POLICY SPOTLIGHT

A Rule-Based Monetary Policy

ROBERT L. HETZEL | SEPTEMBER 2024

In its public communications, the Federal Open Market Committee (FOMC) confines itself to forward guidance—that is, to predicting a path for the funds rate based on the FOMC's forecasts for the course of the economy. But forward guidance does not explain how the FOMC responds to new information that alters those forecasts or how it plans to impose consistency in its response. Such explanations are particularly important for financial markets, which are always forward-looking and would benefit from knowing the underlying consistency in FOMC policy. A rule-based monetary policy can deliver that consistency and thereby can stabilize prices, economic output, and employment.

A Stabilizing Monetary Policy Requires Consistency

Historically, monetary policy has fallen into one of two classes, depending on the following criteria:

- Is the FOMC focused on maintaining price stability while allowing market forces free rein to determine levels of employment?
- Is the FOMC attempting to balance off the achievement of low inflation and a socially desirable low rate of unemployment, with each taken as separate, competing objectives?

The Committee does not explicitly communicate its reaction function (rule). But an explicit reaction function has real advantages for financial markets: It allows them to better predict how the FOMC will respond to changes in the economy, not only in the present but also in the future.

How Can the FOMC Follow a Rule When It Cannot Predict the Future?

A standard FOMC objection to making explicit its reaction function is the inability to foresee all contingencies. The Committee thus argues against a rule-based policy and in favor of discretion, contending that a rule would tie its hands in response to an emergency and deprive it of leeway to respond to unusual events.

But a rule does not constrain the FOMC from responding to negative shocks to output. On the contrary, if the FOMC has a credible rule assuring financial markets that its future behavior ensures price stability, then the stabilizing properties of the price system have the maximum freedom to work.

Monetary Policy Does Not Operate in a Political Vacuum

At times when the political system has favored price stability, the FOMC has focused on maintaining price stability. And at times when the political system has favored low unemployment to lessen social divisions, the FOMC has focused on trading off between a socially desirable low rate of unemployment and low inflation.

In a similar manner, the economics profession has divided into two groups: One group has been partial to focusing on price stability and the other partial to juggling the two objectives of low inflation and low unemployment.

However, the FOMC should always seek to maintain—and communicate—its independence from political direction. The language of discretion creates a problem for the perception of such independence.

Learning from the Past

In the past, monetary policy has destabilized the economy. Unfortunately, the FOMC lacks systematic procedures for learning from such experiences in order to always improve policy. Rather, the implicit message is the following: Period by period, the FOMC does the right thing without the need to discipline "the right thing" over time.

As a result, monetary policy is not accountable and is subject to the vagaries of the political appointments process. Stability requires a rule that is widely understood and supported by the public.

Further Reading

Robert L. Hetzel, "Enhancing FOMC Transparency: Making Implicit Monetary Policy Rules Explicit" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, July 24, 2024).

Robert L. Hetzel, "What the Fed Needs to Do to Control Inflation and Stabilize the Economy" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, June 6, 2024).

Robert L. Hetzel, "Getting Monetary Policy Right: What Should the Federal Reserve Have Learned from Its Pandemic Response?" (Mercatus Special Study, Mercatus Center at George Mason University, Arlington, VA, February 22, 2024).

Robert L. Hetzel, "What Is the Monetary Standard? The Fed Should Tell Us" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, July 19, 2023).

ABOUT THE AUTHORS

Robert L. Hetzel is a senior affiliated scholar at theMercatus Center at George Mason University and a retired economist from the Federal Reserve Bank of Richmond. His research agenda is the evolution of central banking in the modern regime of fiat money. He is currently working on a book entitled *Milton Friedman and the Great Debates over the Monetary Standard*.

ABOUT POLICY SPOTLIGHTS

Mercatus Policy Spotlights provide a high-level overview of key issues facing the nation's policymakers and introduce relevant policy positions.

MERCATUS CENTER
George Mason University

WWW.MERCATUS.ORG