Nicely Taylored?
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The Federal Reserve has raised interest rates by another quarter of a percentage point. Is there method in its moves?

BEFORE his second term is over, President George Bush will leave his mark on two of the most important, unelected arms of government. As well as picking one or more judges to serve on the Supreme Court, he will have to find a new chairman of the Federal Reserve, which acts as the judge, jury and executioner of American monetary policy. On Wednesday November 10th, the Fed handed down its latest judgment, raising its benchmark rate of interest, the federal funds rate, by a quarter of a percentage point to 2%.

The current Fed chairman, Alan Greenspan, will retire shortly after his term as a governor expires at the end of January 2006. Who will replace him? One plausible candidate is John Taylor, the Treasury’s point man for international affairs. He may not be the favourite to take charge but, according to many of his peers, the Fed long since submitted to “Taylor’s rule”. This rule, which Mr Taylor first expounded in 1993, tries to capture the method behind the Fed’s interest-rate moves. Though it enjoys a great deal of discretion, America’s central bank, Mr Taylor argued, is systematic, not capricious, in responding to the rhythms of the economy.
According to the Taylor rule, the Fed responds to two things in particular. First, it notes whether inflation has drifted above or below its preferred level—which he assumed to be about 2%, though the Fed does not admit to having a number in mind. Second, it calculates whether the economy still possesses any spare capacity—idle workers or idle machines—that it is not fully employing.

What would the Taylor rule now prescribe? Inflation, the Fed said in its statement on Wednesday, remains “well contained”. According to September’s figures, rising energy costs pushed consumer prices up by 2.5% over the previous 12 months. But by the Fed’s preferred measure (the so-called core PCE deflator, a price index for personal consumption expenditures) prices rose by only 1.5%. The Fed is thought to be comfortable with inflation in a range of 1% to 2%. So, according to the Taylor rule, at least, price pressures do not give the Fed any immediate cause to raise interest rates.

But is America fully employed? In its latest World Economic Outlook, published in September, the International Monetary Fund predicted that the American economy will fall short of its productive potential this year by 1.3% of GDP. Next year, this “output gap” will narrow to 1%. The economy has been remarkably slow to find work for all the hands left idle since the last recession, in 2001. But, as the Fed noted on Wednesday, the labour market is once again raising hopes. In October, firms added 337,000 workers to the payrolls. If this pace of hiring continues, the path back to full employment will be swift and sure.

But there is still a long way to go. About 62.3% of American adults of working age are currently employed. At the height of the bubble economy in 2000, 64.7% were. Another 5.3m people would have to find work to make up the difference. Those dizzying peaks of employment may never be regained. But they give some idea of what a truly tight labour market would look like.

America is not yet fully employed, and not yet threatened by inflation. Why, then, is the Fed raising interest rates? From where the economy now stands, surely the Taylor rule would suggest holding rates or even cutting them? The Taylor rule, however, would suggest not starting from here.

The rule requires some notion of an “equilibrium” rate of interest that will neither restrain nor stimulate the economy. In his original paper, Mr Taylor put this rate at 4%. In other words, if inflation were on target, and the output gap closed, the federal funds rate should stand at 4%. (If the economy is more productive now and capital more profitable, as most economists believe, this equilibrium rate of interest would be still higher.) With inflation currently a touch below target and an output gap of 1.3%, Mr Taylor’s original rule could perhaps justify a federal funds rate as low as, say, 2.5%—but not 2%.

The notion of an equilibrium rate of interest owes something to the “normal” or “natural” rate of interest posited by Knut Wicksell, a Swedish economist, in 1907. But though Wicksell defined the concept of a natural rate of interest, he did not think you could put a number on it. You will know it when you miss it, he said. If interest rates were held below the natural rate, prices would “rise and rise and rise without any limit whatever”. If rates were held above it, prices would fall.

Prices in America are not rising without any limit. Perhaps, then, the federal funds rate is not as far below the natural rate as the original Taylor rule would imply. But other tell-tale signs suggest interest rates are unnaturally low. American households saved just 1.2% of their disposable income in the second quarter, and just 0.4% of it in the third. An absence of thrift and explosion of credit were, Wicksell said, sure signs that money was too easy—ie, rates were too low. The Swede, then, would accuse America’s chief judge of monetary policy of being too lenient. But the jury is still out.