

Inflation Targeting and Financial Stability -- Lessons from the Crisis

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Pre-crisis Monetary Policy

Flexible inflation targeting (FIT) – Main features

- Maintain average inflation near target using the short term interest rate as the main instrument of monetary policy
- Given inflationary expectations adjust the nominal rate so as to, additionally, stabilize output around potential in the short run
- FIT can be summarized analytically as follows: Given inflationary expectations, choose the nominal rate so as to minimize a weighted average of the inflation and of the output gaps where the weight on the output gap is the “flexibility parameter”

Pre-crisis Monetary Policy – Cont.

- Do not try to deflate bubbles
- Financial stability considerations not explicitly present

Impact of Crisis on Monetary Policy

- Crisis has reminded Central Banks (CB) of the traditional Lender of Last Resort (LLR) function of the CB
- The crisis brought to the forefront new tradeoffs and problems both in the short and in the long runs

Short Run Issues

- The CB as “firefighter” in face of private and public sector uncertainty (bailouts)
- The need for cooperation between fiscal and monetary authorities in times of systemic crises
- The liquidity trap and the zero bound
- Non conventional monetary policy

Long Run Issues

- How and when to disengage from non conventional monetary policy?
- Who should be in charge of financial stability?
- How does depletion of CB capital affect the Bank's independence?

Long Run Issues – Cont.

- Should CB deflate real estate and other bubbles?
- Optimal taxation consideration and how to deal with oversized debt accumulation?
- When are CB interventions in the foreign exchange market feasible and/or desirable?

Background Paper

- Further details appears in the paper:
“Reflections on the Crisis and on its Lessons for Regulatory Reform and for Central Bank Policies”

Available on the web at:

<http://www.tau.ac.il/~alexcuk/pdf/Bocconi-Revised%20&%20Expanded-12-09.pdf>

or at:

http://www.sciencedirect.com/science?_ob=ArticleURL&_udi=B7CRR-4YS9RPM-1&_user=48161&_coverDate=04%2F04%2F2010&_rdoc=1&_fmt=high&_orig=search&_origin=search&_sort=d&_docanchor=&view=c&_acct=C000005078&_version=1&_urlVersion=0&_userid=48161&md5=4a79e62980ce5e562490a26d451615f0&searchtype=a