Monetary Policy in the United States and the Euro Area

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Current US Monetary Policy Stance

Interest on Reserves (IOR): 0.25%
(Federal Funds: 0.20%)

Long-Term Assets: $1.7 trillion
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Effective IOR is thus -0.75% to -1.75%. 
The Taylor Rule

Original: $\text{IOR} = 2 + \text{Inflation} + 0.5*(\text{Inf. Dev.}) + 0.5*(\text{Gap})$

$= 2 + 1 + 0.5*(-1) + 0.5*(-5)$

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Optimal policy under uncertainty about Gap argues for original coefficients when Gap is small (< 2%) and larger (e.g., Rudebusch) coefficients when Gap is large. *Gap is now large.*
The Svensson Rule

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- As implemented in Sweden and United Kingdom, get back to targets within 2 to 3 years (or at least have offsetting errors).
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FOMC’s June 2010 forecast shows gap of (at least) -2% and inflation deviation of -0.7% after 2-1/2 years.

- Far from targets and errors are compounding, not offsetting.
- This implies that policy is far too tight.
- Private forecasts broadly consistent with this conclusion.
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€100 billion long-term assets → no effect on 10-year bond yield

Effective policy rate is thus 0.40%.
(Significantly tighter than in United States.)
Euro Area Svensson Rule

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Central banks should exclude VAT changes from inflation targets.

- Otherwise, monetary policy tightens with fiscal tightening and loosens with fiscal loosening.
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Modest ($100+ billion) monthly rate of purchase of l.t. assets.
- Even greater risk of seeming ineffective.
- No implicit commitment.
- Significant balance sheet risks (eventually).
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Target 4-year Treasury yield at 0.25%.
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  • No implicit commitment.
  • Smaller balance sheet risks.
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Extend unlimited 24-month discount window credit to banks on good collateral at 0.25%.
  • Similar in spirit to ECB’s unlimited allotment of 12-month credit to banks.