BA 311 – Money and Banking

INFLATION

- Increase in prices and decrease in real value of static savings
- Targets are set by the central banks
- What is the "right" level of inflation?
- US traditionally targets a 1-2% inflation rate to keep liquidity sufficient for economic growth
- What happens when rates are "too low" – or we see disinflation?
- What happens when inflation rates are "too high"?
- Focus of central banks is to provide stability (remember… risk = deviation from expectation). Desire to keep inflation and output stable and minimize business cycle impacts.

TAYLOR RULE

- Central banks generally apply opposite pressure to natural economic forces to moderate business cycle impacts
- Taylor Rule – Developed by Dr. John Taylor at Stanford University
- Looks at Neutral Real Interest Rate (rate where output equals potential output), the output gap (the difference between actual and potential economic output), the difference between targeted inflation and actual inflation, and coefficients that look at a regression to determine how a change in one variable impacts another.
- Criticized that it may not work at extremes

TAYLOR'S RULE (THE EQUATION)

i = r* + pi + 0.5 (pi-pi*) + 0.5 (y-y*)

Where:

i = nominal fed funds rate

r* = real federal funds rate (usually 2%)

pi = rate of inflation

p* = target inflation rate

Y = logarithm of real output

y* = logarithm of potential output

Read more: [Taylor's Rule](http://www.investopedia.com/terms/t/taylorsrule.asp#ixzz4gJrSvWAh) http://www.investopedia.com/terms/t/taylorsrule.asp#ixzz4gJrSvWAh
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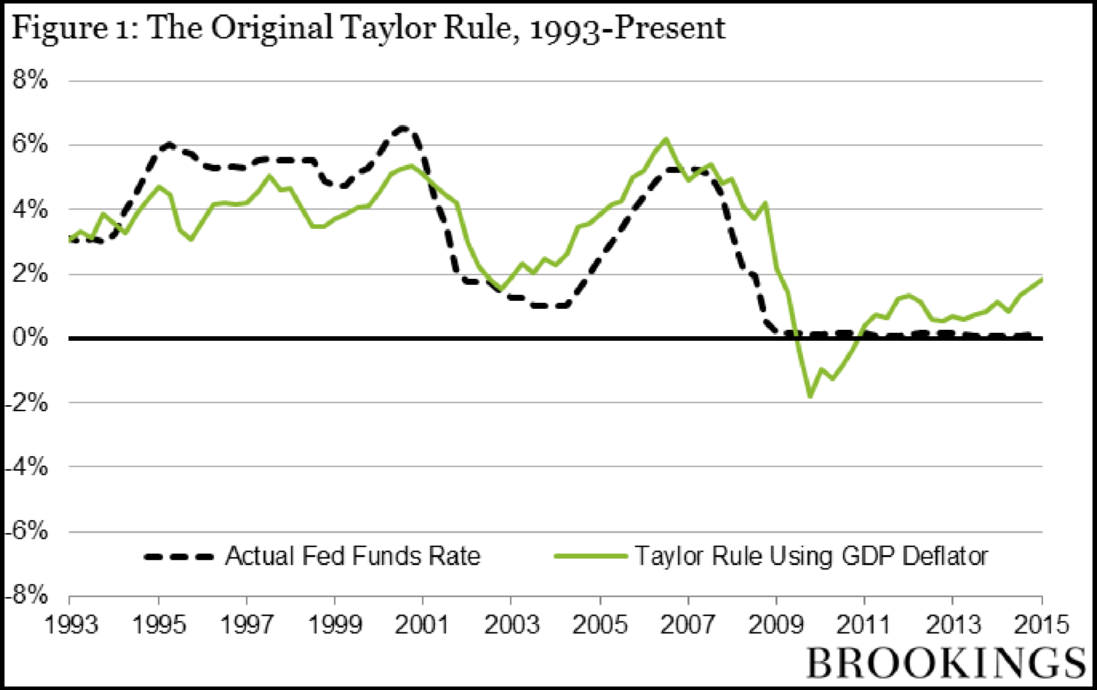
HISTORY OF THE TAYLOR RULE IN PRACTICE



CHALLENGES TO USE

- Looks at historical data, but economy is operating real time and prospectively
- Finding proper coefficients is difficult (ex: real inflation rate, real capacity for output gap) because they are estimated
- Bad data leads to bad results (GIGO)
- Policy pressure may make “overreaction” or “underreaction” desireable

FOMC

- FOMC meet every 6 weeks and analyze the information available and set rate targets.
- Three economic tools used by FOMC – Teal, Red & Beige Books
- Teal Book – confidential – "Report to the FOMC on Economic Conditions and Monetary Policy"
- Red Book – confidential - Summary of Commentary on Current Economic Conditions by Federal Reserve District – Contains Company Names
- Beige Book – Public – Red Book, redacted
- https://www.federalreserve.gov/monetarypolicy/beigebook201701.htm

STRUCTURE CHALLENGES - TIME CONSISTENCY

- Time Consistency – central bank claims to work to maintain low inflation, but is pressured into expansionist policy to raise inflation later.
- Public refuses to believe central bank, and acts as if high inflation is the norm, blunting expansionary effects and creating inflation trap.
- How to combat this?
- Ideology of appointees
- Public pressure
- Independence
- Rules or Guidelines for policy implementation

STRUCTURE CHALLENGES - CENTRAL BANK INDEPENDENCE

- Fed is independent from Congress and President – elected officials can't control the policies. Is that good? Why?
- Argue that it is undemocratic – the "people" can't control the Fed (quickly at any rate). Pros and cons?
- Research shows that independence leads to more stability and lower inflation (generally)

MONETARY POLICY RULES

- Can be either discretionary policy or rule based policy. What does that mean?
- Monetary policy rules provide increased predictability in policy – but what happens in reality?
- As banking became more complex, monetary targets became harder to manage – money demand is unstable.
- Focused on "fixed growth" of the money supply.
- Money supply targets were the focus in the 1960-1990 era for many economists. Shift of focus to inflation targeting more recently.

INFLATION TARGETS

- Fed targets interest rates and adjusts the money supply to achieve a certain inflation rate level
- Rate target is generally transparent
- Inflation targeting may cause volatility in output stability.
- ECB uses hybrid method
- ECB, Fed, other central banks communicate on inflation targets and policy. Why?
- Inflation impacts exchange rates. How?

THE BEST ECONOMIST EVER (IMHO)