

---

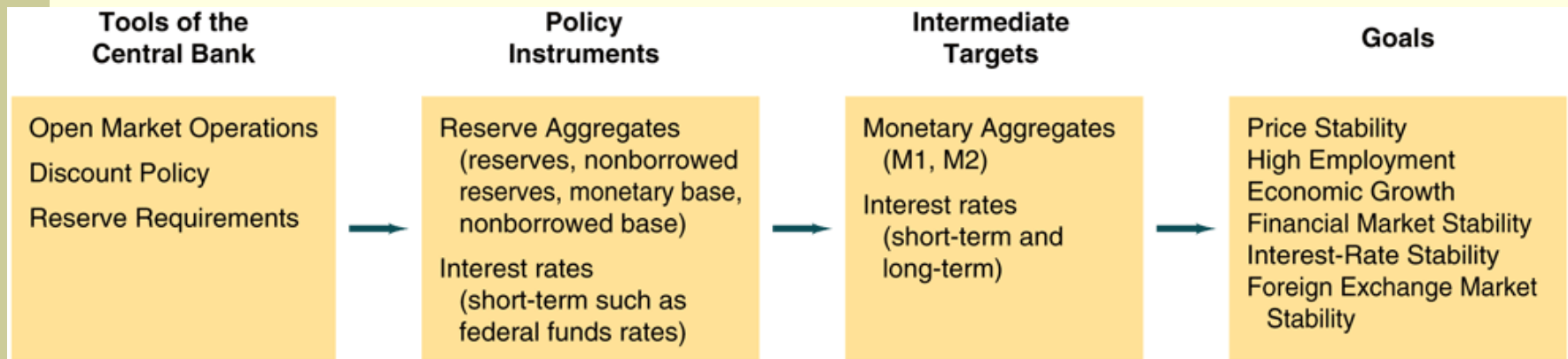
# Lecture 8: The Conduct of Monetary Policy and Transmission Mechanism

Dr. Runchana Pongsaparn  
9 February 2013



# The Conduct of Monetary Policy

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



# Tactics: Choosing the Policy Instrument

---

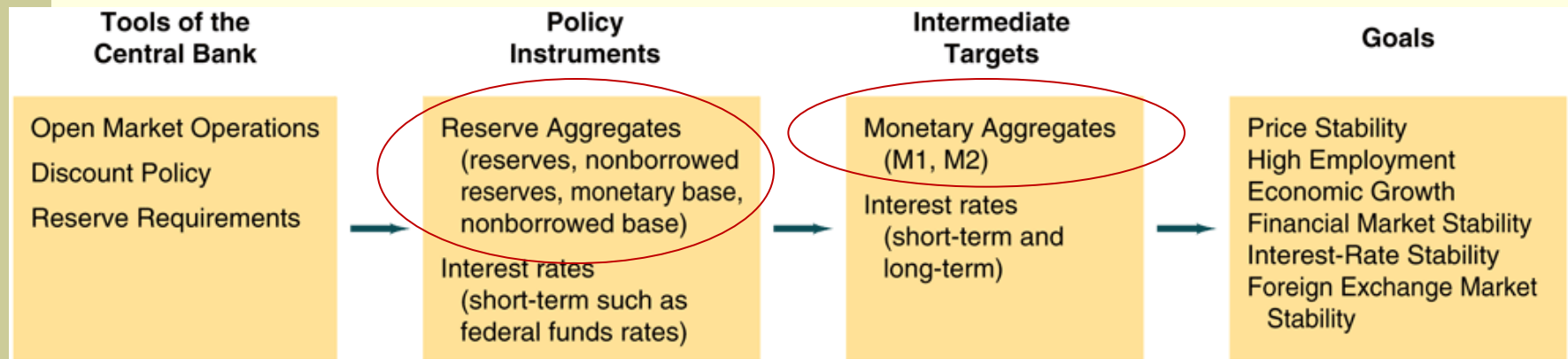
- Tools
  - Open market operation
  - Reserve requirements
  - Discount rate
- Policy instrument (operating instrument)
  - Reserve aggregates
  - Interest rates
  - May be linked to an intermediate target
- Interest-rate and aggregate targets are incompatible (must choose one or the other).

# Criteria for Choosing the Policy Instrument

---

- Observability and Measurability
- Controllability
- Predictable effect on Goals

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

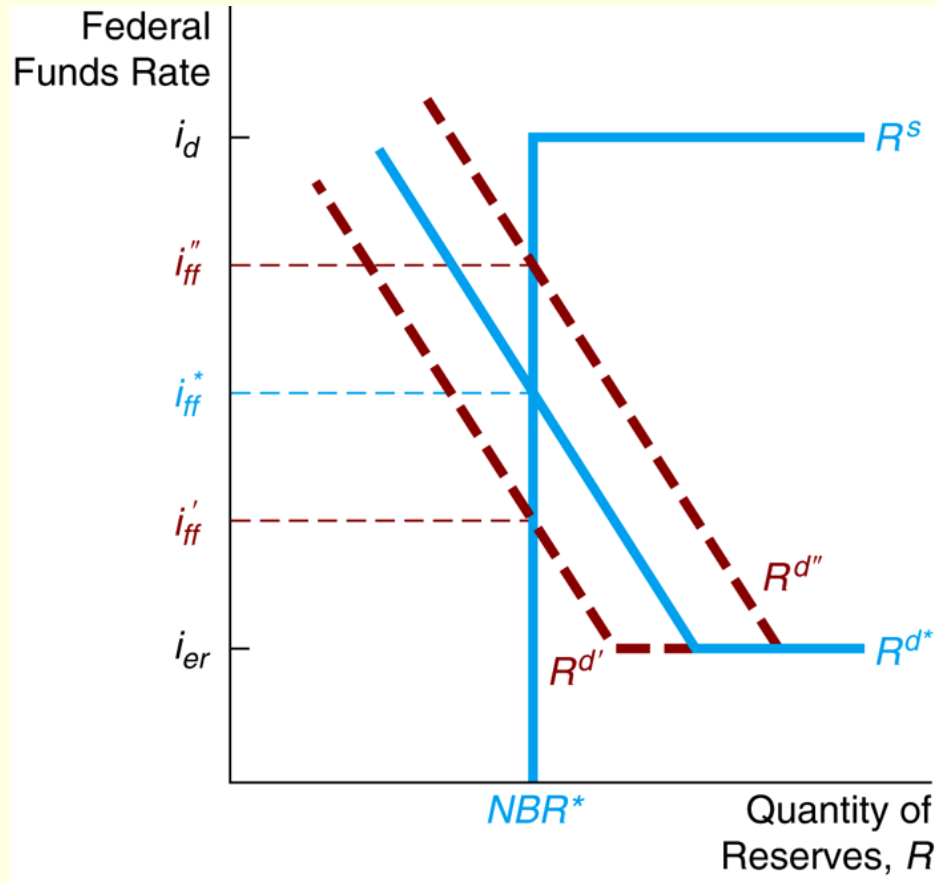


# Monetary Targeting

---

- Based on QTM:  $MV = PY$
- Advantages
  - Central bank has ultimate control of the target
  - Monetary policy independence
- Disadvantages
  - Must be a strong and reliable relationship between the goal variable and the targeted monetary aggregate
  - Difficult to communicate with the public

# Result of Targeting on Reserves



# Monetary Targeting I

---

- United States

- Fed began to announce publicly targets for money supply growth in 1975.
- Greenspan announced in July 1993 that the Fed would not use any monetary aggregates as a guide for conducting monetary policy

# Monetary Targeting II

---

## ■ Japan

- In 1978 the Bank of Japan began to announce “forecasts” for M2 + CDs
- Bank of Japan’s monetary performance was much better than the Fed’s during 1978-1987.
- In 1989 the Bank of Japan switched to a tighter monetary policy and was partially blamed for the “lost decade”

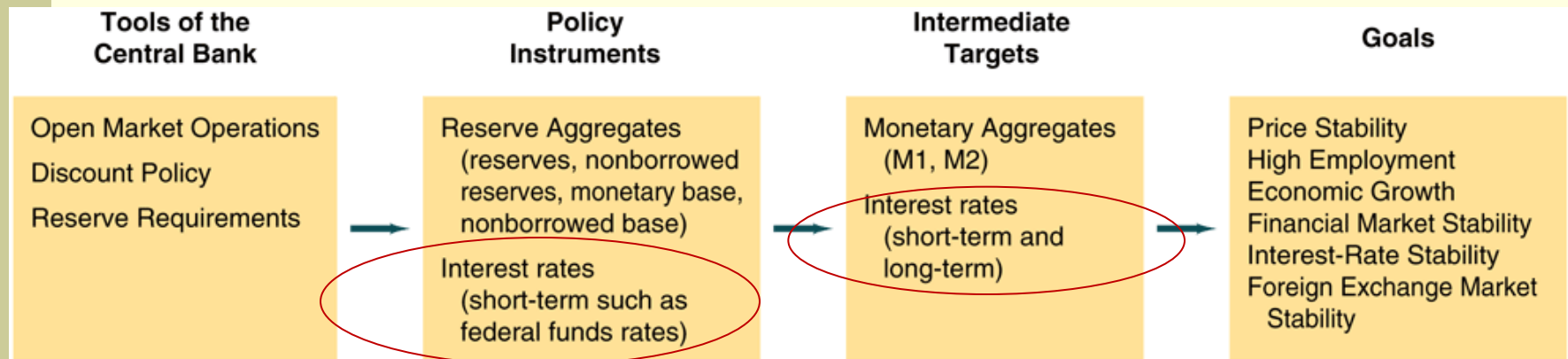
# Monetary Targeting III

---

## ■ Germany

- The Bundesbank focused on “central bank money” in the early 1970s.
- A monetary targeting regime can restrain inflation in the longer run, even when targets are missed.
- The reason of the relative success despite missing targets relies on clearly stated monetary policy objectives and central bank engagement in communication with the public.

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

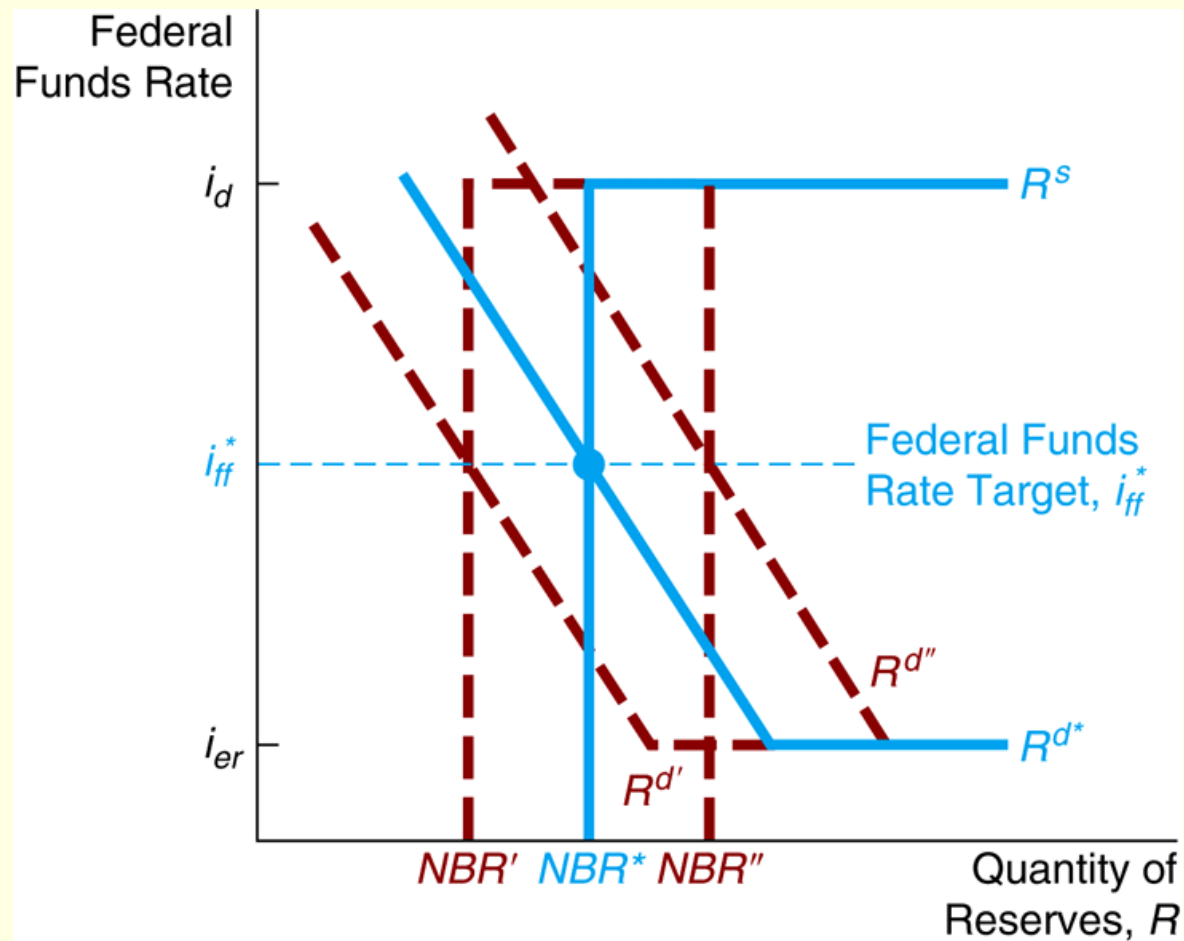


# Inflation Targeting I

---

- 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

# Result of Targeting on the Federal Funds Rate



# Inflation Targeting III

---

## Advantages

- Involve the development of forecasting tools
- State clearly the policy interest rate to enhance the clarity of policy signal
- Easily understood
- Stresses transparency and accountability

## Disadvantages

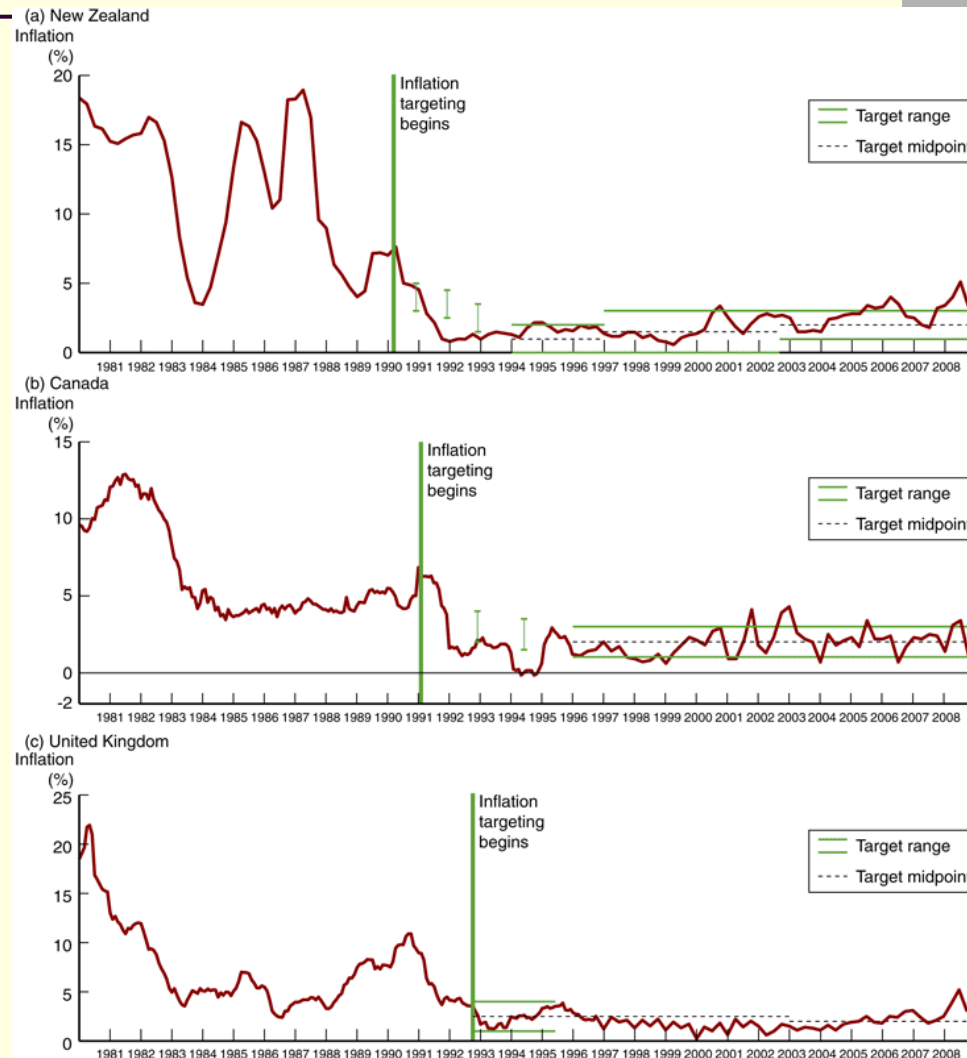
- Long policy transmission lag to the stated target requires forecasting capability and pre-emptive policy moves
- Focus on inflation alone may induce short-term volatility of output

# Inflation Targeting II

---

- 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 then, 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.

# FIGURE 1 Inflation Rates and Inflation Targets for New Zealand, Canada, and the United Kingdom, 1980–2008



Source: Ben S. Bernanke, Thomas Laubach, Frederic S. Mishkin, and Adam S. Posen, *Inflation Targeting: Lessons from the International Experience* (Princeton: Princeton University Press, 1999), updates from the same sources, and [www.rbnz.govt.nz/statistics/econind/a3/ha3.xls](http://www.rbnz.govt.nz/statistics/econind/a3/ha3.xls).

# Monetary Policy with an Implicit Nominal Anchor

---

- 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.

# Monetary Policy with an Implicit Nominal Anchor II

---

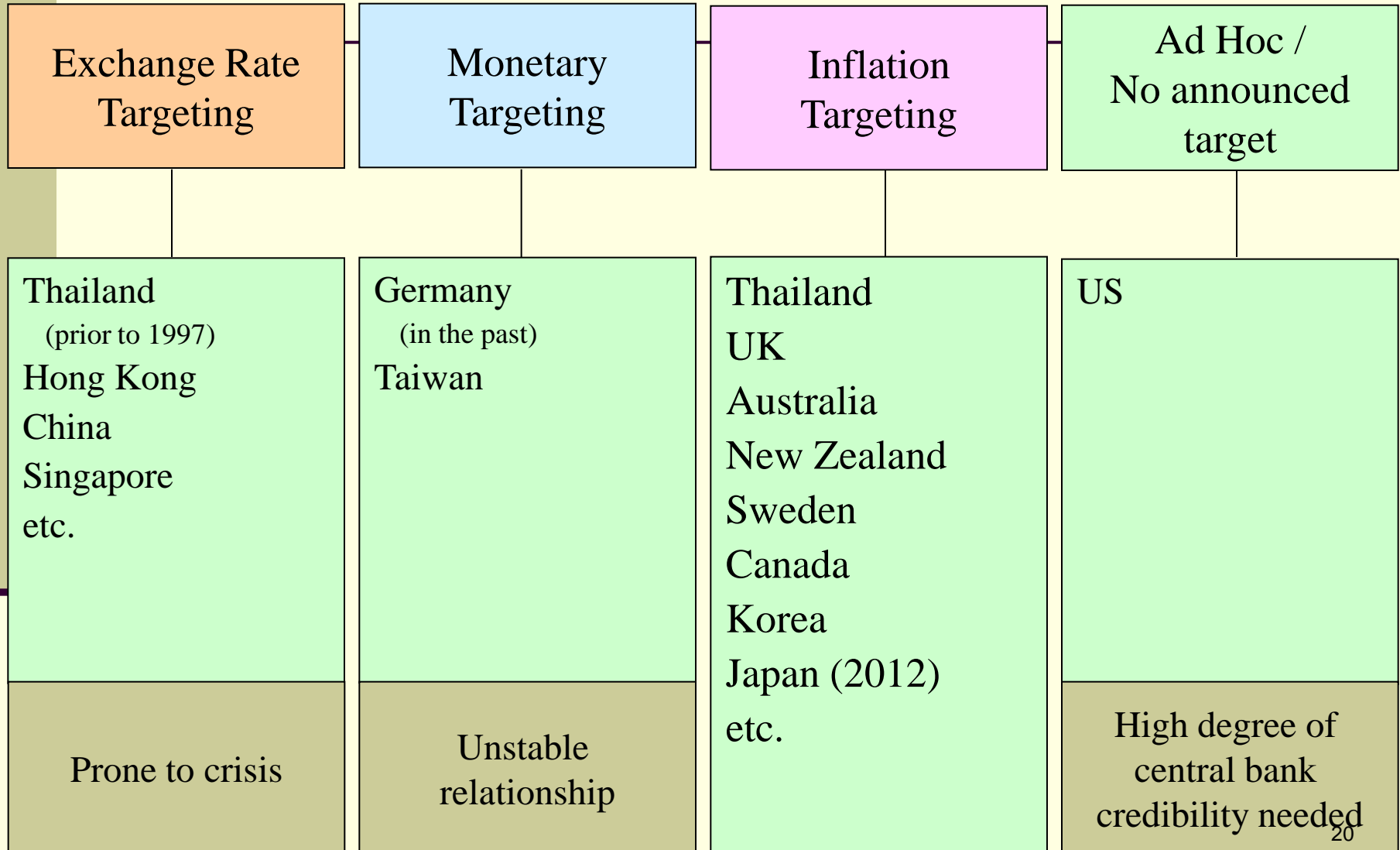
## ■ Advantages

- Uses many sources of information
- Demonstrated success

## ■ Disadvantages

- Lack of transparency and accountability
- Strong dependence on the preferences, skills, and trustworthiness of individuals in charge
- Inconsistent with democratic principles

# Monetary Policy Framework in Different Countries



# The Taylor Rule

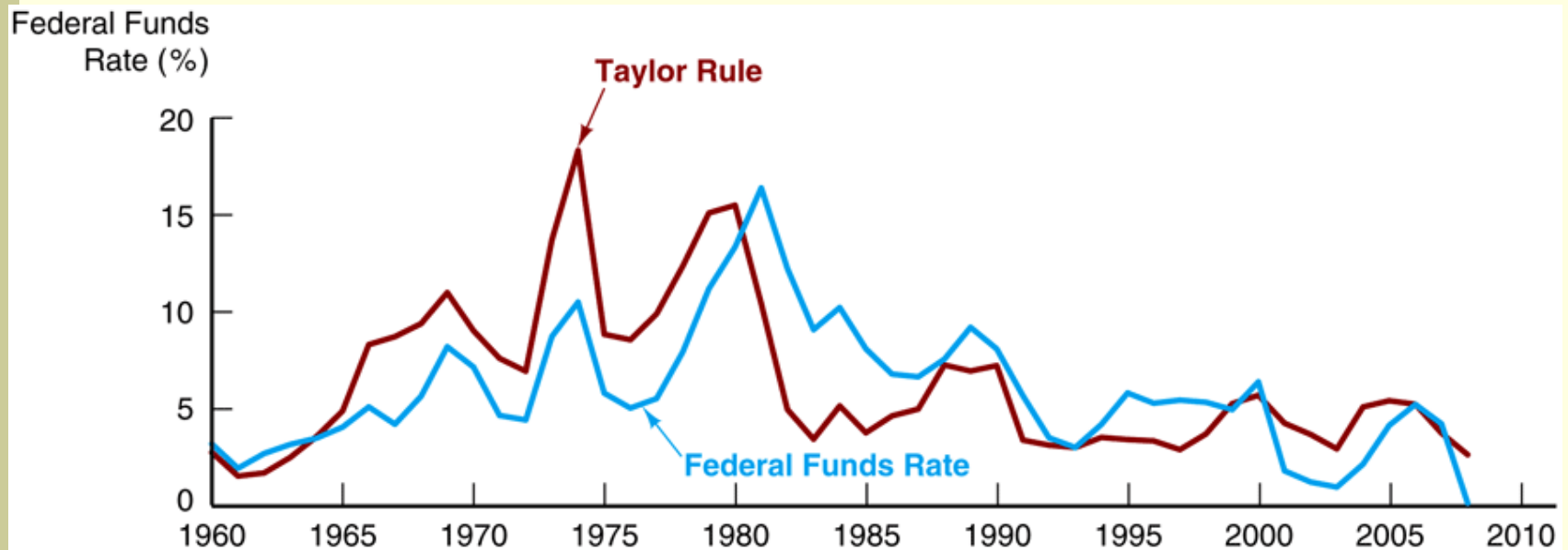
---

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

- 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

# The Taylor Rule for the Federal Funds Rate, 1970–2008



Source: Federal Reserve: [www.federalreserve.gov/releases](http://www.federalreserve.gov/releases) and author's calculations.

# Central Bank's Response to Asset Price Bubbles: Lessons From the Subprime Crisis

---

- 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 solely by irrational exuberance

# Central Bank's Response to Asset Price Bubbles: Lessons From the Subprime Crisis

---

- Should central banks respond to bubbles?
  - 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.

# Central Bank's Response to Asset Price Bubbles: Lessons From the Subprime Crisis

---

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



# Transmission Mechanism

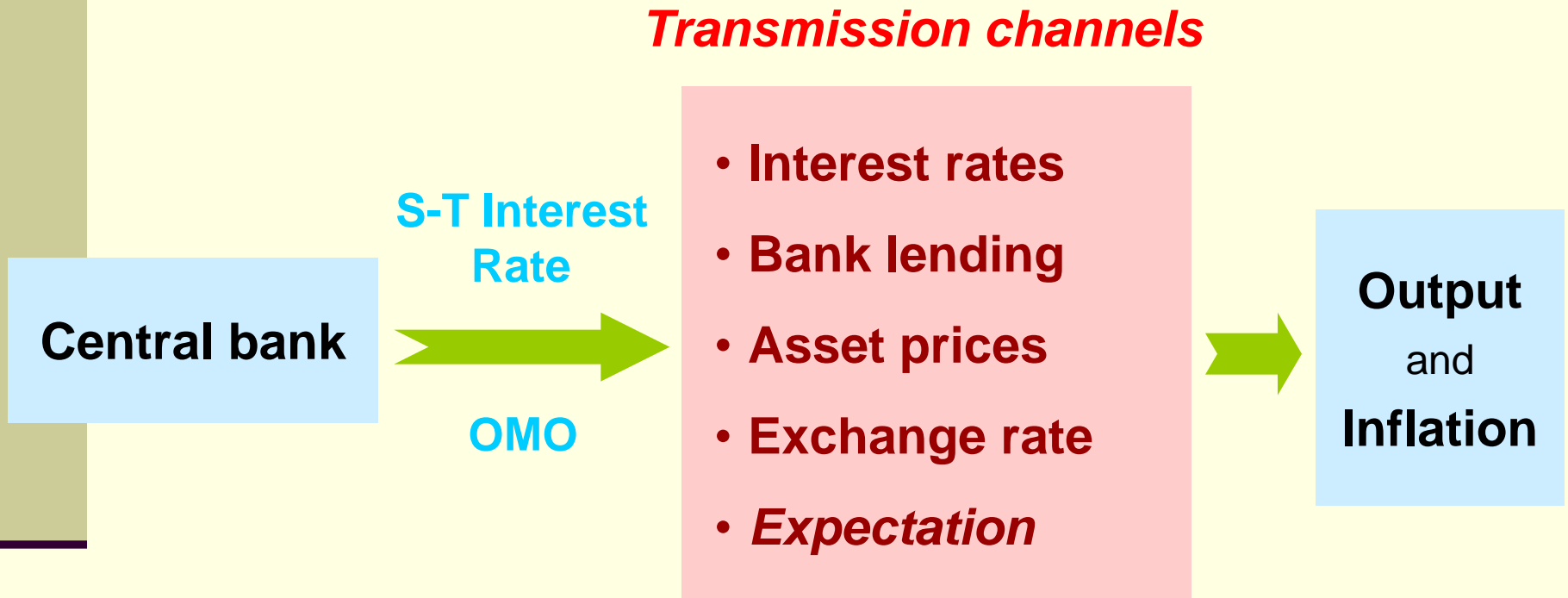
# Transmission Mechanism: Theory

---

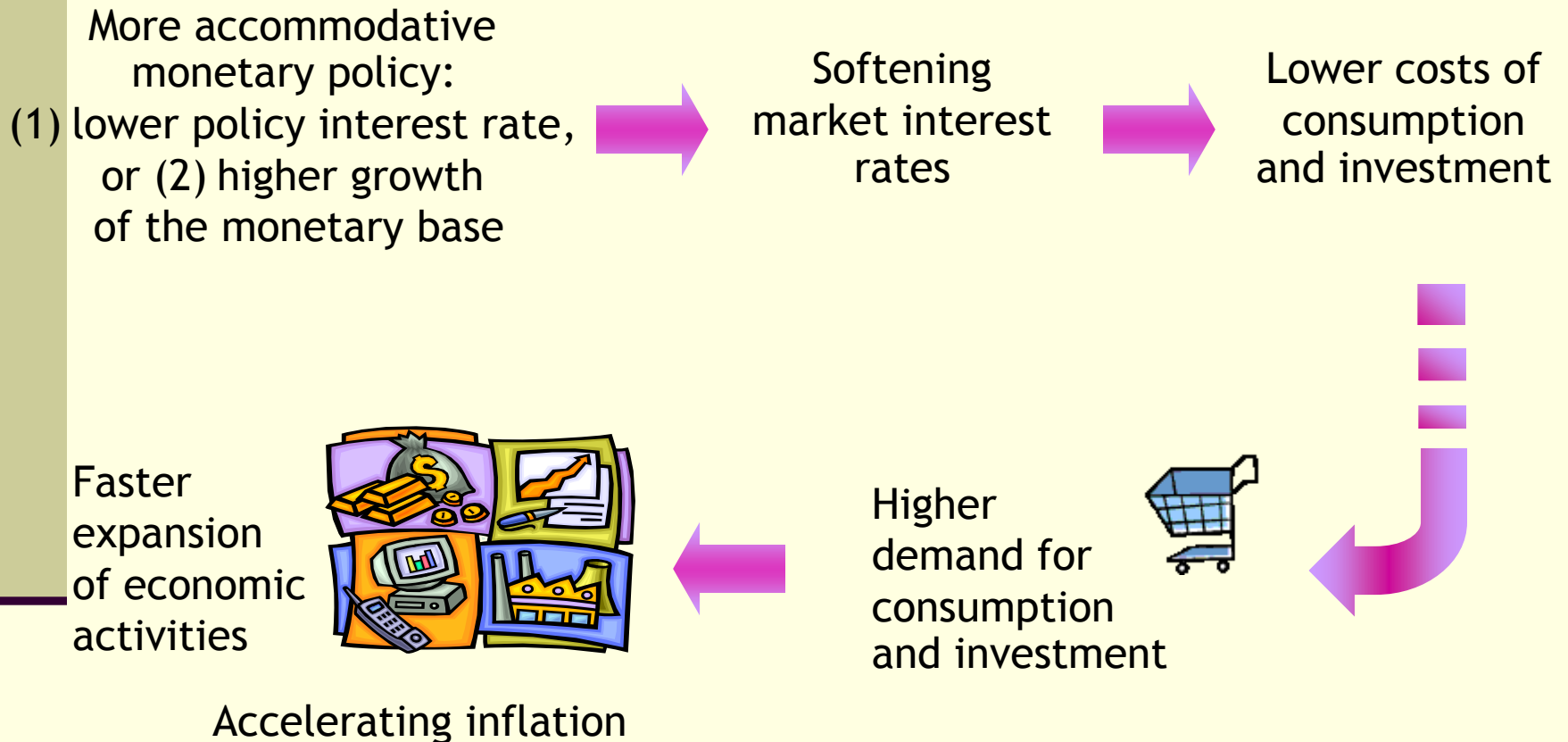
## How to evaluate empirical evidence

1. **Structural model evidence: build a model to explain the channels through which one variable affects the other (transmission mechanism) (Keynesian)**
  - **Advantages: helps with prediction, gauges the effects of changes in institutional factors, confirms the direction of causation**
  - **Disadvantages: over-reliance on the model**
2. **Reduced-form evidence: whether one variable has an effect on another (the black box) (Monetarists)**
  - **Advantages: no restrictions imposed on how the mechanism works**
  - **Disadvantages: misleading, correlation does not imply causation**

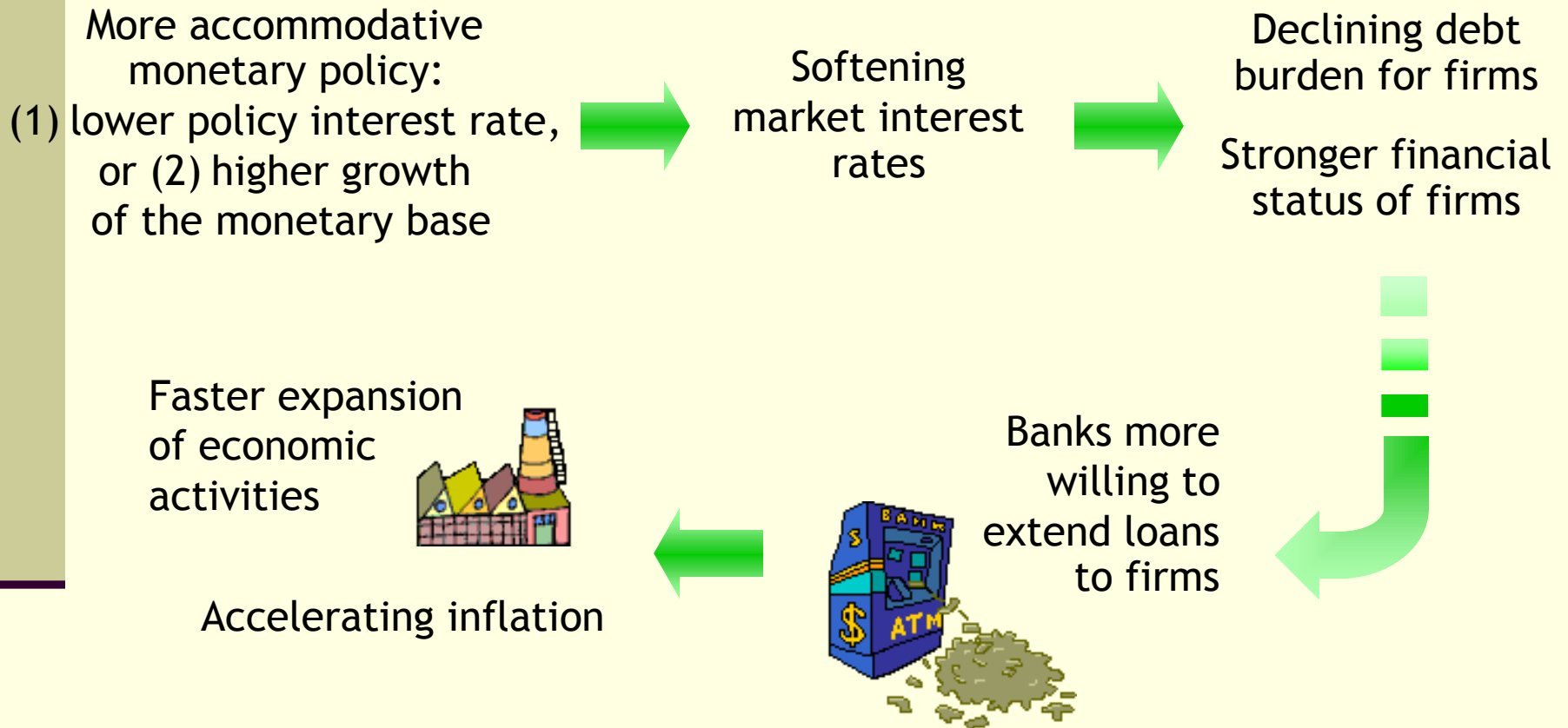
# Monetary Policy Transmission



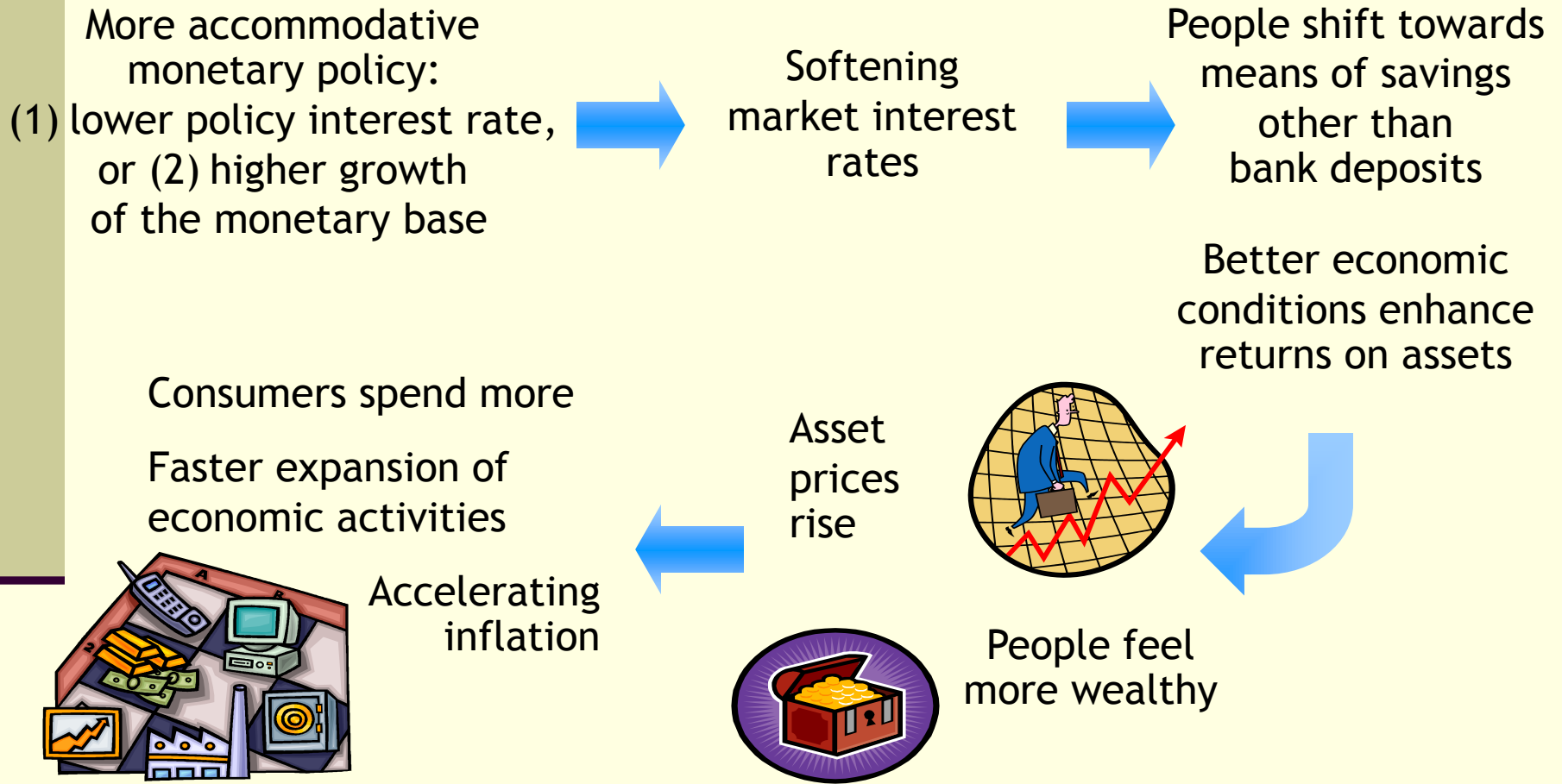
# 1. Interest Rate Channel



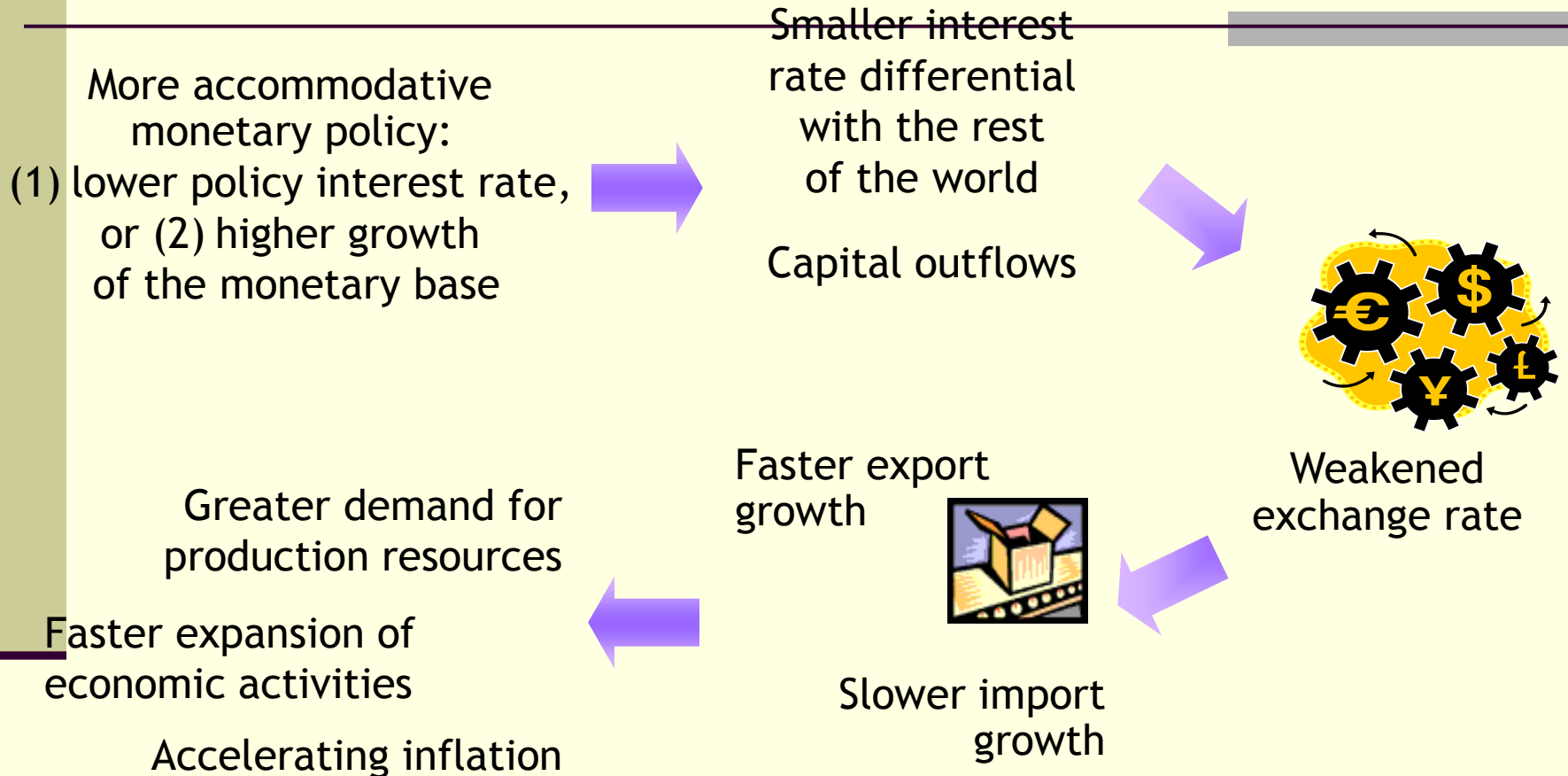
## 2. Credit Channel



# 3. Asset Price Channel



# 4. Exchange Rate Channel



# 5. Expectations Channel

More accommodative  
monetary policy:

(1) lower policy interest rate,  
or (2) higher growth  
of the monetary base

People expecting  
more favorable  
economic  
conditions



Stronger growth of  
consumption and investment



Faster expansion  
of economic activities  
Accelerating inflation



Weaker growth of  
consumption and investment



Slower expansion  
of economic activities  
Decelerating inflation