

Summary 'monetary theory and policy II'

Little controversy

1. Long term effects of money

Systematically high rates of money supply growth lead to high inflation and high nominal interest rates

Over the long term, output and productivity growth are driven by supply side factors

There does not seem to be a long term trade off between inflation and unemployment

Nevertheless, countries with excessive inflation tend to perform poorly. However, inflation may be only a symptom rather than a cause for bad macroeconomic performance

A great deal of controversy

2. Short term effects of money

Most economists (and all policymakers) believe that money matters for real economic activity in the short run. That is, that there exists a negatively sloped short run Phillips curve, which **can** be exploited by policymakers temporarily (or be induced by monetary policy). The long run Phillips curve is vertical.

For money to matter there must be some nominal rigidity in the economy such as wage/price inflexibility or some other friction such as incomplete information that prevents prices from adjusting quickly.

While these frictions are typically thought to be the reason for the short term effects of money, in reality the channels through which monetary policy affects output are not well understood (credit channels, term structure, investment, stock market...).

The ability to use monetary policy to manipulate unemployment is more limited when the average inflation rate is high (and variable) because the Phillips curve becomes steeper.

There exists a sizeable and intellectually respectable school of macroeconomics (the real business cycle school) that argues that monetary factors do not play any role for real economic activity even in the short run.

Fluctuations are driven by supply factors exclusively. All unemployment is voluntary.

3. Economic policy

a. Activistic vs non-activistic

The old debate: The monetarists have argued that the policymakers do not know enough about the economy, so their action can cause greater instability. They should abstain from stabilization.

The new Keynesian theory claims that at any point there may exist many equilibria in an economy, some better than other. A bad equilibrium (high unemployment) is the result of a coordination failure (economic agents ignoring the externalities associated with their actions). A government can improve things by helping people coordinate on the right equilibrium

b. Rules vs discretion

Opportunism in the conduct of monetary policy can prove costly in the long run by undermining policy credibility and hence fueling inflationary expectations. Regaining credibility has proved difficult as it has typically required tight monetary policy and high unemployment.

As a result, many economists now espouse the thesis that there should be no discretion in the conduct of monetary policy because it tends to lead to abuse. This in turn leads to the destruction of the reputation of the central bank and to high inflation. This argument in favor of rules is in addition to that offered by monetarists which postulates that central banks ought to not intervene because they do not know enough about the economy.

c. Form of policy rule

Should the interest rate or the money supply be the instrument?

Should it react to inflation only (strict inflation targeting) or also to real output, the exchange rate and so on?

Should it be legislated?.

The major central banks seem to have an –perhaps implicit- inflation target over the medium run. In the short run they use an interest rate instrument to react to both output and inflation developments (Taylor rule).

4. Open economy issues

In an open economy, the effectiveness of fiscal and monetary policy depends on the type of the exchange rate regime in place. Monetary policy is ineffective under a fixed regime. If a country pegs its currency, then it forgoes the ability to use monetary policy for any other objective

Countries adopt a fixed regime in order to reduce exchange rate uncertainty, and also to reduce domestic inflation (to disinflate). In the latter case the currency tends to become overvalued (because domestic inflation does not fall enough immediately) which can invite speculative attacks.