Flexible Rules Versus Discretion: The Fed's "New" Data-Dependent Approach

Michael Bordo,
Rutgers University and Hoover Institution, Stanford University

SOMC | SHADOW OPEN MARKET COMMITTEE

Shadow Open Market Committee Meeting
Princeton Club, New York City
March 29, 2019

E21 Manhattan Institute

ECONOMIC POLICIES FOR THE 21ST CENTURY

Recently, key Federal Reserve officials have spoken about following a data driven approach towards addressing FOMC monetary policy decisions (Clarida (2018), Williams (2019), Powell (2019)). According to them, monetary policy at this juncture requires raising the prominence of incoming data before continuing to normalize the policy interest rate.

Subsequent to these statements the Fed has signaled that it has paused (temporarily?) in its rate hiking normalization cycle. The question I pose is: What does data dependence mean? Does it mean that the Fed is moving away from its implicit rules-based policy guidance towards more discretion? Or could it effectively signal a return to outmoded fine-tuning or stop-go strategies?

Fed Vice Chair Clarida laid out his notion of data dependence in a clear and reasoned way. In many respects what he described is an approach consistent with a rules-based strategy. He stressed relying on intermeeting data to update views about the appropriate policy stance by focusing on: (1) the state of the business cycle: real activity measures relative to potential and inflation relative to the 2 per cent target; both of these variables are in conventional instrument rules (e.g. the Taylor rule (1993), Clarida, Gali and Gertler (2000)) that the Fed has traditionally monitored (Yellen 2017); and (2) revisions to policy benchmarks such as the unknown parameters in conventional instrument rules such as the neutral real rate of interest (r*) and the natural rate of unemployment (U*).

Because the 'true' values of r* and U* are unknowable, revised estimates of them are very important in determining whether the Fed's trajectory for the policy rate should be

maintained. This has certainly been the case since the Fed began its normalization cycle in 2015. It has progressively revised its estimates of r* and U* despite considerable debate in the profession over r* and U*. These revisions have arguably been responsible for keeping the policy rate so low and the upward trajectory so shallow.

Going forward, if the Fed underestimates r*, insufficient monetary restraint could result, thereby fueling overheating and possibly requiring a sharp tightening of monetary policy in the future. This could prove particularly problematic if r* has truly fallen (albeit not as low as the Fed's estimates). In this case, the Fed would eventually find itself behind the curve at the same time that a lower steady-state r* implies a greater chance the Fed may find itself flat-footed with too little ammunition to counter a future recession (see e.g. Wieland (2018)). With respect to U*, if the Fed revises down its estimate too much, the greater is the chance of an inflation overshoot – as was the case in the 1960s.

President Williams (2019) defined data dependence as "the hard economic data, …, anecdotal evidence provided by business executives, and information provided by financial market behavior." The Fed has paused its tightening cycle before in the face of such incoming data in the form of global headwinds and stock market turbulence. These events, before the recent pause, turned out to be transitory.

Given this, what do we make of the Fed's 'new' approach. At first glance it *appears* to be consistent with what Bernanke (2003) and Bernanke and Mishkin (1997) and Ben Friedman (2012) coined constrained discretion. This strategy is a hybrid between pure discretion (which can lead to time inconsistent behavior as in Kydland and Prescott (1977)), and rules

(like Milton Friedman's (1960) CMG rule and John Taylor's (1993) eponymous FFR instrument rule). This constrained discretion strategy addressed the main criticism of Ben Bernanke, Rick Mishkin and Ben Friedman that explicit rules are not flexible enough to deal with big shocks. In other words, constrained discretion can be viewed as following rule-like behavior but allowing judgment by knowledgeable and credible officials (Mishkin, 2018).

While flexible, constrained discretion's main attraction is that it in principle guards against the tendency of past policy makers to excessively fine-tune – i.e. over react to short-term financial market whimsy and macroeconomic data releases. As an earlier generation of SOMC members (Karl Brunner, Alan Meltzer and Anna Schwartz) argued, fine-tuning/stop-go policies of the past generated a key source of macroeconomic instability. These policies exacerbated the business cycle and threatened price stability. This earlier historical record suggests that we need to be cautious about the new "data-dependence" approach.

For constrained discretion to differ from *unconstrained* discretion, it is important that the Fed be clear and transparent about how incoming data revises the policy path. For it is only when we have such clarity that we can ensure that the Fed is following its articulated strategy in both word and deed.

Achieving this level of credibility is difficult. I should note that another hybrid rule that I once posited (Bordo and Kydland (1995)) is a contingent rule as followed under the classical gold standard in which convertibility of central bank notes into gold at a fixed price would be maintained except in the event of a well- known contingency like a major war. In that case

convertibility would be suspended until the emergency has passed. That rule has been criticized because of the difficulty of identifying contingencies ex ante.

The Fed's new approach also is subject to concerns about clear communication ex post. Without additional information well above and beyond the dot-plots, it is difficult to know whether the Fed's data-dependent strategy will result in rule-like behavior or will mask a return to "looking at everything" discretion of an earlier era. Without clear, constrained discretion, the Fed also opens up itself to threats to its independence from political pressure, and paying too much attention to the asset price markets and their self-interested pundits.

Indeed, the latest decision by the Fed should raise some eyebrows. With very little revision in its output and inflation forecast as well as little change in private sector forecasts, the Fed appears to have taken two policy rate increases off the table for 2019. At the same time, they note that commodity prices are lower than a year ago, and financial markets have been volatile. How important were these developments in the decision? We just don't know. This leads me to ask, is the Fed's 2019 data-dependence strategy truly a break from the shibboleths of the fine-tuners? The jury is still out.

References

Ben S. Bernanke (2003), "Constrained Discretion and Monetary Policy." Remarks before the Money Marketeers of New York University, New York, New York, February 3, 2003.

Ben S. Bernanke and F. S. Mishkin (1997) "Inflation Targeting: A New Framework for Monetary Policy" *Journal of Economic Perspectives*, Vol 11. No.2 (Spring); pp 97-116.

Michael Bordo and Finn Kydland (1995) " The Gold Standard as a Rule: An Essay in Exploration" *Explorations in Economic History*. October

Richard Clarida, Jordi Gali and Mark Gertler (2000) "Monetary Policy Rules and Macroeconomic Stabilitry: Evidence and Some Theory" *Quarterly Journal of Economics* (February) : pp 147-180.

Richard Clarida (2018) "Data Dependence and U.S. Monetary Policy" Speech New York City November

Benjamin Friedman (2012) "Rules Versus Discretion at the Federal Resereve: On to the Second Century" *Journal of Macroeconomics*. Vol 34 :pp 608-615

Milton Friedman (1960) *A Program for Monetary Stability*. New York: Fordham U Press.

F.E. Kydland and E.C. Prescott (1977) "Rules rather than Discretion: the Inconsistency of Optimal Plans" *Journal of Political Economy* 85,3:pp 473-492.

F.S. Mishkin (2018) "Improving the Use of Discretion in Monetary Policy" Columbia University (mimeo) October.

Jay Powell (2019) "Monetary Policy Normalization and the Road Ahead' Stanford University. March

J.B. Taylor (1993) "Discretion Versus Rules in Practice" *Carnegie – Rochester Conference Series on Public Policy*, 39: 195-214.

Volker Wieland (2018) "R-Star: The Natural Rate and its Role in Monetary Policy" chapter 2 in Michael D Bordo and John Cochrane (eds) *The Structural Foundations of Monetary Policy*. Hoover Institution Press

John C. Williams (2019) "Monetary Policy : A data dependent approach" . New York, March

Janet Yellen (2017) "The Economic Outlook and Monetary policy" Stanford University . January