

Chapter 23 – Beyond Inflation Targeting

Following the *Great Inflation* of the 1970s, central banks focused on steadying inflation at a low level in order to promote economic stability. In many countries, policymakers adopted an explicit strategy of *inflation targeting* – announcing a quantitative inflation objective as the primary goal to which all other policy goals are subordinated (see Chapter 18). Some countries, like the United States, were not explicit inflation targeters, but they showed much greater sensitivity to inflation in setting policy than they had in the 1960s and 1970s.

Inflation stabilization contributed significantly to the *Great Moderation* – a period of reduced economic volatility in the industrial world that began in the mid-1980s and persisted for more than two decades (see Chapter 22 for other factors that lowered steadied economic activity). The Great Moderation survived many shocks – including surging oil prices, the emerging market crises and the global equity bubble of the late 1990s, and numerous wars. Despite these shocks, the recessions in this period were fewer and milder than during the 1970s and early 1980s. In Figure 1, note the infrequent declines of economic activity between 1983 and 2008.

The financial crisis of 2007-09 ended the Great Moderation. The two-quarter plunge of economic activity following the September failure of Lehman Brothers was the largest drop in many industrial countries since the Great Depression. The *Great Recession* also is setting records for other indicators that measure the four Ds of business cycles: depth, duration, sectoral diffusion and geographic dispersion.

The return of economic volatility around the industrial world cannot be attributed to an insufficient policy focus on inflation. In the years prior to the financial crisis, some central banks probably could have done better in keeping inflation low, but their policy misses were small and temporary compared to the persistent inflation errors of the late 1960s and 1970s. As a result, long-term inflation expectations – reflected in surveys and in long-term bond yields – remained tame in recent years, in sharp contrast to the earlier period.

What should we conclude about inflation targeting as policy strategy? Keeping inflation low and steady remains *necessary* for economic stability. In light of the Great Recession, however, it is *insufficient* to secure stable economic growth. Something else is needed, too. As a result, the policy focus on financial stability and related factors is certain to intensify.

At this stage, central bankers are looking for *reliable* early-warning indicators that anticipate macro-economic threats to financial stability. For example, asset bubbles – unsustainable price increases that are unwarranted by economic fundamentals – can contribute to financial instability. The surge of U.S. housing prices prior to the crisis of 2007-09 is a case in point. Rapid credit growth also has preceded many

episodes of financial instability.¹ The greatest danger arises when an asset bubble infects the balance sheet of the banking system – including shadow banks (see the Chapter 3 module: Shadow Banking). However, not all asset bubbles or credit expansions prompt financial crises. One example is the global equity bubble that peaked in 2000.

It is doubtful that policymakers will ever develop an alarm that always signals future financial instability and never sends a false warning. The viral nature of financial innovation – the mutating response of intermediaries to changing regulation – suggests that intermediaries will again find ways to take risk that avoid scrutiny until the risks become systemic (see the Chapter 14 module: Crisis Policy – Balancing Risks). As a result, anticipating systemic threats will remain one of the most difficult aspects of the job for central bankers.

What will policymakers do if there seems to be a conflict between the objective of keeping inflation close to an explicit target and the objective of financial stability? Prior to the crisis, the conventional wisdom among central bankers was that monetary policy should respond to asset price or credit developments only insofar as they influence inflation prospects. Anything that distracted monetary policy from the primary objective of low, steady inflation – even temporarily – would add unnecessarily to economic instability.

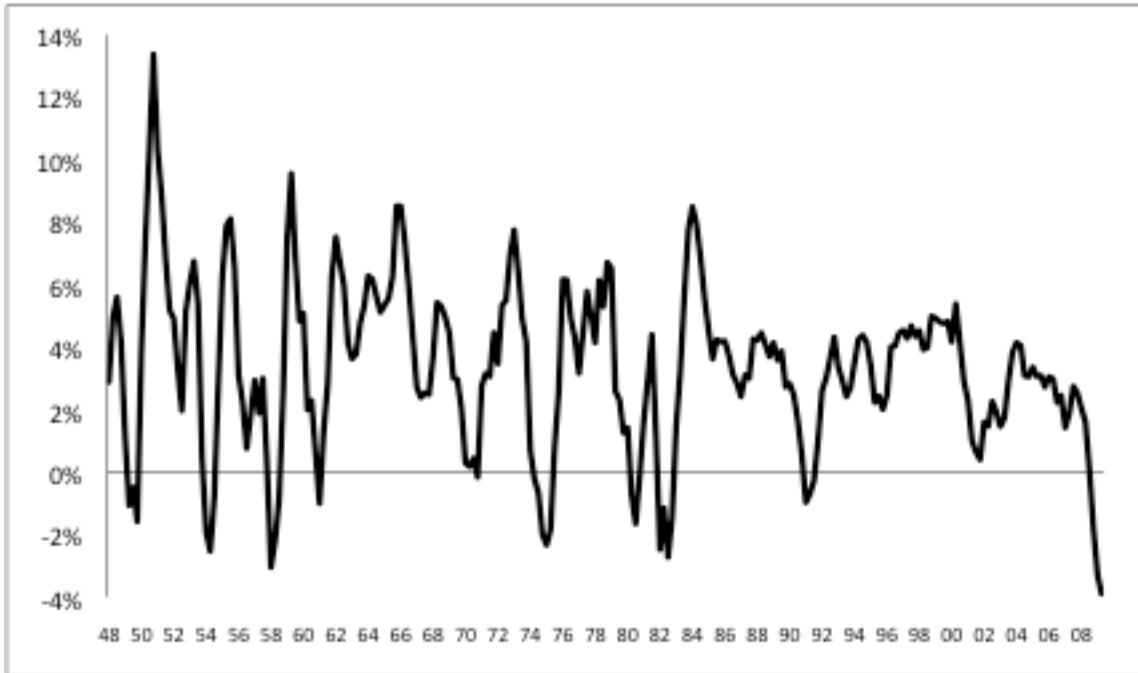
The conventional wisdom also assumed that central banks could limit the economic damage from a collapse of asset prices by cutting interest rates aggressively after the fact. However, the widespread fallout from the U.S. housing bubble – despite zero policy rates and the massive expansion of central bank balance sheets – is forcing central banks to reconsider.

Will policymakers target asset prices or credit growth in the future? Highly unlikely. Asset prices are so volatile that targeting them would create unnecessary interest rate and economic volatility. And credit growth is far from a perfect indicator of systemic risk. However, central banks may be more willing to tolerate *temporary* deviations from their inflation objective if their systemic alarm bells persuade them that such tolerance would prevent a crisis.

Policymakers also are thinking about new tools for securing financial stability. The conventional interest rate tool alone cannot secure multiple objectives and probably will remain devoted for the most part to stabilizing inflation. However, a range of new *macro-prudential tools* may augment the standard policy toolkit in coming years (see the Chapter 14 module: Micro- vs. Macro-prudential Regulation). These new tools probably will become the primary instruments for securing financial stability – at least until the next crisis emerges.

¹ See, for example, Claudio Borio and Matthias Drehmann, “Assessing the Risk of Banking Crises – Revisited,” *BIS Quarterly Review*, March 2009. http://www.bis.org/publ/qtrpdf/r_qt0903e.pdf

Figure 1. United States – Real GDP Growth (year-to-year percent change), 1948-2Q 09.



Source: Bureau of Economic Analysis and authors' calculations.