Comment on Kocherlakota,
"Rules versus Discretion: A Reconsideration" [*]

Lars E.O. Svensson

Stockholm School of Economics, CEPR, and NBER

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In this fine paper, Narayana Kocherlakota argues that the FOMC's ambition in 2009-2010 to achieve price stability and maximum employment was too limited and that policy was not sufficiently expansionary, to a considerable extent because the FOMC was influenced by the Taylor Rule. In particular, he shows that a more expansionary policy would have been feasible and that staff simulations of optimal policy, included in the material distributed before meetings to FOMC participants, were more expansionary than the policies chosen by the FOMC. In a theoretical section, Narayana shows that, if a central bank's objectives are not too different from society's, central bank discretion is better than a commitment to a simple instrument rule, such as a Taylor rule. This is because the central bank can then take relevant private information into account in its decisions. Narayana then shows that there is no evidence that the FOMC has objectives too different from society's, so discretion would be better than a Taylor-type rule for the FOMC. He finally considers the FORM Act, the legislation passed by the House of Representatives that would require the FOMC to treat the Taylor Rule as a key benchmark in its decision-making about policy. He finds that the analysis of his paper implies that this move by the House is a mistake. He concludes:

> The House would be much better off requiring the FOMC to communicate a collective forecast for employment and prices, and to explain clearly why policy is not being used to close any gaps between that forecast and the Committee's ostensible goals. Congress should re-orient its perspective about what constitutes appropriate monetary policy away from the FOMC's choice of its instruments and toward the FOMC's pursuit of its goals. Such a change in focus would incentivize the Committee to pursue rapid recoveries in unemployment and inflation, rather than allow it to stick closely to its prior reaction function.

I could not agree more with Narayana's conclusion about the House and Congress and how it should reorient its perspective about what constitutes appropriate monetary policy. I also find his comments about FOMC deliberations and discussions extremely interesting and valuable.

In the rest of this discussion, I will say a few words about FOMC policy and briefly contrast its policy with that of Sveriges Riksbank in 2010. Furthermore, I will furthermore question the statement that there is broad consensus that central banks should closely follow Taylor-type instrument rules and argue that "forecast targeting" is a more appropriate and realistic monetary policy, as for instance clearly articulated by Ben Bernanke.

Federal Reserve policy 2009-2010

I agree with Narayana that it would have been technically possible for the FOMC to conduct more expansionary policy during 2009-2010, as for instance the staff's optimal policy projections show. But I am not convinced that this was necessarily mainly because the FOMC was influenced by the Taylor Rule. For instance, I did not see much evidence of this in the transcripts of November 2009 and 2010. I did not find any mention of the Taylor Rule in the November 2009 transcripts and only brief references to it on 5 out of 238 pages in the November 2010 transcripts.

From an external observer's point of view, it seems that constraints in the form of internal dissent in the FOMC as well has external opposition from Congress may have played a role and prevented a more expansionary policy. Certainly the apparent FOMC tradition of largely consensus rather than majority decisions and related limitations on the acceptable number of dissenters are likely to give the marginal dissenter a strong position and could lead to inertia in decision-making. Also, opposition and even hostility from Congress and a related potential threat to the independence of the Federal Reserve could also have limited the scope for policy actions. When I in a BPEA paper (Svensson 2011b) compared the monetary policies of the Federal Reserve and the Riksbank during 2010-11, I could not exclude that Federal Reserve policy was roughly consistent with optimization under various constraints, including opposition from Congress.

I furthermore think that it is important to retain a sense of proportion about Federal Reserve policy during the Great Recession. I think it is fair to say that Ben Bernanke and his colleagues at the FOMC most likely saved the US and probably the world from the Great Recession turning into the Great Depression II. Trusting his judgment and his previous research on the Great Depression and on unconventional monetary policy with the federal funds rate at its lower bound

(such as the BEPA paper Bernanke, Reinhart, and Sack 2004), Ben led Fed monetary policy out onto a limb to save the US economy. Without this, US and world economic developments would have been inconceivably worse.

An international perspective helps to retain a sense of proportion. The FOMC does pretty well in such a comparison. In particular, it does much better than the Riksbank. In the June 2010, FOMC and Riksbank forecasts of inflation and unemployment were very similar. The inflation forecasts were both below 2 percent (the implicit and explicit inflation target, respectively, of the FOMC and the Riksbank) and the unemployment forecasts were both far above a long-run sustainable unemployment rate (figure 1). In this situation, the FOMC kept the federal funds rate at its perceived lower bound, prepared QE2, communicated further policy easing, and launched QE2 later in the fall of 2010. With reference to these FOMC forecasts, Bernanke (2010) said that "[g]iven the Committee's objectives, there would appear--all else being equal--to be a case for further action." He certainly did not mean a case for policy tightening. But this is precisely what the Riksbank did in this situation.

The majority of the Riksbank's Executive Board raised the policy rate from 25 basis points in June 2010 to 200 basis points in July 2011 (figure 2a).[1] Whereas US core PCE inflation stayed above 1 percent during the next few years, Swedish inflation fell rapidly to close to zero (figure 2b). Whereas the real federal funds rate stayed substantially below zero, the Riksbank's real policy rate thus increased several percentage points (figure 2c). Whereas the US unemployment rate came down quickly the next few years, the Swedish unemployment rate stayed up (figure 2d). Imagine if the FOMC would have conducted a policy similar to that of the Riksbank!

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[1] As a Deputy Governor of the Riksbank during 2007-2013, I dissented in favor of easier policy at every policy meeting from April 2009. Svensson (2013) summarizes my lessons from these years as a policy maker.

Figure 1. FOMC and Riksbank forecasts, June 2010

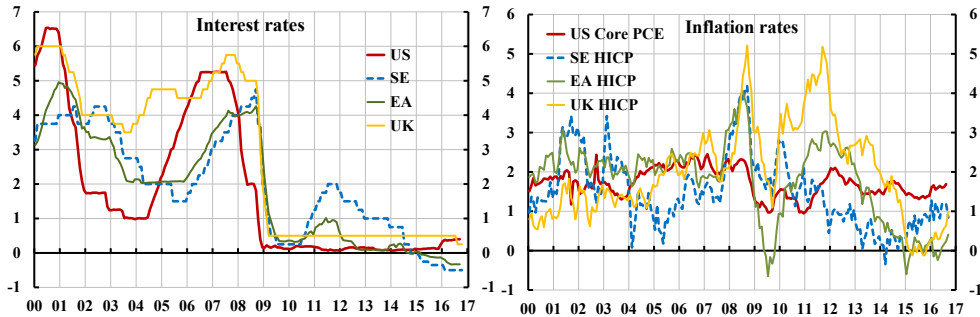a. Inflation   b. Unemployment
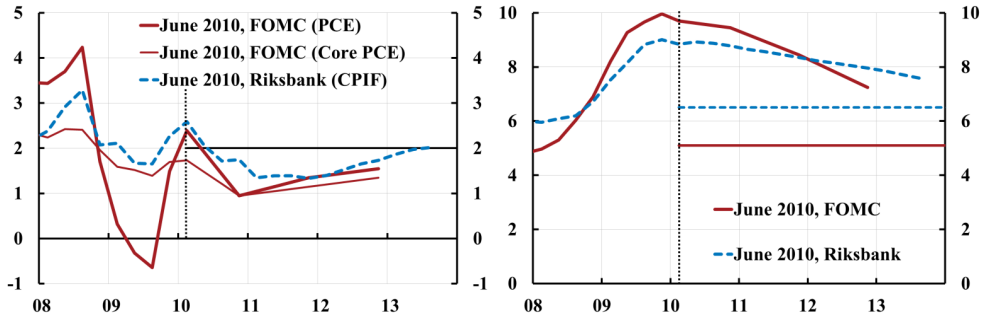
Note: Horizontal lines in panel b show each central bank's estimate of the long-run sustainable rate of unemployment. Source: Svensson (2011b).

Figure 2. Interest, inflation, and unemployment in the US, Sweden, and selected economies

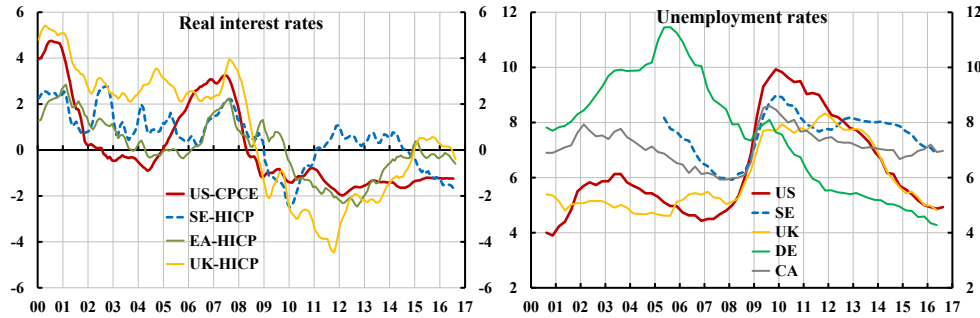a. Interest rates   b. Inflation rates

c. Real interest rates   d. Unemployment rates

Note: EA, DE, and CA denote the Eurozone, Germany, and Canada. Inflation is measured in terms of HICP for the non-US economies. Real interest rates are 3-month moving averages of policy rates less inflation.

A "broad consensus" that central banks should follow Taylor-type rules? What about to "forecast targeting"?

Is there a broad consensus that central banks should follow Taylor-type rules? First, a Taylor-type rule implies that the central bank is only responding to current inflation and the current output.[2] It is pretty obvious that real-world central banks respond to much more information than inflation and output and thus do not mechanically follow Taylor-type rules. Furthermore, it is obvious that Taylor-type rules are not optimal. Optimal policy responds to all relevant state variables (including all relevant information), and there are many more relevant state variables and much more relevant information than current inflation and output. (Svensson 2003)

Second, it is true that many papers in monetary macroeconomics assume that monetary policy mechanically follows a Taylor-type rule. But I believe that this to a large extent for convenience. Incidentally, the same papers often assume that households optimize in a rather sophisticated way, instead of mechanically following a consumption function. This is in spite of central banks having simple objectives and usually employ many Ph.D. economists who are specialists on optimal monetary policy. In contrast, households have complicated objectives and employ no specialists in optimal policy. Who are more likely to display optimizing behavior, households or central banks? (Svensson 2003)

Generally, I don't think "rules versus discretion" is the best way of phrasing the problem. Discretion with stable objectives and stable constraints also results in systematic, rule-like policy. Instead, I think it is better to think in terms of different kind of rules, such as instrument rules versus targeting rules. Real-world commitments by central banks are not to follow a particular instrument rule but to achieve their targets, what can be seen as a "targeting rule." Achieving the targets is the rule.

Ben Bernanke (2015b) has put it very well, as quoted by Narayana: "The Fed has a rule. The Fed's rule is that we will go for a two percent inflation rate. We will go for the natural rate of unemployment. We will put equal weight on those two things. We will give you information about our projection, our interest rates. That is a rule."

What Ben is talking about here is what can more precisely be called "forecast targeting." This can be described as choosing the policy rate and policy-rate path such that the resulting forecasts of

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[2] To be precise, a Taylor Rule responds to the output gap, not just to output. Estimating potential output involves a whole set of difficulties, not discussed here but in Svensson (2011b).

the target variables (inflation and unemployment) "look good," where "looking good" means best stabilizing both inflation around the inflation target and unemployment around its long-run sustainable rate. Forecast targeting rather than Taylor-type rules is further discussed and promoted in Bernanke (2004, 2015a), Kohn (2012), Qvigstad (2005), Svensson (1997, 2011a), and Woodford (2007).

In regard to the quote above, Narayana criticizes Ben for not providing any target horizon. "As a result, Bernanke's description is equally consistent with a plan to return inflation to target over 1 year, 2 years, or twenty years." But if the dual mandate, as in the staff's optimal policy projections, is reasonably interpreted as having a quadratic loss function with equal weight on squared deviations of inflation from the target and unemployment from its long-run sustainable rate, a fixed target horizon is inappropriate. The horizons at which inflation and unemployment optimally get close to, respectively, the target and long-run sustainable rate then depends on the initial situation and the shocks.[3] Forecasts of inflation and unemployment "looking good" means that they achieve an efficient tradeoff between inflation and unemployment-gap stability, with approximately equal weight on each. This is for all practical purposes equivalent to the statement in Federal Reserve (2016) that the FOCM "follows a balanced approach in promoting [its objectives], taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate." [4]

Forecast targeting then implies that the central bank responds and adjusts policy to any information that materially affect the forecasts of inflation and unemployment. This information includes much more than new information about current inflation and output. Indeed, one can say that the new information is filtered through the forecast, and the new information that is relevant for the policy settings is the information that shifts the forecasts. And current inflation and output are then relevant for policy only to the extent that they affect the forecasts.[5]

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[3] Because optimal policy implies that inflation and unemployment *asymptotically* approach the inflation target and the long-run sustainable rate of unemployment, "get close to" is more correct than "return to."
[4] Former Deputy Governor of Norges Bank Jan Qvigstad has formulated the "Qvigstad rule," which when applied to inflation and unemployment implies that the forecasted inflation and unemployment gaps should have the same sign (Qvigstad 2005).
[5] Importantly, the relevant information includes all information that materially affect the forecasts, not only any private information of the central bank, the case dealt with by Narayana. And transparent monetary policy implies that any relevant private information of the central bank should soon, through central bank communication, become public information.

Thus, several policymakers and researchers have argued against Taylor-type rules in favor of what can be called forecast targeting. I welcome very much that Narayana has joined this group.

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