

So far from Ricardo, so close to WickSELL

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Monetary and financial stability

- Not normally a trade-off.
- Price stability a prerequisite for financial markets to function well
- But CPI stability does not rule out asset price bubbles

Japan in the 1980's

- No significant CPI inflation
- If the CB had worked with an inflation target, it would not have acted differently.
- But two enormous asset-price bubbles were growing over the decade.

Conclusion:

Inflation targeting cannot be the end-all of monetary policy

- 1990 was a *long time ago*. Much has changed:
 - – payments practices and the monitoring of credit
 - – deregulation of banking and the rise of financial conglomerates
 - – securitization of loans
 - – the growth of derivatives markets

Lessons of History?

- Each major stage in the evolution of finance has introduced new instabilities
- learning to stabilize the system has taken time
- Adaptation by trial-and-error
- Some of the “errors” have been huge

- Will the present stage in financial evolution be different?
- Two questions:
 - 1) Have the developments mentioned above made the world a safer place – so we do not have to worry?
 - 2) If something does go wrong, are the powers of Central Banks adequate to cope with the consequences?.

A Century of inflation targeting (theory)

- Michael Woodford, **Interest and Prices**
(2003)
- Wicksell “Taylor’ed” to modern taste
- Knut Wicksell, **Geldzins und Güterpreise**
(1898)

Wicksell's Spectrum

Ricardo

Wicksell



$$M^s = \left(\frac{1+g}{g+r} \right) G$$

$$g \rightarrow 0$$

$$r \rightarrow 0$$

$$P = \frac{V}{X} M$$

P indeterminate



- Wicksell: Not there yet, but getting closer
- Still *some* demand for outside money, but small, getting smaller....

- Patinkin's theorem (1960)
 - sufficient that CB can control *one* interest rate and *one* nominal quantity (for which the private sector unable to produce a close substitute)

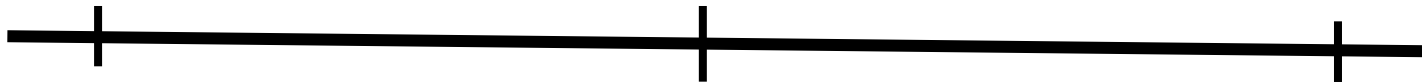
- Will controlling copper coins do?
- Suffices only to create “coin shortage”

- For larger stocks, the “no close substitute” condition always suspect
- Result: Goodhart’s Law

Wicksell's Spectrum again

Ricardo

Wicksell



$$M = \frac{1+c}{c+r} B$$

Revival of the quantity theory

Powers of central banks

- Inflation targeting successes
- Claim deserved – or historically unique conjuncture?

- Was Greenspan “the most powerful man in the world”?
- If you hike Bank rate 13 or 14 times and the market pays no attention, how powerful are you really?
- Or was it masterly matching of market rate to natural rate?
- Also: attempts to reflate by Bank of Japan

Easy money and no inflation

- World awash in liquidity, but no inflation.
- How explain it?
- Milton F: “inflation always and everywhere... etc.
- Lemma: absence of inflation also a monetary phenomenon
- So: Exchange rate policies of a number of CBs
- But also: Bank of Japan and Fed were fighting deflation

- Suppose a *very* expansionary monetary policy ... and no inflation.
- What do you get?
- A: asset price inflation and general deterioration of credit standards

The trouble with inflation targeting

- Wicksellian policy *adaptive*
- Behavior of price level should tell you whether your policy is too little, too much, or just right...
- Crucial feedback loop short-circuited by exchange rate policies of China, Russia, et al.
- Price level gave *no clue* to Fed that it was more than a dozen quarter-points below the market

- Japan since 1990 shows that inflation-targeting will not by itself protect against financial instability
- To which we may now add:
- Inflation targeting may mislead you into policy actively damaging to financial stability

A Safer World?

- We have had some asset-price inflation and considerable lowering of credit standards
- How serious is it? – We don't know.
- Has securitization of loans and credit derivatives made the world a safer place?

- Risks now widely dispersed
- No longer concentrated in the banks

- But system as a whole has taken on more risk
- Risk spreads exceptionally compressed

Liquidity and Imbalances

- The sanguine view:
- LTCM was dealt with so smoothly
- Enron et al. did not spook the market
- Amaranth caused not a ripple....

- What dangers might materialize will depend on:
- First, how the extraordinary liquidity will be absorbed (through inflation or contractionary policies)
- Where the inflationary pressures will first be felt and how national policies react

- Second, how (and when) current financial imbalances will eventually be resolved.
- The two are obviously related and the possible scenarios are numerous
- We live in interesting times.....