Rethinking inflation targeting

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Over the last two decades, inflation targeting has become the predominant monetary-policy framework. It has been essentially (though not explicitly) adopted by major central banks, including the US Federal Reserve, the European Central Bank, and the Swiss National Bank. But the 2008 global economic crisis, from which the world has yet to recover fully, has cast serious doubt on this approach.

The Bank for International Settlements has long argued that pure inflation targeting is not compatible with financial stability. It does not take into account the financial cycle, and thus produces excessively expansionary and asymmetric monetary policy. Moreover, a major argument in favor of inflation targeting – that it has contributed to a decline in inflation since the early 1990s – is questionable, at best. Disinflation actually began in the early 1980s – well before inflation targeting was invented – thanks to the concerted efforts of then-US Federal Reserve Board Chair Paul Volcker. And, from the 1990s on, globalization – in particular, China's integration into the world economy – has probably been the main reason for the decline in global inflationary pressure.

A more recent indication that inflation targeting has not caused the disinflation seen since the 1990s is the unsuccessful effort by a growing number of central banks to reflate their economies. If central banks are unable to increase inflation, it stands to reason that they may not have been instrumental in reducing it.

The fact is that the original objective of central banks was not consumer-price stability; consumer-price indices did not even exist when most of them were founded. Central banks were established to provide war financing to governments. Later, their mission was expanded to include the role of lender of last resort. It was not until the excessive inflation of the 1970s that central banks discovered – or, in a sense, rediscovered – the desirability of keeping the value of money stable.

But how to measure the value of money? One approach centers on prices, with the consumer price index appearing to be the most obvious indicator. The problem is that the relationship between the money supply (which ultimately determines the value of money) and prices is an unstable one.

For starters, the lag time between changes in the money supply and price movements is long, variable, and unpredictable. Given this, targeting consumer prices in the next 2-3 years will not guarantee that the value of money remains stable in the long term.

Moreover, different methods of collecting consumer prices yield different results, depending on how housing costs are treated and the hedonic adjustment applied. In short, monetary policy has been shaped by an imprecise, small, and shrinking subset of prices that exhibits long and variable lags vis-à-vis changes in the money supply.

Unfortunately, monetary policymakers' effort to operationalize the objective of ensuring that the value of money remains stable has taken on a life of its own. Today's economics textbooks assume that a primary objective of central banks is to stabilize consumer prices, rather than the value of money.

Furthermore, economists now understand inflation as a rise in consumer prices, not as a decline in the value of money resulting from an excessive increase in the money supply. Making matters worse, central banks routinely deny responsibility for any prices other than consumer prices, ignoring that the value of money is reflected in all prices, including commodities, real estate, stocks, bonds, and, perhaps most important, exchange rates.

In short, while price stabilization through inflation targeting is a commendable objective, central banks' narrow focus on consumer prices – within a relatively short time frame, no less – is inadequate to achieve it. This was highlighted by the surge in many countries' housing prices in the run-up to the 2008 financial crisis, the steep decline in asset and commodity prices immediately after Lehman Brothers collapsed, the return to asset-price inflation since then, and recent large currency fluctuations. All are inconsistent with a stable value of money.

Central banks' exclusive focus on consumer prices may even be counterproductive. By undermining the efficient allocation of capital and fostering mal-investment, CPI-focused monetary policy is distorting economic structures, blocking growth-enhancing creative destruction, creating moral hazard, and sowing the seeds for future instability in the value of money.

Within a complex and constantly evolving economy, a simplistic inflation-targeting framework will not stabilize the value of money. Only an equally complex and highly adaptable monetary-policy approach – one that emphasizes risk management and reliance on policymakers' judgment, rather than a clear-cut formula – can do that. Such an approach would be less predictable and eliminate forward guidance, thereby discouraging excessive risk-taking and reducing moral hazard.

History hints at what a stability-oriented framework could look like. In the last quarter of the twentieth century, many central banks used intermediate targets, including monetary aggregates. Such targets could potentially be applied to credit, interest rates, exchange rates, asset and commodity prices, risk premiums, and/or intermediate-goods prices.

Short-term consumer-price stability does not guarantee economic, financial, or monetary stability. It is time for central banks to accept this fact and adopt a comprehensive, long-term monetary-policy approach – even if it means that, in the short term, consumer-price inflation deviates from what is currently understood as "price stability." Temporary fluctuations in a narrow and imprecisely measured CPI are a small price to pay to secure the long-term stability of money.

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