

## Lecture session 9

### Review group work on inflation and employment of selected country

#### 10. Domestic Macroeconomy: Inflation, Unemployment and Role of Macroeconomic Policy

- 10.5. Monetary targets: advantages and disadvantages – trilemma (impossible trinity)
  - 10.5.1 Constraints on monetary policy
    - [1] Fixed versus flexible regime
    - [2] Monetary policy independence – discretion over use of instruments
    - [3] Capital market liberalization versus capital controls
  - 10.5.2 Advantages / disadvantages over targets:  $E$ ,  $MS$  or  $\pi$
- 10.6. Deriving the Phillips Curve (PC)
  - 10.6.1 Adaptive price expectations
  - 10.6.2 Deriving PC in  $\pi, y$  space
  - 10.6.3 Shifts in PC ( $\Delta P^e$ )
- 10.7. Modeling AD and AS shocks in relation to PC
  - 10.7.1 AD shock and macroeconomic adjustment
  - 10.7.2 AS shock and macroeconomic adjustment
- 10.8. Inflation targeting ( $\pi^T$ ) and monetary rule (MR)
  - 10.8.1 MR: CB minimizes fluctuations of  $P$  from  $\pi$  from  $\pi^T$  and  $y$  from  $y_n$
  - 10.8.2 Trade-off between deviations in  $\pi$  and  $y$ ; disutility with bigger deviations
  - 10.8.3 Loss function:  $L = (Y_t - Y_n)^2 + \beta (\pi_t - \pi^T)^2$
- 10.9. Modeling using the 3-equation model: IS, PC and MR
  - 10.9.1 Inflation shock: central bank response and adjustment to equilibrium
  - 10.9.2 Temporary AD shock: IS shift, CB response, and adjustment to equilibrium
  - 10.9.3 Permanent AS shock: MR shift, CB response, and adjustment to equilibrium
- 10.10. Unorthodox monetary policy
  - 10.10.1 Traditional MP: what it is, how it works, and why it broke down in 2008
  - 10.10.2 Non-conventional MP: negative i-rates and quantitative easing (QE)
  - 10.10.3 Forms of QE: credit easing, “operation twist”, portfolio rebalancing
  - 10.10.4 Rethinking on i-rates and negative i-rates
  - 10.10.5 Effectiveness of QE and negative i-rates; consequences for currencies
  - 10.10.6 MP after QE: lessons learnt (not learned)

**Study questions:** What is the trilemma that confront any central bank? Why is the new PC upward sloping in  $\pi, y$  space? How can you explain movement along and shifts of the PC curve? How does the PC curve relate to wages, prices and employment? What is the monetary rule and how does it relate to deviations in inflation from  $\pi^T$  and output from  $y_n$ ? How does the CB minimize its losses to deviations in  $\pi$  and  $y$ ? How is the 3-equation model useful in understanding CB behavior given its preferences towards deviations in  $\pi$  and  $y$ ? What is unorthodox MP? What conditions make it necessary to use non-traditional MP instruments? Can you explain how/why these tools are effective? What role should fiscal policy play under such conditions? Could quantitative easing or negative interest rates be the cause of a currency war between countries whose central banks used it and those that have not? What is the longer-term implication of using unorthodox MP for central bank independence and its relationship with fiscal policy? What monetary policy lessons were taken from the Great Depression? What monetary policy lessons were taken with the break up of the Bretton Woods system in the 1970s and the stagflation of the early 1980s?