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Issues in Monetary Policy

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1.1 INTRODUCTION

Financial innovation and other developments in an advanced monetary economy will add to the many routes by which monetary policy influences financial assets and the real economy. However, the transmission mechanism of monetary policy is something that is well understood by the undergraduate economics student. The mechanism by which money influences the economy is through two principal routes. These are known as the ‘direct mechanism’ and the ‘indirect mechanism’. The direct mechanism is what is familiarly known as the ‘real balance effect’, whereby an excess holding of money by firms and households is diminished through a spending mechanism. Households and firms purchase goods and assets until the desired holding of money comes into line with the actual amount of money held. The indirect effect is the effect money has on interest rates, asset prices and the exchange rate, which in turn affects the real economy through changes in consumer spending, investment and trade. The impact of the indirect effect depends on how sharply interest rates and asset prices react to the initial monetary shock – the liquidity effect, and subsequently how fast interest rates and asset prices respond to expectations of future monetary policy – the expectations channel. The complex route by which the indirect effect of monetary policy develops in a financially advanced economy was anticipated in Friedman’s Counter-Revolution in Monetary Theory (see appendix 2). Keynesians of all descriptions concentrated on the minutia of the transmission mechanism, denying the existence of one particular route or arguing the weakness of another.1 In contrast, the Monetarists led by Friedman argued that the channels by which money influences the economy are many, in continuous change and results in impact lags that may be ‘long and variable’. The response of an economy to monetary shocks depends on the speed at which expectations adjust to these shocks.

1.2 THE MONETARIST COUNTER-REVOLUTION

Expectations are the key to understanding the short run trade-off between the real sector (real GDP, unemployment, etc.) and the nominal sector (nominal GDP, inflation etc). The conclusions of the Monetarist counter revolution led by Friedman (see appendix 1) are now part of mainstream thinking. Basically, there is no long run trade-off between nominal and real variables. The supposed trade-off between inflation and unemployment, which was the mainstay of British economic policy in the 1960s and mid-70s, was in reality a trade-off

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1 Even modern day New Keynesian models, while accepting the framework of the New Classical rational expectations school, pay little attention to the direct mechanism. See for example the Bank of England Quarterly Model in Harrison et al. (2005).

between unexpected inflation and unemployment. There is no central bank today that does not recognise the importance of market expectations in setting monetary policy. The effectiveness of monetary policy depends in part on the state of expectations. An expansionary monetary shock is likely to have a stronger impact on the economy if it was unexpected than if it was expected. The speed of adjustment of an economy to a monetary shock and decomposition of the growth in nominal GDP into real GDP growth and inflation depends on inflation expectations and the expectations generating mechanism. The insights of Friedman (1970), Walters (1971), and Lucas (1972) are now safely part of mainstream economic thinking. Theory has firmly grounded the view that rules dominate discretion.

While accepting the implications of the Monetarist and New Classical theories by the world’s central banks, the policy debate has shifted towards the anchoring of expectations. In the UK the question of instrument of control was largely by-passed and the focus of debate was principally about the intermediate target or simple rules that hinged on the path of nominal variables. The unhappy experience of monetary policy in the 1980s in the UK saw broad money targets being superseded by narrow money targets and ultimately, exchange rate targets. The collapse of the ERM and the observed instability of the velocity money in the 1980s in the UK and other advanced economies swung the academic and policy debate towards the targeting of alternative nominal variables as a means of anchoring inflation expectations.

1.3 PRACTICE AHEAD OF THEORY

The Monetarist counter revolution was theory that explained the failure of demand management policies and the inability to exploit the fictional trade-off between inflation and unemployment. The near universal acceptance of the key tenets of the Monetarist message by central banks represents the victory of theory over practice. In contrast, the success of inflation targeting by central banks, according to Mervyn King the Governor of the Bank of England (chapter 1), represents the success of practice over theory. Indeed inflation targeting has been viewed by many as an apparent success for central bank policy. But it can be argued that this success has been because of the return of a type of discretion in the setting of interest rates. Central bankers take in a wide range of information in deciding monetary policy which has elevated the basis of their judgement to an ‘art’ form that eschews the simple monetary target rules of the Monetarists. This is the challenge the Governor has made in the first essay of this book. Much of the remaining essays in the book take up the challenge.

According to King, inflation targeting avoids the one extreme of sticking to a rigid monetary rule or the other extreme of generating fixed reaction functions derived from an optimising framework. By avoiding rigid rules or ‘learnable’ reaction functions and being flexible (read discretion), the central bank has a better chance of meeting its stated aim. Influencing expectations is one way, of making the market do the work of the central bank. The Governor’s articulation of the ‘Maradona theory of interest rates’ is an example of how the target can be reached without changing monetary policy. This of course will work only if the Bank of England is correct and the market is wrong. However, King is clear that the market cannot be systematically wrong, in the same way that Maradona cannot always score by running in a straight line. The problem is that the market does not have a learnable rule or reaction function

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2 The Treasury Green Paper on Monetary Control (1980) came out against monetary base control on pragmatic grounds and had even won over some of its most powerful supporters – see Walters (1984).
3 See for example Svensson (2000).
4 See Bernanke et al. (1999).
to converge on and like the Monetary Policy Committee of the Bank of England it also looks at everything to try and second guess monetary policy.

The success of inflation targeting is not measured simply in terms of the target but also in terms of financial stability and inflation volatility. Based on the record, the Governor would appear to be correct. But has this simply been luck? Should the Bank be targeting other variables? Should it pay more attention to the monetary aggregates and introduce new or reintroduce hastily discarded other instruments of control? What lessons can be gleaned for monetary policy in general and what lessons can be learned from the experience of other central banks? These questions and others (but not necessarily answers) can be found in the following essays.

1.4 THE DANGERS OF PRACTICE WITHOUT THEORY

David Smith questions the effectiveness of depending on a single instrument of control and takes aim at the new Bank of England macroeconomic model. His chapter argues that the history of monetary policy errors since the 1960s have stemmed from the failure to control the supply of broad money. Other instruments that could be used to control broad money growth have either been removed from the Bank (funding policy, currency intervention) or are not part of the remit of the MPC (reserve requirements, special deposit calls). He takes aim at the new macroeconomic model used by the Bank and argues that because its New-Keynesian (NK) structure offers no role for broad money or credit, the model constrains the monetary debate. To be fair, the constraint is not due to the lack of a role for money. Money is implicit in the Bank model but because it assumes continuous equilibrium in the market for money the ‘LM’ curve could be validly replaced by an interest rate function. The problem occurs if we think of money as a ‘buffer stock’, which raises the possibility of aggregate disequilibrium between money demand and money supply. If this possibility is accepted, then measures of broad money must play an explicit role in the macroeconomic model.

Andrew Lilico argues that price level targeting offers several advantages over inflation targeting. In principle, price level targeting could produce higher economic growth, less need for fine tuning, results in a lower average rate of inflation or even deflation, and offers a superior way of dealing with deflationary depression. The chapter distinguishes between inflation volatility and inflation uncertainty. A credible price level targeting policy means that any deviation from the target results in a predictable movement back to the target, therefore lowering inflation uncertainty, reducing the inflation risk premium and creating higher growth through marginal investment. A credible price level target also generates self-regulating actions by the market to reinforce the target, lessening the need for fine tuning and eliminating a liquidity trap situation. However, one problem Lilico recognises is that the central bank has to identify changes in the price level caused by temporary demand shocks and permanent supply shocks. The outcome is a trade-off between short-run and long-run price level volatility.

Keith Pilbeam takes up the issue of supply versus demand-based shocks to the price level within the framework of an open economy theoretical macroeconomic model. The analysis extends the seminal work of Poole (1970) to ask the question, when is a price level target most appropriate. It turns out that a price level target is output stabilising when the economy is hit by money demand shocks and aggregate demand shocks but not when it is hit by supply side shocks. In the wake of rising oil prices and the aftermath of hurricane Katrina in 2005, this issue has a contemporary resonance. Pilbeam argues that in the case of negative supply shocks, some flexibility to the price level target is necessary. The problem for the central bank is trying to distinguish between the different types of shocks. Forward looking asset market
variables such as the rate of interest and the exchange rate reflect market expectations of shocks to the economy. However, the central bank may fail to distinguish between different types of shocks particularly when they result in the same qualitative response from forward looking asset market variables. This is a classic ‘signal extraction’ problem. In a rational expectations framework, it is not just the central bank but also all economic agents that are trying to extract information from the observed forward-looking variables. In this case it is not clear what the optimal policy response should be.\(^5\)

Patrick Minford squares up to the challenge of practice over theory made by King. In his essay the economy is modelled in a general equilibrium representative agent framework. The representative agent is assumed to be liquidity constrained, is risk averse and aims to smooth consumption. Expectations are rational. The utility of the representative agent is maximised when the variance of the real wage is minimised. Faced with different types of shocks, agents chose a wage contract that is fixed, indexed to the price level (or auction wage) or some combination of both (endogenous). The economy is assumed to be hit by monetary shocks and productivity shocks. These shocks cannot be neatly separated in demand and supply influences. In keeping with the general equilibrium nature of the model, the productivity shocks also affect demand through its effect on the return on capital and investment decisions. Using stochastic simulation, several policy questions are posed. Interest rate control is compared with money supply control. Under interest rate control shoe-leather costs are minimised but the variance of unemployment is higher compared with money supply control. Money or price-level targeting produces different results on the volatility of real wages and unemployment. Under money supply targeting, prices are less stable and therefore real wages and consumption of the employed are less stable. However, the volatility of unemployment is minimised under price level targeting. The welfare implication for the economy depends on the relative weighting of the various elements. The policy maker is faced with the choice of weights that maximise the welfare of the representative agent and in this result we may have a clue to the success of the Bank of England. It could be said that the Bank of England has been lucky so far with a benign period for the experiment of inflation targeting. It was period of relative calm. However, as the global economy enters a new phase of high oil prices and potential for supply-side shocks the Monetary Policy Committee may be faced with some real choices and trade-offs.

Dowd takes aim at the Bank of England’s inflation fan charts. The Bank has for sometime been forecasting both inflation and the density function of the forecast, which gives the probability of inflation being above or below the mean or mode. The fan chart is a measure of inflation uncertainty. While the Bank has been assiduous in assessing its performance in relation to the point forecast, Dowd shows that the density forecasts have been biased. The fan charts reveal that the Bank thought that there was a significant probability that inflation would not remain at the point forecast but rise over time. This outcome has not materialised and the Bank appears to have failed to learn from its mistakes. In essence it has exaggerated the risk of medium term inflation. But does this matter? The Bank has a good record on its point forecast of inflation and has a successful track record of steering the economy based on the point forecast. In which case Dowd asks, why do they forecast the density?

The financial crisis created by the collapse of LTCM highlighted the fact that banks are not the exclusive foci of a modern financial system. In a rapidly developing financial world, where

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\(^5\) Minford and Peel (1983) show that the minimum output variance outcome is a monetary policy rule that minimises the variance of monetary policy shocks.
disintermediation and capital market transactions dominate, non-bank financial corporations are as much the attention of central banks and regulatory authorities as the banks. Forrest Capie and Geoffrey Wood re-examine the role of the central bank within the modern financial system. The role of the central bank is to maintain financial stability. The question Capie and Wood pose is that given that the central bank has to act as a crisis manager, should the Lender of Last Resort (LOLR) function be extended to non-bank financial institutions. What should be the central bank response to unstable asset prices? In situations of financial crisis the line between insolvency and illiquidity is not easy to draw. With the aim of ensuring financial stability it is hard to avoid an implicit Too-Big-To-Fail (TBTF) policy. They conclude that it is not the business of central banks to stabilise asset prices but to be prepared to act as LOLR only if the financial system is threatened.

Tim Congdon traces the monetary transmission mechanism from its roots in Irving Fisher, through Milton Friedman and to Patinkin’s well-known ‘Real Balance Effect’. The principal theme is the emphasis on the stability of the desired ratio of money to expenditure. The key distinction is the adjustment of the individual’s holding of money relative to his desired holding and the adjustment of the economy as a whole between actual and desired money balances. Where an individual can adjust their actual holdings of money to disequilibrium between actual and desired, the adjustment for the economy as a whole is more complicated. For example, an excess supply of money leads to an excess demand in all other markets al la Patinkin. Everyone tries to get rid of their excess money by acquiring goods and assets. The resulting excess demand in all other markets brings about changes to variables such as asset prices and goods prices that feedback on to the level of desired money balances. Ultimately, desired money balances rise to match the actual level of money balances when the price level rises in line with the rise in the money supply. As Yeager (1968) has put it, unwanted money will continue to be passed around until it ceases to be unwanted. In this chapter Congdon also takes a swipe at the Bank of England’s view of the transmission mechanism. First, the Bank pays little or no attention to the direct mechanism of the real balance effect and focuses only on the indirect mechanism of the rate of interest. Second, Congdon argues that sector imbalances of money play an important role in the transmission mechanism. An excess of money held by the non-personal sector would be translated into asset demands and asset prices, which eventually feeds into domestic demand. Peter Warburton presents some econometric evidence to support this proposition in an annexe to this chapter.

Empirical evidence is beginning to mount that the Bank of England does implicitly target asset prices.6 This is something that many economists outside the Bank have suspected but Gordon Pepper and Michael Oliver pose the question, should they? They start with an examination of types of traders in capital markets. Although not using the same language, Pepper and Oliver describe the workings of the stock market in terms of the interactions of ‘informed’ and ‘noise traders’ in the sense of Shiller (2005). An implicit monetary loanable funds theory is linked to the disequilibrium money framework of David Smith and Tim Congdon’s essays. Expectations are not rational in this world. The players that inhabit the stock market have extrapolative expectations underpinned by sentiment, intuition, inertia and herd behaviour. Fuelled by excess money balances stock market players interact to generate speculative bubbles. Should the central bank target asset prices? Despite the role of money in initiating a speculative bubble Pepper and Oliver conclude that the central bank should not target asset prices but be available to act as LOLR to deal with the consequences of a crash.

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The final chapter by John Greenwood traces the monetary policy history of Japan in the last three decades of the 20th century. In particular this chapter focuses on the monetary policy of the Bank of Japan (BOJ), which took Japan from a period that had experienced one of the best monetary policies of the OECD economies to one of the most inept. In this chapter we find relevant lessons for the Bank of England, lest the success of its inflation targeting policy gives rise to complacency. During the golden era (1976–85), the BOJ oversaw a period of low inflation and steady economic growth based on monetary targeting. Monetary policy began to go off the rails in the five years of 1985–89 when the BOJ took their eye off the growth in the money supply so as to pursue external objectives. The result was acceleration in money growth and rapid growth of stock and real estate prices. But what was remarkable about the period was the relative lack of goods price inflation. The pricking of the asset price bubble in 1989–91 had the desired effect but also tipped the economy into recession, the medium term results of which are well known. Greenwood takes the reader through the policy responses (fiscal and monetary) and the failures of monetary policy to deal with medium term deflation. The lesson for the Bank of England is obvious. The BOE has been successful in its inflation targeting policy in delivering low inflation and steady economic growth. But a number of economists would argue that they, like the BOJ, have taken their eye off the monetary ball and with broad money growing in mid 2005 in double digits, the consequences for asset prices have not been appreciated. The question for the Bank is whether it has sufficient instruments of control to buttress a sliding economy if the asset price boom turns into a protracted debt deflation.

This book brings together a collection of essays that picks up the gauntlet thrown down by the Governor of the Bank of England. Even as Pepper and Oliver suggest that there is much that economic theory can learn from the practitioner, the current successful policy of inflation targeting is not a situation of practice ahead of theory. Minford shows that there is no inconsistency between theory and practice and indeed the success of the Bank of England may partly be due to the benign environment it has overseen. The other essays challenge the Bank’s view of the transmission mechanism, its over-reliance on the single instrument of control and its role in the monetary system. In particular, in failing to heed the lessons of recent UK monetary history and of the experience of Japan, the Bank is in danger of forgetting the fundamental lessons provided by the Monetarist counter-revolution.

REFERENCES


