

Rules, Discretion, and the Future of the Fed



This issue of *Region Focus* appears as the Federal Reserve System welcomes a new chairman. On February 1, Ben Bernanke became only the 14th person to hold that position in the institution's 92-year history. The transition presents an opportunity to look back on the notable success that the Fed has enjoyed under outgoing Chairman Alan Greenspan, and to think about

the future of monetary policy.

The Fed's effectiveness in securing price stability over the past 25 years has been unmistakable. Greenspan's predecessor, Paul Volcker, took a series of bold steps to bring down inflation from double-digit levels. And since the late 1980s, early in Greenspan's tenure, inflation, as measured by the Consumer Price Index, has dropped from an average of more than 4.5 percent to about 2.5 percent in recent years. Just as important, inflation expectations also have become more stable. Keeping inflation contained over these last two decades is a remarkable accomplishment. And this low inflation did not come at the cost of real economic growth. During this period, the U.S. economy experienced the longest expansion since World War II, bookended by two brief, mild recessions.

Some observers have identified "flexibility" as the key to Fed policy under Greenspan. By this, they mean an approach to policy that is not excessively tied to any one doctrine. They contrast this trait with an approach to policy that follows a rigid rule — perhaps such as a numerical inflation target — and suggest that the success of the last 18 years demonstrates the virtues of discretionary rather than rules-based monetary policy. This distinction goes back 30 years to a paper which argued the opposite, that rules were better than discretion. That paper was written by Finn E. Kydland and Edward C. Prescott, who won the 2004 Nobel Prize for economics.

So does the success of apparently discretionary policy in the Greenspan era prove Kydland and Prescott wrong? No. It strikes me that those who see recent policy as evidence for discretion over rules are using the terms differently than originally intended.

The Kydland and Prescott analysis showed that a central bank taking a discretionary approach may be sometimes tempted to ease policy to boost employment and output, despite the risk of higher inflation. The anticipation that policymakers will behave this way in the future will drive up current inflation. The result is likely to be persistently high

and ever-rising inflation, with no substantial benefit for growth and employment.

To get around this problem, Kydland and Prescott said that policymakers would do better if they could "commit" to a pattern of behavior that avoids the temptation to ease policy at the expense of inflation. To work, this commitment has to be believable, or "credible." A rules-based policy involves any tool that allows the policymaker to credibly commit not to succumb to temptation. One way to achieve credibility is to adopt an inflation target. But this is not the only way. What is essential is a consistent pattern of behavior that the public understands and believes will dictate the central bank's future behavior.

So has the Greenspan Fed been discretionary or rules-based? The flexibility that many people emphasize points to discretion. But I think a careful examination suggests that Fed behavior in recent decades has been closer to what Kydland and Prescott would describe as adhering to rules. This is evident first and foremost in the clear and persistent articulation of a focus on price stability that has come through Greenspan's testimony before Congress and other official communications. Rule-like behavior is also apparent in the attention the Fed has paid to the public's expectations. Most notably, the Fed's move to greater transparency in the last 10 years or so has enabled it to craft Federal Open Market Committee statements that to some extent guide the public's expectations about future policy. This sort of attention to expectations can be every bit as constraining on policymakers as the announcement of and adherence to a narrowly defined rule for setting interest rates.

To my mind, building monetary policy credibility has been the true hallmark of the Federal Reserve under Greenspan's leadership. Maintaining such robust credibility will take continual vigilance. Key to this will be helping the public understand that we intend to respond to future conditions in a way that keeps inflation low and stable. Eventually, this may entail adopting a numerical inflation target or some other more formal, rules-based system. We have Greenspan's stewardship to thank for getting us to this point. Far from being "flexible," the Greenspan Fed gave up the flexibility to let inflation get out of control. Instead, it established credibility for our commitment to price stability.

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