

OXFORD

UNIVERSITY PRESS

Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide in

Oxford New York

Athens Auckland Bangkok Bogotá Buenos Aires Cape Town
Chennai Dar es Salaam Delhi Florence Hong Kong Istanbul Karachi
Kolkata Kuala Lumpur Madrid Melbourne Mexico City Mumbai Nairobi
Paris São Paulo Shanghai Singapore Taipei Tokyo Toronto Warsaw

with associated companies in Berlin Ibadan

Oxford is a registered trade mark of Oxford University Press
in the UK and in certain other countries

Published in the United States
by Oxford University Press Inc., New York

© Peter Bofinger 2001

The moral rights of the author have been asserted
Database right Oxford University Press (maker)

First published 2001

All rights reserved. No part of this publication may be reproduced,
stored in a retrieval system, or transmitted, in any form or by any means,
without the prior permission in writing of Oxford University Press,
or as expressly permitted by law, or under terms agreed with the appropriate
reprographics rights organization. Enquiries concerning reproduction
outside the scope of the above should be sent to the Rights Department,
Oxford University Press, at the address above

You must not circulate this book in any other binding or cover
and you must impose this same condition on any acquirer

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloguing in Publication Data

Bofinger, Peter.

Monetary policy : goals, institutions, strategies, and instruments / Peter Bofinger.
p. cm.

Includes bibliographical references and index.

1. Monetary policy. 2. Monetary policy—Europe. 3. Monetary policy—United States.
4. European Central Bank. I. Title.

HG230.3 .B64 2001 332.4'6—dc21 2001034045

ISBN 0-19-924057-4

ISBN 0-19-924856-7 (pbk.)

1 3 5 7 9 10 8 6 4 2

Typeset by Charon Tec Pvt. Ltd, Chennai, India

Printed in Great Britain

on acid-free paper by

T.J. International Ltd., Padstow, Cornwall

**Universitäts- und
Landesbibliothek
Darmstadt**

Contents

<i>List of figures</i>	xii
<i>List of tables</i>	xiii
<i>List of boxes</i>	xv
<i>List of abbreviations</i>	xvi
<i>Introduction</i>	xviii

Part I. Theoretical Fundamentals of Monetary Policy

1. What is money?	3
1.1. <i>Introduction</i>	3
1.2. <i>A microeconomic approach to the definition of money</i>	4
1.3. <i>Defining money by its functions</i>	11
1.4. <i>Defining money by its statistical properties</i>	14
1.5. <i>The importance of a 'correct' definition of money</i>	15
Appendix 1.1. <i>Definitions of money in the euro area, the United States, Japan, and the UK</i>	15
Appendix 1.2. <i>The concept of (net) financial assets (flow of funds analysis)</i>	17
2. The demand for money	20
2.1. <i>Introduction</i>	20
2.2. <i>The quantity theory of money and the Cambridge approach</i>	21
2.3. <i>The interest rate as a determinant of the money demand</i>	23
2.4. <i>The money demand function of Cagan</i>	32
2.5. <i>Wealth as a determinant of the demand for money</i>	32
2.6. <i>Empirical demand functions for money</i>	34
Appendix 2.1. <i>Cointegration</i>	38
3. The money supply process: starting point of the transmission process	40
3.1. <i>Introduction</i>	40
3.2. <i>Creation and control of the monetary base by the central bank</i>	41
3.3. <i>Consolidated balance sheet of the banking system and the supply of the money stock</i>	46

3.4. <i>The mechanistic multiplier process</i>	48
3.5. <i>A price-theoretic model of the money supply</i>	53
Appendix 3.1. <i>A 'Poole analysis' for shocks</i>	65
4. Monetary policy transmission	71
4.1. <i>Introduction</i>	71
4.2. <i>Limited knowledge about the transmission process</i>	73
4.3. <i>The quantity theory channel</i>	74
4.4. <i>Interest rate channels</i>	80
4.5. <i>Expectations channels (the 'Phillips curve')</i>	95
4.6. <i>Summary</i>	115
Appendix 4.1. <i>The original Poole model</i>	116
Appendix 4.2. <i>The concept of the 'price gap'</i>	121
Part II. Domestic Aspects of Monetary Policy	
5. The ultimate goal and the final targets of monetary policy	127
5.1. <i>Introduction</i>	127
5.2. <i>The long-term view: only price stability matters</i>	131
5.3. <i>Inflation and output growth in the short run</i>	148
5.4. <i>Operational issues of a 'stability-oriented monetary policy'</i>	153
5.5. <i>Summary</i>	160
Appendix 5.1. <i>Different variants of the nominal GDP targeting</i>	161
Appendix 5.2. <i>Calculating the welfare losses of sub-optimal money holdings</i>	162
6. The institutional framework for monetary policy I: 'rules versus discretion'	164
6.1. <i>Overview</i>	164
6.2. <i>Rules versus discretion in monetary policy</i>	165
6.3. <i>The main arguments for limiting the discretion of central bankers</i>	165
6.4. <i>Rules that are imposed on central banks from outside</i>	169
6.5. <i>Summary of the traditional debate</i>	174
6.6. <i>'Time inconsistency': a new argument in support of rules?</i>	174
Appendix 6.1. <i>The debate between the Banking School and the Currency School</i>	202
7. The institutional framework of monetary policy II: the design of the central bank legislation	205
7.1. <i>Overview</i>	205
7.2. <i>Independence of monetary policy</i>	207

7.3. <i>Accountability of central banks</i>	220
7.4. <i>Liability of incompetent central bankers</i>	228
Appendix 7.1. <i>The functions of central banks and the technology of the payments systems</i>	234
8. Strategies ('simple rules') for a stability-oriented monetary policy	240
8.1. <i>The function of simple rules</i>	240
8.2. <i>'Simple rules', intermediate targets, and indicators of monetary policy</i>	245
8.3. <i>Monetary targeting</i>	248
8.4. <i>Inflation targeting</i>	257
8.5. <i>The Taylor rule: a rule for an operating target</i>	268
8.6. <i>A nominal GDP rule</i>	274
Appendix 8.1. <i>The yield structure as an indicator of the stance of monetary policy</i>	282
9. The conduct of monetary policy by the world's major central banks	293
9.1. <i>A comparison of the performance of central banks</i>	293
9.2. <i>The monetary policy framework of the Deutsche Bundesbank</i>	295
9.3. <i>The monetary policy framework of the European Central Bank</i>	300
9.4. <i>The monetary policy framework of the Federal Reserve System</i>	307
9.5. <i>The monetary policy framework of the Bank of Japan</i>	311
9.6. <i>The monetary policy framework of the Bank of England</i>	317
10. The instruments of monetary policy	321
10.1. <i>Basic requirements</i>	321
10.2. <i>Monetary base targeting v. interest rate targeting</i>	323
10.3. <i>Significance of individual monetary policy instruments</i>	336
10.4. <i>Money market management by the European Central Bank</i>	348
10.5. <i>Money market management by the Federal Reserve System</i>	358
10.6. <i>Money market management by the Bank of England</i>	361
10.7. <i>Money market management by the Bank of Japan</i>	364
10.8. <i>The New Political Economy and monetary policy instruments</i>	365
11. Seigniorage and inflation tax	369
11.1. <i>Introduction</i>	369
11.2. <i>Monetary seigniorage and fiscal seigniorage</i>	370
11.3. <i>Macroeconomic stability and seigniorage financing</i>	372
11.4. <i>Optimal seigniorage</i>	382

Part III. Monetary Policy in an Open Economy

12. Important building blocks of open-economy macroeconomics	387
12.1. <i>Introduction</i>	387
12.2. <i>The exchange rate as an operating target of monetary policy</i>	388
12.3. <i>The exchange rate as an intermediate target of monetary policy</i>	391
12.4. <i>The control of the price level in an open economy</i>	403
13. Monetary policy strategies in an open economy	410
13.1. <i>Introduction</i>	410
13.2. <i>Large-currency areas</i>	411
13.3. <i>Small open economies with targeted exchange rates</i>	412
 <i>References</i>	 429
<i>Index of names</i>	447
<i>Index of subjects</i>	450