Modern Monetary Policy

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Outline

1. Modern monetary policy regimes rests on 3 pillars
2. Best-practice monetary policy: Flexible inflation targeting
3. The monetary policy committee
4. Accountability in practice

1. The three pillars

I. A sensible mandate

II. Independence

III. Accountability

1. The three pillars
   I. A sensible mandate

   - What can monetary policy achieve?
     - Nominal variables: Level and variability
     - Real variables:
       - Short run: Level and variability
       - Long run: Not level, determined by real factors. Only variability

   - A sensible mandate:
     - Price stability
     - Real stability (stability in resource utilization)
     - Thus, stabilize inflation around inflation target and resource utilization around long-run sustainable rate
1. The three pillars
   II. Independence

- Several dimensions of independence
  - Operational (functional), institutional, personal, financial
  - Goal vs. instrument independence
  - Legal vs. actual

- Avoids short-run interference by governments/parliaments:
  - Political business cycle
- Avoids ’inflation bias’ from political pressure
- Allows longer horizon in monetary policy
- Clarifies responsibility for fulfilling mandate

1. The three pillars
   II. Independence

- Strong international trend towards increasing independence
- Degree of independence varies across countries
- Norges Bank Watch 2002: “Monetary policy among the best in the world; institutional framework among the worst in the world”
- Informal independence even if not formal
- Safer with formal independence

1. The three pillars
   III. Accountability

- **Democracy**: Independence requires accountability

- **Effectiveness**: Accountability strengthens CB incentives to fulfill mandate

- Accountability requires transparency (more on this later)
2. Best practice: Flexible inflation targeting

- Forecast targeting
  - Forecasts necessary as monetary policy works with lags
  - Set policy rate and choose policy-rate path so corresponding forecasts of inflation and resource utilization “look good” (good target achievement)

- Flexible inflation targeting
  - Stabilize both inflation around target and resource utilization
  - Strict inflation targeting is not optimal

- Transparency
  - Makes policy more effective
  - Improves accountability

2. Flexible inflation targeting
In practice

1. Starting point: Different policy-rate paths gives different forecasts for inflation and resource utilization

2. Policy decision: Choose the policy-rate path for which forecasts for inflation and resource utilization “look good” (best stabilize inflation around target and resource utilization around long-run sustainable rate)

3. Publish the decision, the forecasts (of inflation, resource, and the policy rate), and the ‘story’ (the justification)

2. Flexible inflation targeting

2. Flexible inflation targeting

2. Best-practice flexible inflation targeters

- Reserve bank of New Zealand
- Bank of Canada (outcome)
- Norges Bank
- Riksbank (transparency, but too much leaning against the wind)
- Czech National Bank
- Federal Reserve

- Many other central banks, also in emerging economies, come close

3. The monetary policy committee

Who shall decide and be accountable?

- International trend towards committee decision-making
  - RBNZ notable exception (but informal MPC)
- Why committee?
  - Several heads are better than one (Blinder research)
  - “Person risk” if only one decision maker
  - Committee of competent and independent members provides control mechanism
- Specialized and professional committee for monetary policy decisions (Bank of England)
  - Focus on monetary policy
  - Internal and external members
  - Foreign members
  - Clear accountability

4. Accountability in practice

- Experts and interested parties in media, reports, conferences, etc.:
  - Discussion of current and past policy
- Parliaments and governments: Evaluation of past policy, not interference in current policy (respect operational independence)
- Hearings in Parliaments
  - Avoid superficial political points
  - Expert assistance, evaluation reports, questions
  - Submissions from interested parties

- Official evaluations by experts
  - New Zealand (Svensson 2001)
  - Sweden (Giavazzi-Mishkin 2006, Goodhart-Rochet 2011, Goodfriend-King 2016)
- Independent evaluations (could be sponsored by CB/Government)
  - Norges Bank Watch
  - Annual conference (ECB Watchers’ Conference, US Monetary Policy Forum)
4. Accountability in practice

Transparency

- Transparency strengthens accountability
  - Improves discussion and makes easier the evaluation of monetary policy
  - Strengthens central bank incentives
  - Publishing policy-rate path (forward guidance) part of transparency
    - Internal policy-rate path necessary, then publish
    - Useful information for private sector
    - Allows external consistency check
    - Improves accountability

Summing up and concluding

1. Modern monetary policy regimes rests on 3 pillars:
   - Mandate
   - Independence
   - Accountability
2. Flexible inflation targeting is best-practice monetary policy
3. A monetary policy committee is a good idea
4. Accountability requires
   - Transparency
   - Thorough external evaluation
   - But respect of independence from parliament and government (focus on past policy, no superficial political points, …)

4. Accountability in practice

Transparency: Varies between countries

- Inflation target, stabilization of resource utilization
- CB forecasts, analysis, motivation for decisions (Monetary Policy Reports)
- Analysis of outcomes: Unanticipated shocks, etc.
- Alternative scenarios (interest rates, shocks, international developments, …)
- Forecasts of output, output gap, resource utilization
- Interest-rate forecasts (RBNZ, NB, SR, CNB, Fed, …)
- Attributed (Riksbank) vs. non-attributed minutes