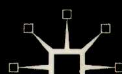
Edited by Axel Leijonhufvud

MONETARY THEORY AND POLICY EXPERIENCE

IEA



Monetary Theory and Policy Experience

Edited by

Axel Leijonhufvud
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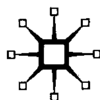

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The International Economic Association

A non-profit organization with purely scientific aims, the International Economic Association (IEA) was founded in 1950. It is a federation of some sixty national economic associations in all parts of the world. Its basic purpose is the development of economics as an intellectual discipline, recognizing a diversity of problems, systems and values in the world and taking note of methodological diversities.

The IEA has, since its creation, sought to fulfil that purpose by promoting mutual understanding among economists through the organization of scientific meetings and common research programmes, and by means of publications on problems of fundamental as well as current importance. Deriving from its long concern to assure professional contact between East and West, and North and South, the IEA pays special attention to issues of economies in systemic transition and in the course of development. During its nearly fifty years of existence, it has organized more than a hundred round-table conferences for specialists on topics ranging from fundamental theories to methods and tools of analysis and major problems of the present-day world. Participation in round tables is at the invitation of a specialist programme committee, but twelve triennial World Congresses have regularly attracted the participation of individual economists from all over the world.

The Association is governed by a Council, comprising representatives of all member associations, and by a fifteen-member Executive Committee which is elected by the Council. The Executive Committee (1995–98) at the time of the Trento Conference was:

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Sir Austin Robinson was an active Adviser on the publication of IEA Conference proceedings from 1954 until his final short illness in 1993.

The Association has also been fortunate in having secured many outstanding economists to serve as President:

Gottfried Haberler (1950–53), Howard S. Ellis (1953–56), Erik Lindahl (1956–59), E.A.G. Robinson (1959–62), Ugo Papi (1962–65), Paul A. Samuelson (1965–68), Erik Lundberg (1968–71), Fritz Machlup (1971–74), Edmund Malinvaud (1974–77), Shigeto Tsuru (1977–80), Victor L. Urquidi (1980–83), Kenneth J. Arrow (1983–86), Amartya Sen (1986–89), Anthony B. Atkinson (1989–92), and Michael Bruno (1992–95).

The activities of the Association are mainly funded from the subscriptions of members and grants from a number of organizations, including continuing support from UNESCO, through the International Social Science Council.

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Professor Michael Kaser, as General Editor of the International Economic Association, undertook the final editing of the manuscript – a hard job that I am infinitely grateful to have escaped.

The core funding for the conference was provided by the University of Trento, through the Department of Economics, and I am grateful to Rector Massimo Egidi, Chairman Geremia Gios and to my colleagues for their generosity in supporting the initiative. The foundation of the Cassa di Risparmio di Trento e Rovereto (CARITRO), through the mediation of its chairman, Professor Giovanni Pegoretti, and the European Financial Group, through its chairman, Dr Spiro Latsis, were major sponsors of the conference as, thanks to Dr Ignazio Visco, was Banca d'Italia. Contributions were also received from Monte dei Paschi di Siena and Consiglio Nazionale delle Ricerche.

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List of Abbreviations and Acronyms

AL	Alesina's central bank legal-independence index
CB	central bank
CBI	central bank independence
CD	certificate of deposit
CEPR	Centre for Economic Policy Research (London)
CNRS	Centre National de la Recherche Scientifique (France)
CPI	consumer price index
CREST	Centre de Recherche en Economie et Statistique
DC	developed country
ECB	European Central Bank
ECU	European Currency Unit
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ES	Eiffinger and Schaling (central bank legal-independence index)
ESCB	European System of Central Banks
EU	European Union
FOI	financial opposition to inflation
FOMC	Federal Open Market Committee
G5(7)(10)	Group of Five(Seven)(Ten)
GCB	group central bank
GDP	gross domestic product
GMT	Grilli, Masciandaro and Tabellini (political and economic independence index)
GNP	gross national product
i.i.d.	independently identically distributed
IMF	International Monetary Fund
IT	inflation targeting
IT	interest rate targeting
LDC	less developed country
LVAU	unweighted legal-independence index
LVAW	weighted legal-independence index
MCI	monetary conditions indicator
NAIRU	non-accelerating inflation rate of unemployment

NBER	National Bureau of Economic Research (Cambridge, Mass.)
OECD	Organisation for Economic Co-operation and Development
OLS	ordinary least squares
POI	public opposition to inflation
PPP	purchasing power parity
PSI	political system index
RPI	relative price inversion
SDR	Special Drawing Right
SUMLV	sum of legal-independence variables
TOR	turnover rate of central bank governors
TSLS	two-stage least squared regression
VAR	vector autoregression

combine to provide certainty about the right course of action, but the policymaker has to decide and to act regardless of this. If this makes monetary policy in some measure an 'art', the licence given to the 'artist' needs to be constrained by rules or by institutional arrangements.

Kumiharu Shigehara reviews and compares the monetary policies of Japan and the USA in the 1980s and 1990s. The Japanese authorities had to confront a number of difficult problems in this period that the Federal Reserve was spared. In particular, one notes that, by standard measures, inflation was both low and steady in the late-1980s build-up of what turned out to be an unsustainable asset price bubble. (Inflation targeting would not have helped much.) Even in retrospect, it is not clear that monetary policy, utilizing conventional instruments, could have done significantly better, either to dampen the asset-price inflation or to accelerate the painfully slow recovery.

Pedro Pou begins by listing some lessons for central bankers from academic research, but his chapter is mainly devoted to lessons for monetary economists to be drawn from Argentine experience. In particular, he reports on extensive studies of the variability of relative prices during the high inflation and since the 1990 'Convertibility Plan' stabilization. Although relative price variability is strongly correlated with inflation, Pou makes the case that, once the 'noise' stemming from price changes that are quickly reversed is removed, relative prices are in effect more flexible and the price mechanism functions better within the stable monetary framework.

Part II focuses on the conduct of monetary policy. Niels Thygesen analyzes inflation and exchange-rate targets in the context of recent European experience and current European issues. He recapitulates the emergence of a strong consensus that monetary policy should be confined to the achievement of nominal stability. In practice, this has come increasingly to mean low inflation targets. For countries not joining the EMU, Thygesen sees exchange-rate targets as a useful shorter-term adjunct to long-term inflation targets. For the ECB, on the other hand, the exchange rate will be of little consequence, while monetary aggregates are likely to be useful, not just as indicators, but also as short-term supplements to the longer-run inflation target.

Dale Henderson and Jinill Kim present a model that succeeds in encompassing most of the earlier literature on monetary policy reaction functions while adding new results. They evaluate seven different targets with respect to three types of shock. Nominal stickiness is taken as given, but the authors consider various forms it may take and show that in some instances results depend on whether wages or prices, or both, are sticky.

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Part III, on monetary regimes, begins with Sylvester Eijffinger's survey of the literature on central bank independence. A variety of arguments and models tend to support the notion that countries with independent central banks will tend to have lower and less variable inflation rates. On the question of whether this will in turn have the benefit of producing higher and less variable growth, opinions are divided. The by now rather large literature exploring sundry hypotheses about the determinants of central bank autonomy offers no conclusive results. While independence of the central bank is neither a sufficient nor a necessary condition for price stability, Eijffinger concludes that the trend towards such independence none the less deserves support, albeit qualified support.

For some time, Michael Bordo and Lars Jonung, individually, together or with other collaborators have pursued a programme of empirical research on macroeconomic performance under alternative monetary regimes. In the course of this work they have compiled a data set that now covers fourteen industrialized countries over a time-span of 115 years! Their chapter for this volume utilizes these data to study the relationship between fiscal and monetary regimes. Up to the 1960s, except for periods of war, monetary regimes constrained the fiscal, initially by commodity convertibility but later by fixed exchange rate regimes in which convertibility into gold played an ever-diminishing role. The final breakdown of Bretton Woods spelt the end of this constraint, and there followed two decades of, first, inflation and then rapid growth of public debt. Bordo and Jonung find that whereas adherence to convertibility rules has produced better nominal performance in the past, there is no clear evidence that it has produced better real performance. None the less, they view the implementation of inflation targeting in the 1990s as a return to a form of convertibility regime.

Finally, in a chapter rich in historical illustrations and legal precedents, Robert Mundell considers the monetary aspects of the sovereignty of states. While fixed exchange rates limit the policy sovereignty of a state, a monetary union is not just a (practically) irrevocable surrender of policy autonomy; it requires member states to relinquish parts of their legal sovereignty as well. Mundell is clearly of the opinion that the extent to which European Monetary Union will eventually encroach on the sovereignty of the member states is far from fully understood in many quarters, and that this lack of understanding is likely to cause unforeseen problems in the future. His recapitulation of the long struggle over monetary sovereignty between the American states and their federal government is particularly instructive in this regard.

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Part I

Central Banking Experience

1
Putting Central Banks in Their Place

John W. Crow
Former Governor, Bank of Canada

The conference was nicely bounded. At one end there was a monetary theorist discussing monetary theory and central banking, and at the other a central banker discussing central banking and monetary theory. The central banking panellists were somewhere around the middle, being asked to write their own tickets – to one end or the other, or to somewhere else.

But central banks are always somewhere in the middle – between economic science and monetary policy outcomes, between governments and financial markets, and so on. And they worry at least as much as anyone else about their proper positioning – or, as Gerald Bouey, my predecessor at the Bank of Canada, put it in his 1982 Per Jacobsson lecture, about 'finding a place to stand'.

Accordingly, these comments address a number of questions related to where central banks might be expected to stand in the political economy world in which they have to operate – starting with some considerations relating to the ways central banks approach the question of monetary policy goals, and then looking at central bank attitudes towards inflation targets as a way of realising those goals. Finally, I consider the extent to which governments (as opposed to central banks) have shown themselves willing to commit to long-run goals for monetary policy.

1 Central banks and monetary policy goals

Central banks are not academies. That being said, they do tend to have relatively strong economic research departments compared to other governmental bodies.

This is a way of attracting good minds into the institution and seeing how they develop in the institution's interests. Also, however, since

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