

CHAPTER 16

The Conduct of Monetary Policy: Strategy and Tactics

Ritsu Kitagawa

Columbia Business School

Outline

Goals and the Nominal Anchor

Inflation Targeting

The Evolution of Fed Strategy

Tactics: Choosing the Instrument and the Taylor Rule

Wrap-up

Reading and objectives

- ▶ Mishkin, *The Economics of Money, Banking, and Financial Markets*, 13th ed.
- ▶ This deck: **Chapter 16** — The Conduct of Monetary Policy: Strategy and Tactics.
- ▶ We have the institution (Ch 13), the mechanism (Ch 14), and the tools (Ch 15). The last question is the hardest: *what should the Fed try to achieve, and how should it choose its day-to-day instrument?*

Learning objectives

16.1–16.3 Nominal anchors; the six goals; hierarchical vs. dual mandates.

16.4 Weigh the pros and cons of inflation targeting.

16.5–16.6 Trace the evolution of Fed strategy and the crisis's lessons.

16.7 Debate whether central banks should respond to asset-price bubbles.

16.8–16.9 Choose a policy instrument; assess the Taylor rule.

PART 1

Goals and the Nominal Anchor

Price stability and the nominal anchor

The starting point of modern strategy: **price stability** as the overriding goal.

- ▶ A **nominal anchor** is a nominal variable — the inflation rate, the money supply — that ties down the price level and anchors expectations.
- ▶ It also disciplines the central bank against the **time-inconsistency problem**: the temptation to goose output in the short run, which markets anticipate, leaving only higher inflation and no lasting gain.

Why an anchor matters

Without a credible anchor, expansionary surprises become expected — so they stop working and just raise inflation. An anchor is how a central bank commits its future self.

Mishkin Ch. 16, Section 16.1.

The six goals of monetary policy

Price stability comes first, but central bankers cite five more:

1. **Price stability** — the primary, long-run goal.
2. **High employment and output stability** — the second half of the Fed's mandate.
3. **Economic growth.**
4. **Stability of financial markets.**
5. **Interest-rate stability.**
6. **Stability in foreign-exchange markets.**

Most of these are complementary with price stability in the long run — but they can conflict in the short run, which is what makes strategy hard.

Mishkin Ch. 16, Section 16.2.

Hierarchical vs. dual mandates

How should the goals be ranked? Two designs:

- ▶ **Hierarchical mandate** (e.g. the ECB): put price stability *first*; pursue other goals only once it is secured.
- ▶ **Dual mandate** (the Fed): two coequal objectives — **price stability and maximum employment**.

Mishkin's reconciliation

Either mandate is acceptable **provided it makes price stability the primary goal in the long run, but not the short run** — leaving room to stabilize output around a credible inflation path.

Mishkin Ch. 16, Section 16.3.

PART 2

Inflation Targeting

What inflation targeting is

A strategy built on five elements:

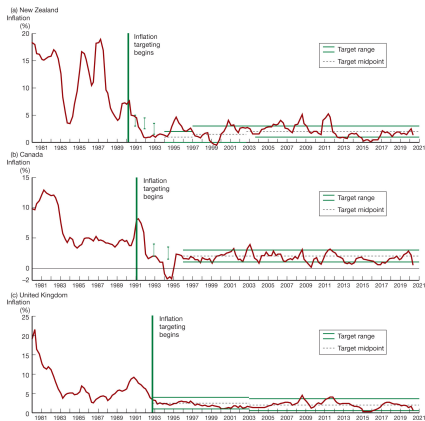
1. Public announcement of a **medium-term numerical target** for inflation.
2. Institutional **commitment** to price stability as the primary long-run goal.
3. An **information-inclusive** approach — many variables inform decisions, not one aggregate.
4. Increased **transparency**.
5. Increased **accountability**.

The pioneers

New Zealand (1990), Canada (1991), and the United Kingdom (1992) led the way — each brought inflation down and kept it near target, generally without a lasting growth penalty.

Mishkin Ch. 16, Section 16.4.

Figure 1 — Inflation and inflation targets: NZ, Canada, UK, 1980–2020



Mishkin Ch. 16, Figure 1 (Bernanke–Laubach–Mishkin–Posen; FRED). After adopting targets, inflation falls toward the band and stays there.

Inflation targeting: the scorecard

Advantages

- ▶ Reduces the time-inconsistency trap
- ▶ Easily understood by the public
- ▶ Stresses transparency and accountability
- ▶ Consistent with democratic principles
- ▶ Improved performance in practice

Disadvantages

- ▶ Delayed signaling (inflation responds slowly)
- ▶ Too much rigidity, if applied mechanically
- ▶ Potential for larger output fluctuations
- ▶ Possible low growth during disinflation

The verdict

The disadvantages largely dissolve under *flexible* inflation targeting — treating the target as a medium-term anchor, not a quarter-by-quarter straitjacket.

Mishkin Ch. 16, Section 16.4.

PART 3

The Evolution of Fed Strategy

From monetary targets to “just do it”

For decades the Fed achieved good outcomes *without* an explicit nominal anchor.

- ▶ Began announcing **money-growth targets** in 1975.
- ▶ **Volcker** (1979) shifted focus to nonborrowed reserves to break inflation.
- ▶ **Greenspan** (July 1993) declared the Fed would no longer use monetary aggregates as a guide.
- ▶ What replaced them was **forward-looking**, preemptive policy — “preemptive strikes” to stop inflation before it started.

Mishkin Ch. 16, Section 16.5.

The Fed's “just do it” approach

Advantages

- ▶ Uses many sources of information
- ▶ Forward-looking; stresses price stability
- ▶ Eases the time-inconsistency problem
- ▶ Demonstrated success

Disadvantages

- ▶ Lack of transparency
- ▶ Lack of accountability
- ▶ Inconsistent with democratic principles
- ▶ Strong dependence on the individuals in charge

The turning point

Bernanke — who had argued for inflation targeting as an academic and a governor — moved the Fed toward an explicit **2% target**, announced in 2012. In **2020** the Fed adopted **average inflation targeting**: it now aims for 2% *on average*, letting past misses shape the near-term target.

Mishkin Ch. 16, Section 16.5; “The Fed’s New Monetary Policy Strategy.”

Lessons from the global financial crisis

The 2007–09 crisis forced four revisions to monetary-policy strategy:

1. Developments in the **financial sector** affect activity far more than was realized.
2. The **zero lower bound** on interest rates can be a serious constraint.
3. The cost of **cleaning up** after a financial crisis is very high — prevention beats cure.
4. **Price and output stability do not guarantee financial stability.**

Implications for inflation targeting

Two adjustments followed: reconsider the **level** of the target (a bit higher, to buy room above the zero bound) and emphasize the **flexibility** of the framework.

Mishkin Ch. 16, Section 16.6.

Should central banks respond to bubbles?

An **asset-price bubble** is a pronounced rise in asset prices above fundamentals that eventually bursts. Two types: **credit-driven** (the dangerous kind — e.g. subprime) and **irrational-exuberance** bubbles.

- ▶ The “**Greenspan doctrine**”: do *not* use monetary policy to prick bubbles. Bubbles are nearly impossible to identify; rate hikes are an ineffective and blunt instrument; the collateral damage to the whole economy is large.
- ▶ The post-crisis counter: central banks should *not* be laissez-faire about **credit-driven** bubbles. The right first line of defense is **macroprudential policy** — regulation that targets credit markets directly — reserving interest rates as a backstop.

Mishkin Ch. 16, Section 16.7.

PART 4

Tactics: Choosing the Instrument and the Taylor Rule

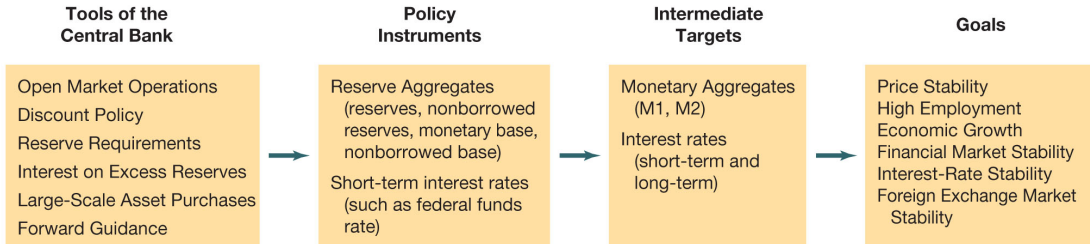
Tactics: choosing the policy instrument

Strategy sets the goal; tactics pick the lever the Fed adjusts day to day.

- ▶ **Tools** (OMOs, discount rate, reserve requirements) drive a **policy instrument** — either a *reserve aggregate* or an *interest rate* — which may be linked to an **intermediate target** and then to the goals.
- ▶ Crucial constraint: **you cannot target an aggregate and an interest rate at the same time** — pick one. Pinning the rate means letting the quantity float, and vice versa.

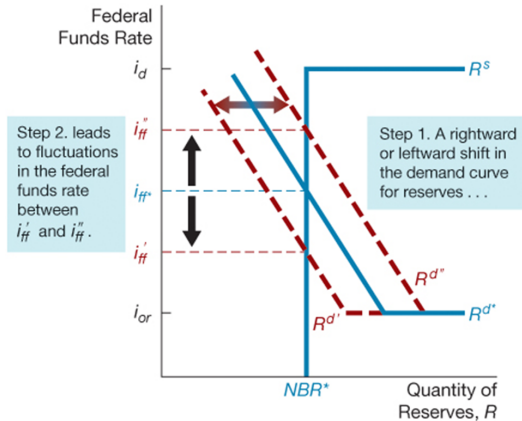
Mishkin Ch. 16, Section 16.8.

Figure 2 — Linkages: tools, instruments, intermediate targets, goals



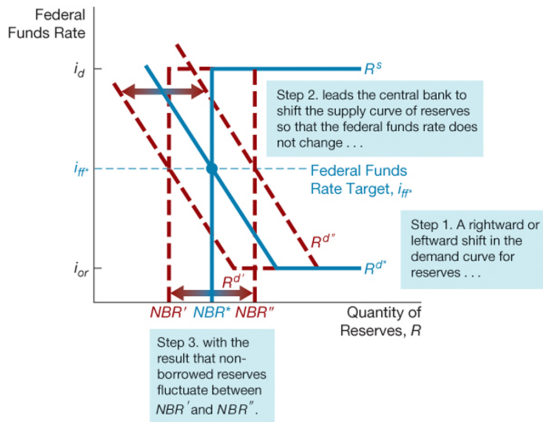
Mishkin Ch. 16, Figure 2. The causal chain from what the Fed directly controls to what it ultimately cares about.

Figure 3 — Result of targeting nonborrowed reserves



Mishkin Ch. 16, Figure 3. Fix the reserve aggregate and the funds rate must fluctuate with shifts in reserve demand.

Figure 4 — Result of targeting the federal funds rate



Mishkin Ch. 16, Figure 4. Fix the funds rate and the quantity of reserves must move instead — the unavoidable trade-off.

Criteria for a good instrument

Three tests decide which instrument to use:

1. **Observability and measurability** — can it be seen quickly and accurately? (Interest rates win over aggregates here.)
2. **Controllability** — can the Fed actually move it?
3. **Predictable effect on goals** — does moving it reliably move inflation and employment?

Why the funds rate won

The federal funds rate scores well on all three — it is observed in real time, tightly controllable, and has a reasonably predictable link to the economy. That is why it, not a reserve aggregate, is the modern instrument.

Mishkin Ch. 16, Section 16.8.

The Taylor rule

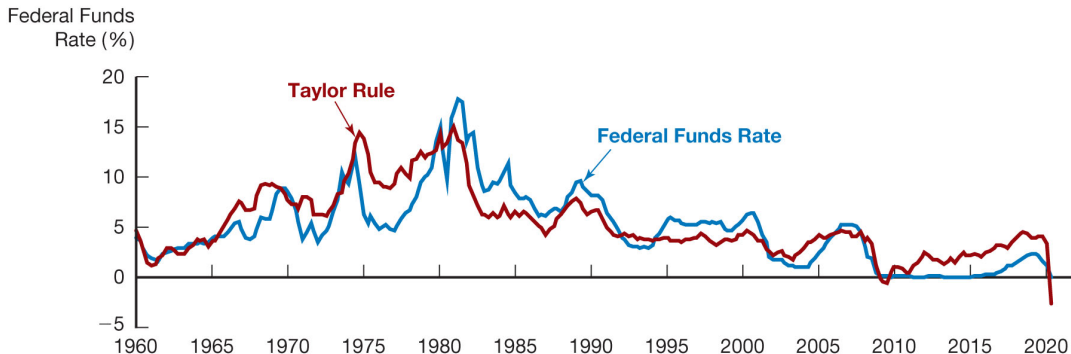
A simple formula for the funds-rate target:

$$i_{ff} = \pi + i_{ff,r}^* + \frac{1}{2}(\pi - \pi^*) + \frac{1}{2}(\text{output gap})$$

- ▶ Built from an **inflation gap** ($\pi - \pi^*$) and an **output gap** (output relative to potential).
- ▶ The output gap also forecasts future inflation, via the **Phillips curve**: when unemployment falls below the **NAIRU** (the non-accelerating-inflation rate of unemployment), inflation tends to rise.
- ▶ Stabilizing real output is therefore not a separate goal — it is part of keeping inflation on target.

Mishkin Ch. 16, Section 16.9.

Figure 5 — The Taylor rule for the federal funds rate, 1960–2020



Mishkin Ch. 16, Figure 5 (FRED). The rule tracks actual Fed policy reasonably well over decades — a useful benchmark, not autopilot.

Using the Taylor rule wisely

Guide, not autopilot

Mechanically following a Taylor rule with **fixed coefficients** is problematic — the equilibrium real rate, the output gap, and NAIRU are all uncertain and shift over time. But the rule is genuinely **useful as a guide**: a transparent benchmark against which to judge whether policy is roughly appropriate.

- ▶ It disciplines discretion without eliminating judgment.
- ▶ It makes the Fed's reaction function legible to markets — itself a contribution to the anchoring that the whole chapter is about.

Mishkin Ch. 16, Section 16.9; "The Fed's Use of the Taylor Rule."

PART 5

Wrap-up

Key terms from Chapter 16

- ▶ nominal anchor; time-inconsistency problem
- ▶ six goals of monetary policy
- ▶ hierarchical vs. dual mandate
- ▶ inflation targeting; average inflation targeting
- ▶ “just do it”; preemptive strikes
- ▶ Greenspan doctrine; macroprudential policy
- ▶ asset-price bubble; credit-driven bubble
- ▶ policy instrument; intermediate target
- ▶ observability, controllability, predictability
- ▶ Taylor rule; inflation gap; output gap
- ▶ Phillips curve; NAIRU
- ▶ zero lower bound

The one idea to take away

Strategy anchors expectations; tactics pick the instrument

A credible **nominal anchor** — today, a 2% (average) inflation target — solves the time-inconsistency problem and ties down expectations. **Tactically**, the Fed implements it through the **federal funds rate**, the instrument that best satisfies observability, controllability, and predictability, guided (not governed) by the **Taylor rule**.

- ▶ The crisis taught that price and output stability are not enough — financial stability needs its own (macroprudential) tools.
- ▶ This closes the monetary-policy block. Next: **Chapter 17** — the foreign-exchange market, where policy meets the rest of the world.