BANK FOR INTERNATIONAL SETTLEMENTS

Central banking post-crisis: Beyond inflation targeting?

by

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Background

- Central banks (CBs) as great winners following the crisis ?
  - Saviours of financial system and new powers
- Beneath the surface, picture is less reassuring
  - Pre-crisis monetary policy (MP) certainties have gone
  - Line between fiscal and MP has become blurred
  - Even ability to control inflation has been questioned
- Threefold challenge ahead
  - Economic: long-lasting scars of the crisis and signs of unsustainable booms in EMEs
  - Intellectual: benchmark analytical frameworks have failed
  - Institutional: independence under threat
- What compass for the years ahead
  - What role for inflation targeting (IT)?

Thesis: 3 features of new compass

- Full recognition of interdependence between monetary and financial stability in analysis and policy formulation
  - Rediscovery of intellectual roots of a monetary economics
  - Adjustments to current IT frameworks
- Keener awareness of the global dimensions of that task
  - Act locally but think globally
- Recognition of the limitations of what CBs can achieve
  - Need to manage expectations to preserve credibility and public support

Structure of presentation

- I. Shift from pre-crisis consensus to post-crisis doubts
- II. Working hypotheses for new compass
- III. Desirable policy adjustments
- IV. Challenges and open questions

I. Pre-crisis consensus: 4 propositions (Ps)

- **P1:** Price stability is sufficient for macroeconomic stability
  - Basis for inflation targeting (± 2-year horizon)
  - Analytics: standard New Keynesian paradigm
- **P2:** There is clear separation between monetary and financial stability functions
  - (Except for LOLR in crisis management)
  - Microprudential orientation of regulation and supervision (R&S) downplayed role of the CB
- **P3:** A short-term interest rate is sufficient to capture the impact of MP on the economy
  - Analytics : perfect substitutability across asset classes
  - Little perceived risk of hitting the zero lower bound
- **P4:** If each CB looks after its own economy, the global MP stance will be appropriate too
  - Equivalent to microprudential approach to R&S
  - Analytics: (strong version) UIP + PPP

I. Post-crisis: consensus and disagreements

- Elements of a new consensus
  - **P1:** Low and stable inflation does not guarantee financial and macroeconomic stability
    - Obvious from lead-up to crisis
  - **P2:** Cleaning up the debris through MP is costly and interest rate policy is not enough
    - Policy rates driven to ZLB and aggressive use of CB balance sheets
  - **P3**: Need to shift from micro- to macroprudential (MaP) orientation in R&S, with key role for CBs
    - Major steps under way nationally and internationally
- Disagreement
  - Should MP seek to lean against financial imbalances (FIs) even if inflation is low and stable ?
  - How serious is the collateral damage of extraordinarily accommodative MP in the wake of a crisis ?

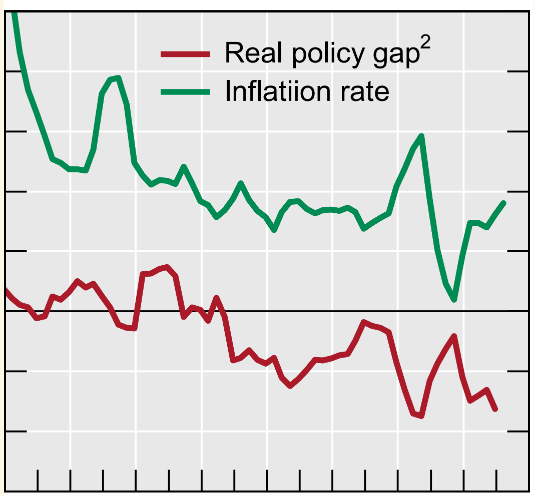
  => Role of inflation targeting

II. 3 working hypotheses (Hs)

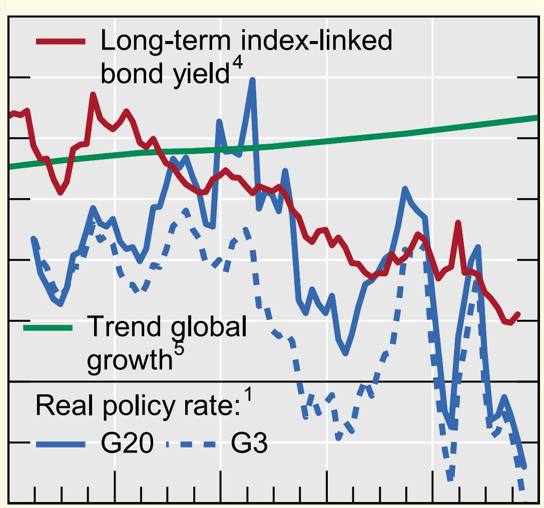
- **H1:** MP contributed significantly to the crisis
  - It supported the build-up of FIs
    - Relatively low interest rates (Graph 1) and impact on risk-taking
- **H2:** Aggressive and prolonged easing post-crisis has serious limitations
  - Post-credit boom crises have long-lasting effects of on output and potential
    - Overestimation of potential during boom; misallocation of resources; debt and capital stock overhangs
  - Easing delays necessary adjustment, raises financial stability risks and can compromise CB independence
- **H3:** Keeping own house in order is not enough
  - Floating exchange rates provide only limited insulation
  - Tendency to underestimate role of global factors (Graph 1)
    - Analogous to shift from micro- to MaP perspective

Graph 1: unusually accommodative monetary conditions

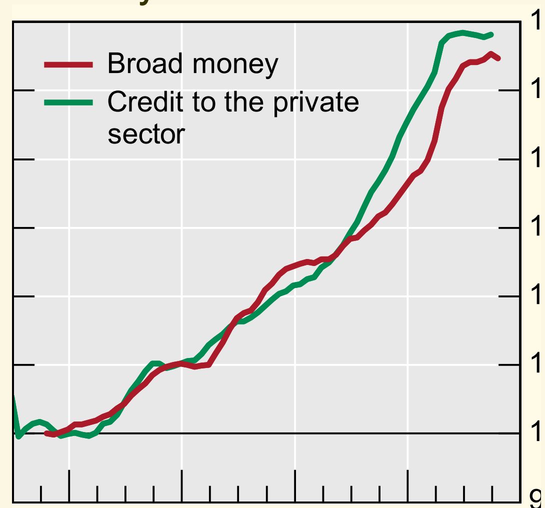
Real policy gap[1]



Interest rates and trend growth[3]



Money and credit[1,6]



[1] G20 countries; weighted averages based on 2005 GDP and PPP exchange rates. [2] Real policy rate minus natural rate. The real rate is the nominal rate adjusted for four-quarter consumer price inflation. The natural rate is defined as the average real rate 1985–2005 (for Japan, 1985–95; for Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia and South Africa, 2000–05; for Argentina and Turkey, 2003–05) plus the four-quarter growth in potential output less its long-term average. [3] In per cent. [4] From 1998; simple average of Australia, France, the United Kingdom and the United States; otherwise only Australia and the United Kingdom. [5] Trend world real GDP growth as estimated by the IMF in WEO 2009 Apr. [6] Relative to nominal GDP; 1995 = 100.

Sources: IMF; OECD; Bloomberg; national data; BIS calculations and estimates.

II. A new form of time inconsistency?

- All very familiar with time inconsistency in context of inflation
- But there is a more insidious form in the context of financial cycles
  - Booms: longer lags
  - Bust: pressure to refrain from normalising rates is huge
- Long-run risk:
  - MP ends up with no ammunition left!
    - After 20 years, JP has not managed to exit!
- And "own-house-in-order" doctrine turns local into global time inconsistency
- Are we seeing this again?
  - Countries at core of crises getting close to exhausting room
  - Policy rates in EMEs are very low despite signs of build-up of FIs
  - Does the global stance of MP add up? (Graph 1)

III. A way forward: 4 policy adjustments (As)

- **A1:** MaP frameworks not sufficient to constrain the build-up of FIs
  - MP has a role to play ("lean option")
  - Overly optimistic expectations about what MaP can do on its own
    - Narrow conception of MP is not a viable blueprint for the future

- **A2:** Reconsider role of aggressive MP to deal with unwinding of FIs
  - need to be aggressive in crisis management but thereafter balance-sheet repair should have priority
    - A1 + A2 = more symmetric MP over financial cycle

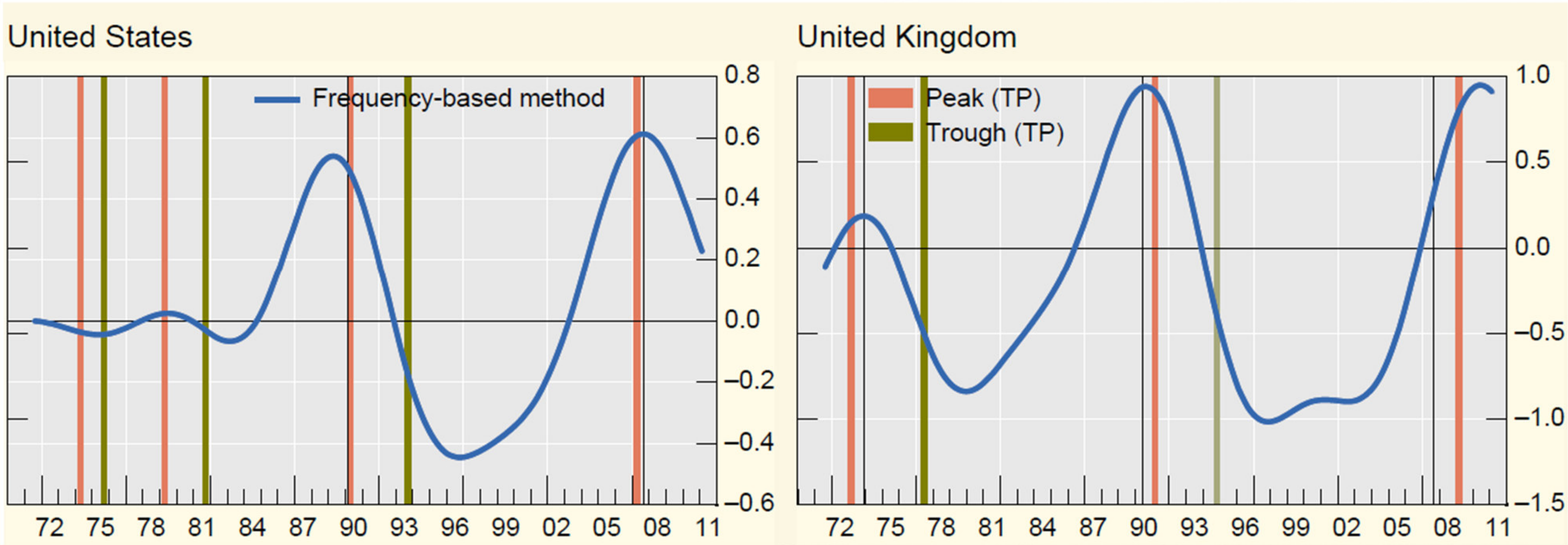
- **A3:** Strengthen further CB operational independence
  - Also critical for MaP policies!
    - There is a constituency against inflation but none against he inebriating feeling of getting richer…

- **A4:** Find ways to internalise spillover effects of individual CB policies and their contributions to global monetary conditions
  - One's house cannot be in order unless global village is

III – Whither inflation targeting?

- Adjustments to IT
  - Shift from near-term to sustainable price stability
  - Lengthen policy horizon and focus on balance of risks
    - Minimum to incorporate <u>medium-term</u> financial cycles
      - Much longer than traditional business cycles and closely linked to banking crises (Graph 2)
    - Needed to avoid “unfinished recessions” (Graph 3)
      - Respond to short-term business fluctuations at cost of larger recessions further down the road
      - Focus firmly on the <u>medium term</u>!
  - No need to change mandate to include financial stability
    - Country-specific issue
    - Analytical framework matters more than mandate
      - Could be counterproductive in some cases
- Is such flexible IT still IT?
  - Beauty is in the eye of the beholder…
- But would suggest that unreformed IT has failed the “no regrets” test
  - Not so before the crisis!

Graph 2: The medium-term financial cycle and crises



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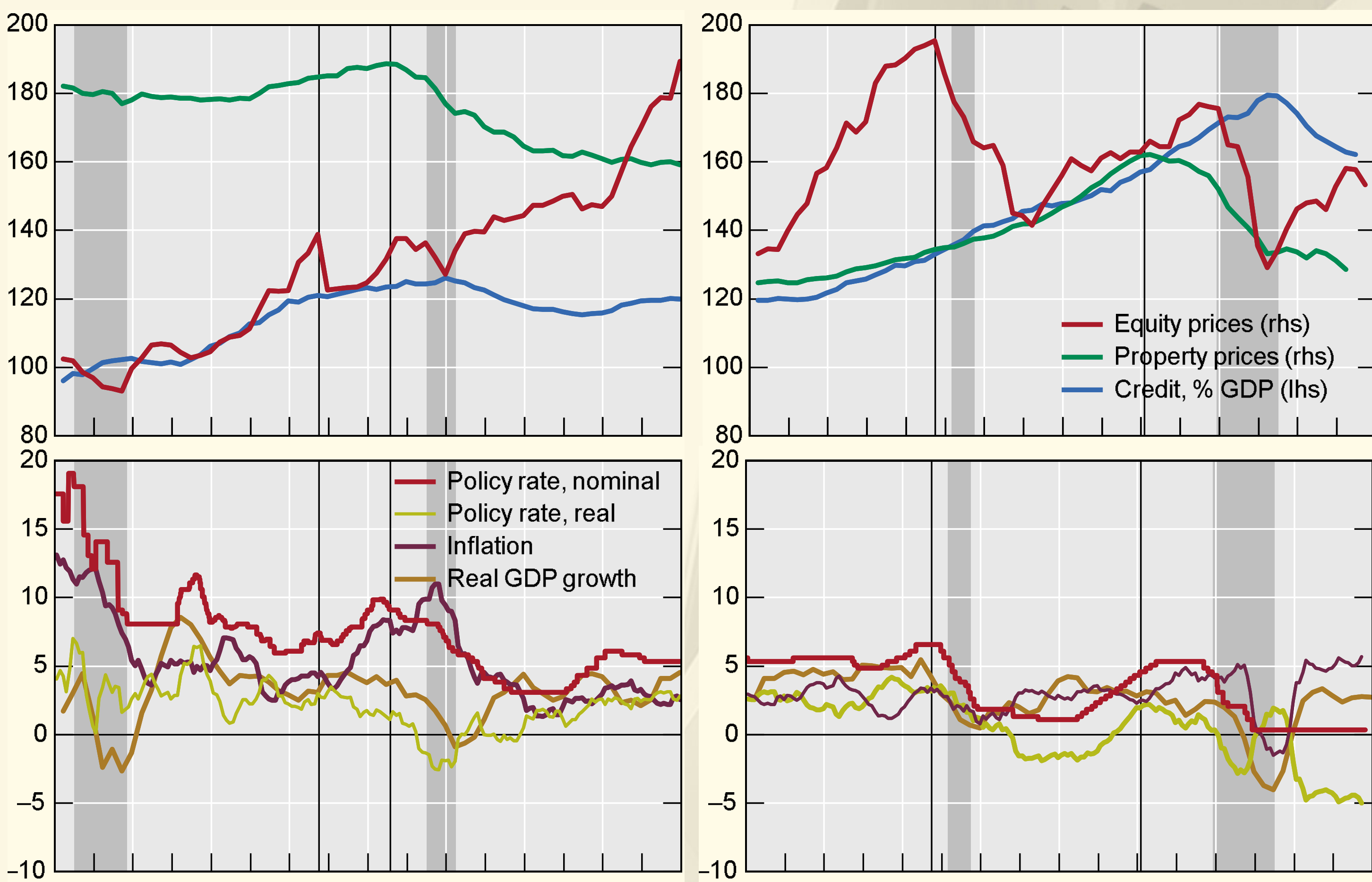
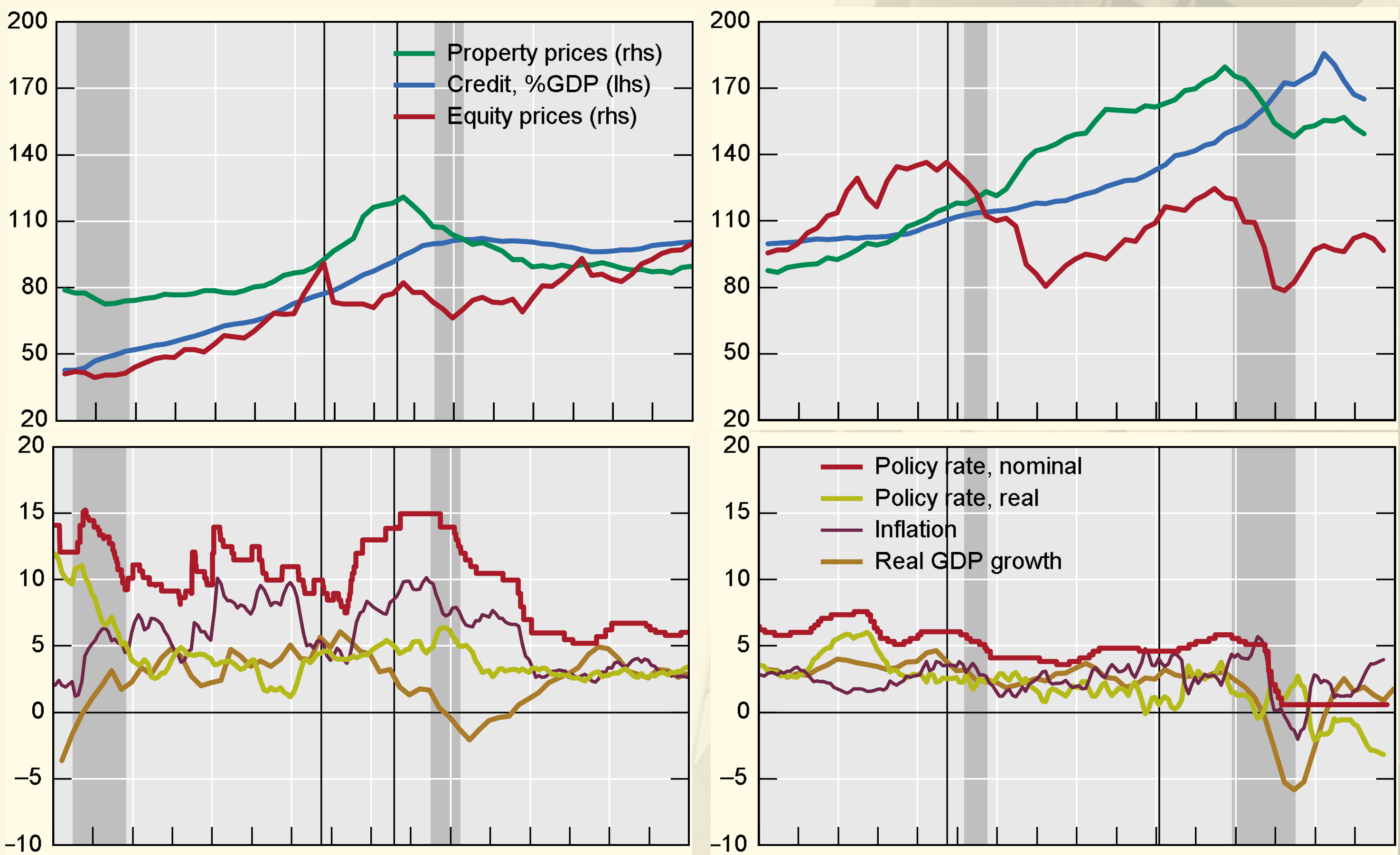
Graph 3: Unfinished recessions : US



Graph 3: Unfinished recessions : UK



IV. Challenges and open questions

- Intellectual challenge: Need new analytical frameworks
  - Financial and monetary factors should be at the core of benchmark macroeconomic paradigms
      - Stock disequilibria key (debt and capital overhangs)
      - Potential/non-inflationary output is not the same as equilibrium/sustainable output
    - Not sufficient to make adjustments at the edges of DSGE models ("real" models disguised as "monetary" ones)
    - Rediscover old monetary economics tradition (eg. Wickell's "pure credit economy" puzzle)
  - Develop policy guides to identify and mitigate FIs in real time
  - Shift from country-centric to more globe-centric analytical approaches
- Institutional challenge: Need to address political economy challenges
  - How to preserve independence at times of bloated CB balance-sheets and ballooning government debt/sovereign risks?
  - How to overcome the perennial obstacles to international cooperation ?
  - Precondition for progress: manage expectations about what CBs can achieve

Conclusion

- Shift in fortunes of central banking
  - Burns (1979): “the anguish of central banking”
  - Volcker (1990): “the triumph of central banking?”
    - But “unfinished business”: financial stability and exchange rates
  - Today? “the doubts of central banking”
    - Agree on new role in financial stability (MaP)
    - But otherwise questions remain…
    - …at a time when their independence is under threat

- Suggested features of new compass
  - Tighter integration of monetary and financial stability functions
    - Rediscovery of intellectual roots of monetary economics
    - Adjustments to IT frameworks
  - Keener awareness of global dimensions of that task
  - Recognition of limitations of what CBs can achieve

Some of the work used as basis for the lecture

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