Economics 435
The Financial System
(11/11)

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UW Madison
Fall 2014
Outline

• Where does a central bank fit in the economy?
• What is the Fed? What is the ECB?
• IS-LM: Textbook monetary policy (pre-2008)
• IS-LM: monetary policy in practice (pre-2008)
• The Taylor Rule
• Problems in implementation
# Central Banks in the Financial System

## Table 14.1: Financial Relationships (Balance Sheets) Between the Banks, the Fed, the Government, and the Private Sector

<table>
<thead>
<tr>
<th>PRIVATE NONFINANCIAL</th>
<th>BANKS</th>
<th>FED</th>
<th>GOVERNMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASSETS</td>
<td>LIABILITIES</td>
<td>ASSETS</td>
<td>LIABILITIES</td>
</tr>
<tr>
<td>Currency (CU)</td>
<td></td>
<td>Currency (CU)</td>
<td></td>
</tr>
<tr>
<td>Deposits (D)</td>
<td></td>
<td>Deposits (D)</td>
<td></td>
</tr>
<tr>
<td>Bonds (B)</td>
<td>Bonds (B)</td>
<td>Bonds (B)</td>
<td>Bonds (B)</td>
</tr>
<tr>
<td>Reserves (RE)</td>
<td></td>
<td>Reserves (RE)</td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td>Loans</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Macroeconomics, 6th Edition*  
Copyright © 2005 W. W. Norton & Company
Federal Reserve System: Organization

Source: Mishkin
Federal Reserve System:
Regional Distribution

Figure 16.1
The Federal Reserve System
The 12 Federal Reserve Banks and their districts.

Alaska and Hawaii are part of the San Francisco District
Comparing Organizational Structure

Table 16.2 Key Aspects of the European Central Bank

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Central Bank (ECB)</td>
<td>The central authority in Frankfurt, Germany, that oversees monetary policy in the common currency area. (Established July 1, 1998.)</td>
</tr>
<tr>
<td>National Central Banks (NCBs)</td>
<td>The central banks of the countries that belong to the European Union.</td>
</tr>
<tr>
<td>European System of Central Banks (ESCB)</td>
<td>The ECB plus the NCBs of all the countries in the European Union, including those that do not participate in the monetary union.</td>
</tr>
<tr>
<td>Eurosistem</td>
<td>The ECB plus the NCBs of participating countries; together, they carry out the tasks of central banking in the euro area.</td>
</tr>
<tr>
<td>ECB Executive Board</td>
<td>The six-member body in Frankfurt that oversees the operation of the ECB and the Eurosistem.</td>
</tr>
<tr>
<td>Governing Council</td>
<td>The (currently) 22-member committee that makes monetary policy in the common currency area.</td>
</tr>
<tr>
<td>Euro</td>
<td>The currency used in the countries of the European Monetary Union.</td>
</tr>
<tr>
<td>Euro area</td>
<td>The countries that use the euro as their currency.</td>
</tr>
</tbody>
</table>
Textbook Monetary Policy (pre-2008)
Monetary Policy in Practice (pre-2008)
Taylor Rules

\[ i_{t}^{FedFunds} = \pi_t + \beta (y_t - y_t^*) + \delta (\pi_t - \pi_t^*) + r_t^* \]

\[ i_{t}^{FedFunds} = (1 + \delta)\pi_t + \beta (y_t - y_t^*) + r_t^* - \delta \pi_t^* \]

• Positive statement? Is this how central banks behave?
• Or normative statement? Is this how central banks should behave?
Federal Funds Rate and Inflation Targets

Components of Taylor's Rule

Actual and Potential Real GDP

PCE Inflation

Output Gap

Page 10: Federal Funds Rate and Inflation Targets shows the observed federal funds rate, quarterly, and the level of the funds rate implied by applying Taylor’s (1993) equation

\[ f_t^* = 2.5 + \pi_{t-1} + (\pi_{t-1} - \pi^*)/2 + 100 \times (y_{t-1} - y_{t-1}^P)/2 \]

to five alternative target inflation rates, \( \pi^* = 0, 1, 2, 3, 4 \) percent, where \( f_t^* \) is the implied federal funds rate, \( \pi_{t-1} \) is the previous period’s inflation rate (PCE) measured on a year-over-year basis, \( y_{t-1} \) is the log of the previous period’s level of real gross domestic product (GDP), and \( y_{t-1}^P \) is the log of an estimate of the previous period’s level of potential output. Potential Real GDP is estimated by the Congressional Budget Office (CBO).
FRB SF Interpretation of the Taylor Rule

\[ i_t^{FedFunds} = \pi_t - 2(u_t - u_t^*) + 0.3(\pi_t - \pi_t^*) + r_t^* \]
“Your Name Here” Interpretation of the Taylor Rule

Baseline Taylor Rule Estimates of the Fed Funds Rate
(1987-2012)

Source: Bloomberg; {TAYL <go>}

Bloomberg Financial Conditions Watch (Dec. 12, 2012)
Issues (within the framework)

• Which activity variable (output, unemployment)?
• Which inflation measure (CPI, PCE deflator, or respective core measures; 12 month, 3 month, etc.)
• What is the “natural” rate of real interest rate?
• Should it be forecasted output and inflation that matters?
• How to deal with data revisions?
Using Forecasted Values of $y$, $\pi$

Source: Orphanides and Wieland (2007)
The Impact of Data Revisions

Figure 3. Actual and Fitted Values of U.S. Federal Funds Rate

Source: Molodtsova, et al. (JME 2008).
http://www.uh.edu/class/economics/news-research/working-papers/docs/2007-03.pdf
Taylor Rules and Inflation Targeting

\[ i_{t}^{FedFunds} = \pi_t + \beta (y_t - y_t^*) + \delta (\pi_t - \pi_t^*) + r_t^* \]

\[ i_{t}^{FedFunds} = (1 + \delta)\pi_t + \beta (y_t - y_t^*) + r_t^* - \delta \pi_t^* \]

• Question of interpretation: Why does the output gap enter? Is it determinant of future inflation (via Phillips Curve)? If so, Taylor rule is inflation targeting.

• More explicit: Set \( \beta=0, \delta=1. \)