



## INTEREST-RATES-FREE MONETARY POLICY RULE

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According to the conventional view, low interest rates are associated with “loose” monetary policy, leading to higher inflation, whereas high interest rates are associated with “tight” monetary policy, leading to lower inflation. Interest rates, however, are unreliable indicators of monetary policy: low interest rates could be the outcome of tight monetary policy just as high interest rates could be the outcome of loose monetary policy.

In “[Interest-Rates-Free Monetary Policy Rule](#),” economist Thomas Raffinot reassesses the stance of monetary policy based on a forward generalization of the Taylor rule without reference to interest rates. Using this new proposed rule as a yardstick, Raffinot evaluates the stance of monetary policy in the eurozone and the United States and argues that tight monetary policy explains (1) the historical collapse in nominal GDP in both regions during the Great Recession and (2) the slow recovery that followed despite the period’s low interest rates.

### THE PROBLEM WITH INTEREST RATES

Key interest rate targets have become the primary means that central banks use to achieve their objectives. One instrument popular with central banks is the Taylor rule, which sets interest rates in response to changes in inflation, in the output gap (the deviation of actual GDP and estimated potential GDP), and in the equilibrium real interest rate (the interest rate that would occur if inflation were steady and the economy were growing at potential). The Taylor rule does provide a clear, predictable way for central banks to implement monetary policy, but it has several drawbacks:

- It can be difficult to measure the output gap and the equilibrium real interest rate in real time.
- The rule is overly simplistic when interest rates approach zero.
- Tight monetary policy is a factor in slowing economic growth—and slowing growth, in turn, is a factor in pushing interest rates down. The level of interest rates, therefore, is not a reliable indicator of the stance of monetary policy.

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## AN ALTERNATIVE TO THE TAYLOR RULE

A generalization of the Taylor rule that uses the price level, an estimate of future potential GDP, and a forecast of inflation would avoid using interest rates. It would also target the forecast for inflation and output, which many economists argue is more important than the present-day estimates.

This new rule is not perfect: it also uses variables that are difficult to estimate in real time and that are subject to revision. Moreover, it is unclear how much weight should be placed on future potential GDP, just as with the standard Taylor rule it is unclear how the current output gap should be estimated.

The new rule is used in two complementary investigations:

- an analysis of the stance of monetary policy in the eurozone and in the United States, using real-time data from the European Central Bank and from the Federal Reserve Bank of Philadelphia
- an ex post analysis of the stance of monetary policy in both areas, using the latest data available

The ex post analysis reveals that monetary policy in the eurozone was too loose from 2004 to 2007 and has been too tight since 2008. This explains why nominal growth has been low or negative since 2008. While the real-time analysis also shows that monetary policy has been too tight since 2009, unlike the ex post analysis, it failed to show that monetary policy was tight in the critical year of 2008. If the European Central Bank had recognized that monetary policy was too tight at the start of the crisis, the recession in the eurozone may have been far milder.

Similarly, the ex post analysis reveals that monetary policy in the United States was too loose from 2004 to 2007 but has been too tight since 2008. The real-time analysis fails to show that monetary policy was too loose from 2004 to 2007, but it does show that monetary policy was too tight in 2008 and subsequent years. While the problem of tight monetary policy has been less acute in the United States than in the eurozone, both areas have experienced very low growth, which explains why interest rates have fallen.

## CONCLUSION

In both the eurozone and the United States, tight monetary policy has led to low nominal growth and persistently low long-term interest rates. This contradicts the conventional view that low interest rates imply loose monetary policy and that high interest rates imply tight monetary policy. The Great Recession illustrates why interest rates are poor indicators of monetary policy and why rules that do not rely on interest rates—such as this forward generalization of the Taylor rule—should be considered as alternatives to the standard Taylor rule.