
The Global Economy

Monetary Policy & Interest Rates



Ride home revisited

- Should the US tie its money to gold?
- What does that mean?
- Why or why not?

2

Ride home revisited

- Ron Paul
 - Paul maintains that a return to using gold and silver as legal tender — in addition to the dollar — would make the dollar more stable while also keeping prices down and defending against government interference in markets.
 - “All I want to do is legalize [the use of silver and gold as money], and if nobody cares, if nobody likes gold and silver, they can keep investing in paper assets and put their savings accounts in paper money.”
- Do you agree? Why or why not?

3

The idea

- Interest rates reflect many things, but the short-term focus of bond traders in most countries is on the central bank

4

Keep it simple

- Lots of stories and institutional detail along the way
- Focus on **central bank balance sheet** and **Taylor rule**

5

Big picture for bond investors

- Bond investors
 - Bond prices fall when interest rates rise (definition)
 - More so for long bonds
 - If you expect rates to rise, hold short bonds
 - Look to Fed for guidance [more coming]

6

Big picture for policy analysts

- Are you worried about inflation or growth right now?
- What should the Fed do?
- Would we be better off with gold as our currency?

7

Big picture for philosophers

- What is money?
- Why does it matter?
- Is gold money? Paper? Bitcoins?

8

Big picture for economists

- Donald Knuth
 - Science is what we understand well enough to explain to a computer. Art is everything else.
- Evidently monetary policy is art

9

Courses related to this topic

- Monetary policy, banks, and central banks (ECON-GB.2333)
 - Tobias Adrian, NY Fed, Head of Capital Markets Group
- Financial crisis and policy response (ECON-GB.2343)
 - Kim Schoenholtz, Professor of Management Practice, Ex-Salomon and Citi, former Chief US Economist at Citi, central bank expert
- Not offered next term, but probably next year

10

Roadmap

- Short history of money
- What should central banks do?
- **Money supply mechanics**
- Interest rate mechanics
- **Taylor's interest rate rule**
- Unconventional monetary policy

11

Short history of money

Stone money

- Milton Friedman, "Stone money," in *Money Mischief*
 - On the island of Yap in the Western Pacific ...
- What's the point?



13

Commodity money

- Gold standard
 - Money tied to gold (eg, 1 oz = \$35)
 - In principle, people can take their money to the central bank and exchange it for gold
 - This guarantees money has value
- Questions
 - Does it deliver stable prices?
 - Is it a waste of gold?
 - An improvement on our current system?

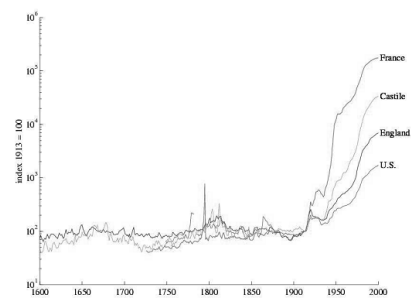
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Commodity money

- David Ricardo, *Proposals for a Secure Currency*, 1816
 - The introduction of precious metals [as money] may with truth be considered one of the most important steps toward the improvement of commerce. But it is no less true that ... it would be another improvement to banish them altogether [in favor of paper money].
- What is he saying? Do you agree?

15

Prices with commodity & paper monies



16

Open question

- How do we deliver stable prices?
 - Commodity money?
 - Central bank policy?
 - Something else?

17

What should central banks do?

Federal Reserve System

- Founded by Federal Reserve Act of 1913
 - The Federal Reserve System and the Federal Open Market Committee should seek “to promote effectively the goals of **maximum employment, stable prices, and moderate long-term interest rates.**”
- So what’s the goal?
- And what about motherhood and apple pie?

19

ECB

- ECB = European Central Bank
- Treaty of Maastricht (1992)
 - The **primary objective of [monetary policy] shall be to maintain price stability.**
 - Without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Community with a view to contributing to the achievement of ... a high level of employment and sustainable and non-inflationary growth.
- How does this differ from Fed? Good idea or bad?

20

Banco Central de Argentina

- BCRA Act of 2003
 - The Argentine Central Bank is a self-governed institution whose primary and fundamental mission is to preserve the value of the currency.
- Good idea? Did it work?

21

Federal Reserve revisited

- Fed policy statement, October 29, 2014:
 - Information received since we met in September suggests that economic activity is expanding at a moderate pace. Labor market conditions improved somewhat further, with solid job gains and a lower unemployment rate. Inflation has continued to run below the Committee's longer-run objective.
 - The Committee today reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate remains appropriate.
- What are they saying? Do you agree?

22

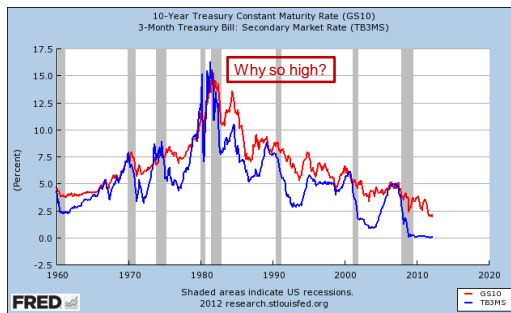
Money & interest rates

Where do interest rates come from?

- We generally think of monetary policy in terms of interest rates
- Where do these interest rates come from?
 - Short-term Treasuries?
 - Long-term Treasuries?
 - Fed funds rate?
 - Inflation-indexed Treasuries (TIPS)?

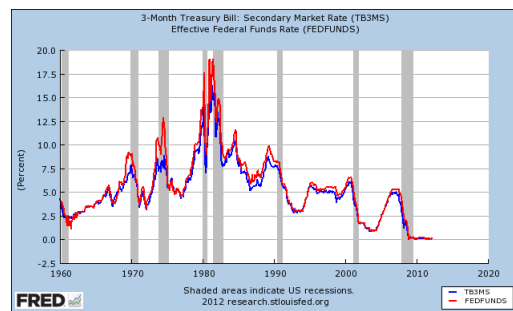
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Where do interest rates come from?



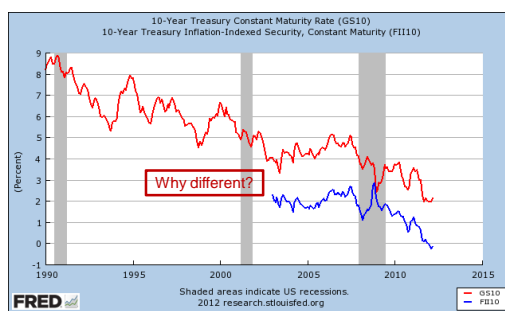
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Where do interest rates come from?



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Where do interest rates come from?



27

Where do interest rates come from?

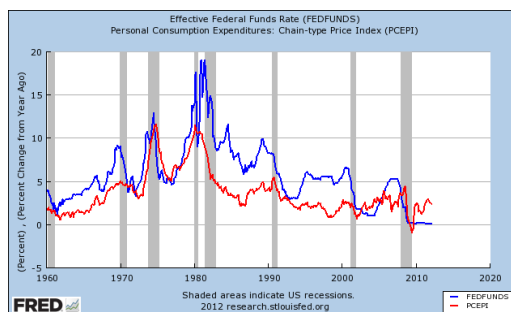
- Interest and inflation (“Fisher equation”)

$$i = r + \pi$$

- i = “nominal” interest rate (payment in dollars)
- r = “real” interest rate (payments in goods)
- π = inflation (expected?)

28

Where do interest rates come from?



29

Where do interest rates come from?

- Summary
 - Inflation is part of the story
 - But there’s still a lot of variation left

30

Money supply mechanics

Reminder: money supply mechanics

Treasury

Assets	Liabilities
	Bonds 200

Central bank

Assets	Liabilities
Bonds 20	Money 20

Households and firms

Assets	Liabilities
Money 20	
Bonds 180	

- How does central bank increase money supply?
- [Think: asset swap]
- Why do households go along?

32

Fed policy statement

- Federal Open Market Committee (“Fed” or “FOMC”)
 - Meets eight times a year
 - Makes public statement immediately following
 - Search: “FOMC”
- Statement includes
 - Interest rate target
 - And recently: asset purchases (“quantitative easing”)

33

Fed policy statement

- Statement of October 29, 2014:
 - The Committee judges that there has been a substantial improvement in the outlook for the labor market since the inception of its current **asset purchase program**. Moreover, the Committee continues to see sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in a context of price stability. Accordingly, the **Committee decided to conclude its asset purchase program** this month.
- What are they saying?

34

Asset market purchases

Central bank usually

Assets	Liabilities
Bonds 20	Money 20

Central bank now

Assets	Liabilities
Bonds 120	Money 20
Agency 100	Reserves 200

- What are these “asset market purchases”?
- How does the Fed finance them?
- Why is it helpful to pay interest on reserves?
- What kind of asset swap is this?

35

Interest rate mechanics

Overview

- Central banks shift AD by changing money supply
- But: Fed policy statement focused on interest rate
- Translation
 - Increase in interest rate is same as reduction in money supply
 - Decrease in interest rate is same as expansion of money supply
- More soon, but that's the point
- Focus on US, but [most] other countries are similar

37

Some institutional detail

- In practice, Fed operates in market for “reserves”
- Reserves are deposits of banks at Fed (“fed funds”)
 - The Fed is the bank for banks
 - Reserves held by banks for transactions or as investments
- Banks trade overnight positions in “fed funds”
 - If they have more than they want, they sell
 - If they have less than they want, they buy
- The rate on these positions is the “**fed funds rate**”

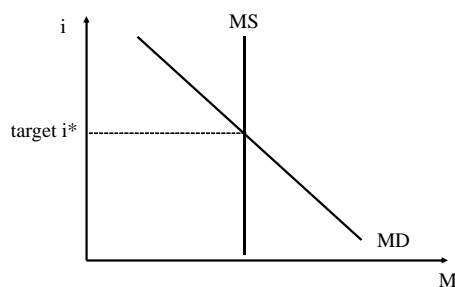
38

Hitting the target interest rate

- How does the Fed hit its target interest rate?
- Demand for money depends on interest rate
 - Why? Currency pays no interest, so hold less if rate is high
 - So... choose supply of money to hit target
- No different from markets for apples, copper, etc

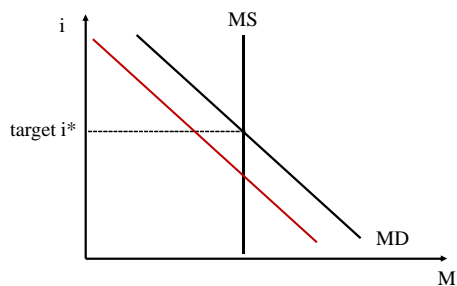
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Hitting the target interest rate



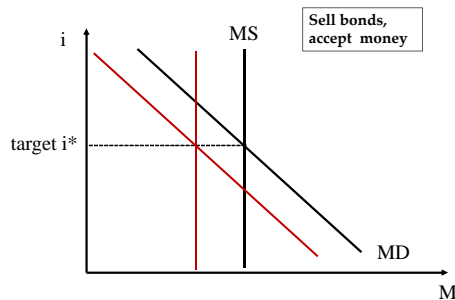
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What if demand changes?



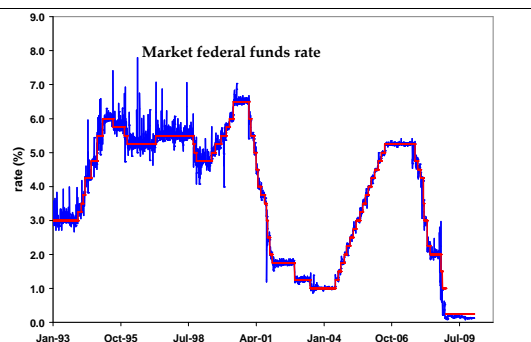
41

What if demand changes?



42

Hitting the target interest rate



43

Hitting the target interest rate

- Summary
 - Increasing money supply lowers interest rate
 - Decreasing money supply raises interest rate
 - We'll talk as if changing money supply and interest rate are equivalent

44

Up next

- What rate do we choose?
 - Could go back to AS/AD
 - But we'll use a popular rule of thumb instead

45

The Taylor rule for the fed funds rate

The Taylor rule

- A formula for setting fed funds rate
- What's good about a formula? Bad?
- What should rate respond to?
 - Inflation?
 - GDP and GDP growth?
 - Condition of financial system?
 - Exchange rate?
 - Other things?

47

The Taylor rule

- John Taylor's rule for setting fed funds rate

$$i = r^* + \pi + a_1(\pi - \pi^*) + a_2(g - g^*)$$

- i = target fed funds rate
- r^* = average real interest rate [2%]
- π = inflation rate
- π^* = target inflation rate [2%]
- g = GDP growth rate
- g^* = average GDP growth rate [3%]
- (a_1, a_2) = numbers/parameters [1/2, 1/2]

Variations?

48

The Taylor rule as bond trader's guide

- What happens to interest rate if
 - GDP growth rises?
 - Inflation rises?
 - Employment rises?
 - Other indicators?

49

The Taylor rule

- What does it suggest on average?

$$i = r^* + \pi + a_1(\pi - \pi^*) + a_2(g - g^*)$$

50

The Taylor rule

- What does it suggest now?

$$i = r^* + \pi + a_1(\pi - \pi^*) + a_2(g - g^*)$$

- Recent numbers
 - Inflation PCE chain index: YOY Sep = 1.4%
 - GDP growth: YOY Q3 = 2.3%

51

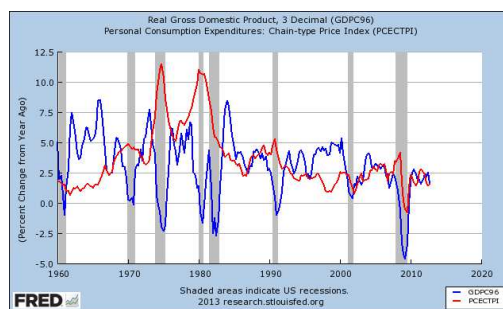
The Taylor rule

- How much does it respond to inflation? Why?

$$i = r^* + \pi + a_1(\pi - \pi^*) + a_2(g - g^*)$$

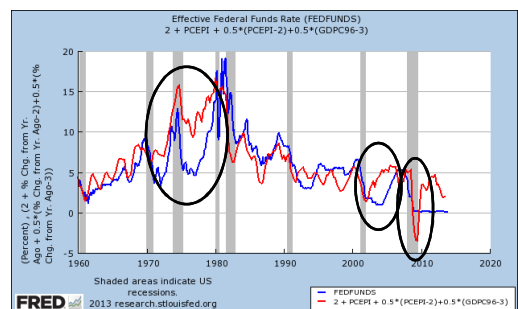
52

US history: inflation and growth



53

US history: Taylor rule



54

The Taylor rule

- What happened in 1970s?
 - Rate below Taylor rule, inflation shot up
 - Same as last week, where we called it too much money
- What happened in 2001?
 - Rate below Taylor rule, justified or mistake?
- What happened in 2008?
 - Taylor rule points to negative rate, can't be done [more soon]
- What should we do now?
 - Taylor rule above target, rate too low?

55

Unconventional policy

Unconventional monetary policies

- Policy 1: quantitative easing
 - What do we do when the interest rate hits zero?
- Policy 2: credit easing
 - How can we mitigate impact of financial disruption?

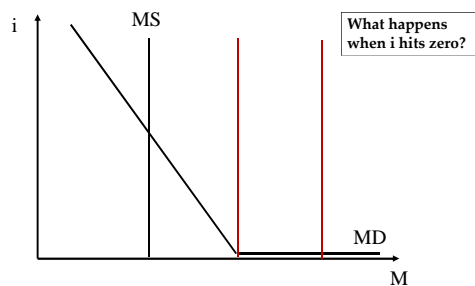
57

Unconventional policy 1

- What happens when interest rate hits zero?
 - Can't have negative interest rates, people would hold cash instead
 - ZLB: zero lower bound
- But: you can still increase money supply
 - QE: quantitative easing
 - New name for an old idea?

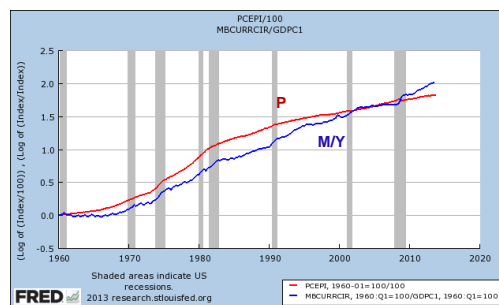
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QE at the ZLB



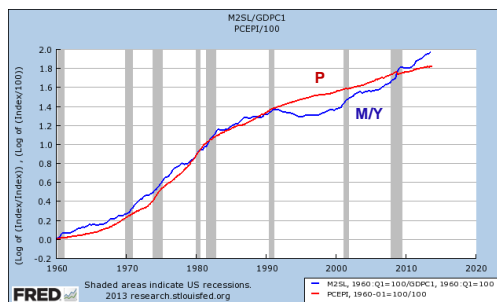
59

Quantitative easing (currency)



60

Quantitative easing (M2)



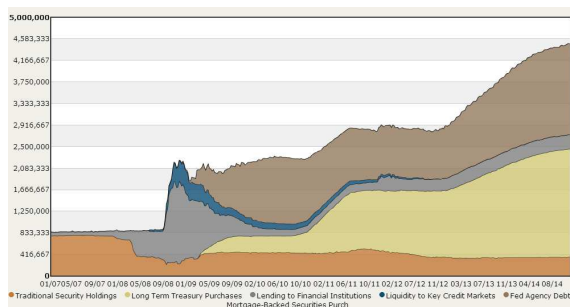
61

Unconventional policy 2

- Another unconventional policy: buy assets
 - CE: credit easing (buy private assets)
 - QE: quantitative easing (buy public assets in large quantities)
- See Cleveland Fed animation
http://www.clevelandfed.org/research/Data/Credit_Easing/index.cfm
- Why?
 - Prop up financial system? Twist yield curve?

62

Quantitative and credit easing



Source: Cleveland Fed.

63

Unconventional policy revisited

- Was it
 - Brilliant strategy that mitigated impact of the financial crisis?
 - Excessive expansion that will lead to inflation down the road?

64

What have we learned?

- Central banks usually target an interest rate rather than the money supply
 - Two ways of thinking about the same thing
- Taylor rule ties interest rate to inflation and growth
 - Bond trader's guide
 - Raises questions when policy differs [like now?]
- When interest rate hits zero, you can still increase the quantity of money

65

The Global Economy Principles of Tax Policy

Ride home revisited

- Should corporations pay more tax?
- People?

67

Roadmap

- New module: crises
- The ideas
- Words and numbers
- Principles of spending policy
- Principles of tax policy
- **Low rates, broad base**

68

Starting new module

- New module organized roughly around economic crises
- First topic: “fiscal policy” = “government finance”
 - Government spending
 - Tax revenue
 - Debt = deferred taxes [next week]

69

The ideas

- Countries differ – a lot – in the magnitude and type of spending, the taxes they collect, and how they manage their debt
- Good tax systems
 - Are transparent and simple to execute
 - Apply low rates to a broad base
 - Pay for government spending [next week]

70

Words and numbers

Words

- An old joke:
 - Opinion polls show that 100% of voters think other people should pay more tax.

72

Words

- *The Economist*, Survey France:
 - An employer who pays a worker twice the minimum wage, or €2,400 a month, has to shell out nearly half as much again to the state in social-security contributions; the employee, for his part, has to hand over 22% of his pay in social-security contributions, on top of income tax. A French pay slip typically runs to over 40 itemised lines.
- Is this a good system? Why or why not?

73

Words

- Ivan Miklos, Deputy Prime Minister of Slovakia, *Financial Times*, on corporate taxes:
 - I am convinced that the reforms of new EU member states could serve as inspiration for the older member states as well. One such reform is the flat tax. ... We now have one of the simplest, most transparent tax systems in the world. ... And our tax revenues have not decreased at all, partly because the reform eliminated most of the incentives and opportunities for tax avoidance. The new system has been particularly popular with German companies.
- Is this a good system? Why or why not?

74

Words

- EIU, *Country Commerce Report*, India:
 - Corporate tax rates have come down in recent years to fairly reasonable levels, in keeping with the government's aim to widen the tax base and ensure greater compliance. But the underground economy, with its untaxed transactions and incomes, remains large.
 - The system remains complicated, however, and is the subject of frequent litigation.
- Is this a good system? Why or why not?

75

Words

- David Leonhardt, "Who will crack the code?" *NYT*, May 25, 2013:
 - Many economists and tax experts believe the United States corporate-tax code is terribly flawed. It includes a notoriously high statutory rate that causes companies to devote resources to avoiding taxes. But it has so many loopholes that the effective corporate tax rate in the United States is slightly lower than the average for rich countries.
- Is this a good system? Why or why not?

76

Words

- Eduardo Porter, "A tax code of politics," *NYT*, April 10, 2012:
 - Our byzantine tax code is built upon a longstanding political deal: Democrats wanted a tax scale with higher rates for richer Americans to finance social programs for the poor and middle class. Republicans countered by pushing for tax exceptions, exclusions and deductions that shielded the incomes of the rich from the taxman and reduced government revenue.
 - This compromise has left us with a loophole-riddled code.
- Is this a good system? Why or why not?

77

Words: summary

- What should we tax?
- Who should we tax?
- How should we tax?
- Why?

78

Words: summary

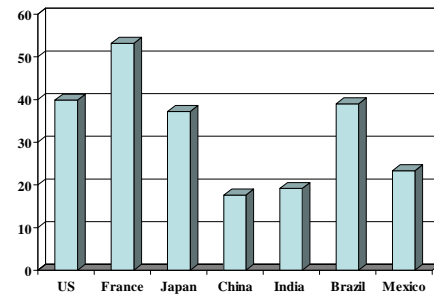
- Check
- <http://conversableeconomist.blogspot.com/2013/12/distribution-of-us-federal-taxes.html>
- <http://conversableeconomist.blogspot.com/2014/07/double-irish-dutch-sandwich.html>

- Also <http://www.nytimes.com/2013/05/26/opinion/sunday/who-will-crack-the-code.html>

The soda industry's success at legally avoiding taxes shows why so many economists and tax experts believe the United States corporate-tax code is terribly flawed. It includes a substantial high-statutary rate that causes

79

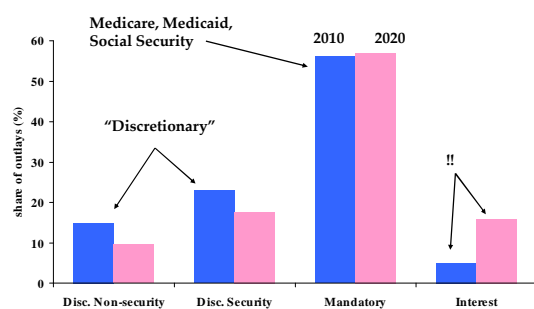
Government spending (% of GDP)



Source: OECD fiscal database.

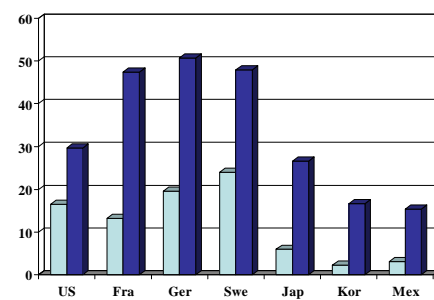
80

US federal government spending



81

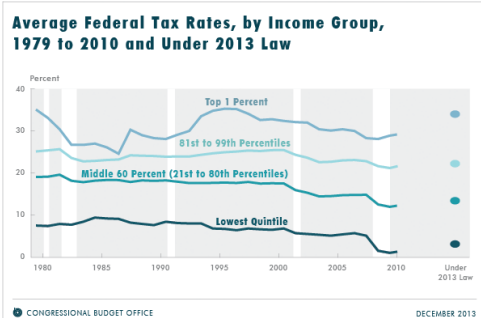
Personal tax rates (% at average wage)



Source: OECD. Green=direct tax. Blue=total incl soc ins payments.

82

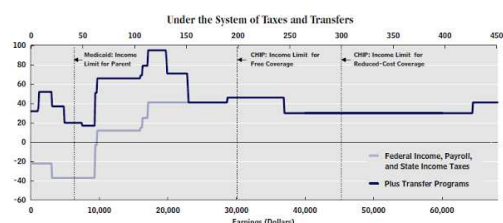
US average tax rates by income (all taxes)



83

<http://www.cbo.gov/publication/44604>

US: marginal tax rates by income

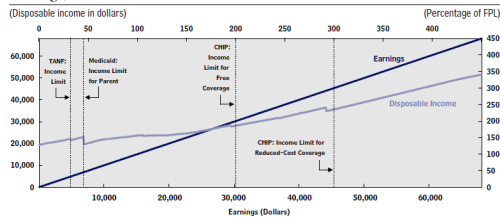


Source: CBO via Cochrane.

84

US: post-tax and pre-tax income

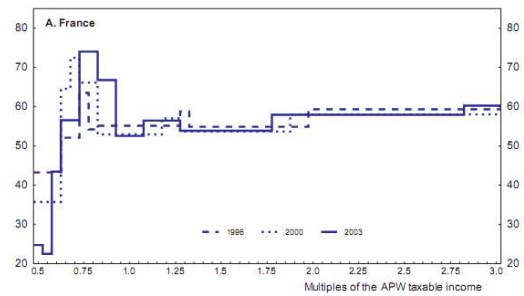
Disposable Income for a Hypothetical Single Parent with One Child, by Earnings, in 2012



Source: CBO via Cochrane.

85

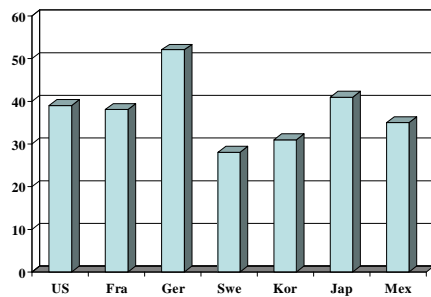
France: marginal tax rates by income



Source: OECD working paper 439, "The French tax system."

86

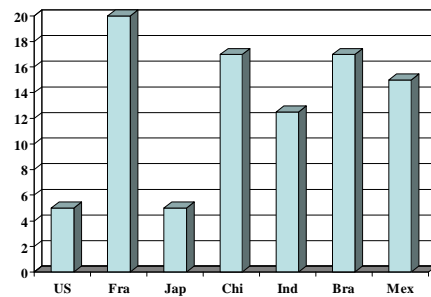
Corporate tax rates



Source: KPMG.

87

Value-added tax rates



Source: Doing Business.

88

Principles of government spending

Government spending

- Classic argument: provide *public goods*
- Public goods are
 - Non excludable: hard to keep non-payers from consuming
 - National security, legal system, fish in the ocean
 - Non rival: my consumption does not affect your consumption
 - Fresh air, NY skyline, public safety
- Hard for a private firm to capture all the benefits, so market would provide too little

90

Government spending

- Many goods partly private, partly public
- Individuals and countries differ on
 - Roads?
 - Security?
 - Education?
 - Mass transit?
 - Sport stadiums?
 - Opera?
 - Health care?
 - Others?

91

Government spending

 **the ONION**

Libertarian Reluctantly Calls Fire Department

April 21, 2004 | [Issue 40•16](#)

CHEYENNE, WY—After attempting to contain a living-room blaze started by a cigarette, card-carrying Libertarian Trent Jacobs reluctantly called the Cheyenne Fire Department Monday. “Although the community would do better to rely on an efficient, free-market fire-fighting service, the fact is that expensive, unnecessary public fire departments do exist,” Jacobs said. “Also, my house was burning down.” Jacobs did not offer to pay firefighters for their service.

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92

Government spending, continued

- Most government spending not goods, public or otherwise
- They're transfer payments to cover
 - Pension funds
 - Disability
 - Healthcare
- Countries differ, but (esp) in rich countries transfers are greater than purchases of goods and services

93

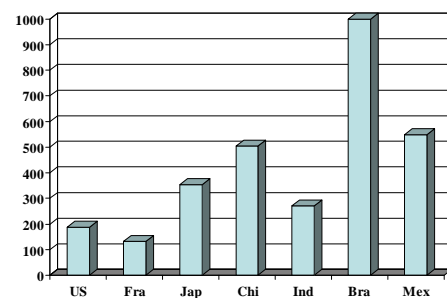
Principles of tax policy

Tax principles

- Societies choose different levels of spending
- They have to pay for it, primarily through taxes
- Which taxes?
- Principles of good tax policy
 1. Transparent and easy to execute
 2. Apply low rates to a broad base
 3. Collect enough revenue to pay for government spending [next week]

95

Complexity of business taxes (hours)



Source: Doing Business.

96

Tax complexity: Vodafone in India

- Civitas.in online case [my summary]
 - Vodafone BV, based in the Netherlands and controlled by Vodafone UK, obtained a controlling interest in CGP Investments Holdings, located in Cayman Island, from Hong Kong-based Hutchinson Telecommunications International Ltd (HTIL)
 - HTIL had a stake in CGP's mobile operations in India.
 - India sent Vodafone a \$2.3b tax bill based on capital gains in its India operations (gains taxed on transfer of control)
 - The Supreme Court rejected the government's argument in March, but the government threatened to pass legislation allowing retrospective taxation of business deals.
 - The saga continues ...

97

Low rate, broad base

Tax "distortions"

- If we start with a good allocation of resources, taxes move us away from it
- We say taxes "distort" decisions to buy and sell
- Examples
 - Tax on cigarettes discourages smoking
 - Tax on labor income discourages work
 - Tax on saving and investment income discourages both
 - In each case: good or bad?

99

Tax "distortions"

- The idea is to raise enough revenue to pay for spending with smallest distortions possible
- Tax principle #2: Apply a low rate on a broad base

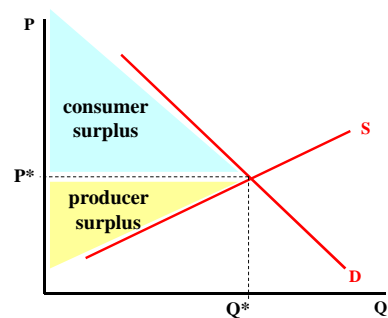
100

Tax "distortions"

- Apply low tax rate to broad tax base
- Why?
 - Taxes "distort" economic decisions
 - High tax rates distort more
- Our thought experiment
 - Tax two markets equally
 - Tax one market twice as much
 - Which is better?

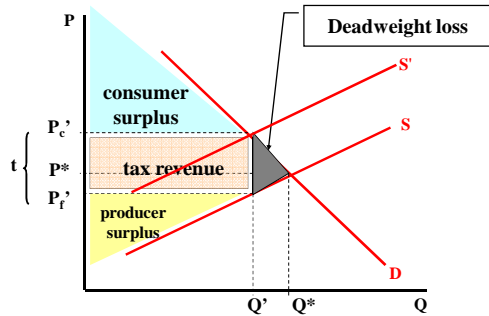
101

Welfare maximized where $S=D$



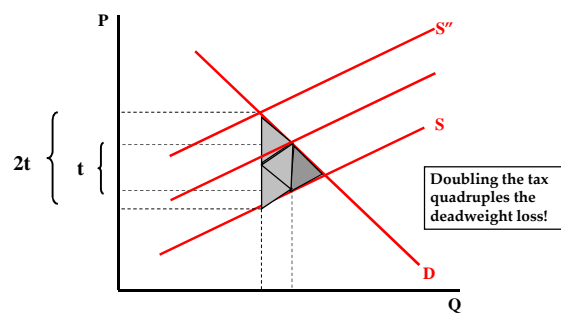
102

Tax destroys surplus



103

Large tax destroys more surplus



104

Tax distortion summary

- Summary
 - Tax at rate t generates loss of one triangle
 - Tax at rate t on two markets generates loss of two triangles
 - Tax at rate $2t$ on one market generates loss of **four** triangles
- Therefore
 - Better off taxing two markets at rate t
 - Principle #3: tax broad base (two markets) at low rate (t , not $2t$)

105

Low rate, broad base

- Should we
 - Make food and clothing exempt from tax?
 - Mortgage interest?
 - Health insurance?
 - Internet sales?
 - Legal services?
 - Education supplied by nonprofits?

106

Low rate, broad base

- “A dance is a dance,” New York Times, October 2012
 - The New York State Court of Appeals ruled last week that Nite Moves, a strip club near Albany, must pay sales tax on admissions fees it collects from customers. State law exempts from sales tax “dramatic or musical arts performances,” including “choreographic” performances. The question was whether a private lap dance or a pole dance qualifies as a “dance.”
- What’s going on here?

107

Low rate, broad base: VAT

- Why tax value added?
- Countries used to tax output at all stages
- Example: 5 stages in value chain, tax each stage on total value

108

Low rate, broad base: taxing interest

- Impact of taxing interest income
- Without taxes
 - Price now of one dollar of consumption now: 1
 - Price now of one dollar of consumption n periods from now:
$$1/(1+r)^n$$
- With taxes
 - Price now of one dollar of consumption now: 1
 - Price now of one dollar of consumption n periods from now:
$$1/[1+(1-t)r]^n$$

109

Low rate, broad base: taxing interest

- Numbers
 - $r = 0.05$ [5%]
 - $t = 0.25$ [25%]
 - $n = 20$ [20 years]
- Compare cost of future consumption
$$1/(1+r)^n = 0.38$$
$$1/[1+(1-t)r]^n = 0.48$$
- This makes future consumption more expensive
 - What does it distort? What are the consequences?

110

What have we learned?

- Countries differ a lot in government spending and taxes
- Taxes change incentives to work, save, etc
- Good tax systems
 - Generate enough revenue to cover spending [next week]
 - Simple and transparent
 - Broad base, low rate

111

Coming up

- Problem Set #4: monetary & fiscal policy
- Due in two classes (three weeks)
- First question doable now

112

For the ride home

- Has the US government issued too much debt?
- What's too much? What are the consequences?
- Have a great Thanksgiving!

113