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Has U.S. Monetary Policy Tracked the Efficient Interest Rate?[☆]

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Abstract

Interest rate decisions by central banks are universally discussed in terms of Taylor rules, which describe policy rates as responding to inflation and some measure of the output gap. We show that an alternative specification of monetary policy, in which the interest rate tracks the Wicksellian efficient rate of return as the primary indicator of real activity, fits the U.S. data better than otherwise identical Taylor rules. This result holds for a variety of specifications of the other ingredients of the policy rule, including the output gap, and of private agents' behavior.

Keywords: U.S. monetary policy, Interest rate rules, DSGE models, Bayesian model comparison

JEL Classification: E43, E58, C11

1. Introduction

Interest rate rules are the tool of choice for economists and practitioners when describing the conduct of monetary policy. Following Taylor (1993), these rules usually model the short-term interest rate as reacting to deviations of inflation from a target, and of output from some measure of “potential.” A very large literature has shown that these two arguments, usually coupled with some inertia in the policy rate, provide an accurate description of the observed evolution of the Federal Funds rate in the United States over the last several decades (e.g., Clarida et al., 2000; Coibion and Gorodnichenko, 2011).

This paper proposes an alternative characterization of the factors influencing this evolution. Its main finding is that policy rules in which the interest rate is set to track a measure of the efficient real rate—the real interest rate that would prevail if the economy were perfectly competitive—fit the data better than rules in which the output gap is the primary measure of real economic activity. We refer to the former as W rules, from Wicksell (1898), who famously cast the problem of monetary policy as an attempt to track a “neutral” interest rate solely determined by real factors.¹

To the best of our knowledge, this paper is the first to demonstrate the empirical plausibility of interest rate rules that respond to the efficient real rate.² Although these rules have not been previously examined

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¹We do not call these rules Wicksellian because Woodford (2003) and Giannoni (2014) already use this term to refer to interest rate rules that respond to the price level, rather than to inflation.

²Neiss and Nelson (2003) is an early attempt to evaluate the properties of the efficient real rate in a calibrated DSGE model. Trehan and Wu (2007) discuss the biases in the reduced-form estimation of policy rules with a constant intercept, when in fact the central bank responds to a time-varying equilibrium real rate, but they do not estimate this response.

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