What about the Friedman rule in practice?

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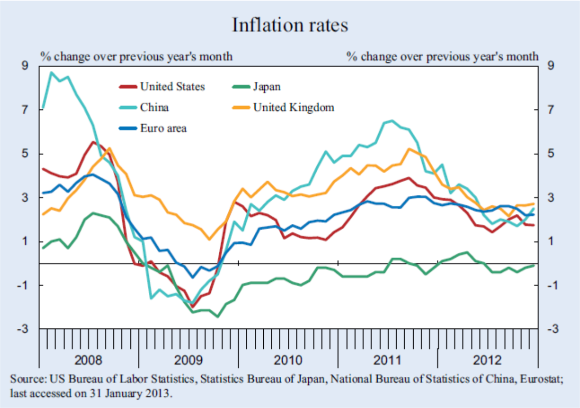
Comments on the role of the Friedman rule

What do modern central banks pursue in practice?

- They do not follow the Friedman rule...
- ...instead, they typically aim at price stability
- ...and price stability is typically defined as being consistent with mildly positive levels of inflation

Overview

Inflation performance of major central banks since 2008



Source: EEAG Report on the European Economy, 2013

ECB

Primary Mandate of the ECB:

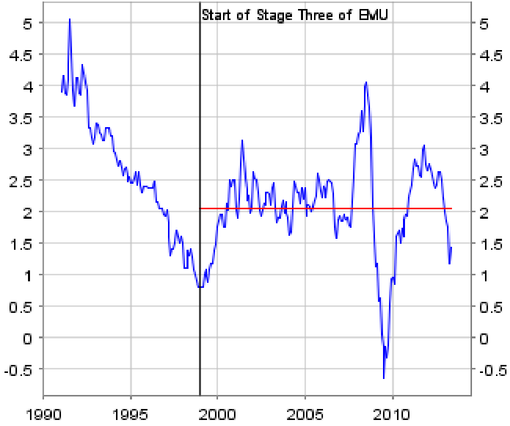
- The Treaty establishes the maintenance of price stability as the primary objective of the ECB

Quantitative definition of price stability:

- The ECB's Governing Council has defined price stability as *"a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term".*
- The Governing Council has also clarified that, in the pursuit of price stability, it aims to maintain inflation rates **below, but close to, 2% over the medium term**.

ECB

Inflation in the euro area:



HICP (annual percentage changes): *blue line*
Average inflation since 1999: *red line*

ECB

Benefits of price stability *(as seen by the ECB)*:
"...Price stability contributes to achieving high levels of economic activity and employment by...

- . . . improving the transparency of relative prices...
- . . . reducing inflation risk premia in interest rates. . .
- . . . avoiding unnecessary hedging activities. . .
- . . . reducing distortions of tax systems and social security systems. . .
- . . . increasing the benefits of holding cash. . .
- . . . preventing the arbitrary redistribution of wealth and income...
- . . . contributing to financial stability..."

Source: ECB, The Monetary Policy of the ECB, p. 56f., 2011

ECB

Benefits of the quantitative definition of price stability *(as seen by the ECB)*:

The quantitative definition of price stability...

- makes clear that not only inflation above 2% but also deflation...is inconsistent with price stability...

  ("It thereby signals a commitment to provide an adequate margin to avoid the risks of deflation...Avoiding deflation is important because in a deflationary environment monetary policy may not be able to provide a sufficient degree of support to the economy by using its interest rate instrument...Although various stimulating monetary policy actions are possible even when nominal interest rates are at zero, these alternative, unconventional policies can be very costly. It is therefore more difficult for monetary policy to fight deflation than to fight inflation.")

- takes into account a potential measurement bias. . .
- takes into account the implications of inflation differentials in the euro area

Source: ECB, The Monetary Policy of the ECB, p. 66f., 2011

Bank of England

- "The Bank's monetary policy objective is to deliver price stability – low inflation – and, subject to that, to support the Government's economic objectives including those for growth and employment. Price stability is defined by the Government's **inflation target of 2%**..."
- "The inflation target of 2% is expressed in terms of an annual rate of inflation based on the Consumer Prices Index (CPI). The remit is not to achieve the lowest possible inflation rate. Inflation below the target of 2% is judged to be just as bad as inflation above the target. The inflation target is therefore symmetrical."

Source: http://www.bankofengland.co.uk/monetarypolicy

Bank of Japan

- "The Bank of Japan conducts monetary policy based on the principle that the policy shall be aimed at 'achieving price stability, thereby contributing to the sound development of the national economy.' The relevant notion of price stability here must be one which is sustainable in the medium to long term."
- *Until January 2013:* "The Bank judges 'the price stability goal in the medium to long term' to be in 'a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI;' more specifically, it has set 'a goal of 1 percent for the time being'."
- Since **January 2013**: "The Bank sets the **price stability target** at **2 percent** in terms of the year-on-year rate of change in the CPI".

Source: http://www.boj.or.jp/en/mopo/outline/sgp.htm/

Federal Reserve System

“Following careful deliberations at its recent meetings, the Federal Open Market Committee (FOMC) has reached broad agreement on the following principles regarding its longer-run goals and monetary policy strategy. . .

- "The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that **inflation at the rate of 2 percent**, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."
- "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. . .”

Source: Statement of the Board of Governors of the Federal Reserve System from January 25, 2012