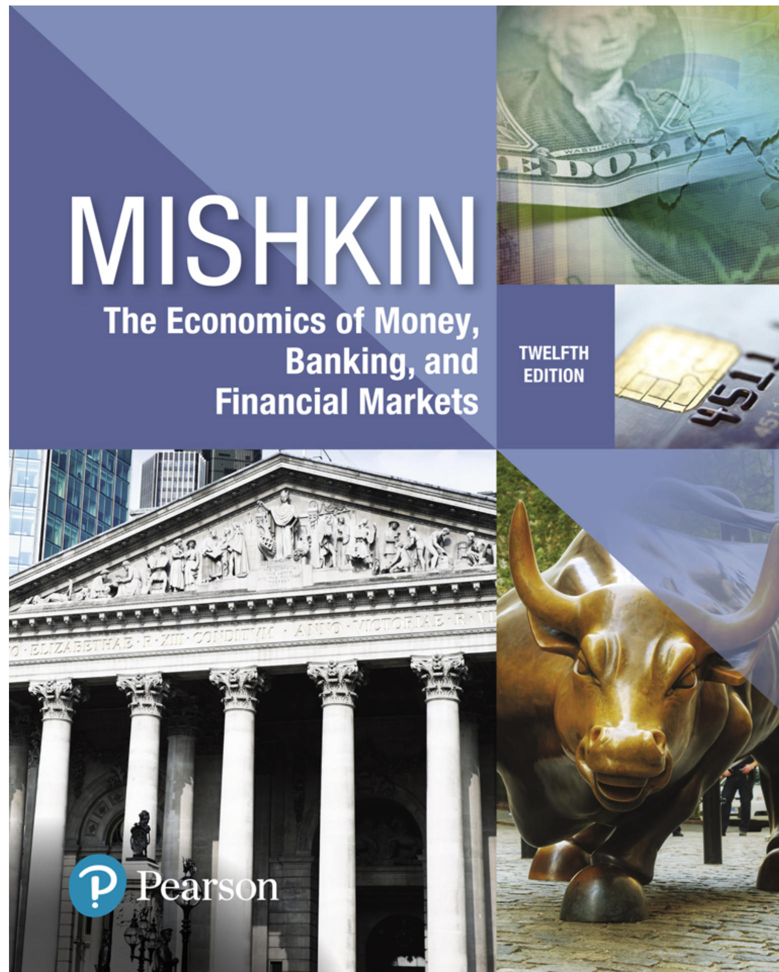
The Economics of Money, Banking, and Financial Markets

Twelfth Edition



Chapter 16

The Conduct of Monetary Policy: Strategy and Tactics

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Preview

- This chapter examines the goals of monetary policy and then considers one of the most important strategies for the conduct of monetary policy, inflation targeting

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Learning Objectives (1 of 2)

- Define and recognize the importance of a nominal anchor.
- Identify the six potential goals that monetary policy makers may pursue.
- Summarize the distinctions between hierarchical and dual mandates.
- Compare and contrast the advantages and disadvantages of inflation targeting.
- Identify the key changes made over time to the Federal Reserve monetary policy strategy.

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Learning Objectives (2 of 2)

- List the four lessons learned from the global financial crisis and discuss what they mean to inflation targeting.
- Summarize the arguments for and against central bank policy response to asset-price bubbles.
- Describe and assess the four criteria for choosing a policy instrument.
- Interpret and assess the performance of the Taylor rule as a hypothetical policy instrument for setting the federal funds rate.

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The Price Stability Goal and the Nominal Anchor

- Over the past few decades, policy makers throughout the world have become increasingly aware of the social and economic costs of inflation and more concerned with maintaining a stable price level as a goal of economic policy.
- The role of a **nominal anchor**: a nominal variable, such as the inflation rate or the money supply, which ties down the price level to achieve price stability
- The time-inconsistency problem

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Other Goals of Monetary Policy

- Five other goals are continually mentioned by central bank officials when they discuss the objectives of monetary policy:
    1. High employment and output stability
    2. Economic growth
    3. Stability of financial markets
    4. Interest-rate stability
    5. Stability in foreign exchange markets

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Should Price Stability Be the Primary Goal of Monetary Policy?

- Hierarchical versus Dual Mandates:
  - **Hierarchical mandates** put the goal of price stability first, and then say that as long as it is achieved other goals can be pursued
  - **Dual mandates** are aimed to achieve two coequal objectives: price stability and maximum employment (output stability)
- Price Stability as the Primary, Long-Run Goal of Monetary Policy
  - Either type of mandate is acceptable as long as it operates to make price stability the primary goal in the long run but not the short run.

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Inflation Targeting (1 of 3)

- Public announcement of medium-term numerical target for inflation
- Institutional commitment to price stability as the primary, long-run goal of monetary policy and a commitment to achieve the inflation goal
- Information-inclusive approach in which many variables are used in making decisions
- Increased transparency of the strategy
- Increased accountability of the central bank

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Inflation Targeting (2 of 3)

- New Zealand (effective in 1990)
  - Inflation was brought down and remained within the target most of the time.
  - Growth has generally been high, and unemployment has come down significantly.
- Canada (1991)
  - Inflation decreased since 1991; some costs in term of unemployment
- United Kingdom (1992)
  - Inflation has been close to its target.
  - Growth has been strong, and unemployment has been decreasing.

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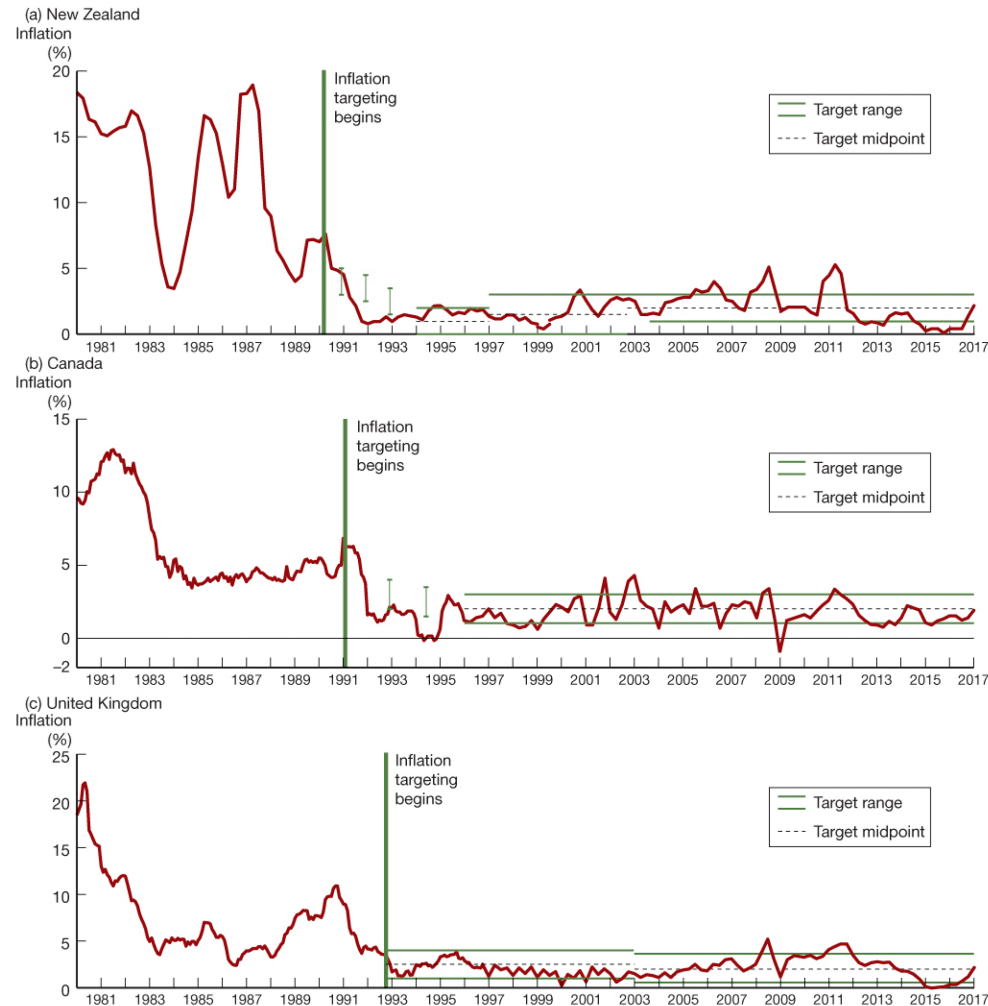
Figure 1 Inflation Rates and Inflation Targets for New Zealand, Canada, and the United Kingdom, 1980–2017



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Inflation Targeting (3 of 3)

- Advantages:
  - Does not rely on one variable to achieve target
  - Easily understood
  - Reduces potential of falling in time-inconsistency trap
  - Stresses transparency and accountability
- Disadvantages:
  - Delayed signaling
  - Too much rigidity
  - Potential for increased output fluctuations
  - Low economic growth during disinflation

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The Evolution of the Federal Reserve's Monetary Policy Strategy (1 of 2)

- The United States has achieved excellent macroeconomic performance (including low and stable inflation) until the onset of the global financial crisis without using an explicit nominal anchor such as an inflation target.
- History:
  - Fed began to announce publicly targets for money supply growth in 1975
  - Paul Volker (1979) focused more in nonborrowed reserves
  - Greenspan announced in July 1993 that the Fed would not use any monetary aggregates as a guide for conducting monetary policy

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The Evolution of the Federal Reserve's Monetary Policy Strategy (2 of 2)

- There is no explicit nominal anchor in the form of an overriding concern for the Fed.
- Forward looking behavior and periodic "preemptive strikes"
- The goal is to prevent inflation from getting started.
- Advantages
  - Uses many sources of information
  - Demonstrated success
- Disadvantages
  - Lack of accountability
  - Inconsistent with democratic principles

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The Fed's "Just Do It" Monetary Policy Strategy

- Advantages of the Fed's "Just Do It" Approach:
  - forward-looking behavior and stress on price stability also help to discourage overly expansionary monetary policy, thereby ameliorating the time-inconsistency problem
- Disadvantages of the Fed's "Just Do It" Approach:
  - lack of transparency; strong dependence on the preferences, skills, and trustworthiness of the individuals in charge of the central bank

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The Evolution of the Federal Reserve's Monetary Policy Strategy

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Inside the Fed: Ben Bernanke's Advocacy of Inflation Targeting

- While a professor at Princeton, Bernanke, in several articles and in a book cowritten with the author of this book, argued that inflation targeting would be a major step forward for the Federal Reserve and would produce better economic outcomes, for many of the reasons outlined earlier. When Bernanke took his position as a governor of the Federal Reserve from 2002 to 2005, he continued to advocate the adoption of an inflation target.

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Global: The European Central Bank's Monetary Policy Strategy

- The European Central Bank (ECB) has also been slow to move toward inflation targeting, adopting a hybrid monetary strategy that includes some elements of inflation targeting.

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Lessons for Monetary Policy Strategy from the Global Financial Crisis

1. Developments in the financial sector have a far greater impact on economic activity than was earlier realized.
2. The zero-lower-bound on interest rates can be a serious problem.
3. The cost of cleaning up after a financial crisis is very high.
4. Price and output stability do not ensure financial stability.

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Implications for Inflation Targeting

- Level of the Inflation Target
- Flexibility of Inflation Targeting

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Should Central Banks Respond to Bubbles? (1 of 2)

- How should Central banks respond to asset price bubbles?
  - **Asset-price bubble**: pronounced increase in asset prices that depart from fundamental values, which eventually burst.
- Types of asset-price bubbles
  - **Credit-driven bubbles**
    - Subprime financial crisis
    - Bubbles driven by irrational exuberance

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Should Central Banks Respond to Bubbles? (2 of 2)

- Strong argument for not responding to bubbles driven by irrational exuberance.
- Bubbles are easier to identify when asset prices and credit are increasing rapidly at the same time.
- Monetary policy should not be used to prick bubbles.

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Should Central Banks Respond to Bubbles?

- **Macropudential policy:** regulatory policy to affect what is happening in credit markets in the aggregate.
- **Monetary policy:** Central banks and other regulators should not have a laissez-faire attitude and let credit-driven bubbles proceed without any reaction.

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Tactics: Choosing the Policy Instrument

- **Tools**
  - Open market operation
  - Reserve requirements
  - Discount rate
- **Policy instrument (operating instrument)**
  - Reserve aggregates
  - Interest rates
  - May be linked to an intermediate target
- **Interest rate and aggregate targets are incompatible (must choose one or the other)**.

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Figure 2 Linkages Between Central Bank Tools, Policy Instruments, Intermediate Targets, and Goals of Monetary Policy

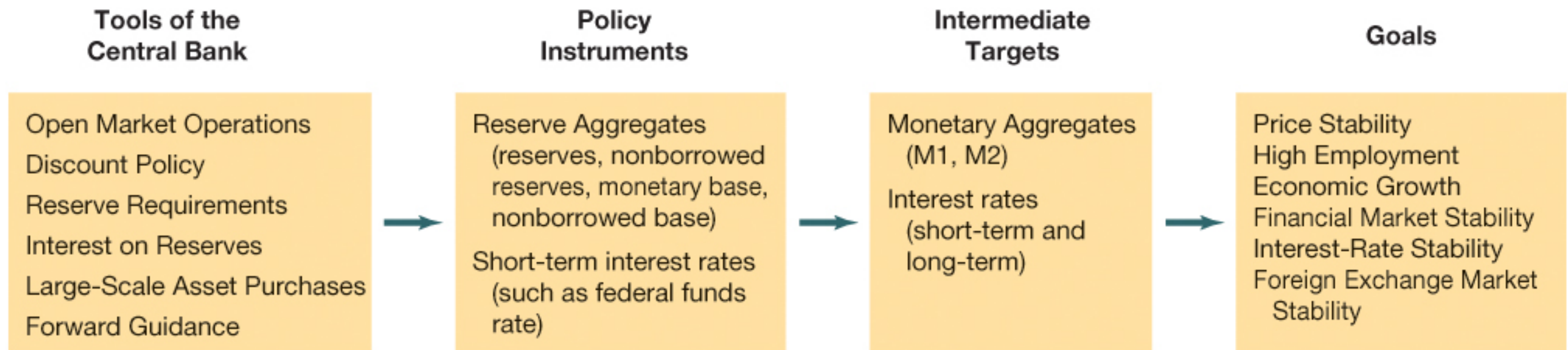

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Figure 3 Result of Targeting on Nonborrowed Reserves

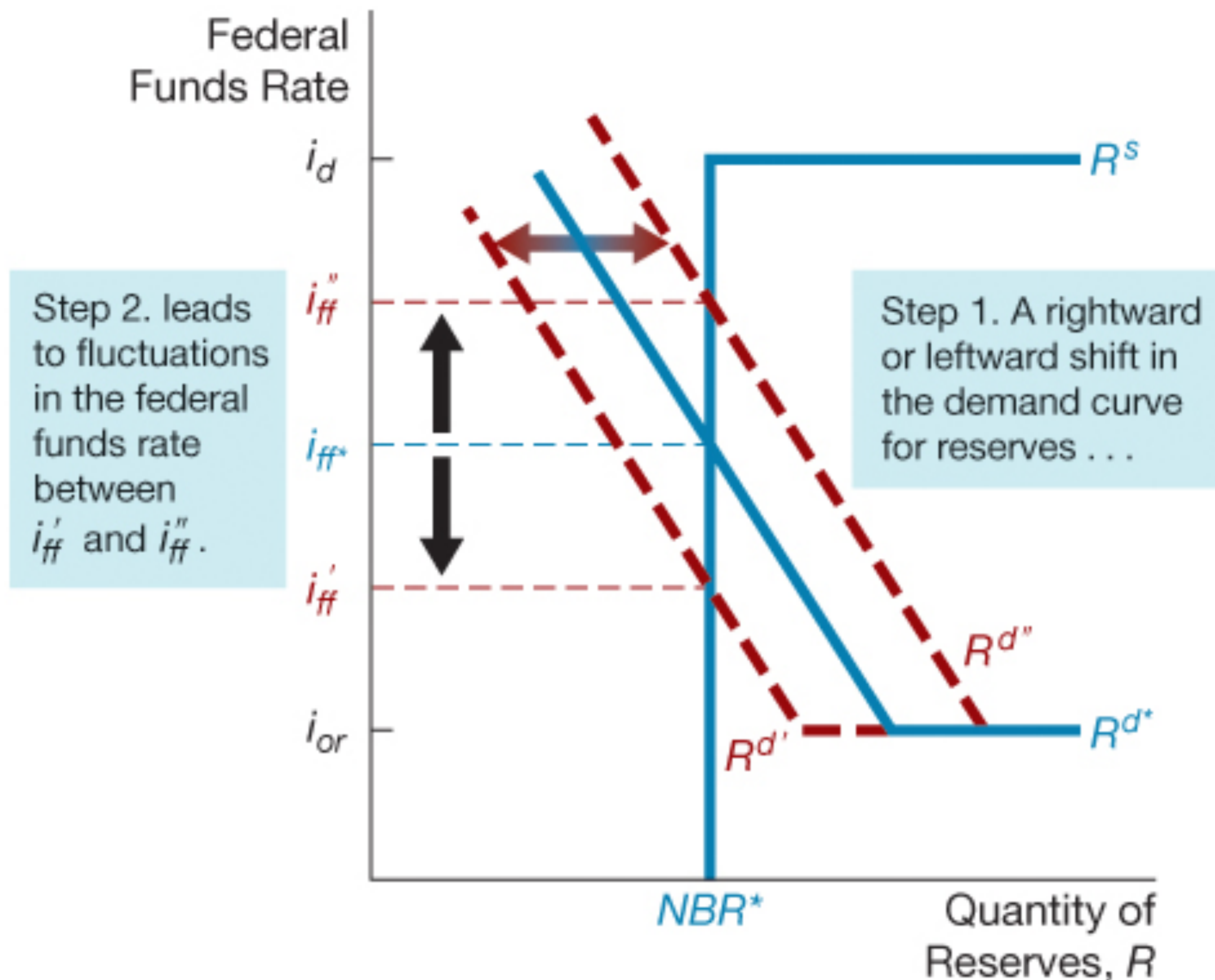

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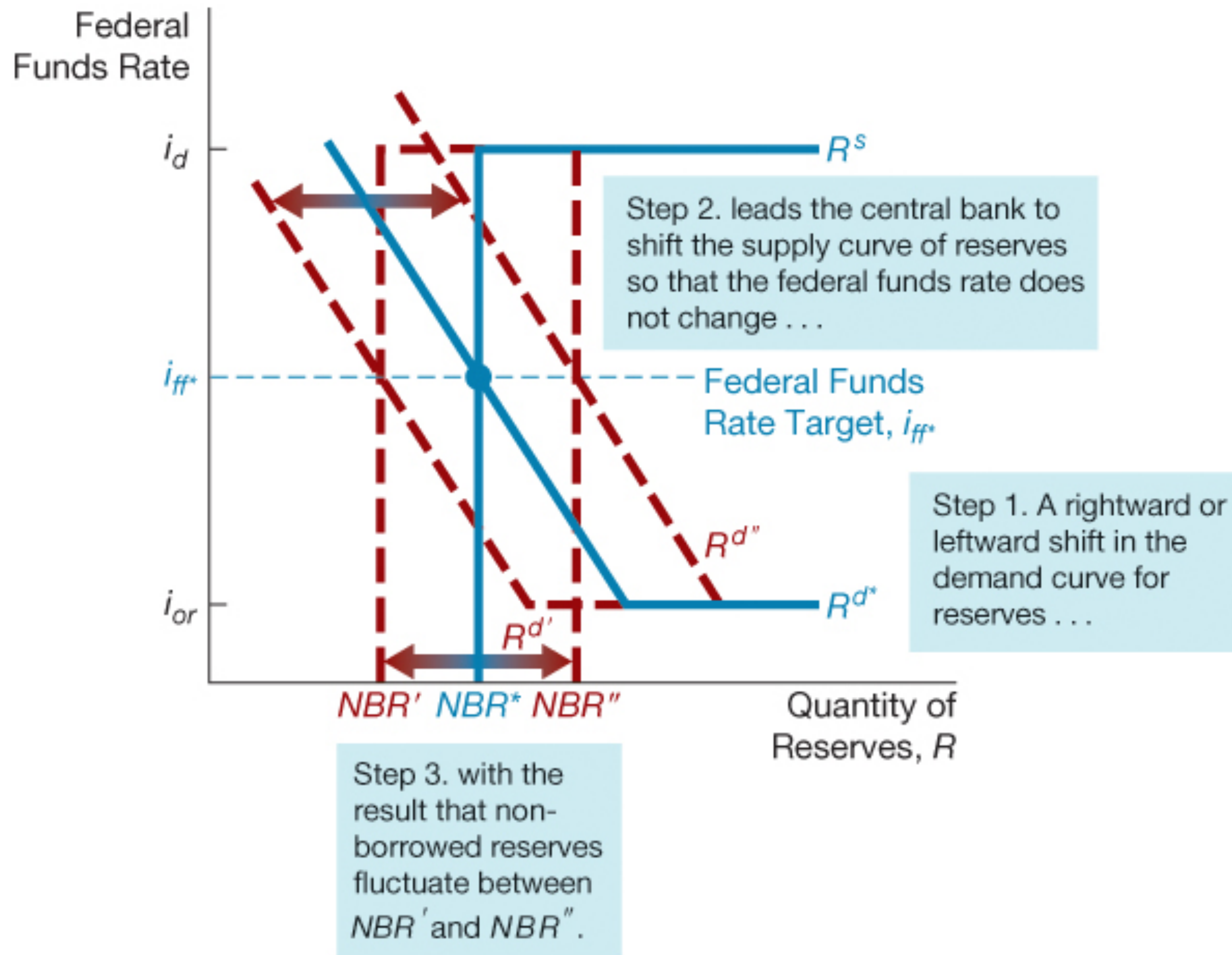
Figure 4 Result of Targeting on the Federal Funds Rate



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Criteria for Choosing the Policy Instrument

- Observability and Measurability
- Controllability
- Predictable effect on Goals

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Tactics: The Taylor Rule

$$\text{Federal funds rate target} = \text{inflation rate} + \text{equilibrium real fed funds rate} + 1/2\ (\text{inflation gap}) + 1/2\ (\text{output gap})$$

- **An inflation gap and an output gap**
  - Stabilizing real output is an important concern
  - **Output gap** is an indicator of future inflation as shown by Phillips curve
- **NAIRU**
  - Rate of unemployment at which there is no tendency for inflation to change

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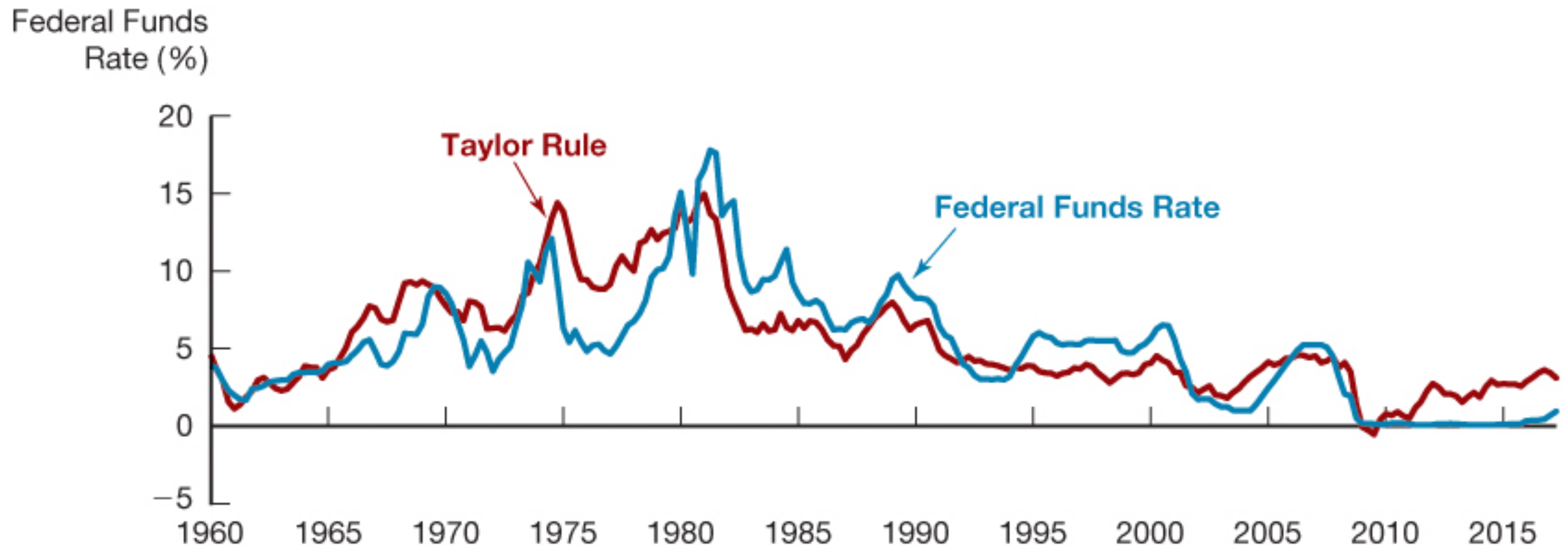
Figure 5 The Taylor Rule for the Federal Funds Rate, 1960–2017



Source: Calculations with Federal Reserve Bank of St. Louis FRED database: https://fred.stlouisfed.org/series/PCECTPI; https://fred.stlouisfed.org/series/GDPC1; https://fred.stlouisfed.org/series/GDPPOT; https://fred.stlouisfed.org/series/DFFGDPC1.

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Inside the Fed: The Fed's Use of the Taylor Rule

- Putting monetary policy on autopilot by using a Taylor rule with fixed coefficients is problematic. The Taylor rule is useful, however, as a guide to monetary policy.

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Inside the Fed: Fed Watchers

- Interest rates have a major impact on investors' and financial institutions' profits. As a result, these parties are particularly interested in scrutinizing the Fed's behavior. To assist in this task, financial institutions hire Fed watchers, experts on Federal Reserve behavior who may have worked in the Federal Reserve System and so have an insider's view of Federal Reserve operations.

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