

# MCI<sup>a</sup>s and monetary policy<sup>☆</sup>

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## Abstract

Several central banks have recently adopted a Monetary Conditions Index (MCI) to guide monetary policy under floating exchange rates. This paper discusses some analytical and practical questions raised by MCIs. Furthermore, using data for Australia, Canada and New Zealand, which all operate monetary policy under floating rates and with an inflation target, it estimates the responses of the central banks to exchange rate changes. The results reveal clear differences between central banks: while the Reserve Bank of Australia does not appear to respond, the Bank of Canada and the Reserve Bank of New Zealand, who use the MCI as an operating target, do respond quite strongly to movements in the exchange rate. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

The day-to-day conduct of monetary policy in a small open economy is arguably more difficult under a floating than under a (credibly) fixed exchange

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<sup>☆</sup> An early draft of this paper with the title ‘MCIs and Monetary Policy in Small Open Economies Under Floating Rates’ was presented at the conference on ‘The Monetary Transmission Mechanism and Financial Integration’ held in Lisbon in 1996 on the occasion of the 150th Anniversary of the Banco de Portugal.

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rate regime. While the daily management of policy under fixed rates mainly involves moving short-term rates in order to maintain the exchange rate in the appropriate part of the band, under floating rates policy makers need to determine to what extent interest rates should react to exchange rate changes.<sup>1</sup> This requires them to form opinions about the sources of the shocks affecting the exchange rate, their effects on macroeconomic conditions, and whether to attempt to offset them. A further question that arises is how they should judge the stance of policy when the exchange rate changes. Needless to say, these are difficult tasks.

In this paper, we discuss a number of issues concerning the role of the exchange rate in the conduct of monetary policy in small open economies under flexible exchange rates. Recently, several central banks have adopted a monetary conditions index, MCI, in order to incorporate the exchange rate in the design and implementation of monetary policy. While the MCI is defined in the same way in all countries – as a weighted average of a short-term interest rate and an exchange rate, real or nominal – its exact use differs between central banks. For instance, the Bank of Canada and the Reserve Bank of New Zealand use it as an operating target: that is, in light of the inflation outlook they form a view of a desirable range for the MCI and use policy-controlled interest rates to achieve it. In contrast, in Sweden, Norway, Finland and Iceland it is merely used as one indicator among many of the stance of policy.

Despite its increasing popularity, research on the economic underpinnings of MCIs has only recently started to appear.<sup>2</sup> In this paper we attempt to make some progress in this direction. The paper consists of three sections. In the second section we use a simple model to derive the optimal feedback rule of a central bank which cares about output and inflation (Section 2.1). We demonstrate that in this specific model, the feedback rule can be written in terms of an MCI, that is, the central bank can minimise its objective function by setting a weighted average of interest and exchange rates in response to changing macroeconomic conditions. Moreover, we show that such an operating target for the MCI has the advantage that it automatically achieves the desired monetary policy stance in the presence of credibility shocks to the exchange rate.

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<sup>1</sup> Of course, this is not to say that the conduct of policy under fixed rates is simple, but rather that the difficult policy questions that arise tend to be of a strategic, and not a day-to-day, nature: for instance, what is the appropriate exchange rate (or basket of exchange rates) to peg to; how widely fluctuation bands should be adopted; and whether, and if so when, the parity should be adjusted. Moreover, if the fixed exchange rate is not seen as credible, further problems arise. Several small open economies have for this very reason adopted floating exchange rates.

<sup>2</sup> See, for instance, Alexander (1997), Ball (1998), Grande (1997) and Svensson (1998). Ericsson and Kerbeshian (1997) survey research on MCIs.

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