International Monetary Policy

3 Central banking: goals [1]

Michele Piffer

London School of Economics

[1] Course prepared for the Shanghai Normal University, College of Finance, April 2011

Lecture topic and references

- In this lecture we introduce the role that central banks play in the society. We will spend the rest of the course understanding our central banks behave in order to achieve their goals
- Mishkin, Chapters 13

Central banks

- Central banks are the government authorities in charge of monetary policy
- Central banks are among the most important players in financial markets. They spend a lot of time monitoring the behavior of financial markets as their intervention goes through such markets
- The main goal of central banks is to guarantee *price stability*. When prices change too fast the information that economic players take from the price system is hard to interpret. Moreover, it is hard to plan for the future in an inflationary environment

Goals

- On top of price stability, there are are other goals that potentially can be given to monetary policy:
  - High employment
  - Economic growth
  - Stability of financial markets
  - Interest-rate stability
  - Stability in foreign exchange markets
- The precise goals of central banks around the world can vary from country to country

Goals

- The European Central Bank (ECB) operates under a *hierarchical mandate*: price stability is seen as the primary, long run goal

> *"The primary objective of the European System of Central Banks shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community"*
> *(Maastricht Treaty)*

Goals

- The Federal Reserve Bank (FED) operates under a *dual mandate*: price stability and long run growth are given similar importance

> *"The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long run interest rates"*

Goals

- The People's Bank of China

  "The objective of the monetary policy is to maintain the stability of the value of the currency and thereby promote economic growth. The monetary policy instruments applied by the PBC include reserve requirement ratio, central bank base interest rate, rediscounting, central bank lending, open market operation and other policy instruments specified by the State Council "

Goals

- The People's Bank of China

  "Under the leadership of the State Council, the PBC implements monetary policy, performs its functions and carry out business operations independently according to laws and free from intervention by local governments, government departments at various levels, public organizations or any individuals...."

Goals

- The People's Bank of China

  "... The PBC needs to report to the State Council its decisions concerning the annual money supply, interest rates, exchange rates and other important issues specified by the State Council for approval before they are put into effect. The PBC is also obliged to submit work report to the Standing Committee of the National People's Congress on the conduct of monetary policy and the performance of the financial industry"

The challenge of central banking in a nutshell

- So far about the introduction to central banking
- In these first few lectures we have basically introduced the environment where central banks operate and explained what their goals are
- The rest of the course will be spent on how technically central banks operate. In this regard it is useful to have an idea of where we are heading to. Let's offer an anticipation

The challenge of central banking in a nutshell

- The point is that there is a very long way that goes from the instruments that central banks can control to the final goal that ultimately rules their behavior

- Moreover, the way in which the economy works is partially uncertainty. The transmission mechanism from monetary policy interventions to the real economy works basically through a "black box"

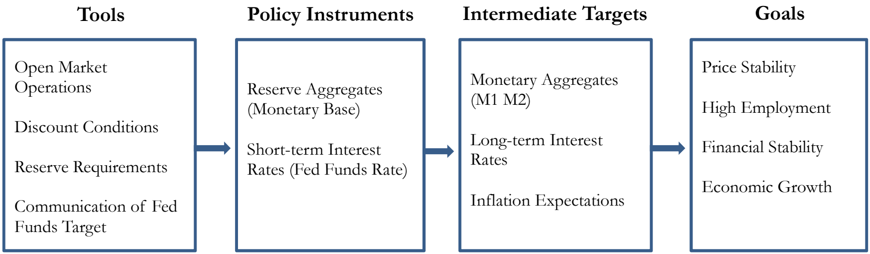
- Additionally, in a market economy the people's behavior is free, hence central banks can influence the economy only by affecting people's *incentives*: central banks cannot impose agents to exchange funds at a given rate, since in a decentralized economy agents interact freely via markets!

The challenge of central banking in a nutshell

- Understanding a bit better the nature of this challenge and the way out of it is the goal of this course
- We will see that central banks can only indirectly affect a very special interest rate, the short term, nominal interest rate on banks' reserves. But the agent's behavior is mainly affected by long run, real interest rates!
- Considered the long and variable lags that affect monetary policy, central banks identify intermediate targets that help mapping their day-to-day operation with the long run, ultimate role of their action

The challenge of central banking in a nutshell

Goals, tactics and strategy



(We will see this figure again, don't worry about the details now)

Plan for the rest of the course

- Understand how the money supply works (banks' balance sheets, OMO, money multiplier)
- Understand the market of reserves (demand and supply, ceiling and floor, discount window, yield curve)
- A simple model of closed economy (IS-LM model)
- International economics, key concepts (exchange rates, balance of payment, PPP and UIP)
- Back to central banking, integrating what we have covered in closed economy (international foreign reserves and exchange rate regimes)
- A simple model of open economy (IS-LM-BB)