Principled Policymaking in an Uncertain World

Michael Woodford

Discussion Paper No.: 1112-01

Department of Economics
Columbia University
New York, NY 10027
August 2011
Principled Policymaking in an Uncertain World

Michael Woodford

ABSTRACT

This paper considers the consequences for the theory of economic policy of allowing for the inevitability of non-routine change in the environment in which policy is conducted. It addresses in particular the modifications that must be made to standard discussions (based on an assumption of “rational” or model-consistent expectations) of the advantages of commitment to a policy rule over a purely discretionary approach to policy. The paper argues that a certain naïve conception of a policy rule --- under which it should be possible to state in advantage a fully explicit formula determining a specific policy action as a function of publicly observable state variables --- makes little sense once one allows for the impossibility of listing in advance all possible future states of knowledge about economic conditions, but argues that purely discretionary policy is not the only coherent alternative. Instead, the paper distinguishes between multiple levels at which a particular systematic approach to policy may simultaneously be described, and argues that a higher-level policy commitment remains both possible and desirable, even if discretion will have to be allowed in the translation of the higher-level policy commitments into a more concrete (lower-level) description of the way that policy should be conducted under the particular future circumstances that arise. Four distinct levels of description are distinguished in the case of monetary policy, where the general idea is developed in greater detail, and the paper concludes with a discussion of ways in which the conventional theory of monetary policy should be modified in the light of the recent global financial crisis.