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 respond 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 imbalances
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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