Interest rates still flout all the rules

A model which will correlate rates and objectives remains a pipe dream

As Federal Reserve chairman Alan Greenspan gave his Humphrey Hawkins testimony to the US Congress last week, highly paid economists around the world listened intently for any hint or nuance of the monetary policy that might give an insight into what is likely to happen after their meeting. How much public opinion will rule when it comes to the next rate decision? The question is the one that must be asked when one looks at the Taylor Rule.

Economic policymakers obviously remain as much an art as a science when they decide what to do, and what to say, about interest rates. Alan Blinder, the former Fed vice-chairman, speaks highly of the Taylor Rule, which links the level of short-term interest rates in a mechanistic way to the amount of spare capacity in the economy and the divergence of inflation from its target rate.

Alan Blinder, the former Fed vice-chairman, speaks highly of the Taylor Rule, which links the level of short-term interest rates in a mechanistic way to the amount of spare capacity in the economy and the divergence of inflation from its target rate. The Taylor Rule seeks to describe how interest rates have been set in the past or to prescribe how they may be set in the future. It is also unclear whether the Taylor Rule seeks to describe how interest rates have been set in the past or to prescribe how they should be set in the future. Perhaps both. As Davies says: "If the reader believes that policy has not been optimal in practice over the last 10 years, this calls the basis of the Taylor Rule into question." The Taylor Rule does appear to overestimate interest rate setting fairly well in the US, whereas Switzerland and Japan, with little evidence that it either underestimates or overestimates rates systematically. It works much less well for the likes of France and Italy, where interest rates have been used to target the exchange rate more than inflation.

The US Treasury and Federal Reserve have experimented with the Taylor Rule under the Taylor Rule suggests. The US Treasury has also carried out its own internal studies. These suggest that the Taylor Rule has worked reasonably well in explaining interest rates since 1982, but that a naive policy rule which simply held real interest rates constant over the period would have worked almost as well.

One of the key assumptions of the Taylor Rule is that the authorities are always influenced when setting interest rates by the degree to which inflation diverges from its target level. But this has been challenged by Atenasios Orphanides and David Wilcox of the US Federal Reserve, who have outlined what they call an "opportunistic approach to disinflation". Imagine that inflation is not too high, but still above the authorities' long-term target. A conventional policymaker would raise interest rates, thereby squeezing economic activity and pushing inflation down towards the target. The opportunistic policymaker would not take deliberate anti-inflation measures, but wait for external circumstances - such as a fall in oil prices or an unforeseen recession - to do the job.

Laurence Meyer, appointed as a Fed governor by President Bill Clinton, said in March "this strategy calls for the central bank to accommodate inflation expectations and at the trend rate of growth. When the next recession arrives, whatever the timing, inflation will ratchet down automatically. This strategy works because it is unlikely that central banks would behave in this way because the economic costs of stable prices are not too high. Moreover, inflation is not distributed widely throughout the population. The costs of reducing that inflation may leave many people relatively untouched, but they bear harshly on the minority who lose their jobs."

The opportunistic approach seems counter-intuitive to the policymakers are often determined to avoid large shocks to the rate of inflation. Having said this, inflation is only as low as it is now in the UK because monetary policy was so tight in the early 1990s. This in turn was a product of the authorities' desire to keep inflation low. Sometimes things have to get worse before they get better.