Inflation Targeting and Its Discontents[*] Opening Remarks

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It is my great pleasure to welcome you all to the 2013 *International Journal of Central Banking* conference on "Inflation Targeting and Its Discontents" hosted by Narodowy Bank Polski. Before I give the floor to our distinguished panelists, let me first make a few remarks that, I hope, will set the stage for the upcoming presentations and discussions.

1. The End of the Divine Coincidence

There is something ironic about the title of our conference. Had it been organized some time in 2004, 2005, or even 2006, the title would probably sound more like "Inflation Targeting—A Philosopher's Stone of Monetary Policy Strategy." After all, the general mood at the time was that we had indeed become better than ever before in conducting monetary policy, and inflation targeting was the key to success.

Today, judging by the conference agenda and the excellent submissions that we have received, it seems that most of us would probably be much more inclined to think of inflation targeting as a project very much under construction, rather than a bullet-proof state-of-the-art approach.

To some extent, I suspect, we all feel humbled by the crisis. It has shattered the belief that stabilizing inflation is both necessary and sufficient for stabilizing output gap. Now, we also know that a crisis of such gravitas as the one we are just recovering from is a fast-track learning exercise.

But perhaps a moment's reflection is also in order: are we not overreacting with all this "discontent" and thus falling prey to an

[*]Welcome and Opening Remarks given at the IJCB conference on "Inflation Targeting and Its Discontents," hosted by Narodowy Bank Polski, September 6–7, 2013.

intellectual bias that is a mirror image of the earlier praise of inflation targeting?

I cannot pretend to offer a definite answer and I look forward to hearing what you have to say on this during the day. Nonetheless, let me suggest my personal view on the matter, starting of course from the case of Poland, which I know best.

2. Polish Experiences with Flexible Approach to IT

We were relatively early converts to inflation targeting. The first elements of the strategy were implemented already in 1998, while the fully fledged regime with a continuous inflation target of 2.5 percent was introduced in 2004. And although the economic landscape has changed tremendously over that time—with Poland's accession to the EU, the food and energy price shocks of 2007–8, and the global crisis—the results in terms of controlling inflation have been remarkable. Annual CPI inflation in Poland over the years 2004–13 averaged 2.9 percent,[1] close to the target and well within our ±1-percentage-point tolerance band for deviations. Contrast this with the average inflation of 16.3 percent a year throughout the period 1991–2003.[2] Also, the volatility of inflation[3] has come down, from 4.9 percent in 1991–2003 to merely 1.2 percent since. Equally important was the anchoring of inflation expectations of both households and financial market participants. Having suffered an almost hyperinflation episode as recently as twenty-four years ago, we are particularly proud of this anchoring of expectations. After all, in a modern fiat currency regime, a central banker is only worth as much as his credibility and—as our colleagues who find themselves at the zero lower bound are well aware—central banking is now more than ever about effective management of expectations.

Similar tendencies—in terms of reducing and stabilizing inflation—have been observed in most, if not all, of the more than thirty countries that have at some point adopted inflation targeting.

[1] Continuously compounded annual rate of CPI level changes from January 2004 to July 2013.

[2] Continuously compounded annual rate of CPI level changes from January 1991 to December 2003.

[3] As measured by the annualized standard deviation of monthly CPI changes.

3. The Comeback of Monetary and Credit Aggregates

I think that what made the IT framework so appealing, especially in emerging markets, was not only the empirics—i.e., the encouraging economic outcomes of the first countries that adopted it—but also the underlying theory, i.e., the elegant New Keynesian model, which on the one hand stressed the costs of inflation and on the other provided scope for the central bank to meaningfully impact aggregate demand via short-term nominal and real interest rates. Monetary transmission mechanism operated largely through macroeconomic aggregates, with no major role for frictions in financial intermediation. Most importantly perhaps, as Lars Svensson observed,[4] there was little role for money and credit in such models: both variables were fully endogenous, highly correlated with the price level, but having no predictive power for inflation beyond its other determinants. And since money and credit developments carried little predictive power for inflation, their fluctuations could be largely disregarded in setting interest rates. Putting it bluntly, the theoretical edifice on which inflation targeting was built left no room for tensions, or trade-offs, between monetary policy and financial stability. The two were assumed to be largely complementary, with price stability fostering financial stability.[5]

The crisis that hit five years ago has taught us the hard way that taking financial stability for granted—when inflation and output gaps are under control—can be very costly. Indeed, output in advanced economies is today more than 10 percent lower relative to pre-crisis trend, and the outcomes in emerging economies are not much better.[6] It is this loss in real wealth that feeds discontentment about inflation targeting and forces us to ask the question today, whether focusing so much attention on inflation has not come at a price of missing something important—the inherent fragility of the financial system and its potential to originate and propagate shocks, with adverse impact on both price and output stability.

It would not be fair to say that similar questions have not been asked before. Indeed, after the bursting of the dot-com bubble, an

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[4]See Svensson (1999).
[5]See Issing (2003).
[6]See International Monetary Fund (2013).

important discussion followed, with contributions from distinguished academics and policymakers, on the role of asset prices in monetary policy. Some were in favor of letting the central bank preemptively prick asset bubbles;[7] others believed that the costs of doing so outweighed the benefits, as the central bank would be adding to macroeconomic volatility instead of containing it.[8] However, for all the reasonable arguments put forward, no clear consensus had emerged. I think it was partly because the debate was framed within the inflation-targeting paradigm in which the central bank had only one goal—stabilizing inflation—and one instrument—the interest rate—to control it with. Thus, it was possible—although ex post not necessarily smart—to argue that central banks should not prick bubbles, because the interest rate, their only instrument, was too blunt a tool for the job.

4. Macroprudential Policy: The Necessary Ally of Monetary Policy

Looking back, we realize now that even if short-term interest rate policy may be too blunt an instrument to prick bubbles, it is not an argument against leaning against the wind but rather in favor of expanding the central bank's armory.

This becomes obvious when we realize that the recent crisis and the output loss that resulted were triggered mainly by excessive leverage, underpricing of risk, gradual buildup of debt, and extreme reliance on short-term funding. What's important is that all this fragility developed amid largely stable prices and closed output gaps, supporting Mervyn King's point that a prolonged period of stability tends to breed overconfidence and complacency. None of these problems—even if correctly identified—could have been properly addressed by changes in the short-term interest rate alone.

But this is no excuse for inaction. If we are to avoid finding ourselves once again with a financial sector that has far outgrown the accumulation of wealth in the household sector and which poses a threat to both price and output stability in the long run, we must stand ready to act preemptively. Clearly, interest rate changes won't

[7] See, e.g., Roubini (2006).

[8] See, e.g., Bernanke and Gertler (2001).

do the trick, and we must be ready to resort to more surgical tools targeted at the problems at hand, be it shadow banks, excessive maturity mismatching, unstable funding, etc. In other words, going forward, macroprudential policy must become a necessary part of regular monetary policy.

5. Alchemy as a Transitional Substitute for Models

Thus, coming back to the question I posed at the beginning, I think the "one goal, one instrument" approach underlying inflation targeting is no longer tenable. But this does not mean that we should discard price stability as the primary objective of an independent central bank. Indeed, as I argued earlier, reducing and stabilizing inflation can be considered a major achievement of modern central banking. We should not, then, throw out the price stability baby with the crisis bathwater.

Rather, it's a little like in Giuseppe Lampedusa's novel *The Leopard*: "Everything needs to change, so that everything can stay the same." In other words, we need to augment and improve inflation targeting, making it more flexible and extending it beyond the usual care for the price dynamics. The pursuit of price stability cannot put financial stability at risk, in the short or long run. As I have already argued, this entails giving the central bank new macroprudential objectives and corresponding new tools to address them.

And with this I turn to you—scholars and researchers from the academia and central banking community—to help us iron out the optimal central bank modus operandi for the post-crisis times. I strongly believe that good policymaking needs to be informed by cutting-edge research.

Unfortunately, despite some noteworthy attempts, macroeconomic models still do not give enough weight to the problems that drove the recent crisis: asymmetric information, financial frictions, leverage cycles, balance sheet management, etc. My fear is that models have so far not fully embraced the world outside the convenient Modigliani-Miller framework, where there is no difference between equity and debt financing.

Let's hope this conference will be one step in the direction of providing a more robust modeling background for future policymaking.

And certainly, as a central banker, I would love to have some—preferably simple—rule that tells me exactly how to identify shocks, how to respond to them, and how to combine monetary and macro-prudential tools. But in the meantime, I am prepared to be more of an alchemist, like the ones centuries ago in Saxony. Although the alchemists could not produce gold on their master's request, they excused themselves with a recipe for china. I cannot keep inflation and output gaps on target at all times, amid constantly changing transmission mechanism and shocks whose nature is not always easy to identify, but at least I can deliver the china of low and stable inflation—of which I am very proud.

Let me conclude by wishing you all insightful and illuminating discussions. Thank you.

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