Goals of the Central Bank

Who sets the goals for central banks? In most cases, the elected government sets the goals and the central bank implements policies to achieve the goals. In practice, though the central bank must seek to achieve all the goals, it may set its own priorities. The primary goal of most central banks is low and stable inflation. For some central banks, this is the only goal while for others, it's the primary goal. Why? Though monetary policy can have some short-run impact on economic growth and employment, it's primary effect over time is on inflation. That doesn't mean inflation is more important than economic growth or jobs, but instead that's what it can impact the most.

In the US, the Fed also has a goal of full employment. The way they typically seek to achieve this goal is to loosen policy during recessions, trying to restore the economy to its potential. This does not imply that they try to fine tune the economy (i.e., reduce interest rates if the economy slows down a little), but intervene when there is noticeable weakness. As discuss earlier, this also coincides with their primary goal of achieving low and stable inflation. How? Recall that when the economy is weak (GDP below its potential and unemployment above NAIRU), there's downward pressure on inflation. To keep inflation from declining too much (and not be low and stable), it implements policies to boost the economy in the short run.

Another goal is financial stability. Though this is not a problem most of the time, it can become a serious problem occasionally, preventing the Fed from achieving the two goals already cited. The primary way it achieves this goal is through sounds regulatory policy. However, sound monetary policy is also necessary. What is sound policy? Policy that keeps inflation in check and is not erratic.

Inflation Targeting

Though most central banks set low and stable inflation as the primary goal of monetary policy, some have an explicit inflation target. In recent decades, the Fed had an implicit target, but in January 2012, it adopted an inflation target of 2%. In doing so, it joined the ranks of other central banks that had already adopted inflation targets. The ECB has set a target of 2%, the Bank of England's target is between 1 and 3%, the Brazilian Central Bank aims for between 2.5 and 6.5%, and so on. Why not 0%? Though it's obvious why high inflation is bad, it may not be so obvious how inflation can be too low. The fear isn't really very low inflation, but concern about deflation (negative inflation, falling prices). Low inflation can turn to deflation if there's a shock to the economy or if the economy is too weak. What's wrong with deflation? Though the details are discussed elsewhere (see inflation), here's a brief list of problems with deflation. When there's deflation, people may wait to buy certain goods, anticipating that prices will decline. Given less spending, the economy weakens. Also, while the Fed seeks to lower interest rates to try to stimulate the economy during a recession, what matters is the real interest rate (interest rate - inflation). As inflation becomes more negative, real interest rates rise, leading to less borrowing and spending, this weakening the economy. Also, deflation is likely to result in lower asset prices, reducing wealth, and lower wages, reducing income; both lead to reduced purchasing power and thus a weaker economy. To minimize the likelihood of deflation, central banks typically prefer inflation to be low, but not too close to 0%.

Many central banks around the world have adopted a policy of inflation targeting. Though there are minor differences, the basic premise is that keeping inflation within a target range in the medium term is the only goal of the central bank. Why focus on inflation? As discussed earlier, this is the economic variable in which the central bank can have the most impact over time. Setting a target and achieving it enhances the credibility of the central bank, allowing for lower long-term interest rates (due to lower inflationary expectations). Why set a
range instead of a specific number? Though central banks have some control of inflation, they don't have complete control and unique factors may cause temporary increases or decreases in inflation. This is also the reason for focusing on the medium term instead of the short term. This also allows for some limited flexibility in implementing monetary policy. One proponent of inflation targeting (Ben Bernanke) described inflation targeting as "constrained discretion." Recent experience has shown that inflation targeting has been quite successful particularly in countries that have had a history of high inflation. Here's a link to a brief discussion of whether the Fed should have an inflation target.

December 2012 Announcement Regarding How Long Monetary Policy Will Remain Accommodative

In recent years, the Fed has announced that it intends to maintain very low interest rates as long as inflation was under control and unemployment was too high. How long would that be? At one point it said given its economic forecasts, it would likely continue to 2014 and later revised that to 2015 (not a guarantee that it would keep rates low until 2015, but it was likely given the Fed's economic forecast). Some economists questioned whether policy should be linked to a date. Even though the Fed stated it was conditional on the state of the economy, markets and others may focus on the date and be surprised if policy was tightened earlier. After some debate, the Fed modified its guidance by removing reference to a date and instead provided specifics about what rates of unemployment and inflation would justify the low interest-rate policy. Here's a quote from the statement released following the December FOMC meeting:

"To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. The Committee views these thresholds as consistent with its earlier date-based guidance. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent."

In other words, even after the Fed ends its policy of quantitative easing, it will continue to maintain low interest rates. When is it likely to begin increasing the federal funds rate? When unemployment declines to 6.5% and/or inflation seems to be getting too high (specifically, when it is forecasted to be 2.5% or more in the next year or two and/or expected inflation starts to rise significantly). Thus, instead of assuming the policy will continue until 2015, markets and others know that monetary policy is likely to be tightened in response to forecasts of rising inflation or a significantly stronger job market. Why did it choose 6.5% for the unemployment rate? Recall that most economists think that NAIRU is now between 5.5% and 6%. Rather than maintaining accommodative policy until the unemployment rate reaches NAIRU, it will begin to tighten as it approaches NAIRU in order to keep inflation under control.

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