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Herding in Money Demand

Money demand and the theory of Big Players

Big Players influence the demand for money in ways not easily captured by traditional monetary theory. Most monetary economists have been in search of a well-specified model that will allow them to track accurately the demand for money and predict its future movements. By the early 1970s, a general consensus had emerged among economists about the functional form of money demand. This form seemed highly stable in the period after the Second World War. At about the same time the Federal Reserve System began a long series of changes in its policies and procedures. As argued below, these changes produced greater Fed activism and discretion. Shortly thereafter money demand estimates became unstable, and the emerging data began to expose shortcomings in the accepted models. Most economists came to believe these problems with tracking money demand were a product of misspecification of the models. Since the 1970s, the game has been one of discovering which measure of income or wealth to use, which measure of risk, and which measure of liquidity, as well as some way to account for advances in payment technologies and institutional change. Yet, no model to date has been robust over time.

The shortcomings of money demand specifications became clear about when the Fed adopted much more discretionary policies. The theory of Big Players suggests a causal connection. Gilanshah and I applied the theory to U.S. money demand from 1950s to 1980s. We found that after 1970, Fed policy grew more discretionary and that this increase in Big Player influence reduced the stability of money demand. We cannot exclude other factors. But the theory of Big Players does predict results that are consistent with the data.
The Fed began to undertake more discretionary policy actions beginning in 1970. Shortly thereafter, the estimates generated by the standard money demand specifications began to show sizable prediction errors. Despite considerable effort, no improved specification of money demand has emerged that can satisfactorily account for its seemingly aberrant behavior during the 1970s and 1980s. If the prediction errors were purely a product of misspecification, have economists been unable to produce a better model for money demand? Financial innovation, changes in definition of money, wage, and price controls, and other factors might have contributed to instabilities in money demand. The evidence reported below suggests that Big Players may also have played a role.

If the theory of the Big Players is correct, then the sort of instabilities generated by the discretionary actions of Federal Reserve policymakers cannot be explained by the addition of new variables. Instead of searching for such a variable, Gilanshah and I compared the behavior of money demand estimates over two periods, the 1950s–1960s and the 1970s–1980s. Using rescaled-range analysis, we tried to find out if the more discretionary monetary policy of the latter period was indeed a factor in the observed instabilities of money demand.

We found evidence that Fed activism did induce instability in money demand. If the result holds under scrutiny, it has important implications for monetary policy. The Fed should not abandon money supply targets, but should pursue them according to a fixed rule. This implication contradicts one common inference drawn from the literature on instability of money demand. Mishkin’s undergraduate text (1995) is representative of this common view. Mishkin argues that “because the money demand function has become unstable, velocity is now harder to predict, and setting rigid money supply targets in order to control aggregate spending in the economy may not be an effective way to conduct monetary policy” (Mishkin 1995, p. 572). But if this instability of money demand is a product of Fed activism, Mishkin’s conclusion does not follow. If discretion produces instability, we have an argument for less of it, not more.

Past chapters argued that Big Players induce “herding” or “bandwagon effects” in organized financial markets. Big Players also induce herding in the demand for money. The argument is similar to that of Chapter 7. Bandwagon effects enter money demand through the role of cash managers. A substantial portion of money demand is, of course, demand of business enterprises. The decision of how much money to hold is often made by a professional cash manager. Scharfstein and Stein (1990) have noted the importance of reputation for portfolio managers. We note that the same holds for cash managers.