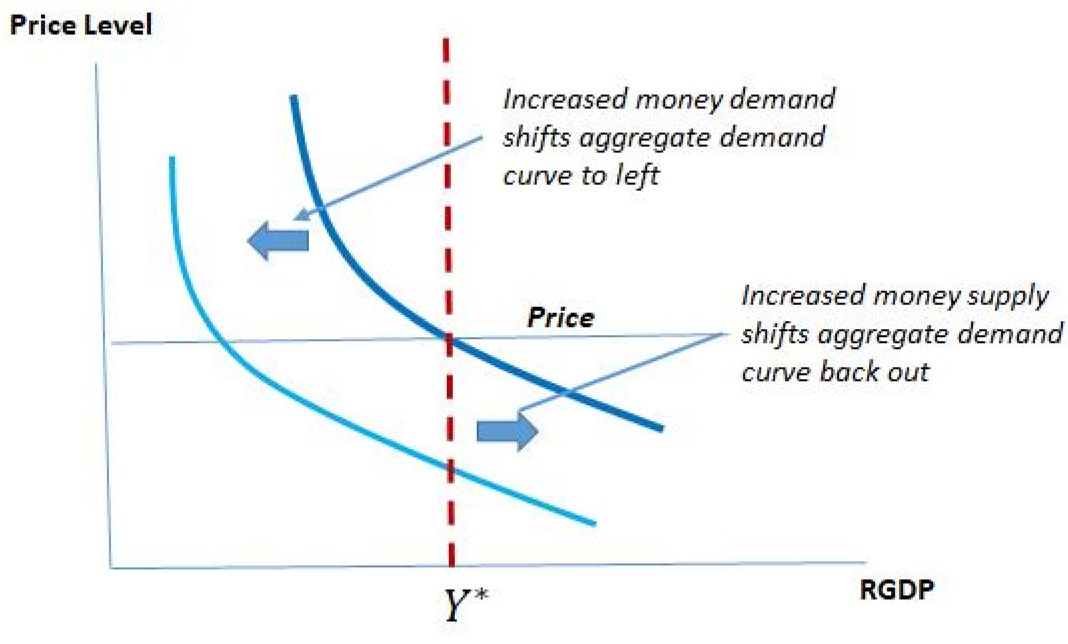
Sunday romininses: John Taylor on NGDP Level Targeting

In the first edition of his Macroeconomics textbook (1986), on page 137, we read:

> The underlying objective of policy is to **maintain a steady or stable level of aggregate demand**. The importance of a stable aggregate demand is one that has been recognized by most economists since the 1930s.
>
> Even economists who normally differ on other issues agree on the principle that it is desirable to maintain a stable growth of aggregate demand.

The chart below is a replica of his chart (pg 136), discussing the appropriate response to an aggregate demand shock, induced by a rise in money demand (equivalent to a drop in spending, no matter what the source).



So, to keep NGDP (aggregate demand) stable, the Fed has to offset an increase in money demand with an increase in money supply. In other words, it should keep MV constant, which implies keeping PY or aggregate nominal spending constant.

However, in a 2011 blog post discussing the nominal GDP targeting proposals that witnessed a revival by Market Monetarists, Taylor argues:

> [i]n comparison with earlier proposals, the recent proposals tend to focus more on the **level** of NGDP rather than its growth rate. This **removes some of the instability** of NGDP growth rate targeting caused by the fact that NGDP growth should be **higher** than its long run target during the catch up period following a recession.

However:

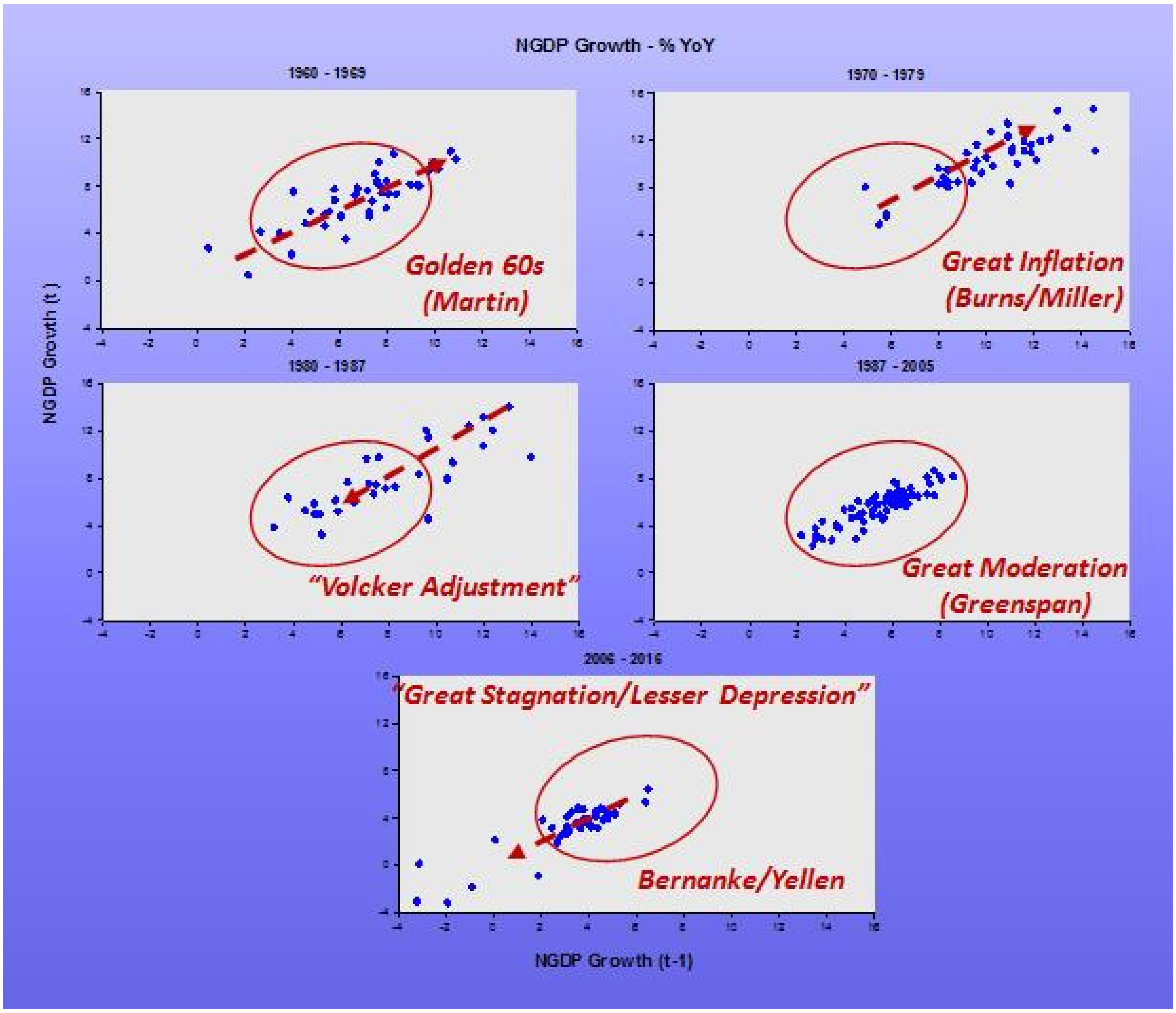
> [i]t introduces another problem: if an inflation shock takes the price level and thus NGDP **above** the target NGDP path, then the Fed will have to take sharp tightening action, which would cause real GDP to fall much more than with inflation targeting and most likely result in **abandoning** the NGDP target.

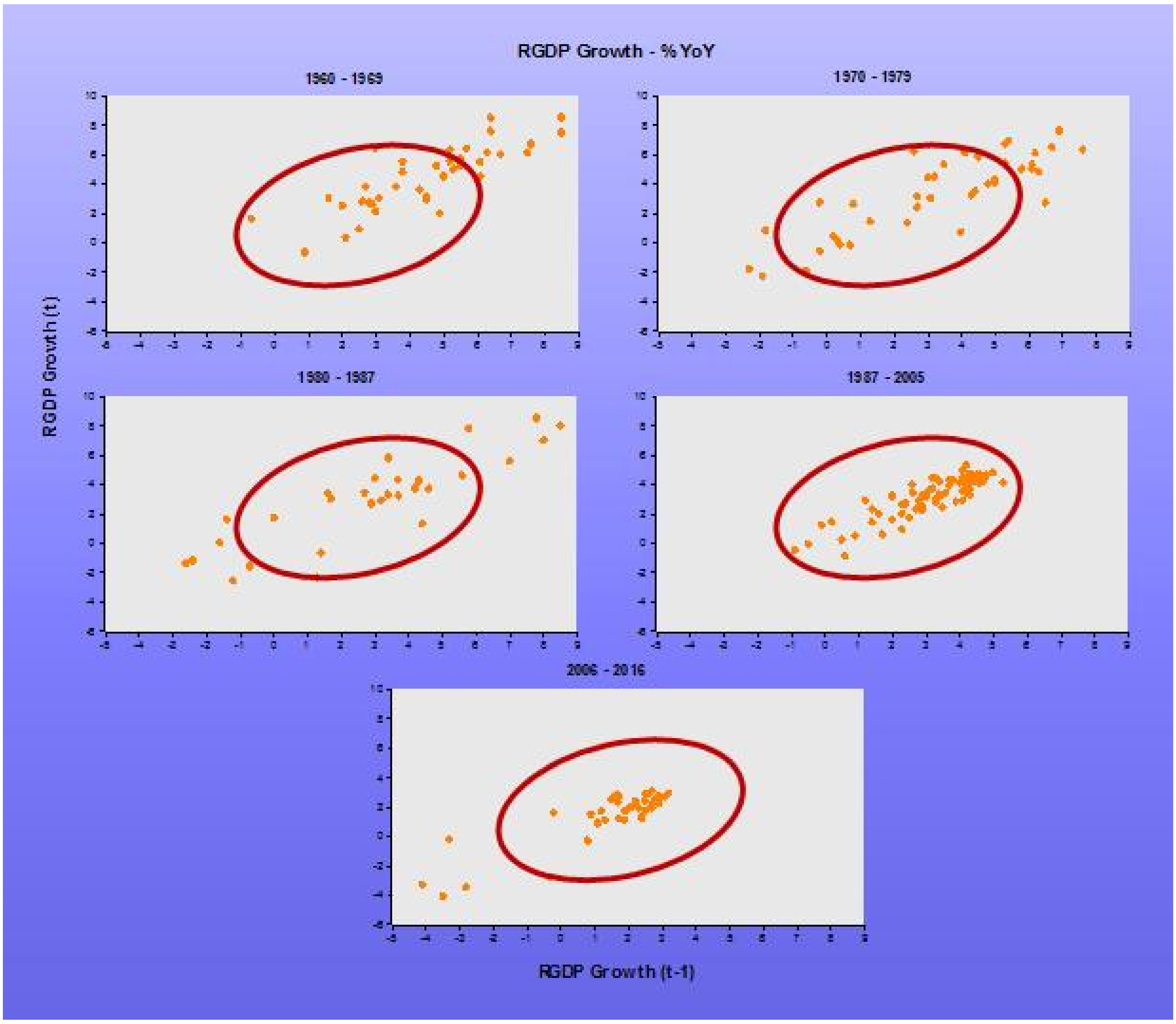
This last reasoning is simply wrong. A negative price (supply) shock **increases** inflation and **reduces** real growth, so that the Fed has only to continue maintaining NGDP on the stable level growth path. In an NGDP level-targeting regime, the Fed **does not react to supply shocks**.

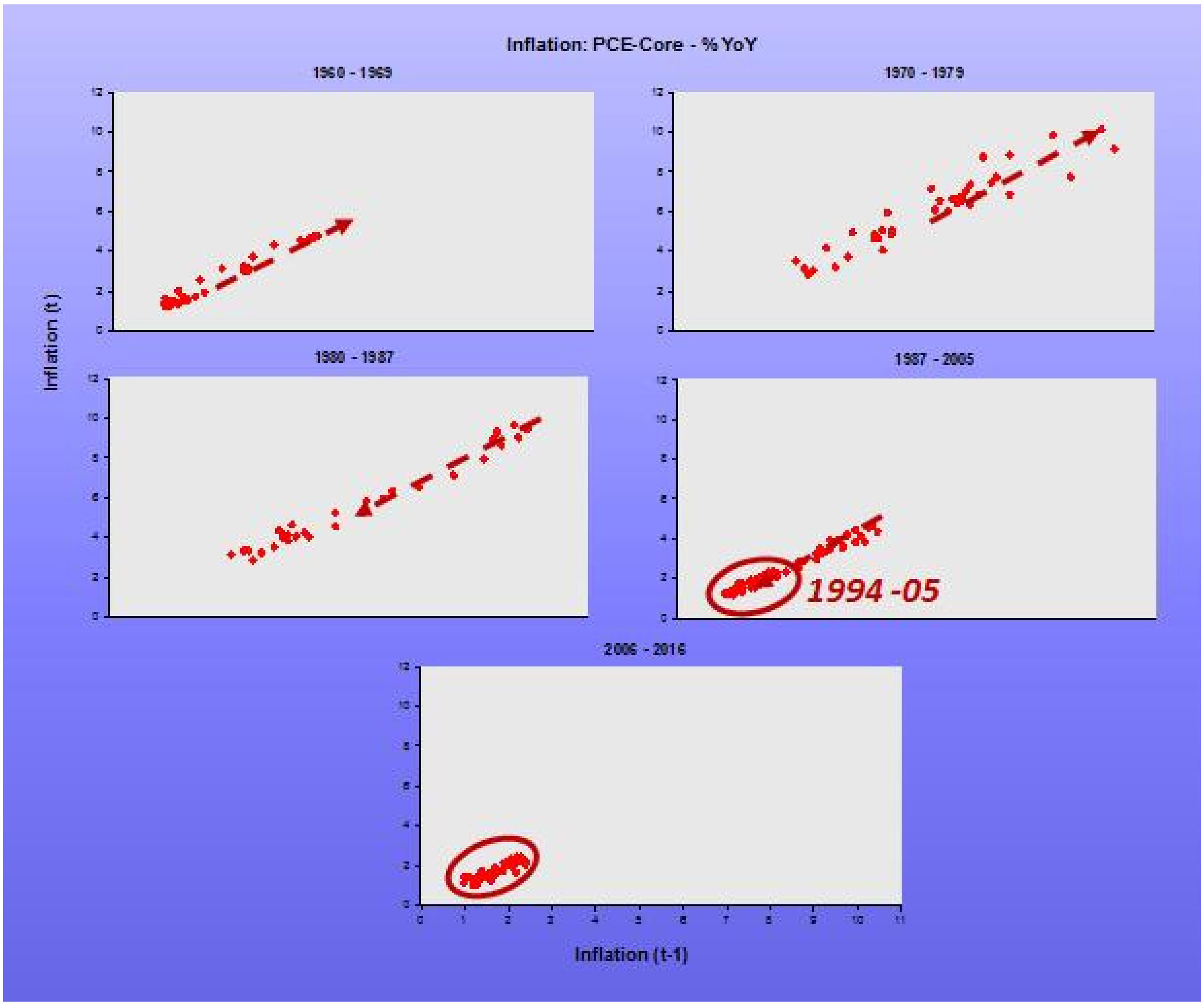
Therefore, Taylor´s belief that the Fed will have to "**take sharp tightening action**" is wrong and misleading.

What evidence is there for the "stabilization properties" of NGDP level targeting?

The panel below shows NGDP growth, RGDP growth and inflation during different periods. Pay close attention to how the system behaved during the so-called "Great Moderation" (1987 – 2005).


NGDP Growth - % YoY
1960 - 1969
Golden 60s
(Martin)
1970 - 1979
Great Inflation
(Burns/Miller)
1980 - 1987
"Volcker Adjustment"
1987 - 2005
Great Moderation
(Greenspan)
2006 - 2016
"Great Stagnation/Lesser Depression"
Bernanke/Yellen
NGDP Growth (t)
NGDP Growth (t-1)


RGDP Growth - % YoY
1960 - 1969
1970 - 1979
1980 - 1987
1987 - 2005
2006 - 2016
RGDP Growth (t)
RGDP Growth (t-1)



During those years, NGDP growth was stable along a level target path. That resulted in stable RGDP growth and low and stable inflation.

That ended when the Bernanke Fed, laser-focused on headline inflation (buffeted by oil shocks) allowed NGDP growth to fall off the stable trend path. After the initial mistake, there is stability in the **lower trend level path**, so inflation has remained low and stable. To the lower trend path for NGDP we associate a lower trend path for RGDP and its growth rate.

It´s not that monetary policy, for the past eight years has been “wrong”, at least up to now. After all, nominal stability is a feature of the present environment, keeping real growth and inflation stable. The problem is that the initial error of letting NGDP fall “off the wagon” was never redressed. This allows us to call the present economy “solid” or “strong”, even when in truth it is mired in a **depression** (because it never experienced a **recovery**).