Monetary Policy in Our Times

Ando, Eguchi, Farmer, and Suzuki, editors

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This book was set in Apollo by Asco Trade Typesetting Ltd., Hong Kong, and printed and *bound by Halliday Lithograph in the United States of America*

Library of Congress Cataloging in Publication Data

Main entry under title:

Monetary policy in our times

Papers and discussions from an international conference sponsored by the Institute for Monetary and Economic Studies of the Bank of Japan held June 22–24 1983
Bibliography: p
Includes index
1. *Monetary policy—Congresses* I Ando, Albert II Nihon Ginkō Kin yū Kenkyūkyoku.
HG205 1983 332 4 6 84-19441
ISBN 0-262-01082 8

Monetary Policy in Our Times

Proceedings of the First International Conference held by the Institute for Monetary and Economic Studies of the Bank of Japan

edited by
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The MIT Press
Cambridge, Massachusetts
London, England

Foreword

This volume is the result of the first international conference sponsored by the Institute for Monetary and Economic Studies, which was established in October 1982 in commemoration of the centenary of the Bank of Japan. Sponsoring this conference, attended by a great number of prominent economists from our fellow central banks in Asia, Oceania, North America, and Europe, from international organizations, and from the academic communities at home and abroad, was a special honor to the Institute for Monetary and Economic Studies and also to the Bank as a whole.

For those engaged in monetary policy making, pragmatism remains a hard-and-fast rule. Most of them, I believe, like to consider themselves "practical men," and none of them, to be sure, like to become "the slaves of some defunct economist," as Keynes wrote in the concluding notes of his General Theory. However, central bankers cannot and should not be "exempt from intellectual influences." I was once told that an influential central bank governor in the interwar period had used to ask his staff economists to give him good reasons for his decisions only after he had taken them. This is certainly not the case now at any central bank. All of them have been making enormous efforts to strengthen research activities with the aim of contributing actively to more appropriate monetary policy making.

Despite these efforts made by all central banks, they have been frustrated by serious economic dislocations during most of the past decade. In particular, the combination of sharp price increases, slow growth, and high unemployment posed formidable challenges to policy makers in the 1970s. These phenomena contrasted strikingly with the earlier two decades, when we enjoyed rapid growth and high employment with relatively low inflation.

Indeed, most people now look back on the 1950s and 1960s as a Golden Age for the economies of industrialized countries, which was also beneficial to the world economy in general. By the mid 1960s many economists came to argue that they had finally learned how to apply modern economic theories to

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practical policy making, and that we could "fine-tune" the economy with short-run macroeconomic policy adjustment to achieve a certain mix of price performance on the one hand and output and employment on the other, depending on our social preference. At the beginning of the 1970s, economic aspirations of people, whether economists or not, were still generally high regarding growth and employment, with little concern about inflation. Why did events in the 1970s diverge so greatly from the general expectations?

In retrospect, we can say that a number of factors which had contributed to the remarkably good economic performance of industrialized countries in the 1950s and 1960s were not sustainable. Let me point out some of them. First, until the late 1960s we had benefited from the Bretton Woods system, which was supported by the dominant strength of the U.S. economy and generally stable U.S. domestic prices. Second, there had been the wave of movements toward free trade with associated benefits of international specialization. Third, a large-scale replacement of capital stock had occurred after World War II, and the shift of resources out of low-productivity sectors into high-productivity sectors with rapid technological progress had been fast and smooth. Fourth, there had been an ample supply of laborers who had maintained a strong positive attitude toward work. Fifth, real energy prices had followed the declining trend, and the supply of raw materials had been stable.

The industrial countries entered the 1970s without full recognition of the nonsustainability of these favorable factors and with a gradual buildup of inflationary pressures and expectations which reflected the generally expansionary posture of macroeconomic policy in the latter part of the 1960s. But it is certainly wrong to conclude that the stagflation of the 1970s was due solely to the weakening or reversal of these factors and the legacy of policy actions in the 1960s. There were also avoidable policy mistakes in the 1970s, such as excessive monetary expansion (notably before the 1973–74 oil-price increase), sharp increases in government spending and persistently large budget deficits, and continued preoccupation with fine tuning and consequent policy U-turns. In the highly interdependent world in which we live now, the undesirable influences of a policy mistake in a country can be quickly transmitted to the rest of the world. The floating-exchange-rate system has not satisfactorily shielded the domestic economy from external influences.

An important lesson we have learned from the unhappy experience of the 1970s is the need for closer international cooperation between policy makers under proper "intellectual influences." It is in full recognition of this need that the Institute for Monetary and Economic Studies organized the international conference on "Monetary Policy in Our Times" as one of its com-

memorative activities for the centenary of the Bank of Japan. The primary purpose of the Institute is to function as the Bank's center for basic studies such as theoretical and empirical research work on monetary and economic issues and the institutional and historical analysis of monetary and related matters in closer collaboration with the academic community, and organizing this conference was one of the ways in which the Institute has attempted to accomplish this purpose in an international context.

Haruo Mayekawa
Governor of the Bank of Japan

Monetary Policy in Our Times

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Introduction

Hidekazu Eguchi
Yoshio Suzuki

The *International Conference on "Monetary Policy in Our Times,"* organized by the Institute for Monetary and Economic Studies[1] of the Bank of Japan, was held June 22–24, 1983. Participants included academic economists from Japan and abroad, economists from the central banks of countries in Asia, Oceania, Europe, and North America, and economists from international organizations.[2]

This conference was intended to tackle a wide range of issues in the theory and practice of monetary policy.

Both the Overseas Special Advisers and the Program Committee saw the importance of communication and dialogue among economists of different views, academic and central-bank economists, and economists from developed and developing countries. In inviting papers and formal comments on them, the Program Committee sought a balance among economists of different streams of thought.

The conference consisted of five sessions. Session 1 included the opening address of Governor Mayekawa of the Bank of Japan and the keynote speeches of Professors Friedman and Tobin. The keynote speeches evoked considerable discussion in subsequent sessions. Sessions 2 and 3 dealt with the domestic and international aspects of monetary policy, respectively. Session 4 addressed itself to anti-stagflation policies. The conference concluded with session 5, an overall exchange of views among participants.

In sessions 2–4, two academic economists delivered papers on each preassigned topic and made supplementary remarks. Four economists from central banks or international organizations commented on the two papers. The floor was then opened for general discussion.

The discussions are summarized in the following sections of this introduction. Here we offer three general conclusions.

First, as the keynote speeches by Friedman and Tobin illustrate, the views, diagnoses, and prescriptions of academic economists differ sharply—especially those of Keynesians and monetarists.

Second, the conference revealed large differences between theory-oriented academicians and pragmatic central-bank economists. The controversy over nominal-GNP targeting was a case in point; central bankers voiced opposition to this proposal on practical and political grounds. Yet each group learned from the other, and further dialogue between them would be productive.

Third, the conference offered economists from developed and developing countries a rare, precious opportunity to communicate. However, most of the papers and discussions at this conference related mainly to major industrial countries. A more intensive and balanced dialogue must await future occasions.

Main Points of Discussion

During the three days of the conference, monetary policy was examined from several perspectives. Many topics recurred repeatedly in different contexts and in different sessions. This summary will focus on the central topics: policies to overcome stagflation, nominal-GNP targeting, international aspects of monetary policy, and monetary policy in Japan.

Policies to Overcome Stagflation

Most of the papers presented at this conference were written with the U.S. economy in mind, and discussions naturally centered on recent U.S. monetary and fiscal policies. Of course, these discussions also have direct and indirect relevance to economic policies in other developed countries.

Appraisal of Recent U.S. Monetary Policy

In the course of the general discussion, Milton Friedman (Hoover Institution) elaborated some of his keynote remarks. As to the recent U.S. monetary policy, he argued that the money supply had expanded excessively since July 1982, that this expansion would inevitably result in an upsurge in inflation with a lag of a year and a half (that is, in 1984), and that such an abrupt change in the Federal Reserve's stance had brought additional uncertainty and instability to the economy. Moreover, Friedman expressed serious doubt about the Federal Reserve System's justification for above-target monetary expansion. The "Fed" claims that institutional changes and financial innovations rendered M1 statistics difficult to interpret and brought a sharp drop in M1 velocity in 1982. However, Friedman pointed out that major changes in the financial system (notably the introduction of Money Market Deposit and

Super NOW accounts) did not take place until the end of 1982. In any case, he said, a decline in velocity is not unusual during recession.

James Tobin (Yale University) criticized the behavior of the Federal Reserve System on quite different grounds. He questioned whether it was prudent for the Fed to stay with its restrictive, rigid monetary targets as long as it did, especially when financial innovation made the economic meaning of the money-supply statistics ambiguous and the velocity of money unstable. The Federal Reserve System was only facing up to reality in suspending its money-supply targets. According to him, the tide of monetarism is on the ebb. Furthermore, although the Federal Reserve System has averted further economic collapse by its change of policy, U.S. interest rates ramain too high. They are still a major obstacle to world economic recovery. He therefore stressed the need for further monetary easing.

In reply to the criticisms by Friedman and Tobin, Stephen H. Axilrod (U.S. Federal Reserve Board) and Frank E. Morris (Federal Reserve Bank of Boston) pointed out that under the current monetary policy the U.S. economy is enjoying recovery with hardly any sign of a new upsurge in inflation. As to Friedman's criticism, Axilrod argued that the recent rapid growth in M1 was partly influenced by precautionary demands in a period of economic uncertainty. But it probably reflected mainly a restoration of demand for M1 due to the lowered nominal interest rates accompanying a decline in the expected rate of inflation. This growth is likely to be a temporary phenomenon typical of a phase of disinflation and to have little impact on the future inflation rate. Furthermore, he opposed Tobin's call for further easing of U.S. monetary policy on the ground that it would endanger sustained noninflationary recovery.

The Transmission Mechanism of Monetary Policy

One major reason for economists' diverse outlooks on the future of the U.S. economy was the difference in the way they see the transmission mechanism of monetary policy.

Tobin, in his comment on money-supply targeting in the United States, questioned the existence of any direct and reliable relationship between money supply and inflation. He argued that money supplies affect prices via aggregate expenditure on goods and services, which are also influenced by other variables. The transmission process involves interest rates and other financial conditions, and the price and inflation outcomes depend on supply conditions in the economy.

Albert Ando (University of Pennsylvania) supported Tobin's argument by

citing empirical findings based on his own macroeconometric model. On the other hand, Friedman stressed the impact of money-supply growth on inflation, while noting that the lag with which an increase in monetary aggregates translates itself into prices may vary from case to case. Thomas J. Sargent (University of Minnesota) added that the lag between monetary growth and inflation is getting shorter as private economic agents learn how to adjust their expectations to new information.

Fiscal Policy and Monetary Control

Sargent, in his paper and in the subsequent discussion, expressed his concern about the lack of coordination between fiscal and monetary policies in the United States. The Reagan administration has endorsed the policy of keeping money-supply growth constant. At the same time, its fiscal plans imply large government deficits over the indefinite future. These monetary and fiscal policies are incompatible in the long run; it is inevitable that one of the two must give way sooner or later. It is analogous to a game of "chicken." The future of the U.S. economy depends crucially on the outcome of this game between fiscal and monetary policies. The game injects new uncertainty into the economy; for this reason, the Reagan administration's attempt to revitalize the private sector has ended in failure.

Sargent thought that the lack of coordination between fiscal and monetary policy in the United States stemmed largely from the lack of centralization in policy responsibility under the U.S. system. But Peter Nicholl (Reserve Bank of New Zealand) commented that lack of coordination between fiscal and monetary policy had occurred and persisted even in a number of countries where the policy responsibility was much more centralized. There must therefore be some more fundamental reasons for this lack of coordination than an absence of centralized decision making—for example, conflicts within the government between the cabinet and officials of the treasury and the central bank.

Ando saw in the large government deficit in the United States a fundamental cause of high real interest rates there. He argued further that, since real interest rates on government securities are now higher than the sustainable growth rate of domestic output, the ratio of public debt to GNP is bound to become larger and larger. Deeply worried about this prospect, he suggested that the optimal policy mix is to reduce fiscal deficits while pursuing a more expansionary monetary policy.

Tobin agreed with Ando's point that stability of the debt/GNP ratio will require a different mix of fiscal and monetary policies. He stressed that this

was as much a responsibility of the Federal Reserve as of the fiscal policy makers, the administration, and the Congress. Although he agreed that future deficits must be diminished, Tobin felt little concern about current fiscal deficits in the United States, which indeed are stimulating recovery. He said the future deficits in prospect result from noncyclical "primary" deficits on transactions other than debt service, accumulation of cyclical deficits into debt on which interest must be paid, and high interest rates.

In the ensuing discussion, most participants—including those from central banks, such as Richard G. Davis (Federal Reserve Bank of New York) and C. A. E. Goodhart (Bank of England)—agreed that there is no absolute limit to government debt absorption in the financial market. However, the consensus among central-bank economists seemed to be that the persistence of the fiscal deficits and the resulting accumulation of government debt is likely to increase both inflationary expectations and interest rates (thereby exerting negative impacts on private investment) and to complicate monetary policy aimed at price stabilization (since it is inevitable that high interest rates will put central banks under various political and social pressures). In this context, many participants expressed serious concern over the accumulation of fiscal deficits in the United States.

High U.S. Interest Rates and the World Economy

Cesare Caranza (Banca d'Italia), Alexandre Lamfalussy (Bank for International Settlements), and other economists from Europe stated that high U.S. interest rates and their influence on exchange rates had constrained economic policy in other countries. Hermann-Josef Dudler (Deutsche Bundesbank) and Sylvia Ostry (Organization for Economic Cooperation and Development) suggested that the deflationary impact of high interest rates may be greater in Europe than in the United States because of higher interest-rate elasticities of expenditures in Europe. Ostry and Goodhart added that, under the present U.S. tax system, after-tax interest rates are in fact substantially lower than pre-tax rates.

Friedman's view was quite different. He argued that high real interest rates are a transitory phenomenon peculiar to the disinflationary phase following hyperinflation and ought not to be of great concern. It is also not fair to hold the United States solely responsible for high real interest rates in the world. For one thing, there is a world capital market, so that, especially under the flexible-exchange-rate regime, real interest rates in different countries tend to be equalized. Insofar as large public deficits raise interest rates, many countries around the world, and not the Unites States alone, have large public deficits and thus contribute to high real interest rates.

Michael R. Darby (University of California, Los Angeles) and Axilrod argued that under the flexible-exchange-rate system individual countries are more or less capable of pursuing independent monetary policies. They could not really see why concern over the possible short-run effect on the exchange-rate movements should prevent countries from pursuing domestically desirable long-run policies, especially now that U.S. interest rates had seen some decline. Axilrod noted that if the dollar was considered to be unsustainably high on exchange markets—and there was reason to think so—then any short-run downward pressure on another country's exchange rate (if that country eased its monetary policy) would be transitory.

Microeconomic Policy to Overcome Stagflation

Ando identified an upward trend in the natural rate of unemployment during the 1970s and argued that the adjustment of economies to external shocks has become less smooth and more painful. To mitigate this friction, we should try to reduce the natural rate of unemployment through microeconomic structural policies. Robert Raymond (Banque de France) suggested that the natural rate of unemployment could not be precisely measured and doubted its practical usefulness in policy formulation; however, he shared Ando's emphasis on the importance of structural problems, arguing that the institutional rigidities in the goods, labor, and financial markets in his country have constrained the propagation of the effects of monetary policy. Kumiharu Shigehara (Bank of Japan) suggested that, while goods and labor markets remain rigid, deregulation and innovation in the financial markets have magnified the impact of financial disturbances on economic activity and hence made the conduct of macroeconomic policy more difficult. In this context, Ostry suggested that labor markets had now evolved so that wage formation in Europe had shown somewhat greater flexibility since the second oil crisis.

Nominal-GNP Targeting

Since the mid 1970s it has been a common practice among central banks in industrial countries to employ monetary aggregates as intermediate targets of monetary policy. Robert J. Gordon (Northwestern University) challenged this practice. His paper contained both a quantitative interpretation of macroeconomic behavior in the United States and a recommendation for the conduct of monetary policy. The quantitative interpretation concluded that the driving force of inflation is the excess of nominal-GNP growth over the growth in real

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