**What caused the shift to rule based price stabilization policy?**

The failure of fiscal accommodation policy

* Lags, timing
* Leakages, openness, small multipliers
* Crowding out
* Constraints, large public debts
* Ricardian equivalence

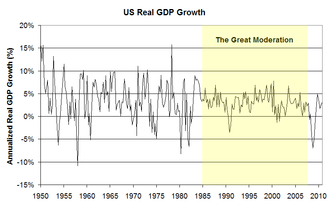
Breakdown of the Bretton Woods system

* Floating exchange rates
* Limited effectiveness of fiscal policy

The policy shift in large economies

* (Germany)
* GB: Thatcher 79-
* USA: Reagan 81-
* France: Mitterrand (81) 82-

**“The great moderation”**



**Developments in economic theory**

Inflationary expectations and the vertical Phillips curve

Rational policy expectations and the failure of systematic discretionary policy

Time consistency and the policy credibility problem

Public choice and the political business cycle

Supply elasticity and supply sidepolicies

**Fundamental insights behind rule-based monetary policy**

* Inflation is a monetary phenomenon

Central bankers responsible

* Inflation is harmful

Inefficient payment system

Relative price uncertainty

Tax distortions amplified

Redistribution of wealth

* The long run Phillips curve is vertical

No long run trade-off

* Expectations are crucial

Inflation expectations

Policy expectations

* The Taylor rule

Higher *real* interest rates to combat infl.

it = it-1 + λ1(πe – π\*) + λ2(y – y\*), λ1 > 1

* The time consistency problem

Temptation to exploit SR Phillips curve

+ Rational policy expectations

= Need for a commitment mechanism

→ Central bank independence

**Rule-based monetary policy**

Intermediate targets

* Exchange rate targeting

Fixed

Adjustable

Crawling peg

* Money supply targeting

Floating exchange rate

Money supply definitions

Stability of velocity

Inflation targeting

Price level or inflation?

The inflation level

The tolerance interval

The time horizon

A numerical target?

Credibility and institutions

**Institutions and procedures for rule-based monetary policy**

* Operational independence of CB

Solution to time consistency problem

* Lender of last resort function

Systemic financial stability

* Operational inflation target

Transparency, accountability

* Publication of inflation forecast

Openness, credibility

* Publication of repo rate forecast

Transparency, consistency

* Publication of minutes

Openness, accountability

* Publication of voting records

Openness, accountability

**Why monetary policy is also an art**

**(Mishkin)**

* There are no perfect macroeconometric models
* Macroeconomic relationships are not stable over time
* No models make use of all valuable information
* Important information can be anecdotal rather than quantifiable
* Managing expectations requires skilful communication

For these reasons monetary policy should always be based on good economic judgement as well as stringent scientific analysis

**Financial bubbles and monetary policy**

* Many examples of bubbels

The Great Depression of ‘29

The crash of ‘87

The Japanese real estate bubble of ‘91

The South East Asia crash of ‘97

The IT bubble of ‘00

The US subprime crisis of ‘07

The ongoing euro crisis since ‘08

* Reasons to be concerned

Threat to financial stability

Cause of real economic fluctuations

Threat to price stability

* Policy response

Reactive policy (after bubble)

Uncertainty about fundamentals

Transparency w.r.t. targeting

Uncertainty about appropriate policy

Preventive policy

Good models for fundamentals

Trade-off between targets

Prevention better than cure

**Financial stability and monetary policy**

* Price stability ≠ Financial stability
* Financial instability can make price stability more difficult to achieve
* Consequences for monetary policy: three views
* Modified Jackson Hole consensus: separation of duties
* Leaning against the wind vindicated: financial stability secondary objective
* Financial stability = price stability:

No separation of duties

* Three questions:
* Effectiveness of macroprudential policy
* Effectiveness of monetary policy
* Risks for price stability