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What LawMicro Has to Teach LawMacro: An Exploration of the Rule of Law and Monetary Policy

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Abstract

Among LawMacro scholars, there is a growing interest in the incorporation of distributional goals into economic institutions and policies, especially central banks. We argue that this approach threatens to undermine the rule of law in monetary policy. This is troubling because the rule of law is necessary for maintaining monetary generality and predictability. Recent macroeconomic failures, such as the Financial Crisis and inflation following the Covid-19 pandemic, highlight the economic consequences of a lawless central bank. Unconstrained and discretionary central banking are only weakly democratically accountable, which raises legitimacy concerns with their pursuit of broader social agendas without explicit statutory authorization. We make the case for strengthening the rule of law to promote monetary generality and predictability and to better ensure democratic accountability.

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1. Introduction

Within the law and macroeconomics (LawMacro) literature, there is a growing interest in empowering discretionary bureaucracies, such as central banks, to pursue broad social agendas outside of established democratic channels. LawMacro scholars advocate interpreting and enforcing banking, finance, employment, and corporate law to achieve political and distributional goals. To its adherents, LawMacro represents an advance over traditional law and economics (LawMicro), which was parochially limited to the explanatory and evaluative criteria of economics.[1]

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1 See, *e.g.*, Yair Listokin's *Law and Macroeconomics: Legal Remedies for Recession* (2019) for a general overview of the main thrust of the argument. Also, Anna Gelpern and Adam Levitin edited an issue of *Law and Contemporary Problems* (2020) providing a wide variety of perspectives. In their introduction, however, they stress the critical importance of the macro moment brought on by the Global Financial Crisis and argue that the post-crisis literature in law

Law indeed matters for macroeconomics, but not in the way LawMacro proponents think. Whatever LawMicro's blindspots – and there are surely many – they do not justify subordinating descriptive social science to prescriptive governance blueprints. Legal rules matter for how the economy works. How we wish the economy to work, at least to the extent this is controllable, will affect the rules we choose. For example, the nuances of bankruptcy law determine how quickly entrepreneurs can calculate and reallocate scarce resources in response to macroeconomic volatility. LawMacro scholars, however, in their eagerness to repurpose old tools for the purpose of social control, have largely overlooked the basic *constitutive* and *coordinative* functions of rules. The proponents of LawMacro tend to overlook the complexities of evolved legal rules that often play important, even if unperceived, roles. Disregarding rules' constitutive and coordinative functions can lead to systematic unintended consequences, especially when they undermine institutions that generate and transmit localized knowledge (Hayek 1945; 1973; Sowell 1980). Everything old is new again; the "pretense of knowledge" (Hayek 1974) is perennial.

Our goal is not to defend LawMicro in its entirety, nor is it to impugn the normative judgments LawMacro advocates bring to their analyses. There is nothing wrong with pointing out the shortcomings of an alternative research project. It is also perfectly legitimate to value expertise and social equality. Instead, we bring the debate back to fundamentals by demonstrating how rules matter for macroeconomic performance. When LawMicro is done well, the emphasis is not so much on how the legal process provides efficient solutions to social dilemmas, but how alternative institutional arrangements affect the ability of individuals to pursue productive specialization and realize peaceful social cooperation through exchange. The rules of the social game dictate the strategies we pursue and the results we achieve (Fuller 1965; Olson 1982; Frye and Shleifer 1997; Glaeser and Shleifer 2002; World Bank 2006; Cooter and Schäfer 2012). As Max Weber argued long ago in his *General Economic History* ([1923] 2023), the operative legal structure matters greatly for economic performance. Weber contrasted the legal structure in China with that of the Western tradition inherited from Judaism and Roman law. Chinese law, in Weber's analysis, was not conducive to modern economic growth and development because it was based on ritual, religious, or magical considerations at the discretion of authorities – the opposite of the *rule of law.*[2]

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has focused on (1) financial regulation and financial stability, (2) the analysis of macroeconomic institutions, (3) international economic coordination, and (4) the relationship between law and macroeconomics. See Gelpern and Levitin (2020, vii). In the conclusion of their introduction, though, they stress how this emerging literature has provided direction beyond the crisis moment because of the troubling problems of persistently low output growth; environmental, health, and technological shocks; migration; and extreme inequality which destabilizes societies. We need, they conclude, new policy tools precisely because the established fiscal and monetary tools have lost their effectiveness (*ibid.*, xvii-xviii). LawMacro is the intellectual foundation for the proposed policy remedies to these social ills.

2 See also Gershman (2015) and Henrich (2020). Also see Hayek (1988), especially chapter 9 and appendix G, on the positive role of rituals and religious traditions as guardians and conveyers of traditions. The key phrase for our purposes in the sentence above is *discretion of authorities*, rather than the emphasis on ritual and religion *per se.*

What matters is how alternative institutional arrangements hinder or encourage social cooperation and complex coordination of economic plans through time. LawMicro encourages a kind of macroeconomic analysis of legal, political, and social institutions, but one that is grounded in the microeconomics of the individual decision calculus. Importantly, from the perspective of the economic way of thinking, while there may be macroeconomic questions and puzzles, there are only microeconomic answers and solutions. Everything must be traced back to the choices individuals make against the constraints they face to render economic phenomena intelligible in terms of the purpose and plans of the actors that constitute the system. Incentives matter. Institutions matter. Individuals matter because they populate the world inside the institutions and make decisions based on the incentive structure they find themselves confronting.

The Keynesian-inspired LawMacro is methodologically and analytically unable to address the distributional questions it purportedly wants to emphasize. Production and distribution are inexorably linked and cannot be separated for public policy purposes without introducing perverse incentives and distortions in the pattern of exchange, production, and distribution (Nozick 1974; Otteson 2014). Policymakers can no doubt play with endowment but cannot do so in an incentive-neutral way. Their acts set in motion myriad adaptations and adjustments that belie and baffle policy planners' designs. It suffers, as we have already stated from Hayek's "pretense of knowledge," and embodies a "fatal conceit."

Applying LawMicro to macroeconomic questions expands the framework of studying how alternative legal rules affect individual and firm decisions to include effects on economic growth, income inequality, and financial stability. However, the channel through which this influence runs is the decision calculus of individuals and their exchange relationships with others. What we learn from studying the long history of economic development is the foundational role that private property and freedom of contract, embedded in the rule of law, play in promoting economic and social progress. The key functions are: (a) protecting persons and property from predation; (b) providing legal certainty, which encourages investment; (c) motivating responsible decision-making on behalf of owners; (d) serving as the background for social experimentation and innovation, which spurs economic and social progress; and (e) expanding the contexts within which economic calculation, guided by prices and profit-and-loss signals, can guide rational resource use.[3]

LawMacro scholars would likely reply we are straw-manning based on an equivocal use of the term "law." On the contrary, everything depends on the results of using legal rules to empower technocrats engaged in top-down governance instead of laying a

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[3] Economic calculation is essential for narrowing down the array of technologically feasible projects to those which are economically viable. Economic calculation is how market-based economic systems tends toward producing *more with less.* If this process is impeded by monetary manipulation or fiscal imprudence, the economic system will end up producing *less with more.* Unfortunately, certain trends in economic thought, such as extreme formalism and excessive aggregation, clouded our understanding of the critical importance economic calculation plays in the wealth and poverty of nations. Finally, we must remember our ability to engage in economic calculation is a function of the legal environment governing economic behavior. Property, prices, and profits are institutionally and causally linked.

foundation for households, businesses, and government to produce bottom-up governance cooperatively. Whether a technocrat is a regulator, politician, or judge makes little difference. For any rule-governed community, interpreting rules such that discretionary authorities can manipulate outcomes based on social values makes governance unstable, unpredictable, and discriminatory (cf. Hayek [1960] 2011). Experts, are, after all, prone to fail (Easterly 2015; Levy and Peart 2016; Koppl 2018). The negative effects on the community will be larger if its values differ from those the discretionary authorities seek to impose. Moreover, even if the community and authorities share values, the community may judge it best to secure them by means other than the rules in question, which are likely crafted with other purposes in mind.

LawMicro is a general paradigm. Its empirical content depends on the history and context of the institutions to which scholars apply it. Drawing on previous work (Boettke, Salter, and Smith 2021), we focus on the Federal Reserve and its extraordinary failure during and after the Covid-19 pandemic. The Fed has a Congressional mandate to pursue full employment, stable prices, as well as an internal (average) inflation target of 2 percent (Powell 2020). Yet, in practice, it is a regime of bureaucratic discretion. The Fed can interpret "stable prices" however it wishes, and there are no consequences (besides the reputational) to missing, or even redefining, its self-imposed inflation objectives. *De facto* institutional irresponsibility largely explains the resurgence of inflation to levels not seen in forty years, which we will discuss further below. To understand the importance of law for macroeconomics, we can hardly do better than highlighting the consequences of lawless macroeconomic policy (Menand 2021; 2022).

The Fed's response to Covid-19 was undoubtedly misguided.[4] To be clear, much of what the Fed did initially can be justified (cf. Cachanosky *et al.* 2021), even in the hypothetical case of a strict rule governing its behavior. We do not deny the shock to markets called for aggressive countercyclical monetary policy. The fatal defect was the lack of a rule that specified a clear and binding target, which would have disciplined the Fed's behavior once economy-wide price pressures arose. In March 2020, the Fed's balance sheet totaled $4.24 trillion. It quickly rose to $7.17 trillion that June, eventually reaching a high of nearly $9 trillion in April 2022. By then, prices, as measured by the Personal Consumption Expenditures Price Index (the Fed's preferred index), rose 6.66 percent per year, more than three times the Fed's unofficial target. Inflation eventually peaked at 7.11 percent that June.

Two factors merit special consideration. First, the Fed's balance sheet expansion was primarily driven by massive purchases of government debt, itself ballooning due to the fiscal response to the coronavirus. The Fed's stock of Treasuries, which totaled $2.52 trillion in mid-March 2020, rose to a high of $5.78 trillion in early June 2022. As a percentage of total public debt, Fed ownership rose from approximately 10 percent at the start of the pandemic to nearly 20 percent at the end. Fed officials

4 We are largely abstracting from the public choice and political economy considerations of the crisis response, instead focusing on the internal inconsistencies between policy goals desired and policy means chosen to achieve those goals. Public choice and political economy considerations confound that process further. See Boettke and Powell (2021) for an introduction of some of the issues raised by public choice and political economy considerations.

wished to keep conditions in the market for government debt stable, at one point purchasing Treasury obligations totaling 50 percent of new issuances. Undoubtedly, the increased demand for government debt kept yields lower than they otherwise would have been, easing the fiscal authority's borrowing costs. This is one step removed from debt monetization. Long ago, Adam Smith ([1776] 1981, v, iii) warned about the "juggling trick" of deficits, debt, and debasement. It seems the government's habit of "spending in excess of revenue (deficit finance), accumulating these deficits into long-standing public debt, and paying off the debt through the debasement of their currency" (Boettke, Salter, and Smith 2021, xi) is still with us.

Second, the Fed's continuance of ultra-loose monetary policy is plausibly related to "mission creep," which Rouanet and Salter (2023, 1) define as the Fed "[expanding] its objectives to tackle various new issues, including climate change, inequality, and supporting small businesses." This partly explains why so many Fed officials hoped inflation was transitory, reflecting nothing more than temporary supply-side problems, such as lingering production bottlenecks from the pandemic. Demand-side inflation, caused by monetary policy, would impel them to change course before they could implement their social agenda. As evidence, note that key Fed decision-makers explicitly referenced their reinterpretation of the Fed's employment mandate to justify continued easy money. Governor Lael Brainard's statement is worth quoting at length: "[the Fed] made changes to monetary policy that can be expected to support fuller and broad-based employment than in earlier recoveries, improving opportunities for workers who have faced structural challenges in the labor market […] The new policy […] could support labor market conditions that help to reduce persistent disparities" (2021). In footnotes 8 and 11, Brainard clarifies she is referring to the racial unemployment gap. Chairman Jerome Powell (2020; 2021) likewise emphasized the Fed's role in tackling unemployment disparities between racial groups (cf. Rouanet and Salter 2023, 14). As Skinner and Binder (2023) observe, the Fed has increasingly expanded beyond monetary policy proper into climate change, inequality, and diversity initiatives (see also Binder 2021).

The Fed's actions here are plainly inappropriate. Ironically, these behaviors reflect what LawMacro scholars claim to want: Policymakers reinterpreting rules (in this case, the Fed's employment mandate) to pursue broad social goals that are, at best, only tangentially related to the rules' accepted meaning. Of course, monetary policy, which is a countercyclical tool, cannot permanently affect racial unemployment gaps, which are a structural economic problem. The Fed's attempt to force a square peg into a round hole resulted in inflation rates not seen in two generations. Consequently, real wages for ordinary workers fell for at least eight quarters. Tragically and predictably, many of the workers whom the Fed had intended to help instead suffered what is likely to be a permanent negative wealth shock due to the erosion of their incomes' purchasing power.

A binding rule for monetary policy can work. Discretion, including "constrained discretion" (Bernanke 2003), cannot. We develop the argument as follows: In Section 2, we survey key historical works on rules-based monetary policy. Section 3 shows how discretion runs afoul of basic information and incentive problems, whereas a rule can overcome them. Section 4 concludes. Our argument illustrates why rules must primarily be used to restrain public authorities rather than empower them. This contradicts a major goal of the LawMacro research program and vindicates older, classically liberal approaches to law, economics, and political economy.

2. Foundations

Arguments for monetary rules have a distinguished history in economic thought. We cannot survey every notable contribution here. Instead, we highlight four exemplary schools of thought: Old Chicago, Ordoliberalism, Virginia Political Economy, and New Chicago. Each contributes something essential to our understanding of how rules affect macroeconomic outcomes.

2.1 Old Chicago

The Old Chicago approach to monetary rules is best exemplified in Henry Simons's essay, "Rules versus Authorities in Monetary Policy" (1936).[5] The foundation of Simons's argument is classically liberal political economy, which "demands the organization of our economic life largely through individual participation in a game with definite rules. It calls upon the state to provide a stable framework of rules within which enterprise and competition may effectively control and direct the production and distribution of goods" (Simons 1936, 1). Simons decries the growing movement to replace general rules with discretionary authorities. However, he also believes the government has an important, and in fact an essential, role in governing the monetary system. Private law (property, contracts, torts, *etc.*) cannot provide adequate monetary policy, nor can bureaucrats. The solution is public governance according to a clear and predictable rule.

Even an imperfect rule, such as "price-level stabilization," is "infinitely better than no system at all" (*ibid.*, 21). Simons is willing to grant the government (in this case, the Treasury, which he hopes to administer the rule) significant leeway to achieve the target specified in the rule. This can be viewed as an early statement of the important difference between target independence and instrument independence in monetary policy. The public sector is an essential co-producer of monetary order. Still, it can only facilitate that order by limiting itself to regular, predictable conduct. Simons's conclusion is unambiguous: "The most important objective of a sound liberal policy, apart from the establishment of highly competitive conditions in industry and the narrow limitation of political control over relative prices, should be that of securing a monetary system governed by definite rule" (*ibid.*, 29). To prevent "legislative (and administrative) tinkering," the chosen rule "must be definite, simple (at least in principle), and expressive of strong, abiding, pervasive, and reasonable popular sentiments." This leaves ample room for reasonable disagreement about the specific target or con-

5 Chapters 2–3 in Jennifer Burns's (2023) biography of Milton Friedman details the Chicago Plan to address the Great Depression, as well as its connection to the price-theoretic foundations that became the hallmark of the Chicago School of Economics as developed by Frank Knight and Henry Simons.

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tent of the rule. But in the essentials, we have advanced little beyond Simons's wisdom.

2.2 Ordoliberalism

Like Old Chicago, Ordoliberalism emphasizes the importance of a strong but limited state (Kolev and Köhler 2022). Whereas the Old Chicago tradition channels American currents of classically liberal political economy, Ordoliberalism is an early 20th-century German development, arising out of the disorder of Weimar and the horrors of the Third Reich. The paradigm was successfully put to work following World War II to rebuild Germany's shattered economy. Ordoliberalism promotes the use of government police power to maintain competitive markets and crucial institutions that private arrangements alone tend to underproduce (Bonefeld 2012; Vanberg 2004). An important example is the monetary system (Kolev and Köhler 2022). Ordoliberals rightly insist competitive and efficient markets rely on a well-functioning system to regulate money's quantity and purchasing power. The state, guided by a strict rule, should oversee such a system.

Walter Eucken, one of the intellectual founders of Ordoliberalism, understood the problem well: "All efforts to make a competitive order a reality are pointless unless a certain level of monetary stability can be ensured. Monetary policy thus has primacy for the competitive order" (1952, 256), he argued. Ludwig Erhard, Chancellor of Germany from 1963 – 1966 and Minister of the Economy from 1949 – 1963, was heavily influenced by ordoliberal thought. He believed the government must build the necessary infrastructure for markets to adapt to changing supply and demand conditions (Erhard 1958), which itself depended on the monetary system facilitating informationally accurate prices (cf. Schnabl 2019). As a final example, the influential economist Wilhelm Röpke regarded the classical international gold standard in high esteem because of its function *as a disciplining rule*, forcing national governments "to behave in matters of monetary and credit policy in such a way that this fixed and free coupling remained an undisputed permanent institution, irrespective of all trade fluctuations" (1959, 76). Although there were significant differences among ordoliberal thinkers about the ideal monetary rule (Kolev 2017; Kolev and Köhler 2022), all agreed that the state had an essential role in promoting such a rule, and that any viable rule must predictably tend towards maintaining the competitive market order.

2.3 Virginia

The Virginia School of Political Economy in the late 1950s and early 1960s forged a new path in political economy, one largely independent from the hegemony of the neoclassical synthesis (market-failure microeconomics combined with Keynesian macroeconomics) spearheaded by Paul Samuelson. The main actors in this scientific enterprise were James Buchanan, G. Warren Nutter, Gordon Tullock, Ronald Coase, and Leland Yeager. They were inspired by Frank Knight and Henry Simons, and they explicitly sought to bring institutions back into the forefront of economic analysis. The neoclassical synthesis had squeezed institutions out of the analytical framework of economics in a quest to have an institutionally antiseptic general theory (Boettke, Leeson, and Smith 2008). Buchanan's early work was in public finance, and one of the main claims he established in his classic essay on "The Pure Theory of Government Finance" (1949) was that one could not do public finance without first postulating a theory of the state. We must have a theory of the appropriate scale and scope of government activity before we postulate various ways to finance those activities. This intellectual move opened the black box of government decision-making to economic analysis. It also led to what Buchanan ([1968] 1999: 5) called a "genuine institutional economics" or an interaction analysis of the rule level of analysis and the analysis of strategic decision-making within the rules. For Buchanan, the play between rules and strategy would become the foundation for a new political economy.

For our purposes, the emphasis on the rule level of analysis produced in macroeconomics, a renewed appreciation in both fiscal policy and monetary policy for binding rules instead of discretion. In the early 1960s, The Thomas Jefferson Center for Studies in Political Economy held a conference that resulted in an edited volume by Leland Yeager, *In Search of a Monetary Constitution* (1962), which laid out the basic Virginia School position on the importance of rules in monetary theory and policy.

Buchanan would later (along with Geoffrey Brennan) develop a more general case for the importance of general and binding rules in economic affairs in *The Reason of Rules* (1985). In this work, Brennan and Buchanan develop arguments not only about predictability that we mentioned in our introduction, but the curbing of opportunistic behavior in politics. Following Hume's dictum that in designing systems of governance it would be wise to assume that all men were knaves, Brennan and Buchanan discuss how alternative institutional designs can both enable government decision-makers to take the actions necessary to have a functioning government and yet constrain those decision-makers from acting opportunistically. This exercise, of course, is one of the defining aspects of Buchanan's entire research program – how does one empower the protective state (law and defense) and the productive state (public goods) without unleashing the predatory state (rent-seeking) (Boettke and Candela 2019)? The answer is to guard against knavery in all its forms. For our purposes, we can say that this knavery comes in the form of opportunism with the guile and the arrogance of the man of systems. The Virginia School's outstanding contribution to modern political economy was to focus analytical attention on governance regimes that guard against the predatory tendencies of politics, which undermine the wealth of nations. Importantly, one of the most damaging policies in this regard is the manipulation of money and credit by monetary authorities (Horwitz 2000; Garrison 2006).

2.4 New Chicago

New Chicago builds on Old Chicago's appreciation for the institutional foundations of market-based coordination while adding new theoretical and empirical tools. Theoretically, New Chicago emphasizes mathematical modeling, rational expectations, and "tight prior" equilibrium analysis. Empirically, New Chicago emphasizes careful measurement and high-powered statistical analysis. These tools can be abused, but when wielded competently, they reveal new dimensions of price-based coordination

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and reaffirm the importance of political and legal rules for constituting the market system.

Kydland and Prescott (1977), arguably the most important theoretical contribution, famously showed that even a benevolent and omnipotent central bank must embrace rules to achieve its policy objectives. Because both central bankers and the public are rational, and the central banks know (and the public knows the central bank knows, *etc.*) that the public dislikes higher inflation but likes lower unemployment, the central bank cannot use discretionary policy to nudge markets towards a more-preferred inflation-unemployment combination.

Period-by-period decision-making is inconsistent; it cannot deliver first-best outcomes so long as the public is aware of the central bank's attempts. The only way out of the morass is a binding rule: a credible commitment *not* to tinker with outcomes on a period-by-period basis, instead focusing on creating a stable foundation for market activity. Barro and Gordon build on Kydland and Prescott, showing that monetary policy "[o]utcomes improve if rules commit future policy choices in the appropriate manner. The value of these commitments – which amount to long-term contracts between the government and the private sector – underlies the argument for rules over discretion" (1983, 589).

In terms of empirics, Chicago monetarists and quasi-monetarists, both before and after the rational expectations revolution, have done important work rigorously documenting the errors to which discretionary monetary policy is prone. Here, we emphasize the contributions of noted Fed scholar Robert Hetzel. His recent book (Hetzel 2023) argues the key challenge confronting central banks under fiat money is defining and committing to a nominal anchor, which is necessary for money's purchasing power to be well-defined. However, the Fed has often gone out of its way to obscure its goals: "Accountability requires transparency and transparency is integrally related to learning. Without a clear articulation of the monetary standard, the Fed has no way of learning from the accumulation of experience. […] The Fed's failure to articulate the nature of the monetary standard is concerning because of the grave consequences of destabilizing monetary policy" (*ibid.*, 4).

In an earlier piece, Hetzel (1997) discusses the importance of monetary rules for democratic self-governance. His essay is worth quoting at length:

> Constitutional democracy protects individual liberty. It does so by placing restraints on the arbitrary exercise of power by government. A primary restraint is the constitutional protection of property rights. The monetary arrangements of a country either promote or undermine that protection. Money is unique in that its value in exchange far exceeds the cost of producing an additional unit. On the one hand, governments have an incentive to print additional money to gain "free" resources, or seigniorage revenues. On the other hand, the central bank must limit the quantity of money in circulation to control prices. Through its influence on seigniorage, money creation affects how government raises revenue. It can also affect who within government decides how that revenue is spent. Through its influence on fluctuations in the price level, money creation influences the extent of arbitrary redistributions of wealth among individuals. The institutional arrangements that govern the creation of money then bear on two aspects of the protection of property rights: the taking and disposition of wealth from the public and the distribution of wealth by government between individuals. A legislative mandate from Congress requiring the Federal Reserve (the Fed) to stabilize the price level and to hold

only government securities in its portfolio would complement the rules in a constitutional democracy that protect property rights (*ibid.*, 45–6).

While we are not committed to a price level target, the way we think about the problem accords with Hetzel. He is correct about the corruptive effects of bureaucratic money manipulation on property rights, the rule of law, and the competitive market economy.

3. Why Rules Work[6]

Milton Friedman (1947) argued in an often-overlooked review essay of Abba Lerner's (1944) *The Economics of Control* that while Lerner's technical economics was logically unassailable, it was woefully deficient as practical political economy. Friedman accused Lerner of ignoring the administrative analysis of public policy. The costs of administration included, in Friedman's accounting, the problem of accurate timing in public policy. He lays out an early conceptualization of his "long and variable lags" argument. The analyst must (a) recognize the problem, (b) design the policy response, (c) implement the policy, and (d) trace the consequences of the policy through the system. The critical issue is that the time gap between recognition and implementation, and implementation and consequences may be such that the original problem is no longer there or has changed in important ways. If this is true, then instead of providing the intended counter-cyclical stability, the discretionary policy response will actually be destabilizing. Rules, Friedman argued (following his mentors Knight and Simons), out-perform discretion. Friedman (1968) later made this argument more widely accepted in the economics profession with his 1968 AEA Presidential address, "The Role of Monetary Policy."

In general, rules should be used to create a stable foundation for economic activity rather than micromanage economic activity. Discretionary central banking necessarily eschews the former for the latter. The supposed benefit of discretion, i. e., that it gives policymakers flexibility to respond to changing circumstances, is illusory. It is impossible for discretion in monetary policy to deliver systematically better outcomes than rules. The basic problem has nothing to do with the foibles or weaknesses of central bankers. Even if the makers of monetary policy were perfectly informed and selfless, rules work better. The most basic problem has to do with information, not incentives. "The monetary knowledge problem is the same kind of problem Mises and Hayek identified for centrally planned economies" (Boettke, Salter, and Smith 2021, 37, citations omitted).

Market economies are vast communications networks conveying information about relative resource scarcities (cf. Mises [1931] 1986, Hayek [1948] 1980). Private property rights and voluntary exchange yield prices that reflect opportunity costs. However, the informational role of the price system presupposes a stable monetary environment. If the public's desired money balances diverge from the supply of money at the prevailing price level (the inverse of money's purchasing power), money can become

[6] We acknowledge that the enforcement of the rule of law relies on the creation of self-enforcement mechanisms or civic education (Brennan and Buchanan 1985; Wagner 1993; Salter 2014; Salter and Young 2018).

a disruptor of exchange rather than a facilitator of exchange. This "monetary disequilibrium" problem (cf. Yeager 1986) requires an institutional solution. There must be some rule or process ensuring adequate liquidity in the economy, meaning changes in the money supply should offset changes in money demand.

Discretionary monetary policy cannot persistently stave off monetary disequilibrium. There is no reliable feedback process akin to supply and demand upon which central bankers can base their policy decisions as money suppliers of base currency. The best they can do is use various statistical aggregates as proxies. However, when the underlying economic conditions change, these data will no longer provide accurate guides to the optimal stance of future policy (Rothbard 1960). Attempting to govern the money supply by bureaucratic discretion is akin to throwing darts at a moving dartboard while blindfolded. "[D]iscretionary central banking will generate monetary disequilibrium *as a regular matter of course*, as the money supplied by the central bank periodically falls short or exceeds the money demanded by the public" (Boettke, Salter, and Smith 2021, 44, emphasis in original).

The information problem is fatal for discretion by itself, but we should also acknowledge the importance of bad incentives. Central bankers are *not* omniscient angels. They are capable but flawed human beings, just like the rest of us. This explains why monetary policymakers fall prey to political pressures as a regular matter. The Fed's history, in particular, contains many cases of "political and bureaucratic pressures shaping both its institutional structure and policy" (*ibid.*, 59).

Political pressures on central bankers fall into two categories: internal and external. Internally, we must remember that central banks are bureaucracies. Shortcomings such as budget exhaustion, status-quo bias, and groupthink are common. In fact, they are the predictable result of nonmarket decision-making in environments where agents have significant power, minimal responsibility, and can underwrite their activity using resources other than their own. Externally, elected officials are keen to steer central bank policy that advances their narrow coalitional interests rather than the public welfare. For example, because the Fed is the monopoly supplier of high-powered money, the temptation to use its balance sheet as an alternative to politically unpopular taxation and regulation to direct social outcomes is enormous. Private interests, such as large banks and other financial institutions, also wish to steer monetary and credit policy. The overlapping social networks and often lucrative career opportunities for financiers-turned-central-bankers (or the reverse) result in many blurred lines between the welfare of specific organizations and the welfare of the economy as a whole.

Given these difficulties, the advantages of strict rules are obvious. Rules are not subject to the knowledge problem because they do not attempt to micromanage the money disequilibrium problem. Instead, they provide economic actors (households and businesses) with clear criteria regarding how the money supply will adjust in response to money demand shocks. In the language of Hetzel (2023), the monetary authority credibly commits to a stable nominal anchor, which sets the cornerstone for the economic edifice. Rules are not subject to the incentive problem because they remove power from central bankers to promote particular interests at the expense of the general interest. There is no point in lobbying a truly impartial referee. While the specific content of the rule clearly matters, it is often more important that *some* rule prevail.

Even a second-best rule is more desirable than discretion once we realize the relevant counterfactual is not blackboard-perfect "constrained discretion" but discretion in a world of actually existing information and incentive problems.

4. Conclusion

Our discussion focused on the "reason of rules" and the political infrastructure of economic and social progress. The rule of law provides the essential framework. Deviations from the rule of law to produce social goals run afoul of incentive and information problems and risk inviting the knaves to overrun the public sector. Within the context of a central banking system, sound economic analysis leads us to conclude that a rule that ties the hands of the monetary authority will outperform the discretion of monetary authorities. The current consensus of constrained discretion is merely discretion by another name. Rule-like behavior is categorically different from rule-bound behavior, as we learned the hard way from the crises of 2008 and 2020.

Our arguments about the importance of rules follow from a microeconomic analysis of decision-making under alternative institutional arrangements. Rather than a revolutionary paradigm shift to LawMacro with a focus on distributional questions and policy goals intended to address questions of social justice, what is required is an expansion of the domain of LawMicro into questions of a macroeconomic nature related to productive specialization and peaceful social cooperation. The mechanics of economic growth and development, we must always remember, follow elementary economic principles. The only way to increase real income per capita is to increase real productivity per capita. We increase real productivity per capita through improvements in physical capital, human capital, and, most importantly, in the rules of the game that determine how individuals interact. The wealth and poverty of nations hinges on discovering and adhering to rules that enable productive specialization by economic actors and their ability to realize the gains from peaceful social cooperation through mutually beneficial exchange. LawMicro, with its emphasis on how legal rules impact individual behavior and shape exchange relationships, provides the basis for a macroeconomics capable of understanding the plight of underdevelopment as well as the miracle of modern economic growth.

No doubt the full story is much longer than this and would include considerations such as McCloskey's (2006; 2010) on the legitimating ideology and the transformation of the culture of economic growth. However, for our purposes, we focus on the foundational role that the rule of law plays in constraining the knavery of monetary authorities – knavery that comes in the form of both opportunism with guile and arrogance born of the pretense of knowledge – and providing instead the framework that upholds a functioning price system, which guides human actors to allocate scarce resources such that the economic system consistently produces more with less. The alternative, a regime of administrative discretion operating according to the rule of technocrats rather than the rule of law, consistently produces less with more. The consequences of that basic economic insight are staggering for human well-being.

LawMacro scholars deserve commendation for focusing their analysis on the durable properties of institutions and the consequences of institutional change. However, the fact remains that their chosen economic framework is, at best, fifty years behind the frontiers of economic scholarship. The macroeconomics of hydraulic Keynesianism and the microeconomics of mechanical redistributionism are no longer scientifically tenable. Those who seek to advance expert-led governance in the service of social justice – beliefs which, we emphasize, we have *not* impugned in our analysis – must find an alternative foundation. Is LawMacro a living academic enterprise that seeks to engage, contribute to, and learn from current economic and political-economic debates? Or is it an ex-post justification for an already agreed-upon project of social control? The direction LawMacro takes over the next few years will give us the answer.

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