I INTRODUCTION

The subject matter of this chapter is the relationship between the two ultimate goals recognized by most central banks, namely, macroeconomic stability and financial-system stability.¹ This is an extremely broad topic and one that could be approached by various distinct methods of analysis – evolutionary/historical, welfare theoretic, institutional, etc. But given my own experience relative to others on the program, it seems most appropriate to narrow the scope of the chapter by focusing primarily on one limited but extremely important set of issues.

These issues, which are closely interrelated, concern macro-oriented rules for monetary policy and the central bank’s role as a lender of last resort. Are macro-oriented rules – such as those advocated by McCallum (1988, 1993), Meltzer (1987), or Taylor (1988, 1993) – inappropriate because of their neglect of financial market conditions? If so, might these rules be modified so as to overcome that neglect? What are the implications concerning lender-of-last-resort responsibilities? Does acceptance of these responsibilities require the operation of a discount window? Or could they be satisfied, as suggested by Goodfriend and King (1988), by means of open market operations that involve smoothing of interest rates?

As here formulated, the answers to these questions depend to a large extent upon the accuracy with which it is possible for the central bank to hit intermediate quarterly targets for the monetary base by means of an interest rate instrument while practicing smoothing – i.e., while avoiding large week-to-week changes in the interest rate. Consequently, a substantial portion of the chapter is devoted to an attempt to measure this accuracy empirically. As the econometric methods utilized are rather rudimentary, our results must be regarded as exploratory, rather than definitive, in nature. But estimation of a
fully structural model is inhibited by data limitations and identification problems, so our first-pass analysis may be difficult to improve upon substantially. In any event, it will provide a starting point for further consideration of the issue.

Organizationally, the analysis begins in Section II with an overview discussion of the broad topic of Part IV, a discussion which serves to justify our attention on the narrower set of issues described above. Section III is then devoted to a background review of some results relating to monetary policy rules, formulated at the quarterly frequency, in which the monetary base is treated as a policy instrument. Section IV develops a framework for the study of a system in which quarterly-average base values are viewed as targets to be achieved by manipulation at the weekly frequency of an interest rate instrument. Basic simulation results pertaining to this system are given in Section V while Section VI takes up some alternative formulations. Finally, Section VII contains a brief recapitulation.

II  MONETARY POLICY RULES FOR THE LENDER OF LAST RESORT?

Before focusing our attention as described above it will be useful to justify that strategy by reference to the broader topic assigned for Part IV: the relationship between the goals of macroeconomic and financial stability. The tension between these goals has recently been expressed by Folkerts-Landau and Garber (1992), writing about the design of the European Central Bank, in terms of the aphorism, 'A bank or a monetary policy rule?' More generally, many economists have expressed doubts as to the compatibility of a strict monetary policy rule – or in any case one featuring a monetary base instrument – with central bank acceptance of lender-of-last-resort (LLR) responsibilities.2 The achievement of a base path as dictated by the rule would conflict, according to this position, with the need to supply liquidity at times of crisis in accordance with the central bank's role as a LLR.

Recent discussions of alternative viewpoints pertaining to the LLR role – see e.g., Bordo (1990), Humphrey (1992), and Summers (1991) – have identified four main positions. These are (i) the classical Thornton–Bagehot doctrine, (ii) a 'modern-pragmatic' position that calls for more lenient management of the discount window, (iii) the so-called 'free banking' contention that no public LLR is needed,