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Author(s): Harris Dellas, Thomas Jordan and Ulrich Kohli

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HARRIS DELLAS
THOMAS JORDAN
ULRICH KOHLI

Monetary Theory: Where Do We Stand?

In June 2007, the *Journal of Money, Credit and Banking (JMCB)*, the Swiss National Bank, and the University of Bern cosponsored a conference in Bern in order to honor Professor Ernst Balternsperger on the occasion of his retirement from the Economics Department of the University of Bern. Ernst has had a long, close, and fruitful relationship with all three of the sponsors. After having studied economics in Zurich, he proceeded to obtain a Ph.D from the Johns Hopkins University. He then joined Karl Brunner at the Ohio State University, where he served as assistant, associate, and full professor. Ernst had a close association with the *JMCB* from the very beginning. First as book review editor (1970–73), then as acting coeditor (1975), and finally as associate editor (1979–93). After returning to Europe in 1979, he taught at the University of Heidelberg and St. Gallen University before joining Karl Brunner again at the University of Bern, where he spent the remaining of his academic career. Ernst and Karl, together with Juerg Niehans, were responsible for the development of monetary economics and the acceptance of monetarism not only in Bern and Switzerland but also all over Europe. Throughout this period, Ernst maintained a close association with the Swiss National Bank, serving as a senior policy advisor. In this capacity, he contributed to the design of the past and present monetary policy framework of the SNB. Last but not least, Ernst had a strong and influential presence in the public affairs of Switzerland. With numerous articles in the popular press, interviews, and public presentations, he helped educate the Swiss public and politicians alike in neoclassical economics and provided a staunch and effective defense of free markets and sensible economic policies against their usual enemies.

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HARRIS DELLAS is at the University of Bern (E-mail: harris.dellas@vwi.unibe.ch). THOMAS JORDAN and ULRICH KOHLI are at the Swiss National Bank, P.O. Box, CH-8022 Zurich, Switzerland (E-mail: Thomas.Jordan@snb.ch and Ulrich.Kohli@snb.ch).

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Ernst's academic research focused squarely on money, credit, and banking. He was among the first to attempt to model the behavior of banks—and financial intermediaries, in general—and help understand the role played by uncertainty, imperfect information, information acquisition, and resource costs for reserve and bank capital management.¹ He studied the working of money and credit markets;² the role of money; credit, and banking for the transmission of monetary policy to the economy;³ and the structure and regulation of financial markets.⁴ He is currently engaged in a project on the monetary history of Switzerland.

Many of the issues that preoccupied Ernst in his long career are still at the center of current research in monetary economics. The papers presented in the conference and included in the present volume of the *JMCB* provide new insights on many of these issues.

In his provocative “How Important Is Money in the Conduct of Monetary Policy?” Michael Woodford evaluates several of the main arguments that have been used to justify assigning an important role to monetary aggregates in the analysis of monetary policy. The most prominent of these arguments are the following: First, if central banks failed to appreciate the role of money in the determination of inflation, they could inadvertently repeat grave, past policy mistakes, such as those that led to the great inflation of the 1970s. And second, models of inflation determination with no role for money (such as the New Keynesian [NK] model) may be coherent but are incomplete and cannot explain inflation unless they are augmented to take into account the additional information provided by the money supply. Moreover, such models are inconsistent with the basic premise of neoclassical economic theory on money neutrality. Woodford addresses the merits of these arguments and he also undertakes a reevaluation of the implications of the empirical evidence on the long-run relationship between money growth and inflation for the design of the monetary policy strategy. His main conclusion is that none of these arguments provides a compelling reason to assign a prominent role to monetary aggregates in the conduct of monetary policy.

In their contribution, “Monetary Aggregates and Liquidity in a Neo-Wicksellian Framework,” Matthew Canzoneri, Robert Cumby, Behzad Diba, and David López-Salido address an important criticism that has been leveled against the standard NK model—namely, that its positive and normative implications about monetary policy are of limited value because the model lacks a properly specified banking system and also a role for monetary aggregates. Their model adds banks and liquid government bonds to an otherwise standard NK. This enables them to introduce a role for government bonds in household and bank liquidity management problems, financial

1. “Costs of Banking Activities—Interactions between Risk and Operating Costs” *JMCB* 72, “The Precautionary Demand for Reserves” *AER* 74, “Alternative Approaches to the Theory of the Banking Firm” *JME* 80.

2. “Predictability of Reserve Demand, Information Costs and Bank Portfolio Behavior” *J of Finance* 76, “The Lender-Borrower Relationship, Competitive Equilibrium and the Theory of Hedonic Prices” *AER* 76.

3. “Credit Rationing: Issues and Questions” *JMCB* 78, “Reserve Requirements and Economic Stability” *JMCB* 82.

4. “Firm Size, Economies of Scale and Concentration in Banking” *JMCB* 1972, “Banking Deregulation in Europe”, *Economic Policy* 87, “Reserve Requirements and Economic Stability” *JMCB* 82.

frictions in the provision of deposits and loans, and an endogenous spread between the money market rate in the central bank's interest rate rule and the rate of return in the consumption Euler equation. This spread can play an important role in the transmission of monetary policy. Canzoneri et al. reach two main conclusions. First, some of the macroeconomic implications of their "banks and bonds" NK-augmented model do differ significantly from those of the standard NK model. And second, monetary indicators— $M2$ velocity and the growth rates of $M2$, L , and public sector liabilities—can be useful in forecasting inflation in their model. The fact that they are not useful in the NK model can thus create a misleading view about the usefulness of monetary aggregates (and $M2$ velocity) in the real world.

The ability of models with flexible price to account for business cycle fluctuations on the basis of supply shocks exclusively has been questioned in the literature. In the last few years and as a result of pioneering work by Beaudry and Portier, macroeconomists have developed an interest in the role of news shocks as an important source of macroeconomic fluctuations. In their contribution, "News and Business Cycles in Open Economies," Nir Jaimovich and Sergio Rebelo study the business cycle effects of news about future total factor productivity (TFP) as well as investment specific shocks in a small open economy. Their analysis makes three important points. First, the standard neoclassical open economy model cannot generate empirically plausible types of comovements in consumption, investment, and employment in response to news about future TFP. Second, they identify both the culprit for this failure and the features required in order to enable the model to generate the correct responses. The culprit is the response of the supply of labor. Good news about the future generates a positive wealth effect that induces a decline in hours worked, making employment and consumption move in opposite directions. The features needed are a weak short-run wealth effect on labor and the presence of adjustment costs to labor or investment. And third, they demonstrate that these features also help produce the appropriate response to sudden "stops" shocks, that is, shocks to open economies that increase the cost of rolling over their existing foreign debt.

Taking its lead from important work by Calvo, Kydland, and Prescott, and Barro and Gordon, a voluminous literature developed in the 1980s addressing issues of credibility and discretion commitment in the context of monetary policy. After a long lull of inactivity, this area is now experiencing a resurgence of interest, mainly in the context of the NK model. The NK literature has demonstrated how a central bank, by credibly committing in advance to behaving in a particular way (following a specific rule), can successfully manage the expectations of the private sector in a way that enhances its pursuit of stabilization objectives. And the gains associated with precommitment and credibility may be obtained even in the absence of any inherent inflation bias. Nevertheless, as Robert King, Yang Lu, and Ernesto Pastén demonstrate in "Managing Expectations," using a standard macroeconomic model and series of examples, the management of expectations can be a subtle and complicated affair in the presence of informational problems. Such problems are typically abstracted from the NK literature. For instance, the private agents may not know the nature of the central bank, namely, whether it will take the actions necessary to produce low and stable inflation in the longer run (what King, Lu, and Pastén term long-term credibility

of the central bank). Or, the agents may also be uncertain about whether short-term policy will be those consistent with the central bank being of low-inflation type (short-term credibility). King, Lu, and Pastén provide a framework for studying how a monetary authority that pursues low inflation but is concerned about real activity manages expectations, taking into account imperfect credibility and, in particular, how it assesses the effect of its policies on private sector beliefs about the likelihood and intensity of discretionary policy actions that would be taken by policymakers who do not value low inflation. In a manner analogous to the time inconsistency literature of the 1980s, King, Lu, and Pastén also derive the implications of the model for the evolution of credibility over time.

Recent monetary dynamic stochastic general equilibrium (DSGE) models typically feature staggered nominal wages and labor adjustment along the intensive margin. While the former feature helps account for the volatility of hours, the latter implies that wages may not matter for the allocation of labor due to the fact that the firms and workers have an ongoing relationship. Under these circumstances, wage rigidity does not help the model exhibit plausible dynamics. The contribution by Mark Gertler, Luca Sala, and Antonella Trigari, “An Estimated Monetary DSGE Model with Unemployment and Staggered Nominal Wage Bargaining,” allows firms to adjust employment along the extensive margin in a search model with nominal wage, staggered Nash bargaining. Subsequently, wage rigidity affects employment by influencing the rate at which firms add new workers to their respective labor forces. Gertler, Sala, and Trigari embed these features in a medium-scale macroeconomic model and estimate its parameters using Bayesian methods. Their main finding is that the model with wage rigidity provides a better description of the data than does a flexible-wage version and that the model fits the data as well as the leading DSGE models, such as Smets and Wouters.

Most of the work on monetary policy in the literature relies on simple rules—such as the Taylor rule—in the context of the NK model. In “Robustness and U.S. Monetary Policy Experimentation,” Timothy Cogley, Riccardo Colacito, Lars Peter Hansen, and Thomas Sargent adopt a richer and more realistic framework that explicitly recognizes the fact that the monetary authorities face uncertainty regarding the true model of the economy. In particular, the policymaker has a prior over two submodels of inflation–unemployment dynamics: one submodel implies an exploitable trade-off while the other does not. Moreover, the policymaker does not fully trust either submodel or his prior probability distribution over them.

Cogley et al. demonstrate that a robust decision maker has an incentive to experiment, but unlike in earlier work by some of these authors, the degree of experimentation is tempered by concerns that the decision problem is misspecified. They demonstrate that the policymaker’s desire to protect against misspecifications of the submodels relative to the desire to protect against the misspecifications of the prior over them lead to opposite directions regarding the degree of experimentation in policy. And they also show that a robust policymaker achieves a robust decision rule by pretending to be a pessimist.

The quality of the papers presented at the conference is a tribute to Ernst’s distinguished career and his many contributions to the economic profession.