11 Monetary Policy in an Open Economy

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I INTRODUCTION

This paper gives an integrated summary of the principles of monetary policy in economies with highly developed financial systems under floating rates. The orientation is frankly normative. The subject is the guidelines that a central bank should follow in conducting monetary policy. In such a discussion, personal judgement inevitably plays a considerable rôle. There are many points on which the evidence is inconclusive and on which competent opinions differ. In such matters of macro-economic policy it will always be so. Without dogmatic claims, the paper presents one observer's conclusions from the historical experience and academic work of recent years.¹

II OBJECTIVES AND INSTRUMENTS

The most general objective of the central bank is the efficiency of the economy. At the microeconomic level, this means that it should contribute to the efficiency of the payments system, of financial intermediation and of asset markets. These aspects will not be further considered here. At the macroeconomic level, the primary objective is price stability. A secondary objective is the reduction of fluctuations in output and employment.² To these must be added, third, the prevention of liquidity crises in the banking system. This list is the same for both open and closed economies. There is no need to recognise separate exchange rate or balance-of-payments objectives. Whatever the central bank may do to influence exchange rates or the
balance of payments is clearly done in the service of the three objectives.

In pursuing these objectives, the central bank’s principal instrument is the supply of base money. As an auxiliary instrument it can also use portfolio shifts between different types of assets with an unchanged monetary base. These shifts are classified as auxiliary because, dollar for dollar, a change in base money is likely to be much more potent than a mere portfolio shift. In addition, the central bank may use regulatory constraints like reserve requirements, credit rationing and interest ceilings. Since these are not basic to the argument, they will not be further considered. There is, however, an alternative set of instruments. Instead of supplying a certain amount of base money, the central bank can set the interest rate at which it supplies base money, thus treating the rate of interest as the principal policy instrument. Correspondingly, instead of converting a certain amount of foreign assets into domestic assets, the central bank can set the exchange rate at which it is willing to perform such portfolio shifts. For every policy instrument expressed as a quantity there is a ‘dual’ instrument expressed as a price or interest rate. This is the price/quantity problem, familiar from the closed economy. Floating exchange rates in an open economy add another dimension.

In addition, there is the problem of the targeting procedure. Consider a military analogy. A hand gun is aimed directly at the target. With a mortar, the gunner learns to train his sight on an auxiliary target, with a spotter measuring the deviation of this auxiliary from the actual target. Monetary policy can be treated like a hand gun, the base money supply (or the interest rate) being aimed directly at the ultimate targets – prices, output and bank liquidity. Under the alternative two-stage procedure, the policy-maker selects an intermediate target – for instance, the supply of money held by the non-bank sector. In the first stage he determines the desired level for this intermediate target in view of the ultimate objectives. In the second stage, he aims the policy instruments at the intermediate target.

In a military context, auxiliary targets are used as second-best procedures because the gunner cannot see the target. In monetary policy, the field of application is less evident because all members of a central bank can be given access to the same information. The traditional protagonist of two-stage procedures has been, characteristically, the Federal Reserve System, whose decision-making happens to be divided between the Federal Open Market Committee in