



What the Taylor Rule Says about Interest Rates

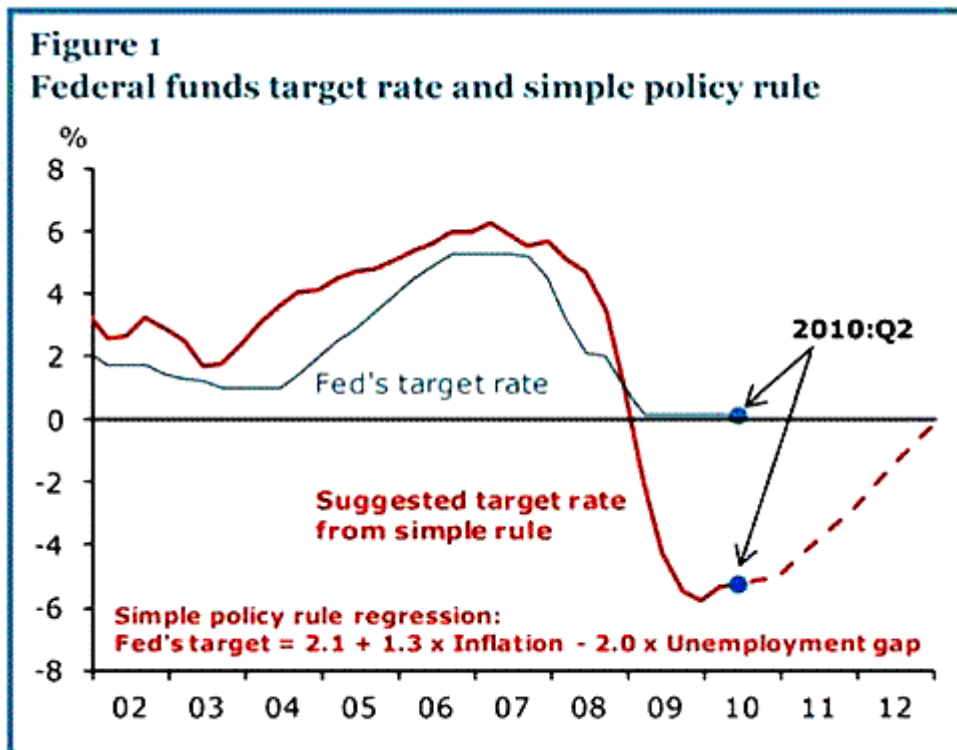
By Charlie Curnow
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Interest rates should stay low for the foreseeable future, and the Fed's use of non-standard monetary policy to bolster liquidity will likely continue, Christopher L. Foote, an advisor to the Boston Fed's Center for Behavioral Economics and Decisionmaking said on September 10 during a meeting of the Financial Planning Association of Massachusetts at Bentley University in Waltham, Massachusetts.

According to Foote, the Taylor Rule, a widely cited forecasting tool, predicts that the current inflation rate of 1.2 percent and the unemployment rate of 9.6 percent will keep the target federal funds rate in the range of -3.5 to -4.5 percent. Since the federal funds rate cannot fall below zero, Foote said, the Federal Reserve will probably continue to employ unconventional monetary policies to encourage bank lending and increase the money supply beyond what its normal toolkit would allow.

The Taylor Rule is a mathematical formula first published by Stanford economist John B. Taylor in 1993 that forecasts the target federal funds rate using the current annualized inflation rate and the difference between the current unemployment rate and the Non-Accelerating Inflation Rate of Unemployment (usually estimated at between 5.5 and 6 percent). According to the Taylor Rule, spikes in unemployment above the natural rate call for lower interest rates, especially when inflation is subdued.

As Foote noted, the Taylor Rule's forecasts have correlated closely with the actual target federal funds rate over the past decade (see Figure 1), even though the Fed does not explicitly follow the rule.



Source: Federal Reserve Bank of San Francisco

The minutes of the latest Federal Open Market Committee (FOMC) meeting support Foote's conclusions. On August 10, the FOMC reiterated its position that stable inflation expectations and low resource utilization warranted "exceptionally low levels of the federal funds rate for an extended period," and that the target federal funds rate would stay in a range of 0 to 0.25 percent, where it has been since December 2008. The Fed also announced at the August meeting that it would make a new foray into unconventional monetary policy by starting to buy longer-term Treasury securities using proceeds from payments on mortgage-backed securities that it holds, as well as other securities issued by U.S. government-sponsored agencies.

Another unconventional policy option being discussed by the Fed is to lower interest rates on excess bank reserves, which increased from near zero in 2008 to more than \$1 trillion by 2010 following an announcement by the Fed that it would begin to pay interest on reserve balances under the Economic Stabilization Act of 2008. A drop on the interest rate on excess reserves from their current level of 0.25 percent to near zero, Federal Reserve Chairman Ben Benanke said in a speech on August 27, could effectively cut the federal funds rate by an additional 0.10 to 0.15 percentage points.

Not everyone on the FOMC agrees with recent moves toward looser monetary policy. At the August 10 meeting, Thomas M. Hoenig, chief executive of the Tenth District Federal Reserve Bank in Kansas City, Missouri, voted against the decision to keep the target



federal funds rate at its current level, restating a position he expressed at previous policy meetings that additional accommodation from monetary policy was unnecessary as the economic recovery entered its second year and continued at a moderate pace. Further monetary accommodation, he said, would contribute to the buildup of future financial imbalances and raise risks of long-term financial and macroeconomic instability.

The next official Fed announcement on target interest rates will occur at the upcoming FOMC meeting on Tuesday, September 21.

Charlie Curnow is an Assistant Editor with Advisor Perspectives.

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