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John Taylor and the Revival of the Rules-versus-Discretion Debate

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Michael D. Bordo, John H. Cochrane, and John B. Taylor (eds), *How Monetary Policy Got Behind the Curve—and How to Get Back*, Stanford: Hoover Institution Press, 2023, 422 pages, 978-081792564-2

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Texte intégral

- 1 After nearly four decades of price stability in most industrialized countries, inflation came back with a vengeance in early 2022. Not surprisingly, this return has been the object of many conferences and seminars organized since then. This was notably the case with the 2022, 2023, and 2024 editions of the annual Monetary Policy Conference of the Hoover Institution. As usual, the Hoover Institution conferences gathered renowned economists from academia (such as Markus Brunnermeier, Barry Eichengreen, Yuriy Gorodnichenko, Ellen McGrattan, Emi Nakamura, Valerie Ramey, Ricardo Reis, or Thomas Sargent), policy circles (such as James Bullard, Richard Clarida, Jeffrey Lacker, Edward Nelson, Charles Plosser, Christopher Waller, or John Williams), and private institutions (such as Beth Hammack, Mickey Levy, Randal Quarles, or Tom Stephenson). The three volumes edited by Michael Bordo, John Cochrane, and John Taylor, bring together the



proceedings of these conferences.

- 2 The central issue addressed during the Hoover Institution conferences was the extent to which the policy conducted by the Federal Reserve was the appropriate one. The main answer was unambiguously negative. It was argued that the monetary policy in the US has been much too expansionary since the Covid crisis of 2020. Moreover, it was also argued that if the Fed had adopted a rule-based approach to monetary policy, the inflationary episode starting in 2022 would have been largely avoided. Accordingly, the main recommendation that emerged from this assessment was that the Fed—but also the other major central banks around the world, which tended to follow a quite similar path during that same period—should now adopt a strategy based on policy rules for the actual conduct of monetary policy.
- 3 The first volume is essentially an evaluation of the policy conducted by the Fed between 2020 and 2022. Many contributions—especially that of Bordo and Levy, Reis, Taylor, and Volker Wieland—stress that in 2021 and early 2022, the monetary authority maintained the federal funds rate at very low levels while the economy was recovering quickly, and inflation began to pick up significantly. According to the five policy rules that the Fed has been reporting on since 2017 (in a section of the semi-annual *Monetary Policy Report*) to give insight into the actual stance of policy, this rate should have been raised from early 2021. This means that monetary policy was overly expansionary during that period. This policy would notably bear responsibility for the surge in inflation that occurred in 2022. Indeed, if the Fed had instead followed the prescriptions of the reported rules, the sharp increase in the prices of energy and raw materials that occurred in 2022 would have only induced a jump in the aggregate price level—not the sustained increase in core inflation that was observed in 2022-2023. Some parallels can therefore be drawn with what happened in the 1970s: had monetary policy not been so expansionary since the mid-1960s, the 1973 oil price shock would not have turned into a persistent increase in core inflation.
- 4 The last two volumes are mostly normative in nature, focusing specifically on how such policy mistakes could be avoided in the future. The flavor of the recommended policies is well illustrated by the contributions of Lacker and Plosser (second volume) and Athanasios Orphanides (third volume). The former authors argue that the Fed should now commit itself to a strategy giving pride of place to the five policy rules reported on in the semi-annual *Monetary Policy Report*. Noting that the Fed “almost never references the prescriptions emanating from these rules in its regular communications to the public about policy,” they stress that it “can and should routinely reference the implications of such a range of monetary policy rules when publicly discussing the likely future path of interest rates” (Bordo et al., 2024, 349). Hence, the whole policy process should be centered around rules in order to avoid the destabilizing effects resulting from discretionary policymaking. Moreover, since “Explaining policy as a systematic pattern of response or reaction function is likely to be as close to a credible commitment as the Fed can achieve while describing the future outlook for policy” (362), organizing policy decisions and discussions around policy rules would make “forward guidance” more efficient. Similarly, following up on a proposal initially made by Taylor in the early 2010s (Taylor, 2011), Orphanides argues that central banks should select a policy rule and commit themselves to explaining any deviation from that rule. The selected rule should display some robustness across the various types of uncertainty central banks are confronted with—especially the uncertainty associated with the right specification of the model economy, and with the estimation of some key (yet unobservable) variables. With this approach,

while policy retains some discretion, decisions are informed by simple rules. The central bank is expected to provide information to the public that can be used to monitor deviations and explain the reasons for substantial deviations. The public disclosure and commitment to explain deviations constrains discretion, facilitating more systematic policy (Bordo et al., 2025, 317).



5 The reader should not be surprised by the conclusions and policy recommendations put forward in these three volumes. Indeed, many of the participants to the Hoover Institution conferences were signatories of the “Statement on Policy Rules Legislation” in 2016, which, under the lead of Taylor, supported a legislation aimed at requiring the Fed to choose a policy rule and to justify any deviation from that rule. The volumes edited by Bordo, Cochrane, and Taylor, should therefore be considered as contributing to the revival of the rules-versus-discretion debate. In the rest of this essay, I will stress the critical role played by Taylor in this revival and show that, in recent years, the debate has turned into a debate between rules and “constrained discretion.”

6 Some twenty years ago—namely, just before the outbreak of the Global Financial Crisis of 2007-08—the rules-versus-discretion debate seemed to be over: Neither pure discretion nor the commitment to a mechanical policy rule (describing how the policy instruments should be set) were any longer advocated by prominent authors. Moreover, some consensus seemed to have emerged since the mid-1990s. This consensus, termed “constrained discretion” by Ben Bernanke and Frederic Mishkin (1997), was suggested as “an attempt to achieve the best of both worlds of rules and discretion by making discretion have rule-like properties” (Mishkin, 2018, 231). In a speech entitled “‘Constrained Discretion’ and Monetary Policy,” delivered in February 2003 before the Money Marketeers of New York University, Bernanke indeed argued that there would be “a middle ground” between rules and discretion,

an approach that I will refer to as *constrained discretion* ... constrained discretion is an approach that allows monetary policymakers considerable leeway in responding to economic shocks, financial disturbances, and other unforeseen developments. Importantly, however, this discretion of policymakers is constrained by a strong commitment to keeping inflation low and stable (Bernanke, 2003, italics in the original).

7 Obviously, the prevalence of such a “middle ground” approach did not mean that there was a similar consensus over all of its aspects—and, in particular, over the way it should be implemented in practice. A critical issue notably involved the procedure required to achieve price stability. In a speech entitled “The Logic of Monetary Policy,” delivered in December 2004 before the National Economists Club, Bernanke described the two main existing approaches—which he termed “simple feedback” and “forecast-based” policies—as follows:

Under a *simple feedback policy*, the central bank’s policy instrument ... is closely linked to the behavior of a relatively small number of macroeconomic variables ... Generally, the macroeconomic variables that drive simple feedback policies are chosen to reflect the central bank’s objectives, and policymakers are directed to adjust the short-term interest rate as needed to offset deviations of these variables from their desired levels ... Under a *forecast-based policy* regime, policymakers must predict how the economy is likely to respond in the medium term—say, over the next six to eight quarters—to alternative plans for monetary policy ... Taking both their baseline forecast and the various risks to that forecast into account, policymakers then choose the plan that seems most likely to produce the best results overall. Their current choice of interest rate corresponds to the first step in implementing the preferred plan (Bernanke, 2004, italics in the original).

8 According to the advocates of the “forecast-based” approach—an approach first named “inflation forecast targeting” by Lars Svensson (1997) and renamed “forecast targeting” in Svensson (2005)—the main advantage of a procedure relying on forecasts is that it enables policymakers to take account of all relevant information. Forecast targeting would provide clear guidance about how to incorporate *judgment* into policymaking: Judgment should affect policy decisions to the extent that it affects the forecast (or the risks to the forecast) of the variables policymakers are concerned with. The criticism usually leveled at this approach is that it would require



substantial knowledge about the functioning of the economy to produce good forecasts—a requirement that would hardly be met in practice.

9 The “simple feedback” approach—which is what Taylor suggested in his seminal 1993 paper under the name “systematic policy”—involves the use of simple policy rules as “guidelines” or “benchmarks” for policymaking. Its proponents argue that by reacting to a short list of macroeconomic variables (and especially inflation and the output gap, the only variables involved in the Taylor rule) in a systematic fashion, this approach makes monetary policy highly predictable. Given the importance of expectations in macroeconomic outcomes, a more predictable monetary policy would, in effect, mean a more efficient policy. They also argue that this approach allows policymakers to deviate from the prescriptions of the rule when necessary—for instance, in response to a financial crisis. But the ad-hoc character of these potential deviations is an aspect especially open to criticism. Svensson (2003, 445) notably finds “the idea of a simple instrument rule as a mere guideline not sufficiently specific to be operational. When shall the rule be followed, and when not?”

10 In any case, the fact remains that, by the mid-2000s, it was widely recognized that central banks should strongly commit themselves to achieving policy goals—and, in particular, price stability in the long run. Moreover, it was also admitted that the only kind of commitment central banks should make dealt with the goals of monetary policy, *not* with the setting of its instruments. The fact that achieving price stability did not involve a concurrent commitment to a specific rule for the setting of policy instruments was stressed on several occasions by Taylor himself. In the first pages of his 1993 paper, he notably pointed out that, in his view,

a policy rule need not be a mechanical formula ... A policy rule can be implemented and operated more informally by policymakers who recognize the general instrument responses that underlie the policy rule, but who also recognize that operating the rule requires judgment and cannot be done by computer (Taylor, 1993, 198).

11 Avoiding confusion with the “commitment” connotation of policy rules was the very reason why Taylor and Bernanke respectively used the terms “systematic” and “simple feedback” policies.

12 The importance of constraining discretion by a strong commitment to price stability was also acknowledged by central bankers themselves. This was obviously the case of the so-called “inflation targeting” central banks (such as the Reserve Bank of New Zealand, the Bank of Canada, or the Bank of England) which, from the early 1990s, adopted numerical inflation targets. This was also the case of other central banks (such as the Bundesbank, the Swiss National Bank, or the Federal Reserve) which, while not adopting explicit inflation targets, did stress that they were considering price stability as the primary goal of monetary policy. Moreover, even though central banks tended to rely primarily on forecast targeting to achieve price stability, some of them also seemed to consider simple policy rules in their decision-making process. After presenting the two competing approaches in the December 2004 speech mentioned above, Bernanke pointed out that at the Federal Reserve, both of them were actually used to provide information to policymakers: “FOMC members routinely compare their policy choices with both the prescriptions of various forms of the Taylor rule ... and the results of model simulations and forecasting exercises undertaken by staff at the Board and at the twelve Reserve Banks.” (Bernanke, 2004) Similarly, Bennett McCallum and Nelson (2005, 602) documented several instances where officials and economists of the Bank of Canada, the Bank of England, and the Reserve Bank of New Zealand, did mention the use of simple rules in the descriptions of their policy procedures.


13 This emerging consensus, however, broke down with the Global Financial Crisis. The first blow came at the 2007 Jackson Hole conference. There, Taylor argued that the overly expansionary policy of the Fed between 2002 and 2004 would have been

the main source of the housing market bubble in the US, and that the subsequent strong tightening of the policy stance would have precipitated its burst. He notably showed that if the Fed had followed the prescriptions of his rule during that episode, this bubble would not have existed. Taylor also recalled that between the mid-1980s and the early 2000s, the Fed had been more expansionary than what was suggested by his rule on two important occasions—namely in the wake of the financial turmoil of 1987 and 1998. According to him, however, those deviations were short-lived and required by the necessity to provide financial markets with liquidity. By contrast, the deviation that would have caused the housing market bubble lasted more than two years, and was given questionable rationale by the Fed—in particular, the necessity to take preemptive actions to respond to negative economic outlooks which, in retrospect, turned out to be too pessimistic. Hence, a commitment involving only policy goals would not prevent central banks from making costly mistakes in their meeting-by-meeting conduct of monetary policy. In other words: a mere commitment to achieving specific goals would not constrain discretion enough.

14 The second blow came in the aftermath of the Great Recession. At that time, the federal funds rate was driven to zero very quickly, and the Fed switched to money supply as its main policy instrument. The Fed then conducted massive open-market purchases to substantially raise the quantity of money circulating in the economy. This was the so-called ‘Quantitative Easing’ program implemented between 2009 and 2013. Right from the start, Taylor was highly critical of this program. He especially stressed that the size of the open-market purchases—and the associated increase in the size of the Fed’s balance sheet—could not be justified on economic grounds. In particular, he pointed out that the Taylor rule would have implied a federal funds rate close to—but very often slightly above—zero over most of the period. In his eyes, only a significantly negative rate implied by his rule would have made the actual sharp increase in the money supply appropriate. Instead, the Fed should have temporarily switched to a rule involving a constant (and moderate) rate of growth for the supply of money—in the spirit of the famous proposal made by Milton Friedman from the 1950s onwards (such as in his 1968 presidential address to the American Economic Association). Taylor further argued that the uncertainty associated with the way the Fed would eventually bring back the size of its balance sheet to normal levels (by withdrawing a substantial part of the injected liquidity) would be responsible for the weak recovery then experienced by the US. Again, it follows that trying to constrain discretion by committing oneself to achieving specific targets in the medium-to-long run would not prevent central banks from conducting inappropriate policies in the short run.

15 These two alleged shifts toward more discretion were the very reason why Taylor, in 2011, proposed to legislate a rule for monetary policy—amounting to a *commitment to a policy rule* (on top of the commitment to policy goals) by the Fed. Taylor introduced his proposal as follows.

A number of years ago I proposed a simple rule as a guideline for monetary policy. I made no suggestion then that the rule should be written into law, or even that it be used to monitor policy, or hold central banks accountable. The objective was to help central bankers make their interest rate decisions in a less discretionary and more rule-like manner, and thereby achieve the goal of price stability and economic stability ... Why legislate a policy rule now? Because monetary policy has recently become more discretionary, more short-term focused, much less rule-like than it was in the 1980s and 1990s, and economic performance has deteriorated. A legislated rule can reverse the short-term focus of policy and restore credibility in sound monetary principles consistent with long-term price stability and strong economic growth (Taylor, 2011, 407-408)

16  Taylor’s proposal involved two requirements. First, each year, the Fed shall have transmitted to the Congress a written report setting forth “the strategy, or rule, of the Board and the FOMC for the systematic adjustment of the federal funds rate in

response to changes in inflation and in the real economy during the current year and future years, along with any additional systematic adjustments needed to achieve the price stability objective” (Taylor, 2011, 412). Second, while allowed to deviate from the chosen strategy, the Fed’s “Board of Governors must provide a written explanation and answer questions at a congressional hearing” (Taylor, 2011, 414).

17 Initially, Taylor’s proposal remained largely unnoticed. Gradually, however, it gained recognition and support among both economists and politicians. Indeed, from the beginning of the Great Recession to the end of 2015, the Fed had kept the federal funds rate to levels very close to zero. Most policy rules of the Taylor variety, however, indicated that this rate should have been raised from 2012 onwards. Hence, for three years monetary policy would have been overly expansionary again. Some leading economists, exemplified by Orphanides (2015), argued that this policy was motivated by an overly optimistic natural rate of unemployment that the Fed tried to reach. By disanchoring long-run inflation expectations, such a policy could ultimately threaten price stability. This potential threat led members of the Republican Party to endorse Taylor’s proposal, and to submit a legislation (embedded in the “Monetary Policy Transparency and Accountability Act”) involving the two requirements of that proposal. The legislation passed the House of Representatives in November 2015 and, under the lead of Taylor, received strong support from the signatories of the aforementioned “Statement on Policy Rules Legislation”—among whom the Nobel Prize laureates Lars Peter Hansen, Robert Lucas, and Edward Prescott.

18 Although the legislation submitted by the Republicans did not pass the Senate, it did generate some revival of the rules-version-discretion debate. The new debate involved, on one side, advocates of a commitment to a policy rule (even though, as in Taylor’s proposal, discretionary deviations would be allowed for in so far as they could be justified) and, on the other side, advocates of the “forecast-based” approach to constrained discretion—i.e., forecast targeting. A conference held at the Boston Fed in October 2017, entitled “Are Rules Made to be Broken? Discretion and Monetary Policy” provides a nice illustration of that debate. There, Taylor argued that ‘constrained discretion’

is an appealing term, and it may be constraining discretion in some sense, but it is not inducing or encouraging a rule as the language would have you believe. Simply having a specific numerical goal or objective function is not a rule for the instruments of policy; it is not a strategy; in my view, it ends up being all tactics. I think there is evidence that relying solely on constrained discretion has not worked for monetary policy (Taylor, 2017, 20).

19 At the same conference, Mishkin (a leading proponent of forecast targeting) identified

five main arguments against adoption of a monetary policy, instrument rule ...
 1. A rule requires a reliable model of the macroeconomy. 2. A rule requires that the structure of the economy is stable. 3. A rule cannot foresee every contingency. 4. A rule does not allow judgement. 5. Monetary policymakers are not less trustworthy than rule (Mishkin, 2017, 5).

20 At the same time, advocates of forecast targeting acknowledged that its actual practice by the Fed displayed some weaknesses. For instance, Mishkin recognized that “Although adopting a nominal anchor such as an inflation target can go a long way to constraining discretion and making it rule-like, it might not create enough accountability to constrain discretion sufficiently” (Mishkin, 2017, 18). To constrain discretion even more while staying within the bounds of forecast targeting, it was suggested that the Fed was more transparent (and, therefore, more accountable) about the way it adjusted the federal funds rate in response to changing economic circumstances. This could notably be done by following the example of the Norges Bank—the central bank of Norway. According to Mishkin, in each meeting this



institution not only provided “a baseline projected policy path along with a fan chart showing the confidence intervals around the policy path”, but also, and most importantly, explained “why the policy path may deviate from the baseline path by providing several scenarios as to how the policy path would change when economic outcomes change” (Mishkin, 2017, 19).

21 The main conclusion that emerged from this 2.0 debate of rules versus discretion was, therefore, that the conduct of monetary policy should be pushed somewhat more toward the rules side of the spectrum. This was, at least, the conclusion that the Fed seemed to draw. As mentioned at the beginning of the present essay, indeed, in 2017 the Fed started to include in the semi-annual *Monetary Policy Report* a full section where current and past policy decisions were compared with the prescriptions of five simple policy rules (most of them being variants of the Taylor rule), and where the advantages and limitations of using such rules in the conduct of monetary policy were discussed. Hence, the Fed seemed to belatedly adopt some version of the “simple feedback” approach to constrained discretion that Taylor had suggested in his 1993 paper.

22 Even though it did not amount to a commitment to a policy rule, this move of the Fed toward a more rules-based approach to monetary policy was welcomed by Taylor and his followers. In a post entitled “Monetary Policy Getting Back on Track,” Taylor notably stressed that “While the Fed has not yet endorsed the Monetary Policy Transparency and Accountability Act, these reforms represent substantial progress in that direction and should be acknowledged.” (Taylor, 2018) Moreover, the Fed did follow the prescriptions of the rules considered in the *Monetary Policy Report* by raising the federal funds rate consistently until 2020. Thus, the additional constraint imposed by the Fed on its own discretion put a break on the rules-versus-discretion debate.

23 That debate, however, has once again been revived since 2021. As we have stressed in the first paragraphs of the present essay, the Fed kept the federal funds rate much below the levels prescribed by most simple rules in the wake of the Covid crisis. Furthermore, the section devoted to policy rules in the *Monetary Policy Report* was withdrawn in 2021 (but reintroduced from 2022 onwards). Advocates of rules-based policies then argued that the move of the Fed initiated in 2017 proved to be insufficient to effectively constrain discretion. In this context, the three volumes edited by Bordo, Cochrane, and Taylor, provide some perspective on the current state of the rules-versus-discretion debate from the rules side. Whatever one’s position on this issue, the arguments and suggestions developed by the contributors are worth considering for anyone concerned with the way monetary policy should be conducted in practice.

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