Flexible Inflation Targeting in the Light of the Crisis

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Introduction

- Questions after the crisis:
  - Did monetary policy contribute to the crisis?
  - Are any modifications of best-practice monetary policy justified?
- Outline of presentation:
  - The cause of the crisis and the role of monetary policy in the crisis
  - Does flexible inflation targeting need to be modified in light of the crisis?

Conclusions

- The crisis was not caused by monetary policy
- Flexible inflation targeting remains best practice
- If done rightly, using all information in financial conditions about future inflation and resource utilization
- Financial conditions perhaps more important indicators than before; perhaps CBs will responde more to given change
- Financial conditions still indicators, not targets

Best-practice monetary policy: Flexible inflation targeting

- Stabilize *both* inflation around the inflation target *and* the real economy (resource utilization around a normal level)
- "Forecast targeting": choose policy-rate path so forecast of inflation and resource utilization (output gap) "looks good"
  (Riksbank: "well-balanced policy")
- Use and respond to all info that affects forecast of inflation and resource utilization
- Not simple instrument rule (not Taylor rule)

The cause of the crisis and the role of monetary policy

- Main causes of the crisis? (Bean 09)
- *Macro conditions*: Global imbalances, low world real interest rates, Great Moderation, underestimation of risk, very low risk premia
- *Distorted incentives*: Lax regulation and supervision, missing bank resolution, US housing policy, securitization, regulation arbitrage, increased leverage
- *Information problems*: Hidden risk in complex securities, underestimation of correlated systemic risks
- This has little or nothing to do with monetary policy!

The cause of the crisis and the role of monetary policy

- Was US monetary policy too expansionary during 2001-2004?
- Ex ante: Expansionary policy right given genuine threat of deflation and liquidity trap
- Real interest rates low because of global unbalances

The cause of the crisis and the role of monetary policy

- Would tighter US monetary policy have prevented the crisis?
- To affect boom and credit growth, substantially higher interest rates needed: Recession, deflation, and eventually liquidity trap?
- No effect on regulatory problems, distorted incentives, information problems
- Kohn (08): (1) Timely confident identification
  (2) Tighter policy check speculative activity
  (3) Sufficient future improvement of performance

Conclusions

- Price stability not enough for financial stability
- Interest rates not enough for financial stability
- For financial stability
  - Regulation, supervision, bank resolution, macro-prudence
  - "A portfolio of instruments" (Bean 09), not interest rates
  - Interest rate too blunt an instrument

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