The Daily Dish

Framing the Interest Rate Debate

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The Federal Reserve influences the economy by managing the federal funds rate – the rate on overnight lending among large money-center banks, and also the interest rate paid by the Fed itself on banks' reserve deposits at the Fed. Moving the federal funds rate up or down has a ripple effect on interest rates at longer and longer maturities – 30 days, 1 year, 5 year, 10 year, and so on – and all types of credit – auto loans, credit cards, mortgages, and so forth. The current target for the federal funds rate is the range from 4.25 to 4.5 percent.

As readers are doubtless aware, the president thinks interest rates should be lower and is on a broad-based public relations and personnel campaign to accomplish just that. But how much lower should rates be? Put differently, how can anyone even have a clue about the "right" federal funds rate?

Treasury Secretary Bessent put some meat on the administration's position in a Bloomberg interview on August 12:

> *I think we could go into a series of rate cuts here, starting with a 50 basis-point rate cut in September. If you look at any model (it suggests that) we should probably be 150, 175 basis points lower.*

So instead of 4.5 percent, Bessent is arguing for 3.0 percent or lower. How can a reader evaluate this debate?

Conveniently, the secretary referred to "models." Probably the most famous model of monetary policy rate-setting is the Taylor Rule, named after its creator, John Taylor. The Taylor Rule deserves a much deeper dive than your morning caffeine will support, but let's just say that the rule embodies the intuition that rates should go up when inflation is higher than the Fed's 2-percent target, and down when unemployment rises above its full-

employment lower bound. It attaches numerical weights to those gaps and delivers a policy rate that is grounded in the empirical evidence on the links between inflation, economic growth, employment growth, unemployment, and interest rates. It also depends on how important you think inflation is versus unemployment; Taylor suggested giving them equal weights (1/2 each), but that is in the eye of the beholder.

What does a Taylor Rule say at the moment? Start out by setting the target rate equal to the long-run neutral rate. If the long-run neutral real interest rate is 1.0 percent, then the neutral nominal rate adds the 3-percent inflation to get a starting point of 4.0 percent.

Notice that this is already well above what Bessent is lobbying for. He must have in mind a neutral real rate of interest that is zero or negative. The Taylor Rule would add on percentage points for the fact that 3-percent inflation is 1-percentage point above the target. Using the weight of 1/2, this means the target rate is now 4.5 percent. Since unemployment is about as low as it's going to get, that gap is zero and the Taylor Rule says the target rate is 4.5 percent.

What lessons are learned by this exercise? First, it is certainly not the case that every disciplined approach to rate-setting, i.e. model, would call for a dramatic cut in rates. So it is far from obvious that the Fed is currently way off the mark. Second, if you care less about inflation being above 2 percent, rates can be lower. And if you think the labor market is headed south – and there are good reasons to be nervous – you would plug in a higher unemployment rate and the Taylor Rule would deliver a lower federal funds rate.

In short, using a Taylor Rule to frame the decision indicates that underneath the White House-versus-Fed politics is a real, difficult debate on the path of monetary policy that has no single, clean solution.