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Historical monetary policy analysis and the Taylor rule ☆

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Abstract

This study examines the usefulness of the Taylor-rule framework as an organizing device for describing the policy debate and evolution of monetary policy in the United States. Monetary policy during the 1920s and since the 1951 Treasury-Federal Reserve Accord can be broadly interpreted in terms of this framework with rather surprising consistency. In broad terms, during these periods policy has been generally formulated in a forward-looking manner with price stability and economic stability serving as implicit or explicit guides. As early as the 1920s, measures of real economic activity relative to "normal" or "potential" supply appear to have influenced policy analysis and deliberations. Confidence in such measures as guides for activist monetary policy proved counterproductive at times, resulting in excessive activism, such as during the Great Inflation and at the brink of the Great Depression. Policy during the past two decades is broadly consistent with natural growth targeting variants of the Taylor rule that exhibit less activism.
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1. Introduction

In the decade since John B. Taylor's celebrated essay on "Discretion versus policy rules in practice" was presented at the 39th Carnegie-Rochester Conference on Public Policy in the Fall of 1992, his analysis has had considerable influence on the way monetary economists and practitioners think about the policy debate. Taylor showed that actual monetary policy in the United States could be usefully described in terms of a simple rule that appeared promising on the basis of policy evaluation experiments. Most importantly he described the monetary policy process in terms of the short-term nominal interest rate that was close to the actual decision making process, and described policy directly in terms of the two major operational objectives of monetary policy, inflation and economic growth.

My aim in this study is to investigate the usefulness of the Taylor-rule framework as an organizing device for describing the policy debate and evolution of monetary policy in the United States. Key to this undertaking is the examination of interest rate policy decisions linked directly to the Federal Reserve's underlying policy objectives, as these may have been understood over time. In the spirit of Friedman and Schwartz (1963), I rely heavily on narrative descriptions of events and ideas, supplemented, as possible, with information available to policy practitioners when policy was made. A major difference is my reliance on the language of interest-rate-based policies, instead of the stock of money, and some of the resulting analysis can be seen as a re-interpretation of earlier findings using the latter language. The ultimate goal of this effort is to use the historical experience to draw lessons about past policy successes and policy errors.

The theme that emerges from this examination is that Federal Reserve policies over many periods, virtually since the founding of the institution, can be broadly interpreted in terms of the Taylor-rule framework with surprising consistency. The Taylor rule serves as a particularly good description of policy, however, both when subsequent economic outcomes were exemplary as well as less than ideal. A recurrent source of errors has been misperceptions of the state of the economy, the result of incorrect assessments of the economy's productive potential. This concept has appeared in policy discussions with different names and in various contexts from the first years of operation of the System. It has often led to false predictions of inflation or disinflation, prompting tightening or easing actions that were only recognized as counterproductive long after the fact. This historical analysis suggests that the Taylor rule appears to serve as a useful organizing device for interpreting past policy decisions and mistakes, but adoption of the Taylor-rule framework for policy analysis is not insurance that past policy mistakes would not have occurred.

2. Two interpretations of the Taylor rule

In his original exposition of a rule-based framework for monetary policy analysis, Taylor offered two interpretations of rules-based policy. The first concentrated on an example presented with a precise algebraic formula. The second emphasized the