



Discussion of Kocherlakota, “Rules vs. Discretion: A Reconsideration”

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Brookings Papers on Economic Activity, Fall 2016 Conference
Washington, DC, September 10-11, 2016

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Summary

- The FOMC’s ambition in 2009-2010 to achieve price stability and maximum employment was too limited
- The FOMC was influenced by the Taylor Rule
- The FOMC could have been more expansionary
- Theory: If CB objectives are not too different from society’s, CB discretion is better than a commitment to a simple instrument rule (such as a Taylor-type rule)
- The FOMC does not have objectives too different from society’s
- Instead of requiring the FOMC to follow a Taylor-type rule, Congress should require 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. That requirement would incentivize the Committee to pursue more rapid recoveries than they did in 2009-10.”



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Comments

- Fed policy
- Broad consensus that CBs should follow Taylor-type rules?
- What about “forecast targeting”?
- Some minor quibbles



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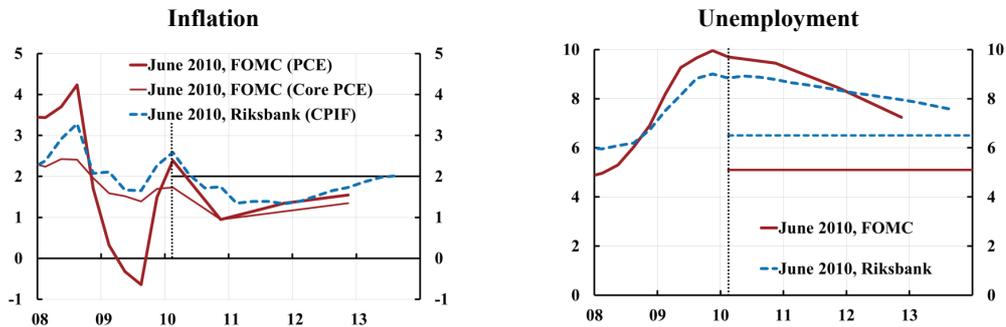
Fed policy

- The Fed could have been more expansionary in 2009-2010
- Influenced by Taylor rule?
- Not much in transcripts (no mention in Nov 2009, 5 out of 238 pages in Nov 2010)
- Transcripts: Downside risks from QE, including risk of high inflation, division inside FOCM
- And what about political constraints (Congress opposition to QE)?
- Svensson BEPA 2011:
Fed may have optimized under constraints.
To get a sense of proportion: At least the Fed was much more expansionary than the Riksbank



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Fed and Riksbank forecasts, June 2010



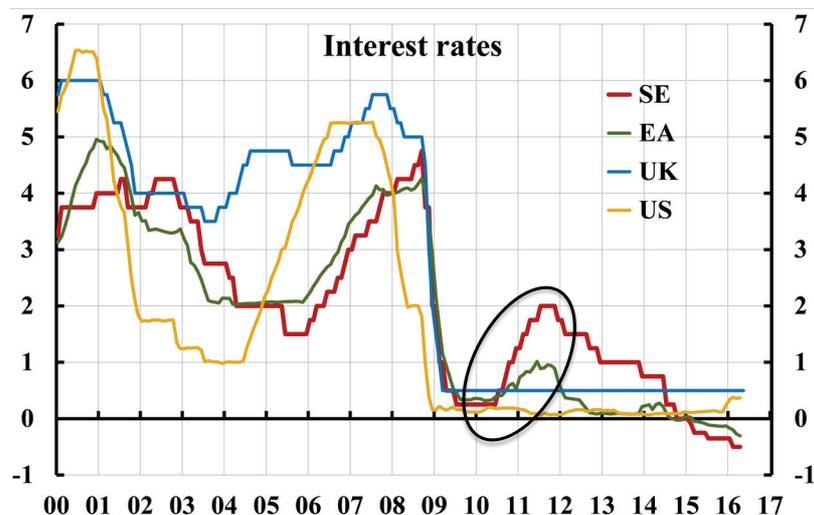
- Riksbank and Fed forecasts quite similar
- Policies very different
- Fed kept policy rate close to zero, started preparing QE2
- Riksbank...

Source: Svensson, Lars E.O. (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.



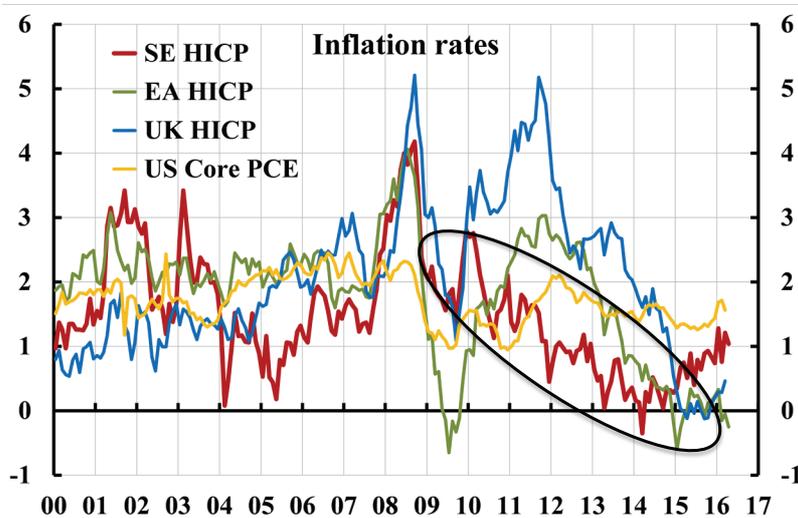
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Riksbank raised the policy rate rapidly



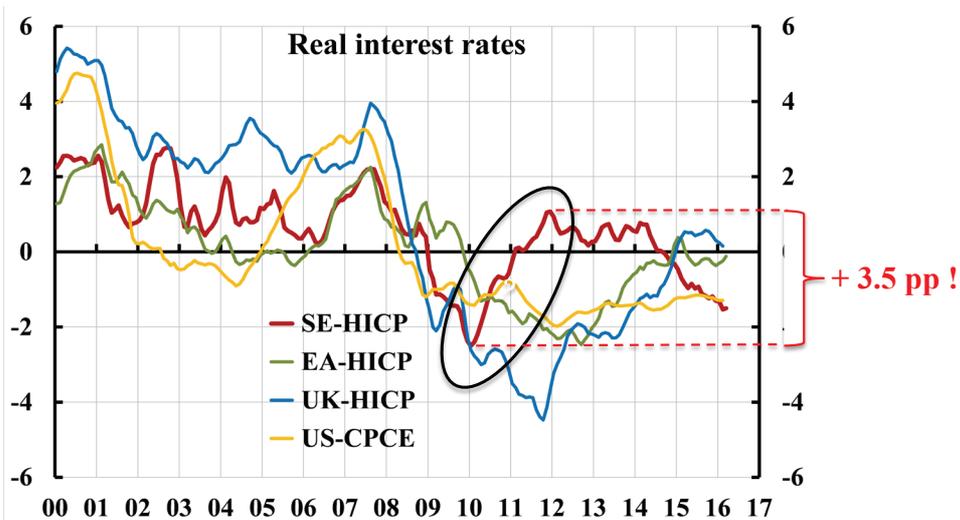
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Swedish inflation fell rapidly



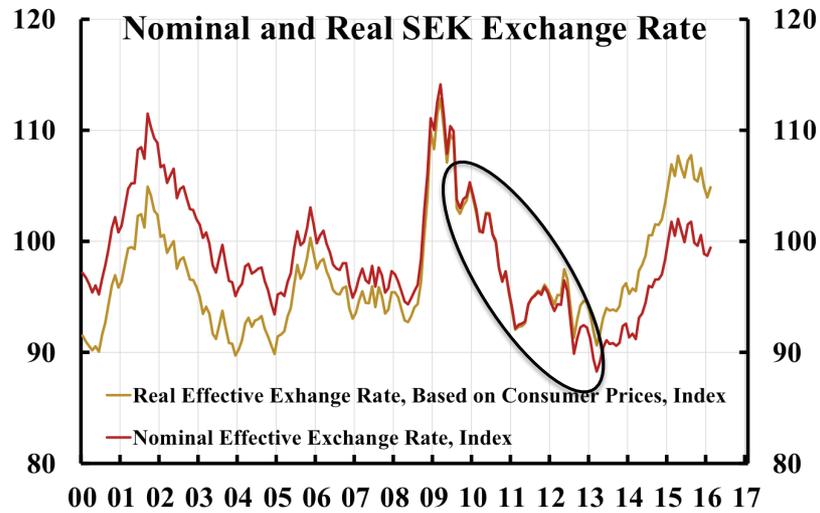
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**Riksbank real policy rate increased even more,
causing large real interest-rate gap to Eurozone, UK, and US**



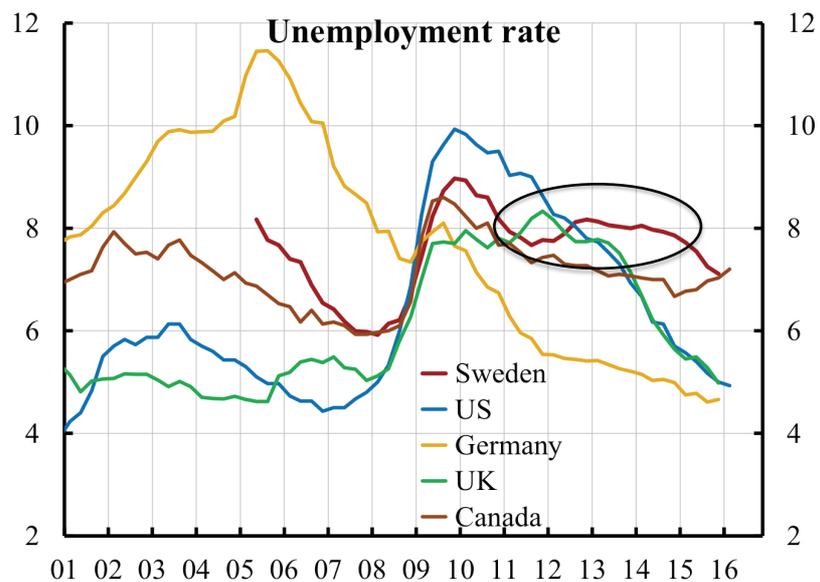
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Swedish Krona appreciated dramatically



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Swedish unemployment stayed high, came down in other economies



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“Broad consensus” that CBs should follow Taylor-type rules? What about “forecast targeting”?

- Obvious that real world CBs respond to more information than inflation and output and do not mechanically follow Taylor rules
- Obvious that Taylor-type rules are not optimal (optimal policy responds to all relevant state variables)
- True that many papers assume monetary policy to follow a Taylor-type rule (but mostly for convenience)
- But the same papers often assume that households optimize instead of mechanically following a consumption function
- This in spite of CBs having simple objectives and usually employ many economists that are specialists in optimal policy (whereas households employ none)
- Who are more likely to optimize, households or CBs? (Svensson 2003 JEL)



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Forecast targeting

- “Rules vs. discretion” not the best way to put it
- Discretion also results in rules, policy rules
- Real world commitments are not to follow an instrument rule but to achieve targets: “targeting rule”
- “The target is the rule” (Bernanke); “the inflation and unemployment gaps should have the same sign” (Qvigstad)
- “Forecast targeting,” set the policy-rate path such that the inflation and unemployment forecasts “look good” (Svensson 1997, 2010 Handbook)
- “Looking good” means best stabilizing inflation around the target and unemployment around its long-run sustainable rate
- Forecast targeting means responding to all information that affects the forecasts



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Forecast targeting

- Bernanke 2015: “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.” [Link](#)
- Bernanke, Kohn, Svensson, Woodford, Yellen, ... All have argued against Taylor-type rules
- And now also Kocherlakota!



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Some minor quibbles

- It should be clarified that, traditionally, discretion and commitment has been discussed in the context of forward-looking expectations rather than private information
- Then a bias towards optimistic estimates of the natural unemployment rate leads to “inflation bias,” meaning higher inflation than the target
- Even if no bias in natural rate estimates and no inflation bias, “stabilization bias” remains (coefficients in optimal policy rule, no response to lagged Lagrange multipliers (lagged state variables))
- Generally no simple but model-dependent mapping between loss-function weights and coefficients in Taylor-type rule
- (Svensson 1997, annual model: Monetary policy affects output in 1 year, inflation in 2 years)



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