The Rules-Discretion Cycle in Monetary and Fiscal Policy

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Overview

- Three long swings: (focus on U.S. macro policy, but broader)
  - First, toward discretion in 1960s and 1970s
  - Second, toward more rules-based policies in the 1980s and 1990s
  - Third, back again toward discretion in recent years

Overview

- Remarkable co-movement in monetary and fiscal policy
- Focus on “balance” between rules and discretion
  - Rules-based: more predictable, systematic, less interventionist
  - Discretionary: unpredictable, less systematic, short-term find tuning
  - Let X measure the balance: higher X means more rules-based

Overview

- Look at macro performance:
  - Inflation, unemployment, length of expansions, frequency and depth of recessions
  - Let Y measure performance: higher Y means better performance
- Want to document and explore cycle in X
  - Examine its effect on Y

The Swing Toward Discretionary 1960s-1970s

Fiscal Policy

- Keynesian ideas about discretionary countercyclical fiscal policy grew popular in academia in the 1950s and 1960s
  - Arguments appeared in the major textbooks
  - Soon applied to actual policy

Fiscal Policy

- The 1962 Economic Report of the President in the US famously rationalized the use of discretion
  - Investment tax credit (1962), Tax surcharge (1968), tax rebates (1975), countercyclical grants to states for infrastructure (1977-78)
- Keynesian discretionary policy continued to the late 1970s

Monetary Policy

- Fed did not follow Milton Friedman's rules message "of setting itself a steady course and sticking to it." (AEA 1968)
- 1965-1970s saw a series of boom-bust cycles in monetary policy with inflation rising steadily higher at each cycle.
- The wage and price controls of the 1970s
  - Epitome of interventionist policy
  - Defended by Fed Chair Burns:

  "wage rates and prices no longer respond as they once did to the play of market forces."

Monetary Policy

- Insider reports (e.g. Maisel's 1973 book) showed little strategy or systematic thinking about policy.
- Econometric studies show that Fed's responses to inflation were unstable over time in the 1970s
  - Rising implicit inflation target
- Not rule-like as it would become in the 1980s and 1990s

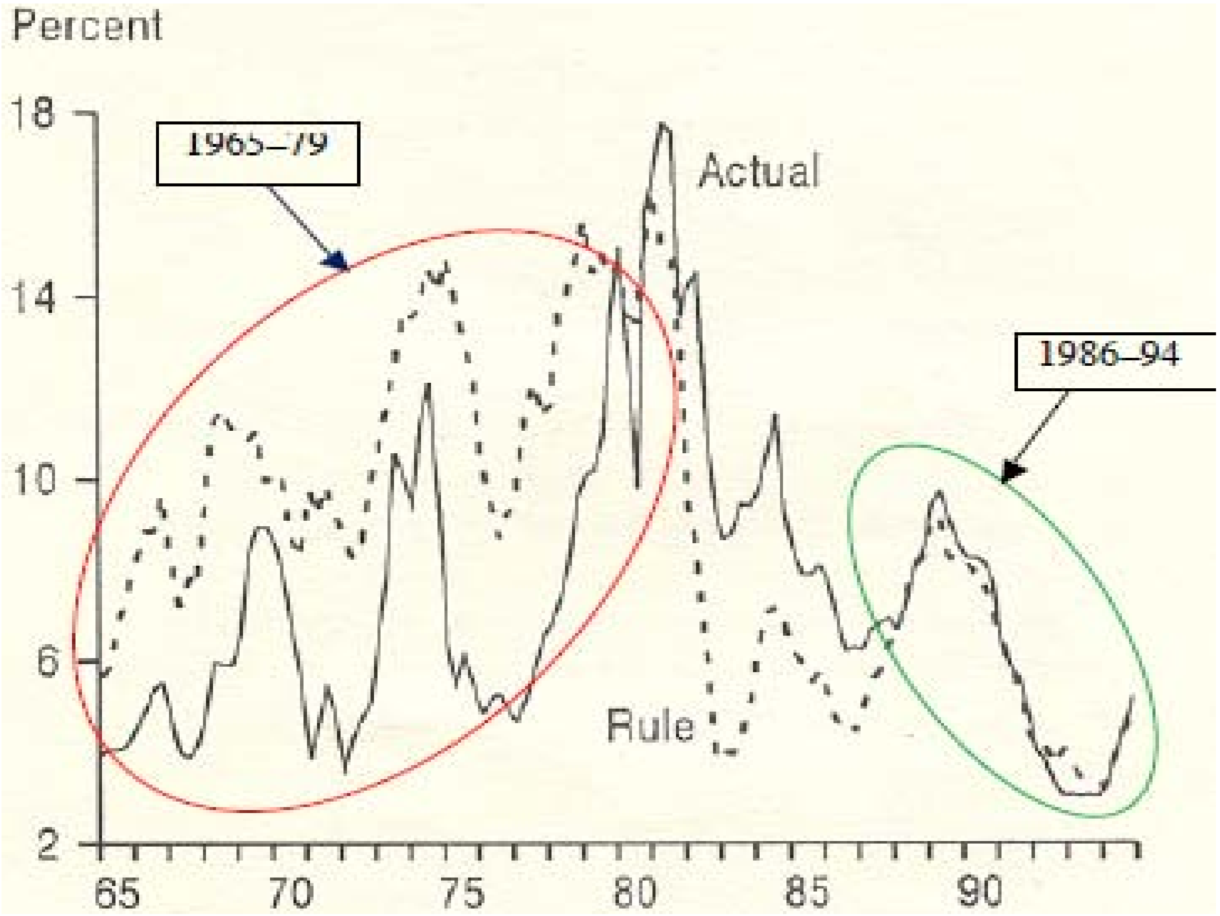


Figure 1. Discretion (1960s-1970s) and shift to rules-based policy (1980s-1990s)

Source: Judd and Trehan (1995)

The Swing Toward Rules 1980s – 1990s

Fiscal Policy

- Research raised questions about discretionary policy
  – Lucas and Sargent “After Keynesian Economics”
- Soon automatic stabilizers dominated cyclical budget changes
- Bush 41: proposed tiny stimulus package in 1992,
  – $10 billion in G future to the present,
  – Did not pass the Congress

Fiscal Policy

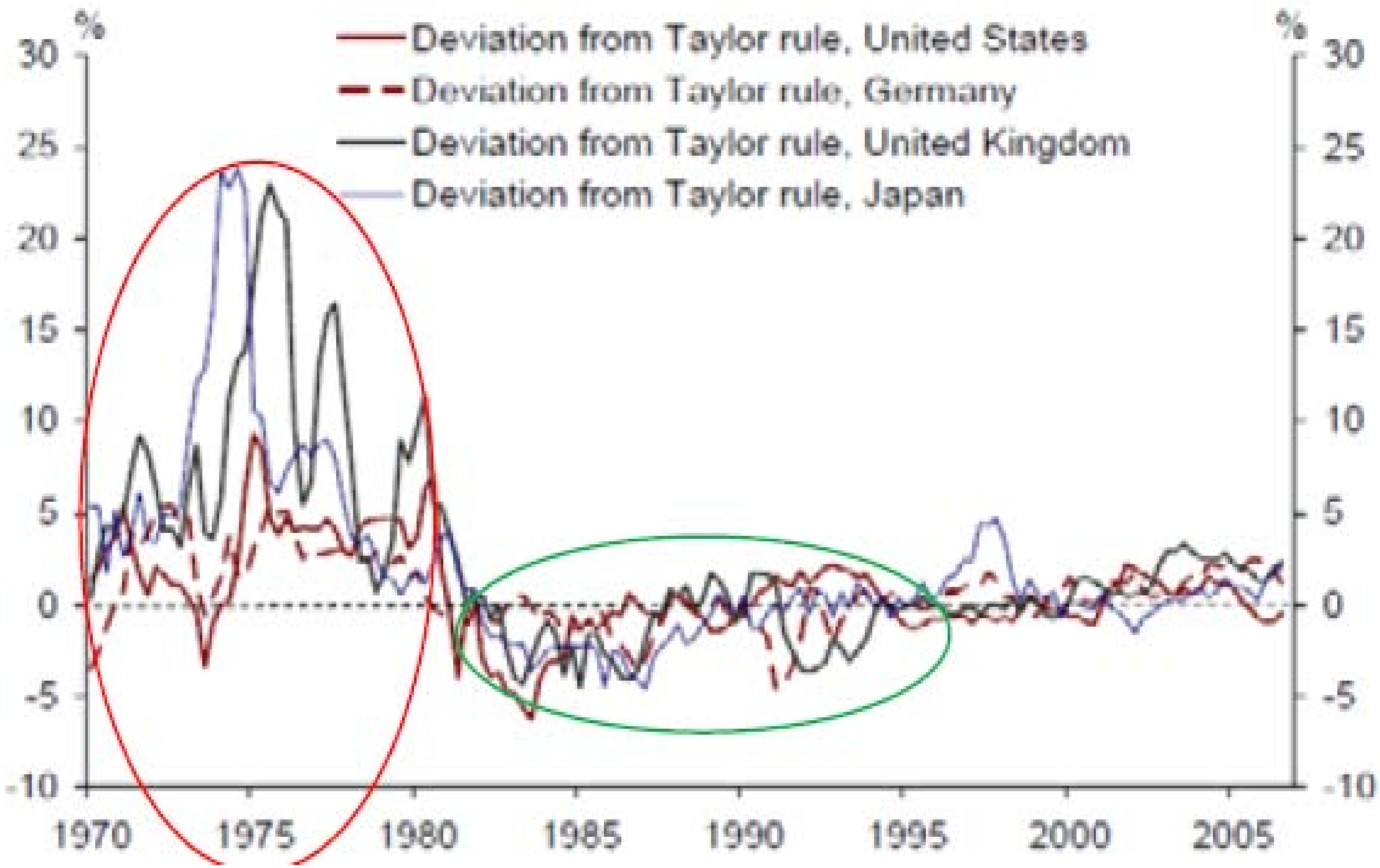
- Clinton: proposed tiny stimulus in 1993
  - $16 billion more G
  - Did not pass the Congress
- Eichenbaum (1997) “there is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible.”

Monetary Policy

- Dramatic shift of policy to inflation with Volcker 1979-87.
  – Volcker (1983) “We have…gone a long way toward changing the trends of the past decade and more.”
- Policy continued in ‘80s and ‘90s under Greenspan.

Monetary Policy

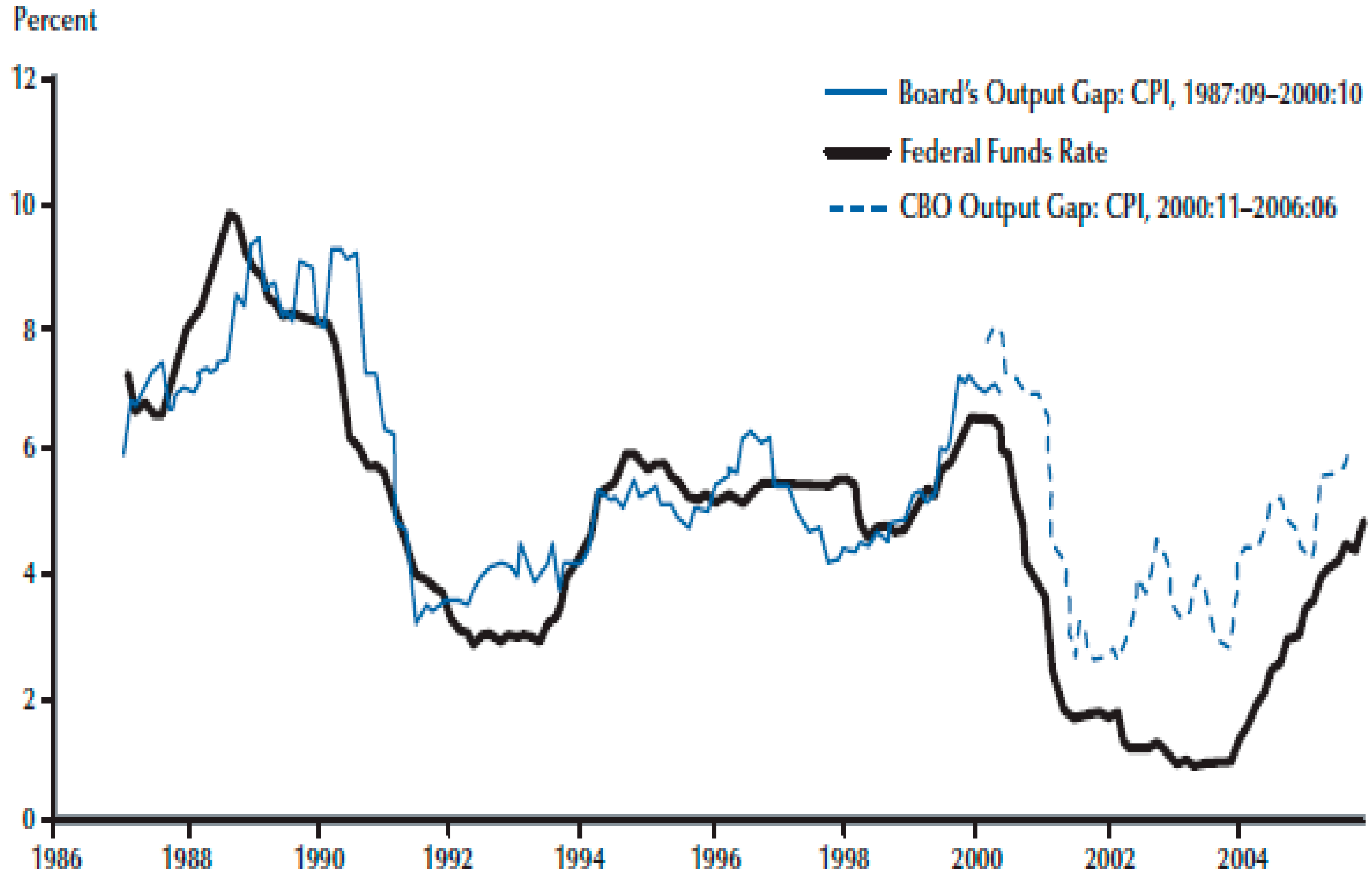
- Additional evidence of more rules-based policy
  - More predictable and transparent decision-making process
  - Focus on expectations of future policy actions.
  - Announcing interest rate decisions when making them.
- Transcripts of the FOMC in the 1990s, many references to rules.
- Finally, actual monetary policy is much closer to simple policy rules



Source: Cecchetti, Hooper, Kasman, Schoenholtz, Watson (2007)

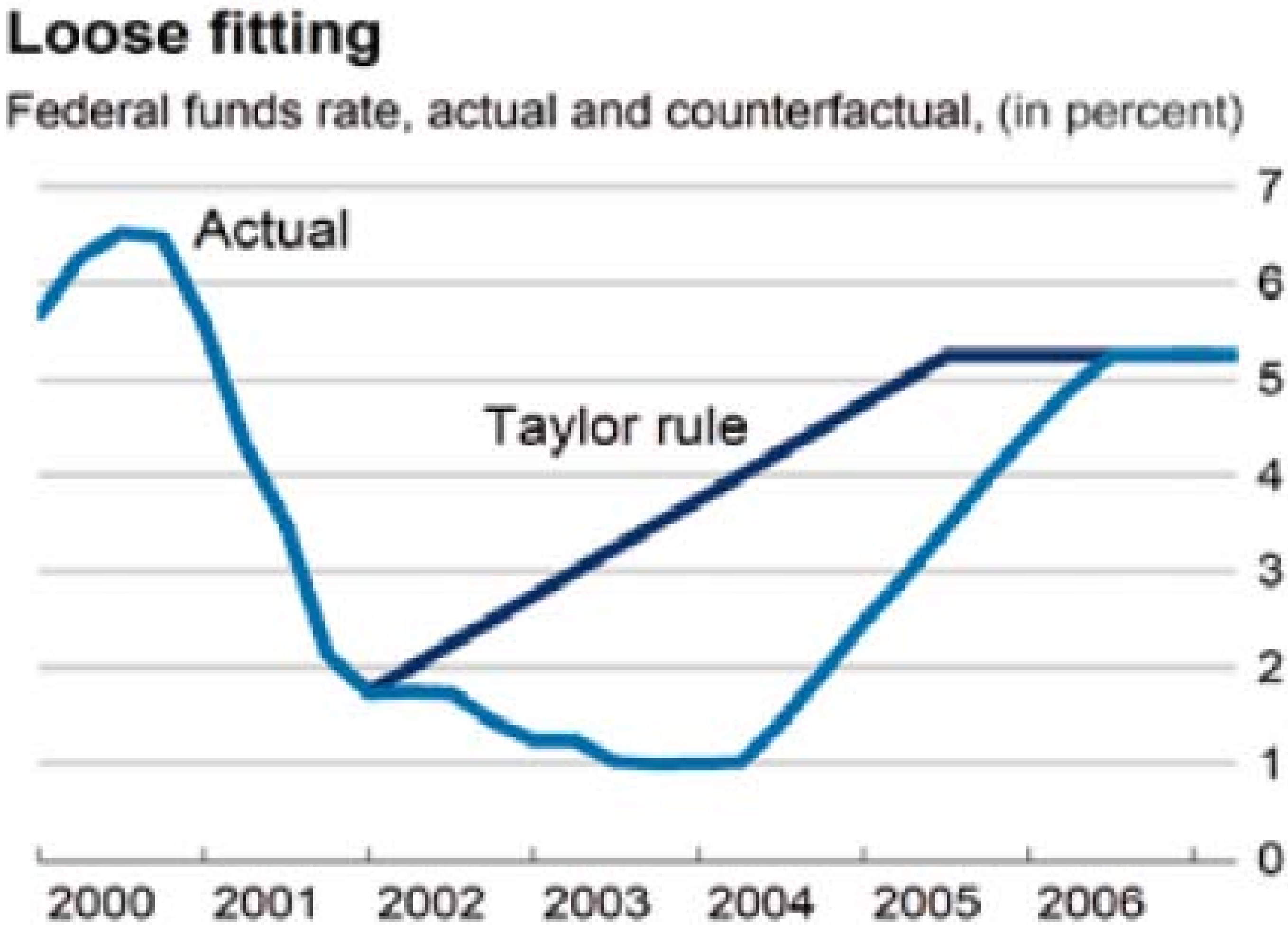
The Swing Away from Rules Recent Years

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

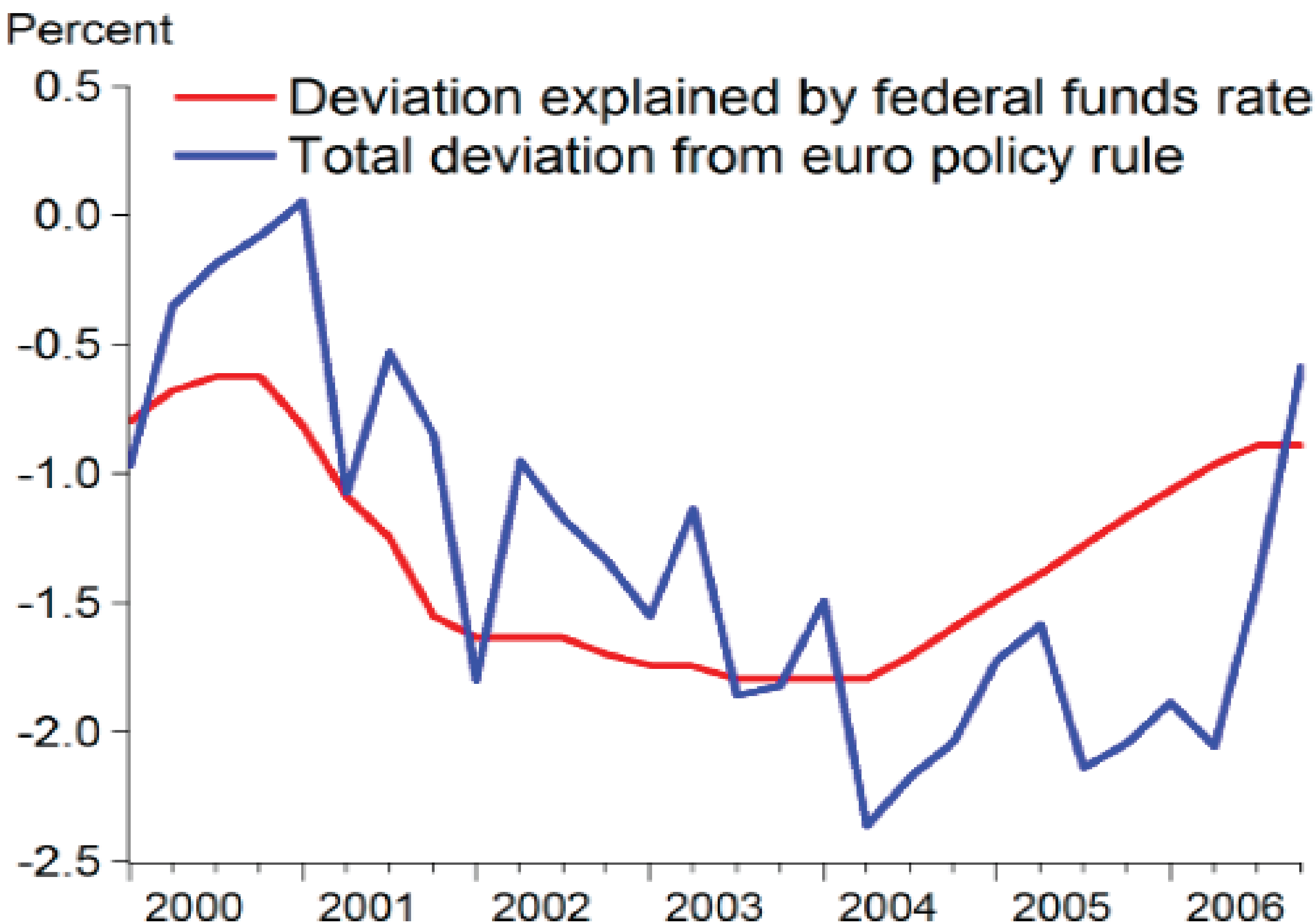


Monetary Policy

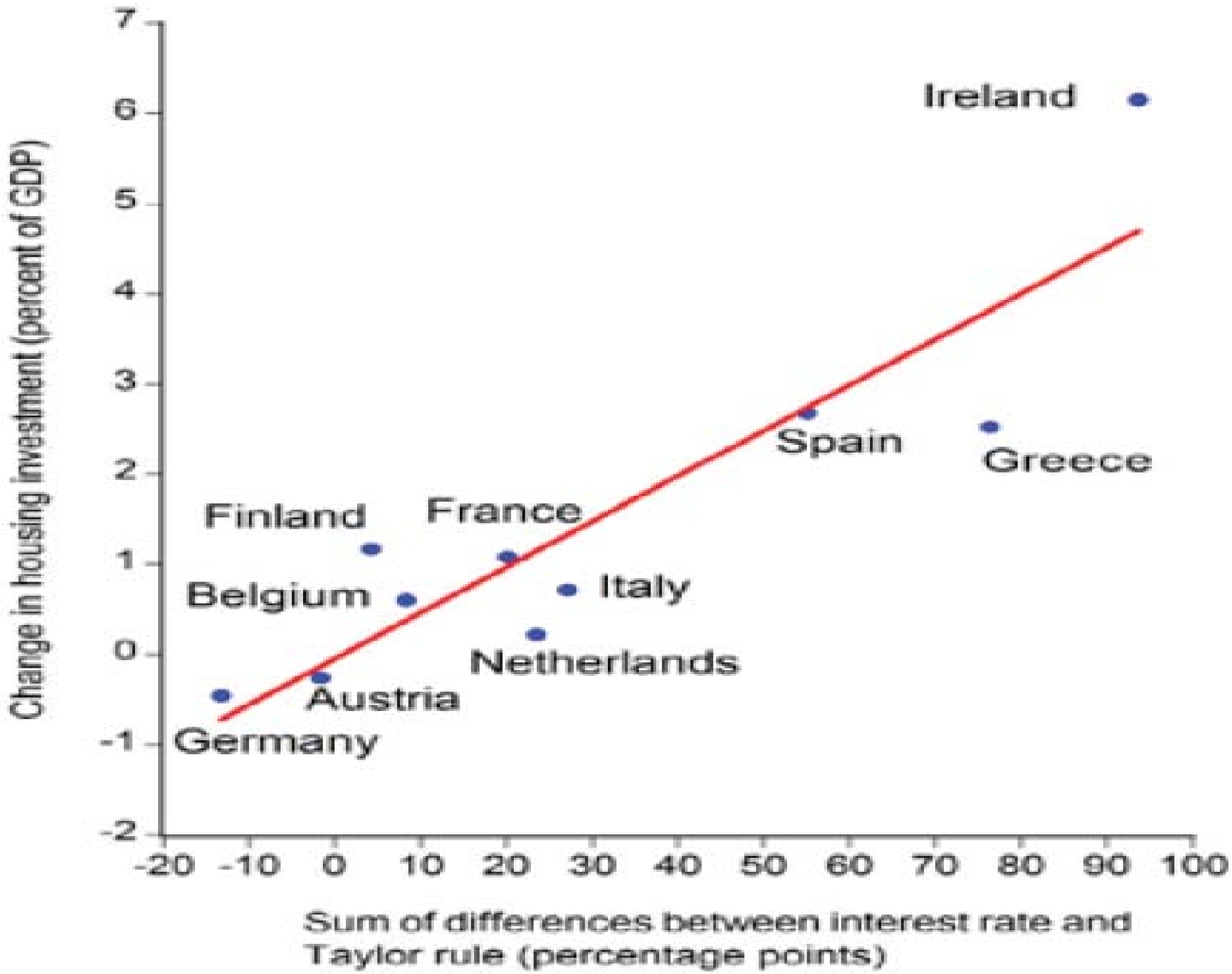
Chart from the Economist, Oct. 18, 2007



Europe Too


Percent
Deviation explained by federal funds rate
Total deviation from euro policy rule
0.5
0.0
-0.5
-1.0
-1.5
-2.0
-2.5
2000
2001
2002
2003
2004
2005
2006

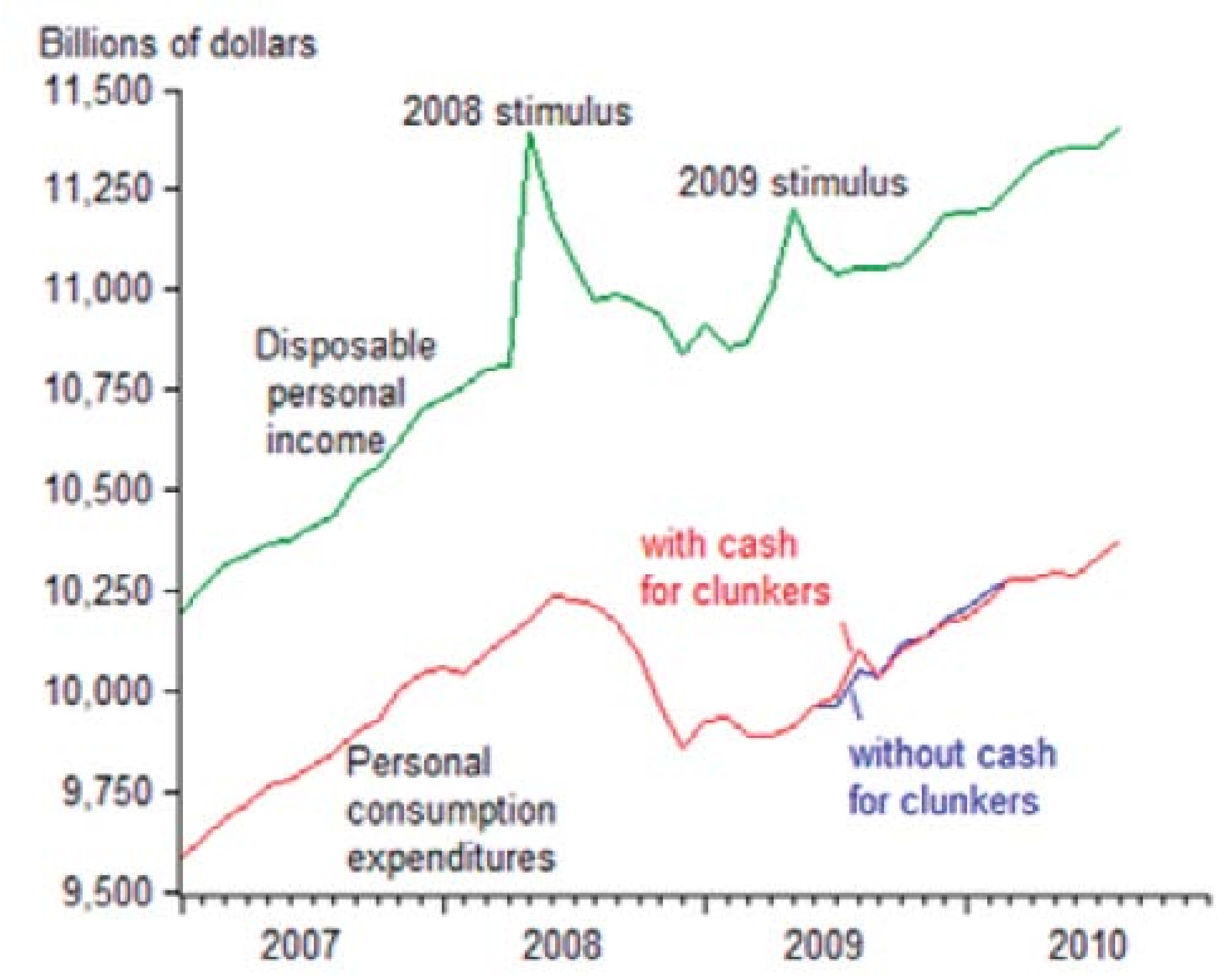
Within Euro Zone



Monetary Policy
Fed Balance Sheet Discretion

- Pre panic:
  - On-again/off-again interventions (Bear Stearns, Not Lehman, AIG,…)
- Panic:
  - Money market mutual fund liquidity facility
  - Commercial paper funding facility
- Post panic:
  - QE1
  - QE2

Return of Discretionary Fiscal Policy



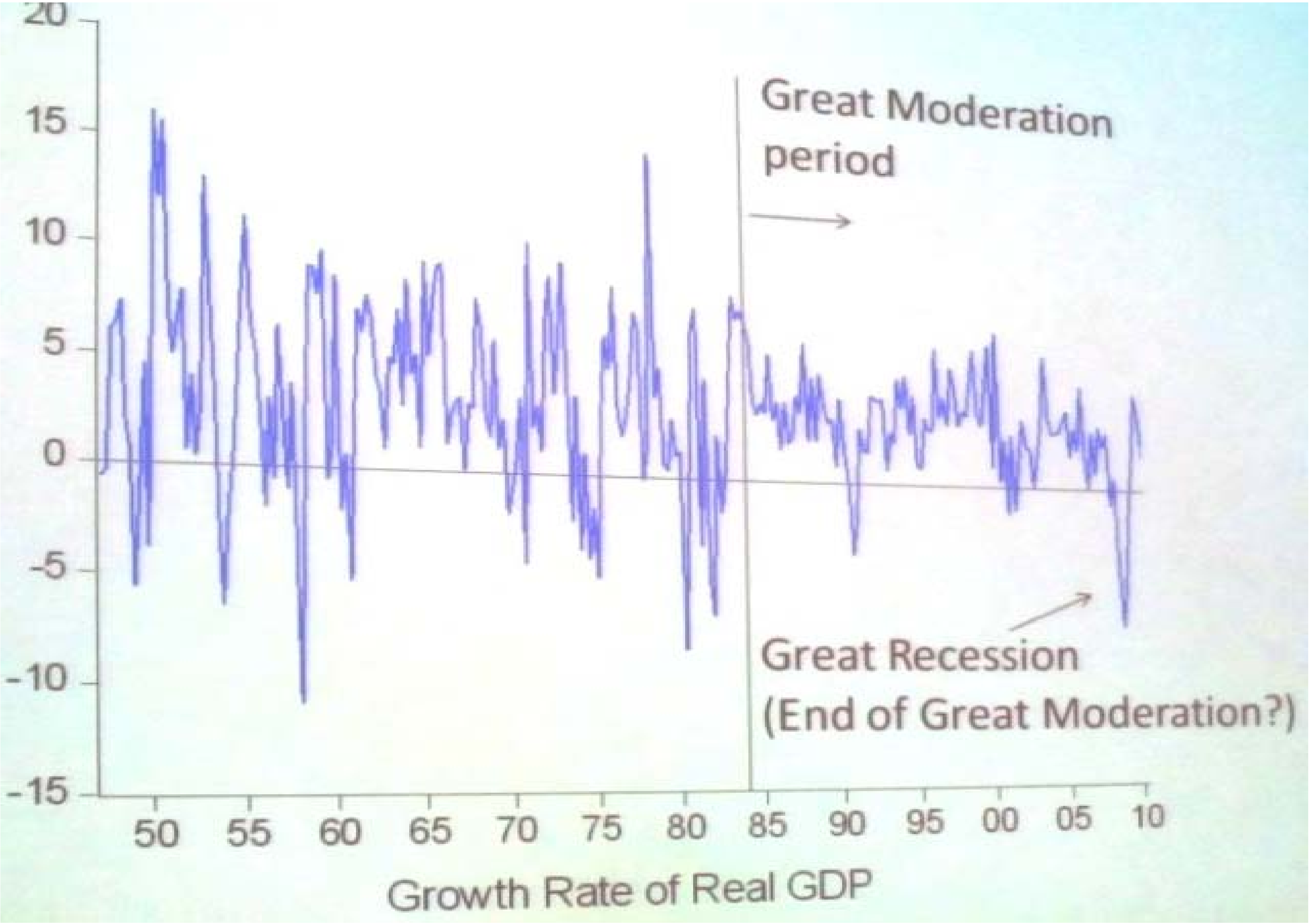
The Impact on Economic Performance

- What happened to Y when X rose and fell?
- First swing to discretion associated with frequent recessions, high unemployment, and high inflation
  - When X went down, Y also went down.
- Second swing to rules-based policies associated with a stability
  - Volatility of real GDP was cut in half. Great Moderation.
  - When X went up, Y also went up.

The Impact on Economic Performance

- Third swing to discretion associated with financial crisis and great recession
  - When X went down, Y also went down.
- Clear positive correlation. But what about causation?

From Great Moderation to Great Recession



Is Cycle Due to the Need for Policy to Improve Poor Economic Performance?

- Could Y have caused X?
- Discretionary Keynesian fiscal policy in the 1960s could not have been a response to the recessions of the 1970s.
- Inflationary monetary policy starting in the late 1960s could not have been caused by the inflation of the 1970s.
- Move to reduce inflation and restore economic stability could not have been caused by low inflation.

Is Cycle Due to the Need for Policy to Improve Poor Economic Performance?

- More plausible case recently?
  - Financial panic of 2008 required large discretionary actions.
- But shift to discretion began before the panic
  - Low interest rates of 2003-2005,
  - Stimulus package of February 2008
  - Unprecedented use of the Fed’s balance sheet in early 2008.

Economic Theory Supports the Policy to Results Causation

- Any dynamic model in which people are forward-looking and take time to adjust their behavior implies that monetary and fiscal policy works best when formulated as a policy rule.
- Time inconsistency argument, Kydland and Prescott (1977).
- Lucas critique (1976): rules are essential for evaluating policy.

Economic Theory Supports the Policy to Results Causation

- Many other reasons why rules-based policies work better.
  - Rules provide predictability and reduce uncertainty.
  - Rules help policymakers avoid short-term pressures from special interest groups and take actions consistent with long-run goals.
  - Rules facilitate communication and increase accountability.
  - Vast literature surveyed by McCallum (1999) and Taylor-Williams (2011).

But haven’t Those Theories Failed?

- Some argue that the recent crisis shows this. But evidence does not show this:
  - Rather the models were right and the policies were wrong.
  - Policy makers did not follow the rule-based policies recommended by models.
  - Avinash Dixit “economic theory came out of this better than policy practice did…”

But haven't Those Theories Failed?

- Specific complaints: models assume efficient markets, rational expectations without financial frictions.
  - But virtually all models used for monetary policy contain frictions.
  - Monetary and credit aggregates are frequently omitted from empirical models, but due to measurement issues which forced econometric modelers to focus on financial prices rather than financial aggregates.
  - Some complain that the models only include a short-term interest rate, but those are the textbook models, not the one built for policy.

Evidence about Specific Policy Actions

- Discretionary actions in ‘60s and ‘70s.
  - Friedman-Phelps prediction consistent with evidence.
  - Gramlich evidence on countercyclical stabilization grants.
  - Blinder evidence on temporary tax changes, price controls
- Rules-based actions in ‘80s and ‘90s
  - Cecchetti, Stock-Watson: monetary shift in ’80s’-90s was beneficial

Evidence about Specific Policy Actions

- Discretionary actions again (Taylor)
  - Too low rates in 2003-2005 added to the housing boom
  - One time payments in 2008 and 2009 did not jump-start consumption
  - 2009 efforts to boost government were ineffective.
  - QE1 had little effect on mortgage rates once risks are controlled for.

Evidence about Specific Policy Actions

- Discretionary actions again (Taylor)
  - On again/off again bailout policies did not prevent panic
  - Fed's interventions in commercial paper and money market funds helped
  - Other implications:
    - Increased debt and monetary overhang.
    - Questions about central bank independence (fiscal policy, credit allocation policy).
    - Unwinding the programs creates uncertainty, inflationary risk

What Causes the Rules-Discretion Cycle?

- Discretionary or rules-based periods overlapped political regimes
  - Discretionary period: Kennedy, Johnson, Nixon, Ford and Carter
  - Rules based period: Reagan, Bush 41, Clinton.
  - Discretionary period: Bush 43, Obama
- So narrow partisanship does not work.
- Economic theory as a forcing factor?
- Broader political trends?
- Endogenous cycle?

Economic and Political Theory

- Economic theory as a forcing factor
  - My own rationale for stressing rules for 40 years
    - Economy is an evolving dynamic stochastic structure,
    - Impact of policy changes occurs with lags
    - People adjust their behavior
    - Not static ISLM, static textbook Keynesian models
    - Only rules made sense, not simple gap filling
  - But what caused the swing back?

Economic and Political Theory

- Political theory as a forcing factor
  - Example: Hayek, *The Road to Serfdom*
  - Ch 6: “Planning and the Rule of Law”
    - Limits government
    - Preserves individual freedom

An Endogenous Cycle

- Shift to rules in the ‘80s caused by dissatisfaction with ‘70s?
- Shift to discretion caused by complacency in ‘80s-’90s?
- Y seems to Granger-causes X negatively.
  - Not inconsistent with X Granger-causing Y positively.
- Dissatisfaction with recent performance may cause swing back toward rules in future
- But can we speed up the cycle and then tame it?

Conclusion

- Clear evidence of a rules-discretion cycle in monetary and fiscal policy
- Strong correlation with economic performance: swings away from rules were associated with the Great Inflation of ‘70s and recent Great Recession
- Much evidence that it is causal:
  - Reverse causation implausible
  - Vast theoretical support
  - Specific studies of particular policy actions
- Questions remain about the cause of the rules-discretion cycle and its cure