Journal of Macroeconomics 54 (2017) 12–23

Contents lists available at ScienceDirect

Journal of Macroeconomics

journal homepage: www.elsevier.com/locate/jmacro

Economic ideas, the monetary order and the uneasy case for policy rules☆

David Laidler

Department of Economics, University of Western Ontario, London, Ontario, N6A 5C2, Canada

ARTICLE INFO

Article history:
Received 21 September 2016
Revised 19 January 2017
Accepted 23 January 2017
Available online 1 February 2017

JEL classification:
E5
B1
B2

Keywords:
Monetary policy
Rules versus discretion
Gold standard
Revolutions in Macroeconomics

ABSTRACT

The problems posed by monetary policy cannot be successfully addressed by legislating enduring policy rules. With the passage of time, economic understanding does not systematically converge ever more closely on a “true” model of the economy, a process which is now sufficiently far along that our current ideas can form the basis for designing such measures. Rather, ideas evolve unsteadily and unpredictably, and disagreement about them is routine. They influence the behaviour of the economy and they are influenced by it as they develop, requiring policy principles to adapt as well. Monetary policy problems thus cannot be solved once and for all, but must be coped with continuously.

1. Introduction

A market economy requires (among other things) a smoothly functioning system of monetary exchange if it is to deliver efficiently allocated resources in the present and over time, incentives and opportunities for innovation that will enhance the productivity of those resources, and hence a rising level of social well-being, not to mention, as some would insist (See Taylor (2016a,b) for a recent and powerful examples) a firm foundation for a free society. Nowadays, the task of keeping monetary mechanisms working is usually assigned to a central bank, perhaps operating in conjunction with other governmental institutions, and its successful execution should not be taken for granted. That is why the desirability of imposing rules on the design and/or implementation of monetary policy is worth discussing.

This paper argues the case for skepticism about such rules, in particular those intended be fixed in place by formal legislation over an indefinite but long horizon. The qualifying phrase here is important, because the word “rule”, as deployed in monetary economics, is anything but precisely defined. At one extreme it refers to a legally binding, even quasi-constitutional, constraint placed on, or goal assigned to, the conduct of monetary policy, such as Simons’ (1936) price stability rule or Friedman’s (1960) money supply growth rule. At another it indicates no more than an operating procedure adopted by a central bank in its own day to day behaviour, of which the archetype is perhaps the Bank of England’s “Palmer

☆ Paper presented at a conference on “Monetary Rules for a Post-Crisis World” held under the auspices of the Mercatus Centre of George Mason University and the Cato Institute at GMU, Arlington Virginia, September 7th, 2016. I am grateful to Michael Belongia, Malcolm Knight, George Selgin and Pierre Siklos for comments on an earlier version, but retain responsibility for all errors and omissions that remain.

E-mail address: laidler@uwo.ca

http://dx.doi.org/10.1016/j.jmacro.2017.01.004
0164-0704/

rule" of the 1830s.[1] And there is much well occupied space between these extremes. Such semantic distinctions matter for what follows, because, as noted, my skepticism is about rules of the first kind. Less rigid arrangements are to be judged on their own specific merits.

My doubts arise because I do not believe that our understanding of the monetary economy develops as a series of ever closer approximations to a "true" model, which has always been there awaiting revelation, and to which today's versions have now come close enough to be used safely as a basis for tying the hands of policy makers. Rather, on my reading of its history, monetary thought is routinely subject to unexpected twists and turns and often marked by sharp disagreements, sometimes with the same good (or bad, depending on one's point of view) ideas disappearing and then re-emerging. This unsteady and unpredictable process in turn influences the institutions through which the monetary system functions, the perceptions of how it does so held by economic agents, including policy makers, and hence upon the economy's behaviour, which in turn, and crucially, feeds back to influence monetary thought, all in an ongoing cycle. To date, and again on my reading, this process has not converged on a view of how the system works that is both reliably confirmed by ongoing experience and precise enough to form the basis of permanently legislated rules for the conduct of monetary policy. Nor am I optimistic that it ever will, or even that, were it to do so, we could have enough confidence in the fact to act upon it.

Let it be emphasised, however, that I do not support an "anything-goes-that-might-seem-to-work-right-now" approach to monetary policy. Parkin (2016) is surely right to insist that empirical evidence suggesting that we can do better than this continues to accumulate. Rather, as will become apparent, I agree with Jacob Viner (1962) that it is desirable at any time for policy to follow "publicly approved principles", and hence, in some usages, to be rules-based in this more limited sense; but I also agree with Viner that the principles in question should be broadly enough formulated to permit policy makers a meaningful degree of discretion in their application, and even more important, should also be understood to be tentative and open to revision as economic ideas evolve.[2]

2. The monetary order and the case for policy rules

Monetary policy rules impinge not just upon the actions of policy makers, but upon much else, and the phrase "monetary order" used in my title encompasses that "much else". It suggests something grander than a "monetary system" or a "monetary policy regime", but whether it should be thought of as standing above these in a relationship such as a constitution might bear to a legislative system, or simply as including more elements of economic life, has not always been clear in the literature. I have always preferred the latter more down-to-earth usage when dealing with practical questions of a type which presume that broader issues, about, say, whether monetary policy should be undertaken by institutions that exist specifically for that purpose, are already settled.[3]

In what follows, then, the monetary order is thought of as consisting of four components:

(1) A set of goals for the monetary authorities;
(2) Institutional arrangements through which those goals interact with those of other branches of policy, measures to attain them are implemented, and the effects of the latter are transmitted.
(3) Private sector agents' knowledge of and expectations about the workings of the items included under headings (1) and (2); and
(4) Political arrangements through which goals are chosen, institutions are designed and if need be modified, and through which the monetary authorities can be held accountable for their performance.

This schema can encompass a wide variety of arrangements, including many, whether imaginary or matters of historical record, that are incapable of providing the support needed by the monetary economy if it is to keep those fundamental economic and social promises mentioned earlier. In particular, each element of any monetary order needs to be compatible with the others if the whole is to function coherently, and they can be incompatible in an endless variety of ways.[4] To create

[1] See Frank Fetter (1965), pp. 132, 145-48, for a description.

[2] For example, I am reasonably comfortable with Canada's current policy regime, which is anchored on a two per cent per annum target value for year-on-year consumer price inflation, but which leaves the monetary authorities a degree of flexibility in choosing the horizon over which deviations from target are to be corrected, and is, crucially, time limited, being open to review every five years. This regime is not legislated, but based on an agreement between the Minister of Finance and the Governor of the Bank of Canada. For an account of its history, see Laidler (2015).

[3] I first used the phrase "monetary order" in Laidler (1993). There I acknowledged borrowing it from Karl Brunner (1984), but it was also used by Robert Mundell (1972) and S. Herbert Frankel (1977), two sources that I had certainly read at their times of publication. This paper also expressed skepticism about monetary policy rules, derived mainly from the problems inherent in the evolution of monetary institutions, rather than, as here, monetary ideas. I believe that the two sets of arguments are complementary. My reference here to institutions that exist specifically to execute policy does indeed indicate that monetary orders based on "free banking" principles will receive little attention in what follows. I believe that competitive free banking systems would be subject to incentives to centralise their reserve holdings, stemming from the existence of economies of scale inherent in this activity, which would cause a centralised authority – perhaps a form of clearing house – to evolve with many of the attributes of a central bank, including the capacity to execute policy interventions. See Laidler (2005-6) for further discussion.

[4] For example, the pursuit of certain mixes of multiple policy goals – price-level stability *and* full employment, particularly when these have been optimistically defined, a fixed value for the exchange rate *and* price-level stability, or perhaps all three in combination - has often been a source of trouble. And even when the goal for monetary policy is simple and therefore apparently attainable – for example price-level stability alone – if, say, institutional arrangements for managing the interaction of monetary policy with the fiscal elements of the broader policy framework enable budget deficits to be treated with insouciance, and assign to the central bank the subsidiary task of supporting the market for government debt, it may not be. This is so whether or not the public believes that the trick can be worked, and regardless of whom they decide to hold accountable and how they do so when it isn't.