Lecture 8: The Conduct of Monetary Policy and Transmission Mechanism

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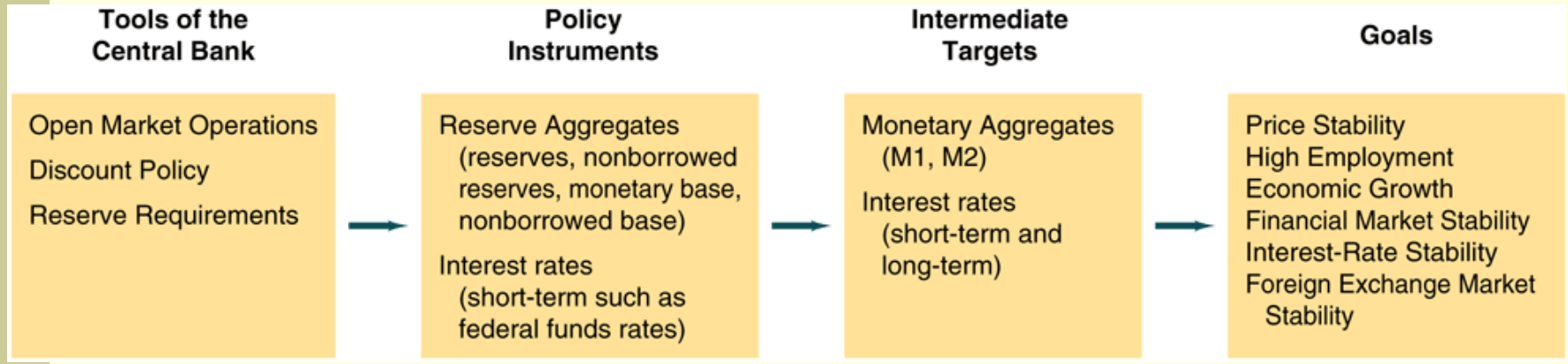
The Conduct of Monetary Policy

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 chose one or the other).

Criteria for Choosing the Policy Instrument

- Observability and Measurability
- Controllability
- Predictable effect on Goals

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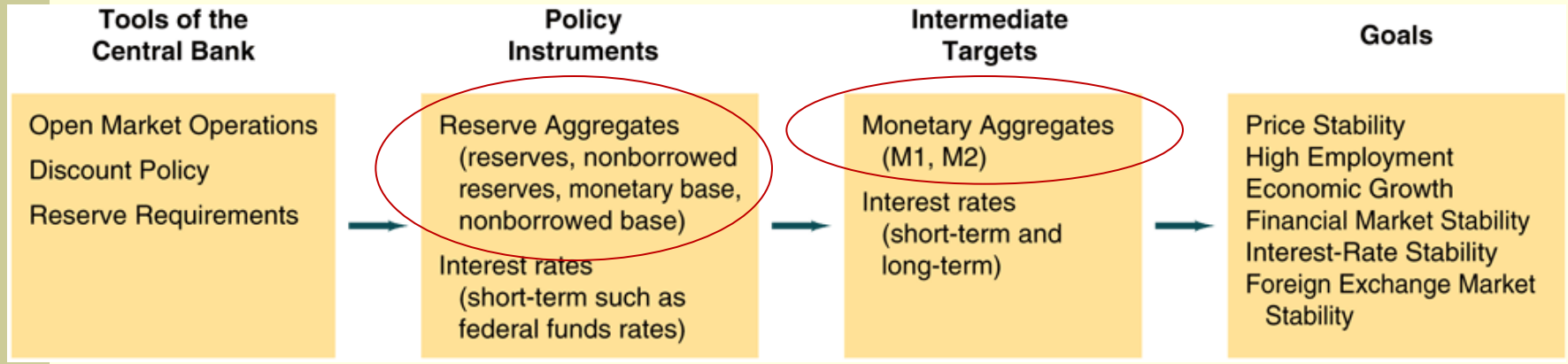
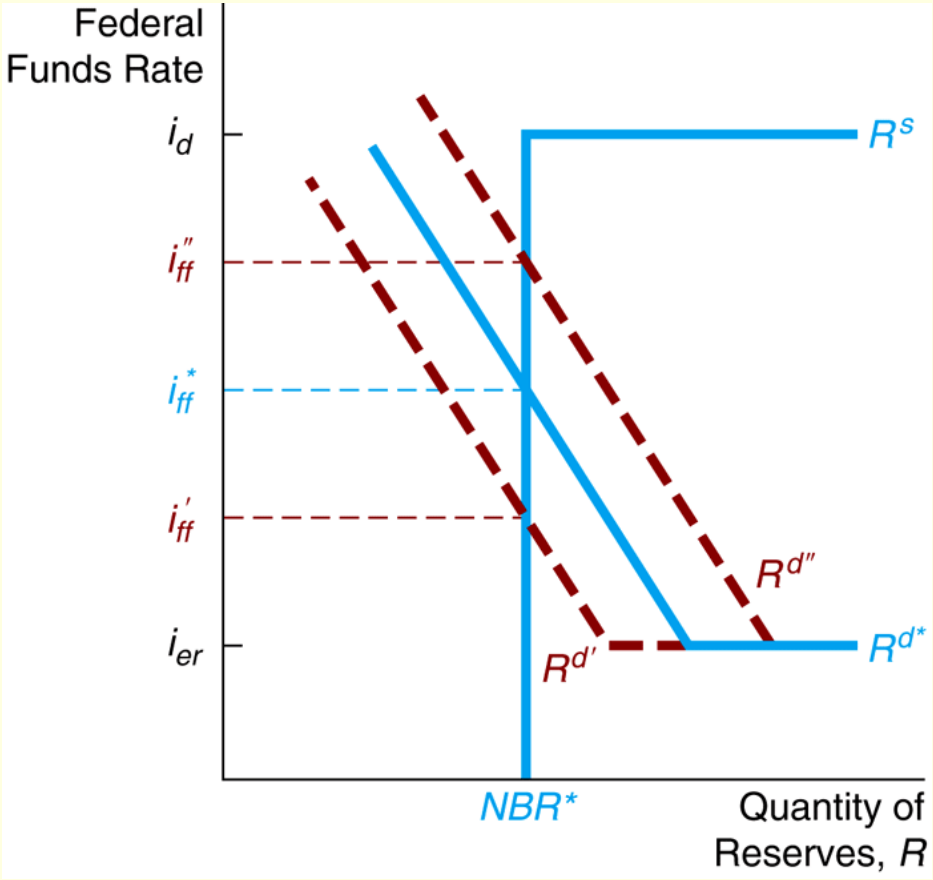


Monetary Targeting

- 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

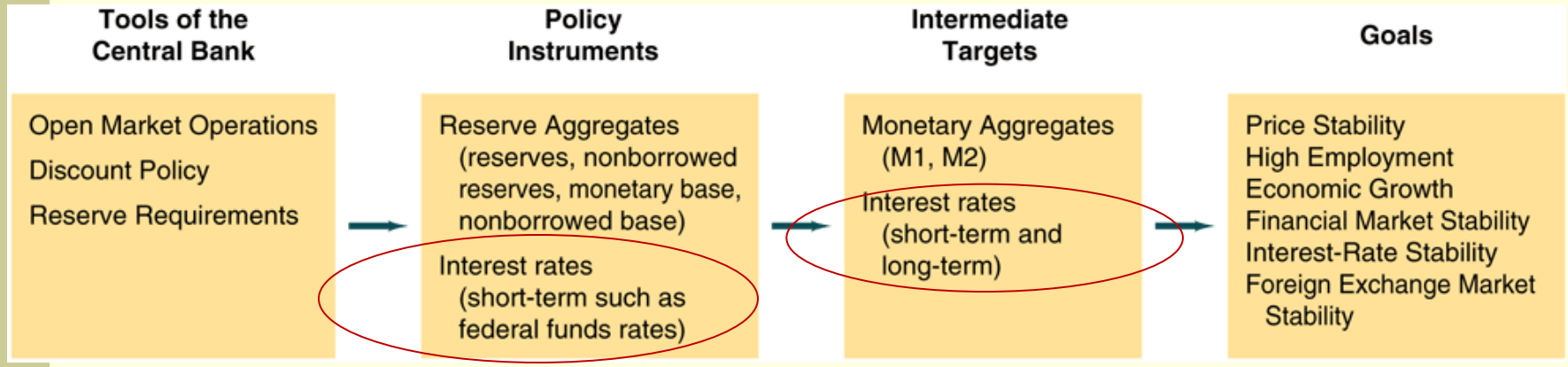
Monetary Targeting II

- 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.

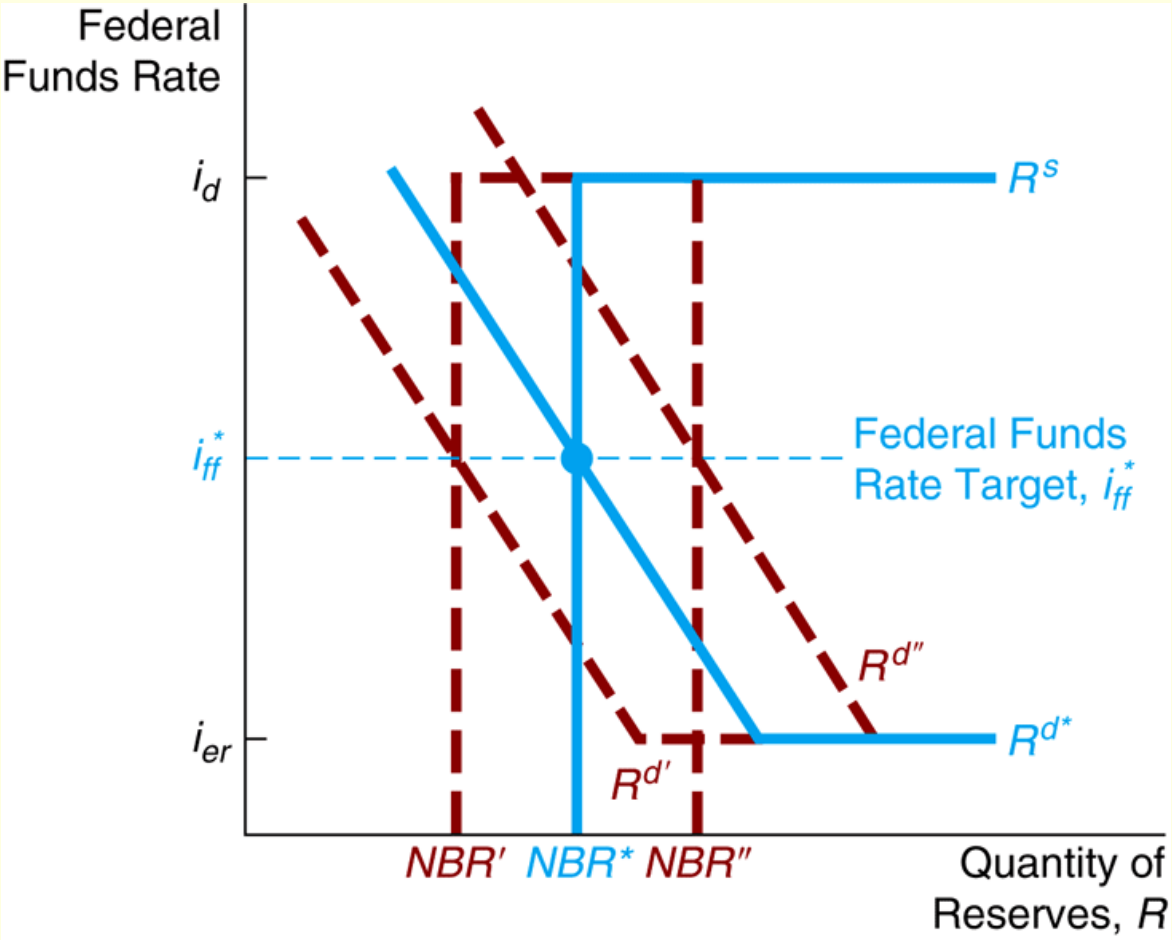
Linkages Between Central Bank Tools, Policy Instruments, Intermediate Targets, and Goals of Monetary Policy



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



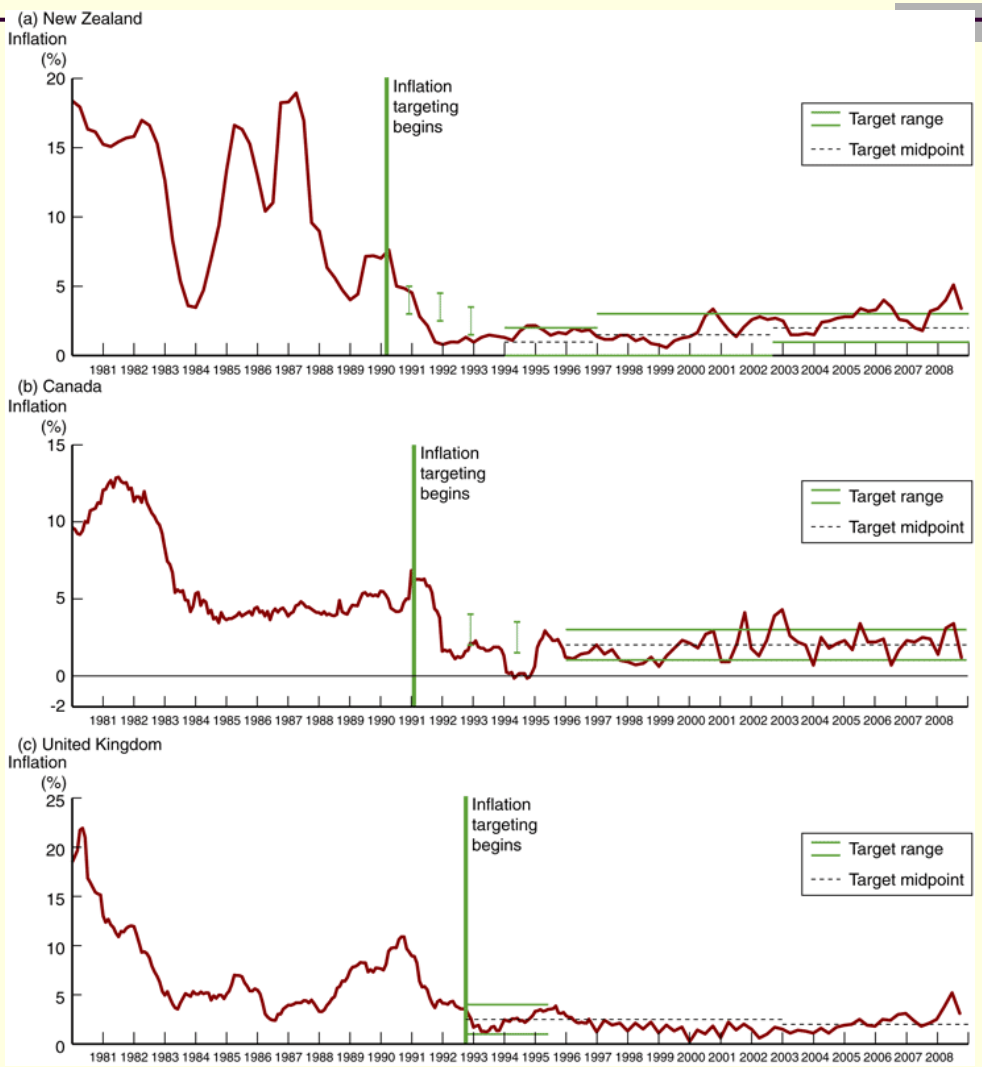
Inflation Targeting III

- 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. Poson, *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.

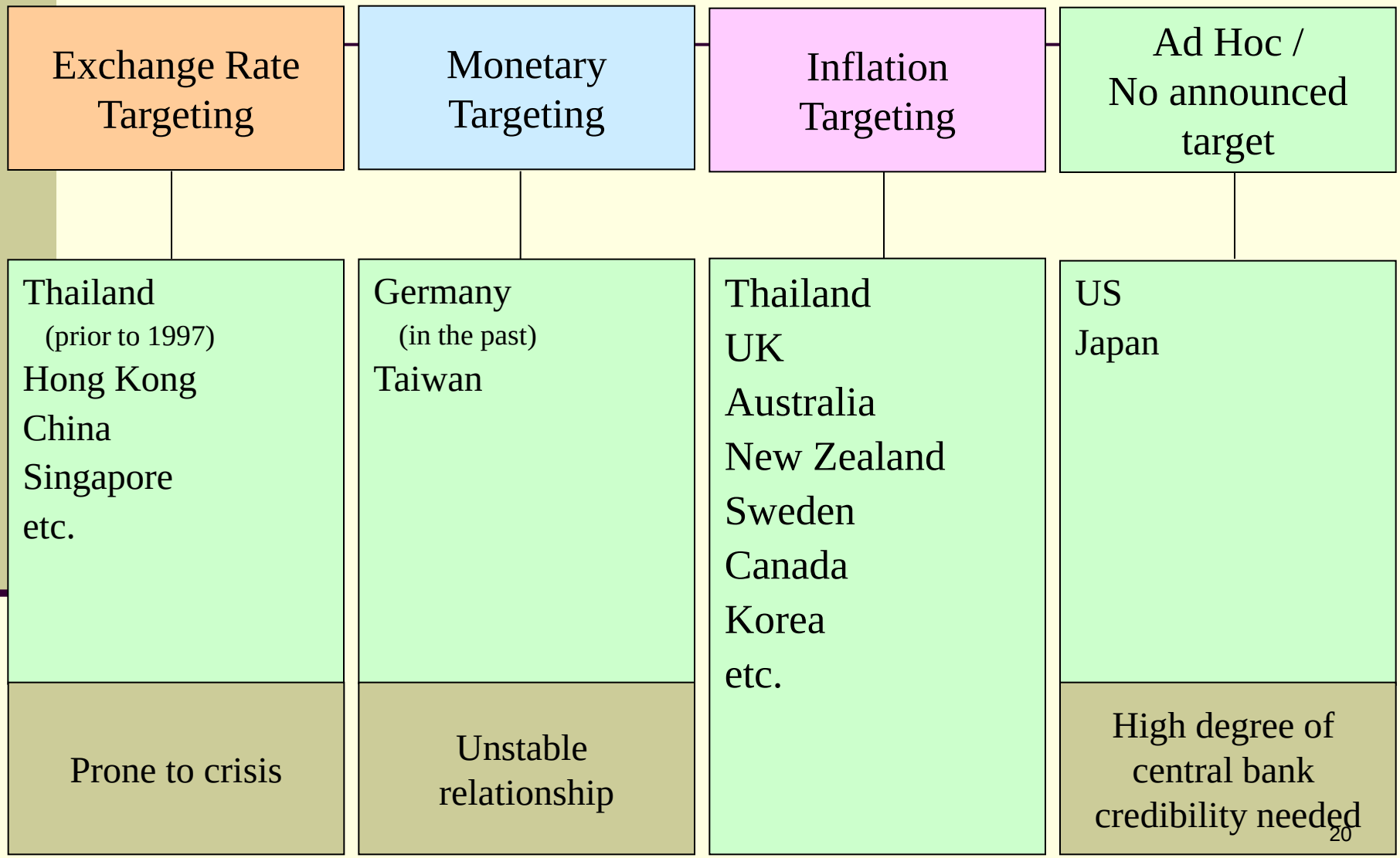
Monetary Policy with an Implicit Nominal Anchor

- 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

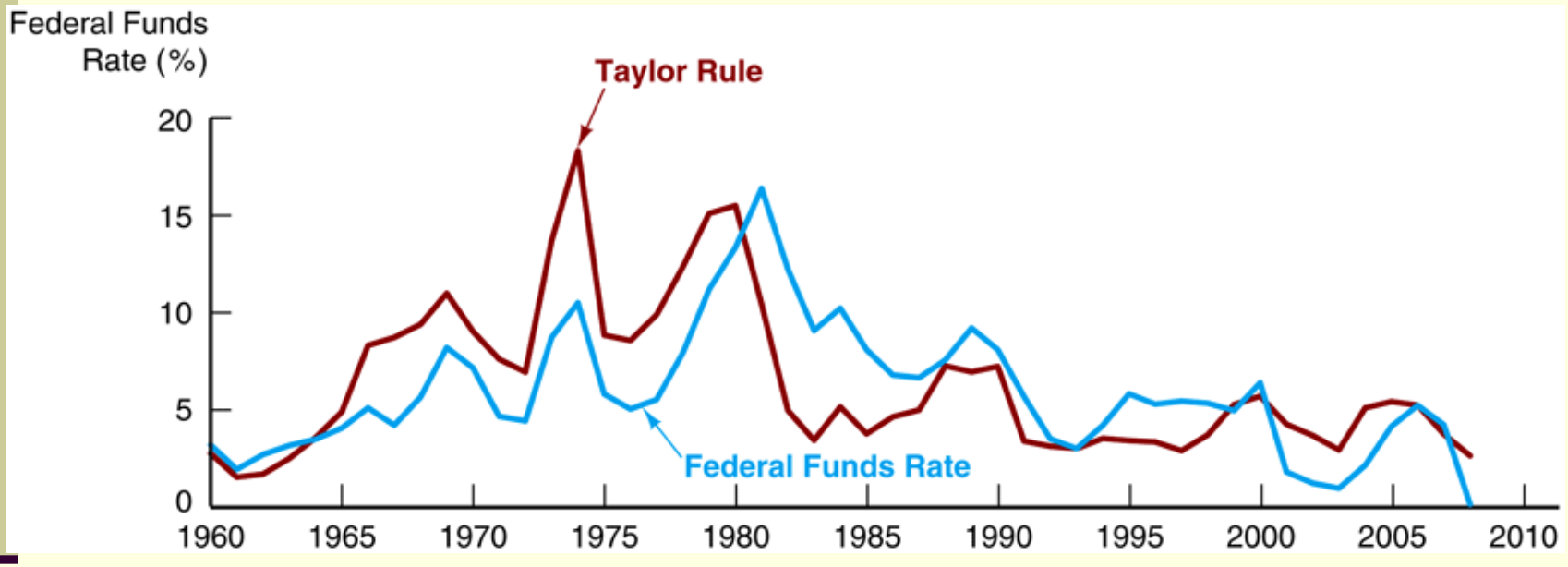


The Taylor Rule

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

- 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

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



Source: Federal Reserve: 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.

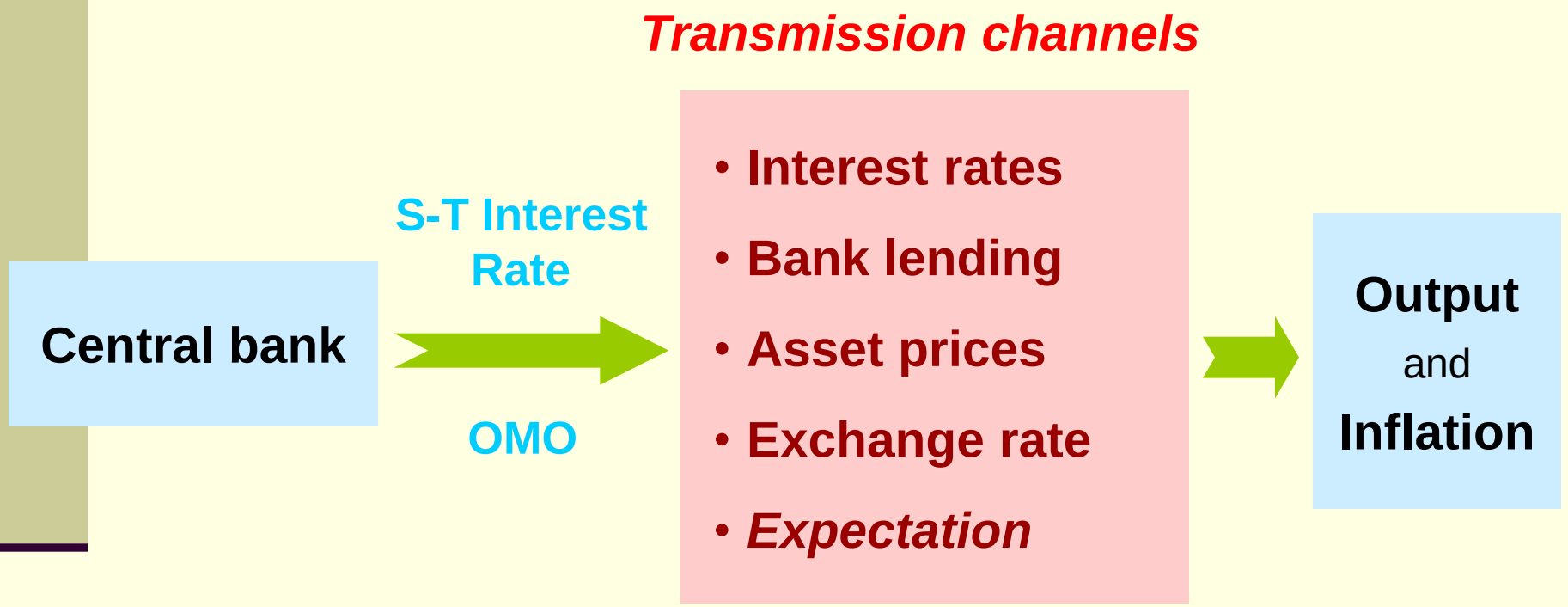
Transmission Mechanism

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

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

Softening market interest rates

Lower costs of consumption and investment

Higher demand for consumption and investment

Faster expansion of economic activities

Accelerating inflation

2. Credit Channel

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

Softening market interest rates

Declining debt burden for firms

Stronger financial status of firms

Banks more willing to extend loans to firms

Faster expansion of economic activities

Accelerating inflation

3. Asset Price Channel

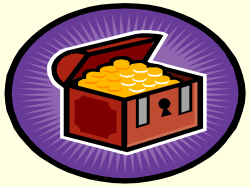
More accommodative monetary policy: (1) lower policy interest rate, or (2) higher growth of the monetary base

Softening market interest rates

People shift towards means of savings other than bank deposits

Better economic conditions enhance returns on assets

People feel more wealthy



Asset prices rise

Accelerating inflation

Consumers spend more

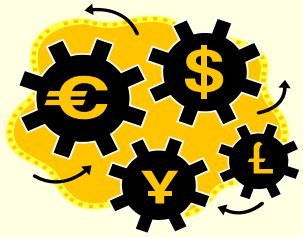
Faster expansion of economic activities

4. Exchange Rate Channel

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

Smaller interest rate differential with the rest of the world

Capital outflows



Weakened exchange rate

Slower import growth

Faster export growth

Greater demand for production resources

Faster expansion of economic activities

Accelerating inflation

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

People expecting worse economic conditions

Weaker growth of consumption and investment

Slower expansion of economic activities

Decelerating inflation