Chapter 16

What Should Central Banks Do? Monetary Policy Goals, Strategy, and Tactics
The Price Stability Goal

- Low and stable inflation
- Inflation
  - Creates uncertainty and difficulty in planning for future
  - Lowers economic growth
  - Strains social fabric
- Nominal anchor
- Time-inconsistency problem
Other Goals of Monetary Policy

- High employment
- Economic growth
- Stability of financial markets
- Interest-rate stability
- Foreign exchange market stability
Should Price Stability be the Primary Goal?

- In the long run there is no conflict between the goals
- In the short run it can conflict with the goals of high employment and interest-rate stability
- Hierarchical mandate
- Dual mandate
Monetary Targeting

• Flexible, transparent, accountable

• Advantages
  - Almost immediate signals help fix inflation expectations and produce less inflation
  - Almost immediate accountability

• Disadvantages
  - Must be a strong and reliable relationship between the goal variable and the targeted monetary aggregate
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
Inflation Targeting II

• Advantages
  ❖ Does not rely on one variable to achieve target
  ❖ Easily understood
  ❖ Reduces potential of falling in time-inconsistency trap
  ❖ Stresses transparency and accountability

• Disadvantages
  ❖ Delayed signaling
  ❖ Too much rigidity
  ❖ Potential for increased output fluctuations
  ❖ Low economic growth during disinflation
FIGURE 1 Inflation Rates and Inflation Targets for New Zealand, Canada, and the United Kingdom, 1980–2005


(continues)
FIGURE 1  Inflation Rates and Inflation Targets for New Zealand, Canada, and the United Kingdom, 1980–2005 (continued)

FIGURE 1 Inflation Rates and Inflation Targets for New Zealand, Canada, and the United Kingdom, 1980–2005
(a) New Zealand; (b) Canada; (c) United Kingdom
Implicit Nominal Anchor

• Forward looking and preemptive

• Advantages
  ♦ Uses many sources of information
  ♦ Avoids time-inconsistency problem
  ♦ Demonstrated success

• Disadvantages
  ♦ Lack of transparency and accountability
  ♦ Strong dependence on the preferences, skills, and trustworthiness of individuals in charge
  ♦ Inconsistent with democratic principles
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<th>Monetary Targeting</th>
<th>Inflation Targeting</th>
<th>Implicit Nominal Anchor</th>
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<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td>Immediate signal on achievement of target</td>
<td>Simplicity and clarity of target</td>
<td>Does not rely on stable money–inflation relationship</td>
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<td>Does not rely on stable money–inflation relationship</td>
<td>Demonstrated success in United States</td>
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<td>Increased accountability of central bank</td>
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<td>Reduced effects of inflationary shocks</td>
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<tr>
<td><strong>Disadvantages</strong></td>
<td>Relies on stable money–inflation relationship</td>
<td>Delayed signal about achievement of target</td>
<td>Lack of transparency</td>
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<td>Could impose rigid rule (though has not in practice)</td>
<td>Success depends on individuals in charge</td>
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<td>Larger output fluctuations if sole focus on inflation (though not in practice)</td>
<td>Low accountability</td>
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**TABLE 1** Advantages and Disadvantages of Different Monetary Policy Strategies
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
FIGURE 2  Result of Targeting on Nonborrowed Reserves
FIGURE 3  Result of Targeting on the Federal Funds Rate
Criteria for Choosing the Policy Instrument

• Observability and Measurability
• Controllability
• Predictable effect on Goals
The Taylor Rule, NAIRU, and the Phillips Curve

Federal funds rate target =

\[ \text{inflation rate} + \text{equilibrium real fed funds rate} + \frac{1}{2} \text{(inflation gap)} + \frac{1}{2} \text{(output gap)} \]

- 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
- NAIRU
  - Rate of unemployment at which there is no tendency for inflation to change
**FIGURE 4** The Taylor Rule for the Federal Funds Rate, 1970–2005

*Source:* Federal Reserve: [www.federalreserve.gov/releases](http://www.federalreserve.gov/releases) and author's calculations.