Lecture 5:
Where the Great Experiment went Wrong.

Gresham College

Jagjit S. Chadha
University of Kent

Kent

April 2015

Outline of Arguments

- Was inflation a sufficient statistic to stabilise an economy?
- If inflation was the present value of output gaps then maybe yes...
- Errors in outgap-ology would exist but probably not persist.
- Stable inflation expectations explained that agents expected the right thing to be done to stabilise output gaps but they do not pin down any particular path for output
- Heavyweight debate on the role of asset prices and financial factors for NK ITs
- Financial structures may have been building a risk to stability

The Start and the End Point

"The received wisdom is that risk increases in recessions and falls in booms. In contrast, it may be more helpful to think of risk as increasing during upswings, as financial imbalances build up, and materialising in recessions."

A. D. Crockett (2000).

"It was to avoid the historic British problem - the violence of the repeated boom and bust cycles of the past - that we established the new monetary framework based on consistent rules - the symmetrical inflation target; settled well understood procedures - Bank independence; and openness and transparency. And side by side with it and as important, a new fiscal discipline with, again, clear and consistent rules - the golden rule for public spending; well understood procedures - our fiscal responsibility legislation; and a new openness and transparency..."

G. Brown (2000)

The Independence Surprise

"We propose a new monetary policy committee to decide on the advice which the Bank of England should give to the Chancellor."

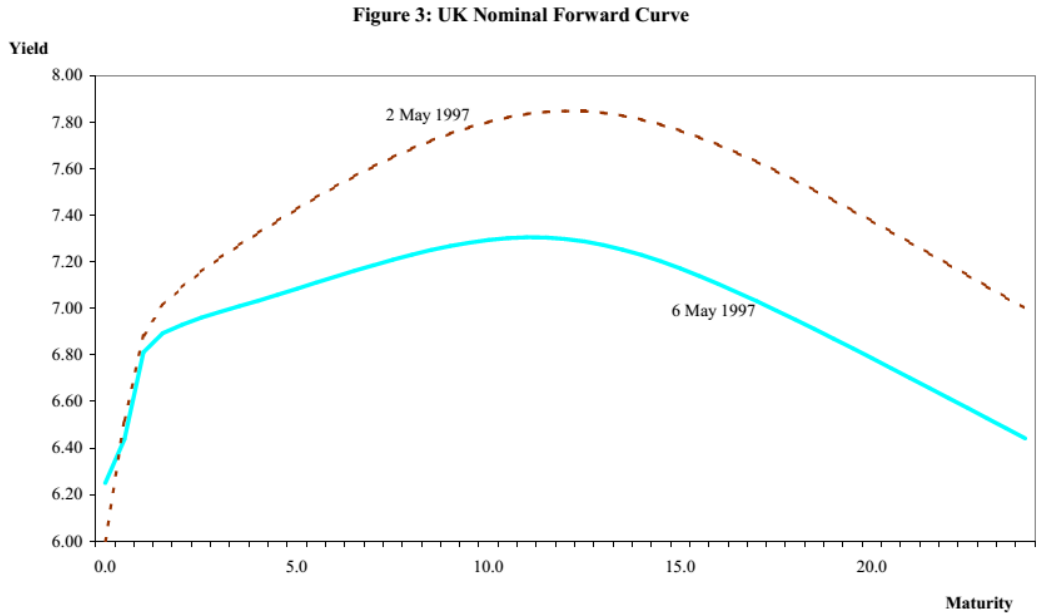
The Labour Party's Business Manifesto published on April 11 1997

"...I was very surprised by the timing – the decision to move [on independence] immediately on taking office...the markets believed that the politicians would not let go of the decisions on implementation of monetary policy. And this was damaging. It meant that inflation expectations did not adjust to the extent that they might have done to the decline in actual inflation. The impact on expectations is shown by the fact that bond yields dropped 50 basis points on the announcement by the incoming government in May 1997."

Governor Sir Eddie George

- Appointment of a conservative central banker? Inflation nutter? Or a credible commitment technology?

Independence Day



- May 6th 1997 - Surprise announcement by incoming Labour Administration
- Consistent with a large increase in inflation aversion.

Economic Record in the Long Expansion

- Output growth and inflation positive and under 5%. See previous lecture.
- RPI and then CPI inflation stable and expectations thereof.
- Fast growth in money and credit, secured on property
- Global lowering of real rates and transfer of funds globally
- Macroeconomic stability accompanied by an increase in risk from financial claims

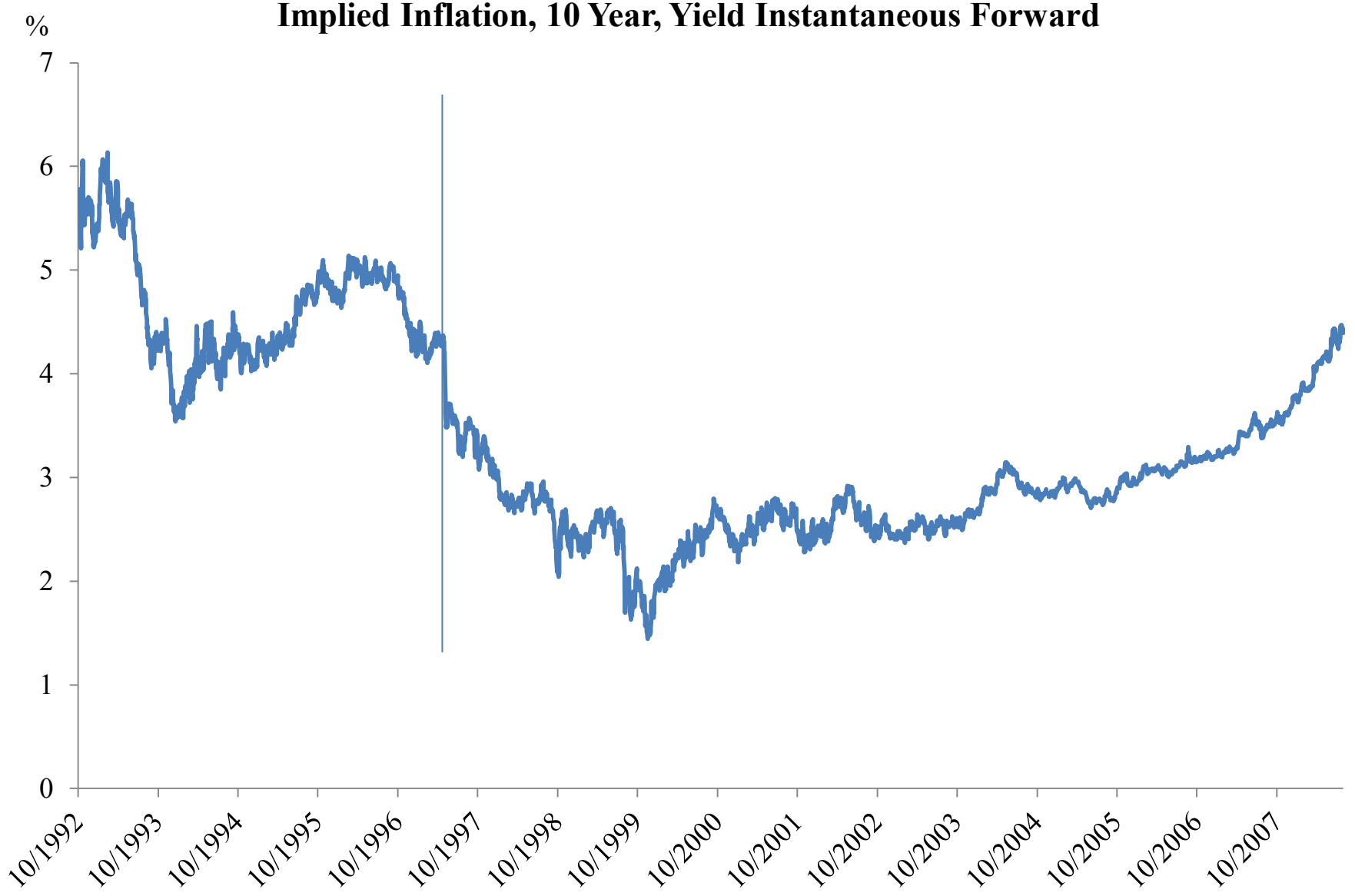

Implied Inflation, 10 Year, Yield Instantaneous Forward
%
7
6
5
4
3
2
1
0
10/1992
10/1993
10/1994
10/1995
10/1996
10/1997
10/1998
10/1999
10/2000
10/2001
10/2002
10/2003
10/2004
10/2005
10/2006
10/2007

Chart 1: Surveys of Household Inflation Expectations

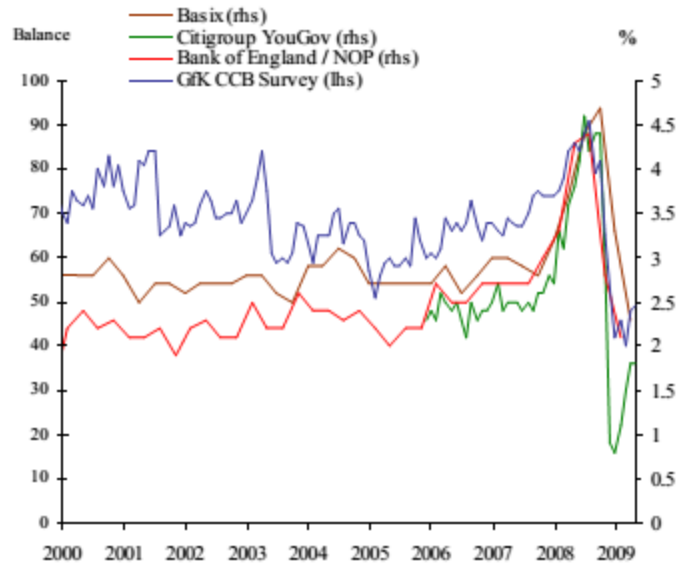
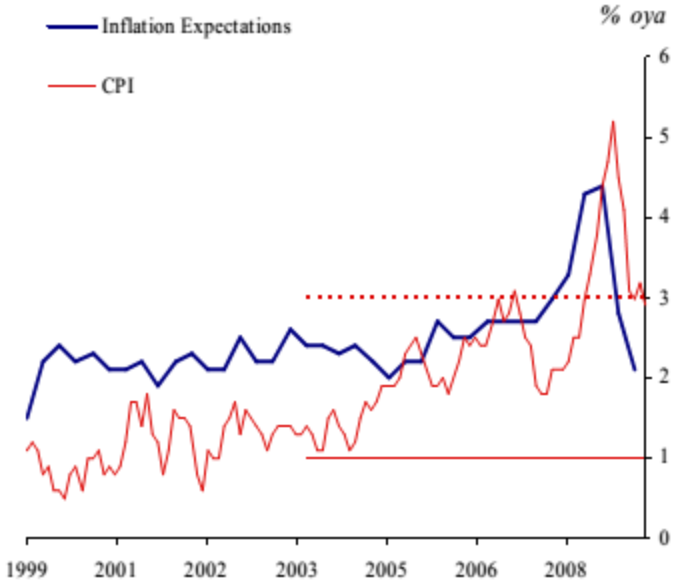
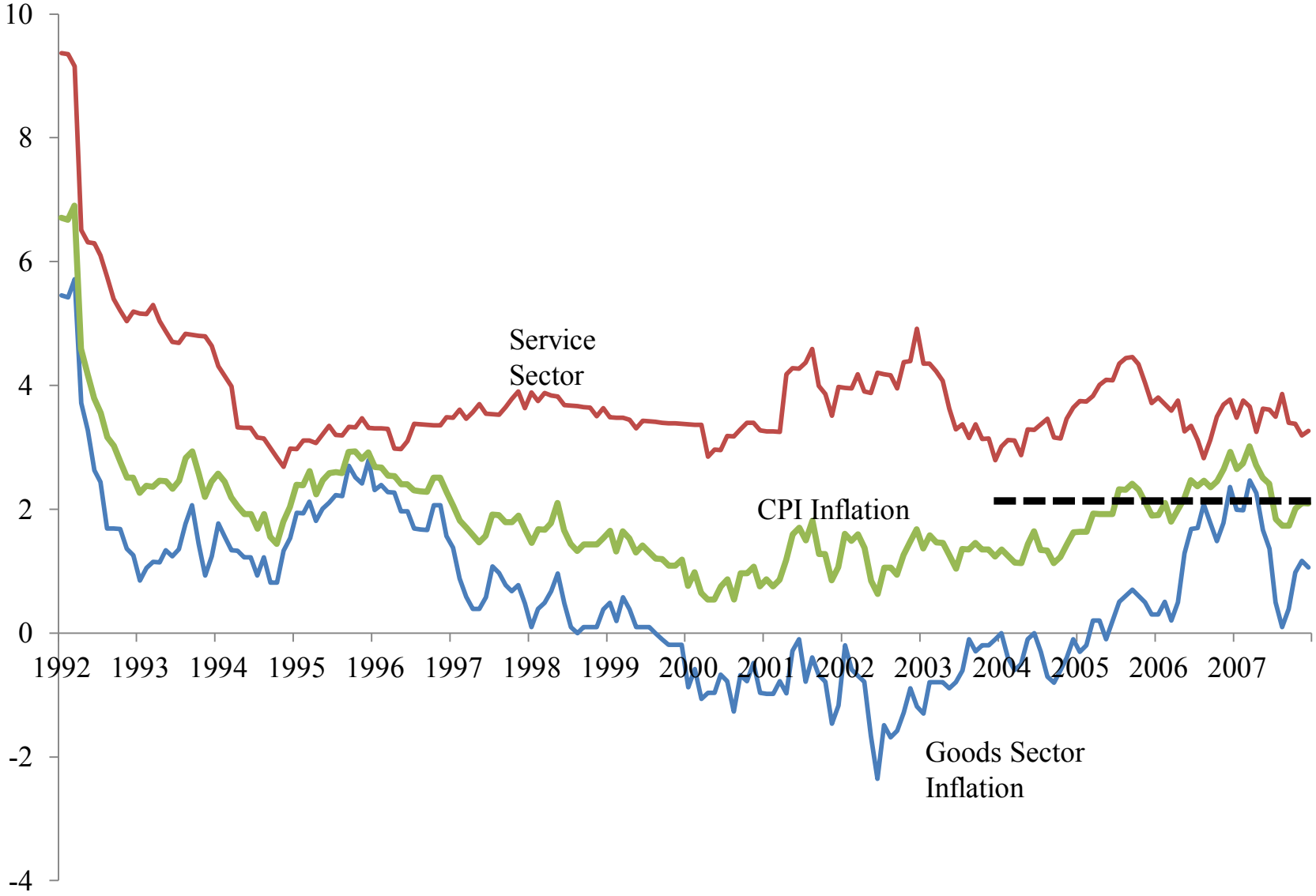
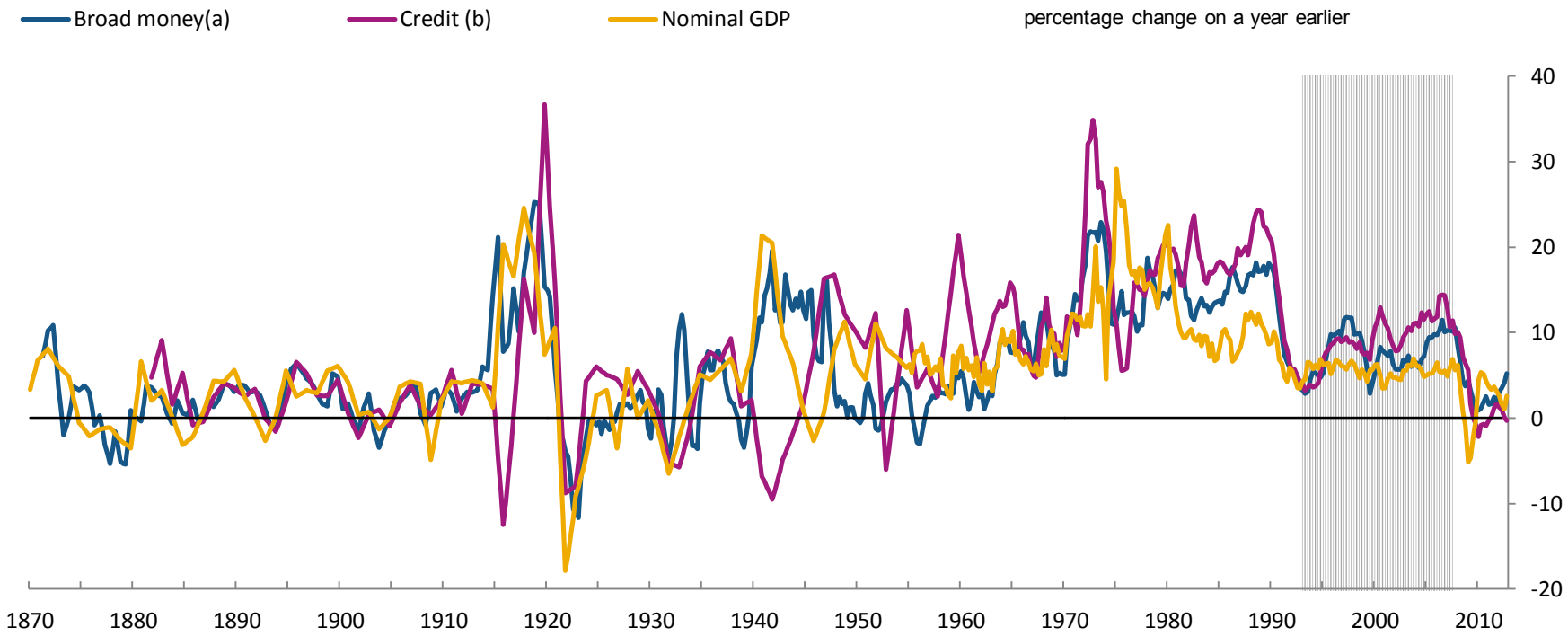


Chart 2: Bank/NOP Median Inflation Expectations and CPI Inflation

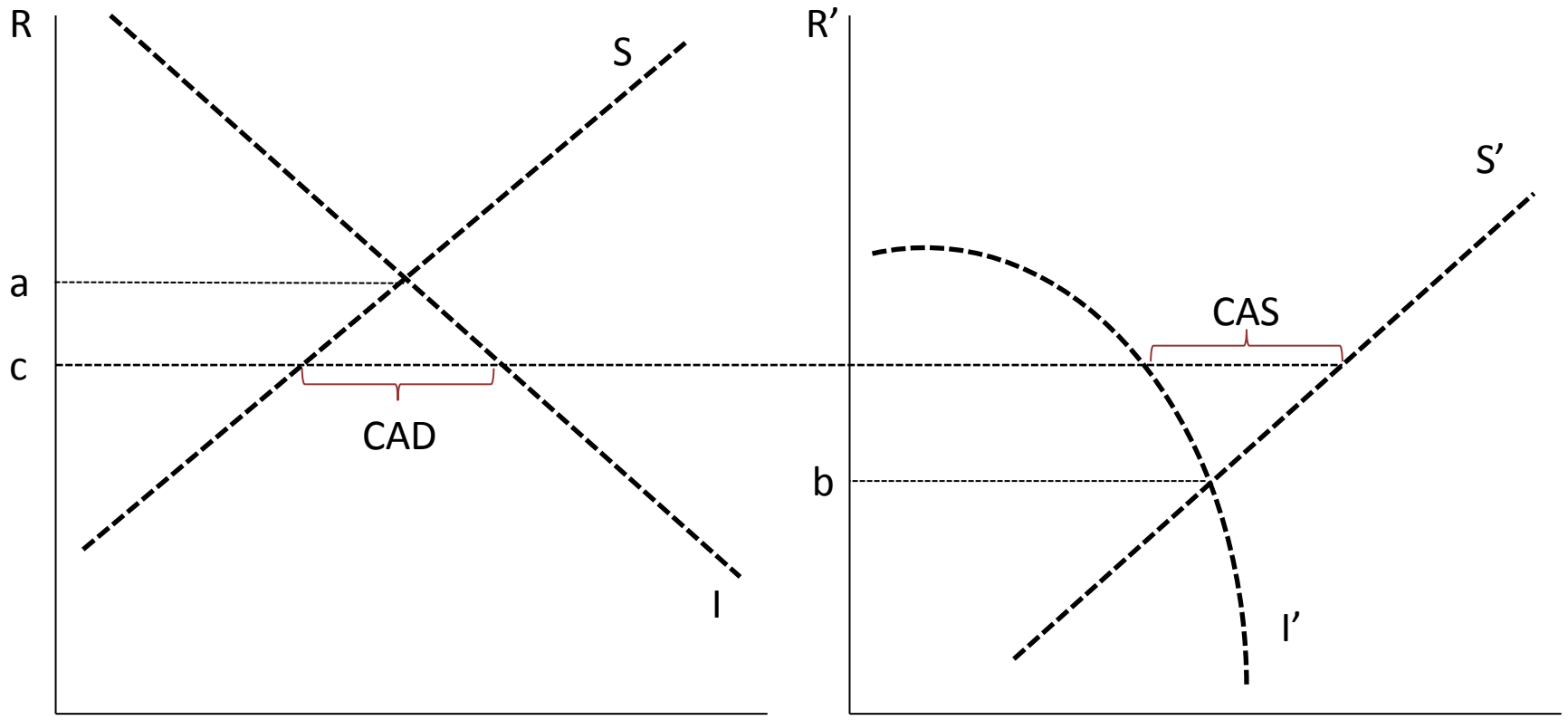



10
8
6
4
2
0
-2
-4
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Service Sector
CPI Inflation
Goods Sector Inflation

Money, credit and nominal spending – a long-run perspective

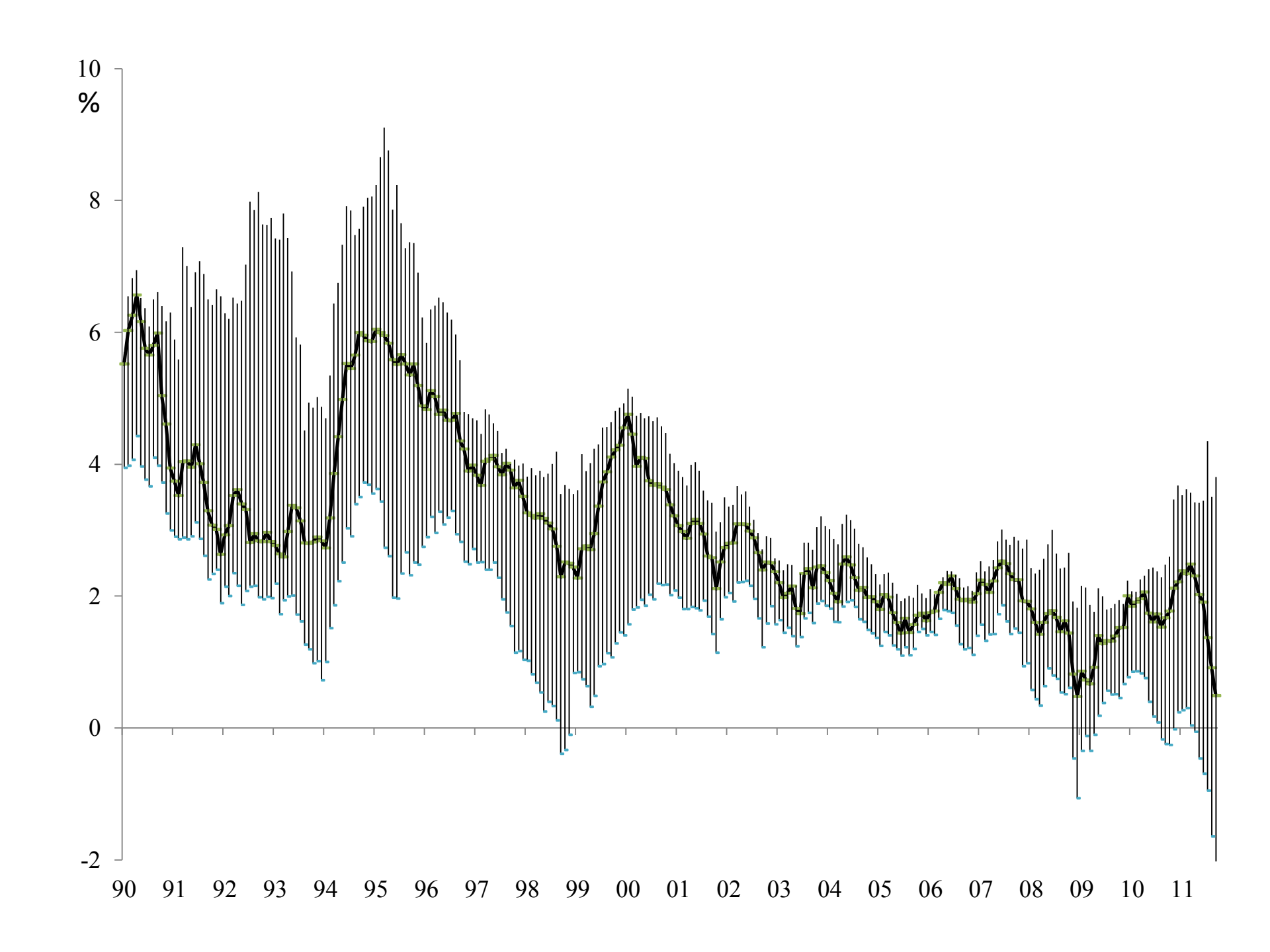


Sources: Capie and Webber (1985) and Bank of England, see Hills et al (2010). Shaded area represents the long expansion 1993-2007Q3.
In this and subsequent charts the shaded areas represent periods of MPC asset purchases (QE) unless otherwise stated.
(a) M3 1945-63, M4 1963-98, M4 excluding intermediate 'other financial corporations' (IOFCs) 1998-2012.
(b) M4 Lending 1963-1998, M4 Lending excluding intermediate 'other financial corporations' (IOFCs) 1998-2012. Data are adjusted to exclude the impact of securitisations and loan transfers.



Debtor Countries: Savings and Investment

Creditor Countries: Savings and Investment


10
%
8
6
4
2
0
-2
90
91
92
93
94
95
96
97
98
99
00
01
02
03
04
05
06
07
08
09
10
11

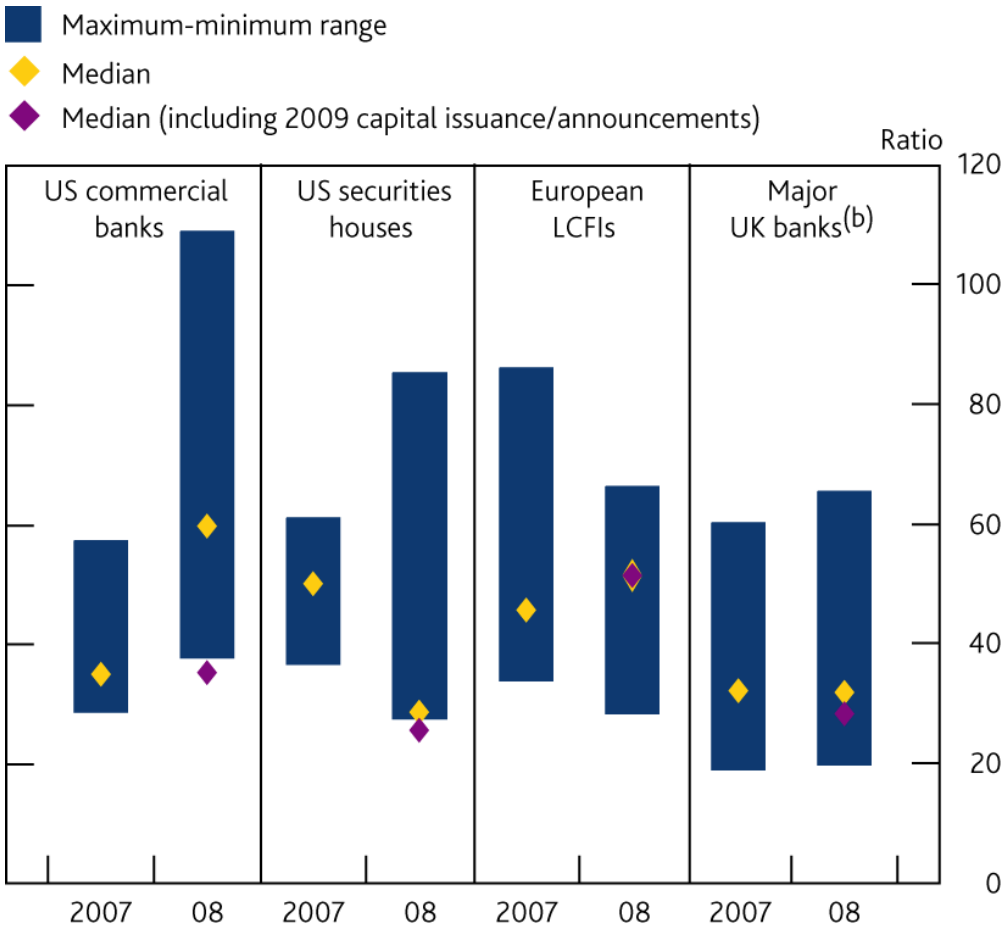
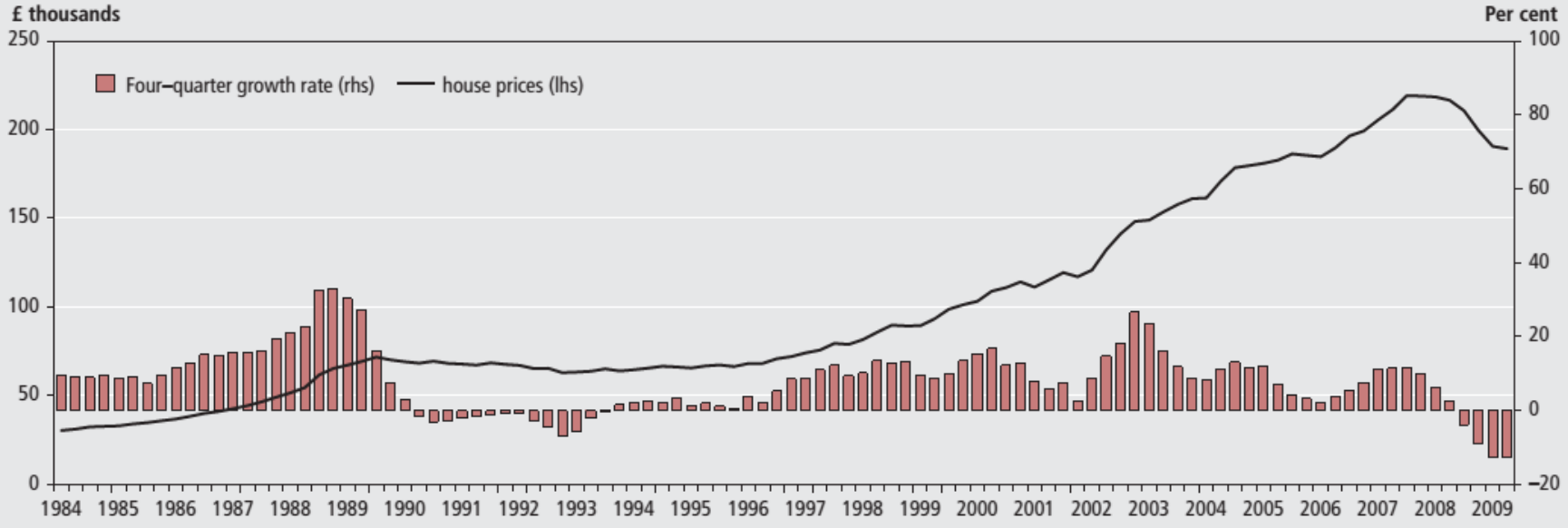

Maximum-minimum range
Median
Median (including 2009 capital issuance/announcements)
Ratio
US commercial banks
US securities houses
European LCFIs
Major UK banks(b)
120
100
80
60
40
20
0
2007
08
2007
08
2007
08
2007
08

Figure 1

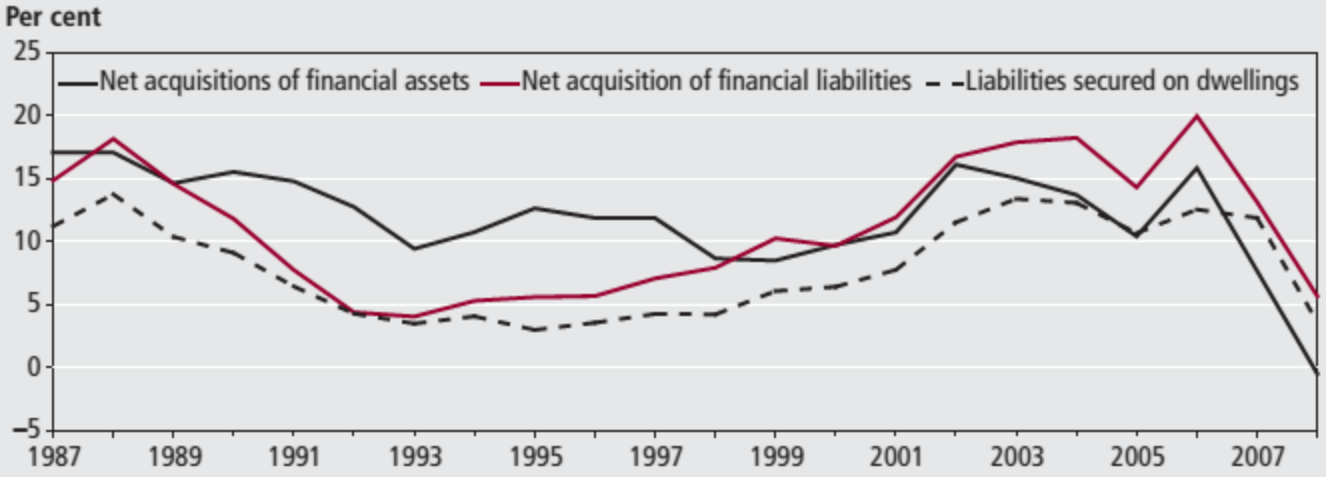
UK average house prices



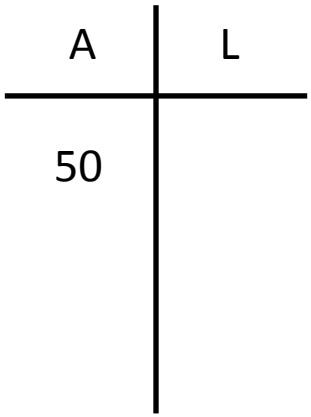
Source: CLG

Figure 6

Household accumulation of financial assets and liabilities as a proportion of disposable incomes

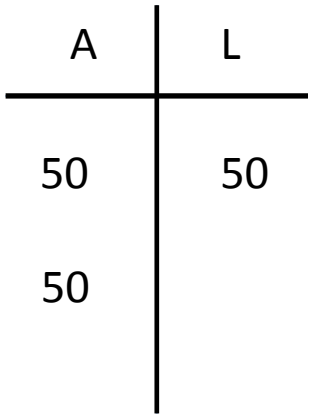


Source: ONS Economic Accounts



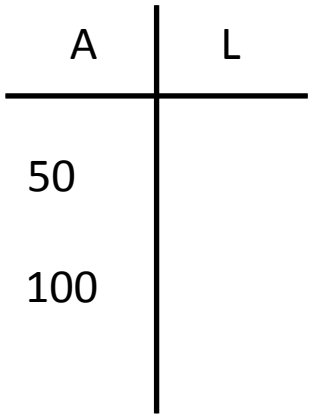
S

T=1



S+E

T=2



S+E

T=3

A	L
50	

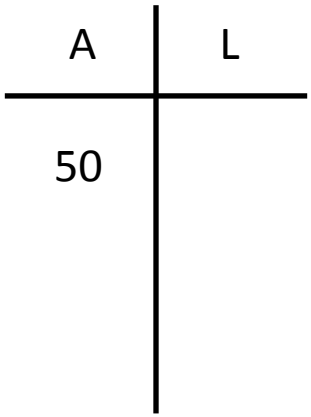
T=1

A	L
50	50
50	

T=2

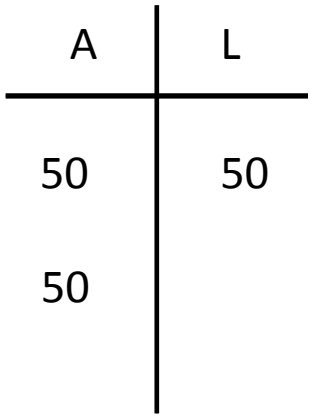
A	L
50	
100+100	

T=3

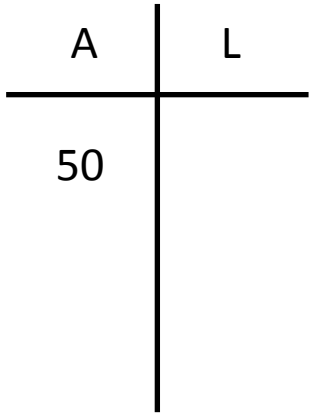


S

T=1

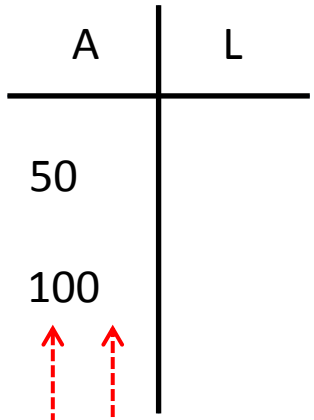


S+E

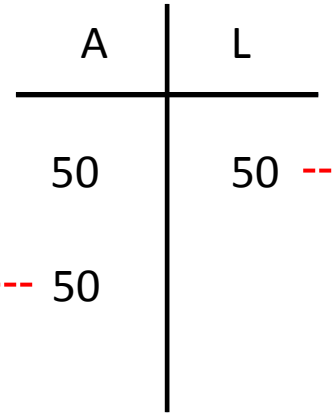


S

T=2

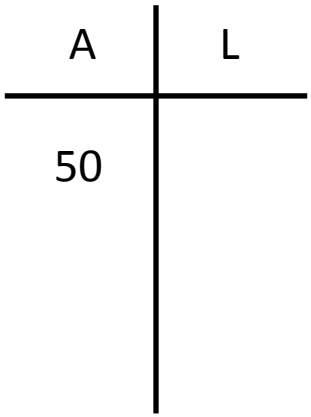


S+E



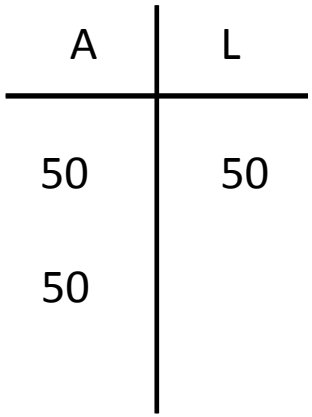
S+E

T=3

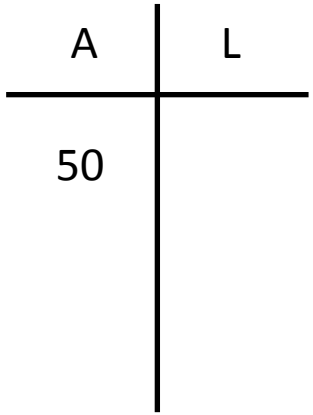


S

T=1

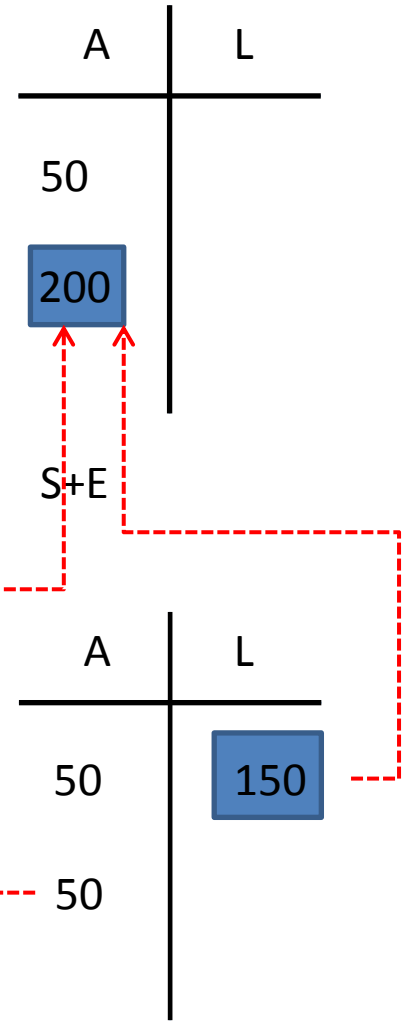


S+E



S

T=2



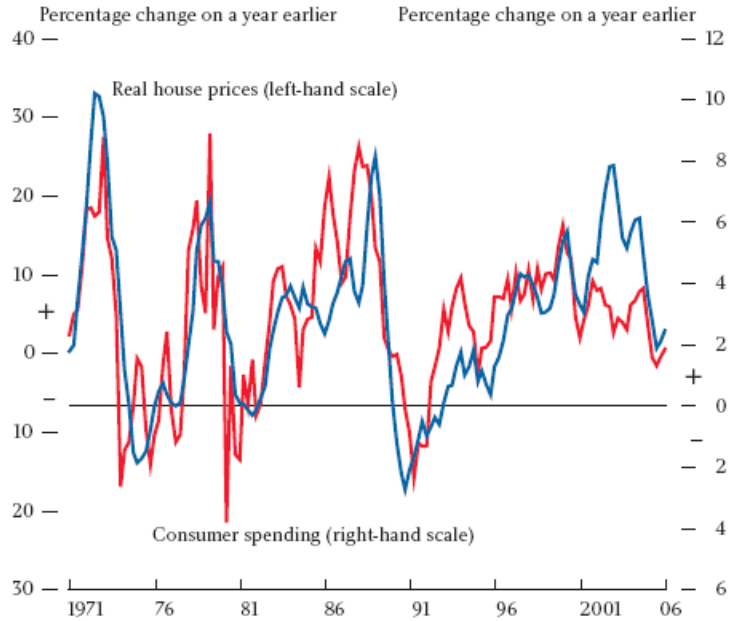
S+E

S+E

T=3

Real House Prices and Consumption (UK)

Chart 1
Real house prices(a) and consumer spending



Sources: Nationwide and ONS.

(a) Nationwide house price index deflated by the consumer expenditure deflator.

Consumption and House Values

	Borrower	Saver	All
Levels:*	0.709	-0.452	0.602
Growth:*	0.453	0.080	0.391

- LHS: BoE QB and RHS: our calculations of correlation between house prices and consumption from BHPS

Inflation Targeting: Flexible, Augmented Nutters

- Was formal independence under IT, a manifesto for nutters or an optimal rule?
- How could we deal with escalating asset prices?

I) 'BIS View' - Augment interest rate reaction functions to prevent or prick bubbles.

II) Orthodox View - make inflation targetry flexible

- Little discussion on direct regulation, or what became known as macro-prudential instruments

Discretion, Rules and Optimality

Stabilise output and inflation with a well understood interest rate reaction function and judge outcomes in terms of output and inflation variance

- As optimality was not credible, then discretion would dominate
- We can improve the outcome by having a conservative central banker (Rogoff) or a financial penalty (Walsh)
- But independence+IT===>optimal rule because of transparency and accountability
- Ex ante claims and ex post outcomes could be assessed and lead to credibility
- Central bankers - may do the right thing as policemen of the social norm but "we can watch the guards" - a panopticon view of credibility.

The Bank's Balance Sheet

The Bank's Balance Sheet

Assets	Liabilities
Public Loans	Notes
Private Loans	Deposits
Private Discounts	Equity
Bullion	

Note: the Bank was a private, profit making company

10

- Cannan (1925). 'The Bank was a private, profit making company'

FIGURE 1 ACTUAL FED FUNDS TARGET RATE VERSUS 90 DAY FUTURES MARKET PREDICTION

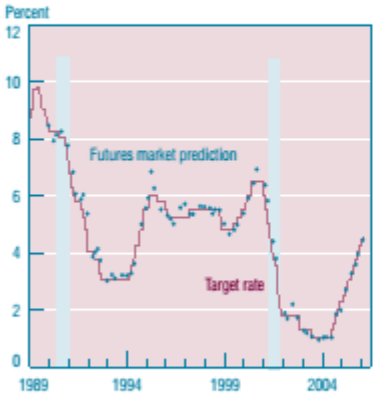


FIGURE 2 PREDICTION ERROR: 90 DAYS AHEAD OF FOMC MEETING

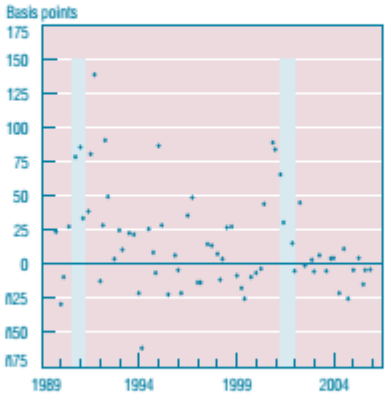
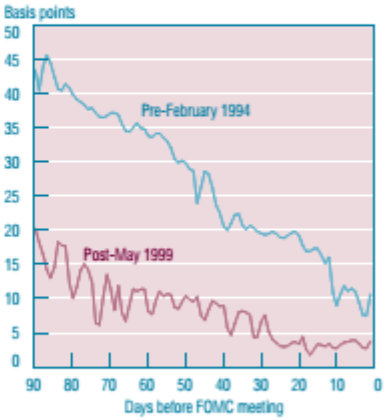


FIGURE 3 AVERAGE ABSOLUTE ERROR



NOTES: Because prices for fed funds futures contracts are based on averages of the daily fed funds rate for the month a contract expires, these prices will reflect two possibly different targets when an FOMC meeting falls within the month of the contract. These figures use data from only "clean" contracts—those which had no scheduled FOMC meeting within the contract month. Half the FOMC meetings are associated with such clean contracts. Shaded bars represent recessions.

SOURCES: Chicago Board of Trade and authors' calculations.

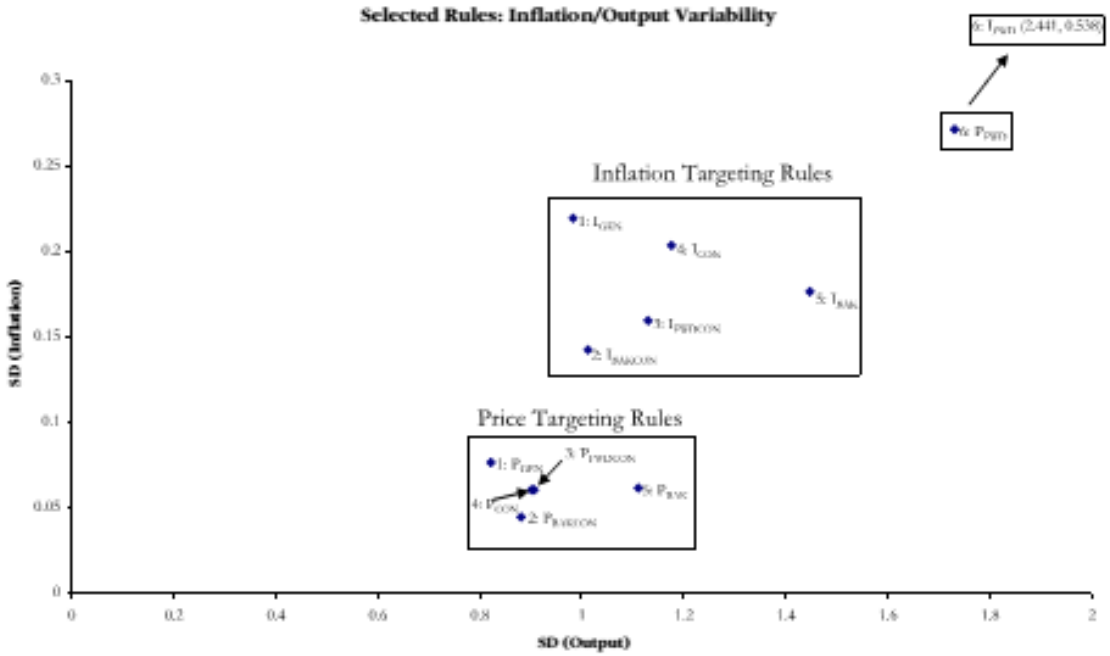


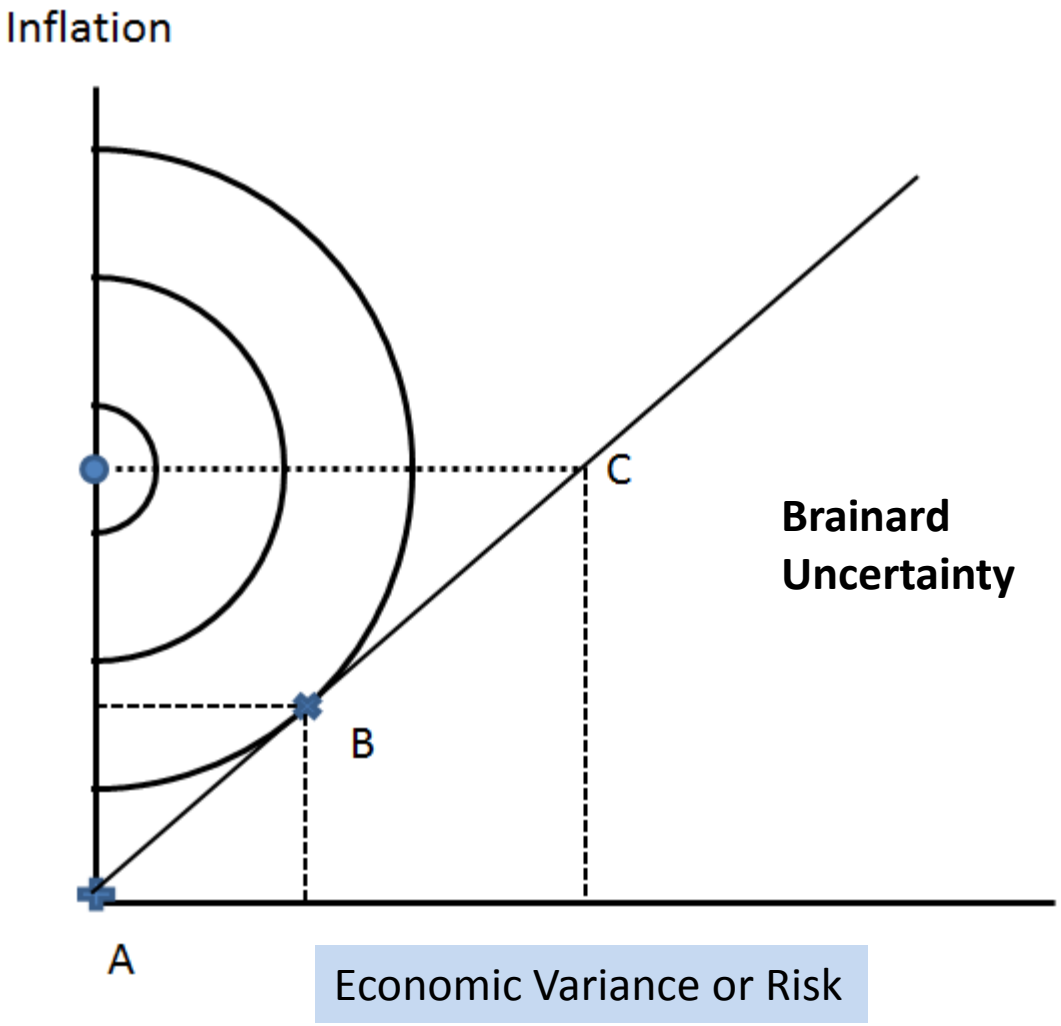
FIG. 7 Comparing the Standard Rules in Output and Inflation Space

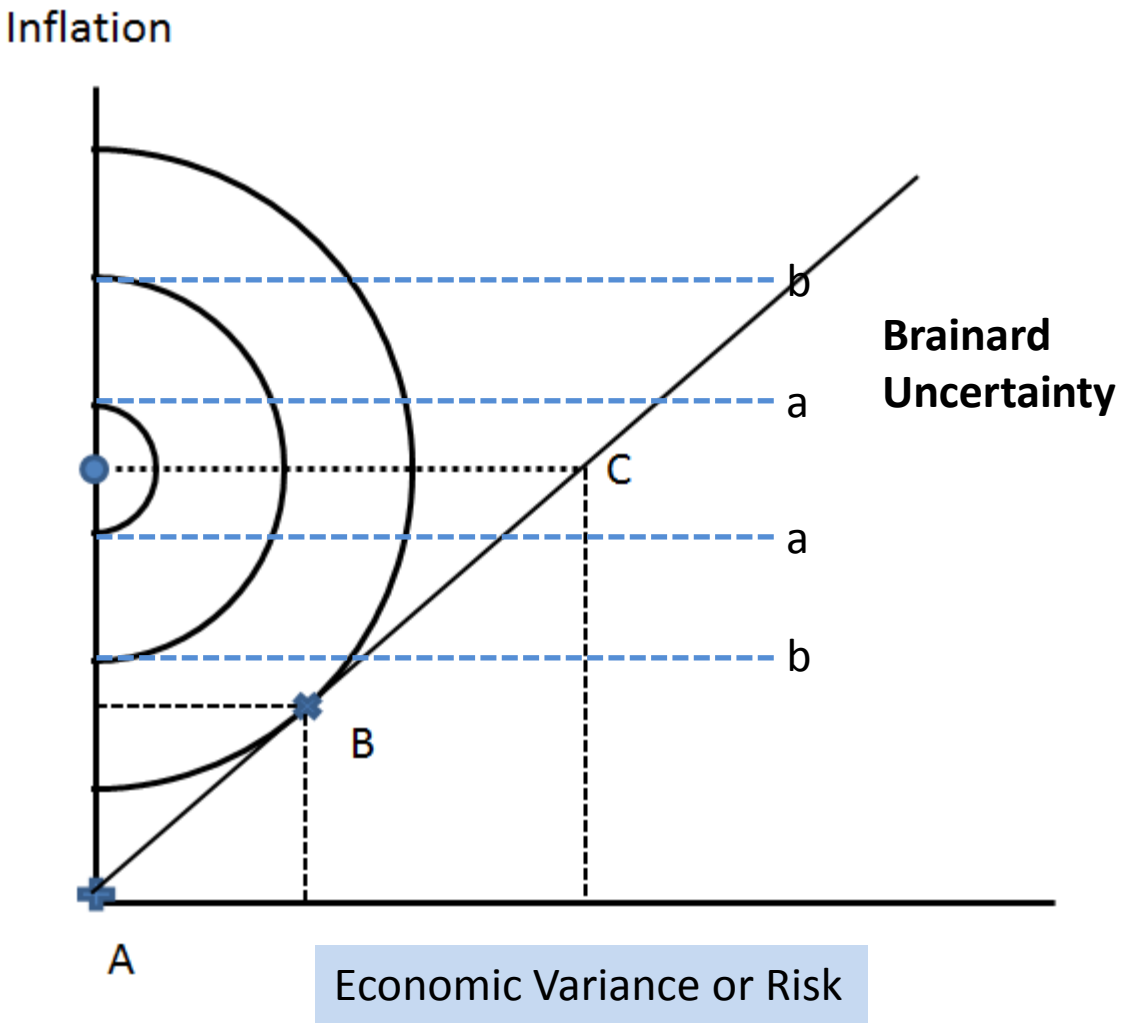
The Orthodox Response to Asset Prices

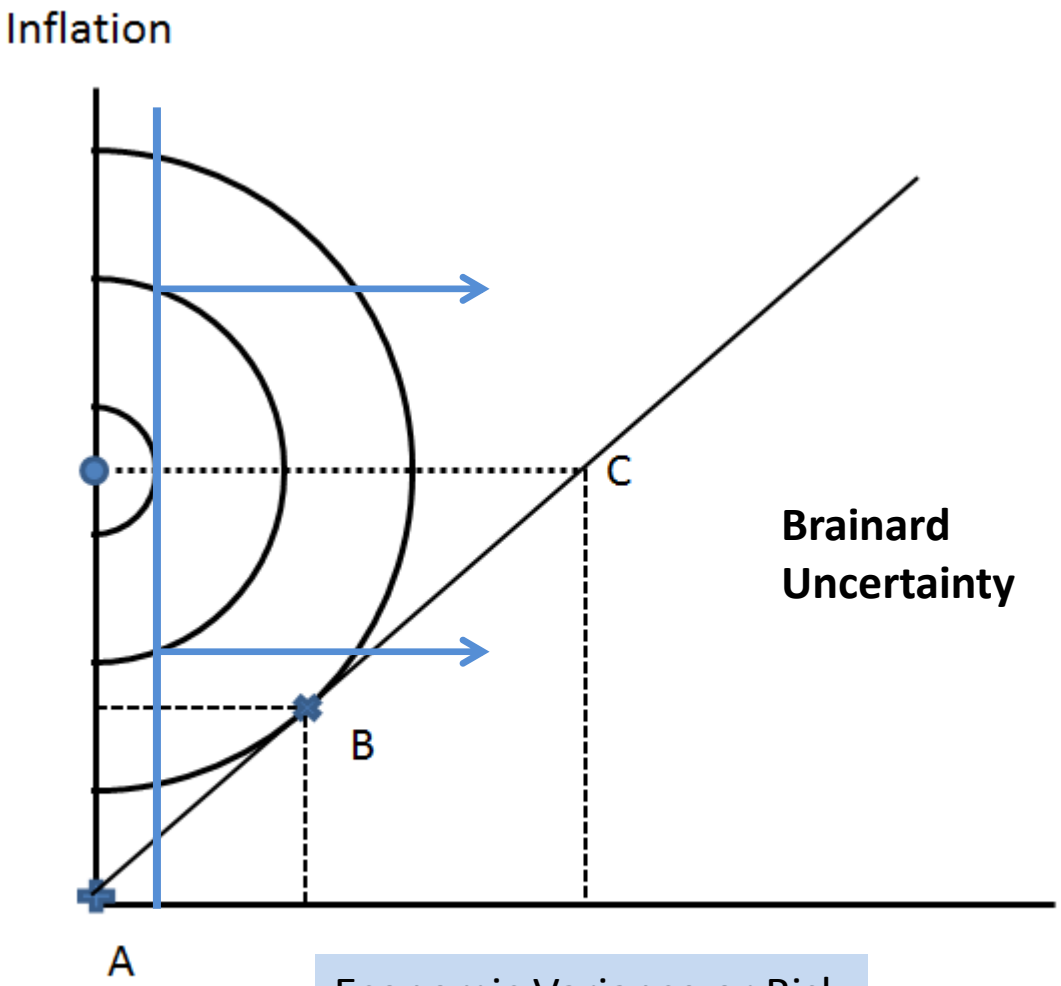
- Financial prices provide information for future output gaps and inflation
- If the MTM changes then our view of the neutral or natural rate of interest will change
- Targeting asset prices, which are a function of policy rate, will be counterproductive
- How do you spot a fundamental vs bubble-like behaviour?
- Offsetting asset prices might conflict with output and inflation objectives
- If we prick a bubble then the resultant crash will require a reversal in rates.

"the optimal policy is in effect to ignore the asset boom, but to mitigate the fallout when it collapses. Furthermore the expectation of a looser monetary policy in the event of a future credit crunch raises expected inflation. Consequently there is an upward bias to inflation"

Bean 2003


Inflation
C
Brainard
Uncertainty
B
A
Economic Variance or Risk


Inflation
b
a
a
b
C
B
A
Brainard
Uncertainty
Economic Variance or Risk


Inflation
C
Brainard
Uncertainty
B
A
Economic Variance or Risk

Money Matters

- Money is neutral but contains information about lending and asset accumulation
- Bundesbank and then ECB retains monetary pillar
- Money and credit may be dislocated and provide distinctive stimulii or represent the build up of risk and a changing economic structure
- Models were not in general considering these possibilities and money did not matter
- Many called for explicit consideration e.g. Kiyotaki and Moore, Goodhart and others.

Money and Macro Models

One ongoing concern is the absence of money or liquidity from the current generation of macroeconomic models. There is probably more agreement in practice over the use of money than it appears. As with a good trader, monetary policy makers should seek to exploit all available and robust correlations with the objects of primary interest. The trader will be concerned with the prices of assets on his or her book and the central banker with fluctuations in output and inflation. There are a number of reasons why a monetary policy maker should not, and in practice probably does not, ignore measures of monetary aggregates when setting monetary policy.

First, money may well provide an early real-time, albeit noisy, signal to the monetary policy maker about the state of the economy. Even though, in the fullness of time the information from output and inflation may encompass the news from money, for those who have to make decisions in real-time many indicators, including money, may have valuable information. Secondly, the components of broad money are likely to provide some clues as to the extent to which financial frictions and collateral constraints are being altered by lending practices and whether the economic cycle is being amplified.

Finally, some fundamental aspects of the monetary balance sheet may require the central bank to monitor developments with monetary implications. For example, monetary and fiscal policies are tied via the government's budget constraint and imply a commitment by the fiscal authority to stabilise the level of public debt is a requirement of monetary stability. In this respect we encourage the continuation of the use of a clear long term framework within which fiscal policy operates. Finally, the implications of developments in our measures of money may not fully reflect the impact of liquidity provision elsewhere on domestic markets (eg through the carry trade) nor on the quantum of risk being run in domestic financial markets (eg due to an increased role for hedge funds)—so we would call for more work to measure monetary dynamics.

Concluding Remarks

- The noughties or naughties party led to quite a hangover: public and private debt
- Near-optimal monetary policy had not quite managed to formulate a plan for financial risk
- Widely understood and seemingly successively policy raised agents' willingness to take risks
- Absence of instruments to deal with risk and perhaps some willful neglect
- How should we deal with measured and unmeasurable uncertainty in the monetary policy game?