The Debates on Alternatives for Monetary Policy in Australia by Malcolm Edey.

This paper discusses the different monetary policy alternatives that are available to policy makers for monitoring and controlling aspects of monetary policy such as money supply, exchange rates and inflation.

Malcolm states that there are two levels of debate, one concerning the appropriate policy system and the other level concerning the parameters and design features. In searching for the system what is required is a choice of realistic alternatives, rather then abstract theories with little relevance to real world situations. The Edey paper focuses mainly on the level of the choice of system.

There are four theoretical possibilities discussed:
1) quantity-setting systems
2) final targeting systems
3) exchange rate or commodity standards
4) laissez-faire approaches

Rate or Quantity setting:
The rules are as follows
1) $m_t = m^T_t$ (quantity rule)
2) $i_t = \gamma (m_t - m^T_t)$ (monetary target)
where $m^T$ is the target path and $\gamma$ represents the responsiveness of policy to a deviation from target.

1 focuses on the monetary base which can be controlled either directly or by appropriate institutional changes. And 2 uses money as an intermediate target, under which another policy instrument is adjusted with the aim of keeping the monetary aggregate on the target path. Edey states that of the cases often sited as having used strict monetary base control such as the Swiss, Bundesbank and the Federal Reserve, in none of the cases was the monetary base variable kept strictly on a predetermined path. It was used more as a signal than a policy instrument.

Rate setting uses short term interest rates to gain systematic influence on the final variables such as inflation and output.
The rules used are:
\[
i_t = r + \pi_t + \gamma (\pi_t - \pi^T_t) \\
i_t = r + \pi_t + \gamma (\Delta p_y_t - \Delta p_y^T_t) \\
i_t = r + \pi_t + \gamma (\pi_t - \pi^T_t) + \gamma 2 (y_t - y^T_t)
\]
where $i$ represents the nominal interest rate, $\pi$ the inflation rate, $p_y$ nominal income, $(y_t - y^T_t)$ the output gap, and the superscript $T$ a target value.

The interest rates respond systematically to deviations from the prescribed paths, expressed in term of inflation targets. The two approaches are quite different in practical terms.
**Price level determinacy:**
Edey takes a statement from Sargent’s 1979 paper, ‘Macroeconomic Theory’, that “there is no interest rate rule that is associated with a determinate price level” (p.45). An element of this is that under a fixed interest rate rule inflation shocks reduce the real interest rate and are reinforcing, this instability collapses to indeterminacy. The limitation of this principle though, is that price level determinacy is ensured in any rate setting policy rule specified to have a stabilizing effect on the price level or on some other variable.

**Targets with and without base drift:**
There is also the question of whether or not to allow base drift, so whether the policy rule should aim to correct accumulated deviations from the target inflation path. It increase long run variability but reduces short run variability. Uncertainty about future inflation increases as the forecast time length increases.

**Fixed Exchange rates and commodity standards:**
An example of fixed exchange rate policy is that of a Currency board which holds reserves of an anchor currency equal to domestic currency base, thus hopefully guaranteeing convertibility. This takes discretion away from the central bank. In the simplest form of commodity standard a commodity such as gold is given guarantee to convertibility with the currency by the currency issuer.

**Monetary laissez-faire:**
This would involve the abolition of central banks, and as such the issuing of currency would be a private market, with issuers free to choose their anchor. This however has the problem that issuers would have the incentive to inflate away their liabilities.

**Criteria for choosing between systems:**
Three characteristics mentioned by Edey
1) the system must satisfy the nominal-determinacy requirement
2) the system must be efficient
3) the system should have desirable properties in terms of discipline, commitment and its effects on inflation expectations.

**Terms of trade shocks:**
Because Australia exports commodities intensively, and imports manufactured goods, it is susceptible to high terms of trade variability, and thus an exchange rate based policy rule would not be very stable.

**Simplicity and credibility:**
There is a trade off between simple rules and complex rules. Complex rules outperform simple ones, but simple ones allow for better understanding and public knowledge. There is a need for balance in flexibility, simplicity, complexity, and effectiveness. Edey describes a framework that allows discretion at the level of interpreting information, but subject to constraints at the level of goals and ultimate outcomes.
The Policy Spectrum in Practice:
The difference between alternative policies is not as different in reality as they are in theory. Of selected OECD countries in 1997, many are Inflation targeting, including Australia, UK, Canada, and New Zealand. France, Italy, Netherlands, Belgium, practice Exchange rate pegging. Germany and Switzerland, practice Monetary Target, while the US and Japan have no numerical target. These countries however don’t stick strictly to the textbook definition of their policies. The target levels of the various countries are all fairly close. The difference comes mainly in the amount of flexibility the central bank allows in the temporary variations of the target. Edey sums up the differences by saying “what distinguishes the inflation targeters is their use of the targets as a formal pre-commitment mechanism and as a vehicle for focusing the public’s expectations and explaining policy actions” (p. 63).

Criticisms of the paper, strengths, weaknesses:
I felt perhaps that there wasn’t enough discussion as to how each policy rule would effect the way the inflation would be targeted in Australia and how the rules would effect the overall economy.

I felt the rules could have been explained in a bit more depth. It felt a bit like the math was just added in rather then forming part of the argument.

The paper did well in comparing and explaining the differences between the different policy options. It gave a clear picture on the theoretical differences and showed the reality of applying the policies in the real world is not always keeping to strict definition, but changes allowing for the best outcomes.

Edey has a valid point in explaining why Australia uses Inflation targeting, and not something like a commodity standard. Also the point of public education by using a simple inflation target band of 2 – 3 % by the Reserve Bank was made well.