PLYMOUTH INSTITUTE FOR FREE ENTERPRISE

IMPLEMENT THE TAYLOR RULE

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ADVANCING AMERICAN FREEDOM

TOPLINE: The Federal Reserve should follow a transparent, rules-based framework like the Taylor Rule to anchor inflation expectations, protect wages and savings from erosion, and facilitate long-term economic planning.

BACKGROUND: The Taylor Rule is a formula that would tie the Federal Reserve's policy rate to 1) the gap between actual and target inflation and 2) the gap between actual and potential output. This predictable approach would allow the market to readily ascertain future Fed policy changes and would ensure the Fed acts against inflation before it becomes entrenched.

Unfortunately, the Fed currently follows a "dual mandate" to promote "maximum employment" and "stable prices." This wide discretion tends to result in the Fed being biased in favor of lower interest rates. The Fed often fails to increase rates until after inflation has been significantly above the "target" inflation rate of 2% for a prolonged period. Artificially low rates tend to induce asset bubbles that benefit select sectors of the economy (e.g., real estate) while harming savers, workers, and creditors. The original Taylor Rule prescribes Fed rates well above current levels.

Action Items (Congress):

- **Enact legislation requiring the Fed to publicly adopt a quantitative reference rule like the Taylor Rule** and to explain any departure from its prescribed rate.
    - The mandate should preserve the Fed's ability to depart from the rule in genuine emergencies but require it to justify such departures to Congress.

How It Would Make Life More Affordable:

- It would lower the inflation risk premium embedded in mortgage, auto, and credit-card rates. Currently, lenders price in the chance that the Fed lets inflation run hot.
- If a rules-based tightening had been in effect in 2021, it would have checked the inflation surge by reining in the newly "printed" dollars across the economy.
    - Instead, real median weekly earnings fell 8.7% during 2021-2022 as the money supply grew 27% in barely two years.
- The Taylor Rule might have prevented real interest rates from turning deeply negative multiple times since 2000.

Related Legislation: Fed Oversight Reform and Modernization Act (H.R. 3189 [114th Congr.]); Monetary Policy Transparency and Accountability Act (H.R. 4270 [115th Congr.]); Price Stability Act (H.R. 5396).

BOTTOMLINE: The Fed's dual mandate has repeatedly led it to hold interest rates too low for too long, helping fuel the mid-2000s housing bubble and the 2021-2022 inflation surge. Anchoring policy to the goal of price stability would protect against future inflation and allow long-term planning with less fear of Fed-caused inflation.