

CHAPTER 18

Conduct of Monetary Policy: Goals and Targets

Goals of Monetary Policy

Goals

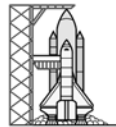
1. High Employment
2. Economic Growth
3. Price Stability
4. Interest Rate Stability
5. Financial Market Stability
6. Foreign Exchange Market Stability

Goals often in conflict

Central Bank Strategy

Tools of the Central Bank

Open market operations
Discount policy
Reserve requirements



Operating (Instrument) Targets

Reserve aggregates
(reserves, nonborrowed
reserves, monetary base,
nonborrowed base)
Interest rates (short-term
such as federal funds rate)

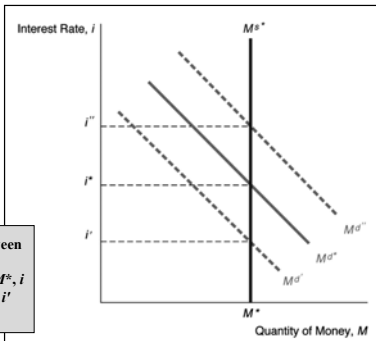
Intermediate Targets

Monetary aggregates
(M1, M2, M3)
Interest rates (short-
and long-term)

Goals

High employment,
price stability,
financial market
stability, and so on.

Money Supply Target

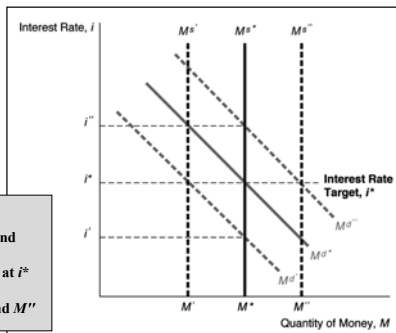


1. M^d fluctuates between M^d and $M^{d''}$
2. With M -target at M^* , i fluctuates between i^* and i''

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Interest Rate Target



1. M^d fluctuates between M^d and $M^{d''}$
2. To set i -target at i^* , M^s fluctuates between M^s' and M^s''

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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 real 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

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Taylor Rule, NAIRU and the Phillips Curve

Taylor Rule

Fed funds rate target = inflation rate +
equilibrium real fed funds rate (2%) +
 $\frac{1}{2}$ (inflation gap) [inflation=2%] +
 $\frac{1}{2}$ (output gap)

Phillips Curve Theory

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

When unemployment rate < NAIRU, inflation rises

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

Phillips curve theory highly controversial

Taylor Rule and Fed Funds Rate

