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Robert Chote · Economics Notebook

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 which might give an insight into the great man's thoughts on the future path of interest rates.

Economic policymaking obviously remains as much an art as a science when analysts have to spend so much time deconstructing central bankers' sentence structures to predict what they will do. It would be so much easier if economists could devise a simple rule telling policymakers and the public what interest rate would deliver the authorities' objectives.

It is not that they have not tried. Economists have long argued over the relative merits of setting interest rates according to rules or discretion. Purely mechanistic regimes are unusual, but in Britain alone money supply targeting, exchange rate targeting, inflation targeting and pure discretion have been tried during the last 20 years with varying degrees of failure.

One of the latest wheezes is the "Taylor Rule", devised by John Taylor of Stanford University. This 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.

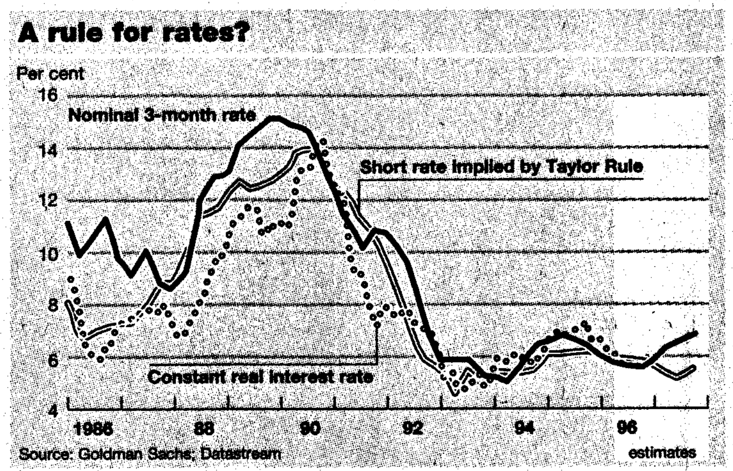
Alan Blinder, the former Fed vice-chairman, speaks highly of the rule, while various central banks and finance ministries have investigated it. Its principal proponent in the UK is Gavyn Davies, chief economist at Goldman Sachs.

The Taylor Rule starts by setting a "neutral" real rate of interest, which Goldman Sachs estimates at 2 per cent for the US or 3.5 per cent for the UK, France or Germany. If inflation is above target then short-term real rates are *increased* by half the excess of inflation over its objective. If economic activity is running below potential, then rates are *reduced* by half the "output gap". Finally, to move from a real rate to the nominal rate relevant for policy setting, you add in the expected rate of inflation.

What does the Taylor Rule say about the current level of UK interest rates? Underlying inflation is now 0.3 percentage points above target at 2.8 per cent, while Goldman Sachs estimates that national output is 1.25 per cent below potential. According to the Taylor Rule, these conditions suggest that real short-term interest rates should be half a point below their neutral level at 3 per cent. Expected inflation is also about 3 per cent, so this implies that base rates should stand at 6 per cent – pretty close to their actual level of 5.75 per cent.

But this calculation is spuriously precise. If you plug in the full range of current output gap estimates held by the chancellor's "six wise people", then the level of base rates implied by the Taylor Rule could be anything from 5 to 6.75 per cent. As UK interest rates have been within this range throughout the last 3½ years, the rule does not really tell us much.

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. But 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 rule into question."



A rule for rates?

Source: Goldman Sachs; Datastream

The Taylor Rule does appear to describe interest rate setting fairly well in the US, Germany 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.

As for Britain, the Goldman Sachs economists argue that the Taylor Rule offers "a first approximation to the policy setting behaviour of the UK authorities". But the Treasury and Bank of England appear to put more weight on inflation and less on the output gap than the Taylor Rule suggests.

The UK 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 throughout 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 Athanasios 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 Federal Reserve to patiently support a continued expansion at full employment and at the trend rate of growth. When the next recession arrives, whatever the timing, inflation will ratchet down another notch. This strategy gradually and at low cost lowers inflation over time until price stability is achieved."

Orphanides and Wilcox argue that central banks might behave in this way because the economic costs of stable, slightly above-target inflation are distributed widely through the population. The costs of reducing that inflation may leave most people relatively untouched, but they bear harshly on the minority who lose their jobs.

The opportunistic approach seems entirely sensible, as long as policymakers remain determined not to allow unfavourable shocks to ratchet inflation higher. 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 result of the high inflation of the late 1980s. So sometimes things have to get worse before they get better.

That illustrates a long-standing feature of central bank behaviour: they have multiple objectives and concentrate on the one or two which are furthest from their desired state. It may look untidy to advocates of rules, but as Princeton's Ben Bernanke has pointed out, central banks may feel more threatened by a public perception that some aspect of the economy is "out of control" than by a record of generally mediocre performance.