

Right Federal Reserve Policy Must Be Based On Rule Of Law

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Once again, my criticism is neither of the man nor even of the institution.

There will be another year like 2008, with different fact patterns, and the Fed will once again make mistakes, though perhaps different ones. The argument for rules is that the sum of such errors will be smaller if the Fed follows a rule rather than engages in discretionary monetary policy.

Friedman also offered a second, political argument on the rule of law. To the argument for a rule, proponents of discretion invariably respond that we can do better than rigid adherence to a rule.

In "Capitalism and Freedom" (1962), Friedman observed that one could with a few word changes make the same argument against the First Amendment and the entire Bill of Rights. "Is it not absurd, one might say, to have a standard proscription to interference with free speech?"

Discretionary proscriptions on speech would create huge uncertainty about what speech is permissible and what is not. It would also violate the very concept of a right. It would be the difference between living in Russia and in the U.S.

Friedman strengthened his rule-of-law argument by noting how much power monetary discretion puts in the hands of a few men. In his words, "it is a bad system to believers in freedom."

The case for a monetary rule is one with the case for legal and constitutional rules generally. The Madisonian vision is not a political system that enables good men to do great things. It is a system that prevents ordinary men from causing great harm to their fellow citizens.

How does this affect the debate over QE? The evidence for its being beneficial on net is thin. But that is a backward-looking argument. Friedman's argument is a forward-looking one. How do we avoid another Great Recession and thus the apparent need for extraordinary monetary policy?

In recent years, Stanford University economist John Taylor has been a torch-bearer of the argument for a monetary rule. His work updated and added to Friedman's work. Thanks to Taylor and others, there is a bill before Congress to implement a rule.

The "Federal Reserve Accountability and Transparency Act of 2014" requires the Fed to follow a rule. The default rule is the eponymous Taylor Rule. The Fed can choose another one, but must follow some rule.

There is any number of alternative rules. The Cato Institute recently established a Center for Monetary and Financial Alternatives to analyze systematically the alternatives. The economic arguments for a rule of some kind are compelling. But so, too, are the political and constitutional ones.

In monetary policy, as elsewhere, the rule of law should govern.

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