1. Introduction

In January 2004 the Cambridge Centre for Economic and Public Policy, based in the Department of Land Economy, University of Cambridge, UK, was inaugurated. To celebrate the event a conference took place in March 2004 at Downing College. Most appropriately, the theme of the conference was the ‘New Consensus Monetary Policy’. The papers included in this volume are a collection of those presented to that conference.

Recent developments in macroeconomic and monetary thinking have given a new impetus to the management of the economy. The use of monetary policy by way of manipulating the rate of interest to affect inflation is now well accepted by both academic economists and central bank practitioners (the works of Bernanke et al., 1999; Clarida et al., 1999, 2000; Issing, 2004; King, 1997; Svensson, 1999, are good examples). The explicit control of the money supply, which was fashionable in the 1970s and 1980s in the UK, the USA, Europe and elsewhere, was abandoned in favour of monetary policy rules that focus on interest rate manipulation by the central bank. The objective is to achieve an inflation target, either specific or within a range.

This volume begins with an assessment of this new thinking in macroeconomics and monetary theory. In Chapter 2, ‘New Consensus Monetary Policy: an appraisal’, Philip Arestis and Malcolm Sawyer suggest that many countries have adopted the New Consensus Monetary Policy (NCMP) since the early 1990s in an attempt to reduce inflation to low levels. Since then, this policy has been praised in most of the literature as a superior framework for monetary policy. This chapter concentrates on the theoretical foundations of this policy, where a number of aspects are discussed. It then turns its attention to an assessment of the empirical work on this new policy, where the distinction between the work that has been done utilizing structural macroeconomic models, and work based in single-equation techniques, is made. The theoretical framework and the available empirical evidence do not appear to support the views of the proponents of the New Consensus Monetary Policy.

Mark Setterfield in Chapter 3, ‘Central bank behaviour and the stability of macroeconomic equilibrium: a critical examination of the “New Consensus”’, argues that the New Consensus model was born of a desire to introduce interest rate operating procedures into New Keynesian macroeconomics, in order to make the latter more realistic at a time when central banks made no
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pretence to be targeting the stock of money in circulation. This chapter demonstrates that any increased realism purchased by the New Consensus model comes at a cost: the stability of macroeconomic equilibrium in the New Consensus model is not analytically robust. This result has important implications for monetary policy because it raises questions about why central banks adopt interest rate operating procedures and whether or not they should. The New Consensus model provides no definitive answers.

An important issue in the New Consensus Monetary Policy is the type of monetary rule the central bank in question may adopt. Georgios Chortareas in Chapter 4, ‘Monetary policy divergences in the euro area: the early record of the European Central Bank’, deals with the so-called Taylor rules used by the European Central Bank (ECB), in an attempt to contribute to our understanding and monitoring of cyclical divergences within the euro area. In particular, Chapter 4 provides some simple analytical tools for assessing the degree of convergence in the monetary policy needs of the Economic and Monetary Union (EMU) member countries. The progress towards EMU is examined to determine whether it enhanced convergence in the monetary policy needs of the participating countries or imposed a straitjacket on them. Taylor rules are utilized as a consistent benchmark that approximates the optimal monetary policy rule in each EMU member country and the aggregate euro area. A set of monetary policy divergence indicators is provided, which is applied to observed interest rates and to the measures of ‘warranted’ interest rates. The simplicity of the imposed Taylor rules renders them a manageable tool for obtaining an indication as to whether the ‘one-size-fits-all’ aspect of monetary policy works. The chapter also examines whether the actual interest rate convergence (or divergence) process corresponds to the convergence (or divergence) process in the warranted interest rates.

Chapter 5 turns to ‘Stock market prices and the conduct of monetary policy under the New Consensus Monetary Policy’. Nigel Allington and John McCombie assess whether or not central banks should take stock market prices into account when determining interest rates in the context of the New Monetary Consensus. They consider whether the collapse of stock prices has an adverse effect on the economy, the causes of stock bubbles and their role in the transmission mechanism. The empirical studies of the relationship between asset prices, the inflation rate and real output are examined, as well as the simulation models that assess whether there is a case for including asset prices in the inflation target. Given that the evidence on these questions is mixed, they report the results of their research on how central bankers actually respond to stock prices using the heteroskedasticity of stock market returns to estimate the monetary policy response. The authors find that a 5 per cent increase (decrease) in the FTSE 100 index increases (reduces) the UK’s three-month interest rate by 12.39 basis points. This translates into a 25-
basis-point change in the interest rate in the same direction as the stock market with a probability of 99 per cent. They report briefly the, mainly critical, response of researchers to this and similar findings for the USA on the reaction of monetary policy to stock prices and the converse.

Chapter 6 remains within the asset pricing area. Philip Arestis and Elias Karakitsos concentrate ‘On the US post-“new economy” bubble: should asset prices be controlled?’ and deal with the US experience of the boom-and-bust asset bubbles. They focus on the 2000 bubble in this economy, and the related issue of the ‘new economy’ paradigm. They analyse the aftermath of the bubble before dealing with the issue of how it might be tackled. Asset price inflation targeting may be both desirable and feasible and in no way conflicts with other policy objectives of the central bank, as for example in the case of inflation targeting. The process of asset price inflation targeting involves monitoring and targeting the impacts of asset prices on the spending patterns of consumers and companies, rather than asset prices themselves. The variable that lends itself as a primary candidate for monitoring and control of asset price inflation is the net wealth of the personal sector as a percentage of disposable income, as it is at the heart of the transmission mechanism from asset prices and debt to consumption.

Michelle Baddeley and Giuseppe Fontana in Chapter 7 are concerned with ‘Monetary policy in the information economy: old problems and new challenges’. They discuss the creation and circulation of money in both the old economy and the new economy. The analysis begins with a theoretical survey of electronic money (e-money) in a world of endogenous money. The survey incorporates a critical analysis of the Mengerian view that money emerges only as a consequence of economizing on transactions costs. Instead the authors argue that it is important to recognize the Chartalist view of money as a social convention reflecting social relations. They argue that the effects of e-money are limited by the fact that there is always going to be a demand for hard currency/high-powered money for taxation purposes. The implications for monetary policy are deduced and assessed. Following from the theoretical analysis, an empirical analysis is then presented, analysing data on conventional monetary aggregates and e-money in both the USA and the EU, focusing in particular on the international differences in social conventions and institutions when using e-monies. Data limitations and issues are also explored.

Stephanie Bell-Kelton and Rex Ballinger in Chapter 8 look at the question of ‘The monetary policy outcomes curve: can the size and structure of public debt undermine policy objectives?’ This chapter examines the relationship between public debt and monetary policy outcomes as follows. When high-debt countries pursue expansionary monetary policy, the outcome may be contractionary because the lowering of interest rates cuts fiscal expenditures, perhaps by a substantial amount (e.g. Italy a decade ago). Similarly,
contractionary policy may have stimulative effects when the country has a high debt-to-GDP ratio, especially if a large portion of the debt is short-term. In contrast, monetary policy should have the predicted effects in countries with low debt-to-GDP ratios. The hypothesis is tested using data from 20 OECD countries.

Mark Roberts in Chapter 9 turns attention to the case of the Bank of England, and reviews monetary policy in a chapter entitled ‘The Old Lady in new clothes: uncertainty and the UK monetary policy framework’. This chapter provides an introductory overview of current UK monetary policy, which was introduced in 1997. It involves an instrument-independent but goal-dependent central bank operating according to procedures that emphasize transparency and accountability in the conduct of monetary policy. In providing this overview, the rationale underlying the design of the framework will be explicitly considered in the context of the theoretical literature on the optimal design of monetary policy dating back to Friedman (1968). The chapter concludes with a brief consideration of both the empirical evidence concerning the introduction of the framework on inflation expectations and the challenges that continue to face policymakers operating within the framework.

Charles Goodhart also focuses on the Bank of England case in Chapter 10, which deals with specific questions relating to the UK monetary policy. This chapter is entitled ‘The experience of inflation targeting since 1993’, and asks four questions about the UK’s recent experience with inflation targeting: (1) why has the economy during this period been so successful and stable? (2) how much has been due to good policy? (3) why is the Bank of England’s forecast made on a constant interest rate path assumption? and (4) why have interest rate changes remained so autocorrelated? If the interest rate is set each time so as to drive forecast inflation into line with the desired target at a horizon date, should not interest rate changes then respond to unforeseen shocks, and be random walk? But they are not. The reasons are explored in this chapter.

Chapter 11 also deals with a specific case, this time Canadian monetary policy. Charles Freedman’s chapter is entitled ‘Reflections on the Bank of Canada monetary policy’, and discusses the developments underlying the changes in the monetary policy framework in Canada over the past 30 years. Since the mid-1970s, monetary policy in Canada can be characterized as using or searching for a nominal anchor in a flexible exchange rate environment. In the 1975–82 period, the anchor was the narrow monetary aggregate M1. With the withdrawal of M1 as the target in 1982, the Bank of Canada searched for an alternative anchor for the rest of the decade. In 1991, it introduced inflation targeting, which has subsequently served as the basis for policy. This particular policy framework is the focus of the chapter.
The next two chapters deal with emerging and developing countries. In Chapter 12 A.P. Thirlwall addresses ‘The determinants of saving in developing countries, and the impact of financial liberalization’. The chapter argues that there can be no question that saving and investment are important for economic growth, both directly and indirectly. The question is: what are the major determinants of saving and investment in developing countries, and to what extent can financial liberalization improve saving and investment performance? The conclusion is that traditional theories of savings behaviour are robust, but the impact of financial liberalization is weak. The chapter ends with the question: what is the optimal rate of interest?

Valpy FitzGerald in Chapter 13, ‘Monetary models and inflation targeting in emerging market economies’, extends and modifies the Keynesian critique of inflation targeting with reference to stabilization policy in emerging market economies. The IMF’s ‘basic monetary programming framework’ for developing countries uses government borrowing and the exchange rate as policy instruments in order to achieve specific inflation and balance of payments targets. This chapter first adapts this standard model in order to include short-term capital flows and the floating exchange rate arising from financial liberalization. In this way, the macroeconomic consequences of the current Fund focus on inflation targeting and the use of a single monetary policy instrument (the interest rate, combined with rigid fiscal and reserve ‘rules’) in emerging market economies can be demonstrated. Second, the chapter encompasses the structuralist critique of the negative effect of inflation targeting on capacity utilization and trade competitiveness, leading to an argument for counter-cyclical monetary policy in response to external shocks. An alternative model is constructed within a comparable macroeconomic framework to that of the IMF in order to permit the shortcomings of inflation targeting to be rigorously demonstrated. A macroeconomic stabilization policy based on real exchange rate targeting, bank credit regulation and an active fiscal stance is shown to be more effective in supporting growth and investment.

Finally, in Chapter 14 L. Randall Wray deals with ‘International aspects of current monetary policy’. This chapter examines the monetary policy appropriate for an open economy operating with a floating exchange rate. It is shown that most of the conventional wisdom is flawed. Briefly, the central bank sets the overnight interest rate target and then supplies or drains reserves to ensure that banks have the quantity desired and/or required. The treasury spends by crediting bank accounts and taxes by debiting them; deficits simply mean that bank accounts have been net-credited, hence reserves have increased. If this has created a position of excess reserves, then the central bank or treasury must sell bonds or the overnight rate will fall. Central bank operations are always defensive, and if international payments cause actual reserves to deviate from desired/required reserve positions, the
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central bank has no choice but to ‘sterilize’ by supplying or draining reserves if it has a non-zero overnight rate target. The chapter questions whether there is any strong reason for the central bank to target a positive overnight interest rate in a nation operating with a floating exchange rate.

We wish to thank Edward Elgar, Dymphna Evans and Matthew Pitman for their encouragement and close collaboration on this and on many other projects. As always we are hugely grateful to all three of them and to their staff. Special thanks must go to Karen McCarthy for a truly excellent job as Deputy Managing Editor. We are also most grateful to our employers and associates who have been very helpful on this and many other occasions. Above all our gratitude and appreciation go to Warren Mosler of Valance Inc., and Senior Associate Fellow, Cambridge Centre for Economic and Public Policy, University of Cambridge, UK, for his continuous and unrelenting support.

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