

EE432 Monetary Theory and Policy



Lecture 7 Central Banks in the World Today

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Outline

- Stability: The primary objective of all central banks
- Creating a successful central bank

Chapter 15



Central Banks in the World Today

**Stability: The primary
objective of all central banks**

Stability: The Primary Objective of All Central Banks

Central bankers objectives:

1. *Low and stable* **inflation**
2. *High and stable* **real growth**, together with *high employment*
3. **Financial market stability**
4. *Stable* **interest rates and exchange rates**

Stability: The Primary Objective of All Central Banks

- The **job of the central bank** is to **improve general economic welfare** by *managing and reducing systematic risk*.
- It is probably *impossible to achieve all objectives simultaneously* - **Tradeoffs**

Low, Stable Inflation

- Many central banks take their *primary job* as the *maintenance of price stability*.
- The **purchasing power of currency** *should remain stable* over long periods of time.
- Maintaining price stability **enhances role of money** as a *unit of account* and as a *store of value*.

Low, Stable Inflation

- *Prices provide the **information** to ensure that resources are allocated to their **most productive uses**.*
- Most people agree that **low inflation** *should be the **primary objective of monetary policy**.*

Low, Stable Inflation

- However, *zero inflation is probably too low.*
- There would be a risk of deflation.
 - This makes ***debts more difficult to repay***
 - It would ***need to cut nominal wages, which is difficult to do.***

High & Stable Real Growth

- ***Maximum sustainable growth in output and employment*** means working to reduce the fluctuations of the business cycle.
- The idea is that there is some **long-run normal level of production** called **potential output**, which depends on things like
 - **Technology**
 - The size of the **capital stock**
 - The number of **labours** and **working hours**.
- In the long run, **stability leads to higher growth**.
 - The greater the uncertainty about future business conditions, the more cautious people will be in making investments of all kinds.

Financial System Stability

- **Financial system stability** is an integral part of every *modern central banker's job*.
- If people *lose faith in financial institutions* and markets, *intermediation will ultimately stop*.
- The *possibility of a severe disruption in the financial markets* is a type of systematic risk.

Interest-Rate and Exchange-Rate Stability

- *Interest-rate stability and exchange-rate stability* are means for achieving the ultimate goal of **stabilizing the economy**.
- For *emerging market countries*, **exports and imports** are crucial.
- *Stable exchange rates are very important*.

Interest-Rate and Exchange-Rate Stability

- Most people *respond to low interest rates* by *borrowing and spending more* and vice versa.
 - Interest-rate volatility makes *output unstable*.
- Interest-rate volatility means *higher risk* and therefore a *higher risk premium*.
 - *Risk makes financial decisions more difficult, lower productivity, and lessen efficiency.*

Creating a Successful Central Bank

Meeting the Challenge: Creating a Successful Central Bank

- To be successful, a central bank must:
 1. Be **independent** of political pressure.
 2. Be **accountable** to the public and **transparent** in communicating its policy actions.
 3. *Operate* within an *explicit framework* that *clearly states its goals and* makes clear the **trade-offs** among them.
 4. Make **decisions by committee**.

The Need for Independence

- **Independence** has two operational components:
 1. **Monetary policymakers** must be *free to control their own budgets*.
 2. The bank's policies **must not be reversible by *people outside*** the central bank.
 - **cannot be overridden** by politicians.

The Need for Accountability and Transparency

1. **Politicians** would *establish a set of goals*.
2. The **policymakers** would *publicly report their progress in pursuing those goals*.
 - **Explicit goals** foster **accountability** and *disclosure requirements* create **transparency**.
 - Legislatures usually *grant central banks* **instrument independence**, not goal independence

The Need for Accountability and Transparency

- Today **every central bank** announces its policy actions almost immediately.
- **Central bank statements** are far *more informative*.
- The economy and financial **markets should respond to information** that everyone received, not to speculation about what policymakers are doing.
- **Transparency** can help *counter the uncertainties and anxieties*.

The Policy Framework, Policy Tradeoffs, and Credibility

- To meet their objectives, central bankers must be independent, accountable, and good communicators.
- Central bankers face the **tradeoff *between inflation, growth and financial stability*** on a daily basis.
- Because policy goals often conflict, **central bankers *must make their priorities clear.***
- This ***limits the discretionary authority*** of the central bankers.

The Policy Framework, Policy Tradeoffs, and Credibility

- Finally, *a well designed policy framework* helps policy makers **establish credibility**.
 - To *do what they say they are going to do*.
- **Expected inflation creates inflation**.
 - Successful monetary policy, then, requires that **inflation expectations** be kept under control.

End of lecture