Monetary policy rules in practice
Some international evidence
Richard Clarida, Jordi Gali, Mark Gertler
Summarised by Susanto Gunawan.

This article describes the major bank in the world conducted their monetary policy since 1979. By estimating the monetary policy reactions functions in two sets of countries: the G3 (Germany, Japan and United States) and the E3 (United Kingdom, France and Italy). G3 countries are pursuing absolute form of inflation targeting which account to gave broad success of their monetary policy. While E3 countries are heavily influenced by German Monetary policy (Bundesbank’s policy) and set as a benchmark. In the time where European Monetary System (EMS) collapses, interest rates of E3 countries were much higher than their domestic macroeconomic conditions. This article was conducted from two motives: First, Central Bank in 1979 planned to reign inflation as this is not easily controlled in today environment. By studying policy conducted by G3 that influence global monetary condition, would give insight of how future policy making in G3 and how European Central Bank should manage the policy. Second, international monetary policies are in distress although inflation is under reasonable control. Also, the collapse of EMS, put stress on E3 countries monetary policy. By understanding the influence of EMS and using G3 policy as guidelines to evaluate E3 policy, will give insight for the future of monetary policy making in Europe. Further, this article analyses the reaction functions from major World Bank through a set of methodology.

In short, the method introduced were essentially a forward looking version of the simple backward looking reaction function which popularised by Taylor (1993). Which suggest that Central Bank to adjust nominal short term interest rates in response to the gaps between expected inflation and output and their respective target. For example: reducing inflation may require a period of output reduction, depending on the degree of nominal changes, (i.e.: Central Bank choosing the course of short term interest). Also, an alternative method introduced where it allow reactions towards variables, but it does not impose arbitrary constraints on the information set used by Central Bank to form expectation. This will test the effectiveness of forward looking against backward looking. However these methods were facing a real life problem as the Central bank may have not completely sacrifice monetary control, they may have pursued policies to maintain interest rates within reasonable bounds, (i.e.: interest rates influence policy independently of the information contain about inflation and outputs).

When analysing G3 countries, it is understood that they has autonomous control over domestic monetary policy. The policy implied is when there is increase in expected inflation, each Central Bank increase the nominal rates that enough to push up the real rates, also adjusting rates in response to the state of output. Giving the reaction function result that is good in characterising the monetary policy of the countries. These bring an outcome that G3 are implying clear focus on controlling inflation. This method is working well against all given variables including the backward looking from each of G3
countries. Germany was targeting money in aggregate, Japan was the lagged inflation and United State was focusing on meeting non borrowed reserve aggregate target.

On the other hand, when analysing E3 countries, it is more complex as they are constrained by their commitment to EMS. By following Germany monetary policy as a guidelines implying that E3 are pursuing policy of high real short term rates that keep the low level of inflation. Exchange rate was set as fixed and also there is an absent of capital control. Generally monetary policy was run by Bundesbank, where interest rate is reflected from the intention of German Central Bank. This article question how the interest rates compare to implied target rate, when Central Bank employ same reaction function as Bundesbank. It is safe to say that Germany monetary policy is the constraint for E3 countries. Due to this matter, G3 policy was unable to describe the monetary policy of E3, since they follow Bundesbank to fight inflation. As the result, low inflation forces to maintain high real rates in order to sustain the exchange rates. The affect leads to the collapse of EMS in 1992 as countries could not sustain the membership with Bundesbank.

In Conclusion, policy making in G3 countries post 1979 provide good guidelines to good monetary management. Where desirable inflation targeting with some allowance for output stability, by rising nominal rate that is enough to increase real rates. The advantage is to set economy to a course of stable long term inflation. However, Policy in E3 countries were less convincing as it is difficult to build credibility through fixed exchange rate mechanism due to stress applied in economy which lead to loss of monetary control.

Reference:

