Principled Policymaking in an Uncertain World

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A crucial legacy of Phelps et al. (1970):

recognition of the importance of economic agents’ anticipations as a determinant of macro outcomes
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Among the profound consequences:

focus on the analysis of monetary policy rules, rather than decisions about individual policy actions.
Why the Focus on Rules?

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  — most easily done by specifying a rule
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  — most easily done by specifying a **rule**

- critique of **discretionary policy** (Kydland and Prescott, 1977):
  — sequential optimization fails to internalize the consequences of people’s anticipation of policymaker’s conduct
  — superior outcome possible through **commitment** to a rule
Doesn’t recognition of the possibility of non-routine change undermine the desirability of commitment to a policy rule?
Questioning the Importance of Rules

- Doesn’t recognition of the possibility of non-routine change undermine the desirability of commitment to a policy rule?

- Undermines a certain conception of policy rules: where rule is understood to be a fully explicit formula specifying precise action for any circumstances.
Questioning the Importance of Rules

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- Undermines a certain conception of policy rules: where rule is understood to be a fully explicit formula specifying precise action for any circumstances

- but not the need to assess policy strategies, rather than individual decisions

- nor the benefits from requiring policy decisions to be based on general principles, rather than an ad hoc
Questioning the Importance of Rules

- Strategies and principles irrelevant only if one views decisionmakers as responding mechanically to current economic environment

— not on basis of anticipations influenced by announced policy commitments

— i.e., only if one denies the relevance of the “modern” turn advocated by Phelps
Questioning the Importance of Rules

Examples of non-RE approaches, under which anticipations should still depend on what is known about CB policy commitments:

- “calculation equilibrium” (Evans and Ramey, 1992)
- “eductive stability” analysis (Guesnerie, 2005)
- “near-rational expectations (Woodford, 2010)
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In any of these cases, analysis of alternative policies requires specification of complete forward path of policy, not just current action

And discretionary policy can allow much worse outcomes than would an optimal policy commitment
Questioning the Importance of Rules

Still, isn’t commitment to a rule impractical, if non-routine change is possible (or inevitable)?
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- Depends on the level of specification of the policy commitment
Levels of Specification of Monetary Policy

- **Operational** level: specific trades undertaken by Trading Desk
  - rule at this level: McCallum (1988)
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- **Policy design level**: principles used to select a target criterion to structure policy deliberations, given a model of the economy
  — example of theory: Giannoni and Woodford (2005, 2010)
Successively lower levels of description:

- progressively more specific about what CB actually does to achieve its goals
- progressively finer details about monetary transmission mechanism become relevant
- progressively more frequent reconsideration of decisions necessary
Levels of Specification of Monetary Policy

When is *discretion* appropriate?

One must distinguish between two types of discretion:

- At which level is it appropriate for decisions to be based on unconstrained social welfare maximization (as the decisionmaker sees it), rather than some narrower charge?

Most appropriate in selection of principles to be followed at the policy design level. Lower-level decisions in particular cases should then be dictated by higher-level decisions about classes of such cases. Like Brandt's (1959) distinction between "rule utilitarianism" and "act utilitarianism."
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  - lower-level decisions in particular cases should then be dictated by higher-level decisions about classes of such cases
  - like Brandt’s (1959) distinction between “rule utilitarianism” and “act utilitarianism”
At what level is it appropriate for decisions to take into account features of the specific situation in a way that may not be made fully explicit in advance?

- more appropriate the lower the level of specification
- not only because finer details of situation matter, but because accountability can be more easily based on results rather than on the grounds for the decision
Dealing with Non-Routine Change

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But more significant change in view of economic structure may make it appropriate to reconsider target criterion

— can still do this in a way that is consistent with same principles of policy design
Dealing with Non-Routine Change

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  - choose the rule of conduct that the policy authority would have wished to commit itself to far in the past, had it then had the knowledge that it has now
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  - a counterfactual similar to Rawls’ (1971) “original position”

  - requires internalization of the consequences of anticipation of the systematic pattern of conduct chosen
Dealing with Non-Routine Change

- If always choose new policy targets from a timeless perspective, reconsideration of policy targets *not an excuse to renege* on prior commitments, simply because incentives different ex post

- if no change in model of the economy, reconsideration will simply lead to *re-affirmation of prior commitment*

- despite “time inconsistency” of the prior commitment (stressed by Kydland-Prescott as reason to forbid reconsideration of policy)
Dealing with Non-Routine Change

- With this principle, no Kydland-Prescott problem even if policy targets are continually reconsidered

  - but will be practical only to reconsider higher-level policy commitments (target criterion) in event of substantial change in economic views

  - this makes it useful to communicate policy commitments at this level to the public (as do inflation-targeting CBs)
To what extent does the crisis require reconsideration of policy rules advocated before 2007?
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For example, inflexible commitment to standard “Taylor rule” will be undesirably contractionary in event of a financial disturbance (Curdia and Woodford, 2010a).

Problem can be “fixed” by adjustment of Taylor rule by factor proportional to increase in credit spread.

But also avoided by higher-level commitment to “flexible inflation target” rather than to specific instrument rule (Curdia and Woodford, 2009).
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- Key difference from standard theory of “flexible inflation targeting”: CB must commit to return to same price level path despite temporary undershooting due to ZLB.
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Key difference from standard theory of “flexible inflation targeting”: CB must commit to return to same price level path despite temporary undershooting due to ZLB.

Not really a different policy commitment than the one that would have been thought optimal if ZLB discounted: simply a clarification of what it requires in additional contingencies.
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Consider model (Woodford, 2010b) in which:
- Monetary stimulus increases leverage
- Leverage affects probability of crisis
- Crisis increases credit frictions

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- Consider model (Woodford, 2010b) in which
  - Monetary stimulus increases leverage
  - Leverage affects probability of crisis
  - Crisis increases credit frictions

- Optimal target criterion relates price level to output gap and “marginal crisis risk”

- Reduces to standard criterion in periods when crisis risk negligible

- And still implies long-run price level invariant to shocks, including financial crises
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Among the lessons most certain to be of continuing relevance: recognition that suitably chosen policy commitments can improve upon purely discretionary policy.