

## Monetary Policy Today: Sixteen Questions and about Twelve Answers

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### 1. The loss function

$$(1a) \quad L = (\pi - \pi^*)^2 + \lambda(y - y^*)^2 \quad \text{or}$$
$$(1b) \quad L = (\pi - \pi^*)^2 + \lambda(u - u^*)^2$$

- (Modestly) important policy issue: core or headline inflation?
- Possibly more important/interesting issue:  $\pi$  or  $p$ ?
- Why quadratic?
- Determining the weight  $\lambda$ . (Svensson's median voter.)

### 2. Transparency

- The two basic arguments in favor.
- No arguments opposed (incl. Morris-Shin)?
- But a simple principle: You cannot disclose what you do not know. (Examples:  $\lambda$ ? future policy decisions?)
  - A simple suggestion: Generate future policy decisions mechanically from an estimated reaction function.
- Is (flexible) "inflation targeting" transparent?

### 4. Individual vs. committee decisionmaking

- Doesn't matter for *homines economici* (except for private information).
- The "real" reasons:
  - Different decisionmaking heuristics
  - Checks and balances (Sibert questions this.)
  - Reduced volatility via "averaging" (A virtue or vice?)
- Blinder-Morgan results in brief.

### 6. Reversal aversion

- *Hypothesis/assertion*: There are fewer reversals than would be optimal.
- *Reason?*: It would make the CB look bad—appear to be admitting error.

### 7. Reasons for gradualism

- Literal "adjustment costs"? What are they?
  - They seem more of the (S,s) type, which should eliminate very small changes.
- Option value (coupled with reversal aversion)
- Serially-correlated shocks and/or learning
- Brainard conservatism
- Smoothing short-term interest rates
- "Unsmoothing" long-term interest rates

## 15. The zero lower bound

- The problem, if  $\pi \leq 0$ , then  $r = i - \pi \geq 0$
- Trick: try to keep  $r^e = i - \pi^e < 0$  anyway.
  - > This requires  $\pi^e \gg \pi$ . (Easy in theory, but...)
  - > This is where "forward-looking" vs. "backward looking" really matters!
- OMO in long bonds to work on term premium
- OMO in non-Treasuries to work on risk premia.
- OMO in foreign bonds to work on exchange rate.

## 12. The interest rate channel

- In theoretical models,  $r \rightarrow y$
- In more realistic models,  $r \rightarrow R \rightarrow y$ 
  - >  $r \rightarrow R$  governed by expectations theory.
- Big problem: The expectations theory of the term structure fails miserably.
- Example:  $E(R_{1,9}) = 10R_{10} - 9R_9$ 
  - > This can be computed for each  $t$  and compared to the actual at  $t+9$ . (See graph.)

## Actual U.S. data (zero-coupon bonds)

