The new economy challenges for central banks?

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What is the new economy?

No standard definition. Driving forces include:

- ICT
- Financial innovation
- Trade and financial market liberalisation & globalisation
- Flexible (product/labour) markets
- Improved macroeconomic policies

Monetary transmission

3 stages:

- Δ policy instrument $\rightarrow$ Δ interest rates (cost of finance)

- Δ interest rates $\rightarrow$ Δ nominal GDP (non-financial activity)

- Δ nominal GDP $\rightarrow$ Δ output vs inflation

Δ Policy instrument $\rightarrow$ Δ interest rates (cost of finance) I

Is monetary policy still effective – can we still influence relevant market rates?

- Can we influence the monetary base in a world of e-money?
- Can we control interest rates if there are perfect substitutes for base money?

Δ Policy instrument $\rightarrow$ Δ interest rates (cost of finance) II

How do market interest rates change?

- Transmission along the term structure faster
- More neutrality between alternative forms of finance
- Role of credit channel

Interest rates → nominal GDP I

Substition, income and wealth effects

- Increased hedging possibilities reduce monetary policy impact
- Differences in marginal propensities to consume important

Interest rates → nominal GDP II

Exchange rate channel

- Come closer to world where uncovered interest rate parity holds
- Globalisation increases role for this channel

Nominal GDP → output/price split

Functioning of markets determining factor

- Greater flexibility tends to increase monetary policy's impact on prices relative to output

Conclusion

- Monetary policy certainly possible
- Transmission mechanism changes
- Economics remains the same – inflation still a monetary phenomenon
  - indicators and relationships may change
  - operating procedures may change