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The Fed's State of Exception

Aug 12, 2021 | **JOHN B. TAYLOR**

STANFORD – Over the past few months, there has been a growing chorus of economic observers voicing concerns about the increase of inflation in the United States. Much of the commentary (including my own) has focused on the US Federal Reserve's apparent continuation of easy monetary policy in the face of rising prices. Despite a sharp increase in the rate of money growth, the central bank is still engaged in a large-scale asset-purchase program (to the tune of $120 billion per month), and it has kept the federal funds rate in the range of 0.05-0.1%.
That rate is exceptionally low compared to similar periods in recent history. To understand why it is exceptional, one need look no further than the Fed's own July 9, 2021, *Monetary Policy Report*, which includes long-studied policy rules that would prescribe a policy rate higher than the current actual rate. One of these is the "Taylor rule," which holds that the Fed should set its target federal funds rate according to the gap between actual and targeted inflation.

The Taylor rule, expressed as a straightforward equation, has worked well when it has been followed over the years. If you plug in the current inflation rate over the past four quarters (about 4%), the gap between GDP and its potential for the second quarter of 2021 (about -2%), a target inflation rate of 2%, and a so-called equilibrium interest rate of 1%, you get a desired federal funds rate of 5%.

Moreover, the Taylor rule implies that even if the inflation rate falls to 2% by the end of this year (which would be well below most forecasts), and economic output reaches its potential, the federal funds rate still should be 3%. That is a long way from the near-zero level implied by the Fed's forward guidance.

Since these calculations use the inflation rate averaged over the past four quarters, they are consistent with a form of "average inflation targeting" that the Fed itself endorsed last summer. They also follow the Fed's own recently suggested equilibrium interest rate of 1%, rather than the 2% rate that has traditionally been used. If the latter had been used, the discrepancy between the policy rate in the rule and the actual level of the funds rate would be even larger.

These higher possible levels for the federal funds rate are largely being ignored in the Fed's reported discussions. Instead, the Fed insists that today's higher inflation is a temporary byproduct of the pandemic's effect on inflation last year. Those who defend its current stance point out that market interest rates on longer-term bonds remain very low. On safe Treasury assets, the five-year yield is only 0.81%, and the ten-year yield is only 1.35% – well below the rates suggested by the Taylor rule when averaged over these maturities. Considering these factors, many commentators are saying not to worry: the markets are probably being rational when they forecast low rates.
The problem with this line of reasoning is that the low longer-term rates are likely being caused by the Fed's own insistence on keeping low rates as far as the eye can see. As Josephine M. Smith and I show in a 2009 study, there is a "Term Structure of Policy Rules" to consider. Effectively, the policy rule for longer-maturity bonds depends on the policy rule for the much shorter-term federal funds rate, as perceived by people in the market. If the Fed convinces the market that it will stay low, the term structure of interest rates will imply lower longer-term rates.

Today's situation is similar to that of 2004, when then-Fed Chair Alan Greenspan noticed that ten-year Treasury yields did not seem connected to moves in the federal funds rate. He called this a "conundrum," because the actual short-term interest rate was not generating as large of an increase in long-term interest rates as one would expect based on previous experience. Monetary-policy tightening was not having as much of an effect on longer-term rates as it had in previous periods of tightening.

During this period, the federal funds rate deviated significantly from what would have been predicted by the Fed's typical response, much as it is doing today. When the actual federal funds rate deviated significantly from the level suggested by policy rules, the short-term interest-rate response to inflation appeared to be much lower, at least from the perspective of market participants trying to assess Fed policy. And this perception of a smaller response coefficient in the policy rule may have led market participants to expect smaller longer-term interest-rate responses to inflation, and therefore lower long-term interest rates.

Today, it appears that the Fed is deviating from monetary-policy rules. It has beaten its own path for forward guidance, and the market is basing its estimates of future rates on the expectation that this deviation will continue. But history tells us that it cannot continue indefinitely. Eventually, the Fed will have to return to a policy rule, and when it does, the conundrum will disappear. The sooner this occurs, the smoother the recovery will be. There is still time to adjust and get back to a policy rule, but time is running out.

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