

Economic Environment and Business Strategy
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Monetary Policy Strategies

Hello, everyone. Welcome to this session on monetary policy strategies. In our earlier discussions, we examined how central banks influence the economy through their monetary policy tools. Today, we shift our focus to the strategic choices that guide the implementation of monetary policy in practice. At the heart of this discussion is a critical question. Should a central bank focus on controlling the money supply or on stabilizing interest rates? Over time, different strategies have emerged, each with its own rationale and trade-offs. One is monetary targeting, also known as money supply targeting; another is monetary aggregate targeting.

This approach emphasizes controlling the growth of the money supply to influence inflation and economic activity. It was more pronounced in the 1970s and 1980s, particularly when central banks sought to curb high inflation. The second approach is interest rate targeting. Instead of focusing on the money supply, central banks may target short-term interest rates directly.

This strategy provides more predictable conditions for financial markets and the broader economy, but it relies heavily on stable money demand. It also includes implicit targeting and inflation targeting. In recent decades, many central banks have adopted strategies that anchor expectations, often through explicit or implicit inflation targets. This reflects a growing understanding that shaping public expectations is as important as the immediate policy instrument. In this session, we will examine the advantages and disadvantages of these competing strategies, their historical significance, and how central banks determine which approach best suits their economic context.

Here, we'll also touch on the growing adoption of inflation targeting as a framework that balances credibility with flexibility. In short, by the end of this session, I hope you will have a clearer understanding of how central banks design their strategies, why they sometimes shift from one approach to another, and how these choices influence financial markets and the real economy. To summarize the strategies, there are competing approaches: one involves targeting a monetary aggregate, such as the money supply (M3), while the other targets the interest rate directly. The first is called monetary targeting, which focuses on the money supply, for example, the monetary aggregates like

M3. The second approach is interest rate targeting, which directly targets the interest rate, particularly the short-term interest rate, such as the Fed funds rate in the US and the repo rate in India.

Then, implicit anchoring, rather than focusing on monetary or interest rate targeting, may be based on the current situation. In this situation, implicit anchoring may be employed, perhaps using inflation targeting or any other relevant monetary variable at that time. Regarding the first one, it involves targeting monetary aggregates. You recall the ultimate targets because, although we use targets such as monetary aggregate targeting and interest rate targeting, the ultimate targets in any economy are the unemployment rate, the inflation rate, and economic growth, which is measured by growth in real GDP. The ultimate targets that the monetary authority would like to control are macroeconomic goal variables, which I have already listed here. However, to attain this ultimate target, the monetary authority uses intermediate targets, one of which is the monetary aggregate, such as the M3 money supply. Simply put, an intermediate target is a variable that a central bank controls, not because the variable is inherently important, but because by controlling it, policymakers believe they are influencing the ultimate policy targets in a predictable manner, such as the inflation rate, economic growth, or the unemployment rate.

the success depends on the exact relationship between the money supply and the goal variable, the intermediate target, and the ultimate targets. Here we can discuss the mechanism of how it works. Here, we can recall some of our discussions from the financial market, specifically the bond market. Suppose we have observed that when the money supply increases, the central bank injects more money into the economy. Then, the expected transmission mechanism is such that it creates portfolio disequilibrium, indicating that there is an excess of money. More money with the public means there will be a portfolio disequilibrium, which means they will be investing, because when they have more money, the demand for bond prices increases.

When bond prices rise, you know that the interest rate will be declining. This means changes in the money supply will create portfolio disequilibrium and, in turn, affect the interest rate through the bond market. In the second stage, when the interest rate changes, for instance, declines, you can see that the cost of borrowing for firms declines. Not only that, but there will also be more money in the public's hands because they will make more demand for durable items, such as vehicles and other durable goods, leading to increased demand. This will make economic conditions more optimistic because the cost of borrowing is low for firms, and there is more liquidity in the public; as a result, their demand will increase.

As a result, there will be an increase in investment by firms. Investment by firms means they will be buying and expanding their production facilities, purchasing more machines

and tools, which creates additional demand for our capital goods. Then, you know, there will be more investment. When production capacity increases as firms expand their operations, it will also increase GDP. That is the reason GDP increases. When GDP increases, employment also increases, and the income of the public and factors of production also increases.

That means economic growth takes place. This is one target; the second is industry targeting. Interest rate targeting is the current strategy employed by the Federal Reserve and the central banks of other major industrialized economies. The Fed Funds rate is the target interest rate. You know that we discussed it in the last session.

The FFR determination in the US is part of the interstate targeting. And in India, you know that the repo rate is also a part of interstate targeting. Using monetary policy tools such as open market operations, the discount window, and the required reserve ratio, central banks determine and influence the country's interest rate. And once these interest rates are determined, using the theorem that the term structure and risk structure of interest rates, you can see that this interest rate will be related to other interest rates. Theoretically, a relationship exists, so the important thing is that keeping the fed funds rate at the target level might require large open market purchases or sales, and therefore a significant change in the money supply.

A focus on the interest rate is, in fact, an alternative to targeting a monetary aggregate. The Fed cannot, in general, do both; therefore, it cannot target a monetary aggregate and the interest rate simultaneously. You can focus on either the money supply, which is a monetary aggregate, or the interest rate. The second point is that short-term interest rates can be observed contemporaneously and closely controlled. The open market does not just look at the computer screen and see the current fed fund rate; therefore, FFR is a short-term operating target, but the money supply is observed only with a lag of a week or two and then only with error.

If the money supply is a target, some other variable that is more frequently observable, such as the level of the bank rate, must serve as an operating target. Interest rate targeting focuses on short-term interest rates, such as the Fed Funds rate in the US and the repo rate in India. Long-term interest rates can also be observed contemporaneously, but they cannot be closely controlled by central banks. In addition to monetary aggregate targeting and interest rate targeting, there is implicit targeting. From the 1980s until Ben Bernanke became the chair of the Federal Reserve in 2006, the Federal Reserve achieved excellent macroeconomic performance, including low and stable inflation, without using an explicit nominal anchor such as an inflation target. Although the Federal Reserve didn't articulate an explicit strategy stating that this much inflation is our target, a coherent strategy for the conduct of monetary policy existed. This strategy involved an implicit, rather than an explicit, nominal anchor in the form of an overriding concern on the part of

the Federal Reserve to control inflation in the long term. Additionally, it involved forward-looking behavior that included careful monitoring for signs of future inflation, using a wide range of information, coupled with periodic pre-M2 strikes by monetary policy against the threat of inflation. In India, we are initially focusing more on inflation targeting.

Since 2016, we have been following inflation targeting by adjusting interest rate targets. This means that, by using the interest rate target, we focus on the interest rate rather than the money supply or monetary aggregate target. We primarily focus on the final goal because the intermediate goal is now interest rate targeting. Our goal is inflation targeting, but at the same time, there are other key objectives, including GDP, the employment rate, and the foreign exchange rate. All these come into play, but to attain everything, the focus will be on inflation. The 2009 report of the Committee on Financial Sector Reforms highlighted the importance of focusing on inflation. Since the expert committee was set up in 2030 to review the objectives and conduct of monetary policy in a globalized and highly interconnected environment.

The committee reviewed the organizational structure, operating framework, and instruments, as well as monetary policy and liquidity management frameworks, to ensure compatibility with macroeconomic and financial stability, as well as market development. Finally, the committee recommended an inflation target of 4 percent, with a band of plus or minus 2 percent around it. In that way, the lowest target level is 2 percent, and the upper limit is 6 percent. The tolerance band was formulated considering the vulnerability of the Indian economy to external supply shocks and the relatively large weight of food in the CPI basket. The expert committee recommended that inflation be the nominal anchor.

This is the key point here. Another key point is that inflation serves as the nominal anchor of India's monetary policy framework. Flexible inflation targeting acknowledges the growth-inflation trade-offs in the short term, and stabilizing and anchoring inflation expectations is crucial for ensuring price stability on a sustained basis. I'm now showing you the monetary policy linkages, monetary targeting in India, and the operational framework from 1985 to 1998. After that, I will show you the reason framework, the framework that we have been adopting. As you can see, on the left-hand side, these are the instruments.

With this instrument, you are now more familiar with CRR (the required reserve ratio), open market operations, and lending to banks. Foreign exchange operations refer to the net foreign exchange purchased by the RBI. The operating target was the reserve aggregates, mainly the monetary base (M0), and the intermediate target was the monetary aggregates. The monetary aggregate is the M3 money supply. From 1985 to 1998, our focus on the intermediate target was the money supply, or monetary aggregates, in short, M3. The goals you are now familiar with are price stability, economic growth, financial

stability, and stability in the foreign exchange market. Economic growth also means employment; when economic growth occurs, employment growth is understood to occur simultaneously. I have taken this from this author; you can obtain the full text by searching for it.

Since 2016, there has been a structural change in our monetary policy framework. The linkages are now evident in the instruments; the policy rate, or repo rate, is the primary instrument and is often referred to simply as the policy rate, rather than the repo rate. Sometimes, people use the term 'policy rate' to refer to liquidity facilities. That came into existence, as we covered in the previous slides: reserve requirements. Now you are familiar with open market operations, lending to banks, the rate, and foreign exchange operations.

These are the instruments, and the short-term interest rate is the operating target. The short-term interest rate is the repo rate, which serves as the intermediate target, as illustrated in the previous diagram. We have seen that the monetary aggregate is the intermediate target, but since 2016, the interest rate has become the intermediate target. The ultimate targets remain the same: price stability, economic growth, financial stability, and stability in the foreign exchange market. As you can see, monetary policy has evolved over time, with changes to both the instruments and the intermediate targets.

Let's now review some recent developments. Inflation targeting has become a primary strategy in monetary policy. Regarding the ultimate targets, you can see that these are the ultimate targets. Now, countries across the globe have begun to focus primarily on price stability, and a trade-off between price inflation and economic growth is often evident. Suppose the central bank expands the money supply; there will be a decline in interest rates, which will promote economic growth. However, at the same time, the increase in the money supply will lead to inflation.

One is inflation targeting, which has grown in interest recently. The theoretical expectation is that it would reduce the effect of political pressures on central banks, as central banks are given a specific mandate. For example, in India, the inflation target is 4 percent plus or minus 2 percent. Therefore, the central government theoretically shouldn't intervene here if the central bank is fulfilling its inflation target of four percent, plus or minus two. Thus, in general, the move to inflation targeting coincides with a grant of greater independence to central banks. So, central bank independent control of its policy instruments and a clear mandate to target inflation greatly limit the government's ability to manipulate monetary policy for political purposes. Another pragmatic motivation for the move to inflation targeting in several countries was that they experienced problems similar to those the United States faced with monetary aggregates as intermediate targets.

It involves inflation targeting, which includes several elements; one is the public announcement of medium-term numerical objectives for inflation. For example, in India, the current medium-term target is 4 percent, plus or minus 2; this is the public announcement. An institutional commitment to price stability as the primary and long-term goal of monetary policy, along with a commitment to achieve the inflation target, should ensure that the central bank's main focus is on preventing any instability in inflation while remaining within the limits of this inflation targeting. So that is an institutional commitment to price stability. An information-inclusive approach in which many variables, not just monetary aggregates, are used in making decisions about monetary policy.

Increased transparency in inflation-targeting monetary policy, through communication with the public and markets about policymakers' plans and objectives, will help businesses and firms better plan their financial portfolios and make investment decisions. Furthermore, it enhances the central bank's accountability in attaining its inflation objectives. I will now list the key advantages of inflation targeting. One is that there will be a time inconsistency problem. The time inconsistency problem arises when a future policy plan is no longer optimal later, even after new information has arrived in the meantime. Here, when policymakers or the central bank clearly defend the inflation target they want to achieve, it reduces time inconsistency.

Second, as I already mentioned, increasing transparency is an advantage of inflation targeting, as it is readily understood by the public and thus highly transparent. This also increases the accountability of the central bank, and communication goes hand in hand with increased accountability. It is consistent with democratic principles because accountability is valuable and it enhances the institutional framework for conducting monetary policy, making it more consistent with democratic principles. Because the central bank is not made up of elected members of the public, it is an allied group, so the inflation-targeting framework promotes the accountability of the central bank to elected officials, that is, to the government and people's representatives who are given some responsibility for setting the goals of monetary policy and then monitoring the economic outcomes. Overall, there will be improved performance, and inflation-targeting countries appear to have significantly reduced both the rate of inflation and inflation expectations.

This has implications for the efficient functioning of the macroeconomy, including markets such as the labor and product markets. However, there are some disadvantages. One is a delayed signal, which means inflation is not easily controlled by monetary authorities alone. For example, if production increases, resulting in more goods and services, supply rises and prices decline.

You are familiar with the demand and supply framework you are using. Similarly, a supply shock will lead to inflation. Simply put, the main point here is that inflation is not

only controlled by monetary authorities alone but is also influenced by other economic factors. Additionally, there is a delayed signaling problem due to the long lags in the effects of monetary policy. Inflation outcomes are revealed only after a substantial lag.

There is too much rigidity. Some economists criticize inflation targeting because they believe it imposes a rigid rule on monetary policymakers, limiting their ability to respond to unforeseen circumstances. For example, in India, if 4% is added or subtracted, the central bank's mandate is always to maintain this. If they have to respond to unforeseen circumstances and may need to engage in some firefighting, this framework sometimes constrains them from doing so.

There can be increased fluctuations in output, and this is another criticism. It can also affect economic growth. If the focus is mainly on inflation targeting, when the economy is in crisis, the interest rate may need to be reduced to the lowest level, which can allow inflation to rise above six percent. Alternatively, if the money supply is increased significantly, the interest rate will drop to its lowest level, which will revive the economy. Because the cost of borrowing will decline for producers, firms, and consumers, credit and money will remain available, and in this way, the economy will revive. However, the cost will be inflation. If there is an inflation-targeting framework with limits, central banks cannot increase the money supply to reduce the interest rate, which will hamper economic growth.

Let me also share some insights into my recent international experience. New Zealand is the champion of inflation targeting. Inflation targeting was initiated in 1989 to maintain price stability. The framework includes mandates that require the Minister of Finance and the Governor of the Reserve Bank of New Zealand to agree on monetary policy targets aimed at achieving price stability. For much of the 1990s, price stability was defined as an inflation rate within a range of 0.2%. In 1997, this definition was slightly loosened to a range of 0.03%. As I already said, New Zealand was the champion. Inflation was brought down and remained within the target for most of the time. Economic growth has been generally high, and the unemployment rate has decreased significantly.

Canada introduced this policy in 1991, and the United Kingdom followed in 1992. In India, as you are aware, we introduced inflation targeting in 2016. I'll show you how inflation has moved before and after inflation targeting, so you can see, for example, the case of New Zealand. This is the inflation-targeting year, and before and after, you can see here in this area that there is a huge fluctuation in inflation. However, afterwards, in this period, you can see that the fluctuation is very low. Similarly, here as well, there are very high fluctuations; however, after they adopted inflation targeting, as shown in this figure, there is stability in inflation.

In this session, we discussed monetary policy strategies, primarily focusing on monetary aggregates targeting, interest rate targeting, and the nominal anchor as an intermediate target. We then discussed inflation targeting as the ultimate goal and examined some of its advantages and disadvantages. Thank you for watching this session. We look forward to seeing you at the next one. Thank you.