Monetary Policy in the United States and the Euro Area

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Current US Monetary Policy Stance

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(Federal Funds: 0.20%)

Long-Term Assets: $1.7 trillion

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Effective IOR is thus -0.75% to -1.75%.

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Original: IOR = 2 + Inflation + 0.5*(Inf. Dev.) + 0.5*(Gap)

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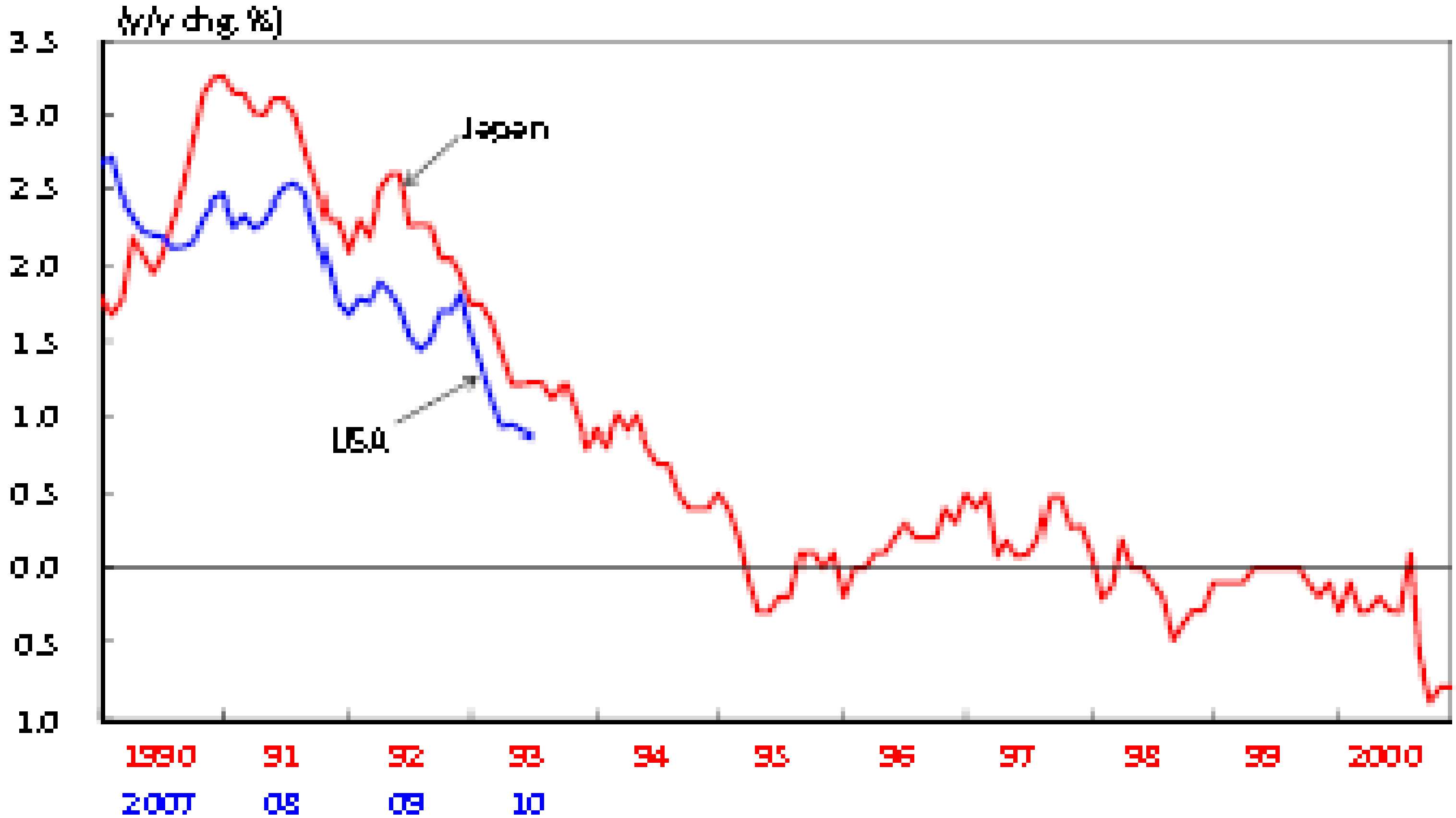
Optimal policy under uncertainty about Gap argues for original coefficients when Gap is small (< 2%) and larger (e.g., Rudebusch) coefficients when Gap is large. ***Gap is now large.***

Chart 1

日本銀行 BANK OF JAPAN

Core CPI Inflation

Inflation developments after the bubble burst look similar so far.



Notes: Core CPI in Japan is computed by excluding perishables from headline CPI. Figures for Japan are adjusted for the changes in the consumption tax rate from 3 to 5 percent in April 1997. US data start from January 2007.
Sources: Ministry of Internal Affairs and Communications, Consumer Price Index; Bureau of Labor Statistics, Consumer Price Index.

From “Uniqueness or Similarity? Japan’s Post-Bubble Experience,” by Governor M. Shirakawa, Bank of Japan, September 16, 2010.

The Svensson Rule

Set effective IOR to minimize future gaps and deviations of inflation from target.

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FOMC's June 2010 forecast shows gap of (at least) -2% and inflation deviation of -0.7% after 2-1/2 years.

- Far from targets and errors are compounding, not offsetting.
- This implies that policy is far too tight.
- Private forecasts broadly consistent with this conclusion.

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€100 billion long-term assets → no effect on 10-year bond yield

Effective policy rate is thus 0.40%.

(Significantly tighter than in United States.)

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Central banks should exclude VAT changes from inflation targets.

- Otherwise, monetary policy tightens with fiscal tightening and loosens with fiscal loosening.

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Modest ($100+ billion) monthly rate of purchase of l.t. assets.

- Even greater risk of seeming ineffective.
- No implicit commitment.
- Significant balance sheet risks (eventually).

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Extend unlimited 24-month discount window credit to banks on good collateral at 0.25%.

- Similar in spirit to ECB's unlimited allotment of 12-month credit to banks.