

Goals and Conduct of Monetary Policy

BFI Lecture 10.2.

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1 What are the Goals of Monetary Policy in the US?

The General Goals of Monetary Policy

The main goals of the FED are:

- ① encourage high employment
- ② promote economic growth
- ③ maintain price stability
- ④ stabilize interest rates and foreign exchange rates
- ⑤ prevent financial market and banking system crashes

How Are these Goals Achieved?

Intermediate and operating targets of the FED

The goals of the monetary policy (MP) cannot be directly achieved.

Intermediate targets of MP

Intermediate targets of MP: Those factors that affect economic growth, price stability and the other main goals of MP. Examples:

- Monetary aggregates: M1, M2, M3
- Short-term interest rates

But even these are not directly controlled by the Central bank.

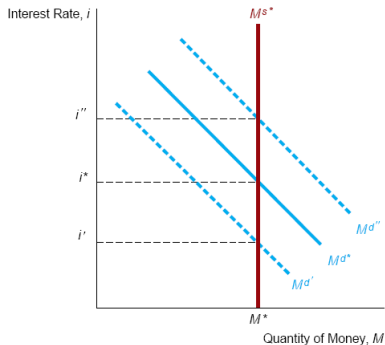
Operating (Instrument) targets of MP

Operating targets of MP: Those factors that affect monetary aggregates and are directly influenced by the decisions taken at the FED. Examples:

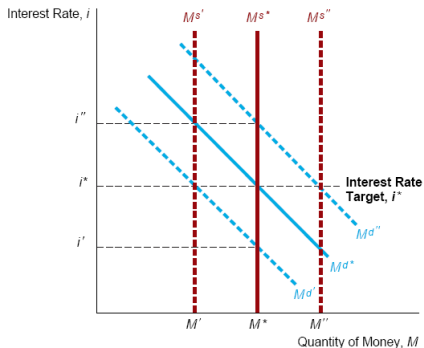
- Interbank interest rate (FED Funds Rate)
- Monetary base: currency held by individuals + bank reserves

Conflicts Between Intermediate Targets

Choosing a monetary aggregate target

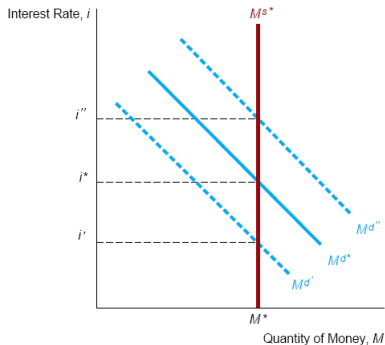


Choosing an interest rate target

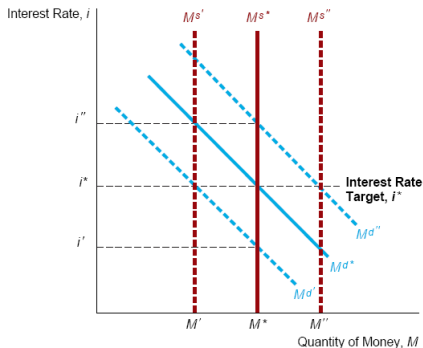


Conflicts Between Intermediate Targets

Choosing a monetary aggregate target



Choosing an interest rate target



If the intermediate targets are in conflict, how to choose between them?

How to Choose Between MP Targets

What defines MP *control*?

① Measurability

- Monetary Aggregates: subject to revisions, adjustments
- Interest rates: Nominal or real?

② Direct controllability

- Monetary Aggregates: discount ratio; reserve requirement
- Interest rates: open market operations. However: expected inflation is very hard to control.

③ Effect on the MP goals

A Bit of US Monetary Policy History

How were the policy instruments developing over time:

- 1 1913 - 1921: Discount rate was the primary tool
- 2 Early 1920s: Open market operations accidentally discovered
- 3 By late 1920s: OMO main instrument
- 4 1933: Reserve requirement introduced
- 5 1942-1952: Interest rate pegs to finance the Government
- 6 1950s-1960s: Interest rate targeting
- 7 1970s: Targeting monetary aggregates
- 8 Since 1980s: Smoothing interbank interest (FED Funds) rates