Economic Policy #05

Monetary Policy I
(Objectives and Institutions)

Overview

- Money is old device but the concept of monetary policy (MP) emerged during the interwar period.
- During 50s and 60s MP was eclipsed by fiscal policy and primarily concentrated on minimizing the cost of public borrowing.
- In the 70s the role of MP was reassessed with disinflation as an overriding policy objective.
- By the late 90s MP geared toward achieving price stability. Increasing sophistication of MP and growing importance of communication.
- Financial crisis in 2008 highlighted the role of CB as guarantors of financial stability, CB engaged in unconventional MP actions.

The objectives of monetary policy

The objectives of MP have varied significantly over time:

- in 70s CB had broad mandates involving difficult trade-offs between alternative targets
- after inflation period during 70s price stability emerged as dominant goal
- some CBs pursue other objectives simultaneously
- after financial crisis 2007-09 discussion about gearing MP more towards financial stability

The objectives of MP: price stability #1

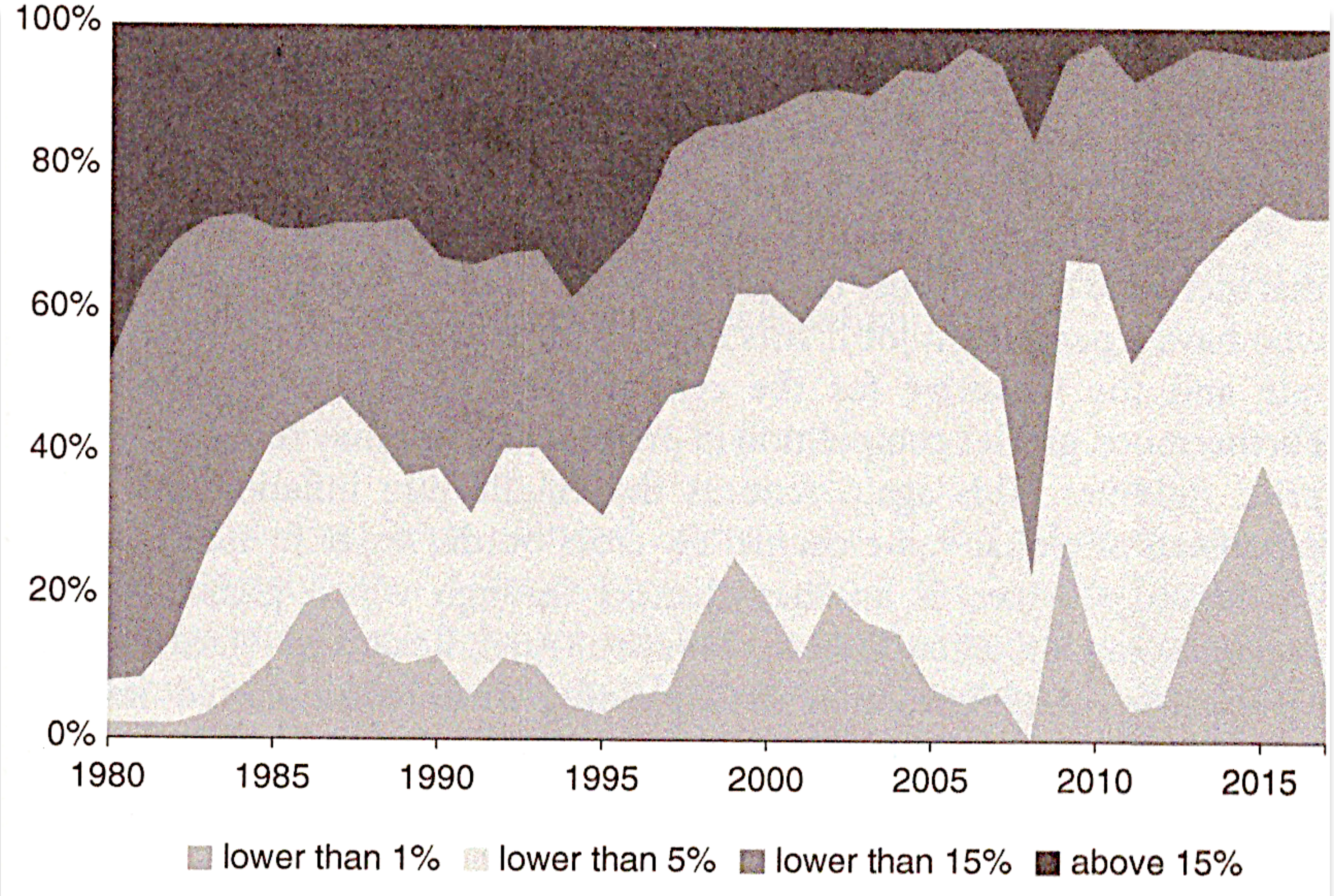
- Inflation should be **neither too high**:
  - Shoeleather costs, menu costs, redistribution effects, uncertainty weighting on individual decisions, risk of generalized indexation and ultimately of hyperinflation,..
  - Ex: Germany in the 1930s, Argentina in the 80s, Zimbabwe in the 2000s,..

The objectives of MP: price stability #2

- … **nor too low**
  - Upward bias in measured CPI
  - Risk of deflation and liquidity trap
  - Downward rigidity of nominal wages points toward 1-4 % inflation band

=> Most central banks have objectives between 1-3 %

BOX. World distribution of annual inflation rates (1980-2016)



Source: Bénassy-Quéré et al. (2019)

The objectives of MP: output stabilization

- MP can be used to stabilize aggregate demand, i.e. support demand through an *expansionary MP* in recession and a *restrictive MP* when demand is ballooning.
- The rationale for *counter-cyclical MP* goes back to the Great Depression in 1930s.
- But desirability and effectiveness of counter-cyclical MP are debated because of variable time lags involved in the transmission mechanism which can transform MP into a *procyclical policy*.

The objectives of MP: exchange rate stability

- Until 90s transition countries relied on a fixed exchange rates as a means of controlling inflation.
- MP of many European countries was geared toward maintaining the external value of the currrency vis-à-vis some larger country.
- The attraction of fixed exchange rates has faded away in recent years.

The objectives of MP: financial stability

- Usually not a formal objective, but in the ’genetic code’ of CB
- Responsibility of the CB as a lender of last-resort to banks is inevitable, but should be exerted with great caution because of:
  - Moral hazard problem
  - Possible incompatibility with price stability
- Asset-price targeting as part of the central bank mandate?

Central bank credibility

CB ***credibility*** is very important for effective MP.

If the CB exploits expectation errors of economic agents and targets a higher level of output (i.e. output above its natural level) in order to reduce unemployment, the outcome is bound to be inflationary because only structural policies can lower structural unemployment. The other result is a lack of credibility.

Central bank credibility (cont.)

How can CB enhance its credibility?

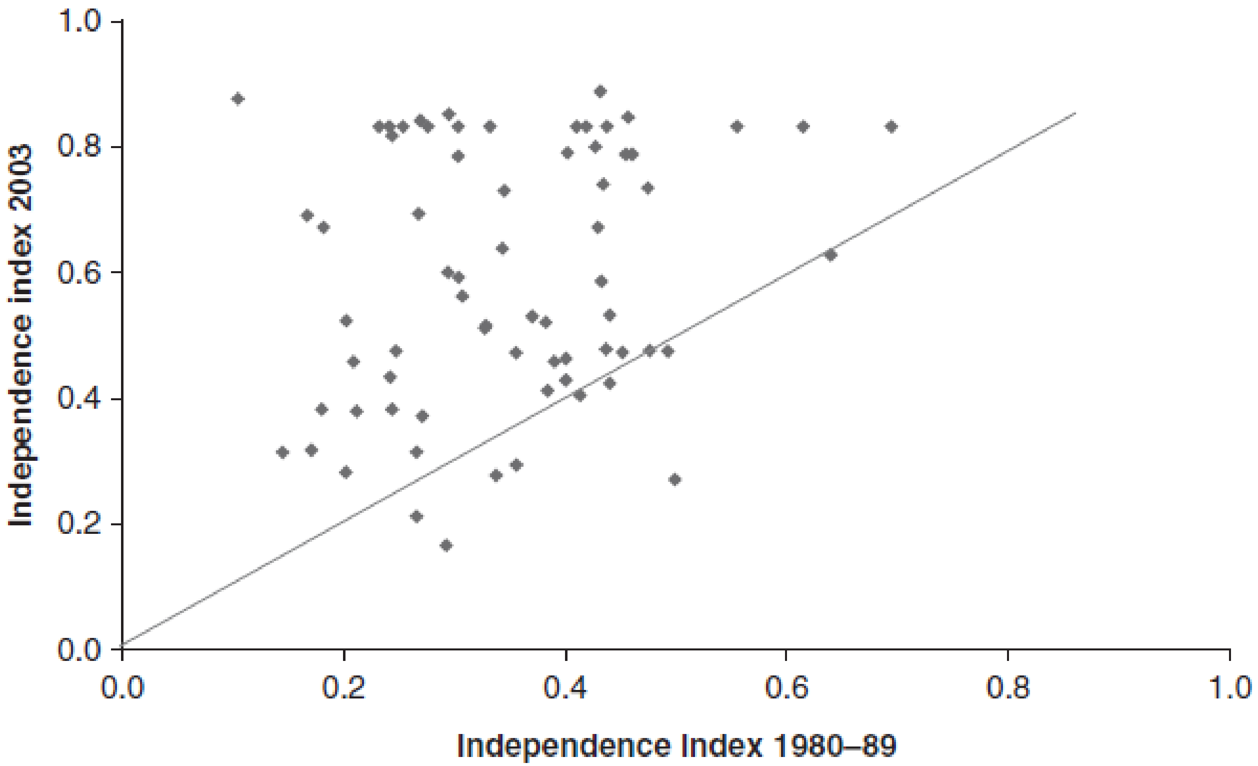
- By *adequate institutional design* (independence, transparency and accountability)
- By *tying its hands*: exchange rate peg, monetary policy rules
- By selecting *conservative central bankers*, i.e. more adverse to inflation than the average of society (K. Rogoff)
- By *incentive contracts*

Importance of CB independence

Why is CB independence so important?

- independent central bank is insulated from the political pressures
- fiscal policy tends to follow a political business cycle, if central banks were subject to political approval, monetary policy would also follow this volatile pattern
- elected politicians do not have the technical savvy to conduct monetary policy
- If the CB was beholden to political interests, the government could amass large budget deficits then turn to the CB to pay off its debts

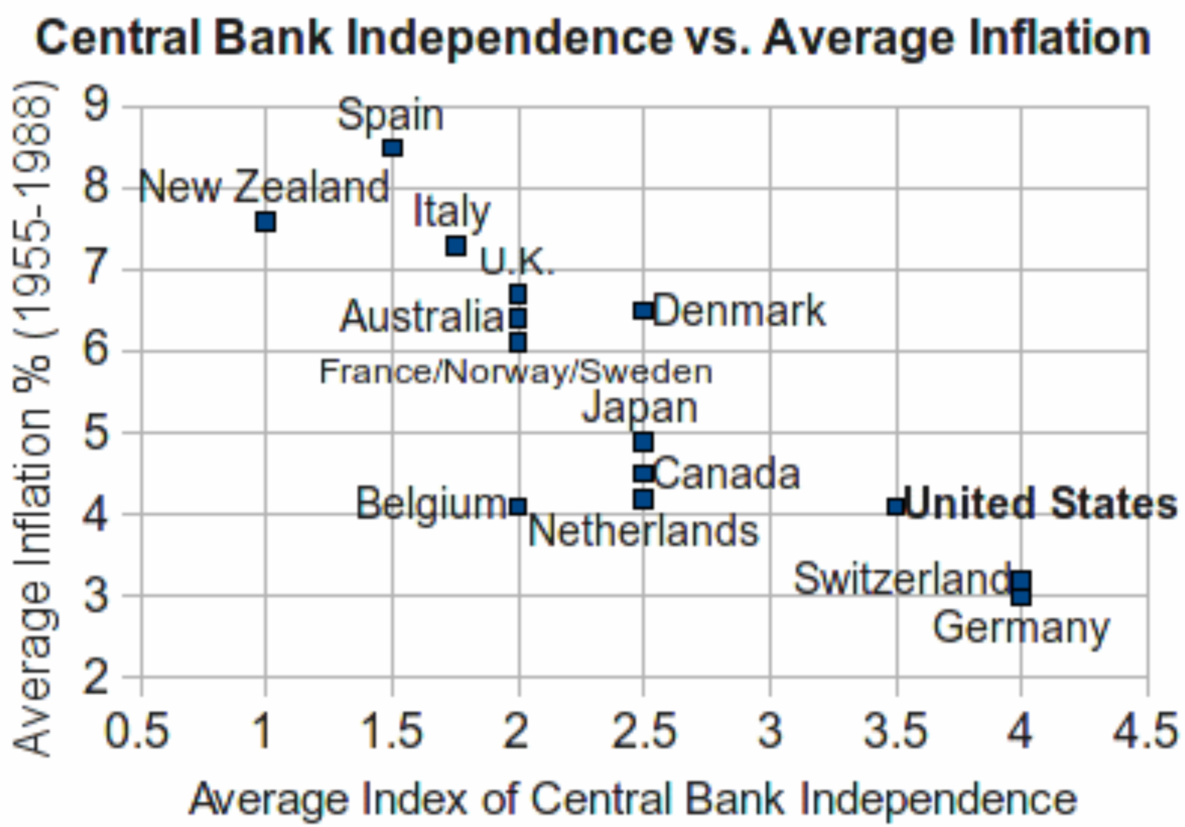
BOX. Central banks: move to independence



Source: Bénassy-Quéré et al. (2012)

=> Increasing number of countries granted full independence to their CB during 1990s and 2000s.

BOX. Central bank independence and average inflation



Source: Bénassy-Quéré et al. (2012)

=> This institutional move to independence resulted from the better ability of independent CB to cope with the inflationary pressures of previous decades.

Central bank independence

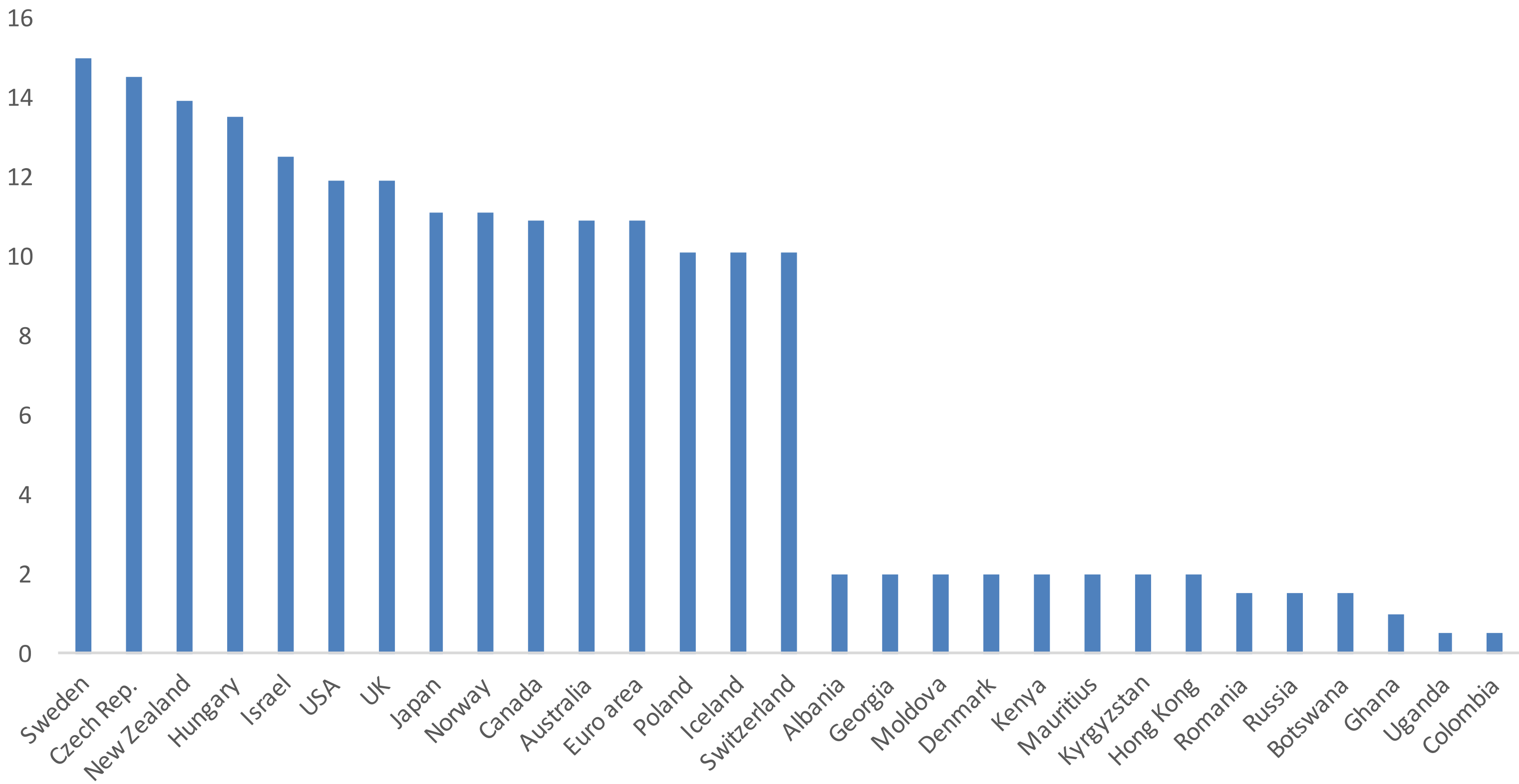
Consider three measures of CB independence:

- *instrument independence*: the central bank is free to set any monetary policy instrument/variable
- *goal independence*: the central bank is free to set its own goals for monetary policy
- *political independence*: the central bank is able to conduct monetary policy without legislative influence

Transparency

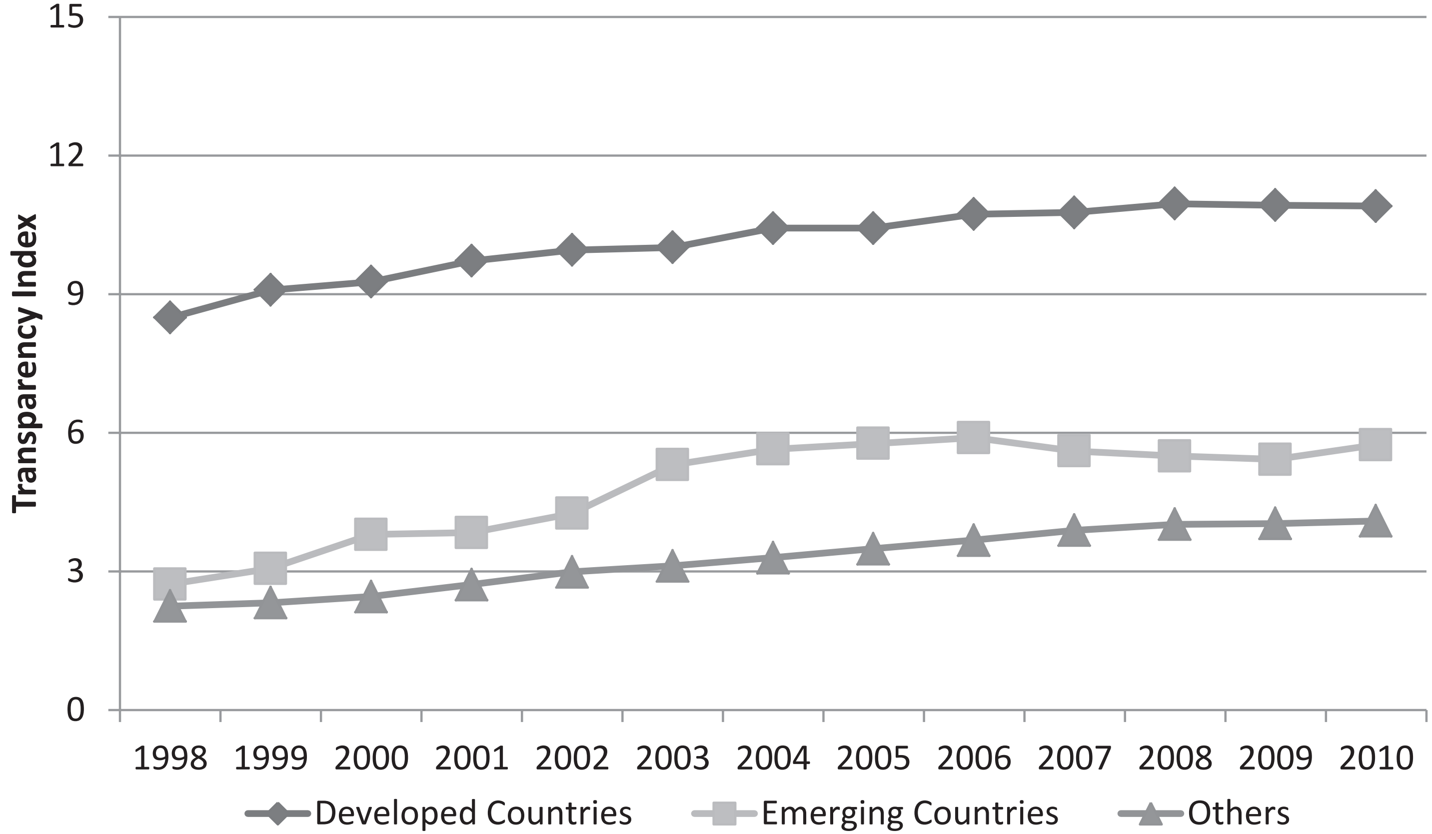
- Central banks can reduce uncertainty by communicating relevant information about macroeconomic fundamentals, the condition of financial institutions and the financial sector more generally.
- It works through the disclosure of models, data, forecasts, methodology, voting records..
- One way how to achieve it is inflation targeting.
- Communication and detailed explanation of the policy decisions is very important.

BOX. Top and bottom central banks in terms of transparency (2014, transparency index ranges from 0 (no transparency to 15 (maximum))



Source: Bénassy-Quéré et al. (2019)

BOX. Trends in transparency by level of economic development



Source: Dincer and Eichengreen (2014)

Central bank accountability

- ***CB accountability*** reflects its exposure to external scrutiny and its answerability vis-à-vis its principal.
- in most countries CB are accountable to the legislative branch
  - US ‘Humphrey Hawkins’ testimony
  - ‘Monetary dialogue’ at European Parliament
  - BoE governor letter

Monetary policy committees

- There has been the move toward collegial decision-making by MP committees in the 1990s and 2000s (e.g. UK, Japan, Sweden, Norway, Switzerland, Brasil).
- It is a by-product of central bank independence.
- A committee has a higher probability of taking the right decisions than a single governor.

BOX. The mandates of central banks: US Fed

- *Legal vehicle*
  - Full Employment and Balanced Growth Act (“Humphrey Hawkins Act”)
- *Price stability*
  - Yes
- *Exchange-rate stability*
  - No, but may intervene on exchange markets, at the request of the US Treasury
- *Output stabilization*
  - Yes, on an equal footing with price stability
- *Financial stability*
  - Yes

BOX. The mandates of central banks: ECB

- *Legal vehicle*
  - EU Treaty (since Maastricht Treaty of 1992)
- *Price stability*
  - Yes
- *Exchange-rate stability*
  - No, but exchange rates are part of the second pillar of the monetary-policy strategy, and the ECB has the sole right to conduct foreign-exchange operations
- *Output stabilization*
  - Yes, but secondary to price stability
- *Financial stability*
  - Yes, but as a secondary competence in support to governments.

BOX. The mandates of central banks: Bank of England

- *Legal vehicle*
  - Bank of England Act, 1998
- *Price stability*
  - Yes, definition of price stability belongs to government
- *Exchange-rate stability*
  - No
- *Output stabilization*
  - Yes, secondary to price stability
- *Financial stability*
  - Yes

BOX. The mandates of central banks: Bank of Japan

- *Legal vehicle*
  - Bank of Japan Law, 1997
- *Price stability*
  - Yes
- *Exchange-rate stability*
  - No, but may be instructed to intervene to exchange markets
- *Output stabilization*
  - No, only as a consequence of price stability
- *Financial stability*
  - Yes

Mandates of CB: key differences

- US Fed has dual mandate of full employment and price stability, while ECB has not.
- ECB decides on objectives, while BoE do not.
- Crisis has prompted fresh discussion on the central bank role in financial stability.
- Example: creation in 2011 of European Systemic Risk Board chaired by ECB President.

… to be continued..