The Taylor rule is not exactly a rule, but it is a useful tool to help economists and Federal Reserve officials think about how they should conduct monetary policy. Forefront talks to the Cleveland Fed’s Todd Clark, vice president of macroeconomics and monetary policy, about the Taylor rule’s ins and outs.

Forefront: What does the Taylor rule (generally speaking) prescribe if growth is going gangbusters and inflation is ramping up?

Clark: As the economy expands above its potential and inflation rises above target [the Federal Open Market Committee’s (FOMC) objective is 2 percent], the Fed should raise interest rates. Conversely, as the economy contracts below its potential and inflation falls below target, the Taylor rule prescribes lower interest rates. In both cases, the Fed would be leaning against the wind. The Taylor rule provides a quantitative prescription for how much leaning is needed by drawing on the historical behavior of Federal Reserve monetary policy.

Forefront: Do FOMC members walk into their meetings expecting to strictly follow the prescriptions of the Taylor rule?

Clark: To be clear upfront, I have never surveyed FOMC members on this question. That said, I feel comfortable saying I don’t think FOMC members — current or past — view a policy rule like the Taylor rule as something that needs to be precisely followed. Rather, the rule serves as a convenient guidepost by providing an effective summary of the past behavior of monetary policy. Also, in theoretical models, the rule tends to work well (compared to other possible rules) in stabilizing the economy. Some FOMC members have explicitly described the Taylor rule that way in public comments.
Forefront: One could argue that precise adherence to a policy rule would undermine the need for the FOMC in the first place, and that this would be a good thing, inasmuch as it would make monetary policy decisions less vulnerable to short-term political pressure. Conceivably, a computer could set monetary policy by following the Taylor rule.

Clark: Yes, but at any time, the FOMC may have good reason to depart from the guidepost due to economic circumstances being more complicated than can be captured by just the economic activity and inflation indicators included in the rule. Financial conditions are a good example. Due to financial conditions being unusually good or bad, the FOMC might have reason to keep interest rates above or below the prescriptions of the Taylor rule.

Forefront: What was the Taylor rule telling the Fed in the years before the financial crisis? That is, some have argued that if it had closely followed the Taylor rule, the Fed would have raised rates sooner and faster, perhaps heading off an asset bubble. Do you think that’s a fair characterization?

Clark: One of the things that evaluations of the pre-crisis period highlighted is that different versions of the Taylor rule, each with some merit, can sometimes yield fairly different policy prescriptions. John Taylor himself has pointed out that his original, simple version of the rule calls for short-term interest rates that would have been significantly higher in the pre-crisis period than they actually were. Others have pointed out that some versions of the rule imply interest rate settings reasonably close to the actual course of monetary policy during the pre-crisis period. These other versions of the rule are thought by some to have advantages, such as basing the rule setting on forecasts of economic activity and inflation instead of past values, in order to make policy as captured by the rule looking forward, as it is in practice. These other versions of the rule also take account of the fact that at the time policy decisions are made, they have to be made on the basis of the preliminary data measures available at the time, not the revised measures available much later in time.

Forefront: Okay, but what do you think?

Clark: Overall, personally, I think Chairman Bernanke’s January 2010 speech to the American Economic Association made a persuasive case that the bulk of the evidence suggests that the course of monetary policy in the pre-crisis period was broadly consistent with Taylor-type rules and that other factors were the primary drivers of the bubble that eventually burst. To me, at least, the contrast between the United States and the United Kingdom provides a very simple indication that monetary policy was not the driver of the boom and bust. The UK experienced a housing boom and bust similar to the one in the US, despite having higher interest rates in the pre-crisis period.

Recommended reading

For more on the Taylor rule, read “Gaps versus Growth Rates in the Taylor Rule” by Charles T. Carlstrom and Timothy S. Fuerst at www.clevelandfed.org/research/commentary/2012/2012-17.cfm

“Policy Rules in Macroeconomic Forecasting Models” by Todd E. Clark at www.clevelandfed.org/research/commentary/2012/2012-17.cfm

Speech

For the full text of Chairman Bernanke’s January 2010 speech to the American Economic Association, visit www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm

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