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Perspectives on inflation targeting, financial stability and the global crisis

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This volume contains four papers presented at the BIS-sponsored sessions at the 2008 and 2009 annual meetings of LACEA. Written by leading central bankers and distinguished academics, they address the challenges confronted in recent years by central banks that practice inflation targeting (IT) and issues arising from the global crisis.

The first two papers were presented at the 2008 session, "Challenges to inflation targeting", one by José de Gregorio (Governor of the Central Bank of Chile) and the other by Guillermo Calvo (professor of economics at Columbia University). Following those are papers from the 2009 session, "Central banks and the global crisis: lessons and challenges", one by Vittorio Corbo (former Governor of the Central Bank of Chile) and the other by Michael Dooley (professor of economics at the University of California, Santa Cruz), The papers are preceded by the introductory remarks of the session chairs, Már Gudmundsson (2008) and Philip Turner (2009).

In his introduction to the 2008 session, "Challenges to inflation targeting", ***Már Gudmundsson*** raises four issues for IT central banks. How should they deal with (i) relative price adjustments; (ii) financial globalisation and the role of the exchange rate; (iii) credit and asset price booms; and (iv) financial stability concerns? Insights on some of these questions were provided by the panelists.

In his contribution, ***Jose de Gregorio*** discusses three topics confronting central banks. The first is *price stability versus financial stability*. Following the Tinbergen principle, interest rate policy cannot deal with both macroeconomic stability and financial stability; additional instruments – such as financial regulation – are needed to deal with financial stability. Moreover, authorities must go beyond the usual coverage in inflation reports and monitor quantities (eg credit growth) as well as prices.

His second topic is *the challenge of relative price shocks*, such as the steep increases in commodity prices seen prior to the Lehman bankruptcy. Those increases were associated with spikes in inflation (generally above target) across the region in late 2007 and the first half of 2008 (see Graph 1). Had these shocks dissipated quickly, they could have been easily managed within an IT framework. However, they were quite persistent, threatening to contaminate inflation expectations. De Gregorio argues that it can be very costly to raise interest rates aggressively in response to such commodity price shocks, and the impact on inflation may be limited. The solution is to allow inflation to return to target on its own by maintaining a sufficiently long time horizon for the inflation target.

Finally, De Gregorio discusses *intervention in foreign exchange markets*. He notes that, although such intervention is sometimes necessary (eg to accumulate foreign reserves), flexible exchange rates can serve as a shock absorber, and they pose fewer risks than in the past because of a lower pass-through from the exchange rate to inflation.

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Guillermo Calvo highlights some important issues in the provision of foreign currency liquidity during turbulent times: First, he notes that, while foreign reserve accumulation is needed in the absence of an effective global lender of last resort, it is hard to determine when foreign reserve holdings are adequate. For example, foreign reserve adequacy in 2007 appeared to be much higher in Asia than in Latin America according to the ratio of foreign reserves to short-term external debt, but it was roughly comparable in the two regions according to the ratio of foreign reserves to M2. He argues that the second indicator is preferable. Second, Calvo recognises the usefulness of facilities such as the International Monetary Fund's flexible credit line (FCL) and the Federal Reserve's foreign exchange swap lines but thinks that there are some issues, such as the fact that not many countries have access, and the relatively short duration of these facilities. Third, Calvo points out that drawing down foreign reserves must be done with care because it can trigger capital flight. Furthermore, foreign reserve use is more effective if it targets specific sectors of the economy, such as the export sector. Calvo concludes with the observation that the global crisis has shown the need to include credit in macroeconomic models. He also notes that treasury bills may be close substitutes for money, in which case foreign exchange market intervention may play an important role in adjusting liquidity.

In his introductory remarks for the 2009 session, "Central banks and the global crisis: lessons and challenges", ***Philip Turner*** outlines three possible perspectives on the policy lessons of the crisis. One is microeconomic – regulators did not provide an effective counterweight to market failures in the banking industry. A second is macroeconomic – an overly narrow focus on price stability led central banks to neglect financial stability. A third is macroprudential – not enough attention was paid to linkages between the macroeconomy and the financial system.

In addressing these issues, ***Vittorio Corbo*** looks at two central bank roles: financial crisis prevention and crisis management. With respect to *crisis prevention*, Corbo argues that monetary authorities have to move away from the "clean up after the bubble" paradigm to one in which monetary policy "leans against the wind". This may require a more discretionary and judgmental approach to asset prices. Furthermore, management of the policy interest rate is not enough for crisis prevention; central banks need to rely on other tools, including macroprudential policies (eg loan loss provisioning rules, capital standards and reserve requirements), procedures to deal with the failure of systemically important institutions, and intervention to avoid large misalignments of the exchange rate. Corbo sees macroprudential regulation as the best way to preserve financial stability by (i) reducing the incentives for increasing leverage during a boom and (ii) increasing the robustness of the system during a bust.

With respect to *crisis management,* central banks must contain the damage of crises and limit their impact on the real economy. In particular, it is necessary to calm markets, reduce uncertainty due to liquidity restrictions, and, if no resolution mechanisms exist, prevent the collapse of systemically important institutions that could induce further damage to the system, even if they are insolvent. To achieve these financial stability goals, central banks need to offer extensive liquidity support against good collateral, reduce the policy rate aggressively and rely on non-conventional policies. Increasing their cooperation with fiscal authorities would complete the policy response.

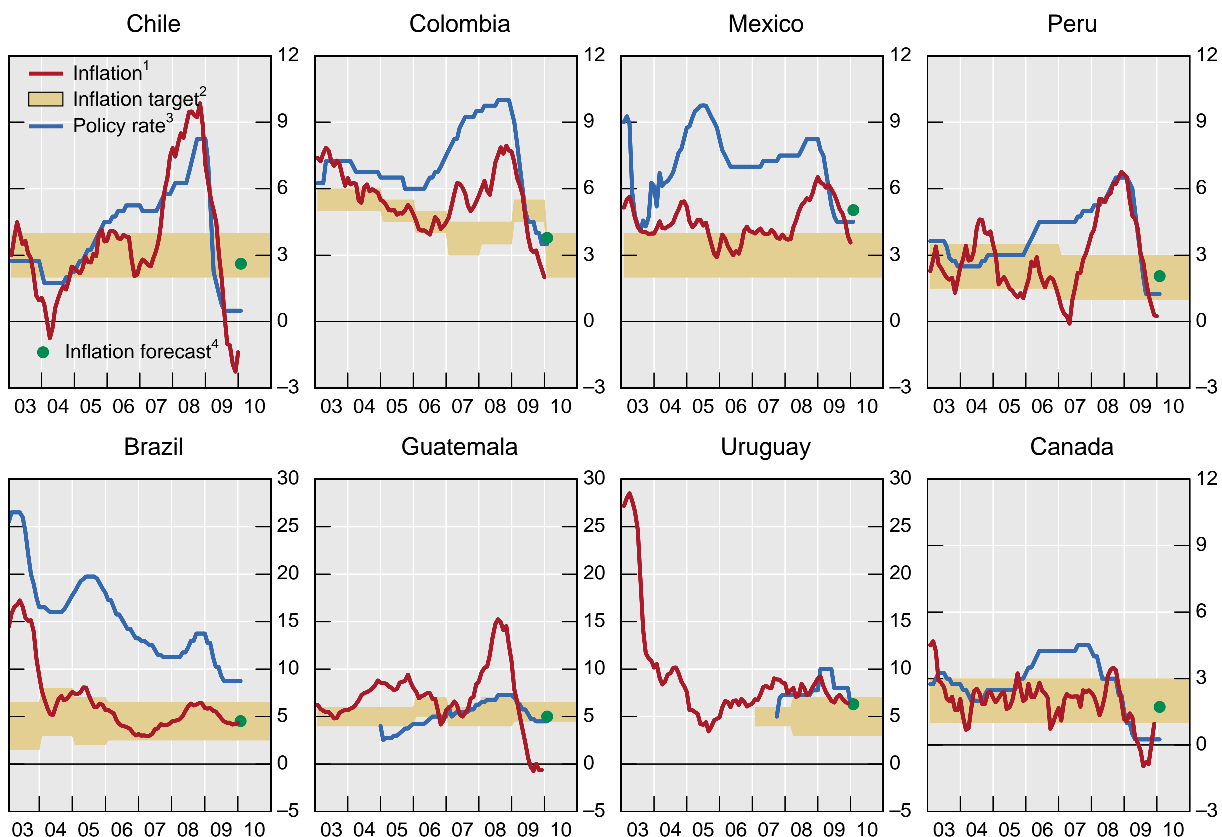
Finally, ***Michael Dooley*** argues that the monetary policy lessons being drawn from the crisis are wrong and that discussions in international forums about countercyclical prudential regulation are based on a misinterpretation of what caused the crisis. In Dooley's view, easy monetary policy in the United States had nothing to do with the crisis. In particular, notwithstanding global imbalances, there was no sudden stop in capital flows from emerging market economies (EMEs) to advanced countries, no spike in US real long-term interest rates and no collapse in the US dollar.

Dooley also argues that current regulatory proposals will do little because firms will find a way around regulations. Crises arise because profit motives and competition push leverage to unsustainable levels. There may be no set of regulations that can deal with the conflict between the profitability of leverage and the vulnerability of the system to leverage unless the system is pushed way beyond its efficient frontier. Therefore, he concludes, regulation is futile. What is needed is much stronger supervision. He identified three false assumptions that render supervision ineffectual: (i) private financial institutions care about the long-run value of the firm; (ii) markets impose self-discipline; (iii) private rating agencies are superior to government agencies in evaluating risk.

Dooley makes two other points. First, he argues that crises are costly because they involve the disappearance of collateral outside the insured system, so the role of the changing value of collateral in crises needs more attention. Second, he suggests that although foreign reserves did not hurt, they helped little in insulating EMEs because the cause of the crisis was a failure in supervision and regulation. Federal Reserve swap lines with EME central banks and the flexible credit line (FCL) of the International Monetary Fund, although useful, are also of little help in insulating economies from such crises.

Graph 1

Inflation and policy rates in inflation targeting countries



[1] Annual change in consumer prices, in percent. [2] Targets announced, in terms of CPI. [3] Forecasts made in January 2010 for year-end 2010, Consensus Economics. [4] For Brazil, SELIC overnight rate. For Chile, monetary policy rate. For Colombia, expansion minimum intervention date. For Mexico, prior to 2008, bank funding rate; after 2008, reference rate. For Peru, interbank rate. For Guatemala, “tasa lider”. For Uruguay, monetary policy rate. For Canada, overnight rate.

Sources: IMF; Datastream; Consensus Economics; national data.