NORTH-HOLLAND

Journal of Policy Modeling
26 (2004) 191–208

Journal of Policy Modeling

The view of Sargent and Wallace on monetary policy: tight monetary policy does not stop inflation: an evaluation of CBRT's monetary policy for 1987–2002

Cem Mehmet Baydur*, Bora Süslü

Department of Economy, Mugla University, İ.İ.B.F., Muğla 48000, Turkey

Available online 20 April 2004

Abstract

This study analyzes the effect of monetary policy on inflation by using Sargent and Wallace's approach. Their assumption is that tight monetary policy is more inflationist than the loose monetary policy in a condition which the public has to borrow. Then, the monetary policy implemented by Turkish Central Bank (CBRT) between 1987 and 2002 is evaluated. It is concluded that CBRT assisted in the rise of inflation by implementing tight monetary policy from 1987 to 1997, and it contributed to the fall of inflation by following relatively loose monetary policy after 1997. Moreover, since the money generation process of CBRT is subject to the foreign assets, it is revealed that CBRT does not have a monopoly power in controlling the inflation rate.

JEL classification: E52

Keywords: Cagan's money demand; Fiscal policy; Monetary policy; Inflation

1. Introduction

It is a well-know fact that financing public deficits through central bank sources is an inflationary process. Generating money without reciprocal equivalence is

* Corresponding author. Tel.: +90-252-2238002; fax: +90-252-2238004.
E-mail addresses: cmbaydur@hotmail.com (C.M. Baydur), borasuslu@hotmail.com (B. Süslü).

0161-8938/$ – see front matter © 2004 Society for Policy Modeling.
doi:10.1016/j.jpolmod.2004.03.007

definitely inflationist. However, for an economy with public borrows, tight monetary policy is more inflationist compared to a flexible (loose) monetary policy. Although this judgement may not seem consistent, Sargent and Wallace proved that it is not efficient in preventing inflation by itself. Economic authorities responsible for monetary and fiscal policies should harmonise these two policies. Another important aspect of Sargent and Wallace's study is that it demonstrates that tight monetary policy leads to higher inflation in the long-term compared to monetary financing in an environment with public deficit. Yet, this study focuses on why tight monetary policy is more inflationist than loose monetary policy without including long term effects.

The reason for such a study is, as Turkish economy commenced domestic borrowing in 1985, to investigate the policies followed by the authorities who though to be less inflationist with regards to CBRT. From 1985 to 2000 the dominant strategy which ruled the economic administration was as follow: monetary authorities who had failed to secure fiscal discipline or had been obliged to do so and who had seen the inflation as merely a monetary phenomenon, fearing from the monetarization of public deficit, tended to domestic borrowing which they thought it could prevent inflation and left the task of fighting inflation to CBRT. This time period will be evaluated within the theoretical framework presented.

2. Tight monetary policy is more inflationists

Although it may be irrational to claim that tight monetary policy is inflationist for an economy in which the following assumptions are valid: The result both the tight monetary policy implemented and in a new period this policy is forced to be abandoned will be inflationist. In order to reveal the inflationist side of the tight monetary policy, primary assumption is to accept a condition in which the public is forced to borrow as a starting point (Sargent & Wallace, 1981: 2). Tight monetary policy will depreciate the inflation in a condition where public acts independently in borrowing process. If priority is given to public authority, i.e., even if public starts borrowing, monetary policy should be compatible with the public borrowing process. Tight monetary policy accelerates the borrowing process by both decreasing the seniorage revenues and increasing interest rates in public borrowings. Aggregation of debt stock results in a higher price level as well. Second, public pays a higher real interest rates than the economic growth rate to borrow. Finally, money demand is accepted as a function of income. This approach means accepting the quantity theory of money (Sargent & Wallace, 1981: 2). When quantity theory is dealt with as in Cagan, general level of prices is defined as a function of both quantity of current money and future quantity of money (Cagan, 1956: 224–240). Thus, it will not be satisfactory to explain prices by looking only current monetary policy, where public borrowings constantly increase. As a factor affecting the general level of prices, the possibility of monetarisation of future public debts takes part in the quantity theory of money (Sargent & Wallace, 1973: