The taylor Rule in the 1920s

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Abstract

In an influential article published in 1993, John Taylor described a rule for setting interest rates that he viewed as important both descriptively and prescriptively for the study of central bank behavior and the setting of monetary policy. Rates too high risked recession while rates too low risked inflation. More recently Taylor has suggested that low rates might also precipitate recession by generating asset price bubbles, and has criticized Federal Reserve policy between 2001 and 2004 and after 2008 on these grounds. But the posited link between low rates and bubbles remains controversial, and the proposition that interest rates are the best mechanism for deflating them far from settled. This paper examines US macroeconomic history and policy in the 1920s, asking what a Taylor rule would have prescribed then and comparing that with what actually transpired. The results of the study are not entirely unambiguous, but they do show that for most of the period a Taylor rule would have mandated a policy rate *lower* than what was actually in effect, indeed often below zero. Yet rates generally above those prescribed did not, in the event, prevent a raging stock market bubble from developing in the second half of the decade. This finding adds to evidence from Britain or New Zealand in the 2000s that asset bubbles can develop when policy rates are above those prescribed by a Taylor rule, as well as when they are below.

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