How the World Achieved consensus on Monetary Policy

Sabine Gausserand

Anne Guagliardo

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Introduction

- Monetary policy in disarray in the 1970's: inflation peaked 10% in 1974 and 1980 + 6 recessions between 1955 and 1985.
- No sucess in reducing inflation during that period.
- Turning point in 1979: Paul Vocker becomes chairman of the Federal Reserve.
- The Volcker Fed brought the inflation rate down to 4 % by1980 .
- Parallel developments around the world: average inflation worldwide declined from 14% to 4% between 1980 and 2000.
  - From 9 to 2% in the industrial economies.
  - From 31 to 6% in the developing economies.

Content

→ *How did the world achieve a working consensus on the core principles of monetary policy by the late 1990's?*

1) Practical and theorical disarray in the 1970's
2) Federal Reserve contributions to monetary policy practice
3) International aspects of the consensus
4) Academic advances contributing to the consensus
5) How consensus theory supports monetary policy practice

Practical and Theoretical Disarray in the 1970's

- Main cause of that trouble: The central bank (Federal Reserve) tended to pursue « go-stop » monetary policy.

→Definitions of **Go-stop policy**:

- Short-term policy aimed at keeping a delicate balance between two seemingly contradictory objectives, such as reducing the unemployment rate as well as the inflation rate.

- A government economic policy in which action taken to boost the economy (**go**) results in inflation or exchange rate problems. Action is then taken to cure these problems, which results in a slow-down of the economy (**stop**). The process was particularly applied to the incomes policies tried out in many countries without much success in the 1960's.

The Bretton Woods system

- **Bretton Woods system (1944)** : obligation for each country to adopt a monetary policy that maintained the exchange rate of its currency within a fixed value terms of gold and the ability of the IMF to bridge temporary imbalances of payments.
- BW system incompatible with the economic situation in the late 1960's, namely an increasingly inflationary go-stop policy in the US.
- Consequences: the system collapsed in 1971 => suspension of convertibility from dollars to gold that contributed to the nervousness about inflation.
- Jamaica Agreement (1976): adoption of a floating exchange rate system.

Keynesians vs. Monetarists

- Macroeconomists had long realized that inflation expectations play a central role in propagating wage and price inflation.

- However, the disarray in monetary policy practice was reflected in deep divisions within the academic world. Two main theories appeared: the Monetarist and Keynesian one.

- They divided sharply over whether monetary policy could manage inflation expectations in practice.

MONETARISTS

Friedman, Brunner, Meltzer

A central bank had the monetary policy tools to act decisively against inflation.

*even if short term inflation can be affected by many factors, long-term sustained inflation is always associated with excessive money growth.

*the control of money is both necessary and sufficient to control the trend rate of inflation.

*the central bank could exercise sufficient control over money to control inflation

KEYNESIANS

Tobin

The price and wage-settings institutions of the economy have an inflationary bias. Consequentely, demand management cannot stabilize the price trend without chronic sacrifice of output and employment unless assisted (occasionally or permanently) by direct income policy of some kind.

Paul Volcker: the turning point…

- Paul Volcker, a Democrat, Chairman of the Federal Reserve in 1979.
- Volcker's Fed is widely credited with ending the United States' stagflation crisis of the 1970s by limiting the growth of the money supply, abandoning the previous policy of targeting interest rates.
- Inflation, which peaked at 13.5% in 1981, was successfully lowered to 3.2% by 1983. The change in policy contributed to the significant recession the U.S. economy (in the early 1980’s), which included the highest unemployment levels since the Great Depression.

Key principles of the new consensus monetary policy

The Volcker desinflation taught 3 lessons:

- Monetary policy alone – without wage, price or credit controls and supportive fiscal policy – could reduce inflation permanently at a cost to output and unemployment.
- A determined independent central bank can acquire credibility for low inflation without an institutional mandate from the governement.
- A well-timed aggressive interest rate tightening can reduce inflation expectations and preempt a resurgence of inflation without creating a recession.

Additional practical principles of the new consensus

-The most important principle is that monetary policy could sustain low inflation with low employment on average, and with infrequent mild recessions.

- Flexibility in moving inflation back to target after a shock.

- It's preferable and more productive to reveal the federal funds rate target to the public. In time, the public would come to see monetary policy through management of the federal funds rate as a stabilizing force for inflation, employment and long-term interest rates.

- Credibility for low inflation strengthens the power of monetary policy to counteract recessions and guards against inflation scares.

International aspect of the consensus

- Other countries followed the tendency to reduce inflation, New Zealand and Canada in 1990 and 1991, UK and Sweden in 1992 and some emerging market economies (Thailand, Philippines) at the end of the decade.
- The Eurosystem was launched in January 1999 to manage monetary policy in the euro area. It includes both the central bank and the national central banks of the countries that have adapted the euro.
- It defines price stability as a rate of inflation below 2%, but aims to maintain close to 2% over the medium term.

Convergence and Divergence in the ideas of the consensus

- Convergence in the ideas of the current consensus theory in 1980:

-prices are marked up over costs.

-price trends depend on expectations.

-natural rate of unemployement at which wage and price setters perpetuate the going rate of inflation.

-inflation accelerates when output is expected to exceed potential.

- Nevertheless, the unresolved problems were crucial:

-the price and wage-setting process.

-expectations.

-transmission of monetary policy.

-real factors business cycles.

The New Keynesian Model / New Neoclassical Synthesis

- Much of the disarray reflected earlier in disputes between monetarist and keynesian economists has been resolved in the consensus benchmark model of monetary policy.
- The consensus model incorportates **classical features** (intertemporal optimization, rational expectations and a real business cycle core) and **keynesian features** (monopolistically competitive firms staggered sticky nominal price setting and a central role for monetary stabilization policy).
- This consensus also bears **new ideas**: central banks should use transparency and communications to facilitate an understanding of their interest rate policy actions to strenghten the credibility of their commitment to low inflation.

Main advances in monetary policy with the consensus model

-The consensus model of monetary policy reinforces 4 main advances in economic policy:

- the priority for price stability.
- the targeting of core rather than headline inflation.
- the importance of credibility for low inflation.
- preemptive interest rate policy supported by transparent objectives and procedures.

Conclusion

- Worldwide progress in monetary policy: great achievement and remarkable success story compared to 30 years ago.
- This new working consensus has helped to reduce the volatility of both inflation and output.
- Still, plenty of unfinished business and scope for controversy.
- Among the main controversial issues are:

- The quantitive significance of sticky nominal price and wage adjustments for monetary policy.
- No theory explains the loss or acquisition of credibility for low inflation.
- How do inflation scares occur?
- Institutional mechanisms to support credibility for target inflation?

→ Need to improve statistical indicators and real-time estimates.

- Today, academics, central bank economists and policy makers around the world work together on monetary policy as never before.
- The worldwide working consensus provides a foundation for future work.

Indeed, this consensus was forged out practical lessons from diverse national experiences over decades and it provides a common ground to understand monetary policy.