

**Commentary for Session “Looking Back:  
Historical Perspective on Policy Rules”**  
including discussion of  
Asso, Kahn, and Leeson (2007)

Edward Nelson  
Federal Reserve Bank of St. Louis

**Conference on “John Taylor’s Contributions to  
Monetary Theory and Policy”**  
**Federal Reserve Bank of Dallas**  
**October 12–13, 2007**

# Scope of AKL paper

- Asso, Kahn, and Leeson (2007): Monetary Policy Rules from Adam Smith to Taylor.
- Coverage of my commentary is subset of AKL subject matter: pairwise comparison of Taylor's view of rules with that of Friedman.
- I consider Simons & Phillips along the way.

# Friedman and Taylor on monetary policy rules: a comparison



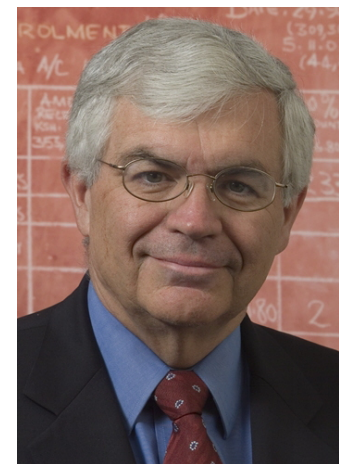
# Polycymaker objective function

- Taylor 79: intertemporal sum of  $\lambda(\pi_t - \pi^*)^2 + (1 - \lambda)(gap_t)^2$
- Friedman (e.g., 1982): basic agreement with this obj. fn.
- Common ground: for monetary policy, stabilization means centering output on its exogenous natural rate—targeting positive gap both infeasible and undesirable (e.g. Taylor, 1987).



# Policy objectives & price stickiness

- Cost of inflation (given natural rate & M/P) comes from price-stickiness-induced fluctuations.
- Of the RE formalizations of NRH, Taylor's work on nominal contracts matches Friedman's views best.
- Also consistent with Simons.
- Relative price dispersion emphasis vindicated by NK literature (e.g. R&W, 1997).



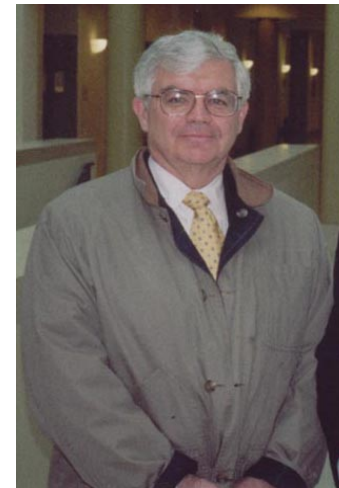
# From objectives to rules

- Common ground on objectives & model.
- Different philosophy about incorporating these into rules.
- Taylor: pursue final objectives directly and make use of structural model in rules.
- Friedman: don't.



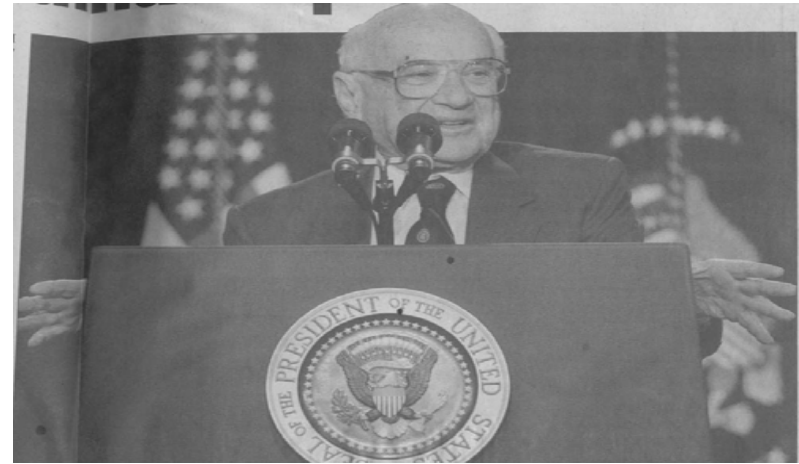
# Incorporating structure in rules

- Taylor: respond to gap, inflation (or forecast).
- Friedman: feedback on inflation is fighting last war; while inflation forecasts & gap estimates too fragile.
- $\Delta m$  rule rationale: model uncertainty plus QT property common to different models.



# Features of simple rules

- Taylor move to simple rules 1981 informed by 1979 control analysis.
- Less model-dependent but with continuing firm view of basic model structure.
- Activist rule for  $\Delta m$  with stabilization but no accommodation role.
- Taylor 2007: 1979/81 rule “essentially a ‘Taylor rule’” for  $\Delta m$ .



# Interest-rate vs. money growth rules

- Taylor has emphasized similarities between  $R$ ,  $\Delta m$  rules.
- CMG a way of automatically generating activist  $R$  rule.
- Friedman critique of  $R$  rules applied most to pegs; good  $R$  rules seemed hard to find.
- Difference across Friedman & Taylor on feasibility of offsetting money demand shocks.



# Postwar business cycles



- Similar views on cycle: potential output generally smooth; pre-1984 output volatile because of price stickiness interacting with destabilizing policy response to real shocks.
- Since 1984: smoothness of output reflects monetary policy becoming “thermostat,” removing effects of nominal rigidity on economy (Taylor 1998, 2005; Friedman in Taylor, 2001).

# AKL on Taylor/Phillips/Friedman

- AKL: important discussion of influence of Phillips on Taylor's work.
- They argue that Phillips accepted that expectations appear in Phillips curve.
- But let's leave aside expectational issue; I argue: still a fundamental difference between Phillips and Friedman/Taylor on PC.



# The power and duty of monetary policy

“...whilst an ‘appropriate’ quantity of money is a *necessary* condition of stable prices, it is not a *sufficient* condition.”  
John Maynard Keynes (1943, p. 185).

“...monetary restraint is a sufficient condition for controlling inflation...”

Milton Friedman (1980a).

- Phillips subscribed to Keynesian position.
- Brought out in treatment of relative price shocks.