

Modern Monetary Policy in Practice: Principles, Challenges and Prospects

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Modern Central Banking: Challenges and Prospects
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Modern monetary policy practice

- ▶ Implementing inflation targeting in practice.
- ▶ Policy objectives and their interpretation.
- ▶ Governance/institutional framework.



The primary operational objective: Price stability

- ▶ Monetary stability.
- ▶ Stability of the purchasing power of the currency.
- ▶ Stability of the national currency.



Price Stability: A Definition

A workable definition of reasonable “price stability” would seem to me to be a situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behavior. Stated more positively, “stability” would imply that decisionmaking should be able to proceed on the basis that “real” and “nominal” values are substantially the same over the planning horizon—and that planning horizons should be suitably long.

(Paul Volcker, 1983)



Towards an inflation target: Bernanke's OLIR

“The OLIR is the long-run (or steady-state) inflation rate that achieves the best average economic performance over time with respect to both the inflation and output objectives.”

“... the OLIR should have long-run credibility, that is, it should be the best (lowest-forecast-error) answer to the question: ‘What do you expect the average inflation rate in the United States to be over the ten-year period that begins (say) three years from now?’ ”

(Ben Bernanke, 2003)

<https://www.federalreserve.gov/boarddocs/speeches/2003/20031017/default.htm>



The statutory mandate and inflation targeting: Two examples

Banco de Mexico

The purpose of Banco de Mexico shall be the provision of national currency to the Mexican economy. In pursuing this purpose, its main objective shall be to procure the **stability of the purchasing power of said currency**. ...

(Banco de Mexico Law, Article 2)

Banco Central de Reserva del Peru

The purpose of the Bank is to preserve **monetary stability**. Its functions are to regulate the money supply, administer the international reserves, issue notes and coins and report on the nation's finances.

(BCRP Organic Law, Article 2)



Inflation targeting practice: Two examples

Banco de Mexico

The main objective of Banco de México is to maintain a low and stable inflation. In 2003, Banco de Mexico's Governing Board established the annual variation of the Consumer Price Index (CPI) of **3% as the permanent inflation target**.

Banco Central de Reserva del Peru

The Bank's monetary policy is designed to fulfill its mandate through the implementation of an inflation targeting scheme. The **inflation target, which ranges from 1 to 3 percent**, aims to stabilize inflation expectations at a level comparable to those of advanced countries and to build a lasting commitment to monetary stability.

(BCRP Inflation Report, December 2023.)



Governance/institutional framework

- ▶ Central Bank independence with a price stability mandate.
- ▶ Building and maintaining credibility: Transparency and accountability.
- ▶ Fiscal-monetary interactions and the prohibition of monetary financing.



Fiscal-monetary interactions

“Almost every action the central bank undertakes has fiscal consequences.”

(Stanley Fischer, 2010.)



Why is the prohibition of monetary financing essential?

“It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it; and that, on any occasion when it was pressed for money to carry on a war, it would cease to pay coin, on demand, for its notes; and from that moment the currency would become a forced Government paper. There would, I confess, be great dangers of this, if Government—that is to say, the Ministers—were themselves to be entrusted with the power of issuing paper money” (Ricardo, 1824).



Challenges and Prospects

- ▶ The importance of well-anchored inflation expectations.
- ▶ Nominal and inflation-protected government bond markets.
- ▶ Monitoring inflation expectations through surveys and financial markets.
- ▶ The simplicity of inflation targeting practice.

