Comments on D. Laidler's "The price level, relative prices, and economic stability : aspects of the inter-war debate" (1)

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Question

Is low inflation together with occational lender of the last resort sufficient as a goal of monetary policy?

Summary of Paper

1. Quantity Theory Tradition

- British Monetary Orthodoxy
  - Principle of Gold Standard

    long-term commitment of not to default on government nominal liabilities

    does not lead to price level stability

  - Principle of Price Stability

    interaction between credit and business cycle can be inherently unstable

    ⇒ case for short-term discretionary policy aimed at stabilizing price

- Principle of Lender of the Last Resort

  central bank provides enough liquidity to the market in the event of financial strain

- Hawtrey 1928-32

  Asset price inflation during 1920s followed by its collapse leads to "credit deadlock"

  public do not want to borrow — $\frac{\text{deposit}}{\text{currency}} \downarrow$

  banks do not want to lend — $\frac{\text{deposit}}{\text{reserve}} \downarrow$

  Fed did not provide enough liquidity

- Pigou, Keynes

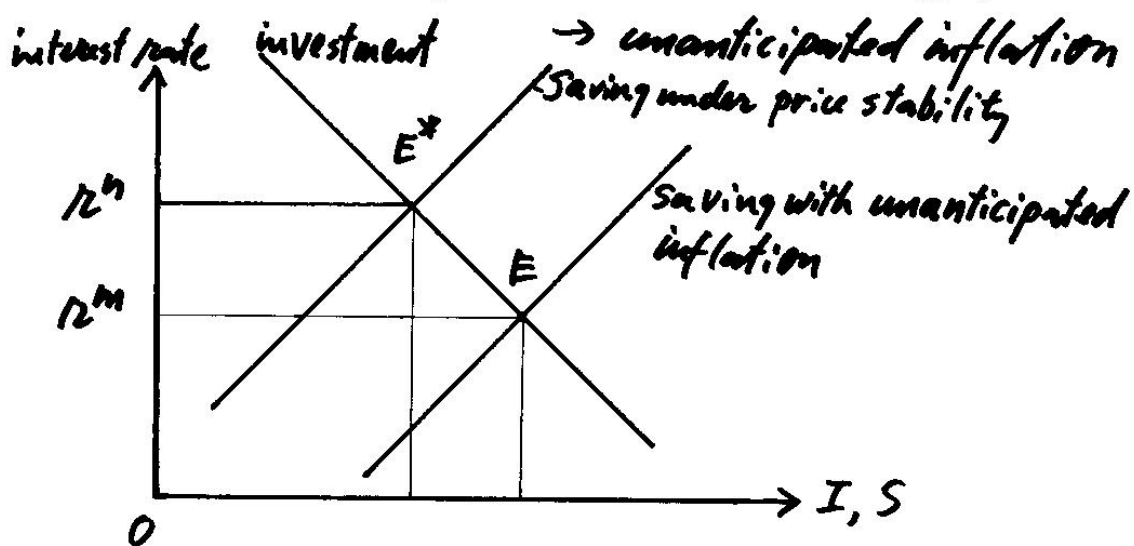
  fixed investment fluctuation can be an independent source of fluctuation

  → price stability is not enough

2. Wicksell - Austrian Tradition

- develop intertemporal general equilibrium model
- add money to real model as a limited participation cash-in-advance constraint model
- market rate of interest can differ from the expected rate of return on investment (natural rate of interest)

⇒ forced saving   new credit creation
→ unanticipated inflation



- forced saving may lead to overproduction in future
  boom is not sustainable
- Austrian consider depression of 1930s as a correction of over-expansion of 1920s
  → advocate passive policy

3. Dennis Robertson

- If technological innovation is main cause of fluctuation, forced saving can be beneficial
  → rigid price stabilization can be harmful

- During depression, monetary policy may not be enough

- Ideal Monetary Policy
  - price stability as a norm
  - complemented by
    - occational forced saving to accommodate a sudden real shock
    - coordination with other policies during recession

Critical Comments

1. Need a better theory

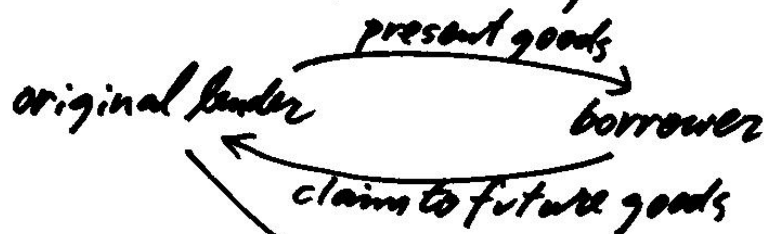
- Quantity theory is a useful short-cut for policy analysis

  standard general equilibrium model and quantity theory are not mutually consistent

- Intertemporal general equilibrium model with cash-in-advance constraint is consistent

  money is disturbance rather than lubricant

- If intertemporal exchange is inherently more difficult than intra-temporal exchange, we should take account the difficulty into theory systematically



limited commitment

borrowing constraint

limited resaleability

2. Need another policy instrument for instability of banking system against asset price fluctuation

- monetary policy has one instrument: short-term interest rate
  - assign to one target which monetary policy is good at — price stability
- asset price boom may endanger the banking system after collapse
  - Anna Schwartz
    - introduce capital requirement of bank which is an increasing function of loan collateralized by real estates and equities