

## Commentary: Monetary Policy in the Information Economy

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I'm perhaps not the ideal discussant, as I agree strongly with everything in Michael Woodford's paper, especially footnote 64. Although I'm known as a slash-and-burn discussant, I will depart from that mode today.

The first main point of the paper is that monetary policy does not depend on surprise to be effective. Consequently, there is no case for secrecy in the conduct of monetary policy. The central bank should make public statements about the goals of policy and the steps it is taking to achieve the goals. This does not mean that the central bank should deliberate in public—only that it should be clear about its goals and policies.

The idea that monetary policy needs to be secret is a demented misunderstanding of an idea that enjoyed a brief vogue twenty-five years ago. It's not clear to me that refuting the idea is needed today, but others here are better judges than I. The original idea—developed by Robert Lucas—was that unperceived changes in the money supply could result in real effects under certain conditions. A fundamental property of the Lucas model was that all *perceived* changes in the money supply affected the price level immediately. So, if a monetary policy works when it is easily capable of controlling the price level, then the concern is backward—in the Lucas model, price level control is improved by disclosure of monetary policy.

Woodford finds this point too obvious to mention. He does point out that the central bank should seek control over real activity only if it has superior knowledge of the right level—and Woodford is skeptical about that idea. In any case, the Lucas model receives little empirical support. The more recent Calvo model, widely used in modern research, does not imply any difference between announced and secret policy.

The issue of transparency receives an interesting modern treatment in Susan Athey, Andrew Atkeson, and Patrick J. Kehoe “On the optimality of transparent monetary policy.” They find transparency almost invariably to be preferred, in the sense that monetary policy should be a stable function of observed variables.

I’d go beyond Woodford to say that we lack any model of price stickiness that commands serious empirical support. In particular, the Calvo model is completely out of touch with the facts about price determination. Many prices—the bulk of business-to-business transactions in particular—are set in informal auctions in each transaction. Nothing could be more distant than prices set by a remote executive once a year.

The second and more important point in the paper is that a central bank can peg a short-term interest rate in any economy, no matter how advanced. Concerns expressed by Ben Friedman and others that the financially inconsequential transactions of the central bank could lose their leverage over short-term interest rates are incorrect. As Woodford explains, the magnitude of the central bank’s portfolio or its transaction is absolutely irrelevant to the central bank’s control of the price level. Much of what Woodford writes resembles the earlier writings of Irving Fisher, Eugene Fama, Fischer Black, and myself—writings that have had no influence whatsoever on modern monetary economics. I wish him good luck in what may be a frustrating enterprise.

The easiest way to see that interest-rate control has nothing to do with the portfolios of the central bank is to consider monetary policy in a setting where there was no central bank—the United States

before the Civil War. The single but completely powerful instrument of monetary policy under the pure gold standard was the gold content of the dollar. The federal government—without any central bank—could have raised interest rates by increasing the gold content and vice versa. A single government official, charged with stabilization of the price level, could have followed a monetary policy identical to that of today's Fed, pegging a short-term rate as an intermediate target. Instead of buying and selling government securities, the official would announce changes in the number of ounces of gold making up one dollar.

Woodford ultimately writes the kinds of words that his predecessors in the Deep Underground wrote: The central bank issues the security that defines the dollar, and it controls the interest rate and ultimately the price level by adjusting either the quantity or the interest paid on that security. Earlier writers in this tradition were hampered by the lack of real-world examples other than U.S.-style central banking. The best we had was Chile's *Unidad de Fomento*. Woodford has the big advantage that New Zealand and Canada have adopted an interesting new system and shows that it works splendidly. In effect, the policy instrument is the interest rate paid on balances at the central bank. This is the analog to the federal funds rate. Rather than using a short-term interest rate target, achieved by trading securities, the new system makes the same rate a direct instrument.

In New Zealand and Canada, the net balances at the central bank are essentially zero. So, a central-bank portfolio and transactions in it are unnecessary.

Woodford's expositional approach is to start with the New Zealand-Canada system in its real-world version and then strip it down to its essentials. Maybe this is a good idea—given the failure of his predecessors to make any intellectual dent. We tried the opposite, showing, in general terms, how the government sets the price level and then describing particular examples.

Woodford notes Hayek's confusion on free-market money. We don't need competing monetary units any more than we need competing

units of weight. We need competing transaction systems all denominated in the same unit. It is an indispensable function of government, not markets, to define that unit.

This is a terrific paper. I hope that Woodford will succeed where others have failed to broaden the parameters of mainstream monetary economics.