

In our discussion of rules versus discretion, “rules” were associated with a passive monetary policy—one in which the monetary rule required that the Fed expand the money supply at a fixed annual rate regardless of the state of the economy. “Discretion” on the other hand, was associated with an active monetary policy in which the Fed changed the interest rate in response to actual or anticipated changes in the economy.

Economist John Taylor has put a new twist on the rule-versus-discretion debate by suggesting a hybrid policy rule that dictates the precise active monetary actions the Fed should take when changes in the economy occur. This so-called Taylor rule combines traditional monetarism, with its emphasis on a monetary rule, and the more mainstream view that active monetary policy is a useful tool for taming inflation and limiting recession. Unlike the Friedman monetary rule, the Taylor rule holds, for example, that monetary policy should respond to changes in both real GDP and inflation, not simply inflation. The key adjustment instrument is the interest rate, not the money supply.

The Taylor rule has three parts:

- If real GDP rises 1 percent above potential GDP, the Fed should raise the Federal Funds rate (the interbank interest rate of overnight loans), relative to the current inflation rate, by .5 percent.
- If inflation rises by 1 percent above its target of 2 percent, then the Fed should raise the Federal funds rate by .5 percent relative to the inflation rate.
- When the real GDP is equal to potential GDP and inflation is equal to its target rate of 2 percent, the Federal funds rate remain at about 4 percent, which would imply a real interest rate of 2 percent.

Taylor has neither suggested nor implied that a robot, programmed with the Taylor rule, should replace Alan Greenspan, chairman of the Federal Reserve System. The Fed’s discretion to override the rule (or “contingency plan for policy”) would be retained, but the Fed would have to explain why its policies diverged from the rule. So the rule would remove the “mystery” associated with monetary policy and increase the Fed’s accountability. Also, says Taylor, if used consistently, the rule would enable market participants to predict Fed behavior, and this would increase Fed credibility and reduce uncertainty.

Critics of the Taylor rule admit it is more in tune with counter cyclical Fed policy than with Friedman’s simple monetary rule. But they see no reason to limit the Fed’s discretion in adjusting interest rates as it sees fit to achieve stabilization and growth. Monetary policy may be more art than science. The critics also point out that the Fed has done a remarkable job of promoting price stability, full employment, and economic growth over the past decade. In view of this success, they ask, “Why saddle the Fed with a highly mechanical monetary rule?”

2. Petition of the Candle makers, 1845

French Economist Frederic Bastiat (1801-1850) Devastated the Proponents of Protectionism by Satirically Extending Their Reasoning to its Logical and Absurd Conclusions.

Petition of the Manufacturers of Candles, Wax lights, Lamps, Candlesticks, Street Lamps, Snuffers, Extinguishers, and of the Producers of Oil Tallow, Rosin, Alcohol, and, Generally, of Everything Connected with Lighting.

TO MESSIEURS THE MEMBERS OF THE CHAMBER OF DEPUTIES.

Gentlemen—You are on the right road. You reject abstract theories, and have little consideration for cheapness and plenty. Your chief care is the interest of producer. You desire to emancipate him from external competition, and reserve the national market for national industry.

We are about to offer you an admirable opportunity of applying your—what shall we call it? No; nothing is more deceptive than theory; your doctrine? your system? your principle? but you dislike doctrines, you abhor systems, and as principles, you deny that there are any in social economy: we shall say, then, your practice, your practice without theory and without principle.

We are suffering from the intolerable competition of a foreign rival, placed, it would seem, in a condition so far superior to ours for the production of light, that the absolutely inundates our national market with it at a price fabulously reduced. The moment he shows himself, our trade leaves us—all consumers apply to him; and a branch of native industry, having countless ramifications, is all at once rendered completely stagnant. This rival...is no other than the Sun.

What we pray for is, that is may please you to pass a law ordering the shutting up all of windows, skylights, dormer windows, outside and inside shutters, curtains, blinds, bull’s-eyes; in a word, of all openings, holes, chinks, clefts, and fissures, by or through which the light of the sun has been in use to enter houses, to the prejudice of the meritorious manufacturers with which we flatter ourselves we have accommodated our country,—a country which, in gratitude, ought not to abandon us now to a strife so unequal.

If more tallow is consumed, then there must be more oxen and sheep; and consequently, we shall be hold the multiplication of artificial meadows, meat, wool, hides, and ,above all, manure, which is the basis and foundation of all agricultural wealth.

The same remark applies to navigation. Thousands of vessels will proceed to the whale fishery; and, in a short time, we shall possess a navy capable of maintaining the honor of France, and gratifying the patriotic aspirations of your petitioners, the undersigned candle makers and others.

Only have the goodness to reflect, Gentlemen, and you will be convinced that there is perhaps, no Frenchman, from the wealth coal master to humblest vender of Lucifer matches, whose lot will be ameliorated by success of this our petition.