

Central Bankers Courses 2008

**Lectures on
Monetary Policy Transmission and Inflation Targeting**

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Lecture outline

The objective of these lectures is to provide an overview of recent advances on the transmission of monetary policy and inflation targeting, with a particular focus on applications to emerging market economies. Most of the material is kept as non-technical as possible (with references to the more technical background research being provided throughout the course).

The lectures are structured in four parts:

1. Empirical evidence on the effects of monetary shocks.
2. The New Keynesian model as a benchmark for monetary policy analysis.
3. Introduction to inflation targeting.
4. Application of inflation targeting to emerging market economies.

Part 1: Empirical Evidence on the effects of monetary shocks

- Conceptual issues about identification in general equilibrium
- Structural VAR identification of monetary policy shocks
 - VAR basics and recursive identification of monetary policy shocks
 - Stylized facts about monetary transmission in G7 countries
 - Monetary transmission in emerging economies: what are the differences and why?
- Robustness of evidence to alternative identification schemes

Part 2: The New Keynesian model as a benchmark for monetary policy analysis

- A stylized New Keynesian model for monetary policy analysis
 - Presentation and intuition behind the three central model equations (New Keynesian Phillips curve, New IS curve, Monetary Policy rule)
 - Understanding the empirical evidence on the effects of monetary policy shocks
- Lessons for monetary policy
 - The case for price stability
 - The problem of dynamic inconsistency and inflation bias
 - The importance of managing private-sector expectations
 - The crucial role of the output gap (and the measurement of natural output)
- Extension of the model to the small open economy case

Part 3: Introduction to inflation targeting

- The design of inflation targeting regimes
- The pros and cons of inflation targeting
- International evidence on the performance of inflation targeting regimes

Part 4: Application of inflation targeting to emerging market economies

- Fundamental differences in emerging market economies
- When can inflation targeting work?
 - Case studies of emerging market economies
 - Overview of different candidate countries

Reading List

Note: References that the participants should read before the lectures are preceded by (*). The other references are meant as supplementary reading material for participants with further interest in the topic. These papers contain further information on the topic, including technical background and applications to specific emerging market economies.

Part 1: Empirical Evidence on monetary Policy transmission

- (*) Christiano, L.J., M. Eichenbaum and C.L. Evans (1998), “Monetary Policy Shocks: What have we learned and to what end?” *National Bureau of Economic Research Working Paper* 6400.
- (*) Romer, C. D. and D. H. Romer (2004). “A New Measure of Monetary Shocks: Derivation and Implications.” *American Economic Review* 94(4), 1055-1084.
- Coricelli, F., B. Égert and R. MacDonald (2006). “Monetary Transmission Mechanism in Central and Eastern Europe: Gliding on a Wind of Change.” *William Davidson Institute Working Paper* 850.
- Dabla-Norris, E. and H. Floerkemeier (2006). “Transmission Mechanisms of Monetary Policy in Armenia: Evidence from VAR Analysis.” *IMF Working Paper* WP/06/248.
- Starr, M.A. (2005). “Does money matter in the CIS? Effects of monetary policy on output and prices.” *Journal of Comparative Economics* 33, 441-461.
- Darvas, Z. (2006). “Monetary Transmission in the New EU Member States: Evidence from Time-Varying Coefficient Autoregression.” *Focus on European Integration* 1/2006.
- Eichenbaum, M and C. Evans (1995). “Some Empirical Evidence on the Effects of Monetary Policy Shocks on Exchange Rates.” *Quarterly Journal of Economics* 110(4), 975-1009.
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- Marshall, D.A. and C. L. Evans (2007). “Economic determinants of the nominal treasury yield curve.” *Journal of Monetary Economics* 54, 1986-2003.

Part 2: The New Keynesian model as a benchmark for monetary policy analysis.

- (*) Clarida, R., J. Gali and M. Gertler (2001). "Optimal Monetary Policy in Open versus Closed Economies: An Integrated Approach." *American Economic Review Papers and Proceedings* 91(2), 248-252.
- (*) Gali and Gertler (2007). "Macroeconomic Modeling for Monetary Policy Evaluation." *Journal of Economic Perspectives* 21(4), 25-45.
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- Chari, V.V. and P.J. Kehoe (2006). "Modern Macroeconomics in Practice: How Theory is Shaping Policy." *Journal of Economic Perspectives* 20(4), 3-28.
- Clarida, R., J. Gali and M. Gertler (1999), "The Science of Monetary Policy: A New Keynesian Perspective," *Journal of Economic Literature* 37, 1661-1707.
- Christiano, L.J., M. Eichenbaum and C.L. Evans (2005). "Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy." *Journal of Political Economy* 113(1), 1-45.
- Corsetti, G. and P. Pesenti (2005). "International dimensions of optimal monetary policy." *Journal of Monetary Economics* 52, 281-305.
- Goodfriend, M. and R. G. King (1997), "The New Neoclassical Synthesis and the Role of Monetary Policy." In: B. S. Bernanke and J. J. Rotemberg (eds.) *NBER Macroeconomics Annual*. Cambridge: MIT Press.
- Goodfriend, M. and R. G. King (2005). "The Incredible Volcker Disinflation." *Journal of Monetary Economics* 52(5), 981-1015.
- Goodfriend, M. (2002). "Monetary Policy in the New Neoclassical Synthesis: A primer." *International Finance* 5(2), 165-191.
- Lane, P. (2001). "The new open economy macroeconomics: a survey." *Journal of International Economics* 54, 235-266.
- Smets, F. R. and R. Wouters (2007). "Shocks and Frictions in US Business Cycles: A Bayesian DSGE Approach." *American Economic Review* 97(3), 586-606.

Part 3: Introduction to inflation targeting

- (*) Bernanke, B.S. and F.S. Mishkin (1997). Inflation Targeting: A New Framework for Monetary Policy.?" *Journal of Economic Perspectives* 11(2), 97-116.
- Bernanke, B.S., T. Laubach, F.S. Mishkin, A.S. Posen (1999). *Inflation targeting: Lessons from the international experience*. Princeton, NJ: Princeton University Press.
- Bernanke, B.S. and M. Woodford (2005). *The Inflation Targeting Debate*. Chicago: University of Chicago Press.
- Svensson, L.E.O. (2000). "Open-Economy Inflation Targeting." *Journal of International Economics* 50, 155-183.

Part 4: Application of inflation targeting to emerging market economies

- (*) Batini, N. and D. Laxton (2006). "Under what conditions can inflation targeting be adopted? The experience of emerging markets." In: Schmidt-Hebel, K. and F.S. Mishkin (eds). *Monetary Policy under Inflation Targeting*. Santiago: Banco Central de Chile.
- (*) Fraga, A., I. Goldfajn and A. Minella (2003). "Inflation Targeting in Emerging Market Economies." *National Bureau of Economic Research Working Paper* 10019.
- (*) Mishkin, F.S. (2000). "Inflation Targeting in Emerging-Market Countries." *American Economic Review Papers and Proceedings* 90(2), 105-109.

- Amato, J.D. and S. Gerlach (2002). "Inflation targeting in emerging market and transition economies: Lessons after a decade." *European Economic Review* 46, 781-790.
- Bakradze, G. and A. Billmeier (2007). "Inflation Targeting in Georgia: Are We There Yet?" *IMF Working Paper* WP/07/193.
- Blejer, M.I., A. Ize, A.M. Leone, S. Werlang (2000). *Inflation Targeting in Practice: Strategic and Operational Issues and Application to Emerging Market Economies*. Washington D.C.: International Monetary Fund (the chapters of this book are available online at <http://www.imf.org/external/pubs/ft/seminar/2000/targets/stratop.htm>).
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- Laxton, D. and P. Pesenti (2003). "Monetary rules for small, open emerging economies." *Journal of Monetary Economics* 50, 1109-1146.
- Mishkin, F.S. (2000). "Can Inflation Targeting Work in Emerging Market Countries?" *National Bureau of Economic Research Working Paper* 10646.