

MONETARY THEORY AND POLICY : RUMINATIONS

(PROFESSOR COMPTON BOURNE)

INTRODUCTION

I have been asked to provide a retrospective statement on monetary theory and practice in the Caribbean. John Robinson and Dave Seerattan have been asked to provide current and future perspectives. There is an inverse correlation between the time dimensions of the topics assigned and the age profile of the speakers. However, I hesitate to make any inferences about causality or predictability for everyone knows about wise heads on young shoulders and about foolish old men. Let us settle for functionality.

THE NATURE OF MONETARY POLICY

From what I have seen in the literature and observed from central bankers, monetary policy may be reasonably interpreted to mean policy actions taken by central banks or other monetary authorities to achieve target levels or desired directional change in the quantum of money, 'aggregate' interest rates, or both with a view to effecting planned or hoped for changes in the volume and price of credit and in aggregate expenditures. The objectives of monetary policy have variously included aggregate price level stability, foreign exchange rate stability, economic growth and employment.

The wording of the immediate preceding paragraph is deliberate. The history of monetary policy in the Caribbean suggests some irresolution and lack of clarity with respect to choice of target variables. Is it money? Which measure of money stock?

Central banks have in part followed intellectual fashion in their choice of monetary aggregate, perhaps moreso in the 1970s commitment to M3 money. However, underlying economic reality in the sense of how the economy really works has also influenced their choice. There is an attachment now as there was in the 1960s to base money, determined by aggregate fiscal transactions and by foreign exchanges.

Interest rates seem to present enormous difficulties for Caribbean central banks. They have been variously treated as targets and as instruments across the region and often time inconsistently in individual countries. On reflection, it seems to me that the confusion is explainable by one or more of the following factors. First, there is no clearly understood model of financial market interlinkages or worse yet financial markets may not be closely interlinked. If these conditions are not satisfied, central banks can be forgiven for not being sure that it is sufficient to target commercial bank rates of interest with the intention of ultimately but not too distantly affecting interest rates system-wide. Second, term structure theories of interest rates may not be applicable. The essence of term structure theory is the direct correlation between term to maturity and interest rates on financial instruments, with due allowance for camel anatomical features in some national financial markets. It used to be that longer was riskier and that patience (postponement of consumption) had to be rewarded. There is now greater risk attached to many short-term instruments and patience is commonly punished by inflation-unaverse governments. Without dependable interest linkages between sub-markets and across maturities, the concept of aggregate interest rates (as a uni-dimensional, uni-directional indicator of changes in all interest rates) becomes quite nebulous. Thirdly, distributional and social welfare considerations are frequently attached to interest rates. Muslim

religious fundamentals preclude interest rates. Western value systems are not so categorical, hedging with the notion of reasonable return on savings and capital, and castigating Shylock and his 20th century counterparts on the curb and in skyscrapers. Distributional and social welfare concerns may cause central banks to treat selected interest rates as non-market variables, to exclude them from the policy set as was once done by arbitrary ceilings on several interest rates in Jamaica, Trinidad and Tobago and other countries.

“Planned or hoped for changes in the volume and price of credit and in aggregate expenditures” alludes to imperfect knowledge and understanding of both the transmission mechanism of monetary policy and the impact of policy. Social scientists defend the imprecision of their discipline and its tendency towards inaccurate predictions and forecasts by reference to the unexplainable dynamic of human behaviour – the stochastic “u”, ultimate cop out for all econometricians. We understood it well, but it has changed in ways we did not anticipate. I do not think that Caribbean central banks believe that they understand the financial sector or the macroeconomy all that well during any short interval of time. I think that they believe that their understanding is better than that of anyone else. They are probably correct. They certainly allocate proportionately more time and resources to the quest for sound knowledge and good information as the basis for monetary policy. However, things do change. Macro-fundamentals change. Open, liberalised economies do not behave the same way as closed, highly regulated economies. The international environment does change and will continue to change. Individuals and institutions do change their preferences and patterns of behaviour, surreptitiously

sometimes. In the financial sector, change is both complex and rapid. Given all of the above, it seems that monetary policy-makers must become experts, detectives, diviners and soothsayers. They try.

Occasionally, it is necessary to insist that monetary policy is not statutorily limited to a single goal or single objective. It also never used to be the case that central banks in any country saw their objective function as uni-dimensional. On the contrary, central banks accepted the obligations of creating a social welfare function which assigned weights to the several objectives of monetary policy and formulated policies which took cognisance of their structural trade-offs. Uni-dimensional, single-valued preference functions are of 1950s Chicago vintage, put in newer bottles and well marketed internationally from global headquarters in Washington, D.C. The Tinbergen instrument rule never said one policy objective. It said that the number of instruments must not be fewer than the target variables. Furthermore, there is a significant difference between target variables and objective variables. I have not heard it argued that a single target variable cannot have multi-impact or diffusion effects. It is somewhat disturbing to me that young and not so young Caribbean central bankers are so quick to accept pre-packaged contemporary orthodoxies. Wider reading and the study of modern economic thought (modern, not "instant" economic thought) seem mandatory for those who would make monetary policy.

A word on policy credibility and rules. Discretionary judgement rather than automaticity is the sine qua non of policy-making. Enforcement of rules, however sophisticated, requires bureaucrats not policy makers. Policy credibility, it seems to me,

emanates not from rigid observance of a preset or pre-announced rule but from the confidence based on past performance that economy participants attach to central actions and commitments. It is this which elicits positive market responses, not senseless automaticity on the part of central banks. Perhaps the point is best made by the story of the suicidal lover who leaps off the cliff. "I'll love you forever", he shouts. "Fool", she mutters.

CONCLUSION

I have reflected on the topic of monetary policy really just to make a few points. First, that policy making under conditions of change and uncertainty is very difficult. Second, there is no credible way of making sound monetary policy other than by careful acquisition of information and knowledge and by judicious application of these to targets and goals discretionarily determined.

Ladies and gentlemen, when my father demanded my presence during his slow, lengthy ruminations, one or two things would happen. First, my attention would wander. Second, I would doze. I hope that my ruminations held your attention. But uncertainty counsels me to stop, lest you doze.

Office of the Campus Principal
St. Augustine
1998-10-21