CONCEPT: TAYLOR RULE

- ***Taylor Rule*** – links the Fed's target for the federal funds rate to several economic variables
  - □ ***Federal Funds Rate*** – the interest rate banks give to *other banks* on overnight loans
  - □ The Fed regularly makes decisions regarding the "correct" federal funds rate
  - □ The Fed does not use the Taylor rule to set the Federal Funds rate
  - □ John Taylor made a mathematical approximation of the target rate based on the following information:

$$Target\ FF\ Rate = Current\ Inflation\ Rate + Equilibrium\ Real\ FF\ Rate + \left(\frac{1}{2} * Inflation\ Gap\right) + \left(\frac{1}{2} * Output\ Gap\right)$$

Current Inflation Rate is equal to actual inflation
Equilibrium Real FF Rate is generally set as 2% (this is the nominal federal funds rate adjusted for inflation)

The sum of these first two terms is what the federal funds rate would be at long-run equilibrium

Inflation Gap is the difference between the Current Inflation Rate and the Target Inflation Rate (set by Fed, usually 2%)

Output Gap is the difference between current Real GDP and Potential GDP

EXAMPLE: Use the Taylor Rule to estimate the target federal funds rate. The current inflation rate in the economy is 4% and the equilibrium real federal funds rate is 2%. The target inflation rate is 2%. Real GDP is currently above potential GDP by 1%.

PRACTICE: Is it possible for the Taylor Rule to suggest a target federal funds rate to be negative? Assume the current inflation rate is 0%, the equilibrium real federal funds rate is 2%, and the target inflation rate is 2%.