John Taylor's Contributions To Economics

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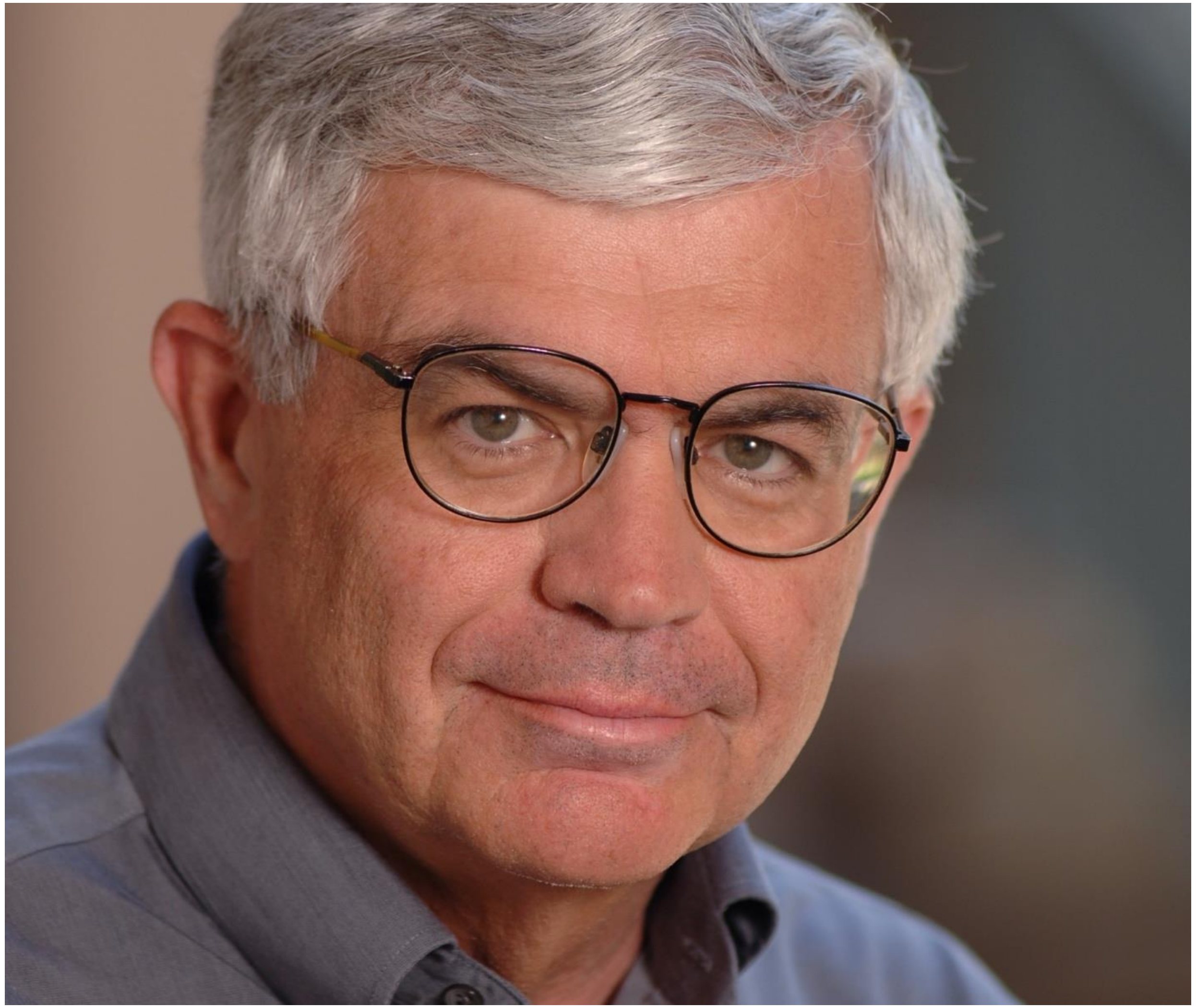
Michael Bordo, John H. Cochrane, Jonathan S. Hartley

In Preparation For "Celebration In Honor of John Taylor" Hoover Conference

Introduction

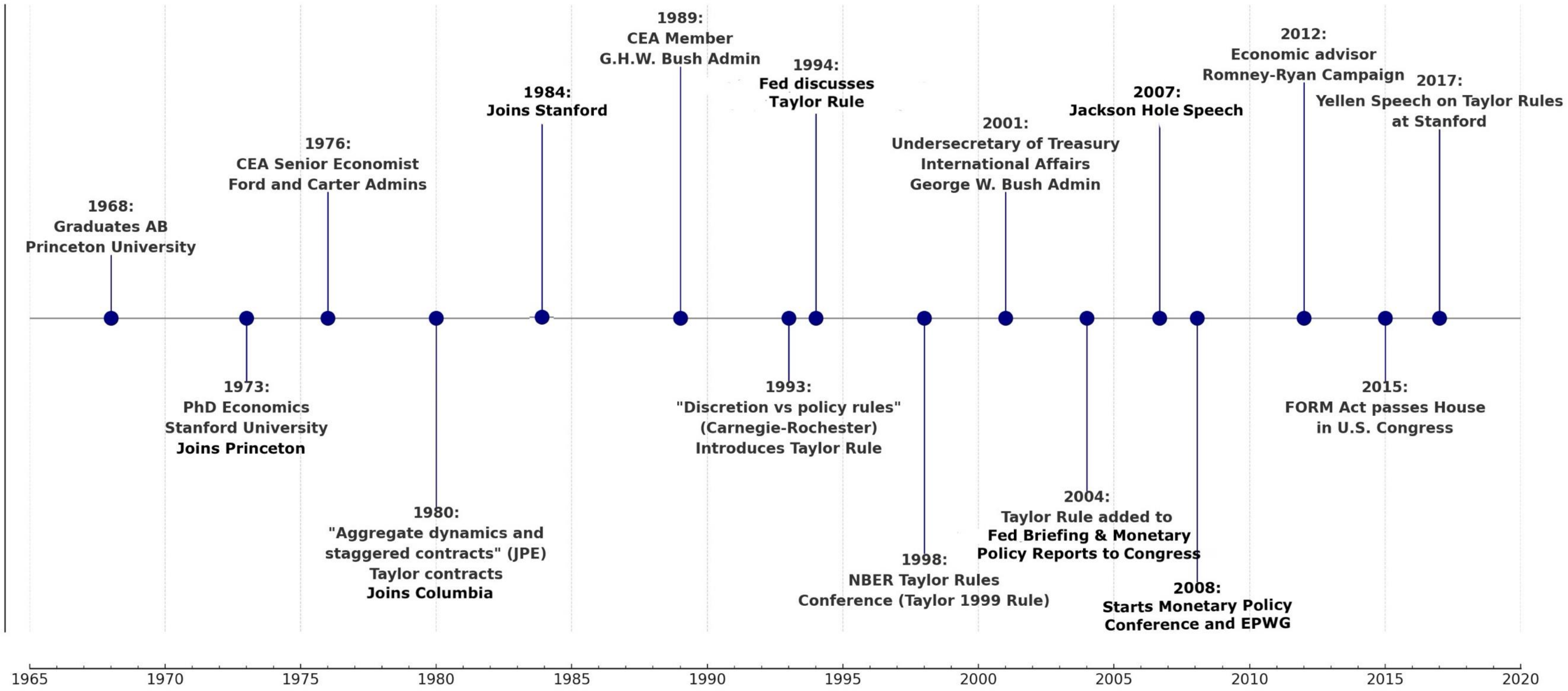
- John B Taylor is one of the greatest and most influential economists of the past 50 years
- His contributions transformed economic thinking and monetary policy making



Introduction: His Contributions

- Macroeconomic theory and econometrics with rational expectations.
- Staggered wage contracts. Early "sticky price" model, in which monetary policy affects output, and inflation with lags. Foundation of New-Keynesian macro.
- Taylor rule for monetary policy. Used by all central banks. JT developed it to a systematic framework for monetary policy.
- International policy interdependence. Following his rule avoids spillover effects
- Fiscal policy
- Warned of the Global Financial Crisis (2007), critique of policies that led to the GFC, and the following stimulus, QE, and slow recovery.
- A skilled US policy maker in the early 2000s.

John Taylor Key Events Timeline



The Taylor Rule

The Taylor Rule is a monetary policy guideline that prescribes how a central bank should adjust **nominal interest rates** based on deviations of inflation from its target and the output gap (actual and potential GDP).

$$i_t = \pi_t + r^* + 0.5(\pi_t - \pi^*) + 0.5(y_t - y_t^*)$$

Where:

- i_t is the nominal interest rate at time t.
- π_t is the rate of inflation at time t.
- π^* is the target inflation rate.
- r^* is the equilibrium real interest rate.
- y_t is the log of real GDP at time t.
- y_t^* is the log of potential GDP at time t (so that $y_t - y_t^*$ represents the output gap).

Taylor Rule Key Importance

Policy Framework:

The Taylor rule uses the interest rate to control inflation while allowing countercyclical policy

The rule stems from the gold standard and money growth rules for predictable policy

It establishes a strategic guideline for conducting and evaluating monetary policy that avoids discretionary policy mistakes

It provides critical information about how the CB will respond to future inflation and economic conditions , enhancing communications and transparency

It is easy to understand by policymakers

Taylor Principle:

Central banks should raise interest rates more than one-for-one when inflation rises

Taylor Rule Key Importance

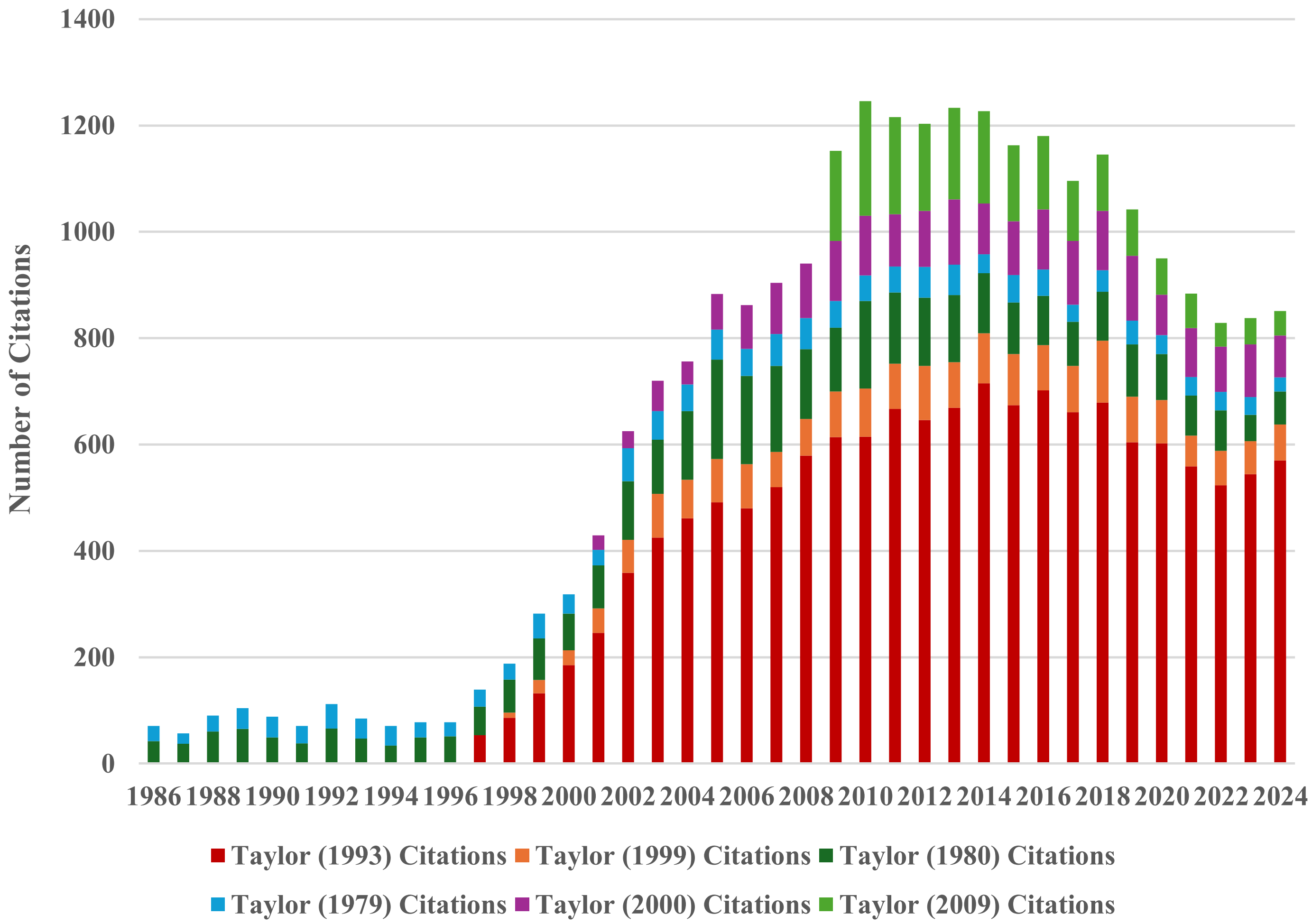
Theory:

The Taylor rule performs well in a wide variety of models. (Taylor and Weiland 2012). Robust to our imperfect models.

Active research: Best rule? Inflation only? Price level? Slow adjustment? Foreign exchange rates? (Taylor, no!) Varying r*? "Supply" shocks?...

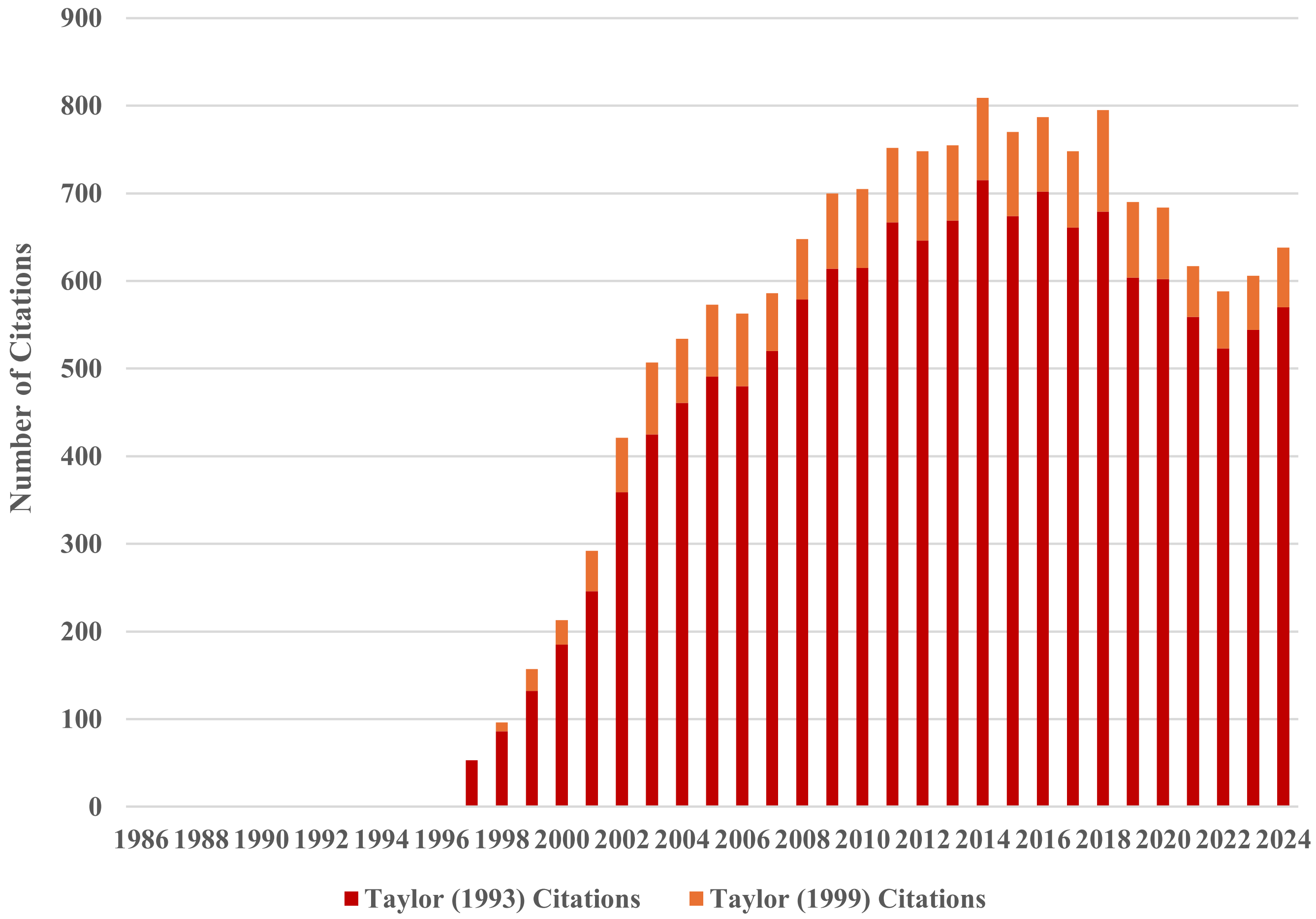
But keep it simple, transparent, accountable!

Most Cited John Taylor Papers



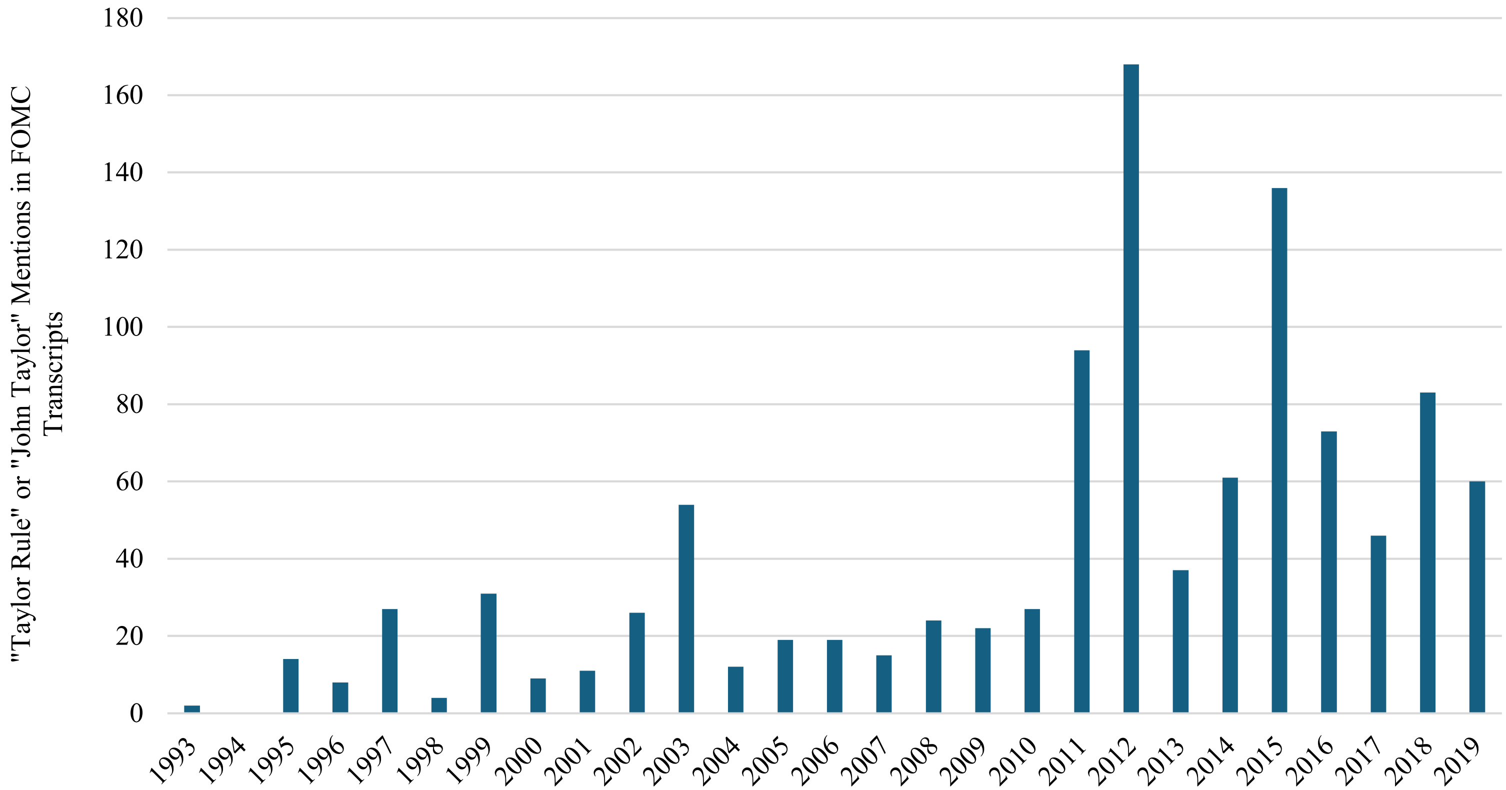
Source: Google Scholar

The Citation Impact of Taylor (1993) and Taylor (1999)



Source: Google Scholar

NUMBER OF "TAYLOR RULE" OR "JOHN TAYLOR" MENTIONS IN FOMC TRANSCRIPTS

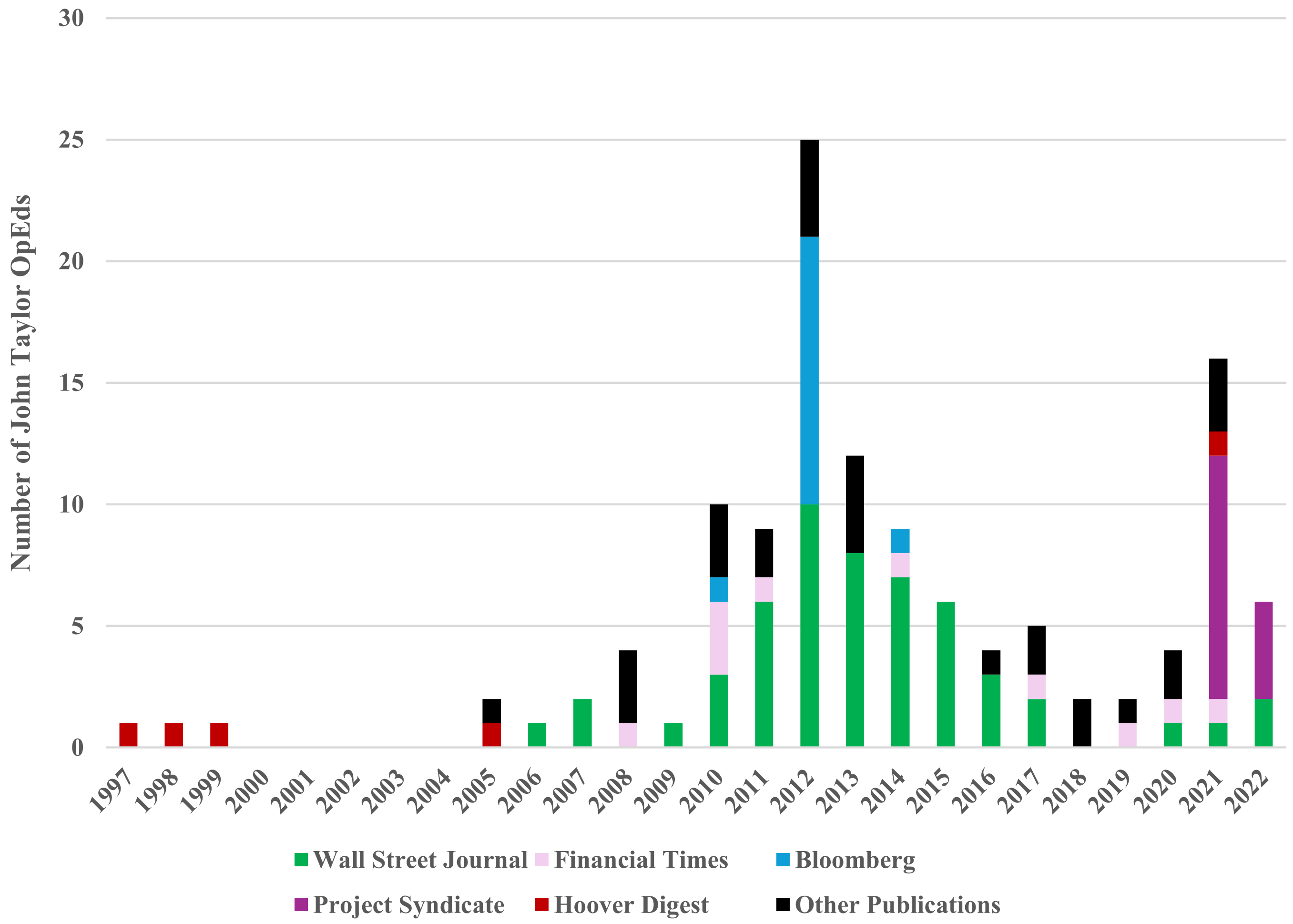


"John Taylor has certainly been crazy successful in his promulgation of the Taylor rule"

- Jim Bullard, FOMC Meeting Transcript, March 19-20, 2019

Source: Federal Reserve Board, Inclusive of Any Mentions of "Taylor Rule", "Taylor (1993) Rule", "Taylor (1999) Rule", "Taylor (1993)", "Taylor (1999)", "Taylor-type Rule", "John Taylor", "Taylor" in a John Taylor specific-context ("Taylor 2 percent", or "Taylor uses GDP deflator", or "Taylor equation")

Number of John Taylor OpEds



Source: John Taylor Archives, Marie-Christine, John Taylor Personal Website (https://web.stanford.edu/~johntayl/)

IV. International Macro Policy Interdependence

- Should central banks react to exchange rates or foreign interest rates?
- Taylor: No, so long as they follow domestic (inflation, unemployment) policy rules. Now standard in large country central banks, and some smaller.
- “Great Deviation” (after Great Moderation). Too low rates, QE, international reactions and race to the bottom made things worse.
- The IMF should aid EMEs in adopting rules-based policies rather than advocate capital controls

The Global Financial Crisis and the Slow Recovery

- John Taylor (2007) saw the debt – financed 2000-2007 housing boom, as a consequence of "too low for too long "policy.
- He warned of the GFC and was a prescient critic of the Fed and Administration's policies throughout the GFC and the Slow Recovery

Chart from *The Economist*, October 18, 2007

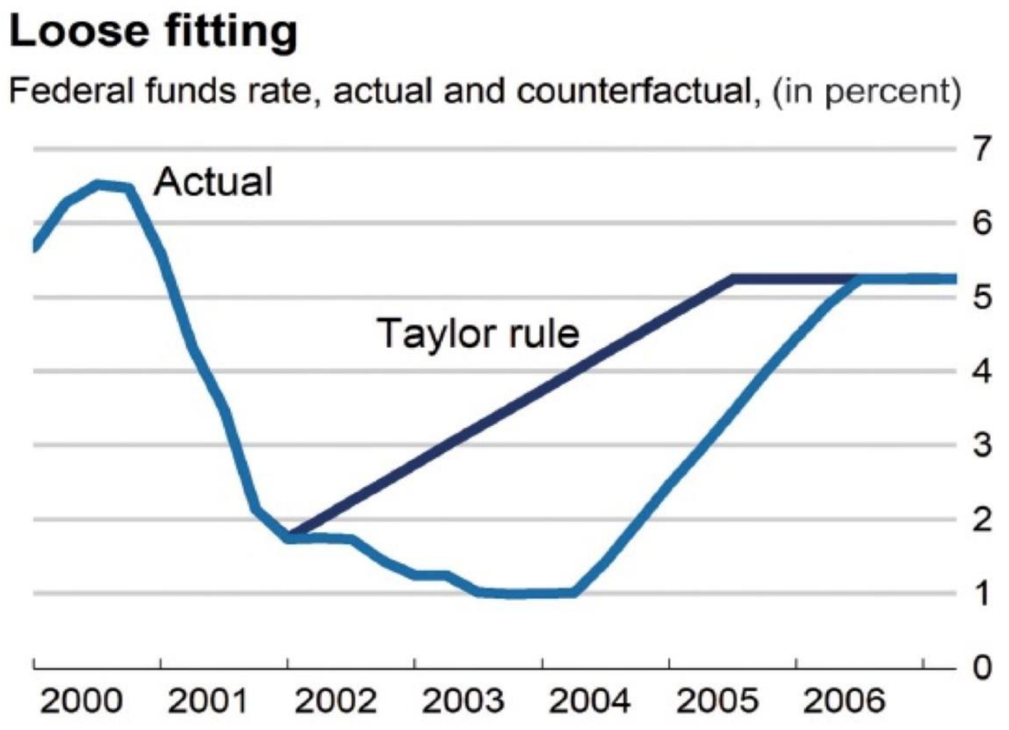


FIGURE 1.

The Global Financial Crisis and Slow Recovery

- Taylor and Williams (2009): Interest spreads largely reflected fears of insolvency, not illiquidity, as the Fed argued.
- The Term Auction Facility aimed at liquidity in December 2007 had little impact
- JT criticized Bear Stearns and AIG bailouts; discretionary TARP and bailouts increased policy uncertainty worsening the crisis.
- JT was an early and strong critic of 2009 fiscal stimulus.
- JT attributed the 2008-2016 slow recovery to QE and forward guidance as significant deviations from rules- based policy. Exchange rates transmitted Fed policies abroad.

John Taylor in Government

- John Taylor was Under Secretary of the U.S. Treasury for International Affairs 2001-2005 in the crisis years after 9/11
- Based on his rules-based approach in economics, his team of 'financial warriors" tackled many challenges:
- Creation of a new currency for Iraq; Saddam Hussein debt; financial reconstruction of Afghanistan; Argentine debt and currency crisis 2001-2002; IMF reform (the Collective Action Clauses); World Bank market-oriented reform.