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IMF Working Paper

Optimal Simple Objectives for Monetary Policy when Banks Matter

by Lien Laureys, Roland Meeks, and Boromeus Wanengkirtyo

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Monetary and Capital Markets Department

Optimal Simple Objectives for Monetary Policy when Banks Matter*

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Abstract

We reconsider the design of welfare-optimal monetary policy when financing frictions impair the supply of bank credit, and when the objectives set for monetary policy must be simple enough to be implementable and allow for effective accountability. We show that a flexible inflation targeting approach that places weight on stabilizing inflation, a measure of resource utilization, and a financial variable produces welfare benefits that are almost indistinguishable from fully-optimal Ramsey policy. The macro-financial trade-off in our estimated model of the euro area turns out to be modest, implying that the effects of financial frictions can be ameliorated at little cost in terms of inflation. A range of different financial objectives and policy preferences lead to similar conclusions.

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