

Lecture #9

Chapter 19

Conduct of Monetary Policy: Goals and Targets

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Goals of Monetary Policy

Goals

1. High Employment
2. Economic Growth
3. Price Stability
4. Interest Rate Stability
5. Financial Market Stability
6. Foreign Exchange Market Stability

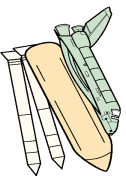
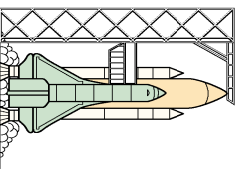
Goals often in conflict

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Central Bank Strategy

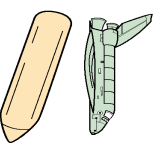
Tools of the Central Bank

Open market operations
Discount policy
Reserve requirements



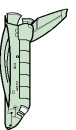
Operating Targets

Reserve aggregates
(reserves, nonborrowed
reserves, monetary base,
nonborrowed base)
Interest rates (short-term
such as federal funds rate)



Intermediate Targets

Monetary aggregates
(M1, M2, M3)
Interest rates (short-
and long-term)

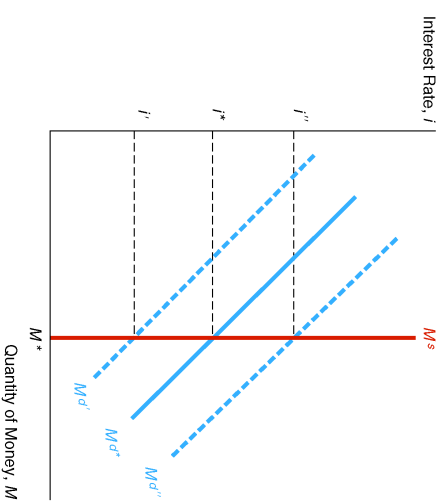


Goals

High employment,
price stability,
financial market
stability and so on.

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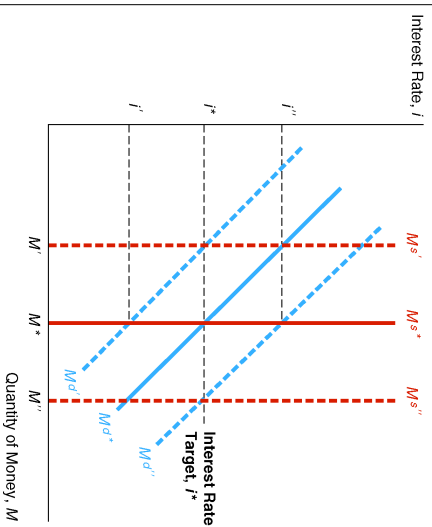
Money Supply Target



1. M^d fluctuates between $M^{d''}$ and $M^{d'''}$
2. With M -target at M^* , i fluctuates between i' and i'''

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Interest Rate Target



1. M^d fluctuates between M^d and M^d''
2. To set i -target at i^* , M^s fluctuates between M^s and M^s''

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Criteria for Choosing Targets

Criteria for Intermediate Targets

1. Measurability
2. Controllability
3. Ability to Predictably Affect Goals

Interest rates aren't clearly better than M^s on criteria 1 and 2 because hard to measure and control real interest rates

Criteria for Operating Targets

Same criteria as above

Reserve aggregates and interest rates about equal on criteria 1 and 2. For 3, if intermediate target is M^s , then reserve aggregate is better

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History of Fed Policy Procedures

Early Years: Discounting as Primary Tool

1. Real bills doctrine
2. Rise in discount rates in 1920: recession 1920–21

Discovery of Open Market Operations

1. Made discovery when purchased bonds to get income in 1920s

Great Depression

1. Failure to prevent bank failures
2. Result: sharp drop in M^s

Reserve Requirements as Tool

1. Banking Act of 1935
2. $RR \uparrow$ in 1936, 1937 to reduce “idle” reserves:

Result: $M^s \downarrow$ and severe recession in 1937–38

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Pegging of interest rates: 1942-51

1. To help finance war: T-bill at 3/8%, T-bond at 2 1/2%
2. Fed-Treasury Accord in March 1951

Money Market Conditions: 1950s and 60s

1. Free Reserves = $ER - DL$

A. Proccyclical M^s

$Y \uparrow \square \quad i \uparrow \square \quad ER \square; DL \uparrow \square \quad FR \square \square \quad MB \uparrow \square \quad M^s \uparrow$

2. Interest Rates

A. Proccyclical M^s

$Y \uparrow \square \quad i \uparrow \square \quad MB \uparrow \square \quad M^s \uparrow$

Targeting Monetary Aggregates: 1970s

1. Fed funds rate as operating target with narrow band
2. Proccyclical M^s

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New Operating Procedures: 1979–82

1. De-emphasis on fed funds rate
2. Non-borrowed reserves operating target
3. Fed still using interest rates to affect economy and inflation

De-emphasis of Monetary Aggregates: 1982–Early 1990s

1. Borrowed Reserves (DL) operating target

A. Pro-cyclical M^s

$$Y \uparrow \square i \uparrow \square DL \uparrow \square MB \uparrow \square M^s \uparrow$$

Fed Funds Targeting Again

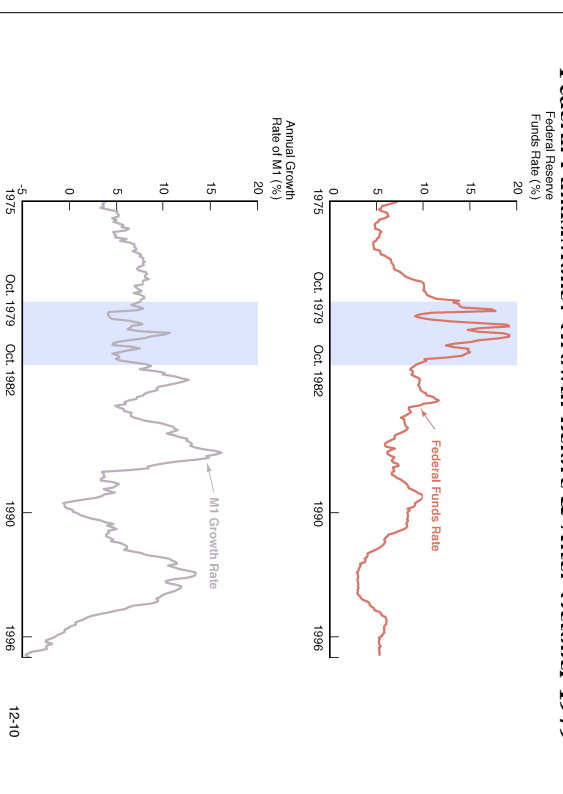
1. Fed funds target now announced

International Considerations

1. $M \uparrow$ in 1985 to lower exchange rate, $M \square$ in 1987 to raise it
2. International policy coordination

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Federal Funds, Money Growth Before & After October 1979



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Monetary Targeting Abroad

United Kingdom

1. Targets $M3$ and later $M0$
2. Problems of M as monetary indicator

Canada

1. Targets $M1$ till 1982, then abandons it
2. 1988: declining \square targets, $M2$ as guide

Germany

1. Targets central bank money, then $M3$ in 1988
2. Allows growth outside target for 2–3 years, but then reverses overshoots
3. 1990s: dilemma of restrain \square , but keep exchange rate in EMS

Japan

1. Forecasts $M2 + CDs$
2. Innovation and deregulation makes less useful as monetary indicator
3. High money growth 1987–89: “bubble economy,” then tight money policy

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Inflation Targeting

Lessons from Monetary Targeting

1. Success requires correcting overshoots
2. Operating procedures not critical
3. Breakdown of relationship between M and goals made M -targeting untenable: Led to inflation targeting

Inflation Targeting: New Zealand, U.K., Canada

1. Announcement of numerical \square goal
2. Commitment to price stability
3. Communication with “Inflation Report”

Lessons from Inflation Targeting

1. Decline in \square still led to output loss
2. Worked to keep \square low
3. Kept \square in public eye: reduced political pressures for inflationary policy

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