Chapter 17 (cont)

Other goals of monetary policy:

1) High employment and Output Stability/ Economic growth

2) Stability of Financial Markets

3) Interest Rate Stability

4) Stability in Foreign Exchange Markets

Linking Central Bank Tools to Objectives

- Central Bank Tools
  - Open Market Operations (OMO), Discount Loans, Reserve Req., Interest on Reserves
- Policy Instruments
  - Federal Funds Rate or Monetary base
- Intermediate Targets
  - Short-term and Long-Term Interest Rates/ Monetary Aggregates (M1,M2)
- Goals (Objectives):
  - Low Inflation, growth, stable interest rates

Linking Tools to Objectives

Desirable Features of a Policy Instrument

- Easily observable by everyone
- Controllable and quickly changed
- Tightly linked to the policymakers' objectives

Monetary Targeting

- The central bank announces that it will target a certain rate of growth in a monetary aggregate such as the money supply

- For example, 5 percent annual growth in M1
- In the 1970's adopted by a number of central banks – US, Germany, Canada, UK

- The Fed began to announce targets for money supply growth in 1975.

- Greenspan announced in July 1993 that the Fed would <u>not</u> use monetary aggregates as a guide for conducting monetary policy

- Advantages
- Flexible, transparent, accountable
- Almost immediate accountability

- Disadvantages
- Must have a strong and reliable relationship between the goal variable (inflation or nominal income) and the targeted monetary aggregate (Link #2)

- This relationship has been shown to be weak.

Inflation Targeting

- Given the breakdown in the relationship between monetary aggregates and goal variables such as inflation and nominal income, a number of countries adopted inflation targeting as their policy strategy.

- Countries such as New Zealand, Canada and the UK have explicit inflation targets. (and Thailand!)

- With inflation targeting, the central bank bypasses intermediate targets and focuses on final objective.

Inflation Targeting – Elements

- Commitment to price stability as the primary long-run goal of monetary policy and a commitment to achieve the inflation goal

- Public announcement of a numerical target for inflation

- Increased transparency of the strategy through communication of strategy

- Increased accountability of the central bank

- Keep inflation low which in turn anchors inflation expectations

- Anchor long-term interest rates to promote growth.

$$\boldsymbol{i = r + \pi^e}$$

- Follows a hierarchical mandate: inflation first, everything else second.

  – Remember: Fed has a dual mandate. Has shied away from adopting inflation targeting.

Inflation Targeting in Practice

"Inflation targeting is a ***framework for monetary policy*** characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's main long run goal."

Bernanke, et. al. (1999).

- A "framework", not a rule
  - A ***policy rule*** is inflexible – requires an automatic policy response regardless of the current economic situation.
  - Purely ***discretionary (or, unconstrained) policy*** reacts only to current developments and has no regard for long-run goals.

- Inflation targeting is meant to be constrained discretion

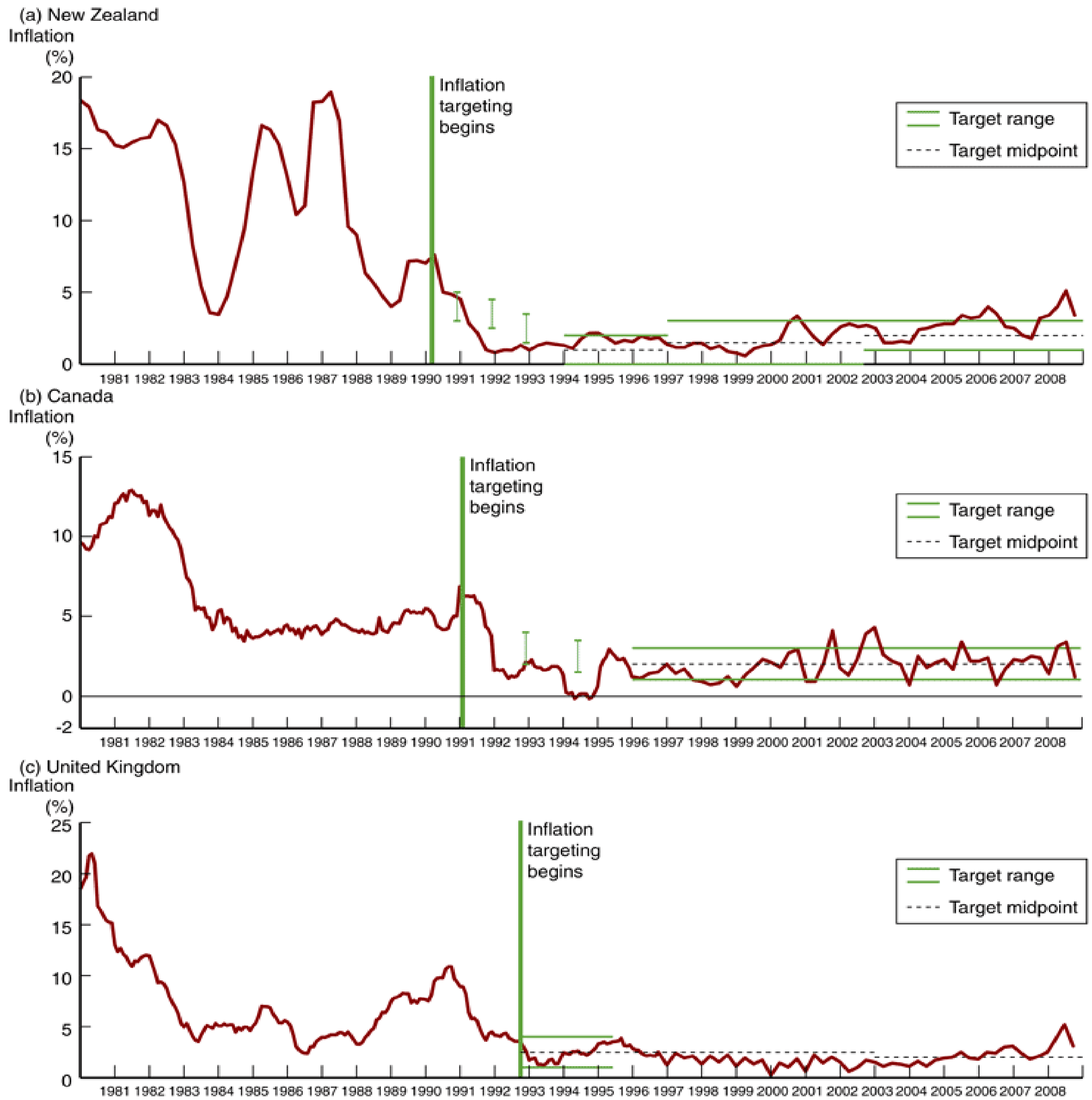
"By imposing a conceptual structure and its inherent discipline on the central bank, but without eliminating all flexibility, ***inflation targeting combines some of the advantages traditionally ascribed to rules with those ascribed to discretion.***" Bernanke, et. al. (1999).

Examples of Inflation Targeting

- New Zealand (started in 1990)
  - Part of central bank reform in 1990
  - Sole objective is price stability
  - Explicit target–range.
  - Inflation was brought down and remained within the target range most of the time.
  - Governor of the central bank is accountable and can be dismissed.

- Canada (1991)
  - Explicit target range.
  - Inflation brought down, some costs in term of unemployment

- United Kingdom (1992)
  - Explicit Target


(a) New Zealand
Inflation (%)
Inflation targeting begins
Target range
Target midpoint
(b) Canada
Inflation (%)
Inflation targeting begins
Target range
Target midpoint
(c) United Kingdom
Inflation (%)
Inflation targeting begins
Target range
Target midpoint
1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008

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- Thailand

Inflation Targeting Advantages

- Stable relationship between money supply and inflation is not needed.
- Does not rely on one variable to achieve target.
- Easily understood
- Focus is long term inflation goal. Reduces potential of over expansion to pursue political goals.
- Stresses transparency and accountability

Inflation Targeting Disadvantages

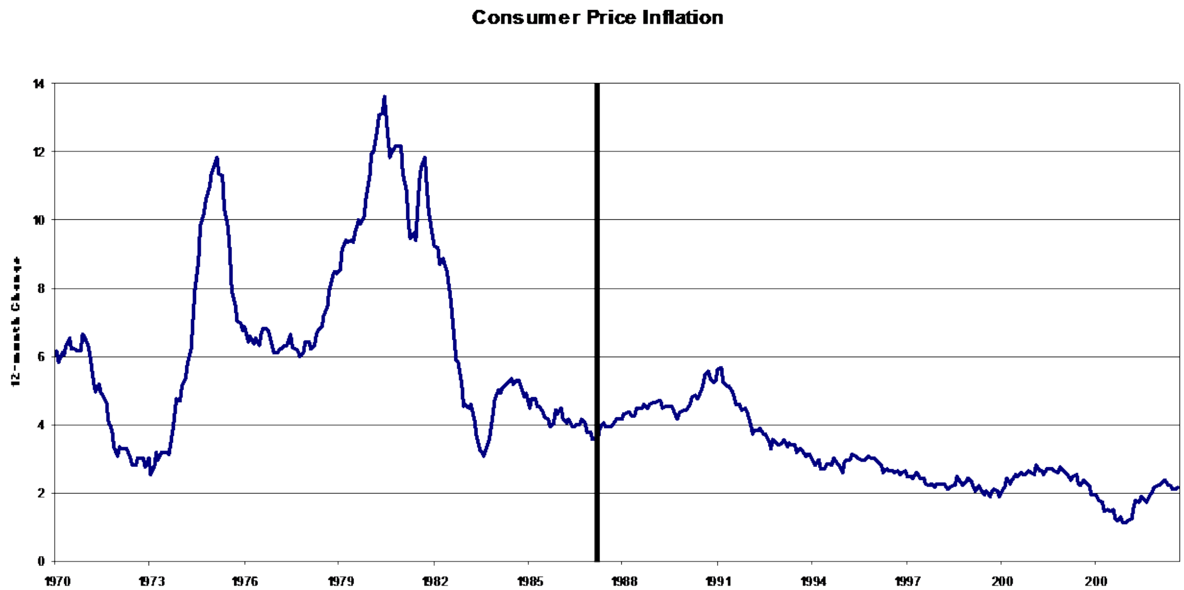
- "Delayed signaling"

- Some economist argue too much rigidity

- Potential for increased output fluctuations.

- Economy experiences low economic growth during disinflation

US does not have an explicit inflation target



- The US has achieved good results without an explicit nominal anchor such as inflation or a monetary aggregate target.

- Fed strategy has been to follow and implicit nominal anchor.

- Fed policy must be forward looking and preemptive
  - The goal is to prevent inflation from getting started.
  - Lag between implementation and impact on real output is about 1 year and about 2 years to affect inflation

- The inflation process seems to have tremendous inertia

Monetary Policy with an Implicit Nominal Anchor

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