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SUMMER SESSIONS

Refresh your knowledge of essential topics in investing

Introduction to Central Banking

Presented by Robin Greenwood

Key Points

- Central banks have multiple objectives and they face tradeoffs in balancing these objectives.
- Both low levels of inflation and low variability in inflation are desirable.
- Central bankers have three primary policy tools. These are the short-term interest rate, forward guidance, and quantitative easing.
- The Phillips Curve describes the tradeoff between unemployment and inflation. When originally studied there was a strong negative relationship, but the last half-century has shown almost no relationship.
- Central bank independence is widely debated. Some point out that political pressure on central bankers creates high average inflation. Others are more concerned that central bankers have immense power, yet are unelected.

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Central banks face multiple objectives. For instance, the U.S. Federal Reserve System's mandated objectives are Price Stability, Economic Growth, Interest Rate Stability, Financial Market and Bank Stability, and Foreign Exchange Stability. There are tradeoffs in balancing these objectives; if the Fed increases the money supply to boost economic growth, it may lead to inflation. One technique to balance tradeoffs is with countercyclical monetary policy, tightening during booms and accommodating during recessions. Countercyclical policy can maintain price stability while mitigating recessionary impact to the labor market.

Price stability is an objective as policy makers desire both low levels of inflation and low volatility in inflation. Inflation erodes the value of nominal assets and deters savings. It creates uncertainty for business and induces a risk premium on both government and corporate bonds. Unexpected inflation creates unwanted shifts in wealth. If high inflation is expected, employees demand wage increases which leads to a wage-price spiral.

Central bankers have three major policy tools. The oldest of these is the short-term interest rate. Forward guidance, or communication about the likely course of future monetary policy, became more widely used in the 1990s. Quantitative easing, the large scale purchase of assets, has been heavily used since the Global Financial Crisis in 2008.

There is a tradeoff between unemployment and inflation called the Phillips Curve after economist A.W. Phillips. When studied in the 1960s, there was a strong negative relationship between the two. Based on this, John Taylor proposed the “Taylor Rule” which quantified countercyclical monetary policy to adjust the federal funds rate based on inflation and GDP. However, since 1970 there has been very little relationship between unemployment and inflation.


A current debate in central banking is independence, or the extent of political influence on monetary policy. Politicians typically want accommodative monetary policy, especially before major elections. For example, Fed chairmen have been pressured by Presidents Johnson, Nixon, Reagan, and Trump. Alesina and Summers show evidence of a strong negative relationship between central bank independence and average inflation. This argues for independence and freedom from political influence. Others have argued that as unelected officials with great power, it's important for central bankers to be held accountable for their decisions. This position is supported by the recent trend of central bankers to broaden their toolkit using quantitative easing, forward guidance, and lending programs.

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