John Taylor
What Happens Next – 07.17.2022

Larry Bernstein:
John, thanks so much for joining us today. In your opening remarks can you discuss if you agree that the Federal Reserve should have started raising interest rates months ago to subdue inflation?

John Taylor:
The FED got behind the curve.

There was another period where the FED was behind almost as much, and it was back in the 70s, when Arthur Burns was the chair of the FED, President Nixon was the President of the United States. And Arthur Burns said, "Hey, it's not us. It's you." And so, he convinced Nixon to have wage and price controls on the whole economy. And, it was a disaster. And eventually, people wised up and realized it was monetary policy and, we learned from that experience. But, what's surprising now is the FED has never been so far behind, when inflation rate's 5%, 6%, 7% even higher by some measure.

The 70s, the FED got so far behind, they had to catch-up. And catching up was damaging. So, this particular episode is different and inflation is not seven or eight years old, it's a year and a half old or two years at the most. That's what the advantages of a rule or a strategy is, the FED could indicate that, "look, we can't have inflation this high and have interest rates this low. So, we're gonna have to raise it."

Some of the members of the FOMC have already begun to talk about that it has to be over 3% or so. What's most important now is the FED indicates inflation is high, expectations of inflation are high, people are worried, we're gonna have to raise rates. And that's not bad, that's good for the economy.

And quite frankly, the economy's already slowing because people anticipate some kind of reaction. I'll finish here, very important for the FED publish rules, that's the hope why we could get out of this with much less damage than in the past.

Larry Bernstein:
John Taylor, you're an economist who created the Taylor Rule. Your rule is meant as a target for the Federal Reserve to set the FED Funds rate. The formula is based on the sum of the rate of inflation, plus the real interest rate plus an additional amount based on the output gap. Can you explain the Taylor Rule's application to today's economy?

John Taylor:
Well, it's a very simple rule so it's easy to explain. The interest rate should be higher if the inflation rate is higher. And there's a coefficient at 1.5, so inflation rises by 1%, the interest rate

should rise by 1.5%. So that's part of it. And if the inflation rate is 2%, and the real rate should be 1%. You should be aiming for 3% in normal times.

Larry Bernstein:
To clarify, the interest rate should be the sum of inflation and the real rate of interest or around 3% in normal times.

Inflation is running over 8% and that is 6% more than the inflation target, but no one is recommending raising rates by 6%. What am I missing?

John Taylor:
Yeah.

I think the most important thing with these rules is you don't surprise people. If the FED moves to 5% overnight, that'll be a surprise. I always argue is that you use these rules in a prospective way. If inflation is going to continue to be this high, we will have to raise rates. That's what good monetary policy is about.

Larry Bernstein:
If the FED is behind the curve, why not raise interest rates immediately to the correct interest rate, why does the FED want to raise interest rates to the correct rate over several months?
John Taylor:

The reason is you don't wanna shock everybody. Members of the FOMC is saying it has to be over 3%. Maybe a couple 75 basis points are what's required. I think the trick here is you have to make the adjustments in a way that is consistent with the markets. It can do damage to have interest rate that's increasing too rapidly. So you have this compromise. I think one year works pretty well and you move to it gradually.

Larry Bernstein:
Beginning last fall when inflation started to increase quickly, both the FED and the Biden Administration said that inflation was transitory and that price increases were caused by supply chain problems. After the war in Ukraine started, the Administration blamed Putin for rising gas prices. Do you believe that inflation is transitory?

John Taylor:
If you look at the data, that's not this transitory thing. There's always supply effects. There's always events happening in the world. It's a monetary phenomenon.

And that's something that has to be emphasized and stressed. I focus a lot on the interest rate being low, there's money growth, there's purchases of assets, all those things which come into play in thinking about it. But the main thing is that as you point out, the transitory aspect seems to have disappeared from the vocabulary and people realize that action needs to be taken. And they're just starting to do that.

Larry Bernstein:
Existing home prices have risen 20% in the past 12 months. What does this tell you about inflation?

John Taylor:
Some prices move more rapidly than others, housing prices go up very rapidly. But they also can come down. And the trick here is monetary policy won't always be accommodating these high prices. And that it can't last. And the hope is that inflation starting with housing or other durable goods will moderate and come down off these very high levels without having the contraction.

That's why I like rules or strategies. You indicate not only where the interest rate is now, but where it will be a year from now or even two years that are necessary to make this a smooth adjustment.

And internationally becomes very important because you cannot have a global inflation and have little inflation in one country. It just doesn't work that way. So, as the FED begins to tighten, you're also seeing other countries raising interest rates.

Larry Bernstein:
The CPI statistics for the US economy show incredible breadth in inflation across goods and services. Sure, oil is up, but everything else is up nearly double digits as well, like food, car prices, housing etc. What do you make of the breadth in inflation?

John Taylor:
Well, first of all, the breadth that's beyond Ukraine, it's beyond the backup in ports. Monetary policy should focus on keeping the overall inflation rate low and keeping the economy steady. I don't mean that it does everything with respect to income distribution, with respect to regulation. The Central Bank focuses on inflation that's a big enough job rather than try to do everything else.

So monetary policy is one aspect. There's fiscal policy, there's regulatory policy, there's international policy.

So, let's focus on the things that monetary policy is good at based on history and based on theory. And do those.

Larry Bernstein:
The US had a $1.9 trillion dollar stimulus in 2021 plus an infrastructure bill. Was fiscal policy procyclical that increased the inflation problem?

John Taylor:
Well, maybe we overdid it. I think the stimulus that we had recently is questionable.

Larry Bernstein:
During the inflation of the 70s, wages got indexed to inflation and it was very challenging reducing inflation afterwards.

John Taylor:
If prices continue to go up, wages will rise. And that'll cause inflation to rise even further. That's the so-called wage price spiral.

We haven't seen it yet. That’s why I think there's some hope that we'll be able to deal with this. Remember a policy which addresses inflation. It doesn't necessarily make unemployment higher. It's just expectations of inflation are lower.

The economy is different, there's more flexibility to deal with these issues than there used to be.

I'd say going back to previous periods, inflation took a long time to build up. Wage inflation took a long time to rise. We're not quite there yet.

Larry Bernstein:
There are lags to monetary policy that means that it takes time for changes in monetary policy to change the economy. Some say that the lag is around 18 months, what does that mean for changing interest rates?

John Taylor:
So, lags are so important. That's, all these rules and strategies were built off of models and ideas that included the lags. It's a big, big thing. You want to have a policy that takes into account the lags.

But I think what we found long ago was that these lags are not fixed. To some extent the lags are based on expectations of what you think is gonna come. And so, expectations can adjust very quickly, and so what many people found working with ideas and equations and theories and models, whatever you wanna call it, is that the economy could adjust more quickly if the central banks were clear about what they're doing.

Some people argue, "Hey, there's no lags. We can fix expectations." We had this theory called rational expectations. Meant that people would just look at what the central bank was doing, and they would adjust their prices and wages accordingly.

Larry Bernstein:
What is your forecast for both nominal and real interest rates in the next year or 2?

John Taylor:
The FED, they're behind now. They hope that by getting the three, three and a half, maybe inflation will come down. But I don't think there's too much question that the real rate has to rise in order to deal with the inflation issue.

Larry Bernstein:
Larry Summers has recently said that we need to get interest rates close to 6% in order to quell the current inflation. Do you agree with him?

John Taylor:
I don't think that Larry has a specific model or rule. He says that it should be higher. He was just at the conference we had here and expressed those views. I think they all tie back to the same thing that rates need to be higher to deal with the inflation rate. I think the most important thing is to experiment in a real time sense with these alternatives. Is it 3%, is it 6%, is it 5%, and what's the speed? The commentary that Larry Summers is putting out is very important. He's been there. He's seen it and is influential.

The fact that the FED chair testifies, there's people who are asking questions, the programs like this, the newspaper, create an important dialogue, so that it's not done in a vacuum.

I think there's a promising aspect of this episode and the people learn from history. I hope we can make this adjustment, and that it's better to be close to some rule or strategy than farther away. Inflation started to increase for that reason.

Whatever strategy or rule you use, and a rule can be a guideline. The FED has to say why they're off if they are off. And it provides a great deal of transparency. It provides a great deal of knowledge of what the FED is doing. There's debates within the FED and that becomes more public, I feel like that this is all part of good policy.

Another reason to be transparent, so the European Central Bank knows as best as possible, what the FED is doing, and the Bank of England, et cetera. So, that provides additional transparency and indication of what you're doing. I tend to use the world strategy rather than rule when I can, who could disagree with having a strategy? Well, you might disagree about a rule. It sounds more tactical, but strategy or overall sense of how policy works is an attractive feature of policy.

We have a global inflation problem right now. You look at Latin America, it's increasing, and in England, it's increasing. It's all over the place, and that's another reason why the FED's actions are important, because it will encourage other countries to raise the rates as well.

Larry Bernstein:
Next topic is asset prices. Stocks are down 20% this year. How do asset prices affect inflation and FED behavior?

John Taylor:
So, asset prices are a very, very important part of the transmission mechanism of monetary policy. So, you don't wanna ignore them. They go in the same direction. A higher interest rate tends to slow the appreciation of the stock market.

Larry Bernstein:
John, I end each session on a note of optimism. What are you optimistic about as it relates to monetary policy?

John Taylor:
I'm optimistic that we'll be able to get the inflation down without much of a harmful effect on the economy. If we have a perfect thing, people adjust their expectations of inflation, adjust their wage demands. Ultimately, we will need a lower inflation rate for a successful economy. My optimistic note is by thinking about the mechanism, thinking about how expectations are formed, thinking about history, thinking about other countries, that we'll be able to get this right.

The inflation rate, while it's been there for a year and a half or more, it's not like it was in previous periods. And so, there's something that can be done about it, and I think the FED, if it can make this adjustment in a smooth way, and that's why I'm optimistic.