

Monetary Aggregates and Liquidity in a Neo-Wicksellian Framework*

by

Matthew Canzoneri⁺, Robert Cumby⁺, Behzad Diba⁺ and David López-Salido⁺⁺

e-mail: canzonem@georgetown.edu
cumbyr@georgetown.edu
dibab@georgetown.edu
david.j.lopez-salido@frb.gov

First Draft: June 1, 2007
This Draft: July 31, 2007

ABSTRACT

Woodford (2003) describes a popular class of neo-Wicksellian models in which monetary policy is characterized by an interest rate rule, and the money market and financial institutions are typically not even modeled. Critics contend that these models are incomplete and unsuitable for monetary policy evaluation. Our Banks and Bonds model starts with a standard neo-Wicksellian model and then adds banks and a role for bonds in the liquidity management of households and banks. The Banks and Bonds model gives a more complete description of the economy, but the neo-Wicksellian model has the virtue of simplicity. Our purpose here is to see if the neo-Wicksellian model gives a reasonably accurate account of macroeconomic behavior in the more complete Banks and Bonds model. We do this by comparing the models' second moments, variance decompositions and impulse response functions. We also study the role of monetary aggregates in predicting inflation in the two models.

* We would like to thank Aleksander Berentsen, Dale Henderson, Steve Myers and conference participants for their helpful comments; however, the usual disclaimer applies. The opinions expressed here are solely those of the authors and do not necessarily reflect the views of the Board of Governors or of anyone else associated with the Federal Reserve System.

+ Georgetown University
++ Federal Reserve Board

1. Introduction

Woodford (2003) describes a class of New Keynesian models that has become the favored paradigm for macroeconomic analysis, and especially for monetary policy evaluation. Woodford himself likes to call these models “neo-Wicksellian” to draw attention to fact that interest rates transmit directly to intertemporal spending decisions, and that monetary policy need not be framed in terms of monetary aggregates.¹ Indeed, monetary policy is generally specified as an interest rate rule in these neo-Wicksellian models, and the modeling of monetary aggregates is often viewed as a needless complication.

While these neo-Wicksellian models have been remarkably successful, there are reasons to be uneasy about the lack of modeling of money markets and financial institutions. First of all, the neo-Wicksellian models equate the money market rate in the monetary policy rule with the interest rate in the consumption Euler equation. But there appears to be a disconnect between money market rates and the quarterly growth of consumption in the U.S. data. The disconnect is exhibited in a number of ways. The Fed seems to be able to control money market rates very tightly, while its control of inflation and consumption growth seems much looser: for example, starting in 2001, the Fed smoothly lowered the federal funds rate from 6.5% to 1.75% in 2002, gradually lowered it to 1.0% in 2003, and then, starting in 2004, the Fed smoothly brought the federal funds rate back up to 5.25% in 2006. But, quarterly growth in consumption during this period fluctuated, seemingly randomly, between 0% and 4%.² There is of course an empirical literature on the disconnect between money market rates and the quarterly growth of consumption going back to Weil (1989)

¹ Footnote 7 of Woodford (2006) gives a concise statement of this.

² Similarly, the Bank of Japan held money market rates near zero for over a year, while real economic activity fluctuated.

and others. Recently, Canzoneri, Cumby and Diba (2006a) found that the spread between money market rates and the rate of return generated by a variety of consumption Euler equations is systematically related to the stance of monetary policy: the spread narrows during a monetary tightening.

A related concern comes from the fact that some central banks use monetary aggregates in forecasting inflation, and from the unease some economists have in performing monetary policy analyses in a neo-Wicksellian framework. Goodfriend and McCallum (2006) say, “Prominent among these [reasons for unease] are the absence from the standard framework of any significant role for money aggregates, financial intermediation, or distinctions among various short term rates that play different roles in the transmission mechanism”.³ And Woodford (2006) discusses the concern of some that neo-Wicksellian models “are coherent as far as they go, but that they are incomplete”.⁴

In this paper, we develop a model in which banks create deposits and make loans. Both of these activities are costly, creating financial frictions that make monetary aggregates “matter” for economic activity. Moreover, bank deposits offer an alternative way for households to do their transacting, and the bank loans may affect aggregate supply and demand in a variety of ways,

³ Goodfriend and McCallum develop and calibrate a model with money and banks, a variety of interest rates, and bonds and capital that can be used as collateral; they use their model to illustrate potential pitfalls of ignoring money and banking when formulating monetary policy. While our modeling of banks is different than theirs, their analysis is in many ways complementary to our own.

⁴ Woodford’s wide ranging discussion of this and related issues gives other references to economists who have expressed concern. His paper was presented at the 4th ECB Central Banking Conference, The Role of Money and Monetary Policy in the Twenty First Century, November, 2006; many of the conference papers discuss related issues.

depending upon how they are modeled (and we have considered alternative approaches). We also assume that government bonds are used by banks and (indirectly) by households in managing their liquidity. This creates a spread between the CCAPM rate (in the consumption Euler equation) and the government bond rate, since government bonds can command a liquidity premium. This spread offers one view of the disconnect between money market rates and the rate of return that affects aggregate demand. And in theory, this spread can buffer the liquidity crunch created by a contractionary open market operation; this has implications for interest rate surprises and for the systematic component of the interest rate rule governing monetary policy.

A standard neo-Wicksellian model is embedded within our model. It is obtained by stripping out the banks and assuming that only cash is useful to households in transacting. There is a money (or cash) demand equation in the neo-Wicksellian model, but it is decoupled from the rest of the model; its sole purpose is to determine the open market operations required to implement the central bank's interest rate rule. There are no financial frictions, other than the seigniorage tax. The money demand equation could be dropped from the neo-Wicksellian model for most applications.

Our model with banks and liquid bonds offers a more complete description of the economy than the neo-Wicksellian model, but the neo-Wicksellian model has the virtue of simplicity. And it is quite possible that this simpler model gives an adequate account of macroeconomic behavior for both the business cycle analyst and the monetary policy analyst. To investigate this possibility, we calibrate the two models and compare their implications for the variables that they share. We compare unconditional moments generated by the models. We use impulse response functions to compare how various shocks pass through our model economies. And finally, we ask if the neo-Wicksellian model undervalues the usefulness of various monetary aggregates in forecasting

inflation. Here, we generate artificial data sets from the two models, and we test the predictive power of various aggregates in bivariate relationships between inflation and nominal growth of the aggregate in question; this appears to be the primary (formal) way in which way monetary aggregates are used at the ECB.⁵

The rest of the paper is organized as follows: Section 2 outlines the two models and explores some of their theoretical differences. Section 3 describes the models' steady state solution, and Section 4 explains how we calibrated the models. Section 5 investigates the quantitative significance of the differences between the two models, and whether the neo-Wicksellian model offers an adequate view of the economy for business cycle analysts and monetary policy analysts alike. Section 6 summarizes our results, and puts several of them – including the use of monetary aggregates – into a more general perspective.

2. Two Models

In this section, we outline two models. The neo-Wicksellian (NW) model, which belongs to a class of models described by Woodford (2003), features Calvo price setting, flexible wage rates, fixed firm specific capital, and an interest rate rule that governs monetary policy. We have included a money demand equation in the NW model, but as Woodford (2006) notes, the only role played by this equation is to determine the open market operations that are necessary to implement the interest

⁵Fischer et al. (2006) report that “...simple bivariate forecasting models have increased in prominence over time at the expense of forecasts that were produced on the basis of money demand equations. ... Indeed, the rising prominence of the bivariate approach can be interpreted as one practical response to a situation from 2001 onwards where growing questions emerged about the stability of money demand equations used in the Quarterly Monetary Assessment.” Of course, the ECB also uses a lot of expert judgement in their monetary projections.

rate rule. Money plays no independent role in the transmission of monetary policy to inflation or real economic activity. Moreover, the model is Ricardian; so, the government's debt management policy plays no important role either.

Our Banks and Liquid Bonds (BB) model adds several features to the standard NW model: new monetary aggregates, financial frictions, and a non-Ricardian element that gives fiscal policy a direct role in creating transactions balances. The cost of creating bank deposits and loans provide the financial frictions, and our assumption that government bonds provide transactions services makes the model non-Ricardian. We begin our discussion with the BB model, since the NW model is embedded within it.

2.A. The Banks and Liquid Bonds Model

Households –

We begin with the households. In the BB model, each household goes to the bank every period (which we take to be a quarter) to make a deposit and to refinance its loan for a fixed durable good, which we might think of as a house. In our benchmark model, bank loans do not feed back into real economic activity, as say a loan to a firm might; we will return to this issue later in the paper.

A representative household maximizes

$$(1) U_t = E_t \sum_{j=0}^{\infty} \beta^j \{ \log(c_t - \eta c_{t-1}) + \phi_{m,t} \log(m_{h,t}) + \phi_{d,t} \log(d_{h,t}) + \phi_b \log(b_{h,t}) \\ - \phi_n (1+\chi)^{-1} [\mu n_t^{1+\chi} + (1-\mu) n_{b,t}^{1+\chi}] \}$$

where c_t is consumption of a CES aggregate of goods, ηc_{t-1} reflects habit in consumption preferences, $m_{h,t}$ are real cash balances, $d_{h,t}$ are real deposits at the bank, and $b_{h,t}$ are real government bond holdings. The household has a continuum of workers of measure one. It supplies μ workers

to the manufacturing sector and $1-\mu$ workers to the banking sector; n_t and $n_{b,t}$ are the hours worked in these two sectors. We assume each household works at all of the firms and all of the banks; with this convenient assumption, the households will be identical in equilibrium despite the dispersion of work effort across firms (due to Calvo price setting), and we can take the short cut of discussing a representative agent. Since the continuum of households has measure one, aggregate values will also be per capita values.

The household uses cash and bank deposits to do its transacting; this is why these variables appear in (1). We interpret bank deposits broadly, so the sum of cash and deposits is equal to M3; in real terms, $m3_t = m_{h,t} + d_{h,t}$. In reality, government bonds provide liquidity in a number of ways; banks, money market funds, mutual funds, pension funds and insurance companies all use them to manage their liquidity. We model banks directly, but we do not model these other financial institutions. We put government bonds into household utility to reflect their value in providing liquidity services outside the banking sector. The parameters $\phi_{m,t}$, $\phi_{d,t}$ and ϕ_b measure the relative usefulness of these aggregates to the household; we make the parameters $\phi_{m,t}$ and $\phi_{d,t}$ time dependent to allow for an m3 demand shock.

$$(2) \log(\phi_{m,t}) = (1 - \rho_{m3})\ln(\bar{\phi}_m) + \rho_{m3}\ln(\phi_{m,t-1}) + \varepsilon_{m3,t}$$

$$\log(\phi_{d,t}) = (1 - \rho_{m3})\ln(\bar{\phi}_d) + \rho_{m3}\ln(\phi_{d,t-1}) + \varepsilon_{m3,t}$$

where $0 < \rho_{m3} < 1$, $\bar{\phi}_m$ and $\bar{\phi}_d$ are the steady state values of these parameters, and $\varepsilon_{m3,t}$ is the shock.

The household's budget constraint is

$$(3) c_t + m_{h,t} + d_{h,t} + b_{h,t} + a_{h,t} + (I_{l,t-1}/\Pi_t)l_{h,t-1} \leq \mu w_t n_t + (1-\mu)w_{b,t} n_{b,t} \\ + (1/\Pi_t)m_{h,t-1} + (I_{d,t-1}/\Pi_t)d_{h,t-1} + (I_{g,t-1}/\Pi_t)b_{h,t-1} + (I_{c,t-1}/\Pi_t)a_{h,t-1} + l_{h,t} + \tau_t + \Omega_t$$

where I_l , I_d , and I_g are gross nominal interest rates on loans, deposits and government bonds. The

household can also purchase a risk free bond, $a_{h,t}$, that does not provide liquidity services; its gross nominal return is $I_{c,t}$. Wages are flexible; w_t and $w_{b,t}$ are the wage rates in manufacturing and banking. Ω_t are dividends from the firms; banks are competitive and earn no profits. $\Pi_t = P_t/P_{t-1}$, where P_t is the implicit price deflator for the CES aggregate of consumption goods, c_t . Finally, τ_t is a lump sum tax. Another constraint is that the household must also get a loan each period to finance its fixed durable good, ℓ ; so,

$$(4) \quad I_{h,t} \geq \ell > 0$$

The household maximizes (1) subject to (3) and (4). Its first order conditions are

$$(5) \quad \lambda_t = (c_t - \eta c_{t-1})^{-1} - E_t[\beta \eta (c_{t+1} - \eta c_t)^{-1}]$$

$$(6) \quad \lambda_t = \phi_n n_t^{\chi} / w_t = \phi_n n_{b,t}^{\chi} / w_{b,t}$$

$$(7) \quad I_{c,t}^{-1} = \beta E_t[(\lambda_{t+1} / \lambda_t) / \Pi_{t+1}]$$

$$(8) \quad \phi_{m,t} / m_{h,t} = \lambda_t (I_{c,t} - 1) / I_{c,t}$$

$$(9) \quad \phi_{d,t} / d_{h,t} = \lambda_t (I_{c,t} - I_{d,t}) / I_{c,t}$$

$$(10) \quad \phi_b / b_{h,t} = \lambda_t (I_{c,t} - I_{g,t}) / I_{c,t}$$

$$(11) \quad I_{h,t} = \ell \quad (\text{if } I_{h,t} > I_{c,t})$$

where λ_t is the marginal utility of wealth (or the Lagrange multiplier for (3)). (6) is a labor supply equation. (7) is the standard consumption Euler equation, and I_c is the consumption CAPM interest rate. The LHS of (8) is the marginal utility of holding one more $m_{h,t}$, and the RHS is the marginal disutility of holding the extra $m_{h,t}$ instead of an $a_{h,t}$. Equations (9) and (10) have similar interpretations for the household's demand for deposits and government bonds.

All of the interest rate spreads will be positive in equilibrium. The spread between the CCAPM rate and the government bond rate – $I_{c,t} - I_{g,t}$ – will play a large role in what follows; it is

positive because government bonds provide liquidity services, and therefore they command a liquidity premium. This spread is the BB model's interpretation of the disconnect between money market rates and the rates that affect aggregate demand via the consumption Euler equation.

Banks –

In the BB model, competitive banks issue deposits and make loans. These activities are not costless. The representative bank uses labor in making loans,

$$(12) \quad l_{b,t} = Z_l n_{b,t}$$

and the bank holds cash and government bonds to manage the liquidity of its deposits,

$$(13) \quad d_{b,t} = Z_d m_{b,t}^\delta b_{b,t}^{1-\delta}$$

where Z_l and Z_d are productivity parameters, and $\delta \in (0, 1)$. Unlike Goodfriend and McCallum (2006), we do not model the federal funds market directly. In the U.S., banks have to meet reserve requirements over a two week reserve maintenance period. A bank with a reserve shortage can borrow federal funds, sell T-bills or use RPs to meet its reserve requirements. This keeps the T-bill yield closely tied to the federal funds rate. In our quarterly model, we simply assume that the central bank targets the T-bill rate, and this is the money market rate that appears in its interest rate rule.

The bank raises funds by issuing deposits and by borrowing at the CCAPM rate; its balance sheet constraint is

$$(14) \quad l_{b,t} + m_{b,t} + b_{b,t} = d_{b,t} + a_{b,t}$$

The bank maximizes the present discounted value of its profits,

$$(15) \quad E_t \sum_{s=t}^{\infty} \beta^{s-t} \lambda_s [(I_{l,s}/\Pi_{s+1})l_{b,s} + (1/\Pi_{s+1})m_{b,s} + (I_{g,s}/\Pi_{s+1})b_{b,s} - (I_{c,s}/\Pi_{s+1})a_{b,s} - (I_{d,s}/\Pi_{s+1})d_{b,s} - w_s n_{b,s}]$$

subject to (12), (13) and (14). Its first order conditions are

$$(16) \quad I_{d,t} + \kappa_t = I_{c,t}$$

$$(17) \quad 1 + \kappa_t \delta (d_{b,t} / m_{b,t}) = I_{c,t}$$

$$(18) \quad I_{g,t} + \kappa_t (1 - \delta) (d_{b,t} / b_{b,t}) = I_{c,t}$$

$$(19) \quad (I_{l,t} - I_{c,t}) / I_{c,t} = w_{b,t} / Z_{l,t}$$

where $\kappa_t = (I_{c,t} - 1)^\delta (I_{c,t} - I_{g,t})^{1-\delta} / Z_b \delta^s (1-\delta)^{1-\delta}$.

These equations have straightforward interpretations. $I_{c,t} - 1$ is the opportunity cost of holding an $m_{b,t}$ instead of an $a_{b,t}$, while $I_{c,t} - I_{g,t}$ is the opportunity cost of holding a $b_{b,t}$ instead of an $a_{b,t}$. So, κ_t is the marginal cost of creating a $d_{b,t}$ via (13). The bank can raise funds by creating deposits or by borrowing at the CCAPM rate. Equation (16) says that the bank will raise funds by creating deposits up the point where marginal cost of doing so is equal to the marginal cost of borrowing at the CCAPM rate; equations (17) and (18) have similar interpretations. Equation (19) says that the marginal cost of making a loan must equal the marginal revenue from that loan, implying that the loan rate must be higher than the CCAPM rate.⁶

Firms –

Our discussion of the manufacturing sector can be quite brief since our treatment of it is now standard.⁷ A continuum of firms, indexed by f on the unit interval, produces a continuum of differentiated consumer goods. Household preferences for these goods are represented by a CES aggregator,

$$(20) \quad c_t = \left[\int_0^1 c_t(f)^{(\sigma-1)/\sigma} df \right]^{\sigma/(\sigma-1)}$$

⁶ This implies, from (11), that $l_{h,t} = \ell$. Households don't want to borrow any more than necessary at this high rate.

⁷ The details can be found in many places; Canzoneri, Cumby and Diba (2006b) is one. The real purpose of our writing down some of these equations is to identify parameters that will be important in the model's calibration.

where $\sigma > 1$, and the implicit price deflator is

$$(21) P_t = [\int_0^1 P_t(f)^{1-\sigma} df]^{1/(1-\sigma)}$$

Firm- f 's production function is

$$(22) y_t(f) = Z_{y,t} \bar{k}^{1-\omega} [\mu_n(f)]^\omega$$

where \bar{k} is the fixed capital stock, and $Z_{y,t}$ is total factor productivity; $Z_{y,t}$ follows a process that is common to all firms,

$$(23) \ln(Z_{y,t}) = (1 - \rho_y) \ln(\bar{z}_y) + \rho_y \ln(Z_{y,t-1}) + \varepsilon_{y,t}$$

where $0 < \rho_y < 1$ and \bar{z}_y is the steady state value of $Z_{y,t}$. As noted earlier, we assume Calvo pricing. With probability $1 - \alpha$, any given firm- f gets to reset its price $P_t(f)$; otherwise, its price is simply scaled up by the steady state rate of inflation. Aggregate output is given by

$$(24) y_t = Z_{y,t} \bar{k}^{1-\omega} (\mu_n)^\omega / [\int_0^1 (P_t / P_t(f))^{\sigma/\omega} df]^\omega$$

where the integral is a price dispersion term that measures the inefficiency due to the Calvo pricing.

This composite good is consumed by households and by the government; that is, the goods market equilibrium condition is: $y_t = c_t + g_t$. We also note that the New-Keynesian Phillips Curve stemming from these models is a difference equation in inflation with the firms' marginal cost as an innovation; a rise in marginal cost – $w_t/Z_{y,t}$ – will increase inflation. Many of our results depend heavily on this.

Monetary and Fiscal Policy –

The government's flow budget constraint is

$$(25) I_{g,t-1} b_{t-1} / \Pi_t = \tau_t - g_t + b_t + m_t - m_{t-1} / \Pi_t$$

where g_t is government spending, and m_t and b_t are the real cash and bond holdings of households and banks ($m_{h,t} + m_{b,t}$ and $b_{h,t} + b_{b,t}$). Letting $liab_t = m_t + b_t$ be total government liabilities, the

budget constraint becomes

$$(26) \text{liab}_t = \text{liab}_{t-1}/\Pi_t + \text{def}_t$$

where $\text{def}_t = (I_{g,t-1} - 1)b_{t-1}/\Pi_t + g_t - \tau_t$ is the total fiscal deficit, inclusive of interest payments.

Both m_t and b_t provide transactions services in the BB model, though these services are not of equal value. The fiscal deficit determines liab_t , which we will call the “liquidity provision” effect of fiscal policy. Then, the central bank’s open market operations determine the composition of liab_t , and the “effective transactions balances” of households and banks; effective transactions balances are the Cobb-Douglas aggregators defined by (13) for banks, and by the utility function for households. So, both monetary and fiscal policy have liquidity effects, and this will be important in what follows.

There are many potential ways to write a fiscal policy rule. The discussion above might for example suggest a rule in which deficits respond to total liabilities. However, we will follow most of the literature in letting the taxes respond to the level of government debt. In particular, we let government spending follow an exogenous process

$$(27) \ln(g_t) = (1 - \rho_g)\ln(\bar{g}) + \rho_g \ln(g_{t-1}) + \varepsilon_{g,t}$$

and we let the rule for taxes be

$$(28) \tau_t = (1 - \rho_\tau)\bar{\tau} + \rho_\tau \tau_{t-1} + (1 - \rho_\tau)\phi_\tau(b_{t-1} - \bar{b})$$

We will always assume that ϕ_τ is greater than the steady state value of the real CCAPM rate, which in turn is greater than the steady state value of the real government bond rate. Our BB model is non-Ricardian since government bonds provide liquidity, but our fiscal policies will be Ricardian in the sense of Woodford (1995) and passive in the sense of Leeper (1991): primary surpluses move to stabilize the debt, and guarantee that the government’s present value budget constraint is satisfied

for any price path.

Monetary policy will follow a standard interest rate rule

$$(29) \quad i_{g,t} = \rho_i i_{g,t-1} + (1-\rho_i)[\bar{i}_g + \theta_\pi(\pi_t - \bar{\pi}) + \theta_y(\log(y_t) - \log(\bar{y}))] + \varepsilon_{i,t}$$

Note that the gap term incorporates steady state output, and not the flex-price level of output.⁸

2.B. The neo-Wicksellian Model

The NW model is embedded in the BB model. There are no banks in the NW model; so, we take out all the equations and variables having to do with banks. We set $\phi_{d,t} = 0$ in the household utility function, but we retain $\phi_{m,t}$. The money demand equation, (8), remains and so does the money demand shock; however, now money is just household cash balances. Finally, government bonds to not provide liquidity services in the NW model; so, we set $\phi_b = 0$ in the utility function. These bonds no longer command a liquidity premium, and equation (9) implies that the spread $-I_{c,t} - I_{g,t}$ collapses. In the NW model, $I_{c,t}$ appears in the interest rate rule, (29), and there is no disconnect between money market rates and the CCAPM rate that affects aggregated demand.

2.C. Theoretical Implications of Banks and Liquid Bonds with Transactions Services

As stated earlier, the BB model adds three basic features to the NW model: new financial assets, financial frictions, and a non-Ricardian element that gives fiscal policy a direct effect on inflation. In this section, we discuss some theoretical implications of these modifications of the NW model. In later sections, we calibrate the two models, and we study the quantitative significance of these theoretical implications.

⁸ Canzoneri, Cumby and Diba (2006b) argue that this specification makes their model fit the data better. As is well known, using a gap term with flex-price output would raise welfare in this kind of model.

Implications for Monetary Policy of the Transactions Services of Bonds

Government bonds provide liquidity in the BB model, and this has two implications for monetary policy: one is the “liquidity provision” effect, and the other is a “liquidity buffering” effect. We have already discussed the liquidity provision effect: government deficits determine the level of $m_t + b_t$, each of which provides transactions services. So, fiscal policy plays a new, and obvious, role in inflation policy. The liquidity buffering effect is somewhat more subtle, and it has to do with what we have called effective transactions balances.

When the central bank conducts a contractionary open market operation (OMO), it sells government bonds for cash, thereby creating a liquidity crunch. In the NW model, the OMO replaces assets (m) that have transactions value with assets (b) that do not. In the BB model, the transactions services of bonds buffer the effect on liquidity. The buffering effect manifests itself in the spread $-I_{c,t} - I_{g,t}$ between money market rates and the rates that affect aggregate demand, and this has implications for both monetary policy surprises (interest rate shocks) and the systematic component of monetary policy (the inflation term in (23)).

To see this buffering effect, note that equations (17) and (18) imply

$$(30) \quad b_{b,t}/m_{b,t} = [(1-\delta)/\delta][(I_{c,t} - 1)/(I_{c,t} - I_{g,t})]$$

$(I_{c,t} - I_{g,t})/I_{c,t}$ is the opportunity cost to the bank of holding a $b_{b,t}$ instead of an $a_{b,t}$; similarly, $(I_{c,t} - 1)/I_{c,t}$ is the cost of holding an $m_{b,t}$ instead of an $a_{b,t}$. So, $(I_{c,t} - 1)/(I_{c,t} - I_{g,t})$ is the cost of holding cash relative to the cost of holding government bonds; when it rises, banks substitute bonds for cash in their liquidity management of deposits. Households face the same relative costs, and their ratio of bonds to cash is proportional to that of the banks,

$$(31) \quad b_{h,t}/m_{h,t} = \{[\delta/(1-\delta)]/[\phi_{m,t}/\phi_b]\}(b_{b,t}/m_{b,t})$$

When the relative cost of holding money rises, both households and banks substitute bonds for cash.

A contractionary OMO raises the ratio of government bonds to cash. The relative cost of money rises to make households and banks accept the new ratio, decreasing the spread, $I_{c,t} - I_{g,t}$. This can be seen directly in equation (30), and it can also be understood in terms of the liquidity premium on government bonds. The increase in government bonds decreases their marginal value in effective transactions balances, and this decreases the liquidity premium that bonds can command.

Now consider the implications for an interest rate surprise of say 6 basis points (or 24 basis points in annual terms). The central bank must conduct a contractionary OMO to raise $I_{g,t}$ by 6 basis points. But in the BB model, a contractionary OMO decreases the spread, and the effect on $I_{c,t}$ is less than 6 basis points. The liquidity services of government bonds buffers the effect of this OMO on the CCAPM rate and aggregate demand. In the NW model, there is of course no spread, and the shock goes straight through to the consumption Euler equation and aggregate demand.

Consider next the implications for the systematic component of monetary policy. When inflation rises by say 1%, (29) requires $I_{g,t}$ to increase by θ_π . This is of course accomplished by a contractionary OMO. In the BB model, the effect on liquidity is buffered, and $I_{c,t}$ rises less than θ_π . So, for a given value of θ_π , the systematic component of monetary policy is less aggressive in the BB model than it is in the NW model.

Implications of Banks and Financial Frictions

Banks modify the NW model in two theoretically important ways: they provide deposits (which may reduce the need for cash), and they provide loans (which may affect aggregate supply or demand in a variety of ways, depending on how loans are modeled). Moreover, the provision of these deposits and loans is costly: the banks need money and bonds to manage the liquidity of their

deposits, and they use labor to create loans. These financial frictions may inhibit economic activity in the BB model. These new elements should affect the way in which shocks pass through our two model economies.

Monetary Aggregates as Indicators of Inflation

In the NW model, the money demand equation is a decoupled equation whose only role is to determine the OMOs necessary to implement the central bank's interest rate rule. The central bank simply accommodates any increase in money demand, leaving interest rates and everything else unchanged. But in the BB model, the money demand equation is part of a nexus of equations determining household and bank demands for a variety of assets. For this reason alone, one might expect monetary aggregates to play a more important role in forecasting inflation.

Banks also provide an aggregate – m_3 – which has been used by some central banks in forecasting inflation. Moreover, in the BB model, the liquidity provision effect of fiscal policy leads one to expect that government liabilities will be useful in forecasting inflation. We will investigate these issues in Section 5.

3. Steady State Equilibrium of the BB Model

In this section, we show that the BB model has a unique steady state equilibrium for suitable specifications of monetary and fiscal policy. As we shall see, the steady state values of consumption, output and work do not depend on monetary policy or on steady state inflation; in this sense, the model has a recursive structure and is super neutral. However, the steady state relationship between inflation and the instrument of monetary policy, I_g , is more complicated in the BB model than in the more conventional NW model, and this is a matter of some independent

interest. (For notational simplicity, we will drop “t” subscripts to denote steady state values in this section.)

In the steady states of both models, the real CCAPM rate is tied to consumer preferences: $I_c/\Pi = 1/\beta$. So, the familiar Fisher equation links the nominal CCAPM rate and inflation. The instrument of monetary policy is however I_g , and the steady state relationship between I_g and inflation depends on an interest rate spread: $I_g = \Pi/\beta - (I_c - I_g)$. In the NW model, the spread vanishes, and the steady state monetary policy can be specified as an inflation target or equivalently as a value of the instrument, I_g . Monetary policy clearly determines steady state inflation in the NW model independently of fiscal policy. In the BB model, government bonds have non-pecuniary returns, and the spread is positive. Moreover, the spread is endogenous, and it depends on fiscal policy. So, one question we will address is whether, for a given fiscal policy, we can work from an inflation target back to a setting of I_g . This will generally be the case; however, there is one simple specification of fiscal policy that determines steady state inflation all by itself.

On the spending side, we will always assume that the fiscal authority sets a target for g/y ($= \gamma_g$), the steady state ratio of government spending to output. To solve for the steady state level of employment, we use the labor demand equilibrium condition linking the real wage to the marginal product of labor.⁹ The Cobb-Douglas production function (24) implies :

$$(32) \quad w = \frac{(\sigma - 1)\omega y}{\sigma \mu n}$$

We next solve for the steady state work effort. Using (32), the household’s first order conditions (5) and (6), and the market clearing condition, $c = (1 - \gamma_g)y$:

⁹ The actual derivation of the following equation would use the pricing equations of firms.

$$(33) \quad \phi_n n^{1+\lambda} = \frac{(\sigma - 1)(1 - \beta\eta)\omega}{\sigma(1 - \eta)(1 - \gamma_g)\mu}$$

Given the work effort, n , the production function determines output, the market clearing condition pins down consumption, and (32) determines the real wage. So, other than setting γ_g , monetary and fiscal policy play no role in the determination of n , y , c , and w .

To solve for the other variables, we have to specify tax policy. In our benchmark tax policy, the fiscal authority uses its instrument to meet a target for b/y , the steady state ratio of debt to output. Later in the section, we will consider tax policies that target a deficit or a ratio of public sector liabilities to output.

First, we derive an expression that relates the CCAPM rate, I_c , to the instrument of monetary policy, I_g . To do this, we use a steady state version of equation (16),

$$(34) \quad I_d = I_c - \frac{(I_c - 1)^\delta (I_c - I_g)^{1-\delta}}{Z_b d^\delta (1 - d)^{1-\delta}},$$

and (9) to get an expression linking the demand for deposits and the CCAPM rate. Then, using (13), (17), and (18), we solve for the bank's demand for bonds:

$$(35) \quad b_b = \left[\frac{(1 - \delta)\phi_d(1 - \eta)c}{1 - \beta\eta} \right] \left(\frac{I_c}{I_c - I_g} \right)$$

In equilibrium, the household's demand for bonds (10) and the bank's demand (35) must add up to the supply, which is pinned down by the fiscal target for b/y , and we get:

$$(35) \quad I_c = \frac{I_g}{1 - \left(\frac{1 - \gamma_g}{b/y} \right) \left(\frac{[\phi_b + (1 - \delta)\phi_d](1 - \eta)}{(1 - \beta\eta)} \right)}$$

Since $\Pi = \beta I_c$, this is the expression we need to relate steady state inflation to the monetary

policy instrument, I_g . For a given fiscal policy – characterized by γ_g and the target for b/y – the central bank can calculate the instrument setting it needs to achieve a given inflation target. (Of course, we can also read (35) the other way around: if the central bank is already committed to a particular value for I_g , the fiscal authority can achieve, say, a lower steady state inflation by choosing either a higher γ_g or a higher target for b/y .)

Note that (35) places a constraint on the fiscal authority’s choice of b/y : the target must be high enough, given γ_g , for the denominator to be positive; otherwise, an equilibrium with positive interest rates will not exist. However, this constraint is (at least in part) an artifice of our choice of functional forms. Our Cobb-Douglas specifications of “effective transactions balances” make it essential for households and banks to hold bonds, even if the gross interest rate on those bonds goes to zero. The denominator of (35) will be positive if the target for b/y makes b larger than what would be demanded when $I_g = 0$.

Finally, we turn to the money and bond markets. Under our benchmark policies, the money stock is endogenous. Using (8), (9), (10), (17), (18), and the market clearing conditions for money and bonds, we obtain

$$(36) \quad \frac{m}{b} = \left[\frac{\phi_m + \delta\phi_d}{\phi_b + (1-\delta)\phi_d} \right] \left(\frac{I_c - I_g}{I_c - 1} \right)$$

which determines the composition of public sector liabilities in the steady state. Note that our benchmark policies also make total public sector liabilities (money plus bonds) endogenous.¹⁰

¹⁰ (36) illustrates another way we could characterize monetary policy in the steady state. Open market operations determine the ratio m/b , and then (36) determines the interest rate spread. We don’t pursue this here, other than to note that a permanent open market operation (or choice of a new target for m/b), will change the non-pecuniary returns on bonds, and (for a given fiscal policy) bring a new steady state rate of inflation.

We now turn to alternative specifications of the steady state tax policy. Suppose the fiscal authority sets a target for the broader aggregate of total liabilities; that is, it sets a target for $(m+b)/y$ (which includes bonds monetized by the central bank). For a given monetary policy, (36) pins down the composition of liabilities, and our steady state results remain basically unchanged.¹¹ For a given fiscal policy, a higher value of I_g corresponds to setting a higher inflation target; and given an I_g , a higher fiscal target for $m+b$ leads to a lower inflation rate.

Tax policy might also target the deficit. If the target is set equal to zero, however, then it follows from expression (26) that the steady state inflation rate is zero, regardless of monetary policy.¹² In this rather peculiar case, monetary policy determines the real value of the public debt.

Setting aside this special case, all the policy specifications we have considered suggest that monetary policy can set and implement an inflation target, even though the “right” value of its instrument, I_g , depends on the fiscal policy. Given the solution for inflation and I_c , the rest of our steady state calculations are straightforward.

4. Calibration of the BB Model

The NW model is now standard in the literature, and for that part of the model, we can take parameter values that are familiar.¹³ We set the Calvo parameter, α , equal to 0.75, so that prices change once a year on average; we set the elasticity of demand, σ , equal to 7, so that the gross markup is 1.17 in the steady state; we set the Frisch elasticity of labor supply, $1/\chi$, equal to 1; we

¹¹ For a unique equilibrium to exist, fiscal policy must still incur enough liabilities to satisfy the demand for bonds at some positive interest rate.

¹² Note that we are abstracting from growth in the steady state.

¹³ See, for instance, Christiano, Eichenbaum and Evans (2005).

set the elasticity of output with respect to labor, ω , equal to 0.67; and finally, we set the habit persistence parameter, η , equal to 0.7. We set the persistence parameters, ρ , in the autoregressive processes for all of the shocks at 0.9. We assume the standard deviations of the shocks are: 0.008 for the productivity shock, 0.01 for the government purchases shock and money demand shock, and 0.00245 for the interest rate shock (in the central bank's interest rate rule). Since we don't have investment in our model, we set the share of government purchases in output to 0.25.

For our benchmark monetary and fiscal policies, we rely on estimates discussed in earlier papers.¹⁴ We set the benchmark parameters in the central bank's interest rate rule at: $\theta_\pi = 2.0$, $\theta_y = 0.2$ and $\rho_i = 0.8$. And we set the benchmark parameters in the fiscal policy rules at: $\theta_f = 0.018$ (which is three times the real government bond rate and is also larger than the CCAPM rate), and $\rho_g = \rho_\tau = 0.9$.

For the financial sector, we calibrated (using the steady state equations) the parameters ϕ_m , ϕ_d , ϕ_b , Z_l , Z_b , and δ to match key averages of monetary and fiscal variables in the U.S. data from 1990 to 2005. In the data, government bonds held by the banking sector are about 25 percent of (quarterly) consumption, and bank reserves (vault cash and deposits at the Fed) are about 5 percent of consumption. The banking sector employs about 1.5 percent of the labor force. Bank loans (including securities) are 4.25 times consumption. Deposits (including checking accounts as well as saving and time deposits) are about 3.75 times quarterly consumption, but deposits issued to households are only about 2.45 times consumption. In our model, we make deposits 2.45 times consumption and scale all the banking sector data above by the ratio 2.45/3.75. Cash held outside banks is about 30 percent of consumption, and we attribute it all to household cash balances. We

¹⁴ See Canzoneri, Cumby and Diba (2006b). For θ_f , we relied on work by Henning Bohn; see Canzoneri, Cumby, Diba and Lopez-Salido (2006).

also attribute government bonds held by individuals, insurance companies and pension funds, which amounts to 80 percent of consumption, to households.

Finally, we set the steady state inflation and federal funds rates at their quarterly averages for this period: 0.7 and 1.1 percent per quarter. And, we set the value of μ so that hours and wages in the steady state are equal across the banking and production sectors.

5. A Quantitative Comparison of the Two Models

In Section 2, we identified a number of theoretical differences between the BB and NW models. In this section, we examine the quantitative significance of these differences. Even if the BB model is thought to be a more complete modeling of the true economy, the much simpler NW model may give a reasonably good account of the way the economy behaves, and its implications for monetary policy may not be too misleading. We begin by comparing time series statistics and impulse response functions generated by the two models. Then, we turn to the potential role of monetary aggregates in inflation forecasting.

5.A. Comparing Time Series Statistics in the Two Models

Tables 1, 2 and 3 present a number of statistics generated by the two models. All variables except interest rates and the inflation rate are in logarithms. The benchmark monetary and fiscal policies were used in the simulations that generated these statistics. The means and standard deviations in Table 1 show a remarkable similarity between the two models. The models were calibrated to have very similar steady states for the variables they share, and the means of those variables bear this out. What is remarkable is the similarity of the standard deviations of inflation, output, and the CCAPM rate. Real monetary aggregates are quite volatile in both models.

An interesting difference does emerge in the variance decompositions reported in Table 2. Productivity shocks play a dominant role in explaining real economic activity in both models, and especially in the NW model. This is typical of models of in this class; indeed, it is difficult to get demand side shocks to do very much in this so called “New-Keynesian” paradigm. Government spending shocks explain less than 1% of the variation in inflation in the NW model, and only 7% of the variation in consumption. By contrast, government spending shocks explain almost 20% of the variation in inflation in the BB model. This is due, at least in part, to the fact that deficits are financed with bonds that provide transactions services in that model. In addition, government spending shocks explain the lion’s share of the variation in m_3 , deposits and household bond holdings; deficits increase the supply of government bonds, requiring households and banks to substitute among their various liquid assets.

The variance decompositions in Table 2, along with the unconditional correlations in Table 3, give some indication of the role that monetary aggregates may play in the two models. The productivity shocks and government spending shocks that explain almost 95% of the variation inflation in the BB model also explain about 55% of the variation in dM_3 (the nominal growth in m_3) and about 90% of the variation in $dLIAB$ (the nominal growth in $m + b$). So, it is not surprising that the correlation between inflation and dM_3 is strong (0.31) and the correlation between inflation and $dLIAB$ is even stronger (0.38). By contrast, productivity shocks and government spending shocks only explain 12% of the variation in dM_h (the nominal growth in household cash balances), and the correlation between inflation and dM_h is virtually zero. This suggests that dM_3 and $dLIAB$ may be good indicators of inflation in the BB model, but dM_h may not. In the NW model, dM (the nominal growth in cash balances) shares the same fate as dM_h ; it will probably not be a good

indicator of inflation. In the NW model, government spending shocks explain almost 90% of the variation in dLIAB, but here government shocks do virtually nothing to inflation. The correlation between inflation and dLIAB is weak (0.12). This suggests that monetary aggregates will not be good indicators of inflation in the NW model.

5.B. Comparing Impulse Response Functions in the Two Models

Impulse response functions show how shocks pass through our model economies. In Section 2, we noted that, in the BB model, government bonds buffer the liquidity effects of open market operations, and government deficits provide liquidity. Here, we use impulse response functions to see if these facts significantly alter the way the economy responds to shocks. Once again, we use the benchmark policy rules for monetary and fiscal policy.

Interest Rate Shocks :

Figure 1 shows how an unanticipated increase in $I_{g,t}$ passes through our two model economies; there is, of course, no spread between $I_{g,t}$ and $I_{c,t}$ in the NW model. The NW model, in the top panel, illustrates a conventional story. The $I_{g,t}$ shock is implemented with an OMO that increases the supply of bonds relative to cash. The real CCAPM rate (R_c) rises, lowering consumption demand via the Euler equation. Output and labor demand fall, decreasing the real wage and marginal cost; and a lower marginal cost means less inflation. The original OMO produces a negative dM, but the systematic part of monetary policy then reverses direction, and dM becomes positive in the next period. So, dM does not appear to be a very good indicator of inflation for interest rate shocks; we return to this issue in Section 4.C.

This conventional story repeats itself in the BB model, but the “buffering effect” of government bonds is evident: the spread $-I_c - I_g$ narrows (not pictured), and this cushions the effect on

inflation and economic activity. R_c rises less; inflation falls less and returns to steady state sooner; and consumption and wages fall less. However, the general patterns are the same as in the NW model, and the quantitative differences are not very large.¹⁵

The financial markets story is of course richer in the BB model. The contractionary OMO forces banks and households to substitute bonds for cash. Households also substitutes deposits for cash, actually making m_3 rise. dm_3 , unlike dm , is consistently positive. Moreover, the rise in the real government bond rate increases the deficit, and government liabilities rise (recall equation (26)); so, dm , dm_3 and $dLIAB$ are all positive from the second period on. None of the monetary aggregates appear to be very good indicators of inflation for interest rate shocks.

The credit tightening passes to the loans market as well. In fact, the real loan rate, R_l , (not pictured) increases more than the CCAPM rate. However, this does not affect household behavior since the amount of loans is effectively fixed in our benchmark model. Following Christiano et al (2007) and others, we also tried making firms borrow from the bank to meet their wage bill. This modification did not change our results in a quantitatively significant way, and therefore we have presented the simpler model. Apparently, the demand for loans will have to be modeled in a different way if the loans channel is to have a significant effect on aggregate supply or demand; we return to this issue in the conclusion.

Productivity Shocks:

Figure 2 shows how an unanticipated increase in total factor productivity of firms passes through our two models. In the NW model, a positive productivity shock leads to higher consumption. However, aggregate demand does not increase enough to accommodate the increase

¹⁵ The differences are larger for lower values of θ_π , but not dramatically so.

in productivity; so, labor demand and the real wage fall. Marginal cost, $w_t/Z_{y,t}$, and inflation fall. The central bank responds to the shock by lowering the nominal CCAPM rate (as evidenced by the rise in the ratio of cash to bonds); m rises and dM is positive. For productivity shocks, dM is not a good indicator of inflation, and as noted earlier, productivity shocks explain most of the variation in inflation in both models.

Moving on to the BB model, the “liquidity buffering effect” of government bonds dampens the systematic component of monetary policy, and this enhances the effect of the productivity shock as it passes through the economy. Real wages and inflation fall more, though consumption rises less. Once again, however, the general pattern of the responses is the same in the two models, and the quantitative difference are not very large.

The more interesting story may be in the monetary aggregates. As in the NW model, the central bank responds to the shock by lowering I_g (as can be seen in the rise in the ratio of cash to bonds). Households substitute away from deposits. Even though $dM3$ is negative, the fall in prices allows $m3$ to rise. $dM3$ is consistently negative and is therefore a better indicator of inflation than dM . $dLIAB$ is also consistently negative; so, both $dM3$ and $dLIAB$ are good indicators of inflation for productivity shocks. And once again, productivity shocks explain about 75% of the variation in inflation in the BB model.

Government Spending Shocks:

Figure 3 shows how an unanticipated increase in government spending passes through the model economies, and here the differences are dramatic. The NW model gives the conventional results. Households want to work more, and consume less, to pay the expected future taxes. However, total aggregate demand rises, and the demand for labor is greater than the increased supply;

so, the real wage rises, increasing marginal cost. Inflation and output go up. The central bank raises the CCAPM rate, killing off the inflation very quickly. The rise in the CCAPM rate, along with the decline in consumption, lowers the demand for cash. dM is negative, at least initially, making it a rather poor indicator of inflation in the case of government spending shocks.

Much more is happening in the BB model. The initial increase in inflation is four times the increase in the NW model, it is much longer lasting.¹⁶ Why is this? First note that the R_c actually falls in the BB model, and its subsequent rise is less than in the NW model. The central bank's interest rule is active, and the real government bond rate, R_g , rises (not pictured). However, the "buffering effect" of government bonds allows R_c to fall. The lower real CCAPM rate makes consumption fall less. More importantly, the fiscal deficits implied by the government spending shock increase total transactions balances, as can be seen by the rise in $dLIAB$. But this is only part of the story.

The non-Ricardian behavior of households really accounts for the differences with the NW model. The future tax liability grows at the rate R_g , but it is discounted at the higher rate R_c . So, the negative wealth effect is smaller than in the NW model, and labor supply does not increase as much. So, the real wage goes up 50% more than in the NW model, increasing marginal cost and inflation.

Household demand for cash balances, m_1 , goes down for the same reasons as in the NW model. But, households substitute toward deposits as well as government bonds. And deposits go up enough to make m_3 rise; dM_3 is positive for a sustained period. Both dM_3 and $dLIAB$ seem to be good indicators of inflation for government spending shocks. And government spending shocks

¹⁶ This presumably accounts for differences in the variance decompositions in Table 2.

explain almost 20% of the variation in inflation.

Money Demand Shocks:

Figure 4 shows how an unanticipated increase money demand – a cash shock in the NW model, and an m3 shock in the BB model – passes through our model economies. In the NW model, the money demand equation is a decoupled equation whose only role is to determine the OMOs necessary to implement the central bank’s interest rate rule. Figure 4 shows all that there is to be seen. In the BB model, an increase in the m3 demand is a contractionary shock that affects inflation and real economic activity. However, the effects are small: the effects on inflation and consumption are two orders of magnitude smaller than the size of the shock itself. The central bank’s use of an interest rate rule insulates the real economy from financial shocks.

In summary, the “buffering effect” of government bonds is apparent in the BB model: it cushions the economy from a contractionary open market operation, and it implies that the systematic part of monetary policy provides less stabilization in response to the other shocks. For interest rate shocks and productivity shocks, the impulse response functions from the two models show similar patterns, and they are not very far apart. Moreover, money demand shocks have little effect in the BB model. The NW model seems to give a reasonably adequate account of the way these shocks pass through the more complete BB model. Government spending shocks are a different story; they have a much larger, and a much more prolonged, impact on inflation in the BB model.

5.C. The Role of Monetary Aggregates in Forecasting Inflation

Some central banks use monetary aggregates in forecasting inflation, and most central banks use some measure of the output gap. The NW model generates only one aggregate, cash balances

held by households. The BB model actually generates three additional aggregates: $m3$ ($m_h +$ deposits), liquidity ($m3 + b_h$), and government liabilities ($m + b$). If the BB model is the more complete description of the true economy, does the NW model give a misleading view of the usefulness of monetary aggregates in forecasting inflation? To answer this question, we imagine a central bank economist using data generated by one or the other of our models to estimate small unrestricted VARs. The question the staff economist asks is if any of the monetary aggregates is useful in predicting inflation.¹⁷

The parameter values in the interest rate rule (29) clearly affect the inflation data generated by our models. A large body of evidence suggests that the inflation coefficient, θ_π , has risen over time: estimates for the pre-Volcker era are quite low, around 1.0 or even below, while estimates for the Volcker-Greenspan era are higher, ranging from 1.5 to 2.0.¹⁸ And the recent emphasis on independent central banks, with strong mandates for price stability, might lead one to speculate that the coefficient will continue to rise in the future. For this reason, we perform our experiments for four values of θ_π : 1.1, 1.5, 2.0 and 4.0.

For each value of θ_π , and for each of our models, we generate 1,000 data sets, each consisting of 40 years of quarterly data. Then, for each data set, we estimate a series of VARs. For each monetary aggregate, we estimate a bivariate VAR with inflation and the rate of growth of the nominal aggregate in question; then, we estimate a VAR that adds either the output gap or the nominal interest rate on government bonds.¹⁹ Finally, for each of these VARs, we generate the

¹⁷ As explained in footnote 6, this appears to be consistent with the way the ECB uses monetary aggregates.

¹⁸ See, for example, Lubik and Schorfheide (2004), and the references therein.

¹⁹ Here, the output gap is defined as the log of output minus its steady state value.

impulse response function for inflation to an innovation in the aggregate, and we plot the median along with a confidence interval constructed using the 33th and 67th percentiles (corresponding to one standard deviation).

Figures 5 and 6 illustrate the basic results – using the benchmark monetary policy – for our two models. Figure 5 shows the plots for shocks to dMh, dM3 and dLIAB in the BB model. dMh is clearly of little or no use in forecasting inflation, either in the bivariate VAR or in the VAR with the output gap added. However, dM3 and dLIAB would seem to be useful, in either of the VARs. They are not helpful in forecasting a few quarters out, but they do seem to have some predictive power in the medium run, where inflation reaches its peak. Plots for dL (liquidity) look like those for dM3 and dLIAB, and plots for the VARs in inflation, the nominal interest rate and the monetary aggregate look much like those for output, inflation and the monetary aggregate.²⁰ Figure 6 shows the corresponding plots for the NW model; there is of course no m3 in that model. Neither dM nor dLIAB produces anything of interest.

The value of θ_π does matter in these plots. Figure 7 illustrates this for dM3 in the BB model. When the central bank's response to inflation is weak ($\theta_\pi = 1.1$), inflation is more volatile, and the predictive power of dM3 is great. When the central bank's response is strong ($\theta_\pi = 4.0$), inflation is less volatile, and the predictive power of monetary aggregates is more limited. Going from the weak response to the strong response cuts the standard deviation of inflation by more than two thirds. Naturally, as the variation in inflation vanishes, so does the value of its indicators.

In summary, growth in nominal cash balances held by households is not useful in forecasting inflation in either the BB model or the NW model. But both dM3 and dL seem to have predictive

²⁰ This is not surprising since our data are generated with an interest rate rule that responds to inflation and the output gap.

power in the BB model. Why is this? For reasons given in Section 5B, these aggregates move consistently in the right direction for the two shocks – productivity and government spending – that collectively account for 95% of the variation in inflation in the BB model. Finally, dLIAB is useful in forecasting inflation in the BB model, but not in the NW model. Why the difference? Not surprisingly, government spending shocks explain more than 75% of the variation in dLIAB in both of the models. But, for reasons that were again given in Section 5.B, government spending shocks explain almost 20% of the variation in inflation in the BB model, and less than 1% in the NW model.

In any case, the implication of these results would seem to be clear. The NW model may give a misleading view of the usefulness of monetary aggregates in predicting inflation in a more complete model.

5.D. Monetary Aggregates: A Reality Check for Inactive Policy Rules?

Inflation seems well in check in many countries whose central banks no longer pay much attention to monetary aggregates. Lucas (2006) worries that this recent success may “lead monetary policy analysis back to the muddled eclecticism that brought us the 1970s inflation”. Estimates of the interest rate rule during the pre-Volcker period usually place θ_π at about 0.8,²¹ and this weak response to inflation is though by some to have been responsible for the high rates of inflation of the 1970s. Would paying more attention to monetary aggregates have alerted the Fed to the problem?

The BB model differs from the NW model in an important way that we have not touched upon yet. Interest rate rules that violate the Taylor principle ($\theta_\pi > 1$) cause a well known indeterminacy problem in the NW model. Not so in the BB model. Canzoneri and Diba (2005) showed that the nominal indeterminacy is intimately associated with the Ricardian nature of the

²¹ See for example Lubik and Frank Schorfheide (2004).

models that exhibit it. In the BB model, government bond liquid provide the non-Ricardian element that is needed to eliminate the problem. Elsewhere, we have analyzed the coordination of monetary and fiscal policies that is needed to eliminate the nominal indeterminacy in a model similar to our BB model.²²

Figure 8 shows how a government spending shock passes through the BB model with an inactive monetary policy rule ($\theta_\pi = 0.8$). Inflation and output rise, and the interest rate rule calls for an increase in I_g . But, the response is too weak to raise the real rate, R_g . Both $dM3$ and $dLIAB$ are however positive, and they should be useful indicators of the impending inflation. In this sense, monitoring the aggregates would serve as a kind of reality check. Figure 7 suggests that even for rules that obey the Taylor Principle, the relevance of this reality check may increase as the response to inflation becomes weaker.

6. Summary and Directions for Further Work

Our BB model adds banks and liquid government bonds to an otherwise standard neo-Wicksellian model. In this sense, the BB model is a more complete modeling of the economy than is the NW model. The extra modeling brings a role for government bonds in household and bank liquidity management problems, financial frictions in the provision of deposits and loans, an endogenous spread between the money market rate in the central bank's interest rate rule and the rate of return in the consumption Euler equation, bank loans that may affect aggregate supply and demand, and bank deposits that can substitute for cash.

²² See Canzoneri, Cumby, Diba and Lopez-Salido (2006). Note that this is not the Fiscal Theory of the Price Level. Fiscal policy is still Ricardian in the sense of Woodford (1995), or passive in the sense of Leeper (1991).

We identified two theoretically important implications of the extra modeling for monetary policy and inflation: the “liquidity provision” effect and the “liquidity buffering” effect. Both are due to the transactions services of government bonds, which is absent in the NW model. Fiscal deficits increase total liabilities ($m + b$), and this has a direct effect on inflation. And the liquidity crunch created by a contractionary open market operation is buffered by the liquidity of government bonds; this reduces the spread between the CCAPM rate in the consumption Euler equation and the money market rate in the central bank’s interest rate rule. Interest rate surprises have less effect on inflation. And more importantly, the elastic interest rate spread makes the systematic component of monetary policy respond less aggressively to inflation; so, all shocks pass through the economy with less monetary stabilization.

The NW model provides a less complete modeling of the economy. But it has the virtue of simplicity, and some have suggested that it gives an adequate account of macroeconomic behavior for the business cycle analyst and the monetary policy analyst alike. To investigate this possibility, we calibrated the models to see if the theoretical differences between the BB and NW models were quantitatively significant. We found that the liquidity buffering effect is readily apparent, and that it makes a difference in the way shocks pass through the economy. But, these differences are not very large. On the other hand, the total transactions balance effect (and the associated non Ricardian behavior of consumers) makes a big difference. Impulse response functions show that a bond financed increase in government spending has a much bigger effect on inflation in the BB model, and the effect is much more persistent, than in the NW model.

We also found that most monetary aggregates – M3, L, and public sector liabilities – are useful in forecasting inflation in the BB model; however, household cash balances are not. The two

monetary aggregates in the NW model – household cash balances and public sector liabilities – are not useful in forecasting inflation in that model. So, the NW model seems to give a misleading view about the usefulness of monetary aggregates in a more complete model. Moreover, growth in M3 or public sector liabilities may provide a reality check against an inadvertent lapse into a policy that violates the Taylor Principle.

We have not studied how central banks should use monetary aggregates in their policy process. However, one point should be made clear: our work does not support strict targeting of, say, M3 growth. The standard deviation of inflation in the BB model is 0.004 (per quarter) under our benchmark interest rate rule; if we replace the benchmark policy with a rule that leans against fluctuations in $dM3$, and does so strongly enough to virtually eliminate them, then the standard deviation of inflation rises to 0.133. The market for money does “matter” in the BB model. Figure 3 shows that an increase in M3 demand raises the real CCAPM rate, lowers consumption demand, and decreases inflation; however, these effects are very small. Moreover, the variance decompositions in Table 2 show that 95% of the variation in inflation is explained by the shocks to productivity and government spending. Innovations in $dM3$ predict inflation because they contain information about these underlying shocks, and not because money growth is the driving force in inflation.

Woodford (2006) addresses a number of theoretical concerns that have been raised about neo-Wicksellian models.²³ Our BB model offers an interesting new perspective on some of the issues involved. First, Woodford argues that the central bank’s interest rate policy pins down the steady state rate of inflation rate without any need to set a long run target for money growth. Essentially,

²³Woodford (2006) discusses the related implications of the neo-Wicksellian model, mainly in response to the criticisms of Alvarez, Lucas, and Weber (2001) and Nelson (2003).

the intercept term in the interest rate rule specifies the steady state CCAPM rate, and then the Fischer equation gives the inflation rate. There is no need to set a long run target for money growth in the BB model either, but there is a spread between the steady state CCAPM rate and the money market rate in the central bank's interest rate rule. And as shown in Section 3, that spread is endogenous and depends upon the fiscal target for the ratio of government bonds to GDP (among other things). This suggests that some coordination of monetary and fiscal policy is needed to control inflation in the long run.

Second, Woodford invokes historical conditions to pin down the initial price level in neo-Wicksellian models. There is no need to do this in the BB model: it determines the price level at each point in time. As Canzoneri and Diba (2005) show, price level determinacy is a generic implication of the government's flow budget constraint in any model that determines real bond balances; real bond balances are determined in the BB model because they provide transactions services and Ricardian Equivalence does not hold.

We view the present modeling as very much a work in progress. So far, we have focused mostly on the liabilities side of the banks' balance sheet. And even here there is much to be done. We have, for example, just postulated a unitary elasticity of substitution between the assets in what we have called effective transactions balances. These elasticities could be estimated, and different elasticities may affect the results we have reported.

In this paper, we have interpreted the quantitative differences in our models as having come from the "liquidity provision" effect or the "liquidity buffering" effect; this seemed natural since the differences appear to be consistent with those interpretations. However, the BB model also has financial frictions and a bank loans mechanism that are absent in the NW model. And these factors

probably deserve more attention. In our benchmark model, household refinance their loan for a fixed durable (which we have likened to a house) each period, and the fluctuating loan rates do not affect household behavior. We also tried making the firms borrow from the bank to meet their wage bill. But the impulse response functions looked virtually the same as those for the benchmark model.

It may of course be that the financial frictions of creating bank loans and deposits are not very costly, and that this extra modeling is not necessary for most macroeconomic applications. We think, however, that it is too soon to be reaching such a conclusion. For example, bank loans could fund entrepreneurs, as in the financial accelerator literature discussed by Bernanke, Gertler, and Gilchrist (1999).

Those who are more interested in the implications for monetary policy implications will probably want to model features that bring more persistence to the inflation process. This would make a clearer distinction between short run and the medium run inflation dynamics. Those who advocate the use of monetary aggregates in forecasting inflation generally admit that their value is limited in the short run; they would argue, however, that monetary aggregates can provide a medium run reality check. For example, Fischer et al (2006) describe the ECB's policy process as drawing upon both "economic analysis" and "monetary analysis", saying: "The former attempts to identify the economic shocks driving the business cycle and thus embodies a thorough assessment of the cyclical dynamics of inflation. The latter analyses the monetary trends associated with price developments over the medium to longer term". Issing (2006) claims that two to three years is the horizon "that is typically considered relevant for monetary policy decisions, given the lags in monetary policy transmission", and this is consistent with empirical analysis. The impulse response

function for the interest rate shock in Section 5 peaks too soon.

Table 1: Theoretical Means and Standard Deviations in the Benchmark Models

BB Model			NW Model		
Variable	Mean	Std D	Variable	Mean	Std D
Π	0.0070	0.0038	Π	0.0076	0.0033
y	0.9050	0.0099	y	0.9019	0.0104
Rc	0.0101	0.0035	Rc	0.0101	0.0039
mh	-0.5866	0.2873	m	-0.6267	0.2711
liab	0.8575	0.2079	liab	0.4089	0.3598
m3	1.6289	0.2173			
deposits	1.5134	0.2591			

Table 2: Variance Decompositions (infinite horizon) in the Benchmark Models

BB Model					NW Model				
	ϵ_p	ϵ_i	ϵ_g	ϵ_m		ϵ_p	ϵ_i	ϵ_g	ϵ_m
Π	76.36	5.07	18.57	0.01	Π	91.08	8.84	0.08	0.00
Rc	17.36	81.33	1.29	0.02	Rc	14.44	83.98	1.58	0.00
y	80.18	6.22	13.60	0.00	y	82.47	6.81	10.72	0.00
c	86.60	6.71	6.69	0.00	c	85.92	7.10	6.98	0.00
n	88.83	3.50	7.66	0.00	n	88.58	4.75	6.67	0.00
mh	52.41	32.45	14.55	0.59	m	58.12	40.08	1.09	0.72
dMh	11.16	87.61	0.81	0.42	dM	10.11	89.08	0.33	0.48
dLIAB	13.33	10.43	76.23	0.01	dLIAB	6.49	6.60	86.90	0.01
dM3	8.22	11.16	46.10	34.51					
m3	0.13	5.64	93.81	0.42					
deposits	0.94	6.78	92.03	0.26					
bh	3.27	8.52	88.09	0.12					
Rc - Rg	4.99	9.31	85.59	0.12					
Rl - Rc	35.08	62.71	2.18	0.02					

Table 3: Correlations in the Benchmark Models

BB Model			NW Model		
Variable	Π	y	Variable	Π	y
Π	1.00	-0.50	Π	1.00	-0.64
y	-0.50	1.00	y	-0.64	1.00
dMh	-0.07	-0.05	dM	-0.07	-0.04
dLIAB	0.38	-0.09	dLIAB	0.12	-0.00
dM3	0.31	-0.05			

Figure 1: Interest Rate (Ig) Shock

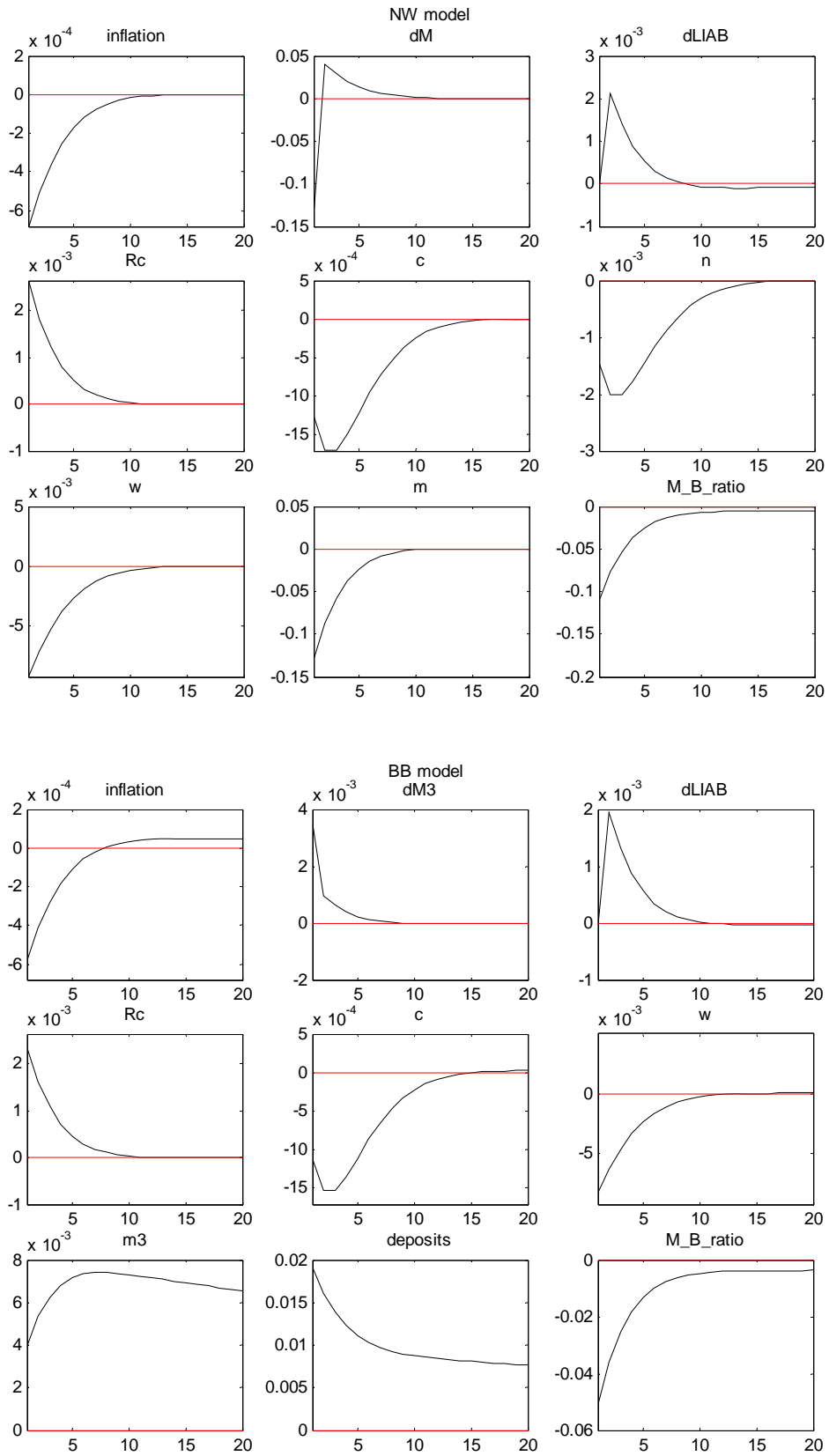


Figure 2: Productivity Shock in Manufacturing

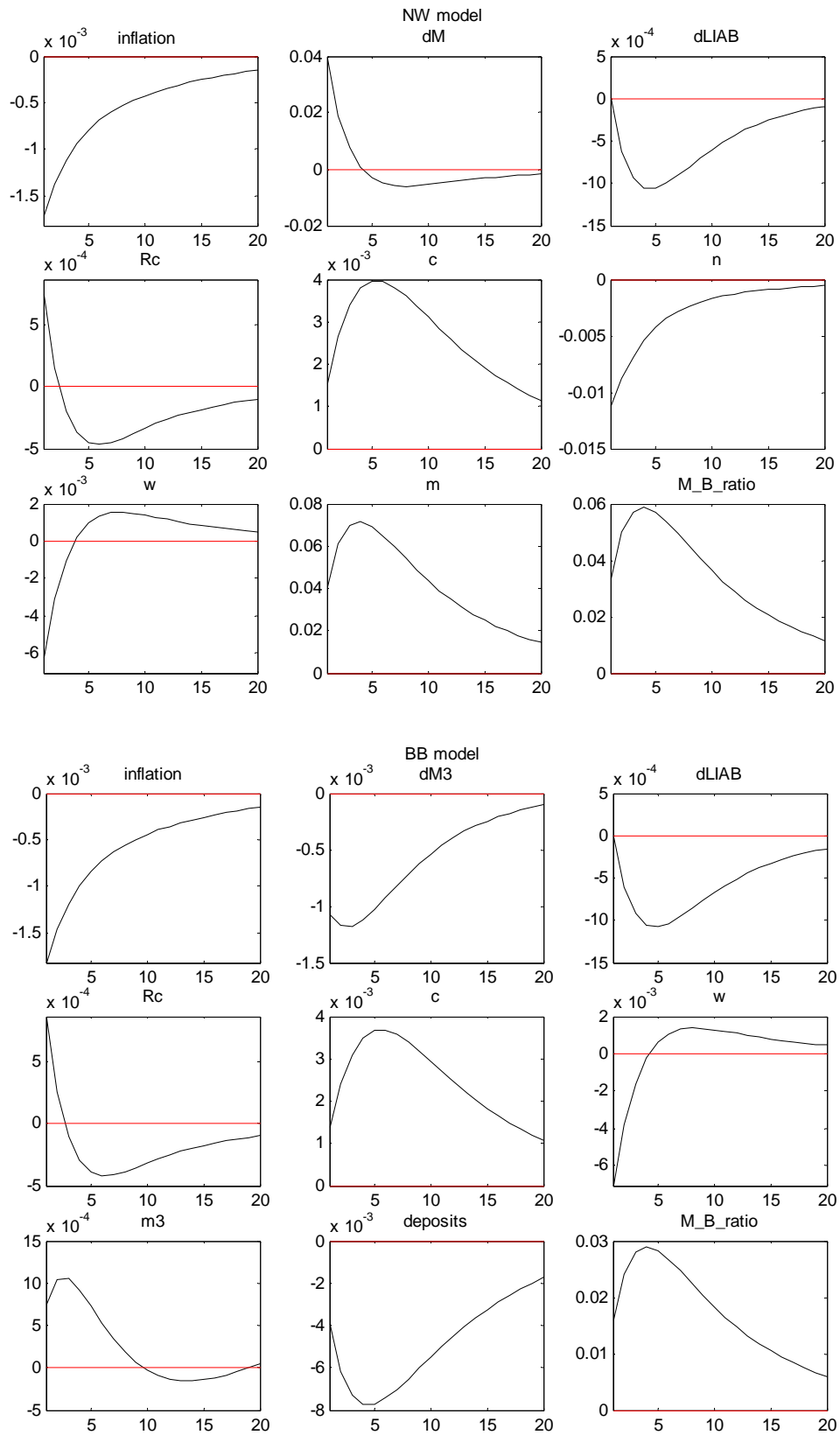


Figure 3: Government Spending Shock

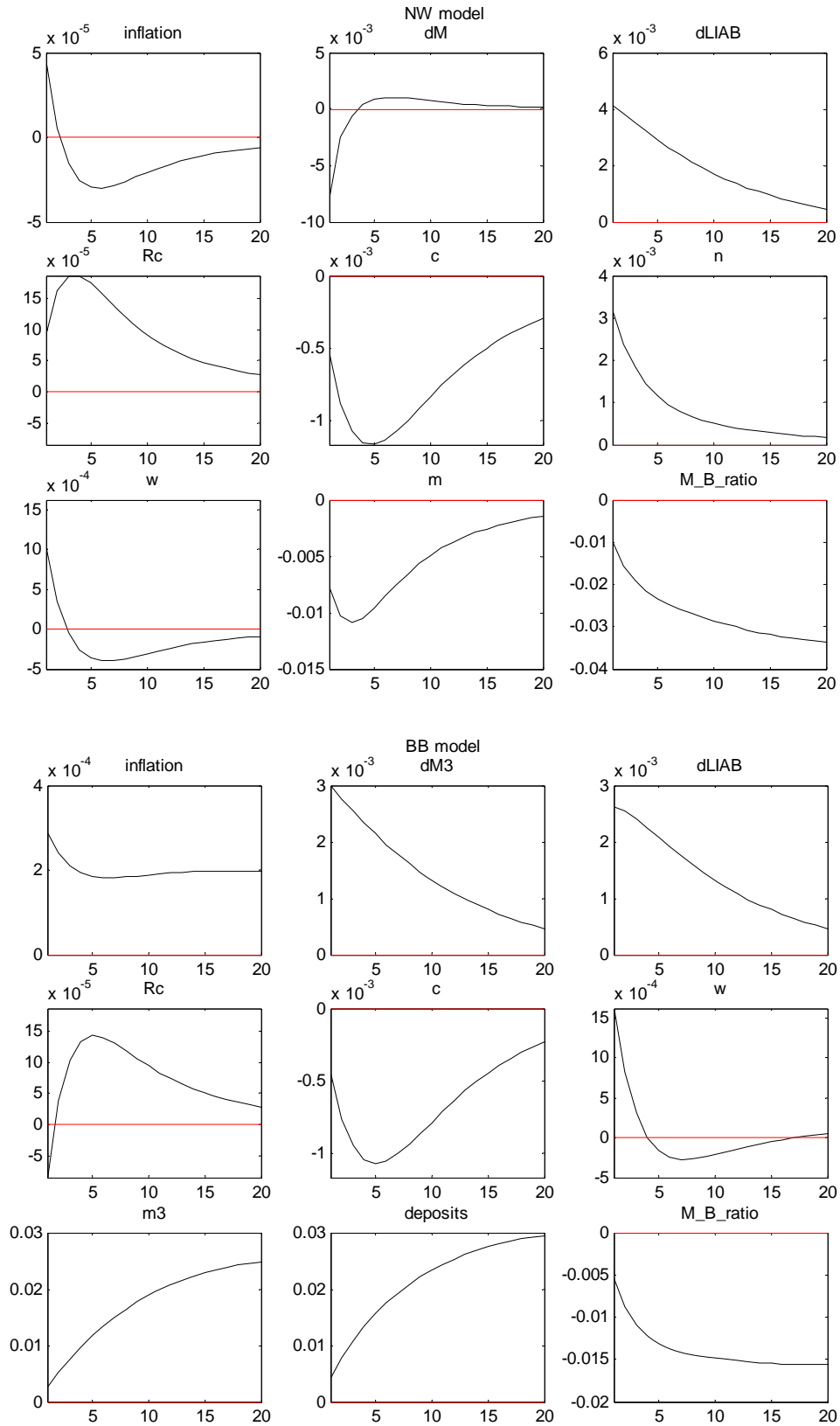


Figure 4: Money Demand Shock

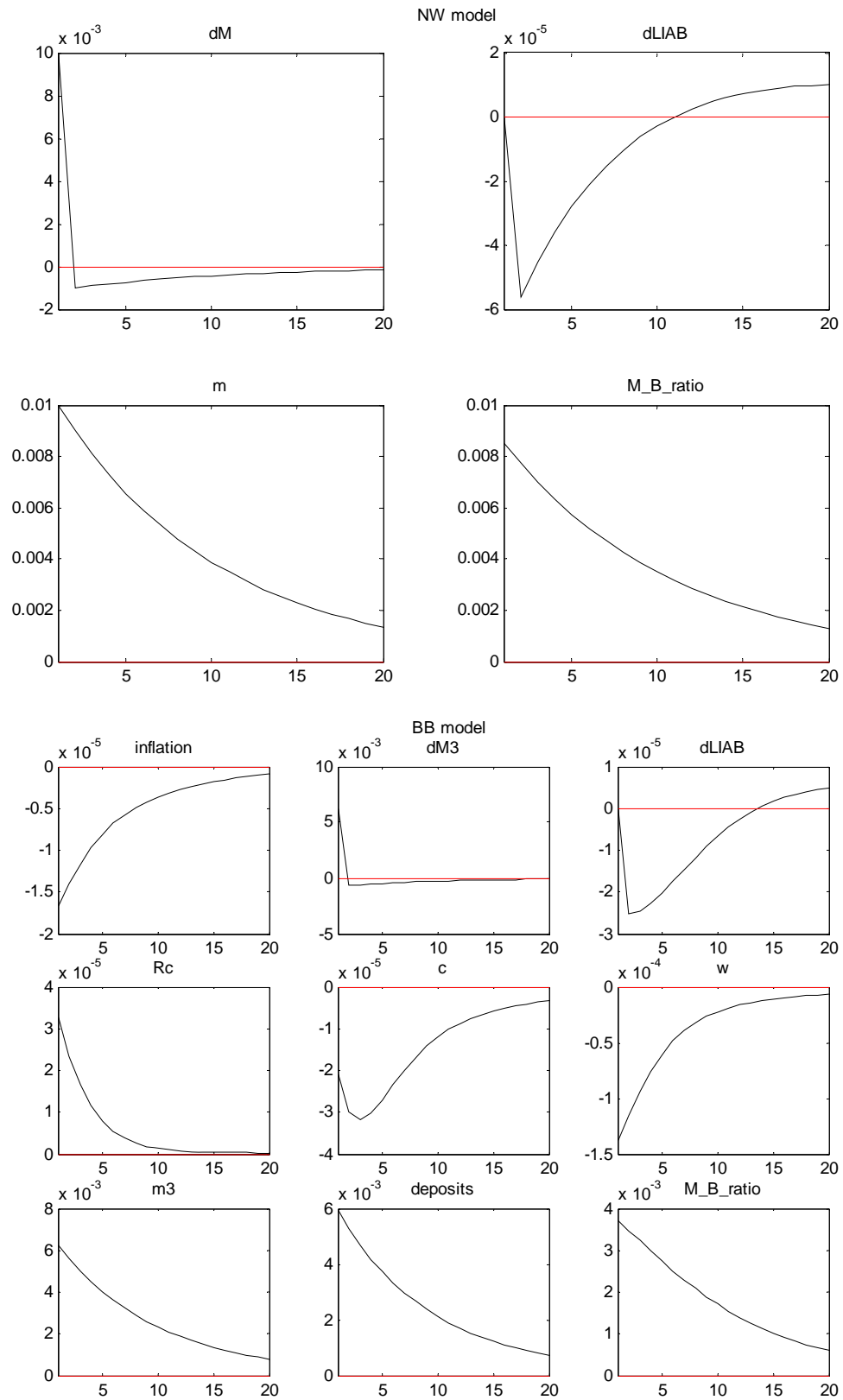
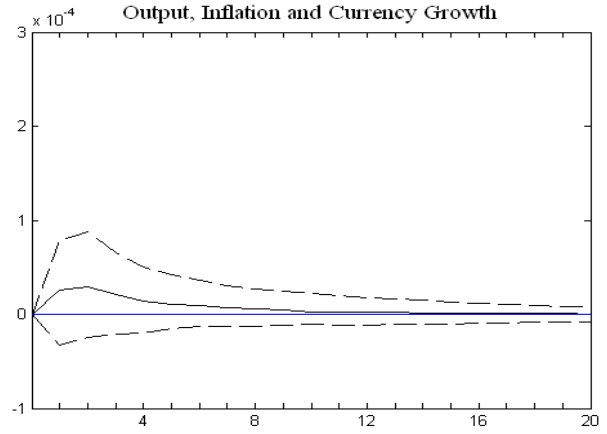
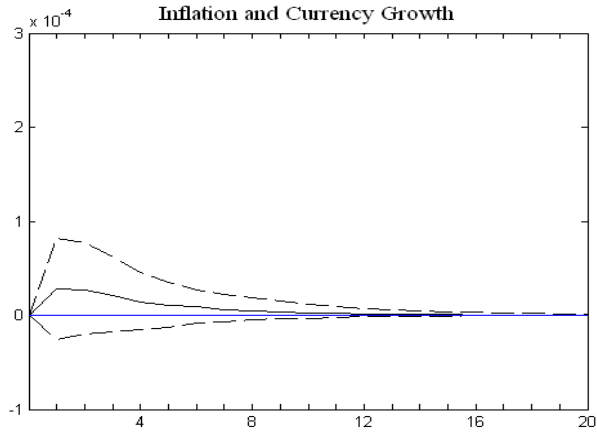
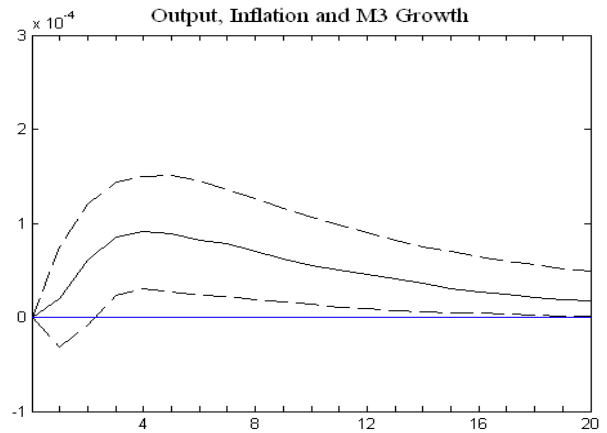
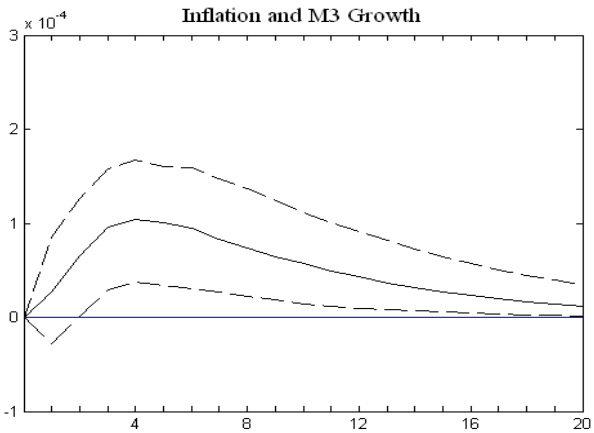


Figure 5: Response of Inflation to a Shock to Nominal Growth in Monetary Aggregates in the BB Model ($\theta_\pi = 2.0$)

A. Shock to Growth of Household Currency Holdings (dMh)



B. Shock to Growth of M3 (dM3)



C. Shock to Growth of Liabilities (dLIAB)

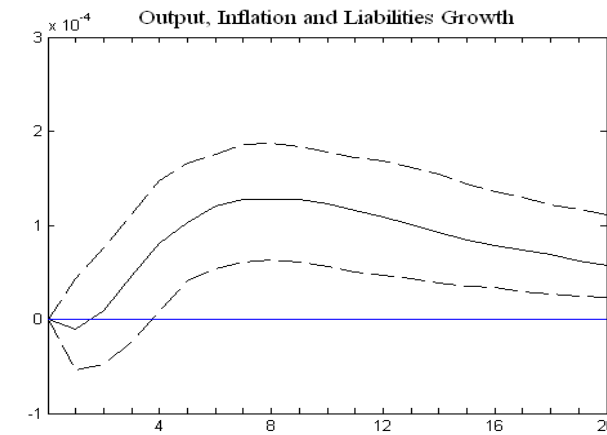
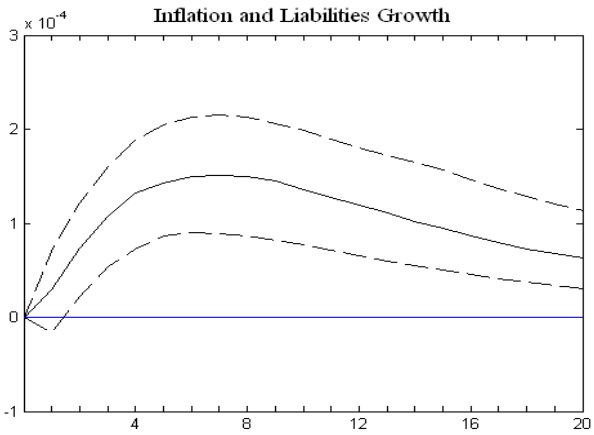
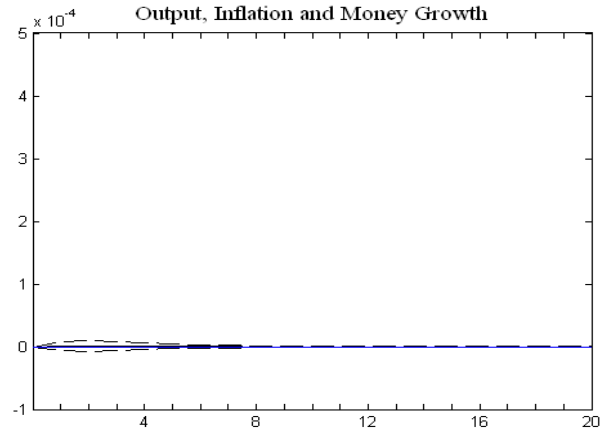
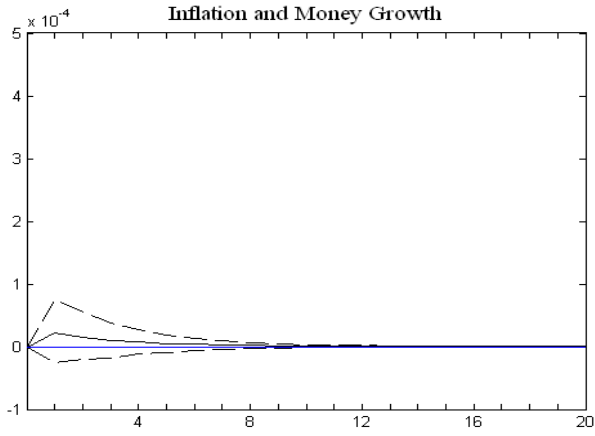


Figure 6: Response of Inflation to a Shock to Growth in Monetary Aggregates in the Neo-Wicksellian Model ($\theta_\pi = 2.0$)

A. Response of Inflation to Money Growth (dMh)



B. Response of Inflation to Liabilities Growth (dLIAB)

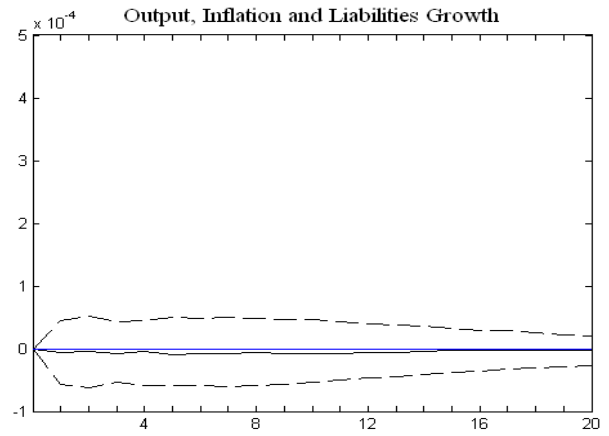
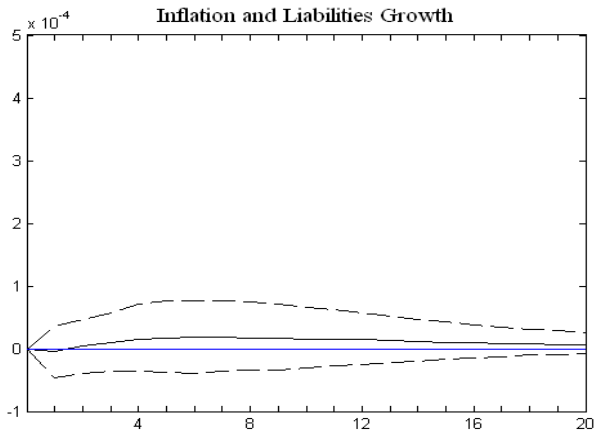
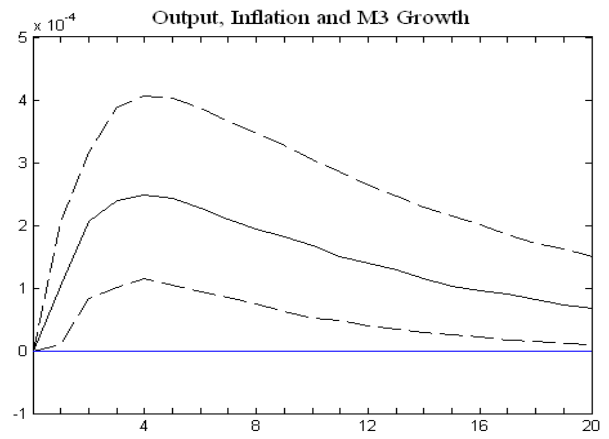
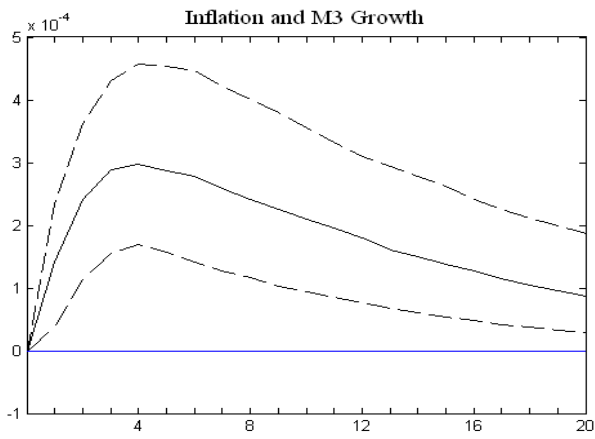
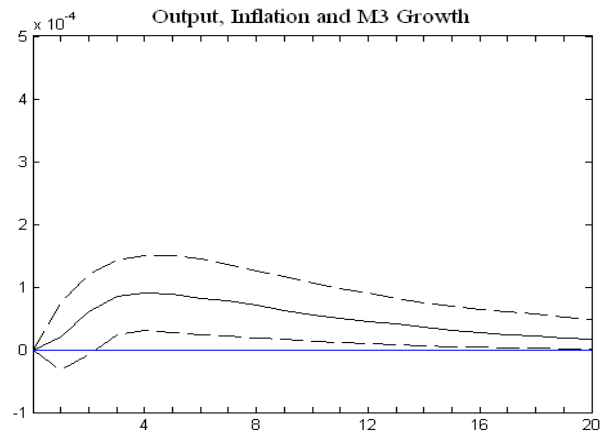
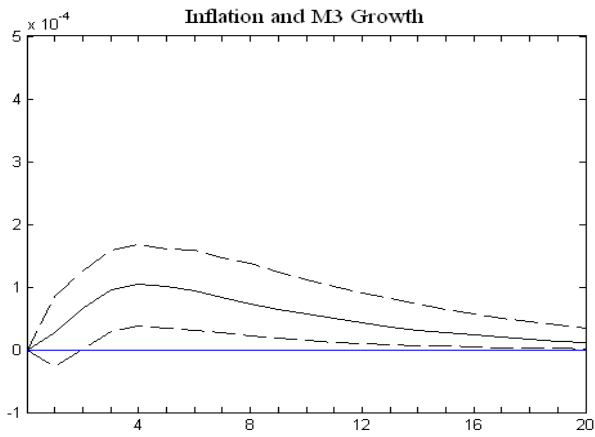


Figure 7: Response of Inflation to Growth in Monetary Aggregates
in the BB Model

A. $\theta_\pi = 1.1$



B. $\theta_\pi = 2.0$



C. $\theta_\pi = 4.0$

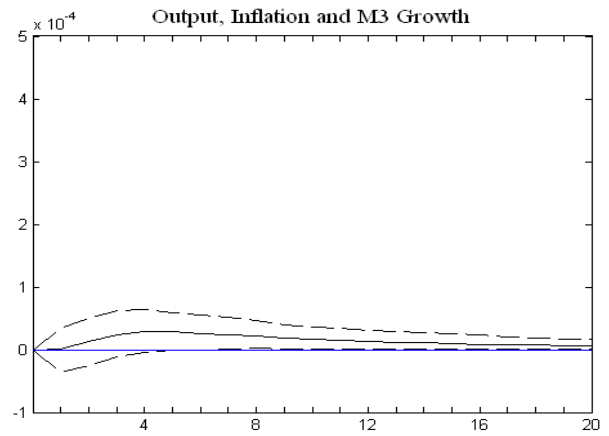
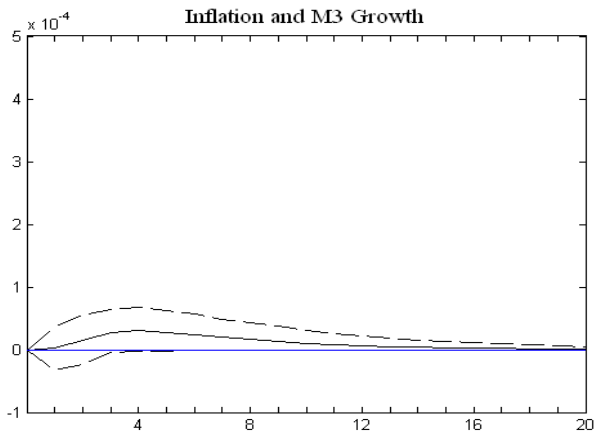
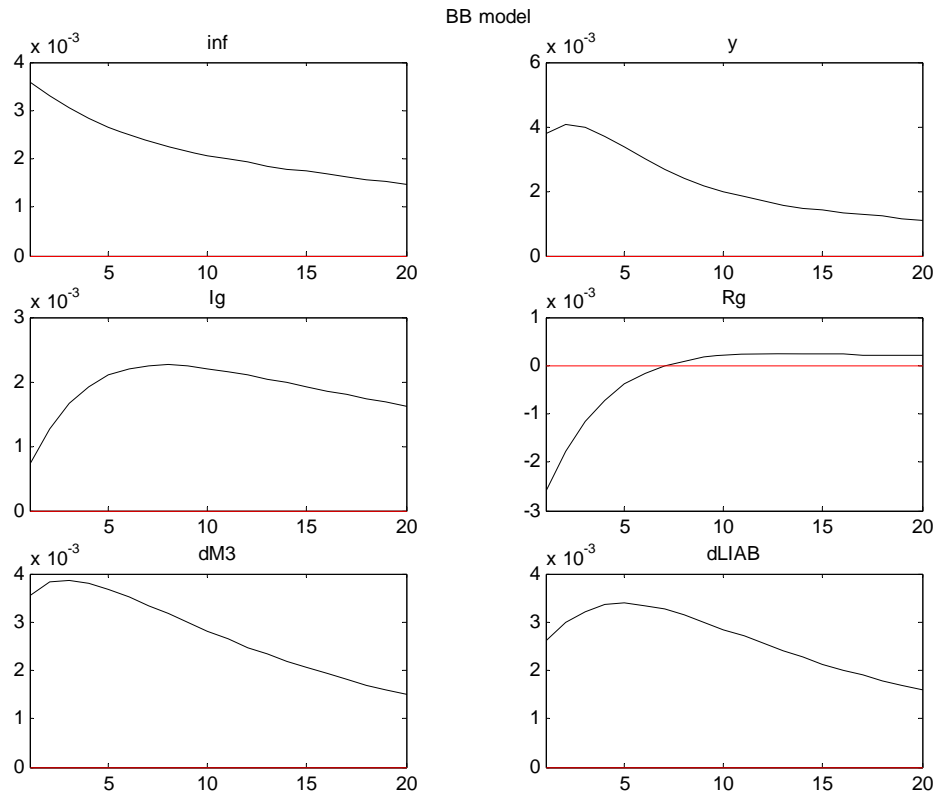


Figure 8: Government Spending Shock; Inactive Monetary Policy ($\theta_\pi = 0.8, \theta_f = 0.012$)



References:

- Alvarez, Fernando, Robert E. Lucas, Jr., and Warren Weber (2001), "Interest Rates and Inflation," American Economic Review, 91(2): 219-225.
- Bernanke, Ben, Mark Gertler, and Simon Gilchrist (1999) "The Financial Accelerator in a Quantitative Business Cycle Framework," in d John Taylor and Michael Woodford (eds), Handbook of Macroeconomics, (Elsevier Science, North-Holland).
- Canzoneri, Matthew and Behzad Diba (2005), "Interest Rate Rules and Price Determinacy: the Role of Transactions Services of Bonds," Journal of Monetary Economics, 52, Issue 2, 329-343.
- Canzoneri, Matthew, Robert Cumby, and Behzad Diba, (2006a) "The Spread Between the CCAPM Interest Rate and the Treasury-bill Rate Is Correlated with Monetary Policy," Journal of Monetary Economics, forthcoming.
- _____, (2006b) "The Cost of Nominal Rigidity in NNS Models," Journal of Money Credit and Banking, forthcoming.
- Canzoneri, Matthew, Robert Cumby, Behzad Diba and David Lopez-Salido, 2006, "Monetary and Fiscal Policy Coordination when Bonds Provide Transactions Services", mimeo.
- Christiano, Lawrence, Martin Eichenbaum, Charles Evans, 2005, Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy, Journal of Political Economy 13, no. 1, February, 1-45.
- Christiano, Lawrence, Cosmin Ilut, Roberto Motto, and Massimo Rostagno, (2007) "Monetary Policy and Stock Market Boom-Bust Cycles", mimeo.
- Fischer, B., M. Lenza, H. Pill, and L. Reichlin (2006), "Money and Monetary Policy: The ECB Experience 1999-2006," an ECB staff paper prepared for the 4th ECB Central Banking Conference, The Role of Money and Monetary Policy in the Twenty First Century, November, 2006
- Goodfriend, Marvin and Bennett McCallum (2006), "Banking and Interest Rates in Monetary Policy Analysis: A Quantitative Exploration," paper prepared for the Carnegie-Rochester Conference Series.
- Issing, Otmar, (2006), speech at the ECB Watchers Conference, Frankfurt, May 5th.
- Leeper, Eric (1991), "Equilibria Under Active and Passive Monetary and Fiscal Policies," Journal of Monetary Economics, 29, 129 -147.

Lubik, Thomas and Frank Schorfheide (2004), "Testing for Indeterminacy: An Application to U.S. Monetary Policy," American Economic Review, Vol. 94, No. 1, 190 - 216.

Lucas, Robert (2006), "Panel Discussion: Colloquium on Honor of Otmar Issing," remarks presented at an ECB Colloquium, Frankfurt, March.

Nelson, Edward (2003), "The Future of Monetary Aggregates in Monetary Policy Analysis," Journal of Monetary Economics, 50: 1029-59.

Weil, Philippe (1989), "The Equity Premium Puzzle and the Risk-free Rate Puzzle," Journal of Monetary Economics 24, no. 3, November, 401-421.

Woodford, Michael (1995), "Price Level Determinacy without Control of a Monetary Aggregate," Carnegie Rochester Conference Series on Public Policy, 43, 1-46.

_____ (2003), Interest and Prices: Foundations of a Theory of Monetary Policy, Princeton University Press, Princeton.

_____ (2006), "How Important is Money in the Conduct of Monetary Policy," mimeo.