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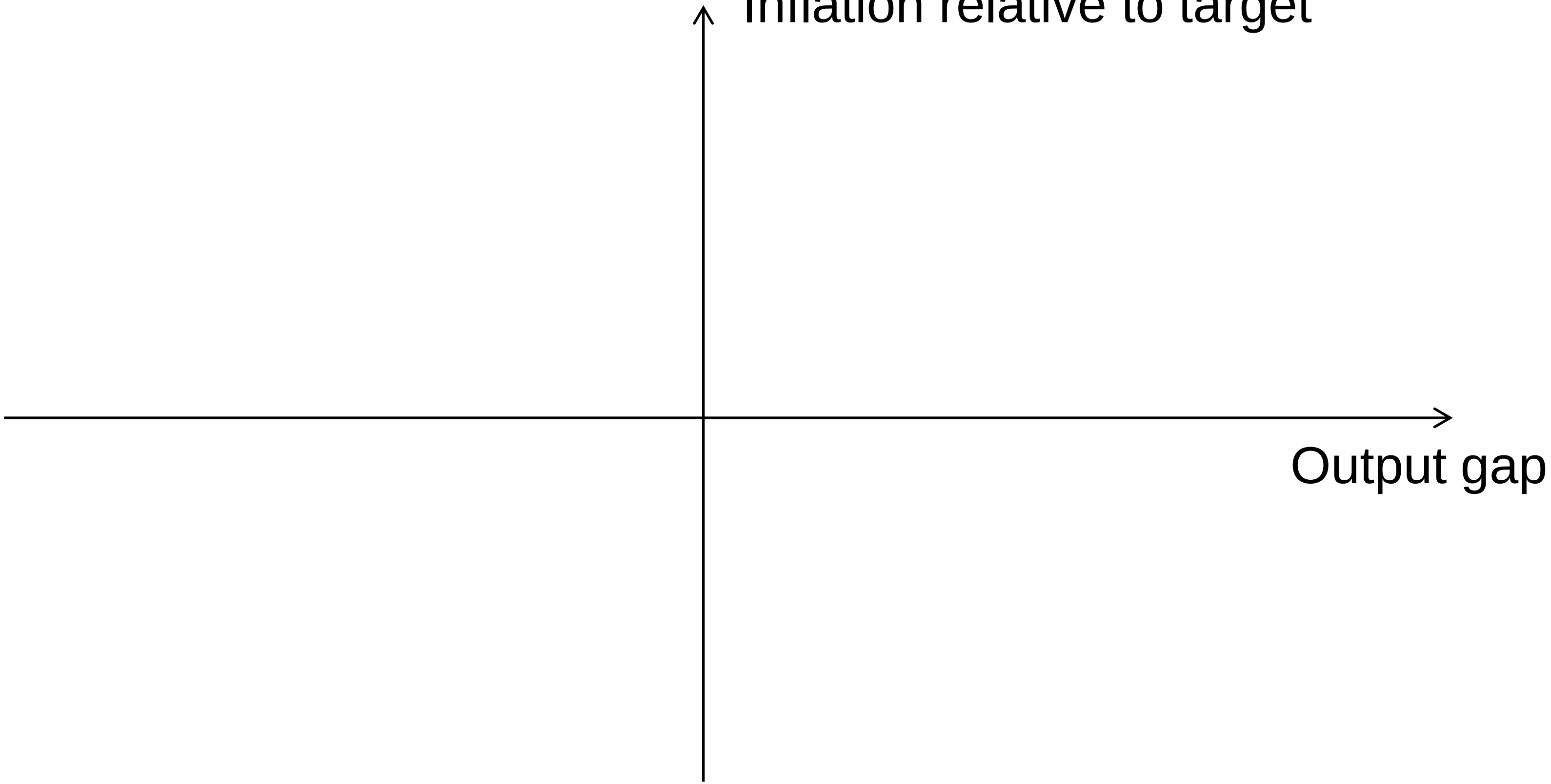
Lambda

Lecture at the London School of Economics

Mark Carney
Governor of the Bank of England

16th January 2017

Monetary policy trade-off



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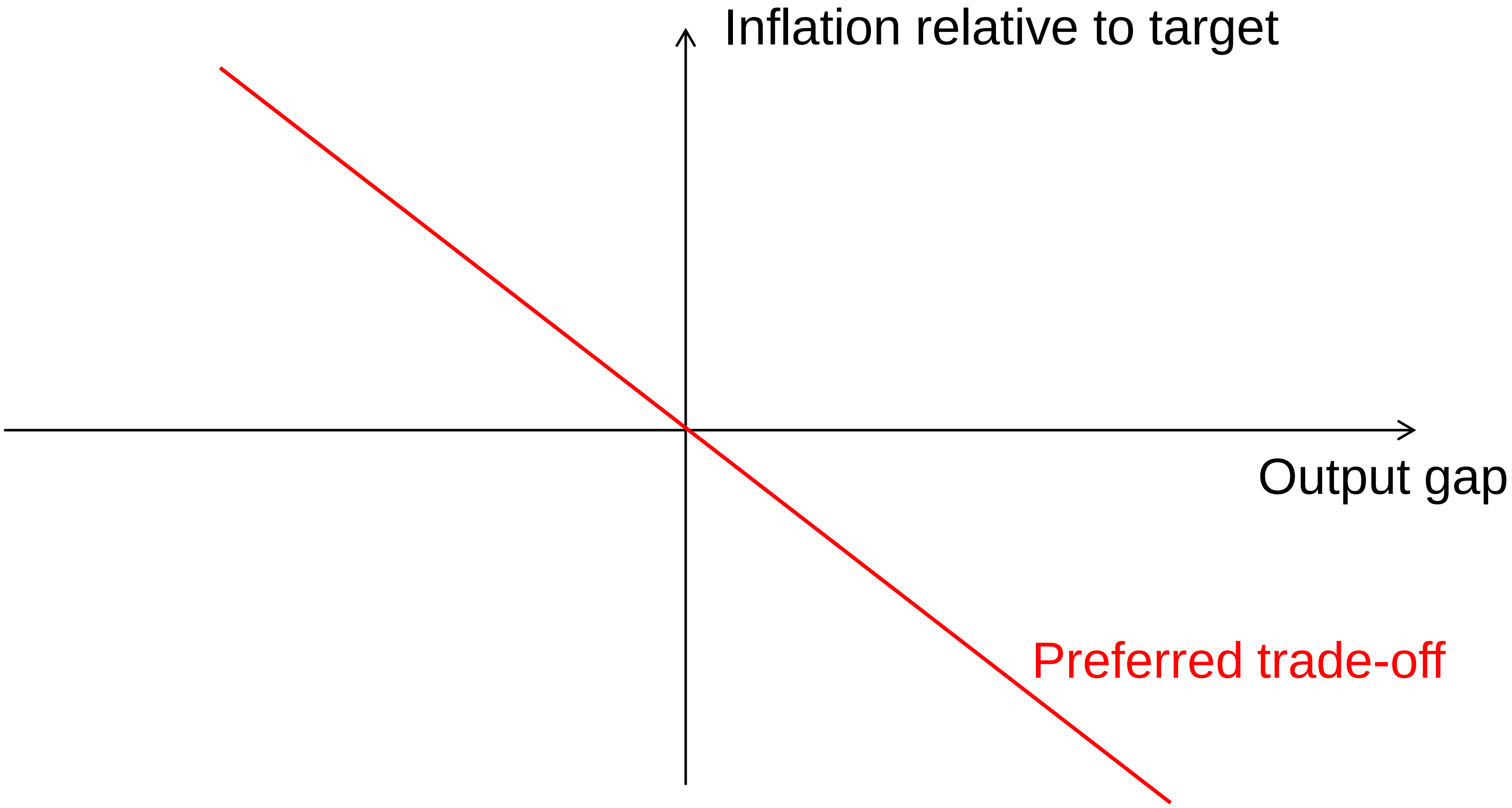
Monetary policy trade-off



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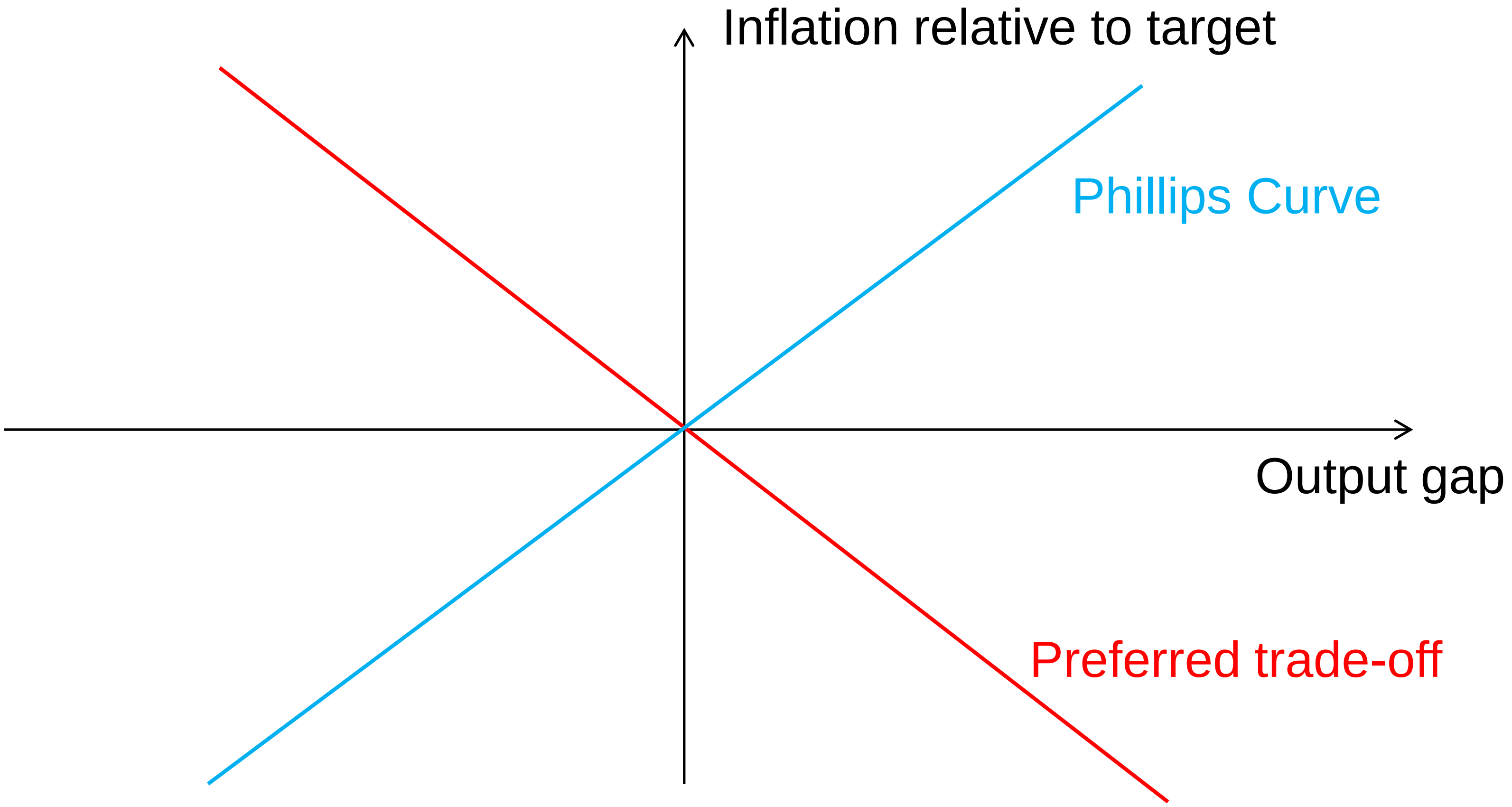
Monetary policy trade-off



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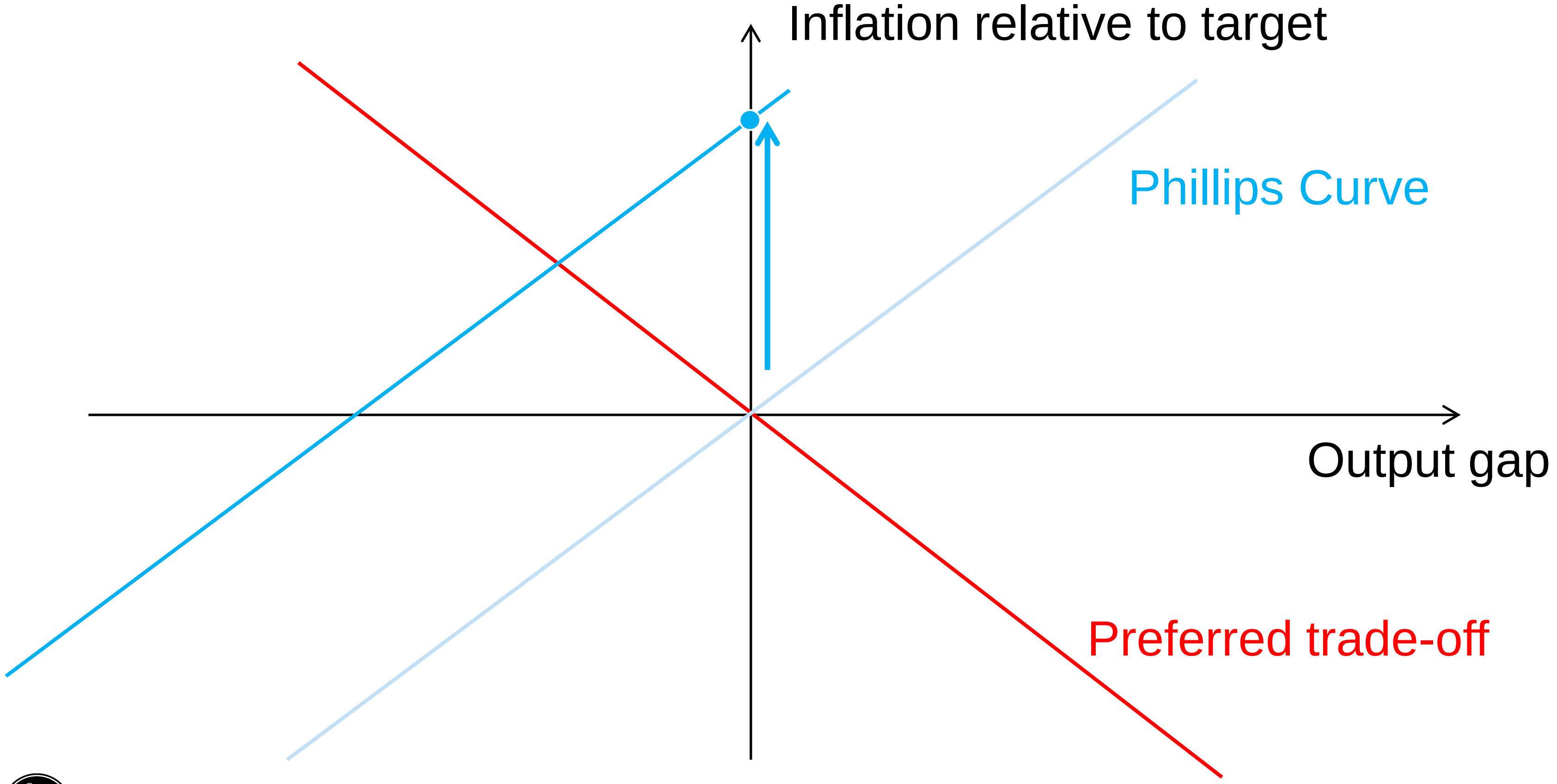
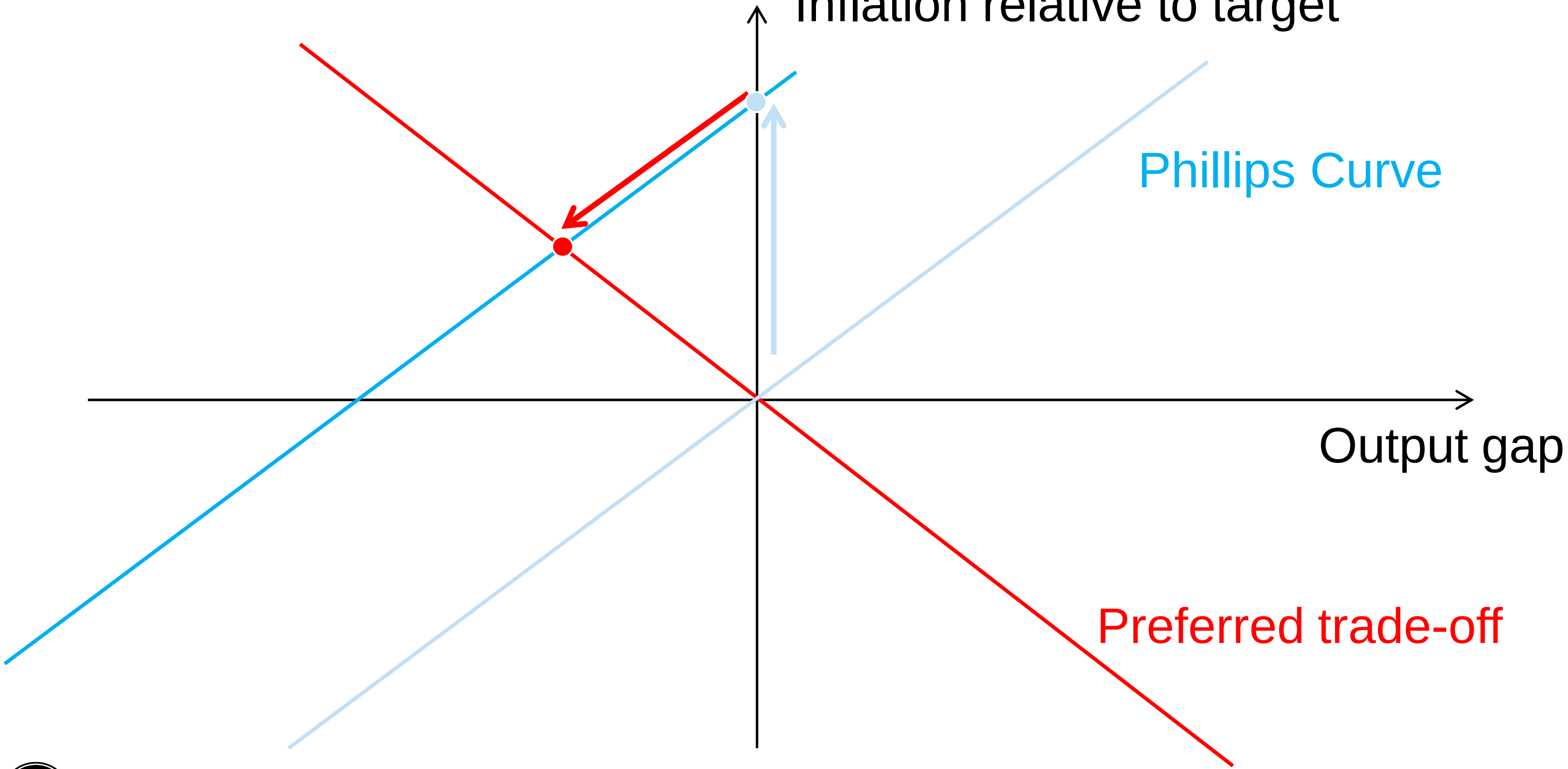
Monetary policy trade-off



Monetary policy trade-off



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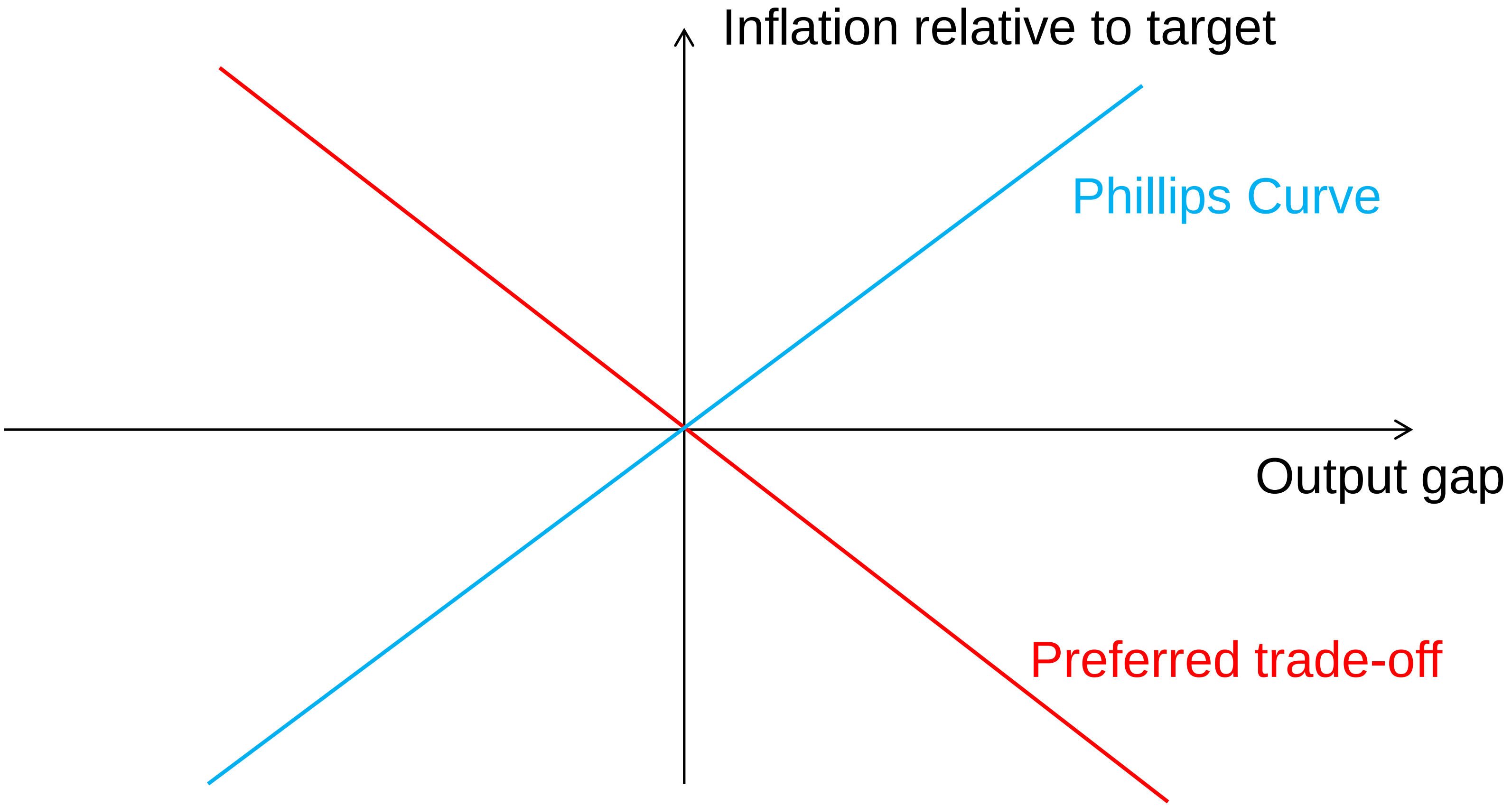
Demand shocks imply no trade-off



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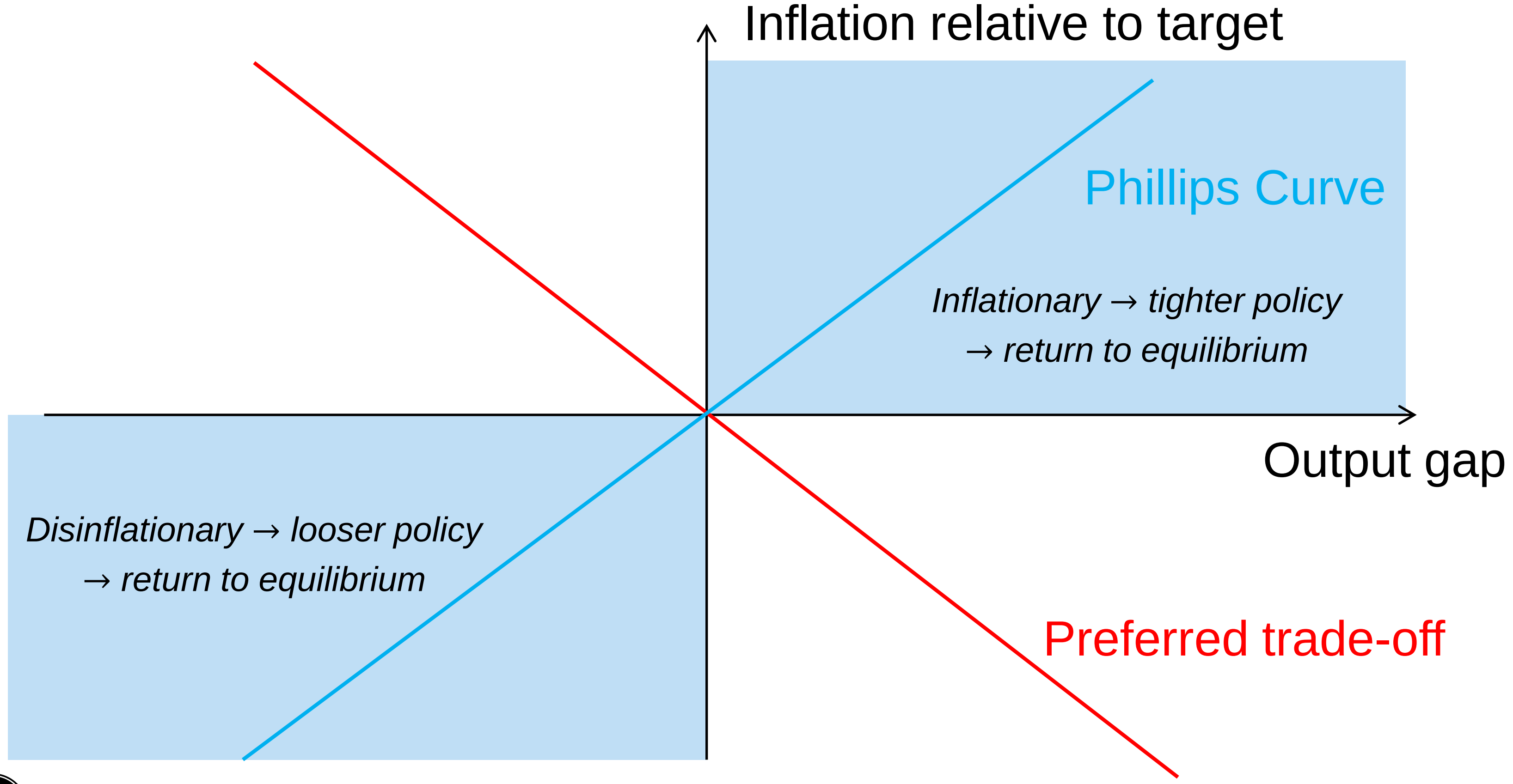

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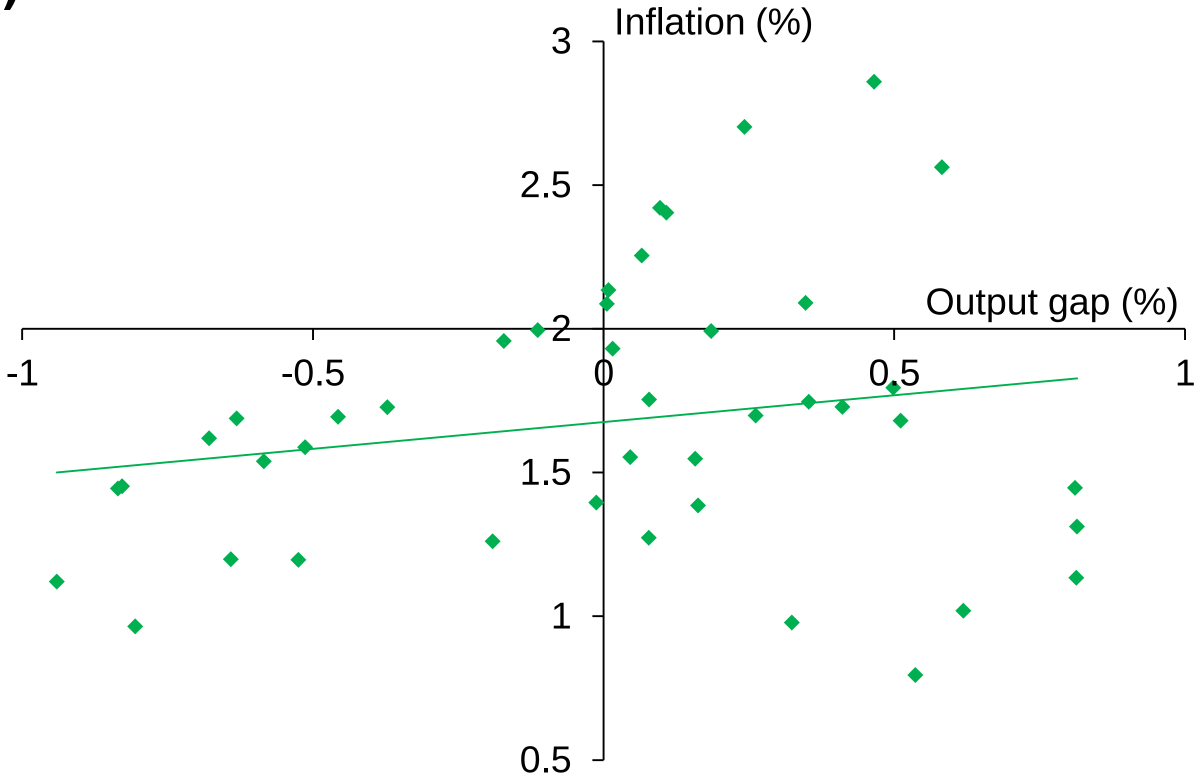
Demand shocks dominated during the “Great Moderation” (1993- 2007)…



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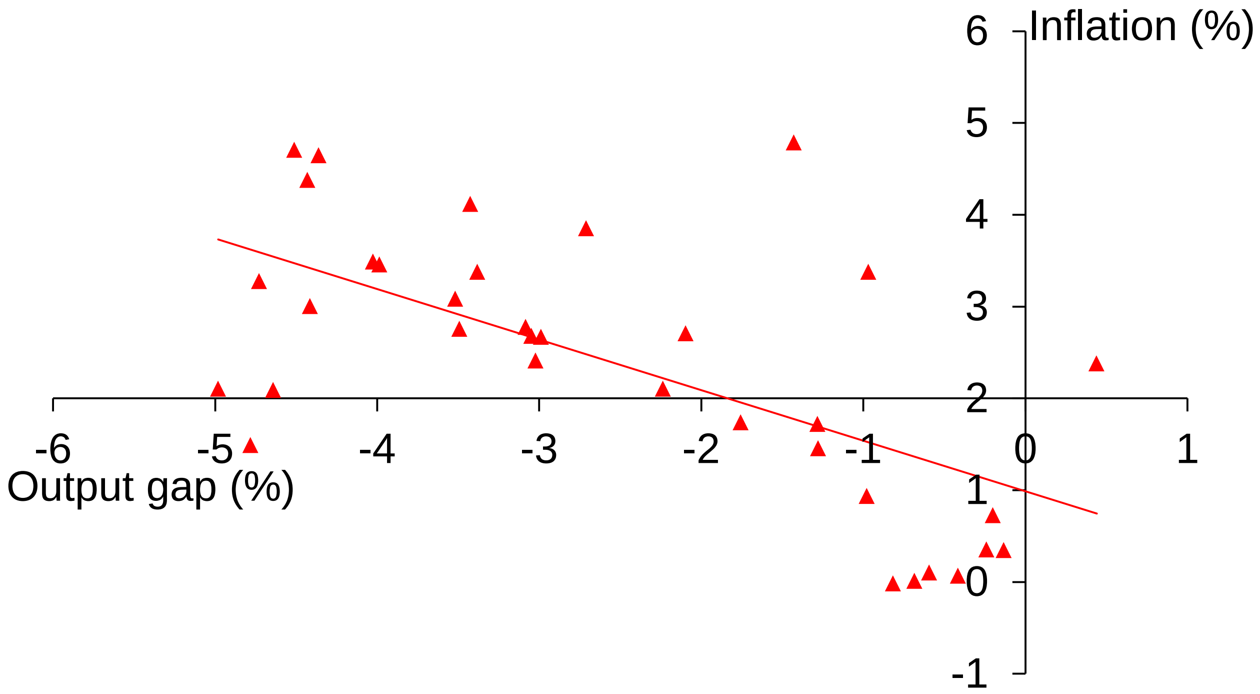
… whereas supply shocks have dominated post financial crisis



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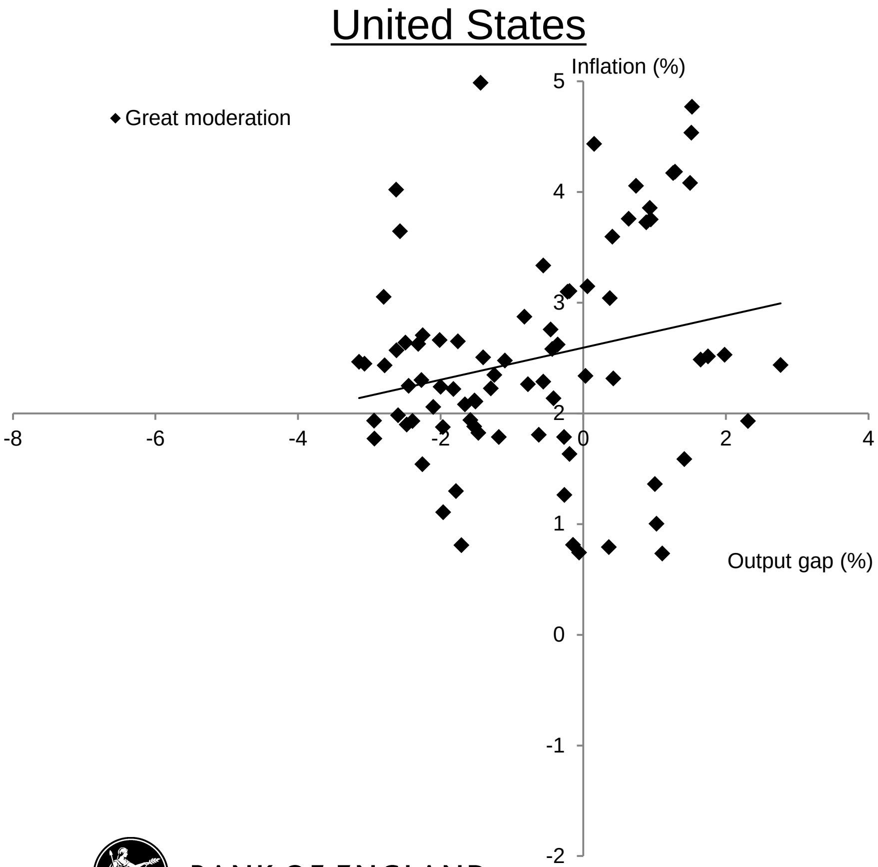
Demand shocks dominated in US…



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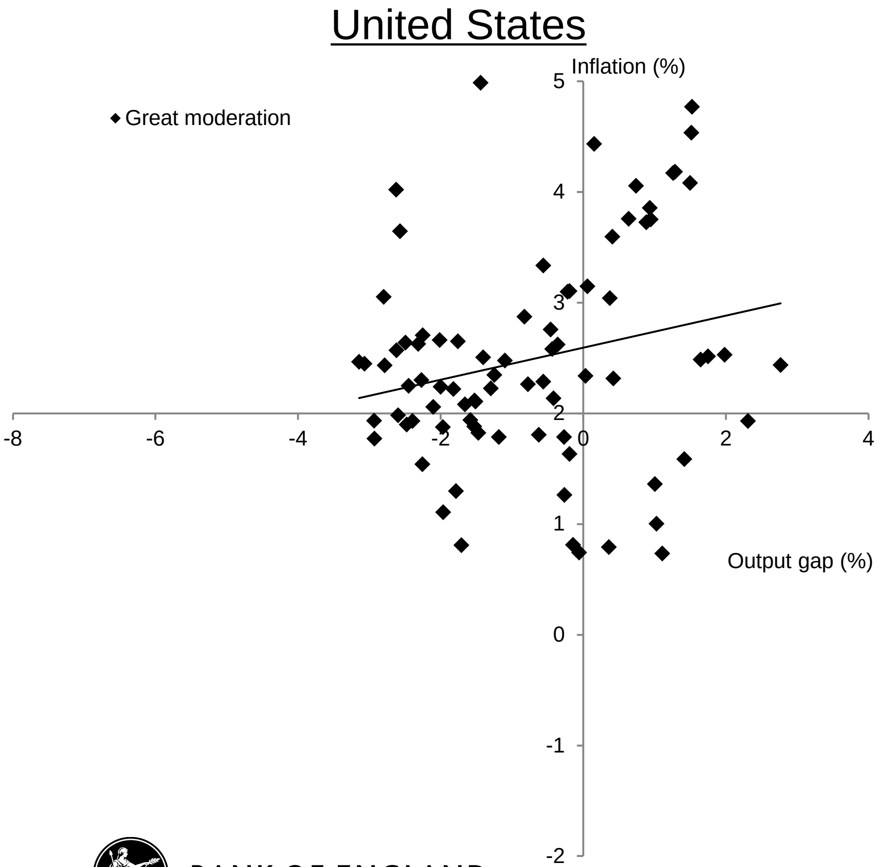
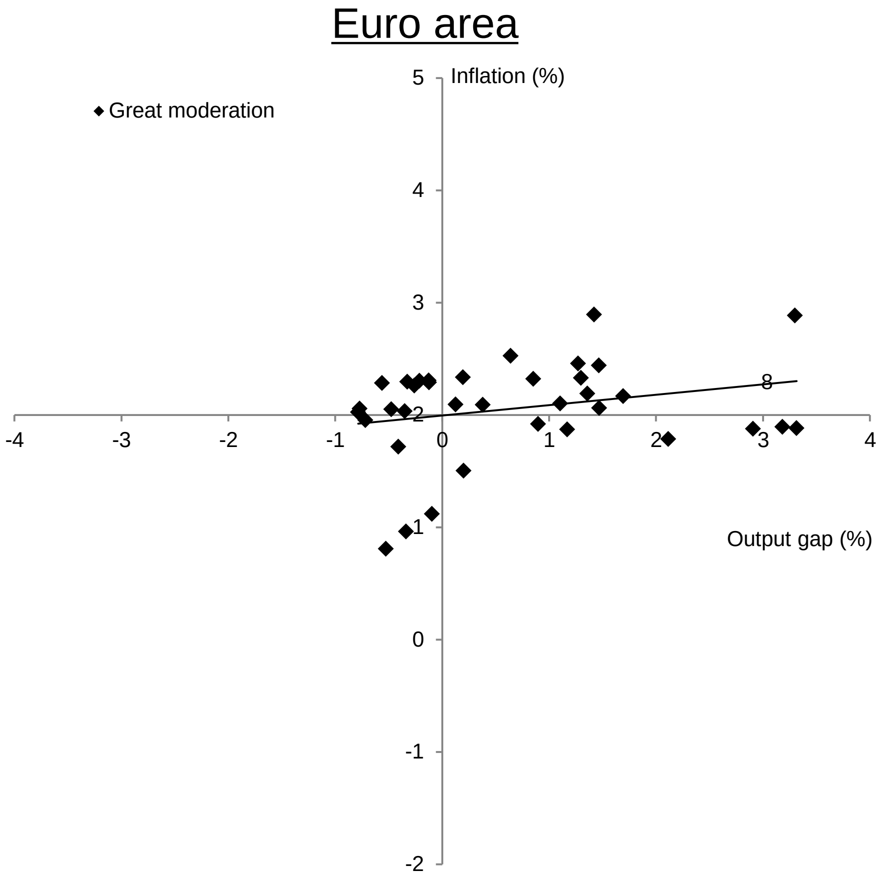
Demand shocks dominated in US… and the euro area





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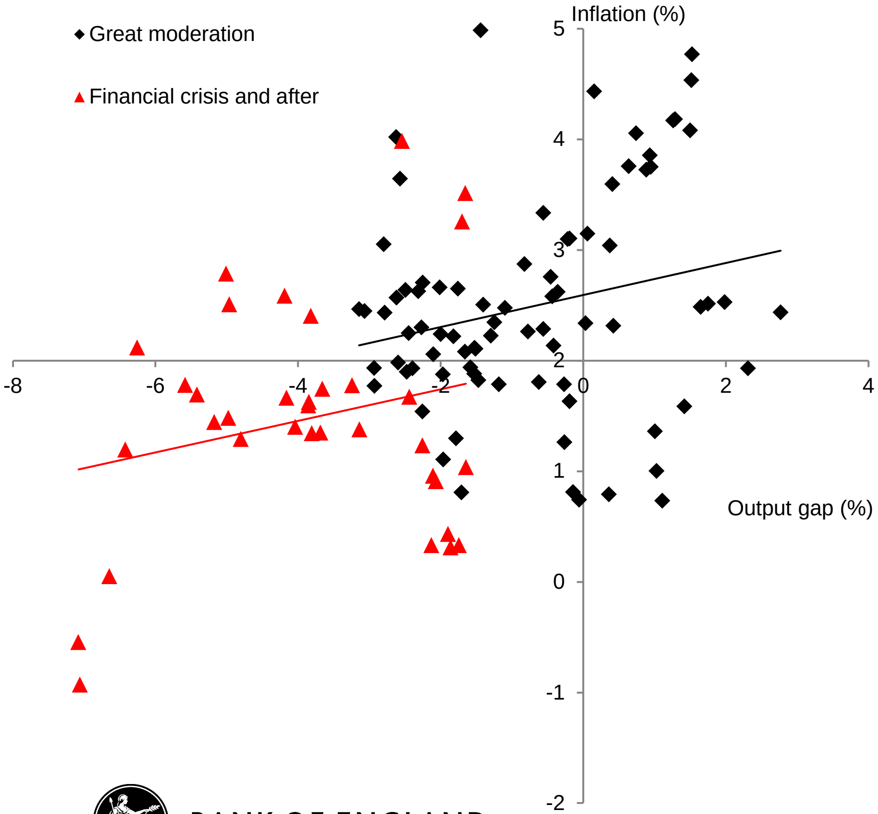
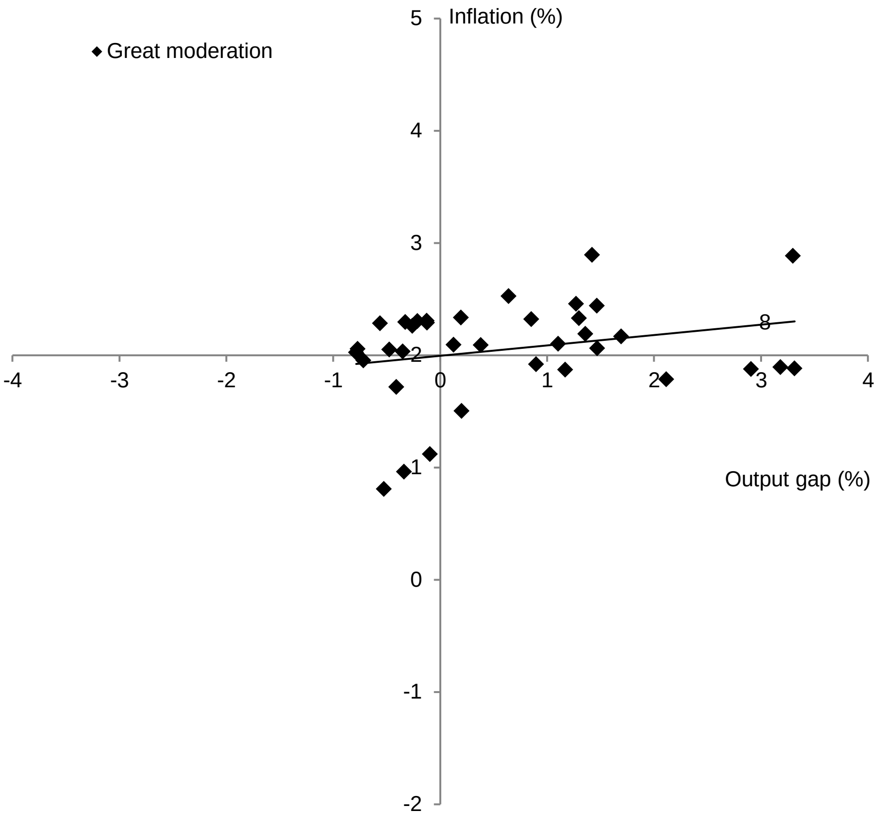
… including post crisis

United States



Euro area



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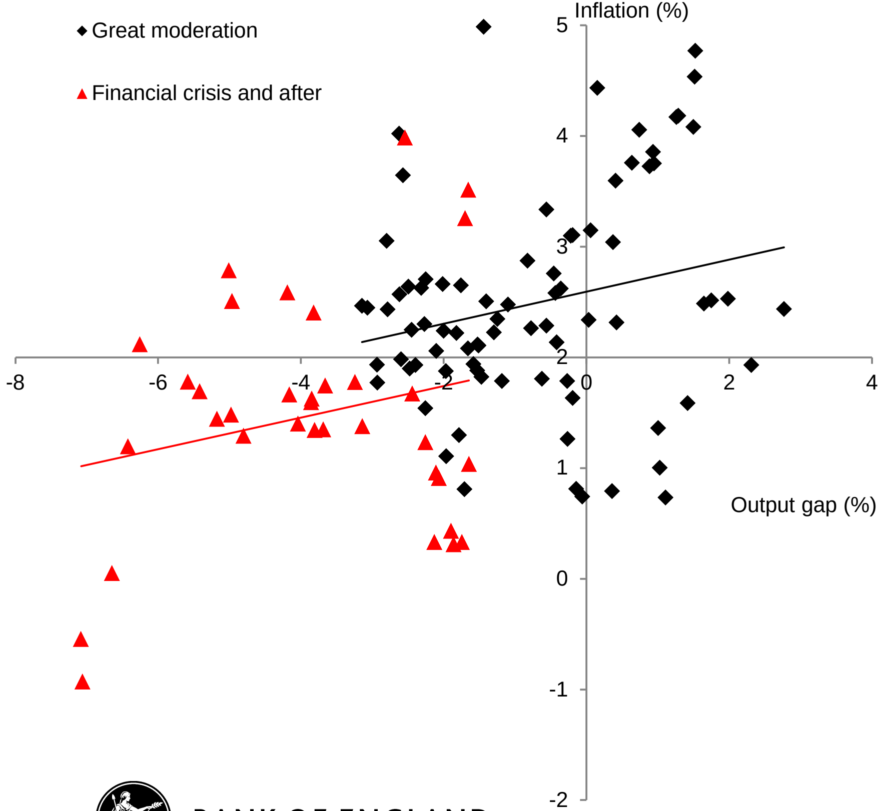
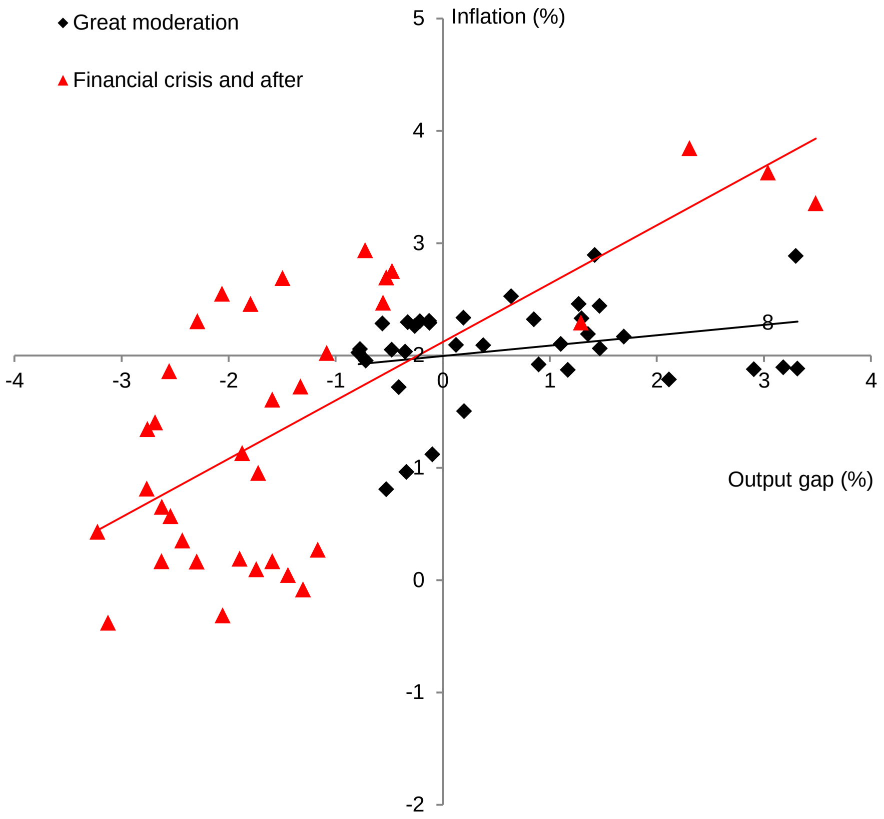
… including post crisis

United States



Euro area



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Policy problem

$$Loss_t \equiv \underbrace{(\pi_t - \pi^*)}_{\text{Deviation of inflation from target}}{}^2 + \lambda(y_t - y_t^*)^2$$

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Policy problem

$$Loss_t \equiv \underbrace{(\pi_t - \pi^*)^2}_{\text{Deviation of inflation from target}} + \lambda \underbrace{(y_t - y_t^*)^2}_{\text{Output gap}}$$

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Policy problem

$$Loss_t \equiv \underbrace{(\pi_t - \pi^*)^2}_{\text{Deviation of inflation from target}} + \overset{\text{Preference for output stabilisation}}{\lambda}\underbrace{(y_t - y_t^*)^2}_{\text{Output gap}}$$

Simple optimal policy

$$\pi_t - \pi^* = -\frac{\lambda}{\kappa}(y_t - y_t^*)$$

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Simple optimal policy

$$\underbrace{\pi_t - \pi^*}_{\text{Deviation of inflation from target}} = -\frac{\lambda}{\kappa}\underbrace{(y_t - y_t^*)}_{\text{Output gap}}$$

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Simple optimal policy

$$\underbrace{\pi_t - \pi^*}_{\text{Deviation of inflation from target}} = -\frac{\lambda}{\kappa}\underbrace{(y_t - y_t^*)}_{\text{Output gap}}$$

Slope of the Phillips Curve

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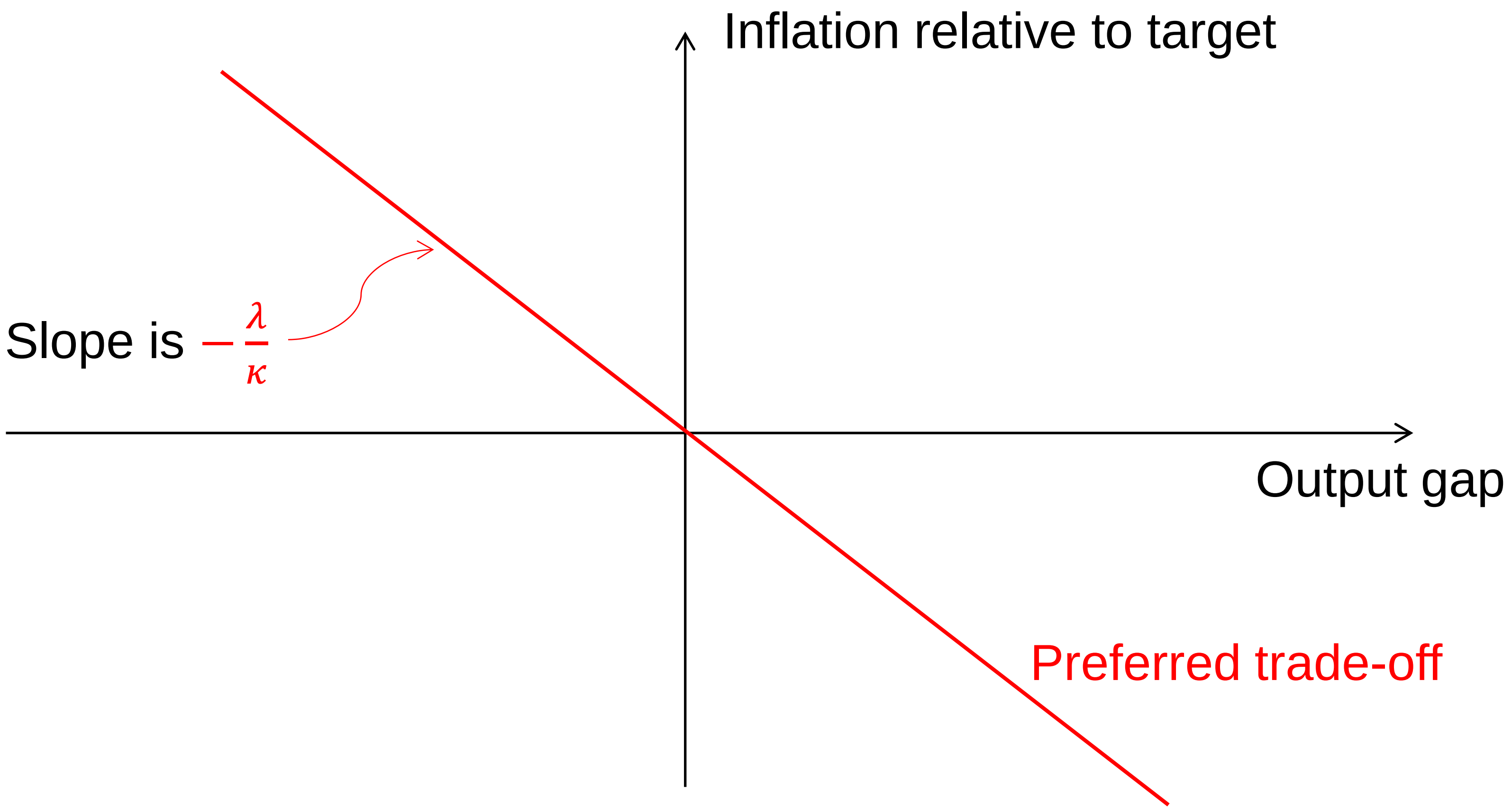
Simple optimal policy



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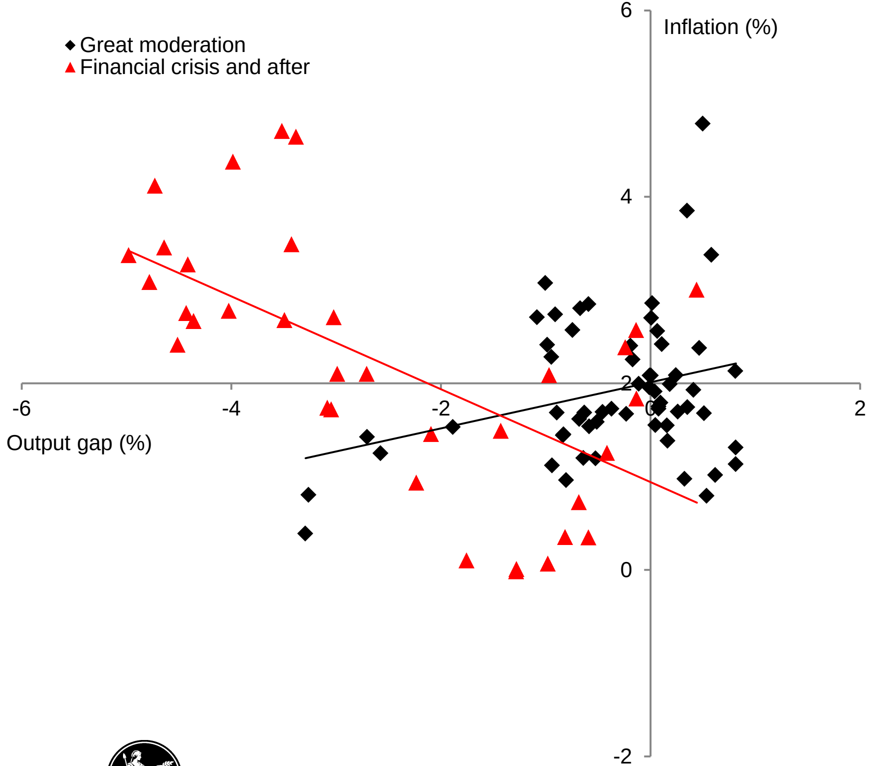
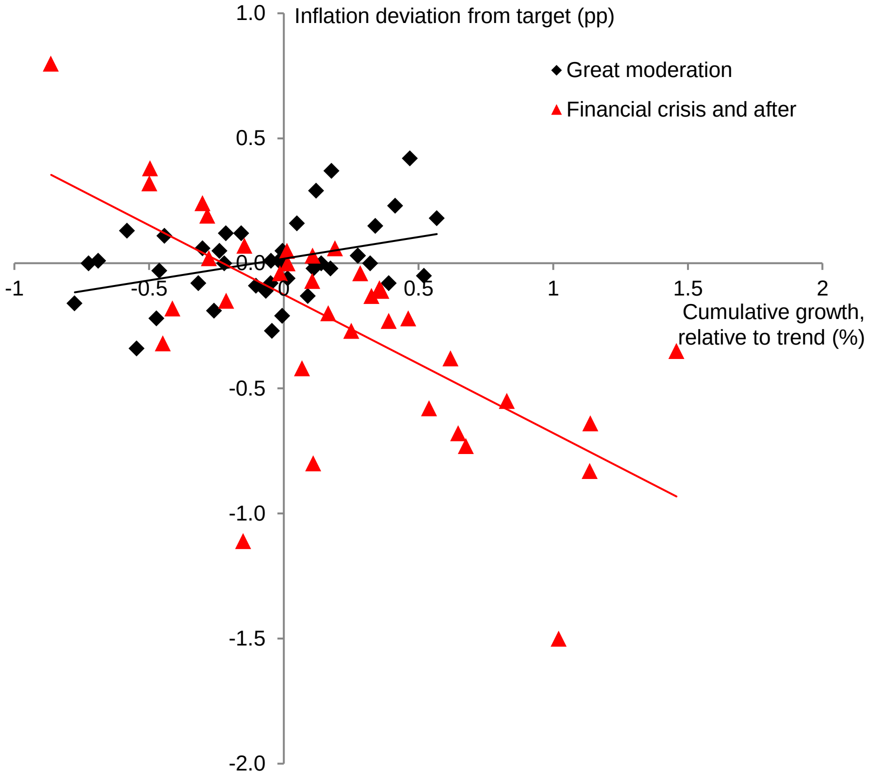
Slopes imply λ around 0.1-0.2 since 1993…

Data outturns



MPC forecasts



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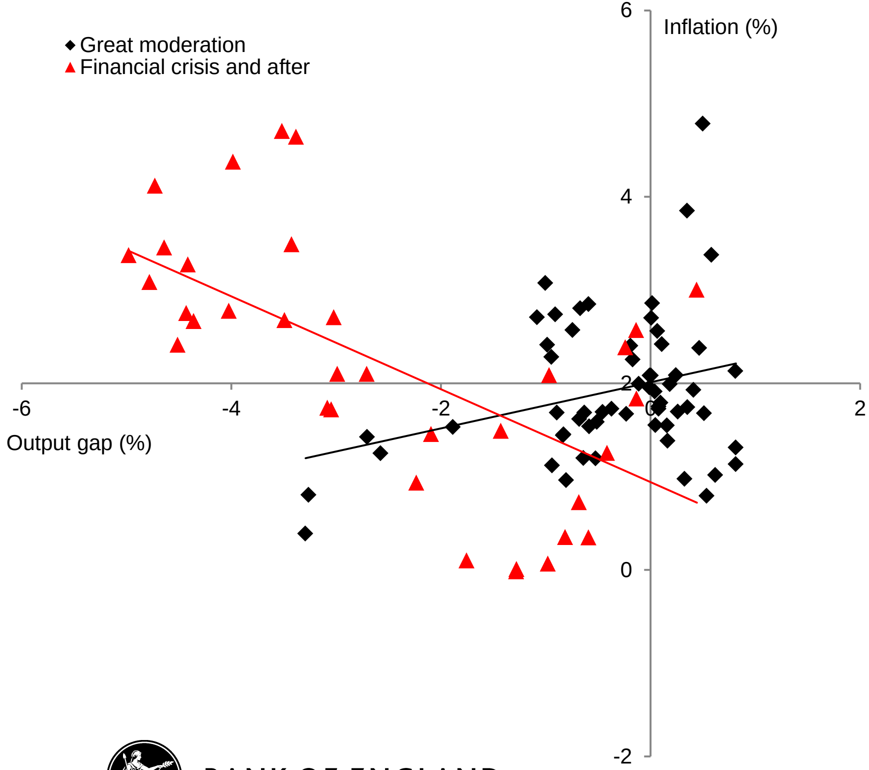
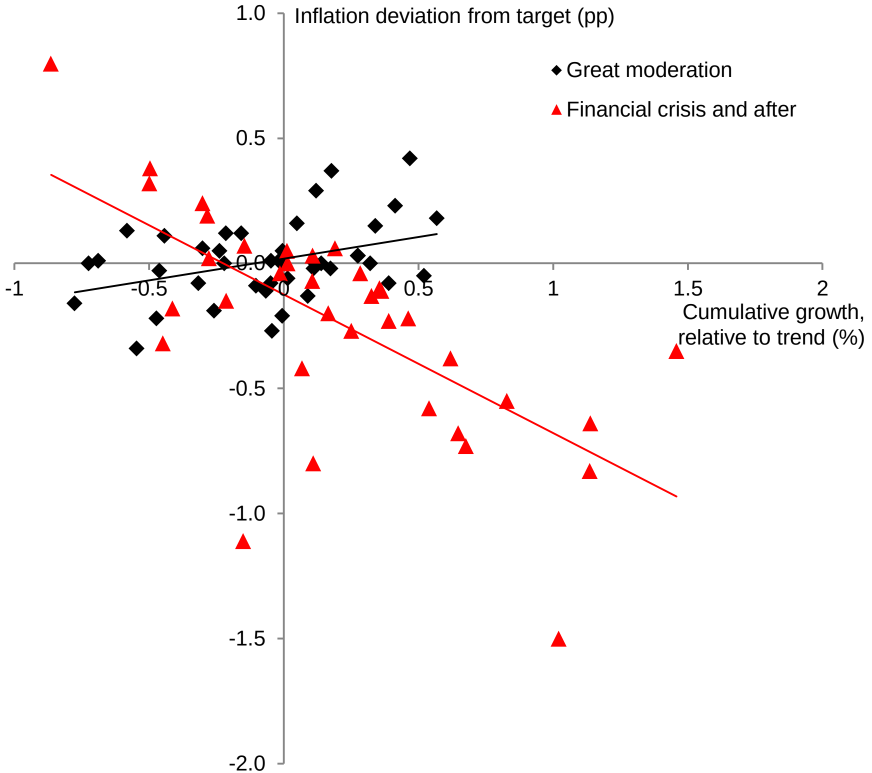
Slopes imply λ around 0.1-0.2 since 1993…and around ¼ since 2008

Data outturns



MPC forecasts



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Loss function with financial stability

$$Loss_t \equiv \underbrace{(\pi_t - \pi^*)}_{\text{Deviation of inflation from target}}{}^2 + \lambda\underbrace{(y_t - y_t^*)}_{\text{Output gap}}{}^2 + \mathbf{1}_{FPC}\beta\underbrace{(\boldsymbol{s}_t - \boldsymbol{s}_t^*)}_{\text{Financial Stability Indicators}}{}^2$$

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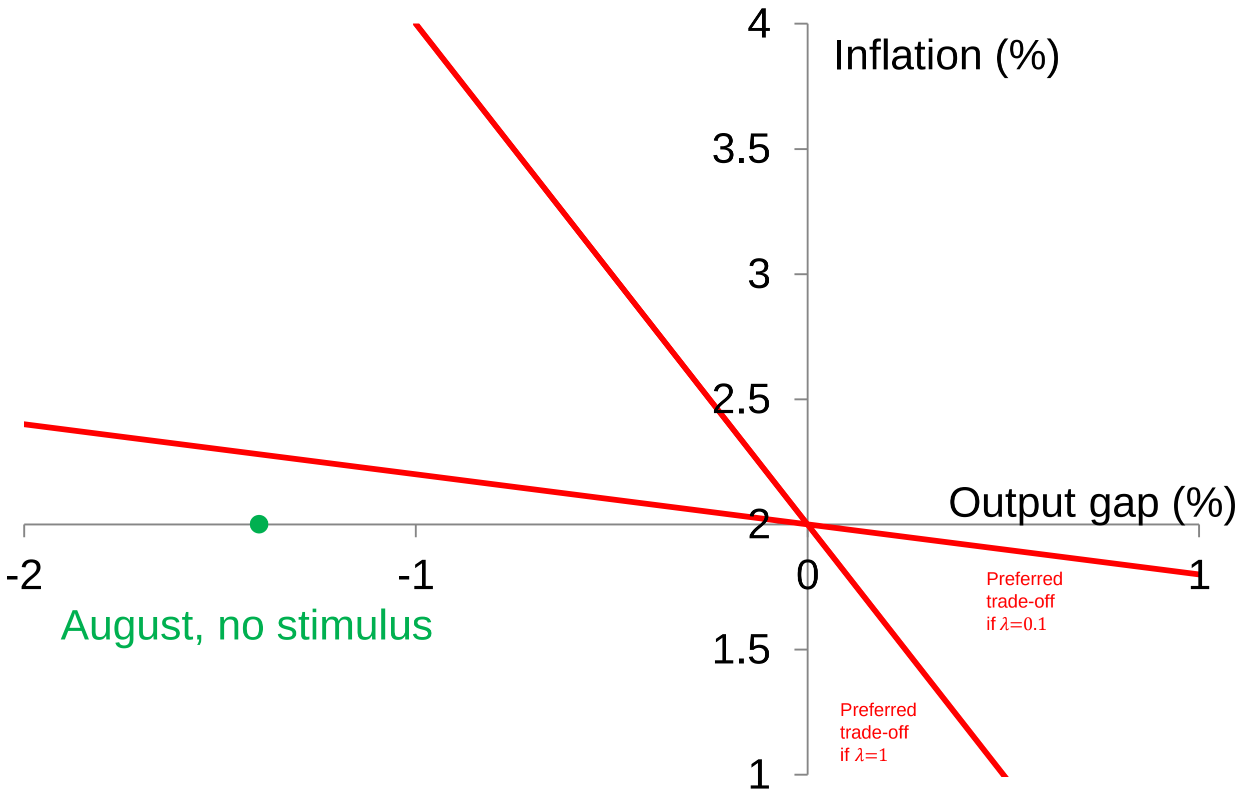
No stimulus in August would have meant no weight on output



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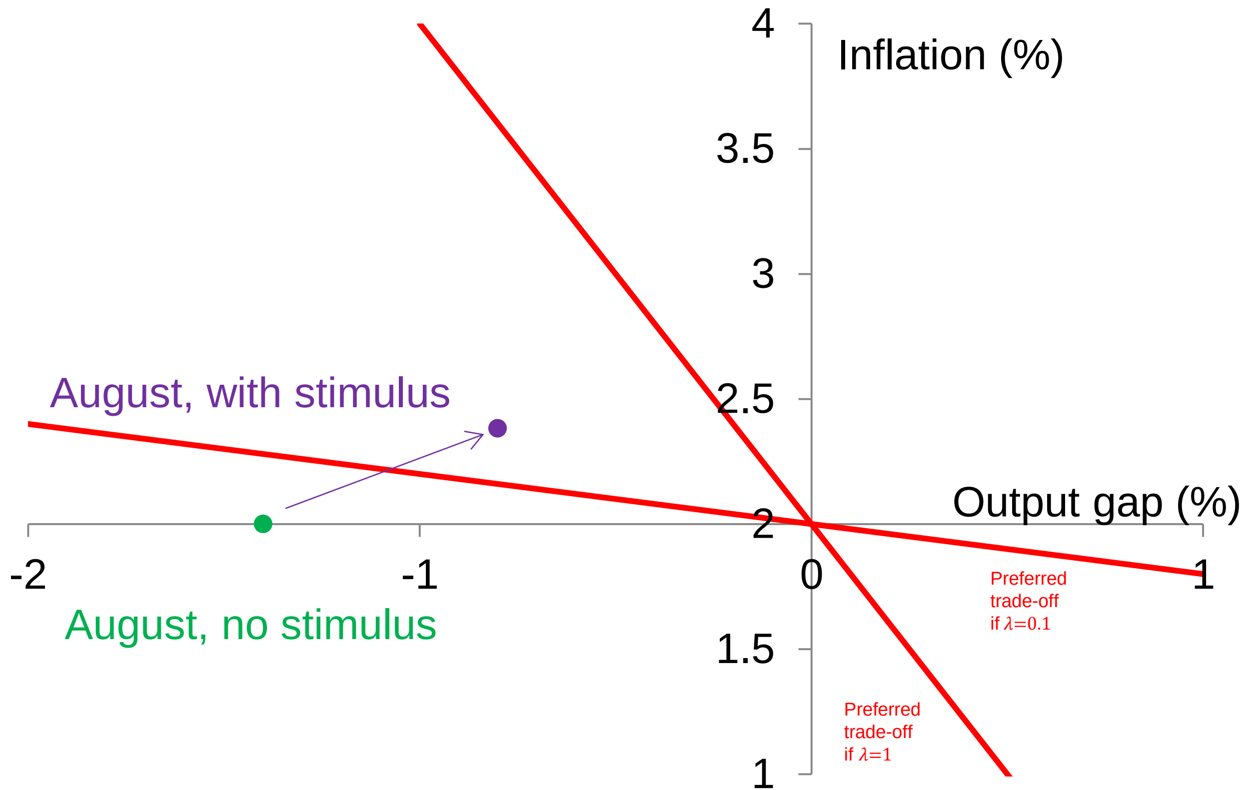
August stimulus traded off some inflation for more output and lower unemployment



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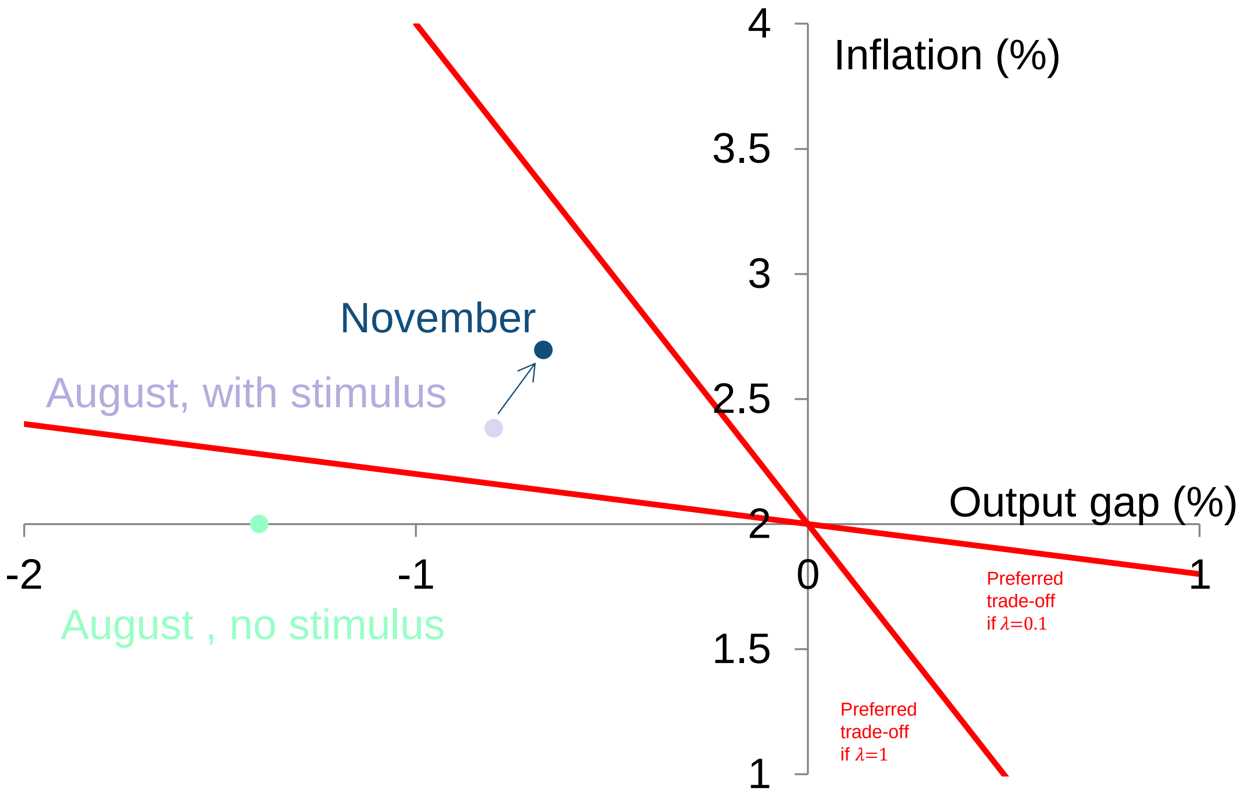
Trade-off more challenging in November



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UK inflation high and volatile during the 1970s and 1980s

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