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# newsletter

STUDY CENTER GERZENSEE

## INTERWIEW WITH MICHAEL WOODFORD

### THE THEORY OF MONETARY POLICY

*Referring to growth theory, Robert Lucas wrote that, once one has started thinking about it, it is hard to think about anything else. Does the same apply to the theory of monetary policy?*

It is certainly a topic that has been very fascinating to me for quite a while now without exhausting my interest. I guess the thing I like the most about it is that, on the one hand, it is full of very subtle conceptual challenges, but at the same time it has a lot of practical importance such that the application of intellectual work is very visible. That makes it especially rewarding as a topic.

*The empirical evidence on the effect of moderate inflation on growth is rather inconclusive, and some economists argue that disciplined monetary policy has contributed little to lowering industrialized countries' output volatility in the recent past. How do you convince your students that monetary economics is nevertheless a relevant topic?*

I think that there is at least fairly clear evidence that bad monetary policy can make real outcomes worse. For example, I am inclined to think that a lot of Japan's problems in the last decade were made worse - though maybe not purely caused - by fairly clumsy monetary policy. I also believe that better monetary policy has been an important factor in Japan's recent recovery. And I think that the fact that the US went through a similar asset price collapse without such bad effects has something to do with a considerably better conduct of monetary policy. Those things make me think that monetary policy does matter for real outcomes.

*In the preface to your recent book on monetary economics, you mention some doubts whether the present moment is ripe for a systematic exposition of a theory of*

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## ACADEMIC CONFERENCES

### MACROECONOMICS AND POLITICAL ECONOMY

On October 1-2, the Study Center Gerzensee hosted the seventh conference in a series organized jointly with the *Journal of Monetary Economics*. Conference organizers Philippe Bacchetta and Robert King (Boston University) selected six papers to be presented.

Daron Acemoglu, of the Massachusetts Institute of Technology, presented "An Economic Model of Weak and Strong States". The model formalizes the notion that the inability of states to collect revenue - the "weakness" of states - creates both advantages and disadvantages, in particular for developing countries. On one hand, the inability to tax makes it difficult for governments to provide productive public goods. On the other hand, it encourages private investments because weaker governments find it more difficult to expropriate citizens. Since economic performance relies both on public good provision and private investments, the model predicts an intermediate level of government strength to be optimal. Many countries feature high taxes despite significant control by society over the government (i.e., despite being weak). Acemoglu's model rationalizes this observation by pointing to the role of institutions fostering trust between citizens and the government.

Alberto Alesina, of Harvard University, presented a paper on "Corruption, Inequality, and Fairness", co-authored with George-M. Angeletos of the Massachusetts Institute of

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## editorial

Macroeconomic policies in both developed and developing countries are often constrained by the political decision process. These constraints deserve a better understanding. Our recent conference with the Journal of Monetary Economics on Macroeconomics and Political Economy has precisely dealt with this issue, both from a theoretical and empirical perspective. The papers presented at this conference are described in the following pages. We also provide a description of the main topics covered at the Summer Symposia in Economic Theory and in Financial Markets organized jointly with CEPR.

In 2004, we were again lucky to be able to offer doctoral courses taught by the best specialists in their respective fields, including a Nobel Prize laureate - Professor James J. Heckman, University of Chicago. Professor Michael Woodford, who recently wrote an influential book on monetary economics, taught one of these courses. A central aspect of his book is the limited role played by monetary aggregates in monetary policy and the crucial role played by interest rates. The enclosed interview gives interesting insights on this view and on the perspective of this author.

**Prof. Philippe Bacchetta**
**Director**

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## INTERWIEW from cover

*monetary policy. Which considerations gave rise to such doubts?*

Mostly the fact that the subject is developing very rapidly. So given that it takes a long time to write a book and that you cannot do it very often, you always have to be a little scared that in a year or two you might already have left behind the things that you wrote. But that did not deter me from trying to write a provisional synthesis of the area.

*I would describe your book as a monograph rather than a textbook on monetary economics. Is this correct?*

That was the intention. If I had defined it as a textbook I would have felt more obligated to cover all of the topics that people think should be reviewed in a course. So this is not a book attempting to survey the area, but to set out in detail some personal views that I hope are of interest.

*Throughout your book, you emphasize the importance of Knut Wicksell's ideas in shaping your thoughts on monetary policy. When and how did you get in touch with Wicksell's writings?*

I suppose I first heard of Wicksell's ideas in Milton Friedman's presidential address to the American Economic Association, which of course I only read many years after he gave it. I was intrigued by what he said about Wicksell's cumulative process there. But I probably did not get seriously interested in Wicksell until a few years later when I read an essay of Axel Leijonhufvud - I think it was called "The Wicksell Connection" - in which he was arguing for the importance of Wicksellian ideas and suggesting that they had been somewhat neglected. One reason this caught my attention is that at that time I had already been very interested in interest rate policy as a way of describing monetary policy. I was also very much interested in the role of expectations in the dynamics of a macroeconomy, and the Swedish school was very important to me for the emphasis they had given very early on to the role of expectations. It was in the mid-1980s that I had started coming across these ideas, but I did not really know what to do with them for quite a while. It was only quite recently that I realized that the ideas I was interested in were closer to Wicksell's ideas than I had immediately understood.

*Do you think that the profession converges towards a consensus on the optimal conduct of monetary policy? Where are the remaining conflicts and dividing lines?*

I think there has indeed been important convergence, even since the time that I began studying macroeconomics, twenty-five years ago. We now have a great deal of consensus on the fact that low and relatively stable inflation are very important features of a good monetary policy regime, and that low and stable inflation can be achieved pretty successfully without various kinds of straightjackets that were popular back in the 1980s. At that time there were proposals of going back to the gold standard as a way of controlling monetary policy, monetary targeting was very important, and people thought that other kinds of simple rules like currency boards might be a way to discipline monetary policy. To a large extent people now accept that competent central bankers can do a good job stabilizing inflation without being tied to such rigid formulas. However, I would not say that there is now complete consensus about the subject. Maybe the biggest controversy concerns the question whether paying attention to some kind of output gap concept makes sense, or whether central bankers should not think about output gaps at all. There is a wide spectrum of different opinions on this question even now. I would say that the debate has become more sophisticated, but that does not mean that all the questions have been settled.

*Do the concepts you propose in your book apply to all countries alike? Or are there some aspects that need to be qualified when talking, e.g., about developing countries?*

I do not claim that the framework I present should be universally applicable. Macroeconomics is a subject where finding successful models requires making good choices about which simplifications are useful. And the simplifications that are not harmful to make may be different for different economies. What I am doing in the book is going through a framework that allows for variations in order to take the models to particular circumstances. But the framework as a whole may be more easily tailored to some countries than to others. In particular, the analytical framework that I use relies a lot on the assumption that financial markets are highly developed and very efficient. This abstraction is reasonably useful for many advanced economies now, but I would not say that with the same confidence for developing economies, where financial market imperfections are much larger and where many households and firms are constrained in their ability to borrow. Those things are probably very important for the transmission mechanism of monetary policy, but they are entirely off-stage in the kind of models that I discuss in my book. Political economy issues are another example of something that I do not discuss in the book. Obviously it is an institutional question whether one can discuss monetary policy rules assuming that enlightened central bankers could implement them if they understood them. In some parts of the world the big problem may not be the understanding of central bankers, but all kinds of pressures that the central bank is subject to. Again, my book is not trying to diagnose those pressures or to discuss institutional arrangements needed to deal with them. It is assuming a setting in which competent central bankers can to a large extent carry out their job without inference, and tries to provide a conceptual framework they can use in doing this.

*In your writings, you stress the benefits of rule-based monetary policy. How would you explain the success of the Federal Reserve whose behaviour is not guided by an explicit rule?*

I do not think that the relative success of Fed policy is entirely contradictory to this. First of all, I believe that the Fed, particularly recently, has behaved in a fairly systematic and predictable way. People in the markets have felt that they could understand and predict the Fed's behavior, and we have observed an evolution toward greater transparency about its goals and about the likely direction of future policy. In my book I emphasize the importance of being able to behave in a way such that the private sector can anticipate policies in advance, and this is one of the most

important advantages of rule-based policymaking. I think that the Fed has made important steps toward behaving in a more systematic way, that this has helped the private sector to anticipate its policy fairly well, and that this is an important element in the recent success of Fed policy. However, I suspect that the Fed can still improve by going further in the direction of committing itself to rule-based behavior. The Fed is neither the leading example of rule-based policy-making at present or the leading example of transparency. But I don't think that it is the worst example for either of these precepts, either.

*One of the recurrent motives in your writings is that central banks should use interest rates as their operating target, paying little attention to monetary aggregates. Given this concept, should people stop estimating money demand equations?*

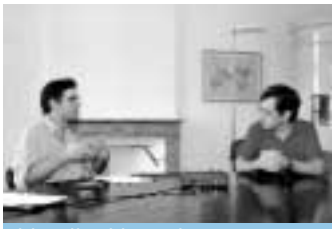
I do not claim that there are no transactions frictions that result in a transactions demand for money, and I have no reason to assert that there cannot be stable money demand functions. But I would argue that this is not as essential a topic for understanding the effects of monetary policy as a lot of the literature of the past few decades had assumed that it was. It is a topic that has been very extensively researched, and I would have allocated more effort to some other topics. For example, the analysis that I have presented suggests that understanding variations in the natural rate of interest ought to be of great practical importance. There is almost no research on trying to implement that empirically and to track variations of the natural rate of interest in real time. This is an example of something that, I hope, will get more research in the future than it had in the past. I also think that untangling the nature of nominal rigidities deserves more research. It has certainly been an important topic of study, but it is not understood as well as it ought to be, given how central it is for understanding what the tradeoffs are for monetary policy.

*In your book, you consider the boundary case of a cashless economy in which there is no transactions motive of money demand. What is the role of central banks in such an economy?*

I think that a cashless economy is a reasonable approximation to the way monetary policy rules affect the economy in economies with highly developed financial markets. But I do not think that it is a literal description of any actual economy, and I do not expect that it should become a literal description any time soon. The role in my analysis is very similar to what it was in Wicksell's book Interest and Prices: some aspects of the analysis are simplified by considering what the consequences of monetary policy would be in this cashless environment. Once one understands this point, one can add in the transactions frictions and ask to what extent they make a difference. The conclusion that I reach in my book is that realistically specified transactions frictions do not make a large quantitative difference for a number of exercises.

Another reason for being interested in what would happen in a cashless world is that there are people who have argued that the development of electronic means of payment might bring about a loss of the transactions role for central bank liabilities fairly soon, and that this would be a very dangerous situation. It has thus been proposed to regulate the development of electronic means of payment to prevent this from happening. I argue that such regulation is not important. My analysis implies that the cashless economy would not make central banks powerless to stabilize prices or to pursue their other stabilization objectives, in so far as people in the private sector would still find it convenient to use central bank liabilities to define the unit of account in which they are quoting prices. And I think this would continue to be convenient even if there is no special role for transfers of central bank liabilities in the payments mechanism. There would continue to be a role for central banks in defining the unit of account and in using monetary policy to achieve stability of the purchasing power of that unit of account. So I think central banks would continue to be as important as they are now.

**Prof. Michael Woodford** is Harold H. Helm '20 Professor of Economics and Banking at Princeton University. He has previously held positions at Columbia University and the University of Chicago, in addition to visiting appointments at a number of institutions in the U.S. and Europe. He has served as a consultant to the Federal Reserve Bank of New York and as Professorial Fellow in Monetary Economics at the Reserve Bank of New Zealand; he is also a Fellow of the Econometric Society and a Research Associate of the National Bureau of Economic Research. In addition to publications in academic journals, he is the author of *Interest and Prices: Foundations of a Theory of Monetary Policy* (Princeton University Press, 2003); co-editor, with John B. Taylor, of *Handbook of Macroeconomics* (3 vols., North Holland, 1999); co-editor, with Ben S. Bernanke, of *Inflation Targeting* (University of Chicago Press, forthcoming); and co-author, with Jordi Gali, Stefan Gerlach, Julio Rotemberg, and Harald Uhlig, of *The Monetary Policy Strategy of the ECB Reconsidered* (CEPR, 2004).



This edited interview was conducted by Philipp Harms