International Monetary Policy

6 Central Banking: Tactics and Strategies [1]

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Lecture topic and references

- In this lecture we put together what we have seen so far and understand how Central Banks achieve their goals
- Mishkin, Chapter 16

Review from previous lecture

- Market of reserves and the interbank rate
- $i_{ff} \in (i_{er}, i_d)$
- i_{ff}^* depends on position of demand and supply of reserves
- OMOs and discount rate affect reserve supply
- Reserve requirements affect reserve demand

The Challenge of Central Banking

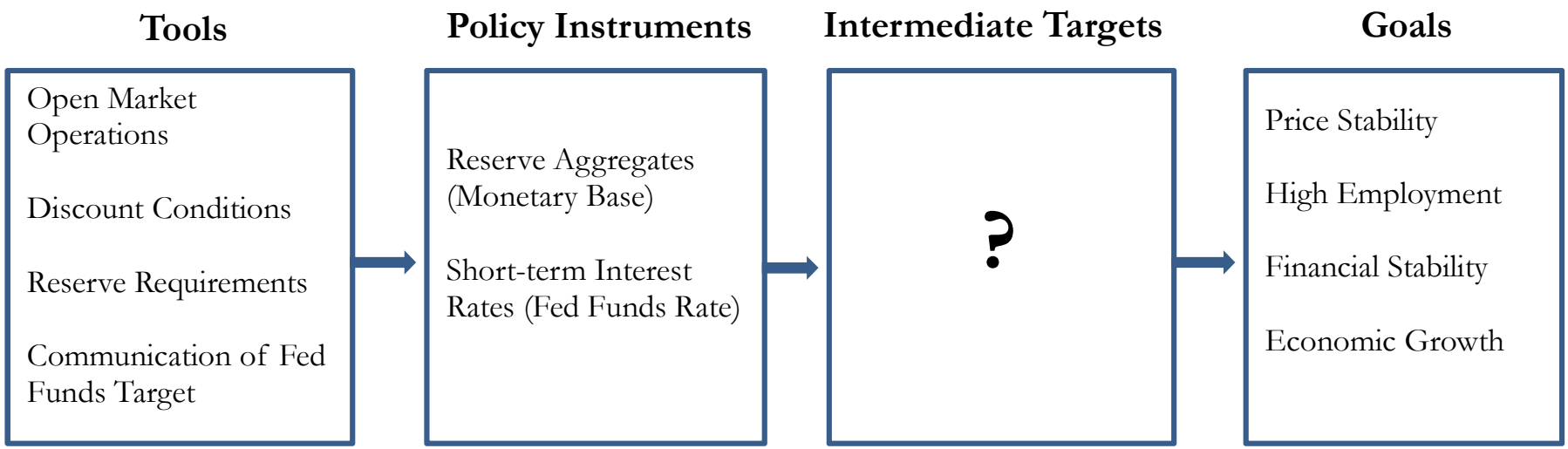
- We have seen so far that the goal of Central Banks is usually price stability, and under certain conditions also high employment and financial stability
- We have also seen that in practice there is a limited set of tools that Central Banks can use in order to influence the economy:

1. Open Market Operations
2. Reserve Requirements
3. Conditions on the Discount window
4. Communication of Interbank Rate target

The Challenge of Central Banking

- There is of course a long and uncertain way that goes from CBs' tools to their final goal
- CBs must come up with a strategy that helps understand how certain operations will map into their final goals
- In practice CBs define some intermediate targets, whose achievement is reasonably believed to signal an indirect achievement of the ultimate goal
- Similarly, CBs decide a policy instrument, which they can directly influence using their tools. The policy instrument is believed to be linked with the intermediate target, and helps achieving indirectly the ultimate goals

The Challenge of Central Banking



Which Intermediate Target?

- In the 1970s many countries adopted a *Monetary Targeting*: the intermediate target was a Monetary Aggregate
- Monetary policy was managed in order to meet certain targets in terms of monetary aggregate growth rate (say, M1 growing at 5 %)
- Policy instruments (usually OMOs) were then used in order to meet the target
- The targeted growth of monetary aggregates was considered to be linked steadily with the achievement of price stability. The only point was to choose an aggregate and a growth rate

Monetary Aggregates in the Euro Area

	Value as of November 2008 ($ billions)
M1 = Currency	804.9
+ Traveler's checks	5.6
+ Demand deposits	405.9
+ Other checkable deposits	306.1
Total M1	1,522.5
M2 = M1	
+ Small-denomination time deposits	1,351.0
+ Savings deposits and money market deposit accounts	4,007.1
+ Money market mutual fund shares (retail)	1,053.9
Total M2	6,412.0

Source: www.federalreserve.gov/releases/h6/hist.

Which Intermediate Target?

- Of course the success of any Intermediate Target relies in the strength of its link with the final goal. If the link is weak, meeting the intermediate target does not signal any possible success in achieving the goal
- Around 1990s many countries abandoned Monetary Targeting, as its relation with price stability was lost
- This was mainly due to the effect of financial innovations, which made it harder to estimate money demand and predict price dynamics out of the equilibrium on the money market
- Many countries shifted to Inflation Targeting

Which Intermediate Target?

- The key intuition of *Inflation Targeting* is that a necessary condition for price stability is that inflation expectations by market players are on target
- High inflation expectations would lead unions to renegotiate work contracts, increasing wages and hence inflation
- Inflation targeting takes inflation expectations as an intermediate target, and creates an institutional setting for central banking to make price stability as credible as possible. This will control inflation expectations and hence inflation itself

Which Intermediate Target?

- The key ingredients on Inflation Targeting are:

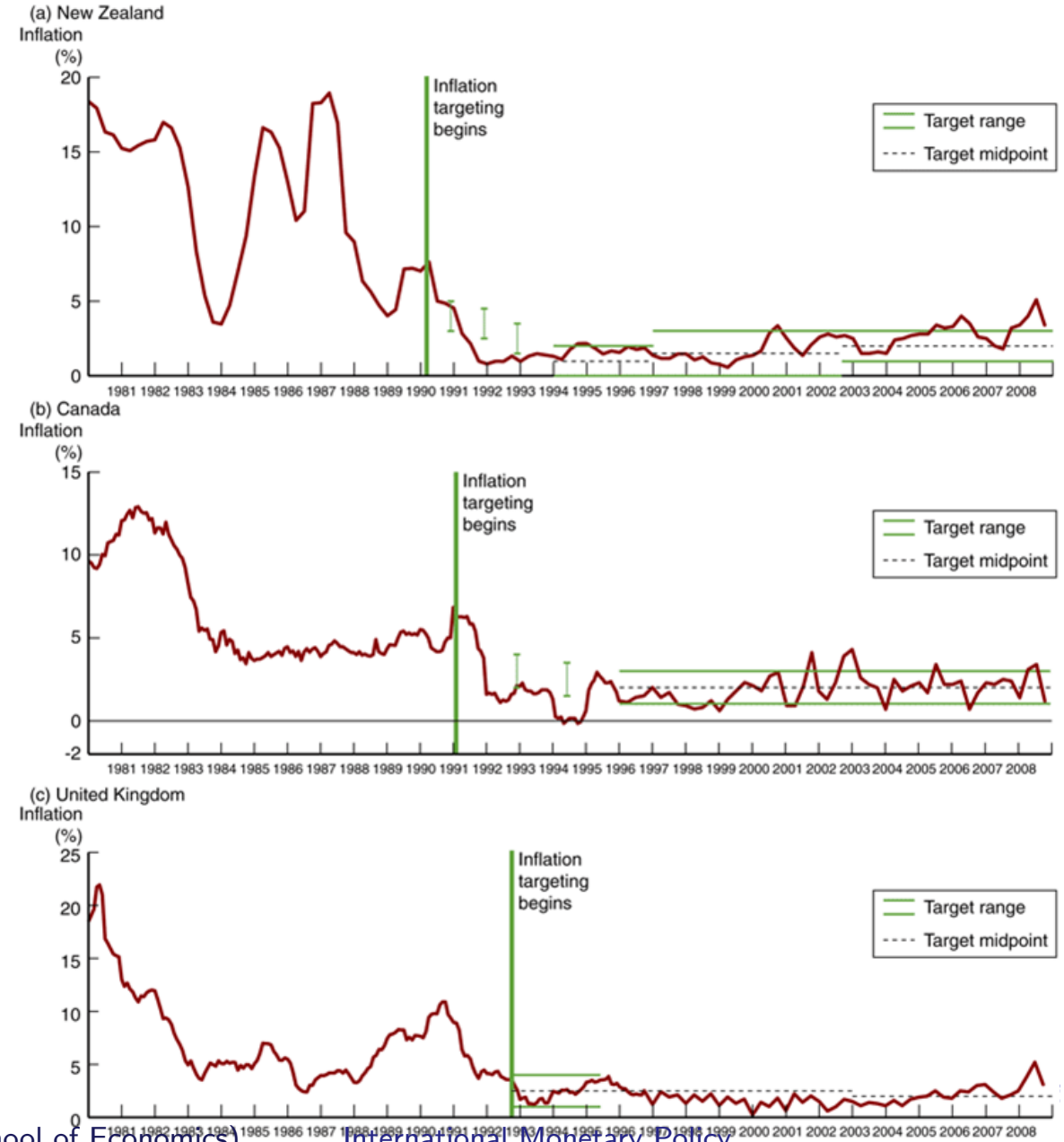
  1. Public announcement of inflation targets
  2. Explicit commitment to price stability relative to other goals
  3. Transparency and communication on how the target is achieved

- Example: in New Zealand the government has explicit right to dismiss the governor if the inflation targets are breached, even for a quarter

- Example: the Bank of England publishes a quarter report, the Inflation Report, explaining the progress being made in achieving the target, and any reason for having failed to achieve the target

- The first country to adopt Inflation Targeting was New Zealand in 1990

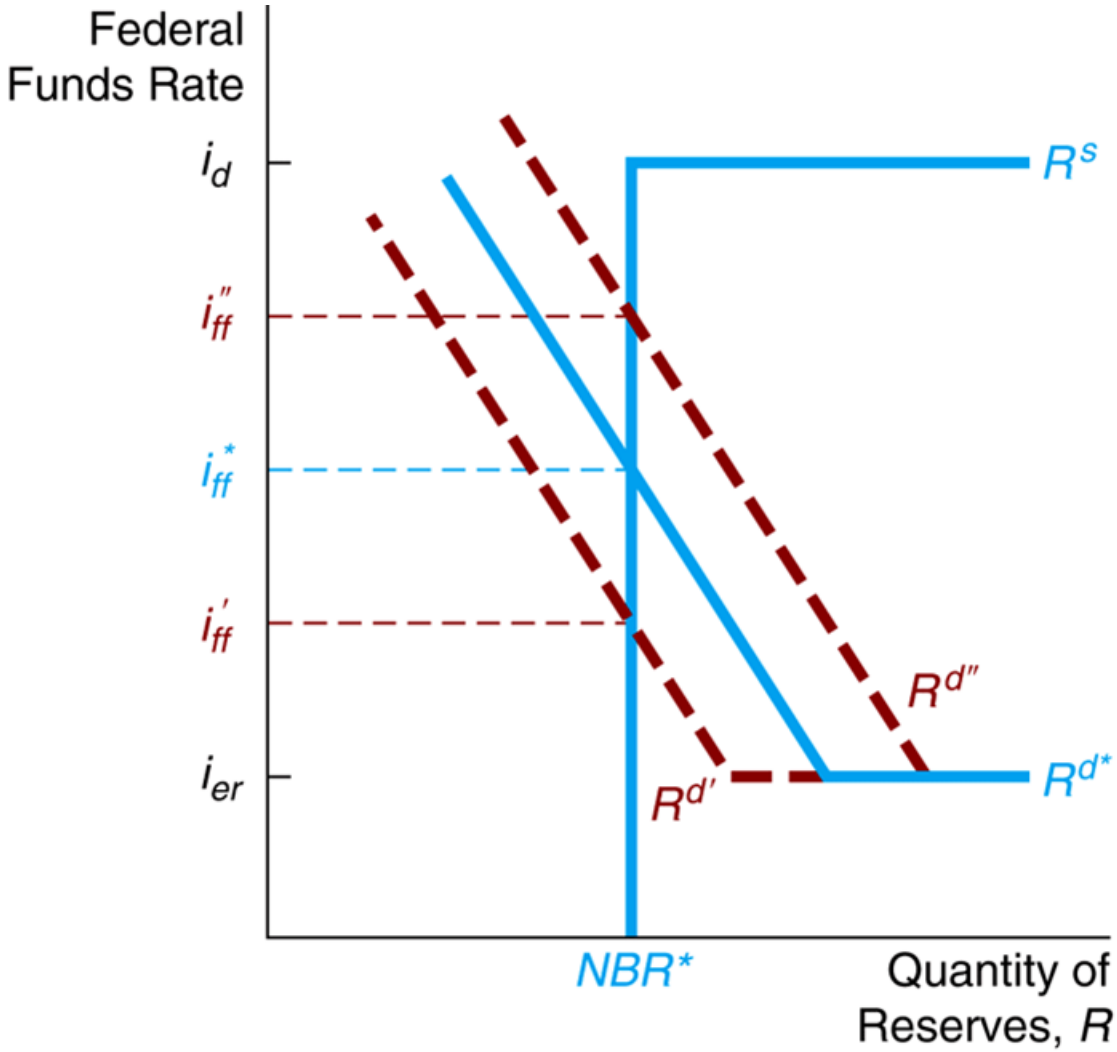
The success of Inflation Targeting



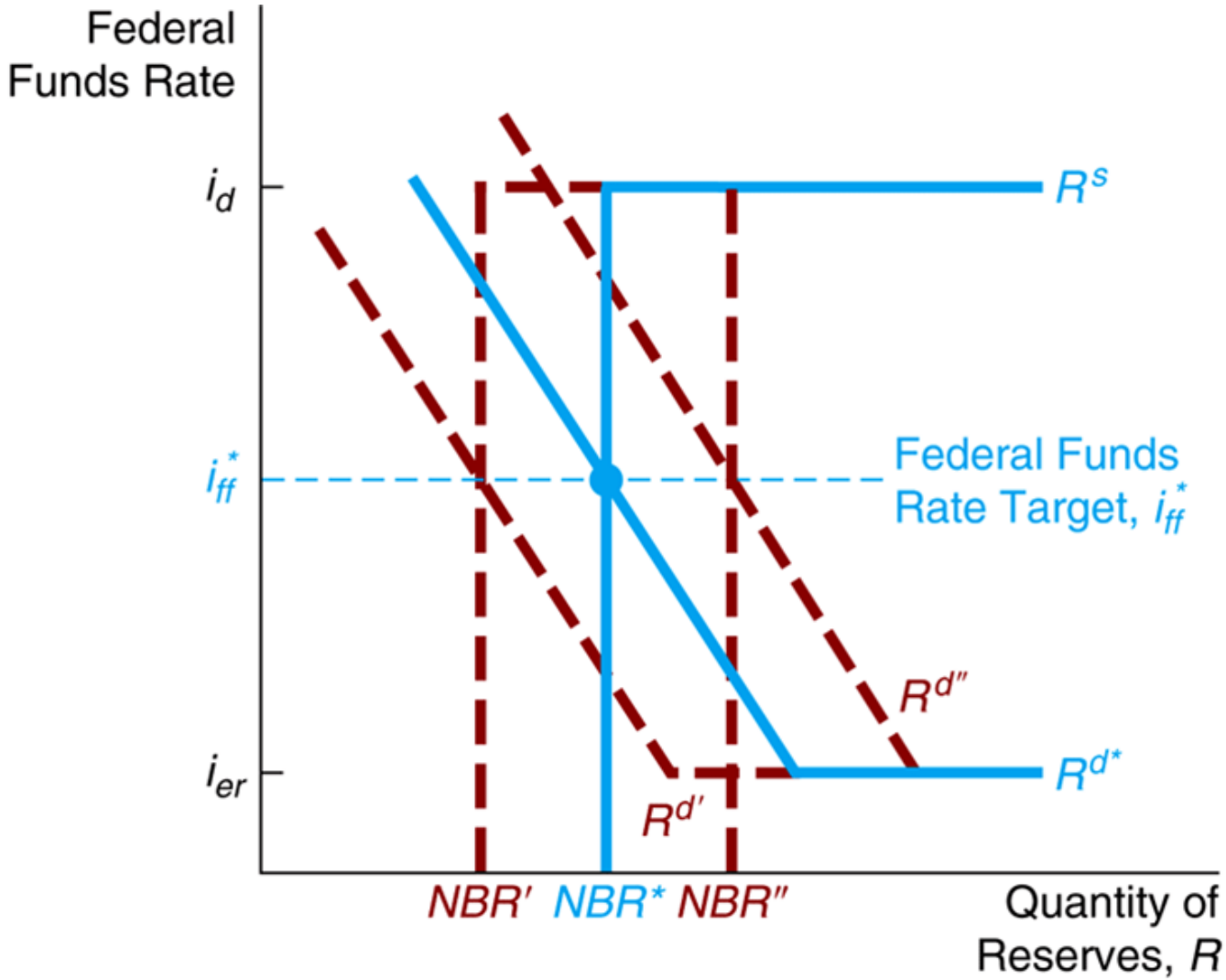
Which Policy Instrument?

- Having defined an Intermediate Target, CBs choose a policy instrument
- CBs control directly the non-borrowed reserves, which coincide with the reserves supply
- Reserve demand depends on market players, and hence is volatile. CBs can form expectations on future demand of reserves, but will anticipate some volatility due to uncertainty
- Can CBs choose to target both the non-borrowed reserves and the fed funds rate at the same time?
- No: choosing one variable involves loosing control of the other

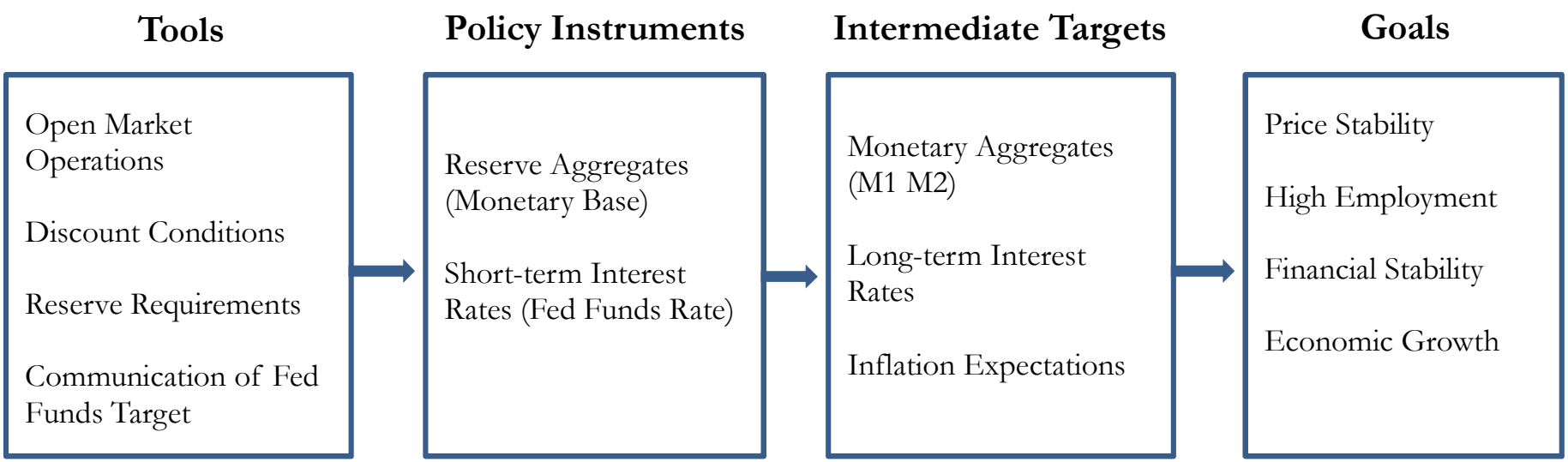
Targeting the non-borrowed reserves



Targeting the Interbank Rate



the Challenge of Central Banking: the Big Picture



Plan for the Future

- So far we have seen how Central Banks behave: what they control, what their goals are and how they achieve them
- But what is the effect of monetary policy on the economy? This is clearly a key question if one wants to understand *how* monetary policy should be run
- To answer this question we have to abandon our pragmatic approach and do a bit of theory
- We will construct a very simple model that helps understand the impact of monetary policy
- We will see the model again after we move from closed to open economy