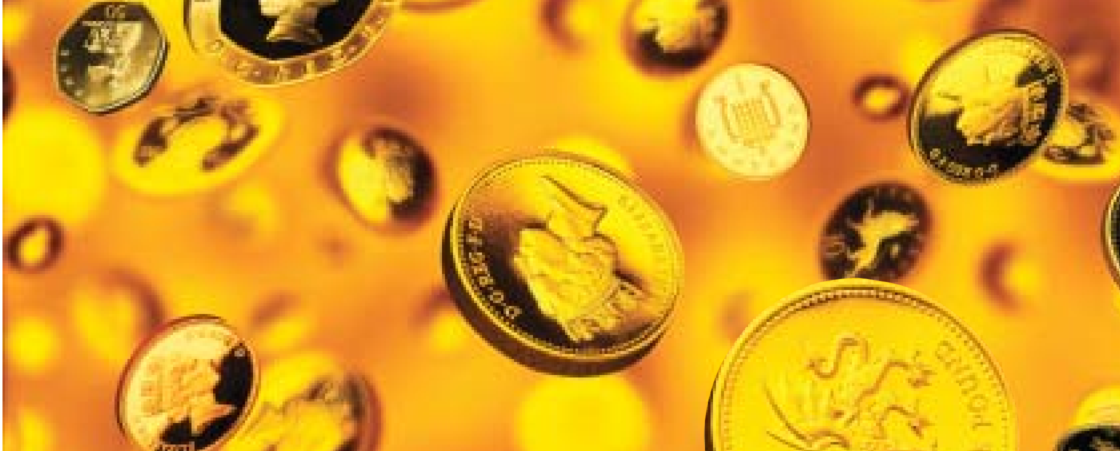
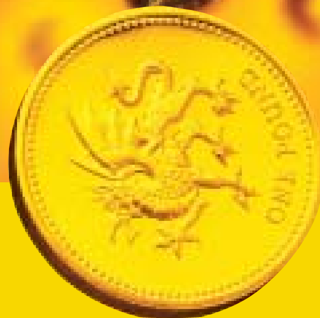




Julian Hodge Institute
of Applied Macroeconomics

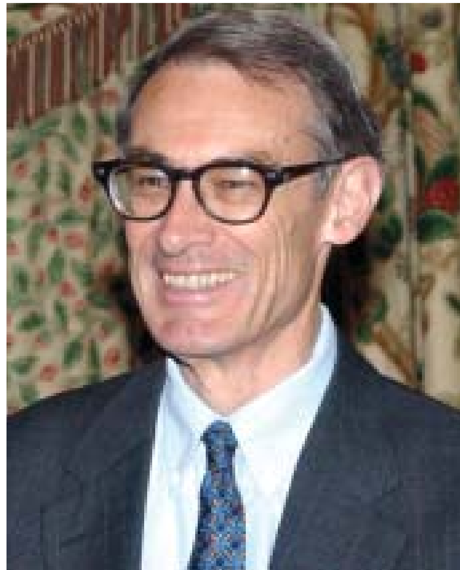
Annual Lecture

British Monetary arrangements

present and future

Tuesday 6th May 2003
Thistle Hotel Cardiff

Professor Bennett T. McCallum
H.J. Heinz Professor of Economics
at Carnegie Mellon University, Pittsburgh



Bennett McCallum is the H.J. Heinz Professor of Economics in the Graduate School of Industrial Administration at Carnegie Mellon University. His other activities include those of a research associate of the National Bureau of Economic Research, a research advisor for the Federal Reserve Bank of Richmond, and a Fellow of the Econometric Society. Professor McCallum has been a consultant to the Federal Reserve Board and a visiting scholar at the International Monetary Fund, the Bank of Japan, and the Reserve Bank of New Zealand. He is the author of Monetary Economics: Theory and Policy (Macmillan, 1989) and International Monetary Economics (Oxford University Press, 1996) and has published over 150 papers on a variety of topics in monetary economics, macroeconomics, and econometrics. He currently serves on the editorial boards of the Journal of Monetary Economics; Journal of Money, Credit, and Banking; Economics Letters; and the International Journal of Finance and Economics. He is a former co-editor of the American Economic Review and since 1995 has been co-editor of the Carnegie-Rochester Conference Series on Public Policy.

British Monetary arrangements
present and future

I am very pleased and honoured to be here for this occasion. I am not a specialist in British affairs, but fortunately it does not take a great deal of expertise to argue the position that UK monetary policy has really been very successful over the past ten years, certainly in relation to the previous 20 years or so. I single out the most recent ten years because that span corresponds fairly closely to the period since the Bank of England began its inflation-targeting regime following the rather painful exit of sterling from the ERM in September of 1992. You are all aware that UK inflation has been quite low in the period since then and I hope very much that you share my belief that keeping inflation low is the primary responsibility of a central bank, with a secondary objective of doing what it can to reduce undesirable cyclical fluctuations in output and employment. One thing that it can do in that regard is to avoid the creation of shocks generated by itself -that is, it can conduct policy in a systematic, predictable, and understandable manner. None of this emphasis on inflation prevention implies that the central bank is unconcerned with the growth of real output and real income, but rather implies the belief that the central bank can contribute most effectively to that goal by providing a stable monetary framework in which private enterprise can flourish.

So, obviously, my impression is that the current inflation-targeting framework in the UK is basically sound. Furthermore, the set-up of the MPC has been designed to elicit the best advice from each of the members, so implementation also seems to be quite good. In fact these rather positive views are quite widely held in the monetary economics profession, with the Bank of England arrangement often drawing praise from scholars in the US and elsewhere. One notable example is worth mentioning.

In 2001 the Swedish economist Lars Svensson (who has now moved to America) completed a commissioned study entitled 'Independent Review of the Operation of Monetary Policy in New Zealand.' This was commissioned by the New Zealand government after a little over ten years of experience with their pioneering inflation targeting regime. This document is quite unusual: a nearly 100-page overview study conducted by a leading scholar for a major monetary institution. In fact, many believe that it is potentially of historic significance. In it, Svensson praises the Reserve Bank of New Zealand as acting in a manner comparable to the Bank of England and the Swedish Riksbank, which he describes as exemplifying 'the best international practice.' That illustrates how the profession thinks about the Bank of England these days.

To emphasize how much better recent inflation experience has been, relative to previous decades, I have prepared a table that gives RPIX inflation for the past 30 years. The most recent 10 years represent the inflation targeting regime, whereas the previous two decades span the rest of the time since the end of the Bretton Woods system. The table's first column reports the inflation rate and the second is the square of inflation minus the target value 2.5 (percent per annum). Of course there was no 2.5 percent target during the earlier decades, but there should have been. The final column gives the square root of the mean loss over each decade, an appropriate measure of the anti-inflation performance. Using that measure, the most recent decade's performance has been over eight times better than the previous decade and over 35 times better than the immediate post-Bretton Woods decade!

obs	INFL	LOSS	RMLOSS
1973	9.200000	44.89000	12.47357
1974	16.00000	182.2500	12.47357
1975	24.20000	470.8900	12.47357
1976	16.70000	201.6400	12.47357
1977	15.90000	179.5600	12.47357
1978	8.600000	37.21000	12.47357
1979	12.60000	102.0100	12.47357
1980	16.90000	207.3600	12.47357
1981	12.20000	94.09000	12.47357
1982	8.500000	36.00000	12.47357
1983	5.200000	7.290000	3.017284
1984	4.500000	4.000000	3.017284
1985	5.200000	7.290000	3.017284
1986	3.600000	1.210000	3.017284
1987	3.700000	1.440000	3.017284
1988	4.600000	4.410000	3.017284
1989	5.900000	11.56000	3.017284
1990	8.100000	31.36000	3.017284
1991	6.700000	17.64000	3.017284
1992	4.700000	4.840000	3.017284
1993	3.000000	0.250000	0.353553
1994	2.300000	0.040000	0.353553
1995	2.900000	0.160000	0.353553
1996	3.000000	0.250000	0.353553
1997	2.800000	0.090000	0.353553
1998	2.600000	0.010000	0.353553
1999	2.300000	0.040000	0.353553
2000	2.100000	0.160000	0.353553
2001	2.100000	0.160000	0.353553
2002	2.200000	0.090000	0.353553

The Japanese situation—and the problem of deflation

But it is important to realise that the type of target utilised by the Bank of England seeks not only to keep inflation low, but also to keep it away from negative values: to prevent deflation. Some of the reasons why this is a good idea are emphasised by the history of Japan over the last ten years, where long-lasting deflation, plus a low steady state real rate of interest, have combined to produce a 'liquidity trap' situation -one in which the nominal interest rate is essentially zero. You cannot push nominal interest rates below zero, so if the Bank of Japan needs to have a monetary stimulus, it cannot get it by lowering the short-term interest rate, in the usual way. In fact Japan has had a very weak level of aggregate demand and historically high unemployment rates over the past six or seven years and monetary stimulus has not been able to be generated by the usual step of reducing short-term rates because they have already been so close to this lower bound of zero.

Obviously, such a situation makes the level of short-term rates a useless tool for monetary policy stimulus. But, one might ask, why it would not work for the Bank of Japan just to create a lot of base money (M0, as it is called in the UK) by open market operations? The reason is that with the opportunity cost (foregone interest) of holding cash equal to zero, rational banks and other asset holders will have expanded their holdings of money to the point of satiation, where the marginal service yield of additional money balances is zero. Thus at the margin money and short-term securities are (under these conditions) perfect substitutes. Consequently, asset holders will be indifferent if an open market purchase by the central bank reduces their holdings of short-term securities in favor of money. Therefore, there will be no asset rebalancing response by private agents to an open market purchase of this type; it will be totally ineffective. In other words, standard open market purchases have no impact on anything. This is the problem that has confronted the Bank of Japan (BOJ) and has puzzled many economists.

I do not want to argue that the central bank can not do anything in such a situation as Japan's during recent years, but what I do want to argue it is there is a need to purchase some unconventional assets - not just the ordinary overnight short term government securities that are usually purchased in open market operations. My own preferred scheme, which I have been promoting for several years, would be for the Bank of Japan (or for most central banks, if in such a situation) to purchase foreign exchange. I think that foreign exchange would be a more effective asset to purchase than domestic (i.e., Japanese) long term government bonds, because it seems to me that foreign exchange is probably a less close substitute for short term Japanese bonds and for money. Furthermore, the exchange rate transmission channel seems more amenable

to economic analysis. Note that this proposed scheme would involve foreign exchange purchases but would not involve an exchange rate target. It would involve use of the exchange rate as an instrument or information variable, with inflation and possibly other macro-economic variables serving as the targets. Therefore it doesn't call for a competitive devaluation, as some people in the IMF have assumed and stated as an objection to this kind of monetary stimulus.

My suggestion would be for the Bank of Japan to use the exchange rate instead of the interest rate as their monetary instrument, 'tightening' conditions by appreciation when inflation or output was high and of course loosening them by depreciation when as now there is deflation and output is low. This is a method for avoiding deflation, which is important for all central banks and has been a leading problem discussed by not only academics but practical people.

I might continue for a minute with the Bank of Japan case by considering why it has not adopted such a scheme. There are really two major reasons. First, there has been a fear by the IMF, the U.S. Treasury under previous administrations, and other nations, that following this kind of scheme would bring about a depreciation of the yen that would reduce Japan's demand for imports. They were worried about this being damaging to the U.S., the Philippines, South Korea, and others of Japan's

various trading partners -especially during the 1997-98 South Asian crisis. I think this worry is probably misplaced. After all, the whole purpose of the proposed change in policy is to increase Japanese income and an increase in Japanese income would very reliably increase Japanese imports. Now the change in the exchange rate that goes along with this whole scheme may work against that, but the working of those effects seems much more dubious than the effect of the income changes.

The second reason is that the Bank of Japan has interpreted their charter - the 1997 Bank of Japan Law, which gave them independence - as

requiring that all foreign exchange transactions must be decided by the Ministry of Finance, i.e., that the Bank of Japan is forbidden to conduct monetary policy in the manner that I have proposed. Since this was a belief that seemed to be halting proposals that several of us economists have made, I decided to study the Bank of Japan Law (in its English translation, of course). What it says is that all foreign exchange transactions made by the Bank of Japan for the purpose of stabilising the exchange rate or co-operating with international agencies (such as the IMF or other central banks) must be directed by the Ministry of Finance. So it does say that for those classes of foreign exchange operations the Bank of Japan must do what the Ministry of Finance suggests. However, the Law does not say anything about foreign exchange transactions conducted for the purpose of conducting monetary policy - but that is what is being proposed here. Also, the Law gives the Bank of Japan the responsibility for conducting monetary policy so as to maintain price stability - which would imply not permitting the deflation they have been having - and supporting a sound macroeconomic policy.

So my conclusion from all of this is that the Bank of Japan Law is ambiguous and perhaps internally inconsistent. In any case, it provides scope for the Bank of Japan to conduct monetary policy via the foreign exchange market if it will simply ask and receive permission from the Prime Minister and the Ministry of Finance. Now the government including the Ministry of Finance has wanted the Bank to be more expansionary for years, so it would seem straightforward for the Bank of Japan to obtain permission to do this sort of thing, rather than just say we cannot because the law says we cannot. I have to admit, however, that nothing is truly straightforward in political relationships involving the Bank of Japan or anything else Japanese!

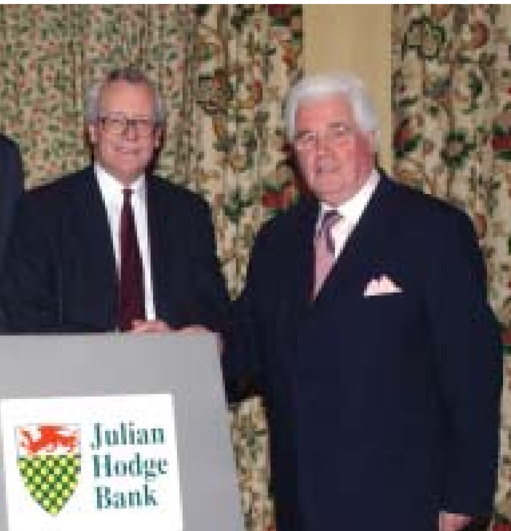
Since I seem to be straying away from the main topic, which is British monetary policy not Japanese, I would like to say that the purpose of this detour is to consider the possibility of deflation - falling prices - and the point of the discussion is to emphasise that an independent central bank does have tools for preventing deflation, if it will just honestly try to do so. It is, after all, not hard to make one's currency fall in value. If all else fails the central bank can make massive purchases of foreign exchange, depreciating the currency both externally and internally. There have even been a couple of arguments about that claim, but just think about it: suppose a country could make unlimited purchases of foreign exchange without depreciating its currency. Then that country could print money and go around buying up all the assets in the world. The citizens of that country would certainly become extremely wealthy even if they didn't get out of their deflation so there could be nothing to be lost from trying this!

The US monetary framework compared

I should say a few words about the major difference between the UK monetary policy framework and that of the United States. The basic difference is the UK has an inflation targeting regime, in which attention is focussed on explicit numerical inflation targets and the quarterly inflation report issued by the Bank of England. We have nothing like that. What we have is a Chairman of the Fed , Alan Greenspan, who has been highly successful during the last fifteen years. But the Fed's formal legislative mandate, which dates from 1975, is either vague or internally inconsistent or both. Therefore, many economists - within the Federal Reserve system, as well as academics--believe that a better official designation of the Fed's monetary responsibilities would be highly desirable. It would provide, we would hope, some institutionalization of a regime of stable low inflation, rather than sole reliance on the skill and judgement of the person that just happens to be the chairman of the Board of Governors.

Prof. Roger Mansfield (Cardiff Business School), Prof. Business School. Director of the Julian Hodge Institute (Chairman, Julian Hodge Bank).

There was a small upsurge in interest in this issue a few weeks ago, especially after the Wall Street Journal published an article describing a supposed dispute between two members of the Board of Governors, Ben Bernanke and Donald Kohn. Bernanke is a Princeton academic who took a position on the Board of Governors about a year and a half ago and after a suitably polite lapse of time began campaigning for an inflation targeting regime. Kohn is an economist who has worked for many years at the Fed as the main policy advisor to Greenspan and who, like Greenspan, is opposed to such a change. He was appointed to be a member of the Board of Governors recently, at the same time as Bernanke. Actually, these two people were not directly arguing with each other but had both given presentations at the same conference held last January in Miami (Kohn was commenting on a paper by Marvin Goodfriend, from the Richmond Fed, who was arguing for an inflation target.) Nevertheless I was really rather pleased that the press was playing up this supposed



Bennett McCallum, Prof. Patrick Minford (Cardiff of Applied Macroeconomics), Eric Hammonds

personal warfare, although there wasn't any, because it meant that the idea of moving towards an inflation targeting regime was getting a lot of attention and made it seem something of a live issue. I was pleased about that. More recently, however, the prospects of anything happening anytime in the foreseeable future have taken something of a plunge because it has become known, first, that Bernanke may be going back to Princeton within the year and, secondly, that President Bush intends to appoint Greenspan for yet another term.

Why is it that Greenspan and Kohn argue against any more explicit inflation targeting legislation? Their stated reason is that it would be too restrictive - that situations could arise in which such legislation would prevent them from taking policy actions that are desirable. That position seems to me rather weak. The most strict of the inflation targeting regimes is that of New Zealand and their regime has not kept the Reserve Bank of New Zealand from moving monetary policy in a more expansionary direction two or three times since their system was introduced. Furthermore, Mervyn King, who will be the next Governor of The Bank of England, does not interpret the Bank of England's system as requiring the bank to be unconcerned with fluctuations in output or to be excessively bound by the inflation targeting aspect of it - instead, he thinks that it is helpful. In fact Mervyn King is widely credited with introduction of the derogatory term "inflation nutter" to refer to someone who is concerned only with inflation performance. It is a phrase that has taken international significance - and Mervyn King was the first to promote the term. This illustrates that he does not believe that keeping inflation low is the only thing that the central bank cares about, that inflation targeting regimes can be valuable even if you believe that other objectives are important.

Thus it seems not to be the case that such regimes would overly restrict the behaviour of a country such as the United States. Many U.S economists believe that the United States would be better off with a legislative arrangement more

like that of the UK or New Zealand; but I do not think we are likely to get one anytime soon. I must say, with respect to Greenspan's reluctance, that there is a possibility that it might stem not from the belief that such a legislative arrangement would be a bad thing so much as a belief that it would be unwise to open up the issue of monetary policy goals to discussion and consideration by the United States Congress. I must say that I too have found that prospect somewhat frightening. The Congress has in recent years seemed quite unable to develop thoughtful and sound legislative arrangements. In the field of economics, discussions feature much posturing to the TV cameras and special interest groups with little evidence of concern for the long run health of the nation. So it is possible that reconsideration of the Federal Reserve system's legislative mandate would leave us with an even more undesirable statement of monetary policy goals than we have at present.

As a result I am becoming more attracted to the idea that the Fed should just move toward an inflation targeting regime on its own, basically by publishing something like the Bank of England's Inflation Report. This would be a quarterly document that would explain the Fed's evaluation of current conditions and its approach to monetary policy plus the way in which these conditions and the approach combine to rationalise its current and recent policy actions. It would be an educational document regarding monetary policy as well as an explanation of what the Fed is currently doing. I think they might just start doing this; if things went well the Congress would then undoubtedly be happy to let them continue.

The issue regarding the Euro

I have thus far have not mentioned the European Central Bank. That omission cannot continue, since presumably the biggest issue of all for most of you in the room is whether the UK will or should join the Euro system. My own first reaction to such an issue is an emotional one - i.e., not entirely logical - which is that it would be a real shame to put an end to the British monetary system in place now so soon after it has established itself as one of the finest monetary policy mechanisms in existence, now or ever. The end of the pound would not only deprive the British people of their national currency but would deprive monetary economists of an excellent object of study and analysis!

Of course that viewpoint is irresponsible, short-sighted, and incomplete. We have to think more seriously about the UK joining the euro system. A natural starting point for that might be to ask whether the Euro system itself is well designed and whether the ECB has been performing well in its conduct of monetary policy. (The ECB has,as you know, received a

lot of criticism.) Since these are huge topics that many of you have read and thought about extensively, there is not much point in my trying to treat them carefully. Let me just make a couple of points very briefly. First, the design provided by the Maastricht treaty of the European central bank is basically rather good, I think. It definitely focuses on the overriding objective of price stability. I also believe that the performance of the ECB thus far has been quite commendable. By contrast, however, the famous stability and growth pact that has to do with fiscal arrangements strikes me as rather poorly conceived.

Turning then to the issue of UK membership, I imagine that you have heard many times the statement of the way that the pure economist puts this issue, which is as follows. Would the advantages of having a common currency with Europe outweigh the disadvantage of being unable to tailor monetary policy to current conditions and developments in the United Kingdom? To me the answer is not entirely clear cut and I could not tell you nearly as much about it as Patrick Minford could. I have been rather impressed by some of his arguments, which suggest that there is a fairly clear answer, but I won't try to develop it myself.

Indeed, in thinking about the issue of possibly joining with the Euro I am constantly driven toward the strongly political nature of the decision. In that regard I have long realised that one of the leading motivations for creating the European monetary system was to develop an economic and political entity that would be large and powerful enough to challenge the United States - they used to worry about challenging Japan, but that has faded away - for worldwide leadership. It was only during the last few months, however, that I have come to realise the intensity and depth of anti-American motivation present in some portions of the European Union. So perhaps the United Kingdom should think about the issue partly along those lines. Does it really want to align itself with a fundamentally anti-American entity? That is of course a very loaded question, posed from an American point of view! But it may nevertheless be important. Of course, one possible answer is that with the UK included as a core member and participant in the Euro system, Europe would become less antagonistic to the United States. But I certainly do not feel much confidence in that regard.

There are more things that need to be said about possible future monetary arrangements for the UK, but I think that I have already run over my allotted time. Thank you very much.

Julian Hodge Bank

A history of past lectures

The first Julian Hodge Institute of Applied Macroeconomics Lecture was delivered in 2000. Since this time the lecture series held in Cardiff, has included some of the world's leading economists.

2000 - Sir Alan Walters - former Chief Economic Adviser to Mrs (now Lady) Margaret Thatcher.
2001 - Professor Otmar Issing - Board Member and Chief Economist, European Central Bank
2002 - Sir Alan Budd - Member of the Bank of England's Monetary Policy Committee and Chief Economic Adviser to the Treasury from 1991-1997.

Before this a series of lectures associated with Sir Julian Hodge commenced in 1970 entitled the Jane Hodge Memorial Lectures.

1970 - The Rt. Hon. Sir Leslie O'Brien GBE , Governor of the Bank of England.
1971 - M. Pierre - Paul Schweitzer, Managing Director of the International Monetary Fund (IMF).
1973 - David Rockefeller LLD, PhD, Chairman, Chase Manhattan Bank.
1973 - H.R.H. The Prince Philip Duke of Edinburgh.
1976 - His Excellency Sheikh Ahmed Zaki Yamani.
1984 - Robin Leigh Pemberton, Governor of the Bank of England.
1990 - Sir George Blunden, Deputy Governor of the Bank of England

The Julian Hodge Institute of Applied Macroeconomics therefore carries on the very proud tradition of promoting debate and understanding of present day economic issues.