# The dangers of discretionary policy

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The economic history of the past 60 years in the US suggests a connection between rules-based policy and good economic performance. But correlation—even an amazing six-decade-long correlation—does not prove causation. First, we must consider the possibility that the correlation reflects a cause-and-effect relationship in the opposite direction—that is, poor economic performance brought about more intervention, and good economic performance permitted less intervention, so that the swings were caused by changing economic performance rather than serving as the cause of it. The basic timeline of events, however, is completely inconsistent with such an explanation. The popularity of discretionary Keynesian fiscal policy in the 1960s could not have been a response to the deep recessions of the 1970s, after all. Similarly, the inflationary monetary policy that began in the late 1960s could not have been caused by the inflation of the 1970s. And it obviously strains credibility to argue that the Federal Reserve's (Fed) move to reduce inflation and restore economic stability in the late 1970s was caused by the low inflation and stable economy of the 1980s and 1990s.

This conclusion is also amply supported by economic theory. Any dynamic model in which people are forward-looking and take time to adjust their behaviour to circumstances implies that monetary and fiscal policy work best when formulated as rules. Government's adherence to known rules allows people to have a clearer sense of what is coming, and, therefore, to make more informed decisions and long-range plans.

Discretionary policies produce suboptimal results because they deny people the benefits of "policy commitments". Such commitments —which give the public the sense that the basic rules of the game are steady and reliable—are essential to the proper functioning of a market economy.

A commitment to a reasonably sound rule—even if it is very far from a perfect rule—is preferable to discretionary policies, however well intentioned or managed.

Moreover, almost by definition, highly discretionary policy limits the ability of market participants to plan, and so tends to distort market behaviour, driving it towards inefficient short-term responses and choices.

Furthermore, consistent rules are crucial for conducting and evaluating economic policy. Since people's expectations are heavily dependent on particular public policies, economic models that try to evaluate policy based entirely on extrapolating historical trends are bound to fail because they do not take policy changes into account. The same principle suggests that economic models will break down if policymakers do not follow relatively consistent rules—and, therefore, that rules have an essential role to play in guiding policymakers towards sound decisions, and in helping them assess the effects of their decisions. Over time, discretionary policy will inevitably make for bad policy.

Recent research shows that the low interest rates set by the Fed from 2003 to 2005 added fuel to the housing boom and led to risk-taking and, eventually, a sharp increase in delinquencies and foreclosures, and an increase in toxic assets held by financial institutions. Research shows that the Fed's deviation from the rules-based federal funds rate of the 1980s and 1990s caused 26% of the increase in US housing prices during the boom—no small portion, given that housing prices only fell by about 30% from their peak to hasten the crisis. It seems clear that the Fed's discretionary measures played a significant role in setting up the recent severe recession.

On the fiscal policy front, the tax rebates and one-time stimulus payments in 2008 and 2009 did little overall to jump-start consumption and, thereby, jump-start the economy, which the proponents of these policies insisted they would. Aggregate disposable personal income increased when the stimulus checks were sent out in the spring of 2008, but aggregate personal consumption did not increase. Similarly, the stimulus-induced temporary increase in disposable personal income in the spring of 2009 did not have a noticeable effect on aggregate consumption. Thus, the evidence shows that, in aggregate, neither stimulus package had any noticeable effect on consumption.

On the whole, evidence over the past few years leaves little doubt about the dangers of discretionary economic policy. And the evidence left in the wake of the policy cycles of the past six decades strongly suggests that rules-based policymaking is a far superior approach.

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This is the last part of a four-partseries.

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