Comment on

by Michael Woodford

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Thanks to Dallas Fed
The Proposed Monetary Policy Research Program

- **Goal**: Practical implementation of *forecast targeting* as a monetary policy rule.

- **Definition**: Policy makers choose instruments of policy so that expected future values of target variables are related in every future period.

- **Example**: An optimally-chosen linear combination of inflation and the GDP gap forecasts should equal to zero.
Why do we need a research program?

• While some central banks follow procedures similar to forecast targeting, none do it the way Woodford proposes.
• Hence, focus should now be on “translational economics” or translating the theoretical ideas into “the actual actions of the central bank.”
• Similar to early work on instrument rules
Still need a decision rule

“Certainly one cannot compare a forecast targeting strategy to [an instrument] rule, without also describing what forecast targeting means for the way in which the policy instrument should be adjusted over time.”
Very useful

• Complementary, not mutually exclusive
• Dual aspects of the same objective:
  – First order conditions and decision rules
• Does not require dumping on instrument rules
• McCallum-Nelson (2005) and Svensson (2005)
• Are forecast targeting rules really
  – greater protection against political pressure?
  – more predictable?
  – more deserving of being called a policy rule?
• Recent evidence that policy rules are helpful:
  – The Great Moderation
  – The Great Monetary Policy Shift
  – An Episode from Mission Impossible?
Illustration of Complementarities

The road to instrument rules went through the land of forecast targeting rules

\[ y_t + \beta p_t = v_t \quad (1) \]

- \( y_t \) is detrended log GDP
- \( p_t \) is detrended log price level,
- \( v_t = \eta_t + \eta_{t-1} \) with \( \eta_t \) iid zero mean.

Analogous to Woodford’s forecast targeting rule (2.3); \( h = 2 \).

Policy objective: minimize quadratic in \( y \) and \( p \) with target 0. Each value of \( \beta \) corresponded to different weights in objective.

The other equation: a staggered contract equation. This was before the Calvo (1983) paper, but the properties are very similar to equation (2.1) in Woodford with annual data.
How big was $\beta$?
Estimated empirically with rational expectations
cross equation restrictions (1956-76)

<table>
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<tr>
<th>Country</th>
<th>$\beta$</th>
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<tbody>
<tr>
<td>Austria</td>
<td>0.0114</td>
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<tr>
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<td>0.1317*</td>
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<td>United Kingdom</td>
<td>0.1165*</td>
</tr>
<tr>
<td>United States</td>
<td>0.2936*</td>
</tr>
</tbody>
</table>
Estimated Tradeoff with Some Wishful Thinking

But what policy instrument settings would do this?

Fig. 1. Effect of a policy induced shift in the output–price stability tradeoff.

Three forecast targeting rules were simulated in a simple VAR model.

\[
(y_t - y_{t-1}) + (p_t - p_{t-1}) = 0 \tag{1}
\]

*Increased volatility*

\[ y_t + (p_t - p_{t-1}) = 0 \tag{2} \]

*Reduced volatility*

\[ y_t + \beta (p_t - p_{t-1}) = 0 \tag{3} \]

*Reduced volatility with tradeoff possibilities*

Hence, instrument rule had to generate (3)-type behavior
The Future of Policy Rules?

• The next Mission Impossible: Prevent the forces of globalization from reversing the missions already accomplished.
  – Check out policy coordination, exchange rate role with newer models

• Better principles for off the rule behavior
  – liquidity, frozen markets, risk management

• Better estimates and micro-foundations of the models—as the research presented at this conference is doing.