

THE MONETARY POLICY CONSENSUS

An exploration of how central banks achieved the Great Moderation through inflation targeting and interest rate policy.

COURSE STRUCTURE

TODAY'S JOURNEY

01

THE MONETARY POLICY CONSENSUS

Understanding the theoretical foundations

02

POLICY IMPLICATIONS

How theory shapes central bank practice

03

STRATEGIES FOR LOW INFLATION

Monetary targeting, fixed exchange rates, and inflation targeting

04

UK IMPLEMENTATION

Bank of England's approach since 1997

CHAPTER 1

INTRODUCTION: THE GREAT MODERATION

> *"No more boom and bust"*
>
> — Gordon Brown, circa 2005

The period from the early 1990s to 2007 saw developed economies enjoy both low inflation and stable GDP growth.



UK ECONOMIC PERFORMANCE

The Great Moderation delivered unprecedented stability in inflation and growth rates.

Real GDP and inflation both stabilised after the early 1990s recession, demonstrating the effectiveness of the new monetary policy framework.





THE GLOBAL PICTURE

ADVANCED ECONOMIES

Eliminated business cycles through sophisticated monetary policy. Central banks credited with achieving macroeconomic stability.

EMERGING MARKETS

Continued periodic crises: Mexico (1994), East Asia (1997), Russia, Turkey, and Argentina (late 1990s).

A UNIFIED FRAMEWORK

The monetary policy consensus united Keynesians and monetarists for the first time on central bank practice.

AGREEMENT ON MONETARY POLICY

Both schools accepted that central banks should focus on price stability through inflation targeting.

CONTINUED DEBATES

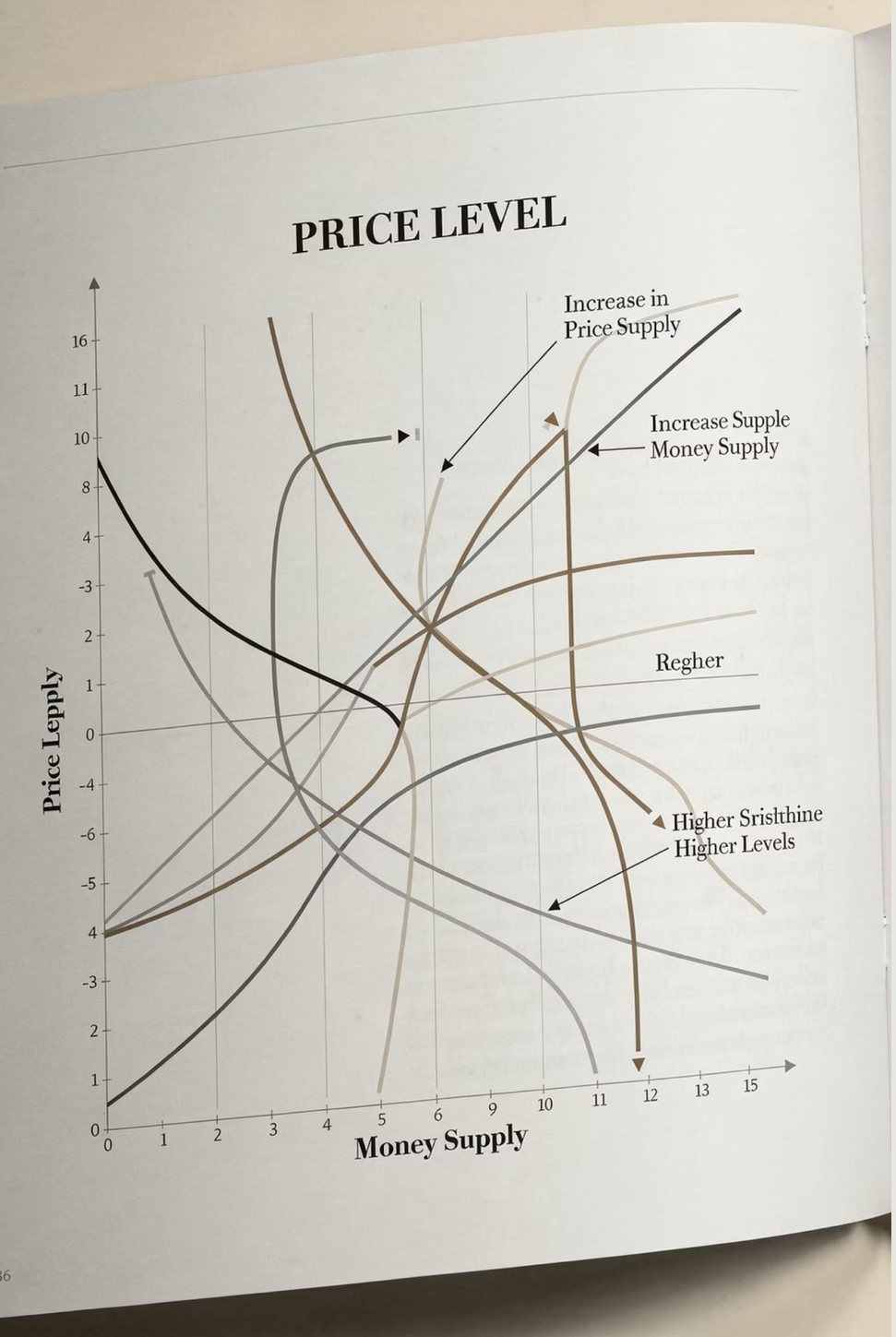
Disagreements remained on government size, fiscal policy, welfare spending, and inequality's role in growth.

CHAPTER 2

THE POLICY CONSENSUS

Five key principles emerged from decades of macroeconomic research and policy experience.





PRINCIPLE 1: LONG-RUN NEUTRALITY

FRIEDMAN'S INSIGHT

In the long run, changes in the money supply affect primarily nominal variables, particularly prices, rather than real economic activity.

PRINCIPLE 2: SHORT-RUN EFFECTS

Money can temporarily affect real variables under specific conditions:

UNEXPECTED INNOVATIONS

Random government actions (Lucas) or deliberate attempts to fool the public (Kydland-Prescott) can create temporary real effects.

NOMINAL RIGIDITIES

New Keynesian economists emphasise sticky prices and wages as channels for short-run monetary influence.



PRINCIPLE 3: POLICY TRADE-OFFS

SHORT-RUN TEMPTATION

Create surprise inflation before elections to stimulate an artificial boom.

LONG-RUN GOAL

Use monetary policy to keep inflation low and predictable.

This conflict between short and long-run objectives creates the time inconsistency problem.



THE CREDIBILITY PROBLEM

1

SOFT CENTRAL BANK

Uses monetary policy for short-run goals, creating reputation for pro-inflationary stance.

2

LOSS OF CREDIBILITY

Attempts to disinflate not believed by public, causing unnecessary recessions.

THE SOLUTION: TOUGHNESS

BUILD REPUTATION

Focus consistently on keeping inflation low creates reputation for toughness.

LOWER CREDIBLE INFLATION

A tough reputation helps keep the credible inflation rate low without causing recessions.

CHAPTER 3

IMPLICATIONS FOR MONETARY POLICY

1

PRICE STABILITY FOCUS

A central bank's main role should be ensuring price stability.

2

POLITICAL INDEPENDENCE

Central banks should be independent of political control (UK: post-1997).

3

CONSERVATIVE LEADERSHIP

Monetary conservatives should run central banks.

4

TRANSPARENCY

Deviations from low inflation strategy must be transparent and publicly accountable.

CHAPTER 4

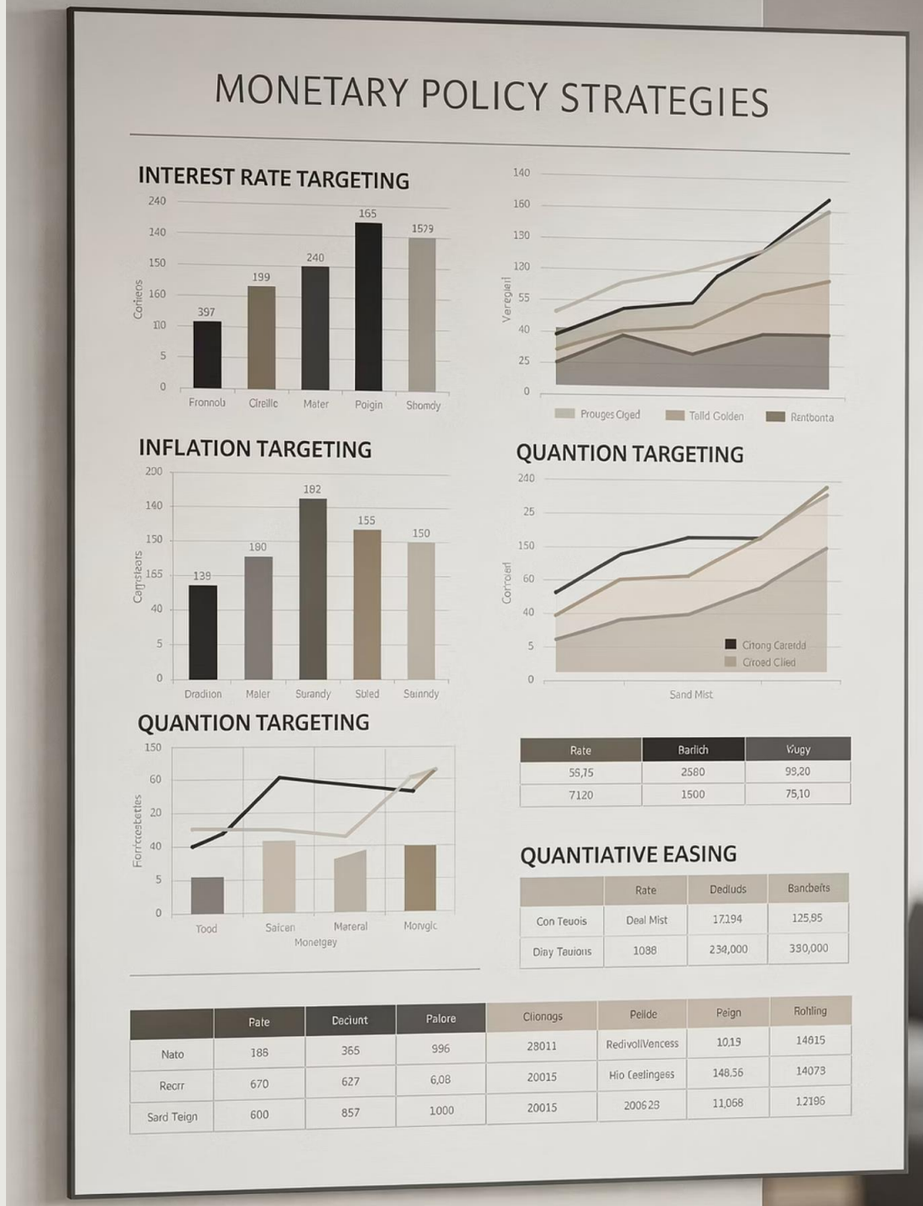
STRATEGIES FOR LOW INFLATION

Three main approaches emerged for achieving price stability:

MONETARY TARGETING

FIXED EXCHANGE RATE

INFLATION TARGETING



STRATEGY A

MONETARY TARGETING

Used historically by Germany and in the 1960s-70s by the US, UK, and Canada, consistent with Friedman's k-percent rule.



THEORETICAL FOUNDATION

From the Quantity Theory of Money: inflation equals money growth minus real GDP growth.



EXPECTATIONS ANCHOR

Predictable money supply provides anchor for inflation expectations, reducing uncertainty and stimulating the economy.



PROBLEMS WITH MONETARY TARGETING

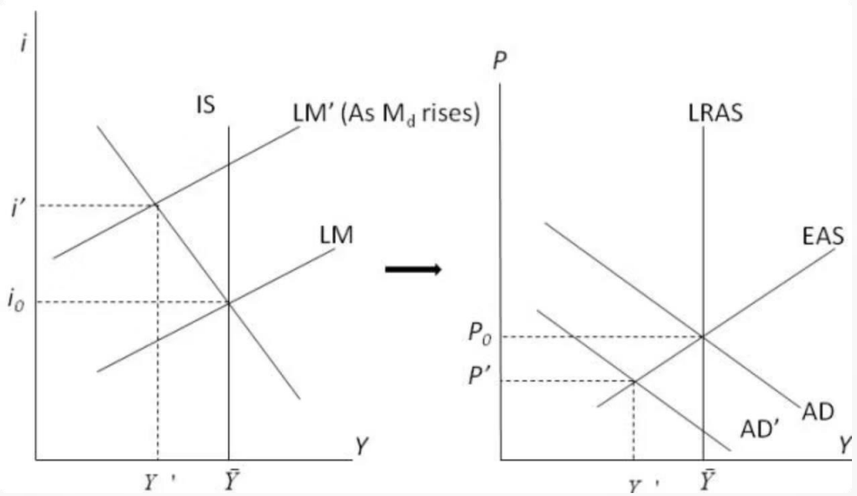
PROBLEM 1: DEFINING MONEY

Difficult to pick appropriate measure (M0, M1, M2). Central bank control over higher-order measures is imperfect, undermining credibility.

PROBLEM 2: UNSTABLE MONEY DEMAND

Theory assumes stable money demand function. In practice, money demand is unstable, making velocity unpredictable and invalidating the QTM equation.

EFFECTS OF MONEY DEMAND SHOCKS



Unstable money demand causes excessive fluctuation in aggregate demand, prices, and real quantities.

A positive shock to money demand shifts LM rightward, causing AD to shift right, leading to higher prices and output volatility.

STRATEGY B

FIXING THE EXCHANGE RATE

Examples: ERM, Argentina, Hong Kong

THEORY

$$\frac{\Delta e}{e} = \pi_{\text{Arg}} - \pi_{\text{US}}$$

Commitment to stable *e* implies

\pi_{\text{Arg}} = \pi_{\text{US}}

PRACTICE

Central bank buys and sells anchor currency as needed. Money supply becomes endogenous, signalling commitment to low inflation.

PROBLEMS WITH FIXED EXCHANGE RATES

COMMUNICATION PROBLEM

Not an obvious way to communicate price stability commitment. Public may not understand the underlying connection.

BALANCE OF PAYMENTS ISSUES

Overvalued rates cause reserve losses; undervalued rates force reserve accumulation (e.g., China). Ongoing problems may force abandonment.

RECESSION CONFLICTS

Severe recessions may force government to divert monetary policy towards domestic goals, abandoning the fixed rate.



THE SPECULATIVE ATTACK PROBLEM

The main problem: fixed exchange rate regimes can be abandoned, creating vulnerability to speculation.

1 OVERVALUED PEG

Market recognises exchange rate is overvalued and regime is unsustainable.

2 EXPECTED DEPRECIATION

Market expects foreign currency to become more expensive when peg ends.

3 SPECULATIVE RUSH

Speculators rush to buy foreign currency now whilst cheaper, to sell later at profit.

4 CRISIS

Collective speculation leads to crisis and premature collapse of regime.

STRATEGY C

INFLATION TARGETING

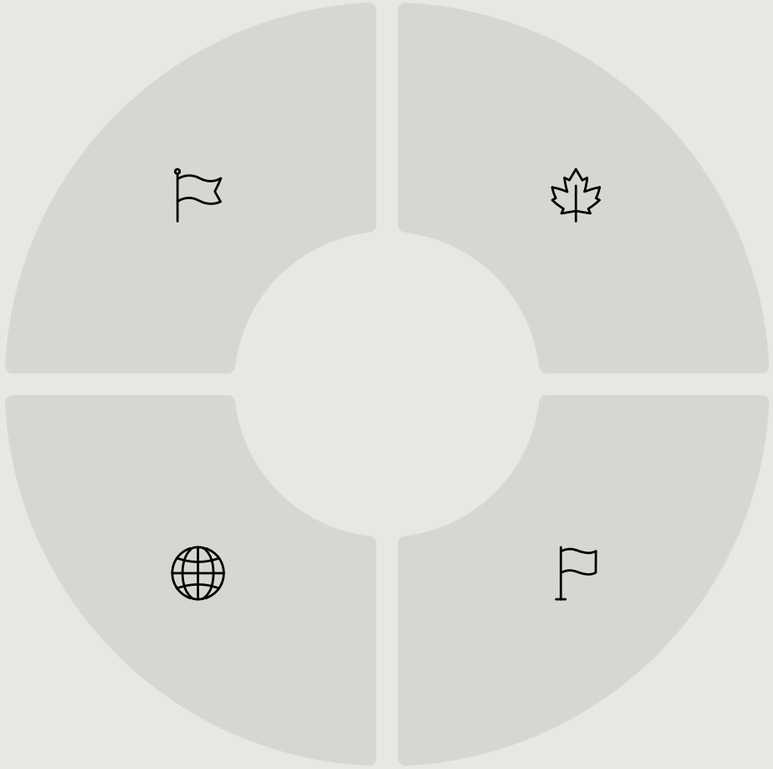
The most recent strategy for promoting price stability. Central banks commit to maintaining inflation at or close to a pre-announced target level.

NEW ZEALAND

First adopter in 1990, following 1989 Reserve Bank Act with personal accountability for central bankers.

GLOBAL ADOPTION

Many Latin American, African, and Asian countries followed. US Fed adopted 2% target in 2012.



CANADA

Second adopter in 1991.

UNITED KINGDOM

Unofficially started 1992 following ERM crisis.



ADVANTAGES OF INFLATION TARGETING

DIRECT COMMUNICATION

Inflation target directly conveys central bank's stance to public and businesses, creating focal point for expectations.

Fulfils Friedman's recommendation to keep inflation predictable and avoid monetary policy becoming a source of fluctuations.

STABILITY BENEFITS

Helps maintain stability of both real and nominal variables in face of most aggregate demand shocks, including money demand shocks.

IMPLEMENTATION CHALLENGE

Inflation is not directly controlled—it can only be influenced through indirect means.

1

PRIMARY INSTRUMENT

Short-term interest rate at which banks borrow from central bank to meet liquidity requirements.

2

TRANSMISSION MECHANISM

Interest rate changes feed through monetary transmission mechanism to affect inflation.

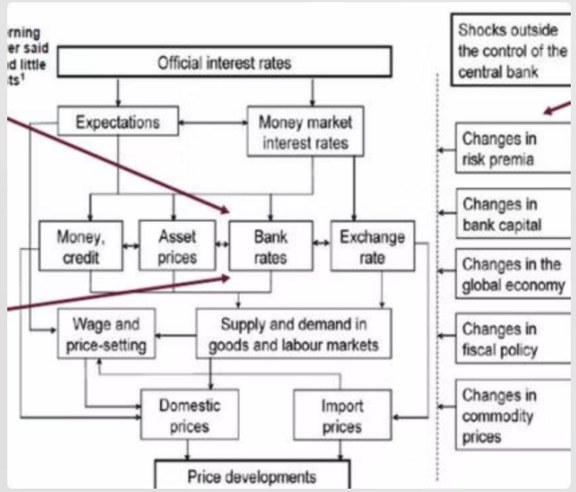
3

MONEY SUPPLY ADJUSTS

Monetary aggregates adjust accordingly: rising when rates lowered, falling when rates raised.

THE MONETARY TRANSMISSION MECHANISM

Official interest rates work through multiple channels—expectations, money markets, asset prices, and exchange rates—to ultimately affect price developments.





CHAPTER 5

INFLATION TARGETING IN THE UK

1992: INFORMAL START

Inflation targeting began roughly following the ERM crisis.

1997: OPERATIONAL INDEPENDENCE

Gordon Brown gave Bank of England operational independence to pursue inflation target, currently 2% (±1%).

TYPES OF CENTRAL BANK INDEPENDENCE

OPERATIONAL INDEPENDENCE

Bank of England has independence to decide how to achieve inflation target without Chancellor interference. Chancellor determines the target itself.

GOAL INDEPENDENCE

Higher level where central bank is independent even in deciding whether to follow inflation targeting and what rate to target.



THE MONETARY POLICY COMMITTEE

COMPOSITION

9 members including Bank of England staff, business people, and academics.

MEETINGS

MPC meets once monthly to set interest rates.

AUTHORITY

Main institution setting UK monetary policy.

ACCOUNTABILITY AND TRANSPARENCY

ACCOUNTABILITY

If inflation exceeds 3% or falls below 1%, the Bank must explain reasons in writing to the Chancellor.

TRANSPARENCY

Bank publishes Inflation Reports detailing calculations and communicating expected inflation course to the public.

These features keep public expectations aligned with Bank's target and demonstrate accountability, making policy stance credible whilst minimising speculation.



FLEXIBLE INFLATION TARGETING

The Bank of England commits to keeping the average inflation rate on target, not the monthly rate.

FLEXIBILITY

Allows temporary deviations when conflicts arise between real sector objectives and counter-inflationary goals.

JUSTIFICATION REQUIRED

Deviations must be justified to Chancellor and public, explaining why deviation occurs and how long it will last.

FORWARD GUIDANCE

Added to Bank's communication strategy since the Great Crisis.

> In August 2013, Mark Carney announced interest rates would remain at 0.5% until unemployment declined below 7%.

FORECASTING

Bank announces forecasts for key macroeconomic variables (unemployment, inflation) and how it will set rates accordingly.

MARKET REASSURANCE

Meant to reassure financial markets that imminent rate increases were not being planned.

CHAPTER 6

CONSIDERATIONS ON THE INFLATION TARGET

What should the optimal inflation target be? Three key debates emerged.



FRIEDMAN'S OPTIMAL QUANTITY OF MONEY

A provocative theoretical argument (distinct from the k% growth rule).

THE ARGUMENT

Marginal cost of printing money is zero, but private cost is the nominal interest rate sacrificed. Money holdings are suboptimal unless nominal rate is zero.

THE IMPLICATION

Since $i = r + \pi$ and real rate cannot be permanently zero, optimal inflation should be $\pi = -r$ (approximately -2%).

THE REALITY

Attracted academic debate but never considered implementable by central banks, unlike the k% rule.

ZERO OR MODERATE INFLATION?

Whilst zero inflation sounds optimal theoretically, several risks make moderate inflation preferable.



DEFLATION RISK

Inflation is imprecisely controlled. Zero target risks deflation, which increases real public debt and discourages consumption.



REAL INTEREST RATE CONSTRAINT

During recessions, negative real rates stimulate economy. With zero inflation, this requires negative nominal rates—considered infeasible by many central bankers.



LABOUR MARKET FLEXIBILITY

Nominal wage rigidity prolongs recessions. Positive inflation allows real wages to fall indirectly, accelerating recovery and easing unemployment.

PRICE LEVELS VS INFLATION RATES

PRICE LEVEL TARGETING

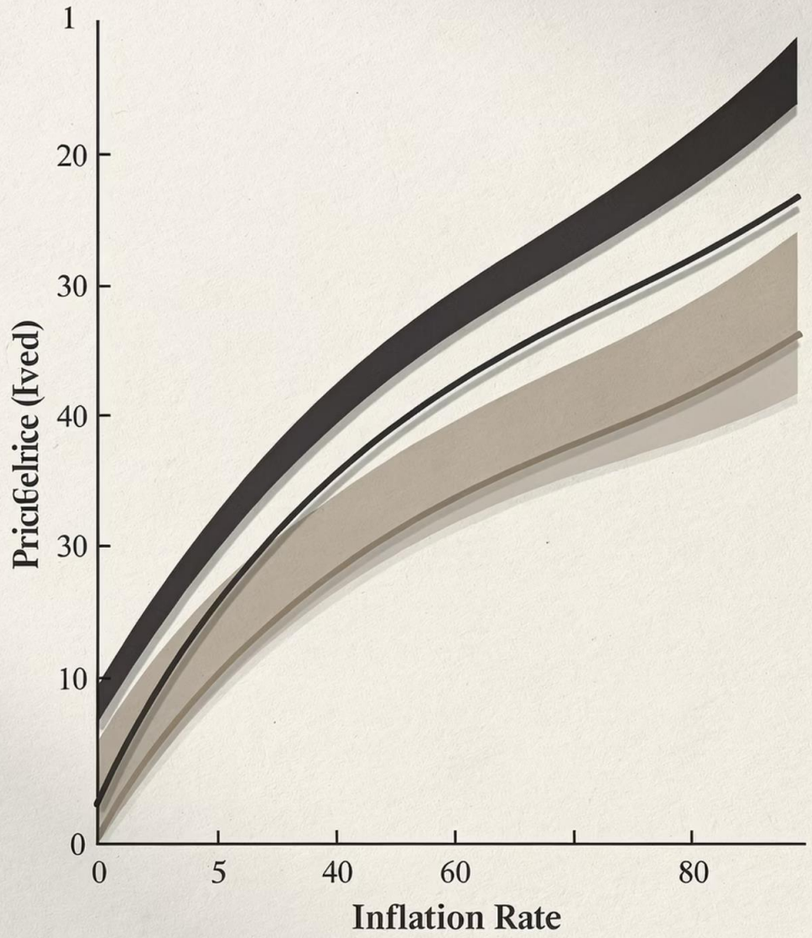
Target average CPI growth at 2% per year. If inflation is 3% one year, next year should be 1% to maintain average.

Irving Fisher's Gold Standard proposal aimed at stabilising price level.

INFLATION RATE TARGETING

Target 2% inflation each year. Bygones are not reversed—prices drift upwards faster than 2% on average.

Most modern regimes follow this approach for similar reasons to why zero inflation is avoided.



CHAPTER 7

SUMMARY: THE CONSENSUS

The Monetary Policy Consensus represents implicit agreement among mainstream economists from different schools.

MAIN GOAL

Central banks should maintain price stability, leaving room for deviation to achieve counter-cyclical real sector goals.

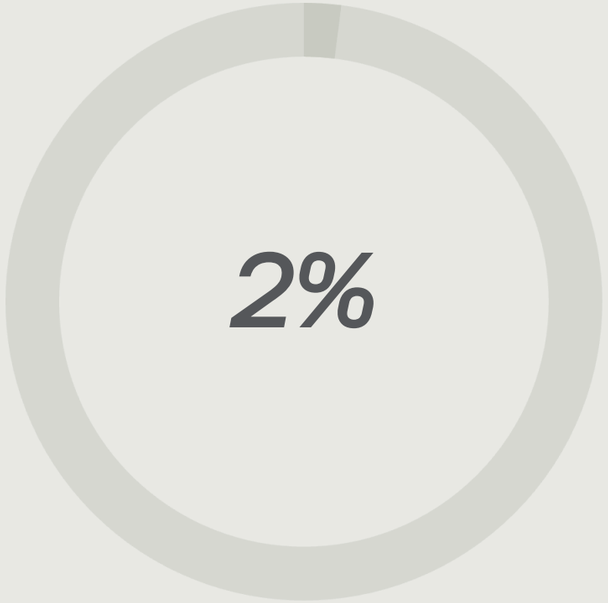
BEST METHOD

Inflation targeting (rather than monetary targeting) best achieves price stability.

PRIMARY TOOL

Interest rates (rather than money supply) should be main driver of monetary policy.

THE 2% TARGET



STANDARD TARGET

Most major central banks pursued inflation targets around 2%, not 0%.

This moderate target balances price stability with flexibility to address deflation risks, real interest rate constraints, and labour market rigidities.



THE GREAT MODERATION ERA

1

EARLY 1990S

Consensus emerges and Great Moderation begins.

2

1990-2007

Period of unprecedented stability in inflation and growth.

3

2007

Financial crisis marks end of Great Moderation.

4

2008 ONWARDS

Great Recession leads to rethinking of consensus.

KEY TAKEAWAYS

1 THEORETICAL UNITY

Monetary policy consensus united Keynesians and monetarists on central bank practice for the first time.

2 PRACTICAL SUCCESS

Inflation targeting through interest rate policy delivered the Great Moderation—low inflation and stable growth.

3 IMPLEMENTATION LESSONS

Monetary and exchange rate targeting failed due to unstable money demand and speculative attacks. Inflation targeting proved superior.

4 INSTITUTIONAL DESIGN

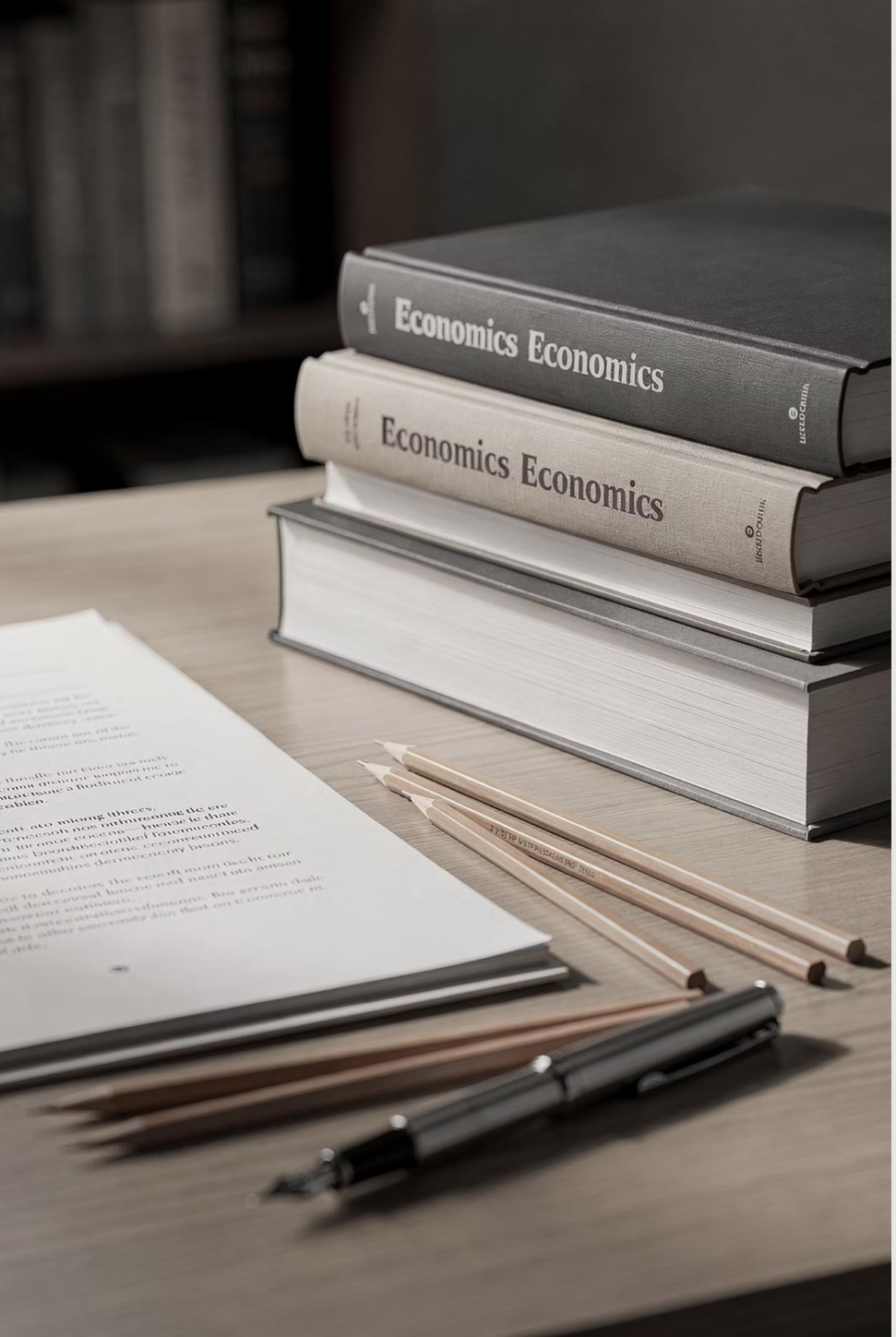
Central bank independence, transparency, and accountability are crucial for credibility and effectiveness.



LOOKING AHEAD

The financial crisis of 2007 and Great Recession of 2008 have led to rethinking of the consensus.

> The next topic will examine how the crisis challenged the monetary policy consensus and what new approaches have emerged.



FURTHER READING

LECTURE NOTES

Topic 7 provides detailed coverage of the monetary policy consensus and its implementation.

TEXTBOOK

Lewis and Mizen, Chapter 16, offers comprehensive analysis of inflation targeting strategies.

Thank you for your attention. Questions welcome.