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Remembering the Taylor Rule

The recent Fed focus on the Taylor Rule means bye-bye to more easing -- and to materially lower market rates.

James Padinha Mar 8, 1999 4:49 PM EST

Mourning (Squared)

JACKSON HOLE, Wyo. -- **Greenspan** delivered this nugget on Feb. 23.

> The Federal Reserve must continue to evaluate, among other issues, whether the full extent of the policy easings undertaken last fall to address the seizing-up of financial markets remains appropriate as those disturbances abate.

Clear enough. "Full extent" plus "remains appropriate" equals the possibility that at least one of the easings might have to be taken back at some point in future.

Fed Governor Meyer delivered this nugget two days later.

> For most of the past three years, monetary policy broadly followed the Taylor Rule prescription, while holding the nominal federal funds rate about unchanged. More recently, however, monetary policy has significantly departed from the Taylor Rule prescription. That is, the nominal funds rate today is lower than could be justified by typical Taylor Rules, given prevailing inflation and labor utilization rates.

Huh?

Meyer is citing a neat little equation designed to guide monetary policy developed by economist **John Taylor** back in 1993. It is called the **Taylor Rule** and is traditionally written as:

$r = p + 1/2(y) + 1/2(p-2) + 2$

Where **r** is the **federal funds rate**, **p** is the inflation rate, and **y** is the **GDP** gap -- the difference between actual and potential output. In plain English, the Taylor Rule dictates that the funds rate be adjusted in response to changes in the inflation rate and changes in the GDP gap.

Some of you may find the Taylor Rule more intuitive (and thanks to reader **Al** for this suggestion) by reducing the equation above to:

$r = 1/2(3p + y) + 1$

This makes it is easier to see two things. The first is that the relationship between the funds rate and the inflation rate and the relationship between the funds rate and the GDP gap are both positively correlated -- that is, the funds rate ought to rise in response to faster inflation and bigger GDP gaps and fall in response to slower inflation and smaller GDP gaps. The second is that the funds rate is thrice as sensitive to changes in the inflation rate as it is to changes in the GDP gap -- that is, the funds rate ought to rise three times as much in response to a one-unit increase in the inflation rate as it would to a one-unit increase in the GDP gap.

Notes:

- The core inflation rate is running at 2.4% and the analysts at **Lombard Street Research** (a crack London-based consultancy) reckon that GDP is now running 2.7% above potential. Plugging these numbers into the Taylor-Rule equation yields a fed funds rate of 5.95%. Note that the Fed currently targets a 4.75% funds rate.

- Does what the Taylor Rule is saying now mean that the Fed ought to jack the funds rate up by 125 basis points at the next **FOMC** meeting ? No -- that's asinine. But what the Taylor Rule does suggest is that monetary policy is relatively loose right now -- and that when G next tinkers with the funds rate (however far into the future that might be) he will nudge it up, not down. Very few market participants understand this, but debt markets do. Debt markets get it. Witness the two-year note, which now yields 5.083% -- a full 33 basis points higher than fed funds. Witness the October fed funds futures contract , which fully reflects the expectation of a quarter-point tightening in autumn.

- At this point, the New Era types will raise two objections. First they will claim that the underlying inflation rate is much lower than 2.4% -- they want to use something as low as (and probably lower than) 1.1%. Next they will claim that the economy is not (owing to workers who are now exponentially more productive) running 2.7% above potential -- they want to use something as low as (and probably lower than) 2.2%.

Then they will plug their numbers into the Taylor Rule equation, come up with a funds rate of 3.75%, and claim that monetary policy is still waaay too restrictive -- that the Fed ought to be planning more easings, not thinking about tightening.

And once again they will have missed the boat entirely.

For now that G has hinted at a too-low funds rate -- and especially now that Meyer has stated flatly that the current 4.75% funds rate is lower than can be justified by the Taylor Rule -- it doesn't matter one whit whether anyone else agrees. Your opinions don't count. Mine don't, those of your favorite traders and technicians don't -- and those of the new-paradigm morons certainly don't. The guy who's in charge of monetary policy in this country has spoken; so, too, has his right-hand man. It's just plain stupid not to listen.

- The people who react to a discussion like this by saying "There is no way the Fed is going to tighten anytime soon" are missing the point. The point is not that tightening is imminent (it isn't). The point, rather, is that, save an acute financial crisis like the one we saw last autumn, you can wave bye-bye to more easing -- and to the possibility that market rates are headed materially lower.

And please think back to Oct. 5: The yield on the 30-year Treasury dipped as low as 4.693% (an all-time intraday low) and it ended the session at 4.712% (an all-time closing low). Now think back to what the New Era types were saying at the time: They told you that yields were headed lower still. To support their case they cited commodity prices at billion-year lows, excess capacity worldwide, booming productivity, restrained wage growth and the death of business pricing power.

And four months later, the yield on the bond had surged by more than one full percentage point (it stands at 5.58% now).

Now these same morons are citing the same stale factors and telling you that they still provide excellent reasons to get long bonds -- especially now that yields have backed up.

But please. Just say no to this crap already.

Greenspan has testified that he and his chums were going to have to think hard about eventually taking back one of the easings. Two days later, Meyer stressed the same thing (please click here for a detailed discussion of the Taylor Rule and here for Meyer's latest remarks on the subject).

Further, using its own documents for growth and inflation this year, the Fed must believe that the policy looseness to which the Taylor Rule points now is only going to get looser as the year progresses; subtracting one full percentage point from the GDP gap still produces a higher Taylor Rule funds rate than the one prevailing now (6.20% against 5.95%), even if the inflation rate rises by only half a percentage point. Greenspan and Meyer know this, and it stands to reason that they have already begun to prepare us for the Fed action down the road.

No -- the Fed is not set to tighten. But the people who think things haven't changed since last fall -- the people who still think that bond yields are set to fall against a backdrop of more Fed easing -- are delusional.

They just don't get it.

Side Dish

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