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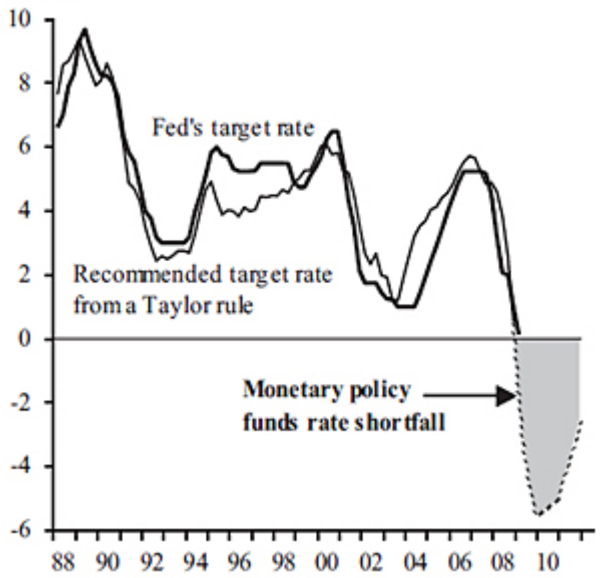
Can the Taylor rule describe the current stance of monetary policy?

One of the constants of monetary policymaking is the never-ending quest to characterize the stance of monetary policy in real time. Is Fed policy too easy? Too tight? Just right? It's not an easy task, but over time academics and practitioners alike have found comfort in the rule-of-thumb characterization commonly known as the Taylor rule. Glenn Rudebusch, writing in the San Francisco Fed's *Economic Letters* a few months back, described the Taylor rule thus:

> "The resulting empirical policy rule of thumb—a so-called Taylor rule—recommends lowering the funds rate by 1.3 percentage points if core inflation falls by one percentage point and by almost two percentage points if the unemployment rate rises by one percentage point. As shown in Figure 2, this simple rule of thumb captures the broad contours of policy over the past two decades."

Here, for your convenience, is the aforementioned Figure 2:

Figure 2
Federal funds rate
Percent



Source: Federal Reserve Bank of San Francisco

The really interesting part of that picture, as noted by Brad DeLong, is the "shortfall" bit. Explains Rudebusch:

> "The shaded area in Figure 2 is the difference between the current zero-constrained level of the funds rate and the level recommended by the policy rule. It represents a monetary policy funds rate shortfall, that is, the desired amount of monetary policy stimulus from a lower funds rate that is unavailable because nominal interest rates can't go below zero. This policy shortfall is sizable. Indeed, the Fed has been able to ease the funds rate only about half as much as the policy rule recommends."

Cue John Taylor, via Bloomberg:

> "John Taylor has a message for economists who say Ben S. Bernanke is ignoring a benchmark guide for interest rates: They're wrong. Taylor should know: He wrote the rule.
>
> "Economists from Goldman Sachs Group Inc., Macroeconomic Advisers LLC, Deutsche Bank Securities Inc. and even the San Francisco Federal Reserve Bank argue the Taylor Rule, a pointer for finding the correct level for interest rates, suggests the Fed should be doing a lot more to stimulate the economy.
>
> "Taylor said his measure shows just the opposite: that Fed policy is appropriate, that central bankers are right to be considering how to withdraw their unprecedented monetary stimulus and that critics who say otherwise are misinterpreting his rule."

The Bloomberg article goes on to describe some haggling over the precise specification of the Taylor rule and what in effect amounts to how fast gross domestic product growth and inflation will throw the rule's prescribed funds rate target back into strictly positive territory. Here's Rudebusch's bottom line:

> "According to the historical policy rule and FOMC economic forecasts, the funds rate should be near its zero lower bound not just for the next six or nine months, but for several years."

Taylor argues to Bloomberg:

> "My rule does suggest a long time before we raise rates. But it also does suggest an earlier rate increase than you would think."

One puzzler about this debate: How does the Taylor rule work once you hit the point at which the Taylor rule can no longer be applied? How policy *can* work in such an environment is provided in the Rudebusch article:

> "Toward the end of 2008, the recession deepened with the prospect of a substantial monetary policy funds rate shortfall. In response, the Fed expanded its balance sheet policies in order to lower the cost and improve the availability of credit to households and businesses. One key element of this expansion involves buying long-term securities in the open market. The idea is that, even if the funds rate and other short-term interest rates fall to the zero lower bound, there may be considerable scope to lower long-term interest rates."

OK, but doesn't that mean the stance of monetary policy is best characterized in terms of some real interest rate or array of interest rates, not the *nominal* federal funds rate that cannot possibly fall to the levels that the Taylor rule says it should?

Perhaps, then, ought we recast the Taylor-rule-based "stimulus shortfall" in terms of the *real* funds rate? That seems like a problem too. Says Rudebusch:

> "Typically, changes in the funds rate affect other interest rates and asset prices quite quickly. However, the economic stimulus from the Fed's cuts in the funds rate was blunted by credit market dysfunction and illiquidity and higher risk spreads."

Precisely. But deep behind that Taylor rule formulation is an assumption about the normal chain of transmission from the funds rate to other interest rates and asset prices. Once we surmise that chain is broken or compromised, how does the Taylor rule of thumb help?

My question: Is the Taylor rule the right tool for discussing the stance of monetary policy at present?

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