Monetary rules vs. central bank discretion [1]

Written by **Ben Southwood** [2] | Thursday 16 May 2013

On Monday I attended a conference in Copenhagen on monetary policy regime change with Lars Christensen of Danske Bank, Sam Bowman, research director here, Anthony J Evans, economics professor at ESCP Europe Business School, and Martin Ågerup, president of Danish liberal think-tank CEPOS, among others. The discussions raised a huge number of interesting ideas, among which was the question of rules vs. discretion in monetary policy. We all agreed that a rule-based system would be a major improvement on the existing system.

The current monetary regime in the UK, and many other major economies, is known as flexible inflation targeting. Under flexible inflation targets, a panel of appointed ?wise men? is tasked with keeping inflation close to a target rate?in the UK 2% measured by the consumer prices index. They set interest rates (and in exceptional times, asset purchases, known as quantitative easing) to control aggregate demand and through that the price level, and achieve their target. The flexible element of the policy is that they have leeway to decide when achieving the target straight away would cause more harm to the economy than the resultant above target inflation. It is this provision that explains the Bank of England?s monetary policy committee?s decisions not to tighten policy despite 40 successive months of above target consumer price inflation in the UK.

There are many problems with this framework?including looking narrowly at consumer prices, rather than all prices in the economy; targeting a rate instead of a level; and judging performance by actually achieved inflation instead of expected future inflation?but here I wish to focus in on the problems with allowing the MPC to decide when and how much to miss their target.

One obvious problem with discretion, as opposed to rules, is that it can be unclear exactly what rate-setters will do in response to shocks. Firms have to worry not only about unexpected changes in market conditions but also unexpected macroeconomic response to these changes. Hence the feverish market interest in a press conference from Mario Draghi or Ben Bernanke, with intense focus on minute changes in tone or wording of statements. Hence the massive market shifts on central bank policy decisions. Measures of economic policy uncertainty [3] have risen to volatile highs, and such uncertainty is widely believed to stymie investment, arguably the most important constituent of national income for staging an economic recovery.

A perhaps more fundamental problem with discretion as against rules is the huge amount of knowledge it assumes the nine-member MPC can amass and act upon. The optimal response to a supply shock, as Bill Woolsey explains in detail [4] will depend on the demand and supply elasticities in that and other markets, not to mention guessing when and in which markets the shocks will hit. So even if an omniscient and perfectly benevolent despot could set the optimal policy with discretion, a rule-based system could be the best?or least bad?actually possible policy.

Allowing central bankers to decide when to hit their target is just allowing central bankers to decide whatever they think is best, and as Woolsey says, it?s completely unsurprising that they come out generally in favour of the system.

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