ways and place the rules and their implications front and center. So while this suggestion does impose a single rule on the FOMC, it does help discipline the discussion and thought processes in ways that are likely to help promote a more systematic approach to policy.

Conclusion

There is a strong case to be made that a monetary policy regime that demonstrates a high degree of commitment would lead to better economic outcomes. However, perfect commitment by policymakers is almost impossible to achieve in a democratic society. Rule-based policy is one useful mechanism to enhance the

credibility of commitment, but it is not perfect. The Fed could improve commitment and communication through a more transparent public discussion of robust rules rather than simply rejecting any role for rules in its approach to decision making. Indeed, policymakers should and could take a more proactive approach. Doing so would be a step in the right direction, head off, perhaps, even worse legislation, and enhance communication and the public's understanding of its monetary policy strategy.

References

- Friedman, M. (1960) *A Program for Monetary Stability*. New York: Fordham University Press.
- Kydland, F. E., and Prescott, E. C. (1977) "Rules Rather than Discretion: The Inconsistency of Optimal Plans." *Journal of Political Economy* 85 (3): 473–92.
- Plosser, C. I. (2014) "A Limited Central Bank." *Cato Journal* 34 (2): 201–11.
- Simons, H. C. (1936) "Rules versus Authorities in Monetary Policy." *Journal of Political Economy* 44 (1): 1–30.