

Business Topics

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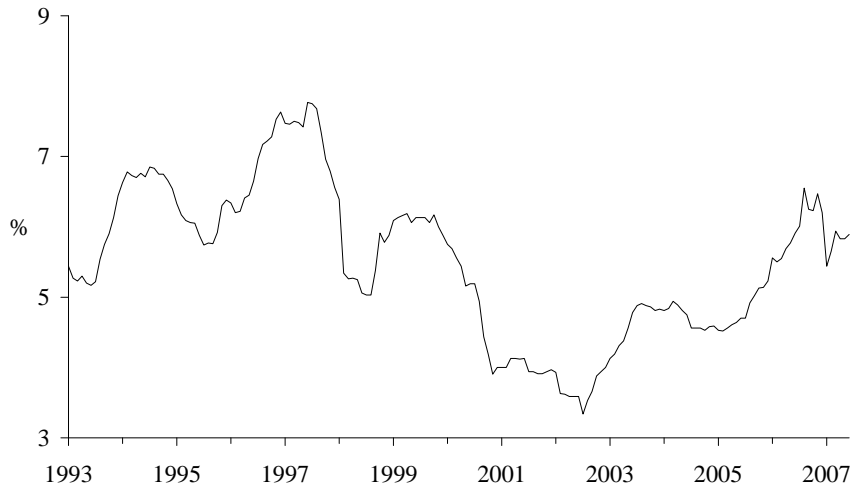
- A Indicators and Forecasts
- B. The commodity crisis — origins and cures
- C. UK monetary muddle
- D. Europe's protectionism — latest estimates

SECTION C: The UK Monetary Muddle-responses to the demand/supply shock crisis

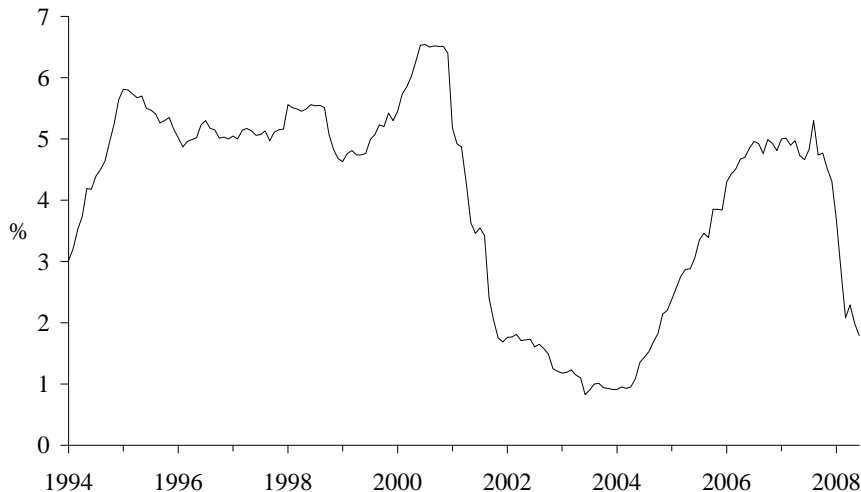
Crisis- demand and supply shocks and responses

- Demand shock — in August 2007 sub-prime crisis struck; major central banks, including US Fed and the ECB, reacted with massive liquidity provision to banks — the Bagehot principle. Bank of England initially refused but has since joined in. Nevertheless risk spread over repo rate has remained large.
- Though concern about 'moral hazard', central banks have treated as demand shock: cutting rates and providing liquidity.
- Supply shock — over the past 3 years rapid escalation of oil and other commodity prices. This has triggered 'dilemma' for central banks.
- Central banks have differed in response: Fed at one end have treated supply shock as causing temporary shock to inflation and cut rates; at other extreme ECB has kept rates up, worrying about permanent effects on inflation. Bank of Eng in between, closer to ECB.

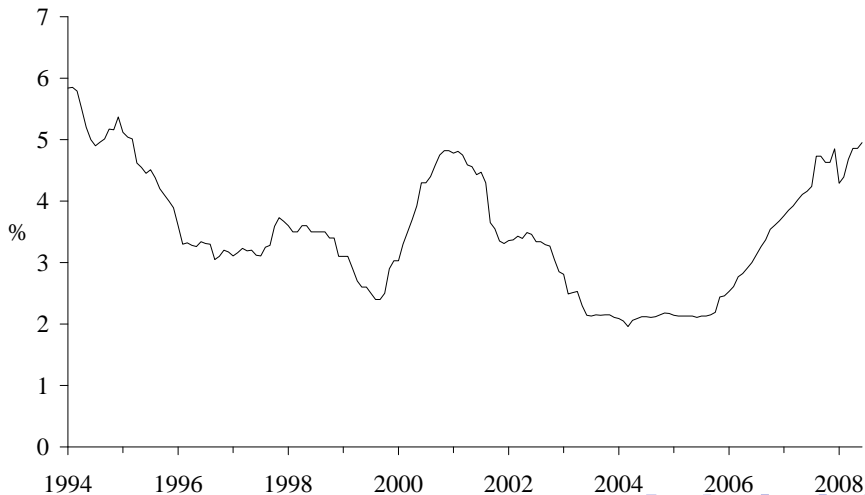
U.K. : 3-Month Interbank Rate



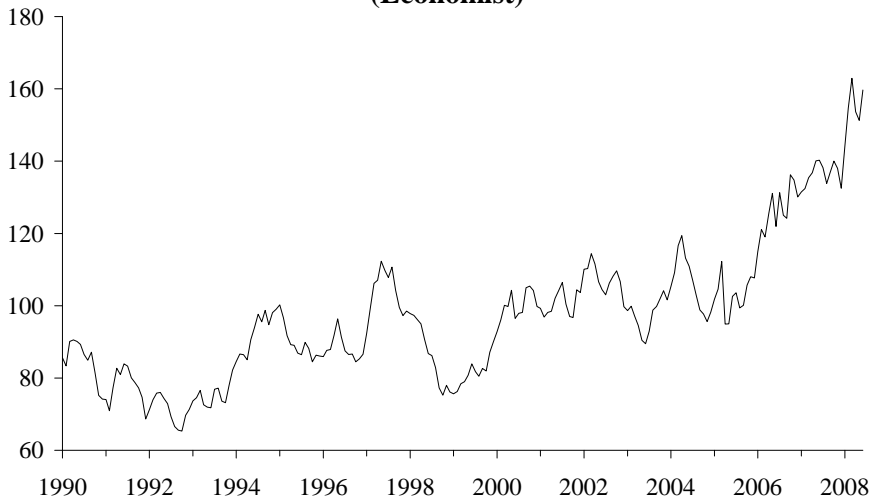
U.S. : 3-Month Treasury Bill Rate



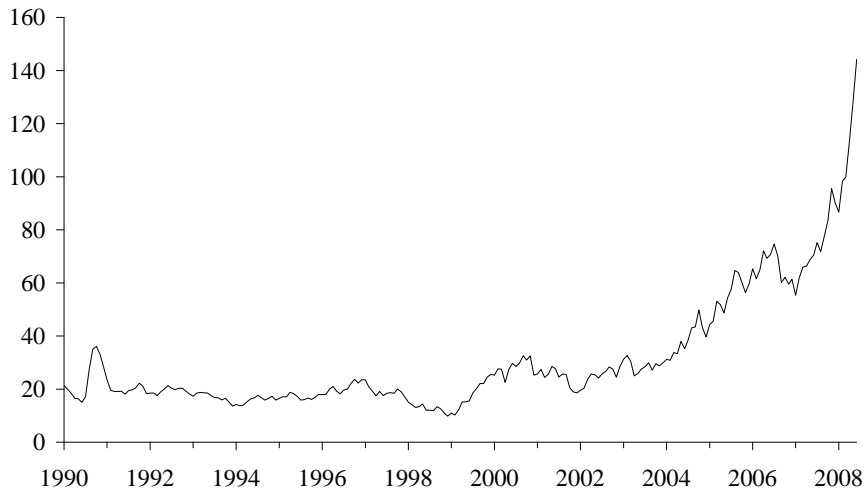
Germany : 3-Month Interbank Deposit Rate



Commodity Price Index (Euro) (Economist)



Oil Price: North Sea Brent

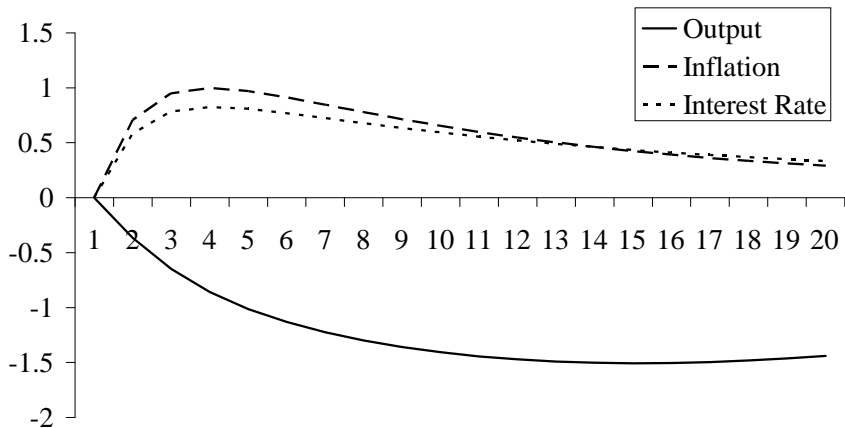


Model of economy — verdict on inflation process

- what do modern models of the economy say about the effects of a) monetary policy on inflation b) world inflation on home inflation?
- on a) the medium-term inflation rate depends on the inflation target; interest rates force that target to be accepted and affect the path of inflation to the target
- on b) world inflation has no effect on medium-term inflation but does affect the path of inflation short-term. Case for targeting 'core inflation'.
- use recent model of EU by Smets and Wouters to evaluate.

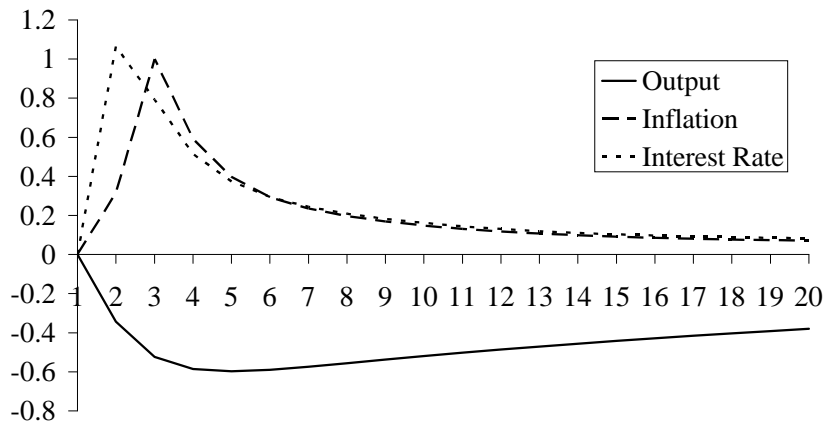
World inflation — effects of rise in world inflation (proxied by productivity fall of 1%) (New Keynesian Model)

Productivity Fall (NK Model)



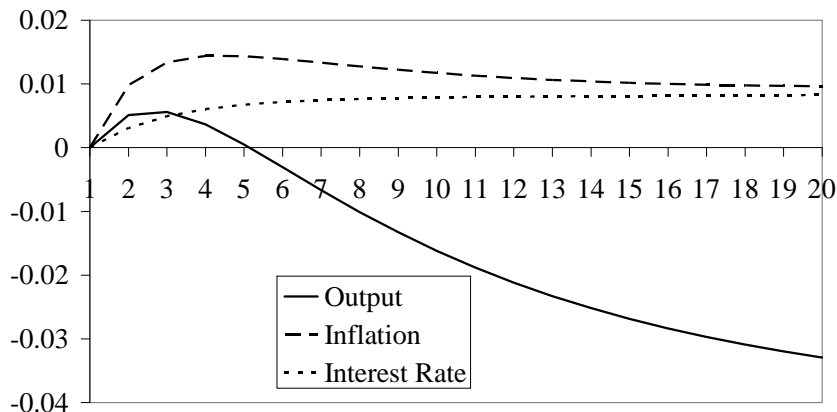
World inflation — effects of rise in world inflation (proxied by productivity fall by 1%) (New Classical Model)

Productivity Fall (NC Model)



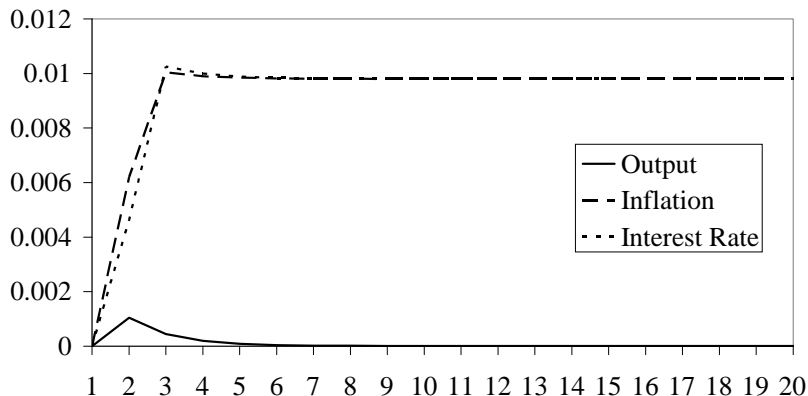
Monetary policy — effects of rise in inflation target by 1% (New Keynesian Model)

Rise in Inflation Target (NK Model)



Monetary policy — effects of rise in inflation target by 1% (New Classical Model)

Rise in Inflation Target (NC Model)



Reasons for worrying about non-monetary factors? I

Learning

- **Learning:** would people be confused by higher world inflation into thinking the central bank had abandoned its inflation target? 'Learn about' higher inflation target from higher actual inflation?
- But the inflation target framework and the same target (except for small definition changes) there for a long time — decade or more.
- Also everyone can see that it is world prices that are rising. Different from 1970s when rising world prices led to fast rising wages as inflation (or other monetary) target were either weak or non-existent.
- What is there to learn?

Reasons for worrying about non-monetary factors? II

Credibility

- **Credibility:** could the central bank abandon or be forced (eg by political pressure) to abandon its inflation target in favour say of keeping down unemployment?
- Legitimate concern: credit crunch/recession causing pain to public and union members.
- But a) central banks determined to maintain independence b) governments would lose support if assaulted bank independence.
- Credibility is secure but some (minor) 'demonstration' of central bank independence possibly needed to reinforce it in short term — slower cuts in interest rates than otherwise?