First Principles: Five Keys to Restoring America's Prosperity

John B. Taylor New York/London: W.W. Norton & Co., 2012, 235pp. ISBN: 978 0 393 07339 3 (hb), $24.95

John Taylor's description of how the US Fed set short-term interest rates in the period 1984–92 has become one of the most cited works in macroeconomics. Duly systematised, the Fed's behaviour entered the lexicon as the 'Taylor rule'. Regrettably, the author's explanation in this short book is so confusing that interested readers would do better to refer to *Wikipedia*. But few economists with an established reputation deign to bring their understanding to non-economists. For that, John Taylor merits praise.

The Taylor rule is now presented from a new perspective. Instead of merely describing an historic period of US monetary policy, the new position is that central banks must become more mechanistic in their policy choices. When first introduced, Taylor had no thought that a 'simple policy rule' might be written into law. Experience now causes him to argue that the Fed should 'establish and report on a policy rule for the interest rate', such that, with every deviation from the rule, its chairman would 'provide a written explanation and answer questions at a congressional hearing'. This would achieve 'a degree of political control without

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interfering in the day-to-day operation of monetary policy.' Déjà vu! Beyond the familiar ring this would have for the Governor of the Bank of England, an analogous compromise was mooted over 30 years ago, in the wake of the collapse of the Bretton Woods fixed exchange-rate system. Economists were then debating the relative merits of exchange rate and money growth targets as alternative rules-based constraints.

The practical application of any such rule requires the measurement of relevant parameters – the natural rate of output and the long-run real interest rate in the case of the Taylor rule – and the assumption that the those parameters remain constant. These are difficulties that the author ignores. Moreover, no examples are cited of any central bank that has ever explicitly used a Taylor rule as a prescription for its choice of official interest rate.

These issues aside, Taylor's main purpose seems to be the promotion of the merits of 'rules versus discretion' quite generally; and it comes across as a polemic against policies currently pursued by the Obama administration. Hayek and Friedman are cited but, 'since they wrote their books', the fast-moving modern world has rendered the security of known rules even more important: (*a*) to facilitate individuals' decisions; and (*b*) to make it easier for policymakers to resist interest-group pressure. With the objective of 'restoring the greatness of the American economy', Taylor outlines a strategy that invokes both freedom and rules.

Unlike Hayek, but close to Friedman, Taylor gives paramount consideration to empirical evidence. In Taylor's world it is desirable that 'government officials set clear rules based on what works and what doesn't'. Yet there is no mention of the 'Lucas critique' or 'Goodhart's law' from mainstream economics, both of which imply that 'what works' may be transient. Other economists, with equally firm commitments to liberal principles, are critical of Taylor's approach. One has likened a central bank setting interest rates to a nationalised industry deciding production levels without the guidance of market prices. Maybe the Fed did decide to continue doing what had worked in the pre-1993 period, but, as R. W. Garrison commented in 'Interest-Rate Targeting during the Great Moderation: A Reappraisal' (*Cato Journal*, vol. 29, 2009), 'true learning happens maybe once each decade, when the cumulative effects of a centrally controlled interest rate disrupts the economy's market mechanisms on an economy wide basis'. In retrospect, a consensus does exist that low interest rates (2003–05) contributed to the US housing bubble. At the time, however, low rates were attributed to a worldwide rise in saving. The difficulty for the Fed was in knowing whether it was following equilibrium rates downward or feeding a boom.

Drawing from his diverse appointments as an economic advisor from the late 1960s, Taylor notes that mistakes and successes were non-partisan. Republican and Democratic administrations were variously culpable. This view is consistent with the observation that limited government and market-based policies are unattractive to politicians who generally wish to be seen to act, whether to counter cyclical downturns, to increase home ownership, or to help the elderly and infirm. Each of these provides an example of discretionary interventions that 'frequently make things worse'. Hence, Taylor's strategy invokes a blanket requirement for rules-based policy adjustments.

Taylor asserts that freedom and prosperity have gone hand-in-hand across the 'broad sweep of human history'. This association showed as the interventionist

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policies of the late 1960s and 1970s were reversed in the 1980s and 1990s. At the heart of macroeconomic failings are the 'economic policy ideas put forth by John Maynard Keynes in the 1930s'. With US Presidents Kennedy, Johnson, Nixon, Ford and Carter, these took the form of countercyclical fiscal packages, followed later by interventions into wage/price decisions. In parallel, the Fed applied discretionary adjustments to monetary growth in the 1960s and 1970s, when (without guidance from the Taylor rule) an apparent trade-off between inflation and unemployment was the focus and where Friedman's monetarist advice was initially ignored. For the imminent future, 'defusing the debt explosion' must be the primary objective: economic policy will be 'back on track' only when the US returns 'to living within its means'.

Beyond concerns for macro-policy, the book contains a hotchpotch of poorly integrated themes: liberty, democracy, low taxation, governance and welfare benefits. There are warnings of longer-term consequences if the US continues its drive towards to an entitlement state, where Taylor might have drawn lessons from the UK to underscore the point. As entitlements remove incentives, they also erode the dignity that derives from self-achievement.

Good times are associated with adherence to what Taylor asserts are five 'principles of economic freedom': a predictable policy framework; the rule of law; strong incentives; reliance on markets; and a clearly limited role for government. Most highly rated are policy predictability and the rule of law. Here Taylor skips Hayek's important distinction between judicial law and parliamentary legislation. It is judicial law that is crucial to a free society, while Taylor-type rules would clearly be the subject of parliamentary legislation. The former upholds the precepts of classical liberalism; the latter asserts the merit of rules over discretion.

It would appear that the concluding chapter was intended to shift the narrative from rebuilding prosperity to 'Rebuilding American Economic Leadership'. On this, Taylor believes the US has been 'a beacon of democracy' and that the world has benefited from 'America's promotion of economic freedom'. However, that argument peters out and the presentation returns to earlier themes of interventions and interest rates and also to problems in the eurozone: 'the European debt crisis . . . has U.S. fingerprints on it'. Quite how is not explained.

While this lively text may serve Republican rhetoric on the 2012 electioneering circuit, it serves no deeper interest.

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