

Review of "Monetary Policy: Rules and Transmission Mechanisms", N. Loayza and K. Schmidt-Hebbel (eds.)

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This book contains fourteen essays on various aspects of the transmission mechanism of monetary policy and on the reaction function of the central bank.¹ Some of the papers deal with common general aspects of those issues while others provide empirical estimates of transmission mechanisms and of reaction functions of monetary authorities for individual countries.

In addition to a general introduction by Loayza and Schmidt-Hebbel, the book features two general evaluations of the robustness of policy rules by Taylor and by Larry Ball, a paper on policy rules when the current account matters by Medina and Valdez, a paper on the effects of uncertainties on monetary policy by Cagliarini and Debelle, a broad paper on monetary policy in Latin America during the nineties by Corbo, an international comparison of inflation targeters with non targeters by Cecchetti and Ehrmann, a paper by Bennett and Loayza on the strategic interaction between fiscal and monetary authorities, and six country specific papers two of which relate to Chile and the rest to the UK, Canada, Israel and South Africa.

Due to differences in openness, depth of capital markets, size, inflationary histories, nature of economic shocks and other structural differences, there often are substantial differences in the transmission mechanisms across different countries. The essays in the book document many of those differences for a group of ten countries for the nineties, and in some cases for part of

¹Earlier versions of most of the papers in the volume were presented at the Third Annual Conference of the Central Bank of Chile in September 1999.

the eighties.² Five channels of monetary policy are considered in various combinations across the different papers and countries in the volume. The traditional interest rate channel, the monetarist asset channel, the exchange rate channel, the credit channel and the "expectations" channel. A rough comparison of the relative importance of these channels across six countries suggests that the interest rate and the exchange rate channel operate in all of them and the asset channel in none. The credit channel operates only in Chile and Israel and the expectation channel only in the UK and Canada.

The second basic issue examined by the essays in the book concerns the reaction function of the central bank. Many of the papers contain estimates of Taylor rules over the nineties for the countries considered as well as some calibrations. The basic specification across papers is the one suggested by Taylor's (1993).³ Following Clarida, Gali and Gertler (2000) some papers use future values of the inflation gap and of the output gap as expected in the present instead of current or lagged actual values as done by Taylor.⁴ In addition some papers add the current account deficit as a share of GDP in Latin American countries to reflect a current account objective. In some cases the equation also features a foreign interest rate.

In all countries examined there is a meaningful response of the bank's rate to inflation. But there is a significant response to the output gap only in a subset of countries. The country papers provide new interesting evidence on the magnitude of the bank's response to the rate of inflation during the nineties. The papers suggest that in the UK, Canada and Chile policy leaned against inflation by raising the real rate in response to increases in inflation, but that in other countries policy accommodated inflation, or was neutral.

Many of the economies discussed are small and open making their economic activity and rates of inflation sensitive to foreign shocks. In such economies monetary policy has to take into account the additional shocks as well as the additional channels of transmission of monetary policy that are due to openness. Based on US and UK experience Taylor argues that the welfare gains from adjusting his baseline rule to account for the open economy channels does not

²The countries are: the UK, Canada, Australia, Chile, Israel, South Africa, Colombia, Costa Rica, El Salvador and Peru.

³Taylor John (1993) "Discretion versus Policy Rules in Practice", **Carnegie-Rochester Conference Series on Public Policy**, 39, 195-214.

⁴Clarida, R., Galí, J. and M. Gertler (2000) "Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory", **Quarterly Journal of Economics**, 113, 147-180.

appreciably increase welfare. Ball, proposes a modified rule that stabilizes a linear combination of inflation and of the real exchange rate. Both Taylor and Ball recognize that, due to different degrees of openness and other structural differences, numerical simulations from the US and the UK are of limited use for small open economies with substantially narrower capital markets. Two of the papers present quantitative estimates of the passthrough coefficient. Its average value is estimated to be 0.7 for the UK (Cunnigham and Haldane) and 0.4 for Israel (Leiderman and Bar-Or). In both countries the passthrough is found to be higher during expansions than during recessions.

Over the nineties some countries have moved from either an exchange rate anchor, or a money stock anchor to inflation targeting and the short term interest rate became the predominant monetary policy instrument. Corbo's paper discusses the reasons for these institutional changes in several Latin American countries and documents cross country differences in the implementation of inflation targets. Cecchetti and Ehrman estimate the change in the relative aversion of policymakers to inflation variability and to output variability in twenty three countries. They find that the relative aversion to inflation variability increased in all countries during the nineties but that it increased by more among the nine explicit inflation targeters.

In summary, the detailed, country specific, information in the volume highlights the substantial amount of diversity across countries and particularly, between mature developed economies like the US and the UK on one hand and Latin American economies on the other. Paradoxically, the variety of approaches and methodologies used in the volume to tackle the same basic issues underlines the fact that, in spite of substantial advances, our knowledge of the transmission mechanism is still quite diffuse. In spite of this, the book contains valuable new information about the transmission process, about monetary policy rules and about changes in monetary policymaking institutions during the nineties.