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

1. The three pillars
II. Independence

- 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 (RBNZ 1990, Bank of England 1997, ECB 1998, Sweden 1999)
- 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)

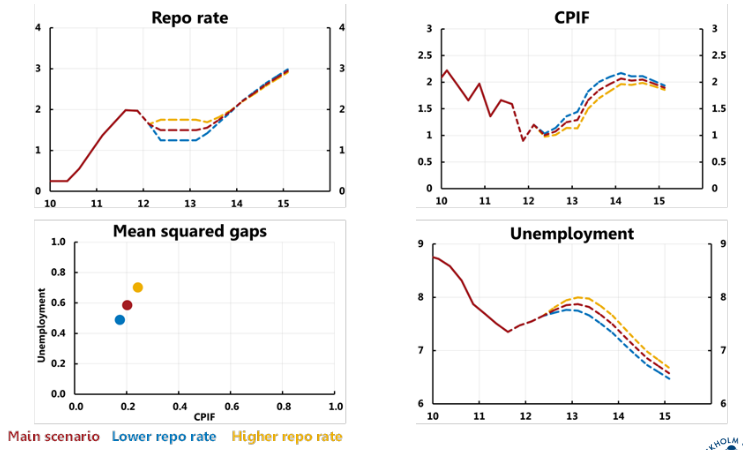
2. Best practice: *Flexible* inflation targeting

- 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

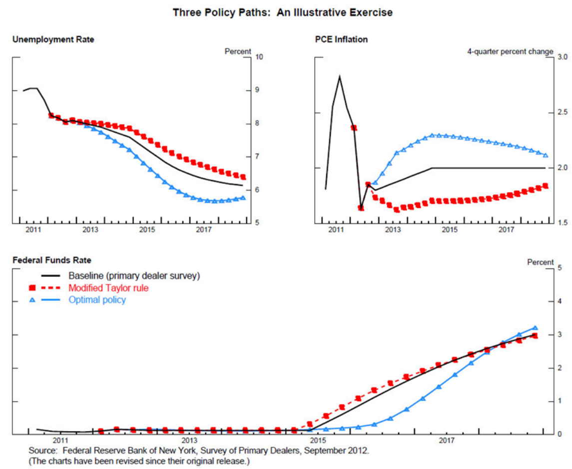
2. Flexible inflation targeting
In practice

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
In practice: Illustration – Riksbank Feb. 2012



2. Flexible inflation targeting
In practice: Example – Fed, Yellen (2012)



Source: Yellen, Janet L. (2012), “Revolution and Evolution in Central Bank Communications,” speech at the Haas School of Business, University of California, Berkeley, November 13, 2012, www.federalreserve.gov.

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

4. Accountability in practice

- Official evaluations by experts
  - New Zealand (Svensson 2001)
  - Bank of England (Kohn 2001, Pagan 2003)
  - 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

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

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 evaluaiton
   - But respect of independence from parliament and government (focus on past policy, no superficial political points, …)