

Demystifying Alan

Amaze your friends! Predict the Fed's next move

BY KIM CLARK

Throughout its 86-year history, the Federal Reserve has fostered the image of a mysterious temple where our fates are determined by a cabal of secretive economists whose massive craniums are packed with arcane data. The financial press scrutinizes every word of its cagey chairman, Alan Greenspan. Some even watch the thickness of his briefcase for signs of intentions to raise or lower in-

cent. (Taylor uses the number derived from the national accounting of all goods and services instead of the more popular consumer price index.) To that he adds 2 percentage points, representing a lender's after-inflation profit. Taylor then adds two counterbalancing formulas to determine how much the Fed should move the federal funds rate. That's the interest rate at which banks lend to each other. It helps determine prime and credit card rates.

The Fed is supposed to keep the economy strong and inflation low. That's why it usually raises interest rates on signs that inflation may be taking off and lowers rates if the economy is not growing fast enough. So Taylor takes half the difference between inflation and the Fed's target for inflation. (He recently dropped his target from 2 to 1 percent.) He adds that to half the percentage difference between the gross domestic product, which is the nation's output of goods and services, and the level that the policy maker thinks is sustainable. (The Congressional Budget Office says GDP is currently 3.6 percent above a sustainable level.)

What does the formula tell us about today's economy? It depends on what you think is tolerable inflation and how fast the economy can safely grow. If you use Taylor's advice, the formula works out like this: $2 + 1 + 1/2(1 - 1) + 1/2(3.6)$. The answer: 4.8 percent, a smidgen higher than the current federal funds target of 4.75 percent.

But Taylor, and, to judge from his comments last week, Chairman Greenspan, believe they may have been underestimating the rate at which the economy can safely grow. It doesn't take much of a raise of that target before Taylor's rule recommends a drop in interest rates. So, if Taylor's right, when the Fed meets to decide interest rates again May 18, odds are it will do nothing at all.

Now if only some egghead could invent a formula to translate what Greenspan says into plain English, investors would be all set.



terest rates. The attention is warranted, since even the slightest interest-rate tick can roil markets and create or destroy millions of jobs.

Perhaps predicting the Fed's moves on monetary policy isn't so difficult after all. A Stanford University economist has invented a formula, simple enough for a high school algebra student to use, that does a surprisingly good job of forecasting the Fed's actions. The formula can't foretell responses to emergencies such as the Fed's easing of rates after the collapse of the ruble last fall. But since it was published by economist John B. Taylor in 1993, the Taylor Rule, as it is called, has "seemed to work pretty well as a predictive framework," says Federal Reserve governor Lawrence Meyer. Translated from cautious econo-speak, that's strong praise.

It works like this. Taylor starts with the annual inflation rate, currently about 1 per-