

Greenspan's Rule

BY DOUG CAMPBELL

“A Taylor Rule and the Greenspan Era.” Yash P. Mehra and Brian Minton. Federal Reserve Bank of Richmond *Economic Quarterly*, Summer 2007, vol. 93, no. 2, pp. 229-250.

Stanford University economist John Taylor suggested what became known as the “Taylor rule” in 1993 as a means for central banks to control inflation while stabilizing the economy. In general, the Taylor rule instructs policymakers to lean against the wind — to keep interest rates relatively high when inflation is elevated or employment is above full, and to set a low target rate when conditions are reversed. Policymakers take into account the “output gap” — the difference between actual and full-employment output levels — and the difference between actual inflation relative to the central bank’s target level. Overall, following the Taylor rule may help the Fed implement policy, insofar as its predictability helps generate reasonable public expectations about future short-term interest rates.

While Taylor originally proposed the rule as a guide to policy, he and other economists also established that the rule neatly summarized actual monetary policy behavior during the 1980s and 1990s. More recent research suggests that policy actions taken by the Federal Reserve under former Chairman Alan Greenspan followed the Taylor rule but with “interest rate smoothing” — that is, making changes in the target federal funds rate in small, cautious, and predictable movements. Also, some economists have found that monetary policy follows a “forward-looking” Taylor rule, focusing on expected economic developments and seeking an equilibrium rate consistent with price stability and full employment, and that it focuses on “core” inflation. (The core inflation measure usually eliminates items like energy and food products.)

In a new paper, economists with the Richmond Fed generally confirm that monetary policy under Greenspan is accurately described by the Taylor rule. Further, Yash Mehra and Brian Minton find empirical support that the Greenspan Fed’s policy rule “was forward-looking, focused on core inflation, and smoothed interest rates.” A key innovation of their paper is that it uses real-time data (the numbers available to policymakers at the time of their decisions) for economic variables and then checks whether the results change with final, revised data. Also, the authors used state-of-the-art forecasts from the Fed’s Greenbook.

The authors do identify a few periods of departure from the rule, probably due to special macroeconomic developments. But overall their research suggests that the Taylor rule “predicts very well the actual path of the federal funds rate from 1987 to 2000.”

“Doing Good or Doing Well? Image Motivation and Monetary Incentives in Behaving Prosocially.” Dan Ariely, Anat Bracha, and Stephan Meier. Federal Reserve Bank of Boston Working Paper No. 07-9, Aug. 27, 2007.

Participants in a unique experiment were asked to donate between a choice of two charities — one perceived by the donors as “good,” the other as “bad,” and randomly assigned either public or private settings. In return, some donors received monetary incentives. The authors set up this experiment to test the notion that, when it comes to prosocial behavior, people won’t respond very strongly to monetary incentives in public settings. Individuals seeking social approval want to signal traits which are generally seen as good — like charitable giving and volunteering. But if people are offered a tax break for a donation — and everybody knows about it — then this may erode the image gain.

Their results bear out this intuition: The “bad” charity did better when donors operated in private settings, and vice versa with the “good” charity. “Monetary incentives are more effective in facilitating private, rather than public, prosocial activity.” The authors conclude: “People want to be seen as doing good; without extrinsic incentives, an observer will attribute the prosocial act to one’s innate good traits which motivate people to behave prosocially.” A possible policy implication is that government should expect tax benefits for items like environmentally friendly water heaters to be more popular than for hybrid cars — because neighbors can’t see into people’s basements.

“Economic Theory and Asset Bubbles.” Gadi Barlevy. Federal Reserve Bank of Chicago *Economic Perspectives*, Third Quarter, vol. 31, no. 3, pp. 44-59.

The author provides a contrarian view on asset bubbles. Chicago Fed economist Gadi Barlevy says that the popular press inaccurately terms a “bubble” as a situation in which the price of an asset has risen so high so fast that it is susceptible to a collapse. Academics prefer a more rigorous definition: “a situation where an asset’s price exceeds the ‘fundamental’ value of the asset.”

Of course, many asset prices do display bubble-like tendencies, in both the popular and academic sense. In such cases, Barlevy warns that meddling with bubbles can be treacherous. The main reason that bursting a bubble might be advantageous is because bubbles “divert resources from other productive uses.” But pricking a bubble might aggravate some fundamental inefficiency in the economy, or make some households worse off. **RF**