Issues in Monetary Policy

The Relationship between Money
and the Financial Markets

Edited by

Kent Matthews

Philip Booth

John Wiley & Sons, Ltd

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To Alan Walters from whom we all learned so much and to whom the IEA is grateful for his contribution to the development of the Shadow Monetary Policy Committee

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Issues in Monetary Policy

Kent Matthews and Philip Booth

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-of 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

[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).

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