

Comments on Charles Wyplosz' Paper:

“What Do We Know About Monetary Policy  
that Friedman Didn't Know”



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by

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## Comments on Charles Wyplosz' Paper

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- Some disclaimers"
  - i. It is difficult to comment on a PowerPoint.
  - ii. My background is mostly fiscal.
  - iii. I cannot claim to be well acquainted with the recent literature on monetary policy.
  - iv. Because of the positions that I held in the past, my preoccupations have been with real life and not theoretical aspects of policy.
  - v. My comments will undoubtedly reflect the above characteristics.



## Comments on Charles Wyplosz' Paper

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- Charles starts by distinguishing “(roughly) unchanged fundamentals” from what he calls new and controversial “details”. Unfortunately, the devil is often in the details.
- Among the “unchanged fundamentals” he lists the view that “inflation is a monetary phenomenon”. Although most would agree with him we face the possibility that prices can change because of the significant change in some imports (oil? rice? etc.). How should monetary policy respond to these externally generated shocks on prices?
- Core inflation or headline inflation?



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- He seems to accept the notion of the “long-run neutrality” between monetary expansion and economic activity. However, the long run is the summation of many short runs and short runs have implications for the long run. So what is the meaning of neutrality?



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- Another question: Is it possible to have long run neutrality without a close relationship between money growth and prices? Wouldn't such a relation imply a money growth rule that Charles says "came and went?" Can we accept long run neutrality while rejecting a money growth rule?



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- On monetary policy channels:  
Channels have become complex. The direct interest rate channel has become less important. Presumably differential risks among assets have become more important. But measurement of risk is very difficult because of financial innovation. This must have made policy much more difficult than in the past.



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- On monetary policy channels:
  - i. The issue of asset prices appeared during the 1997-98 financial crises in Southeast Asia.
  - ii. I has raised the question of the measurement of some assets:
    - book value or market value?
  - iii. And the question of links with monetary policy.
  - iv. And of links between asset prices and the relevant inflation rate that should guide monetary policy.  
(Current criticism of Greenspan).



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- On monetary policy channels:
  - i. Do we have full and current information on the balance sheets of all those who operate in the financial markets?
  - ii. Again should we use “value to market” that may change by the minute, or book value?
  - iii. What if important market operators (Hedge funds etc.) are not regulated or monitored? Recall that contracts backed by hedge funds have exceeded 30 times the U.S. GDP in recent years should monetary authority ignore their behavior?



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- On Inflation Target
  - i. High is bad, but inflation can be too low. Again, which measure of inflation?
  - ii. Friedman's negative optimum inflation rate has not caught on.
  - iii. Best theory is optimal tax from public finance? No!
    - (a) impact of collection lags for tax revenue
    - (b) even low inflation brings many distortions (because of lack of indexation in tax system and in financial contracts).



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- Fiscal-monetary policy interactions
  - Dreams of economists: “The overall public sector inter temporal budget constraints”. Significance? At what level of spending and taxes?



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- Central Bank Independence:  
Real or apparent?



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- The Rational Expectation Revolution:
  - i. “Only unanticipated monetary policy matters”. But if channels cannot be identified; risk cannot be measured; interest rate channel is “tenuous”, what does that statement mean precisely?
  - ii. Whether anticipated or not, monetary policy will have an impact either when it is carried out or at the time it was anticipated. It is just a question of timing.



## Comments on Charles Wyplosz' Paper

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- Problems created by information asymmetries
  - Information asymmetries can create problems in many areas, from buying used cars that turn out to be “lemons”, to tax evasion, to monetary policy.
  - One aspect that I missed from Charles' informative presentation is the growing complexity of the financial market and how it must affect information asymmetries and monetary policy



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- Complexity is creating enormous problem of asymmetric information. It is also leading to the mispricing of many financial assets.
- This leads to the question of whether a market system, where prices are not right (because information is not available) and where risk cannot be assessed properly, can satisfy the conditions that lead to optimal results a la Hayek.



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- At the cost of sounding presumptuous, I would like to call attention to a paper that I wrote a couple years ago called “Complexity and Systemic Failure”. It was published in a book, Transition and Beyond, edited by Saul Estrin et al. (Palgrave, 2007). It seems highly relevant to our discussion and to the recent developments in the financial market.



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- Conclusion:

This is a much more complex world than Friedman's. But we still may not know much more than he did. In relative term there has been little progress in monetary policy since Friedman's time in relation to what we need to know.