Contents

List of Contributors xiii

1 Issues in Monetary Policy 1
   Kent Matthews and Philip Booth
   1.1 Introduction 1
   1.2 The monetarist counter-revolution 1
   1.3 Practice ahead of theory 2
   1.4 The dangers of practice without theory 3
   References 6

2 Monetary Policy: Practice Ahead of Theory 9
   Mervyn King
   2.1 Introduction 9
   2.2 What can monetary policy do? 11
   2.3 Learning and its implication for monetary policy 14
   2.4 Inflation targeting as a framework which accommodates learning 20
   2.5 Conclusion 23
   References 23

   David B. Smith
   3.1 Introduction 25
   3.2 Current arrangements 26
   3.3 The conventional theoretical macro model (CTMM) 26
      3.3.1 Role of interest rates in the CTMM 28
      3.3.2 Time series considerations 28
   3.4 How the Bank’s main macro model constrained the monetary debate 31
   3.5 The new Bank of England quarterly model 32
   3.6 The monetarist case for a big central bank 33
   3.7 Lessons from Britain’s monetary history 34
   3.8 Main conclusions 35
   References 37
## Contents

### 4 Why Price-Level Targeting is better than Inflation Targeting

*Andrew Lilico*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 Introduction</td>
<td>39</td>
</tr>
<tr>
<td>4.2 How do inflation targeting and price-level targeting differ?</td>
<td>39</td>
</tr>
<tr>
<td>4.2.1 Long-term price stability</td>
<td>39</td>
</tr>
<tr>
<td>4.2.2 Short-term inflation volatility</td>
<td>40</td>
</tr>
<tr>
<td>4.2.3 Output volatility</td>
<td>41</td>
</tr>
<tr>
<td>4.3 What is there to gain from long-term price stability?</td>
<td>41</td>
</tr>
<tr>
<td>4.4 Inflation volatility is not same thing as inflation uncertainty</td>
<td>42</td>
</tr>
<tr>
<td>4.5 Price-level targeting generates its own credibility</td>
<td>42</td>
</tr>
<tr>
<td>4.6 Price-level targeting is self-regulating</td>
<td>43</td>
</tr>
<tr>
<td>4.7 Price-level targeting offers escape from a low-employment equilibrium</td>
<td>44</td>
</tr>
<tr>
<td>4.8 The ‘costs’ of price-level targeting have corresponding benefits</td>
<td>45</td>
</tr>
<tr>
<td>4.9 Price-level targeting vs. average inflation targeting</td>
<td>46</td>
</tr>
<tr>
<td>4.10 The history of price-level targeting</td>
<td>46</td>
</tr>
<tr>
<td>4.11 Conclusion</td>
<td>47</td>
</tr>
</tbody>
</table>

References: 47

### 5 A Price Targeting Regime Compared to a Non Price Targeting Regime. Is Price Stability a Good Idea?

*Keith Pilbeam*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Introduction</td>
<td>49</td>
</tr>
<tr>
<td>5.2 The ultimate objective of economic policy</td>
<td>49</td>
</tr>
<tr>
<td>5.3 Modeling economic shocks</td>
<td>50</td>
</tr>
<tr>
<td>5.3.1 Assumptions of the model</td>
<td>50</td>
</tr>
<tr>
<td>5.4 The model</td>
<td>51</td>
</tr>
<tr>
<td>5.5 Determining Equilibrium</td>
<td>53</td>
</tr>
<tr>
<td>5.6 A money demand shock</td>
<td>55</td>
</tr>
<tr>
<td>5.7 Aggregate demand shock</td>
<td>56</td>
</tr>
<tr>
<td>5.8 An aggregate supply shock</td>
<td>57</td>
</tr>
<tr>
<td>5.9 The search for an indicator</td>
<td>58</td>
</tr>
<tr>
<td>5.10 Conclusions</td>
<td>60</td>
</tr>
</tbody>
</table>

References: 60

### 6 Optimal Monetary Policy with Endogenous Contracts: Is there a Case for Price-Level Targeting and Money Supply Control?

*Patrick Minford*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1 Introduction</td>
<td>63</td>
</tr>
<tr>
<td>6.2 Considerations in designing monetary policy arrangements</td>
<td>63</td>
</tr>
<tr>
<td>6.3 Monetary policy: Is inflation targeting the best we can do?</td>
<td>66</td>
</tr>
<tr>
<td>6.4 Interest rate control – what does it do?</td>
<td>69</td>
</tr>
<tr>
<td>6.5 Money supply targeting and feedback rules – a stochastic simulation analysis</td>
<td>69</td>
</tr>
<tr>
<td>6.5.1 Comparing money- and price-level targeting</td>
<td>70</td>
</tr>
<tr>
<td>6.5.2 Should we use interest rates rather than the money supply as the short-term instrument of control?</td>
<td>71</td>
</tr>
<tr>
<td>6.5.3 How important is the zero bound in setting the inflation target rate?</td>
<td>73</td>
</tr>
</tbody>
</table>
Contents ix

6.6 Conclusions 74
Annex: The representative agent model (RAM) 75
References 78

7 Forecasting Inflation: The Inflation ‘Fan Charts’ 81
Kevin Dowd
7.1 Inflation forecasting 81
7.2 The inflation fan charts 82
7.3 The Bank’s forecast inflation density function 83
7.4 Evaluating the Bank’s inflation forecasts 84
  7.4.1 Backtesting of the fan charts 84
  7.4.2 The credibility of the fan charts vs. the stability of the inflation rate 87
  7.4.3 The Bank’s forecasts vs. those of a naïve alternative 88
  7.4.4 The MPC’s density forecasts vs. the empirical inflation rate 89
7.5 Conclusions 90
Annex: The two-piece normal density function 91
References 92

8 Asset Prices, Financial Stability, and the Role of the Central Bank 95
Forrest Capie and Geoffrey Wood
8.1 Introduction 95
8.2 What is price stability? 95
8.3 Financial stability 96
8.4 The lender of last resort 96
8.5 Do asset prices matter? 98
8.6 Should institutions be propped up? 99
8.7 Financial benefits of monetary stability 100
8.8 Conclusions 101
References 102

9 Money, Asset Prices and the Boom-Bust Cycles in the UK: An Analysis of the Transmission Mechanism from Money to Macro-Economic Outcomes 103
Tim Congdon
9.1 Introduction 103
9.2 Traditional accounts of the transmission mechanism 103
9.3 Asset prices in the traditional accounts 105
9.4 The ownership of capital assets in the UK 106
  9.4.1 The monetary behaviour of the different sectors of the UK economy 106
  9.4.2 The monetary behaviour of financial institutions and asset prices: analytical sketch 108
9.5 Asset prices and economic activity 109
  9.5.1 Financial sector money in the boom-bust cycles 112
  9.5.2 Financial sector money and asset prices in the Heath-Barber boom 114
  9.5.3 Financial sector money and asset prices in the Lawson boom 116
9.6 Conclusion: Money and asset prices in the transmission mechanism 118
Annex: Econometric analysis of one type of real balance effect 119
References 121
x  Contents

10 Money, Bubbles and Crashes: Should a Central Bank Target Asset Prices?  123
   Gordon T. Pepper with Michael J. Oliver
   10.1 Introduction 123
   Part A: The monetary theory of bubbles and crashes 124
      10.2 Types of traders in securities 125
         10.2.1 Persistent liquidity trades 126
         10.2.2 Demand for money 126
         10.2.3 Supply of money 127
   10.3 Extrapolative expectations 128
      10.3.1 Sentiment 128
      10.3.2 Intuition 129
      10.3.3 Decision-taking inertia 129
      10.3.4 Crowds 129
      10.3.5 Discounting liquidity transactions 130
      10.3.6 Short-term risk versus profits in the longer-term 130
      10.3.7 Financial bubbles 131
   10.4 Debt-deflation 131
      10.4.1 The cure for debt-deflation 132
   Part B: Should a central bank target asset prices? 133
      10.5 Preventing financial Bubbles 133
         10.5.1 Political will 134
         10.5.2 Two basic problems 134
         10.5.3 Overfunding 134
         10.5.4 Official intervention in markets 135
         10.5.5 Monetary Base Control 136
         10.5.6 MBC compared with overfunding 138
      10.6 Conclusions – an answer and a question 138
         10.6.1 The answer 138
         10.6.2 The question 138
   Annex: Disequilibrium 139
   References 140

11 Monetary Policy and the Bank of Japan  141
   John Greenwood
   11.1 Introduction 141
   11.2 Japan’s golden era in monetary policy, 1975–85 142
   11.3 How monetary policy went off the rails, 1985–89 143
   11.4 The bursting of the bubble, 1989–91 144
   11.5 Assessment of policy responses 145
      11.5.1 Initial policy response – fiscal expansion 145
      11.5.2 Monetary policy – interest rate strategy, 1990–93 146
      11.5.3 Monetary policy – interest rate strategy, 1993–2001 148
      11.5.4 Monetary policy – quantitative expansion 151
   11.6 Monetary policy – deliberate yen depreciation 154
   11.7 Monetary policy – government borrowing from the banks 155
   11.8 Restructuring policies 157
   11.9 Conclusion 158
   References 158
### Appendix 1: Unemployment versus Inflation? An Evaluation of the Phillips Curve

*Milton Friedman*

<table>
<thead>
<tr>
<th>Contents</th>
<th>xi</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 1: Unemployment versus Inflation? An Evaluation of the Phillips Curve</td>
<td>159</td>
</tr>
<tr>
<td>Appendix 2: The Counter-Revolution in Monetary Theory</td>
<td>171</td>
</tr>
<tr>
<td>Index</td>
<td>185</td>
</tr>
</tbody>
</table>