Lesson 2: Monetary Policy (Part II)

Monetary Policy Tools

Required reserve ratio

- All banks are required to hold a certain proportion of their deposits in the form of reserves.
- Reserves are defined as "vault cash plus deposits at the Fed".
- Note that this policy tool is not used much in developed economies anymore.
- However, it is still used in many developing economies, including India and China.

The central bank's policy rate:

- The central bank's official policy rate influences short and long term interest rates and eventually has an impact on the broader economy. In the U.S., this rate is known as the discount rate.
- It is the rate at which the Fed stands ready to lend reserves to depository institutions in case their reserves fall below required levels.

The most important interest rate in the conduct of U.S. monetary policy is the Fed Funds Rate (FFR)

- It is the interest rate at which banks make overnight loans of reserves to each other.
- The Fed sets a target FFR by manipulating the quantity of reserves in the banking system through open market operations.

Generally speaking, the higher the policy rate, the higher the penalty that banks will have to pay the central bank if they run short of liquidity. This would make them more conservative in lending, reducing broad money supply.

Open market operations

- Involve the sale and purchase of government securities.
- They are conducted by the central bank to directly influence the level of reserves held by banks.

The Transmission Mechanism

If the central bank increases its official policy rate:

Important: The central bank aims to have a direct effect on inflation expectations (and asset prices and the exchange rate) by setting the official policy rate at a particular level. By resetting expectations of inflation, it hopes to eventually have a real impact on aggregate demand, which subsequently influences actual domestic inflation.

The above analysis (rather simplistically) suggests that the use of contractionary monetary policy:

- Has an impact on economic growth in the short run.
- Has an impact on the rate of inflation (or the price level) in the long run.

Monetary Policy Strategies

Inflation targeting:

- Under this strategy, the central bank makes a public commitment to achieve an explicit inflation target, and to explain how its actions will achieve that target.
- Inflation targets are specified in terms of a CPI inflation rate.
- The argument here is that inflationary expectations must be managed, and, when everyone is aware (and believes) that the central bank will move to contain inflation within an acceptable range, spending and investing decisions will be made wisely.

Exchange rate targeting:

- Many developing economies choose to target their currency's exchange rate rather than an explicit level of inflation.
- The central bank supports the target exchange rate by buying and selling the domestic currency in the foreign exchange market.
- Basically, the aim here is to "import" the inflation experience of an economy with a good track record on inflation, by tying the domestic currency to the currency of that economy.
- However, the downside is that in its efforts to maintain the exchange rate at the stated level, the central bank could lose control over domestic money supply and interest rates which can become more volatile.
- Further, if the central bank loses credibility regarding its commitment and ability to support the exchange rate, the domestic currency can come under speculative attacks and lose significant value, which can eventually lead to a full-blown crisis (e.g. Asian financial crisis of 1997-98).

Qualities of Effective Central Banks

The success of the central bank in meeting its objectives depends on its level of independence, credibility and transparency.

The central bank should be independent and not come under political pressures when formulating policy.

- There are two aspects of central bank independence:
    - Operational independence is when the central bank decides the level of interest rates.
    - Target independence is when the central bank determines the inflation rate that is targeted and the horizon over which this target is to be achieved.

The public should have confidence in the central bank i.e., it must have credibility.

- If economic agents believe that the central bank will hit its inflation target, the belief itself could become self-fulfilling.
- If economic agents do not believe that the central bank is credible, they might expect high inflation (irrespective of the target).

There should be transparency in the central bank's decision-making.

- Transparency comes from the central bank clearly explaining its views on the economy and communicating its views on various economic indicators to economic agents on a regular basis.
- Transparency is a way of building credibility for the central bank.

Finally, (if the central bank follows an inflation targeting strategy), the central bank must have a realistic, forward-looking inflation target.

- The target should be well above 0% so that the threat of deflation is minimized.
- The central bank should target future inflation, not current inflation because:
    - The monetary transmission mechanism takes time to flow through the economy.

- The current headline inflation rate reflects historical inflation (inflation over the past 12 months).

Challenges to the Effectiveness of Monetary Policy in Developing Countries

- The government bond market and interbank market are typically not sufficiently liquid or developed to facilitate the smooth conducting of monetary policy.
- The economy experiences rapid changes, which makes it difficult to identify the neutral rate.
- Rapid financial innovation results in frequently changing definitions of money supply.
- The central bank may lack credibility due to its poor historical record in controlling inflation.
- The government may be reluctant to let the central bank operate independently.

Contractionary and Expansionary Monetary Policies

When the central bank believes that the current growth rate of economic activity will lead to inflation, it will look to reduce money supply and increase interest rates. Such actions are known as contractionary measures as they are meant to rein in an overheating economy.

When the central bank believes that the current level of economic growth is too slow and inflation is weakening, it will look to increase money supply and reduce interest rates. Such actions are known as expansionary measures as they are meant to stimulate a receding economy.

The Neutral Rate of Interest

The neutral rate is the rate of interest that neither slows down, nor spurs growth in the underlying economy. When the policy rate is below (above) the neutral rate, monetary policy is expansionary (contractionary)

- Real trend of growth in the underlying economy: This corresponds to the rate of economic growth that gives rise to stable inflation in the long run.
- Long run expected inflation.

Generally speaking, central banks do communicate what they believe to be the neutral rate in the economy. However, their estimates are constantly monitored and changed to reflect evolving economic circumstances.

It is very important for the central bank to determine the source of any shock to the system before deciding on its policy response:

- If inflationary pressures build due to a demand shock (e.g. rising consumer and business confidence) the appropriate response would be to tighten monetary policy to rein in domestic demand.
- If inflationary pressures build due to a supply shock (e.g. rising oil prices) monetary tightening would take the economy further into a recession with lower consumption and higher unemployment.

Limitations of Monetary Policy

The monetary transmission mechanism is not as seamless and straightforward as it appears to be in theory. Central banks do not always have strict control over money supply:

They cannot control the amount of money that households and businesses choose to save.

While central banks can influence the ability of banks to extend loans and create credit, they cannot easily control the willingness of banks to do so.

There are risks involved with quantitative easing as the central bank pumps money into the system by purchasing risky (toxic) assets. If it accumulates too many low-quality assets, economic agents could eventually lose confidence in the central bank and fiat money.

If the central bank lacks credibility, there is a lesser chance of its "policy message" being successfully transmitted through the economy.