Chapter 18

Conduct of Monetary Policy: Goals and Targets

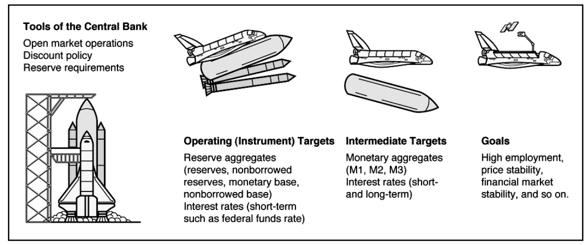
Goals of Monetary Policy

Goals

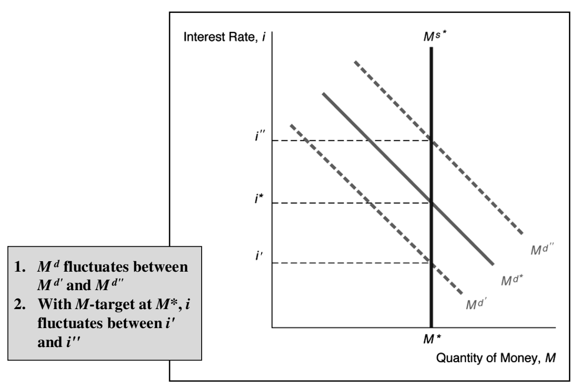
1. High Employment (up to *natural rate of unemployment*)
2. Economic Growth (e.g., supply-side policies)
3. Price Stability (low inflation)
4. Interest Rate Stability
5. Financial Market Stability
6. Foreign Exchange Market Stability

Goals often in conflict (e.g., price stability and high employment)

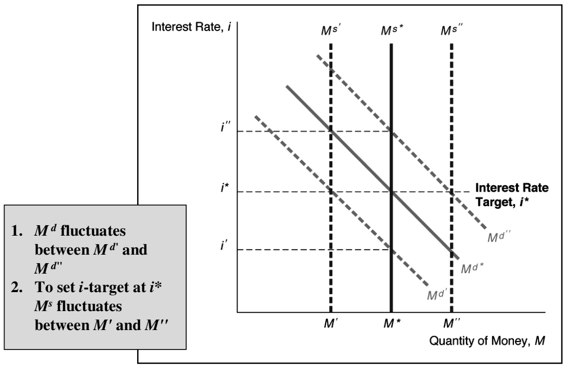
Central Bank Strategy



Money Supply Target



Interest Rate Target



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 <u>real</u> 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

History of Fed Policy Procedures

Early Years: Discounting as Primary Tool

1. Real bills doctrine: discount loans not inflationary if for production
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. Required reserves $\uparrow$ in 1936, 1937 to reduce "idle" reserves:

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

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. Interest Rates
   A. Procyclical M
      $Y\uparrow \Rightarrow i\uparrow \Rightarrow MB\uparrow \Rightarrow M\uparrow$
      $\pi\uparrow \Rightarrow \pi^e\uparrow \Rightarrow i\uparrow \Rightarrow MB\uparrow \Rightarrow M\uparrow$

Targeting Monetary Aggregates: 1970s

1. Fed funds rate as operating target with narrow band
2. Procyclical M

New Operating Procedures: 1979–82

1. Deemphasis on fed funds rate
2. Nonborrowed reserves operating target
3. Fed still using interest rates to affect economy and inflation

Deemphasis of Monetary Aggregates: 1982–Early 1990s

1. Borrowed reserves (*DL*) operating target
   A. Procyclical *M*
      $Y\uparrow \Rightarrow i\uparrow \Rightarrow DL\uparrow \Rightarrow MB\uparrow \Rightarrow M\uparrow$

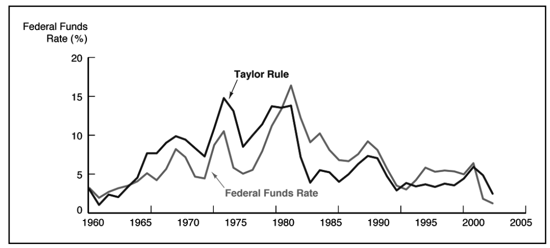
Fed Funds Targeting Again: Early 1990s to the present

1. Fed funds target now announced

International Considerations

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

Taylor Rule and Fed Funds Rate



Taylor Rule, NAIRU and the Phillips Curve

Taylor Rule

Fed funds rate target = inflation rate +
equilibrium real fed funds rate +
1/2 (inflation gap) +
1/2 (output gap)

Phillips Curve Theory

Change in inflation influenced by output relative to potential, and other factors

When unemployment rate < NAIRU (nonaccelerating inflation rate of unemployment), inflation rises

NAIRU thought to be 6%, but inflation falls with unemployment rate below 5%

Phillips curve theory highly controversial