Beyond inflation targets

By David Cobham
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Over the last three decades or so, central bankers and academics have become increasingly confident that inflation targeting is the key to preserving macroeconomic stability. But this is virtually impossible to prove, and the 2008 financial crisis suggested to many that monetary policy should focus on more than the prices of goods and services. So how should a revised mandate for central banks be structured to maintain their focus on low inflation while allowing monetary policy to address other issues when appropriate?

The contribution that inflation targeting makes to macroeconomic stability is difficult to discern for a simple reason: it is impossible to know what would happen if a country's central bank pursued the opposite course. Unable to compare outcomes directly, researchers have employed a variety of strategies to identify the impact of inflation targeting, and have typically found it to be substantial (though the effect becomes small or even zero when countries' starting points are taken into account).

For example, a case study of the United Kingdom for 1997-2007 – a period of full inflation targets and policy independence for the Bank of England (BoE) – indicates considerable improvement from a poor starting point. The focus on price stability was accompanied by relatively low inflation (compared to the past, as well as to other major economies), strong growth, and little output volatility.

However, over this period the UK also experienced sustained exchange-rate misalignment, which the BoE's Monetary Policy Committee was unwilling or unable to address within its existing mandate. The MPC also failed to respond to any of the three bouts of rapid growth in house prices that preceded the financial crisis, arguing that they were structural in nature –caused by the decline in inflation and interest rates since the 1980's – so a monetary response was not appropriate.

In the run-up to the crisis, the US Federal Reserve Board (an informal inflation targeter) was even more committed than the MPC to this orthodox view – so committed, in fact, that it barely allocated any time or resources to analyzing house-price fluctuations.

So, while inflation-targeting central banks worked hard to nail down inflation expectations in goods and services, they made no effort to influence asset-price expectations. Indeed, the "Greenspan put" (former Fed Chairman Alan Greenspan's monetary-policy approach) eliminated the downside risk by setting a floor under asset prices; but it set no ceiling on the upside. If major banks had had a "lean against the wind" strategy in reserve, that would have influenced expectations and at least partly stabilized asset prices, possibly mitigating – or even averting – the most damaging effects of the financial crisis.

The notion of integrating asset-price concerns into inflation targeting remains a source of significant controversy, with opponents citing the Tinbergen Principle: if policymakers have one instrument, the interest rate, they can pursue only one objective, price stability. Attempts to pursue multiple objectives, the logic goes, would confuse financial markets and private-sector agents.

But central banks *have* pursued multiple objectives simultaneously, without bringing about bad outcomes or destroying their own credibility. Likewise, since 2008, many central banks – under pressure from governments – have been reacting specifically to other developments in the real economy (particularly unemployment), rather than maintaining their single-minded focus on long-term price stability.

This is particularly obvious in the UK, where the government, desperate to see an economic recovery before the 2015 elections, has been pushing the BoE to introduce credit subsidies and, more recently, forward guidance. As a result, the BoE's decisions have been attuned to the short-run trade-off between growth and inflation – meaning that it has been making decisions about goals, not just instruments.

What central banks need now is a revised mandate that upholds price stability as the primary, long-term objective, while allowing policymakers to pursue other objectives when appropriate. Specifically, the central bank should be able to move slowly on price stability if it regards the real economy as unacceptably weak, or if an asset-price misalignment threatens financial stability and cannot be defused quickly by the new macro-prudential instruments.

Under the current arrangements for the BoE, if inflation moves more than one percentage point away from its target (in either direction), the bank's governor is obliged to write an open letter to the Chancellor of the Exchequer explaining the deviation and providing a plan to eliminate it, including a projected timeline.

A revised remit for the BoE – or, in some form, for other inflation-targeting central banks – could take this requirement further, specifying a primary and long-term target for inflation from which policymakers can deviate if doing so is deemed necessary. In such cases, the central bank's governor should be required to write an open letter explaining the bank's decision, including how long it expects to give priority to the non-inflation objective and how it foresees returning to normal operations.

Such an arrangement would allow the central bank to take a wider view of its responsibilities in a context of transparency and accountability, but in a way that both preserves its anti-inflationary credibility and prevents politically motivated or otherwise inappropriate policy decisions.

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