

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

Contents

List of Contributors	xiii
1 Issues in Monetary Policy	1
<i>Kent Matthews and Philip Booth</i>	
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
<i>Mervyn King</i>	
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
3 Are the Structure and Responsibilities of the Bank of England Optimal and If Not, Does It Matter?	25
<i>David B. Smith</i>	
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

4	Why Price-Level Targeting is better than Inflation Targeting	39
	<i>Andrew Lilico</i>	
4.1	Introduction	39
4.2	How do inflation targeting and price-level targeting differ?	39
4.2.1	Long-term price stability	39
4.2.2	Short-term inflation volatility	40
4.2.3	Output volatility	41
4.3	What is there to gain from long-term price stability?	41
4.4	Inflation volatility is not same thing as inflation uncertainty	42
4.5	Price-level targeting generates its own credibility	42
4.6	Price-level targeting is self-regulating	43
4.7	Price-level targeting offers escape from a low-employment equilibrium	44
4.8	The 'costs' of price-level targeting have corresponding benefits	45
4.9	Price-level targeting vs. average inflation targeting	46
4.10	The history of price-level targeting	46
4.11	Conclusion	47
	References	47
5	A Price Targeting Regime Compared to a Non Price Targeting Regime. Is Price Stability a Good Idea?	49
	<i>Keith Pilbeam</i>	
5.1	Introduction	49
5.2	The ultimate objective of economic policy	49
5.3	Modeling economic shocks	50
5.3.1	Assumptions of the model	50
5.4	The model	51
5.5	Determining Equilibrium	53
5.6	A money demand shock	55
5.7	Aggregate demand shock	56
5.8	An aggregate supply shock	57
5.9	The search for an indicator	58
5.10	Conclusions	60
	References	60
6	Optimal Monetary Policy with Endogenous Contracts: Is there a Case for Price-Level Targeting and Money Supply Control?	63
	<i>Patrick Minford</i>	
6.1	Introduction	63
6.2	Considerations in designing monetary policy arrangements	63
6.3	Monetary policy: Is inflation targeting the best we can do?	66
6.4	Interest rate control – what does it do?	69
6.5	Money supply targeting and feedback rules – a stochastic simulation analysis	69
6.5.1	Comparing money- and price-level targeting	70
6.5.2	Should we use interest rates rather than the money supply as the short-term instrument of control?	71
6.5.3	How important is the zero bound in setting the inflation target rate?	73

6.6	Conclusions	74
	Annex: The representative agent model (RAM)	75
	References	78
7	Forecasting Inflation: The Inflation ‘Fan Charts’	81
	<i>Kevin Dowd</i>	
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
	<i>Forrest Capie and Geoffrey Wood</i>	
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
	<i>Tim Congdon</i>	
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

10 Money, Bubbles and Crashes: Should a Central Bank Target Asset Prices?	123
<i>Gordon T. Pepper with Michael J. Oliver</i>	
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
<i>John Greenwood</i>	
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**

159*Milton Friedman*

Appendix 2: The Counter-Revolution in Monetary Theory

171*Milton Friedman*

Index

185

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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-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

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).