Key Challenges for Central Banks

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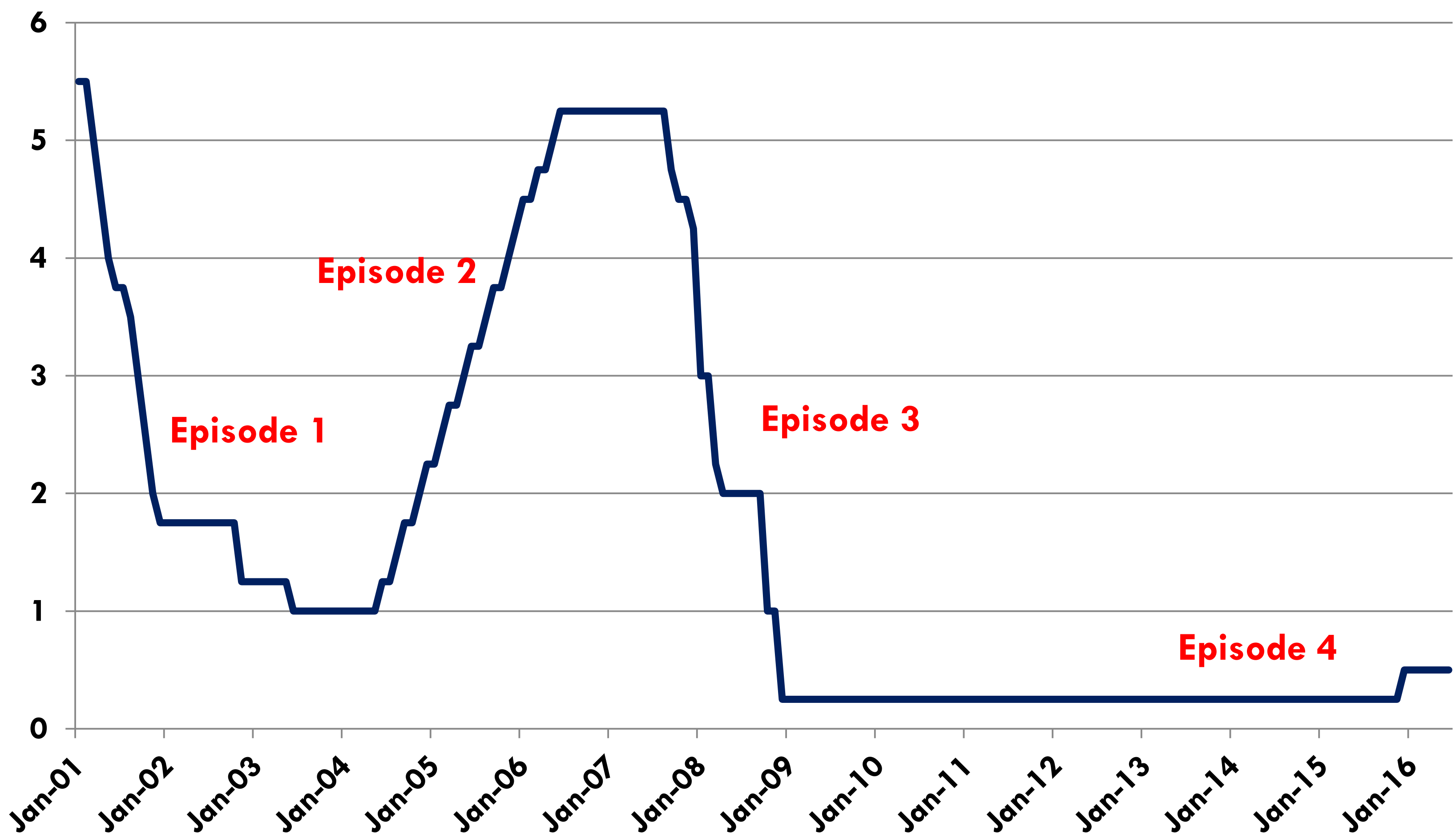
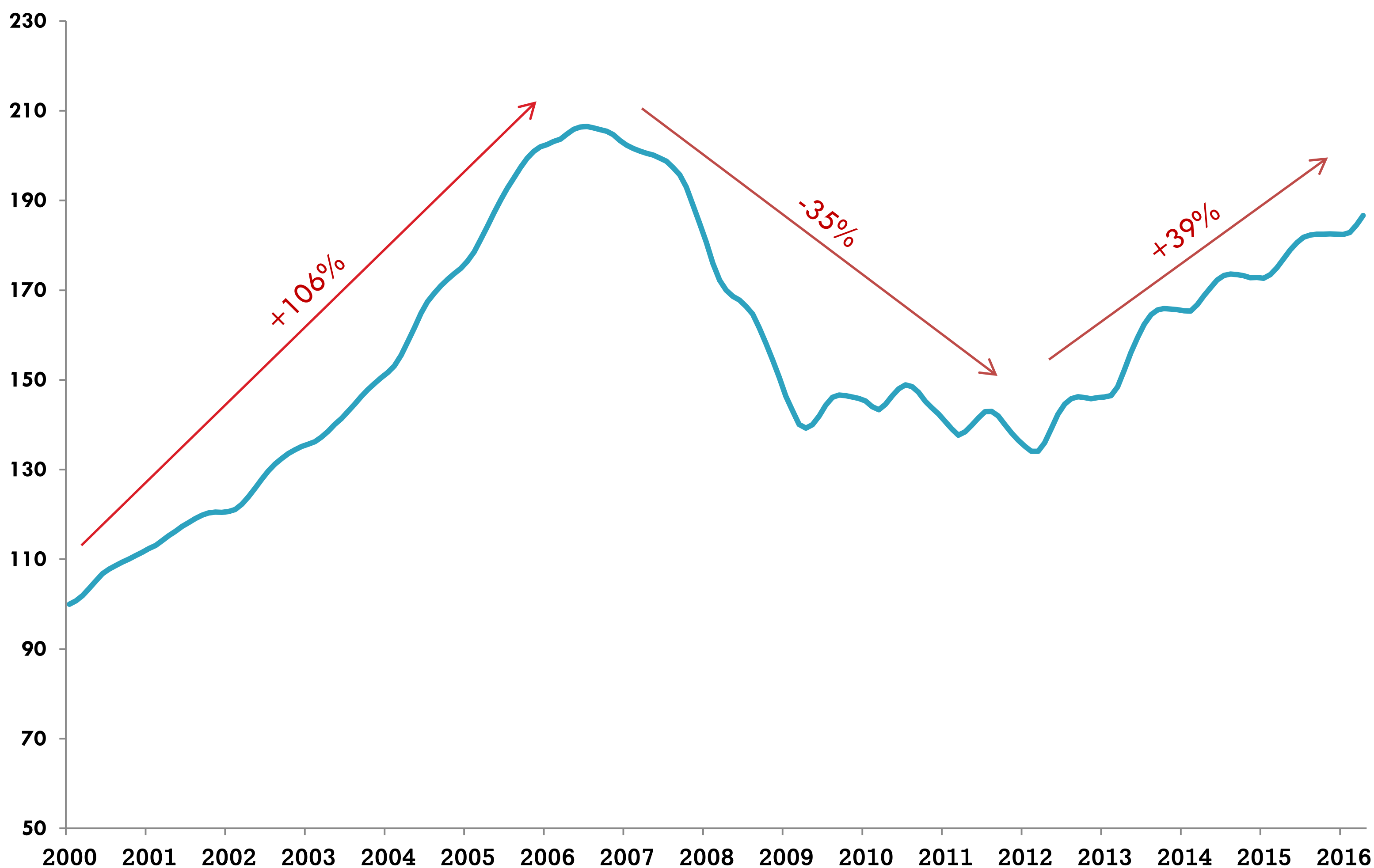
Background

- The typical legal mandate for an independent central bank includes three main goals: price stability, support of real economic activity, and financial stability
- Ever since its introduction, flexible inflation targeting regimes have focused mainly of the first two foregoing goals
- A typical assumption made has been that one could deal with financial stability via macro-prudential measures
- Our main point below is that while central banks have had a key role in avoiding a major global crisis like that of 1929, in setting their policy rates they have not given enough attention to the financial sector, and to asset prices in particular
- Accordingly, there is a need for a broader version of flexible inflation targeting

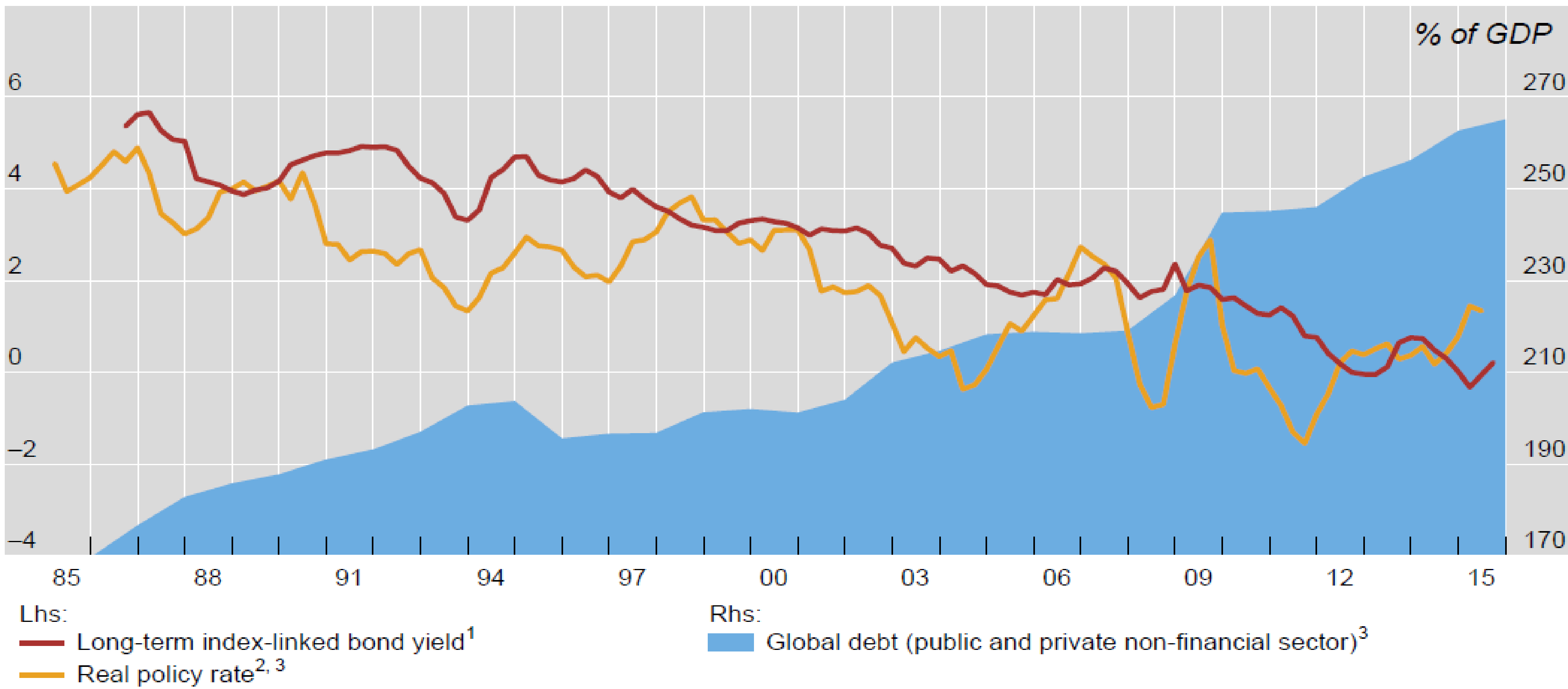
The ups and downs of the Fed funds rate over the last 15 years were mainly guided by inflation and output considerations…



…yet they may have had a de-stabilizing impact on housing and other prices (see the Case-Shiller index below)



Graph 5: Interest rates sink as debt soars

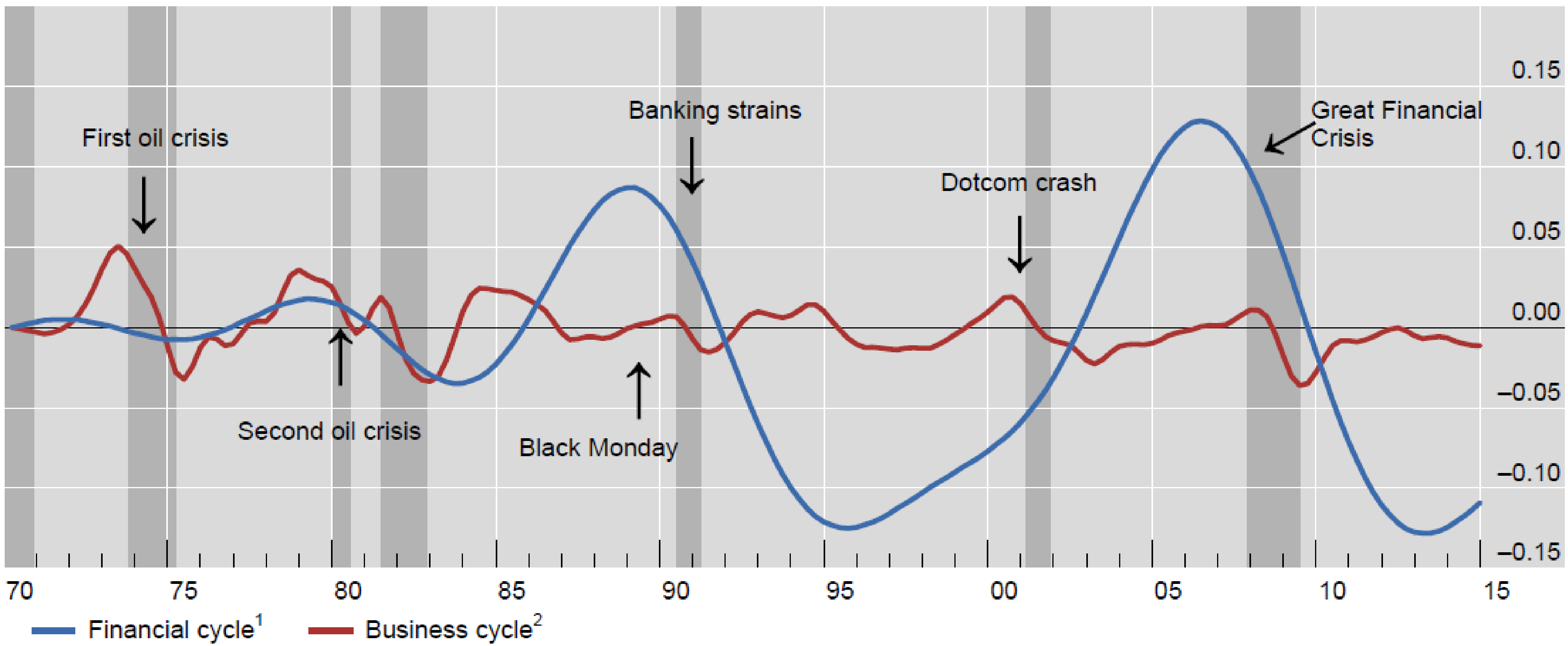


[1] From 1998, simple average of France, the United Kingdom and the United States; otherwise only the United Kingdom. [2] Nominal policy rate less consumer price inflation. [3] Aggregate based on weighted averages for G7 economies plus China based on rolling GDP and PPP exchange rates.

Sources: Borio and Disyatat, VoxEU June 2014.

Graph 1: The financial cycle is longer than the business cycle

(the US example)



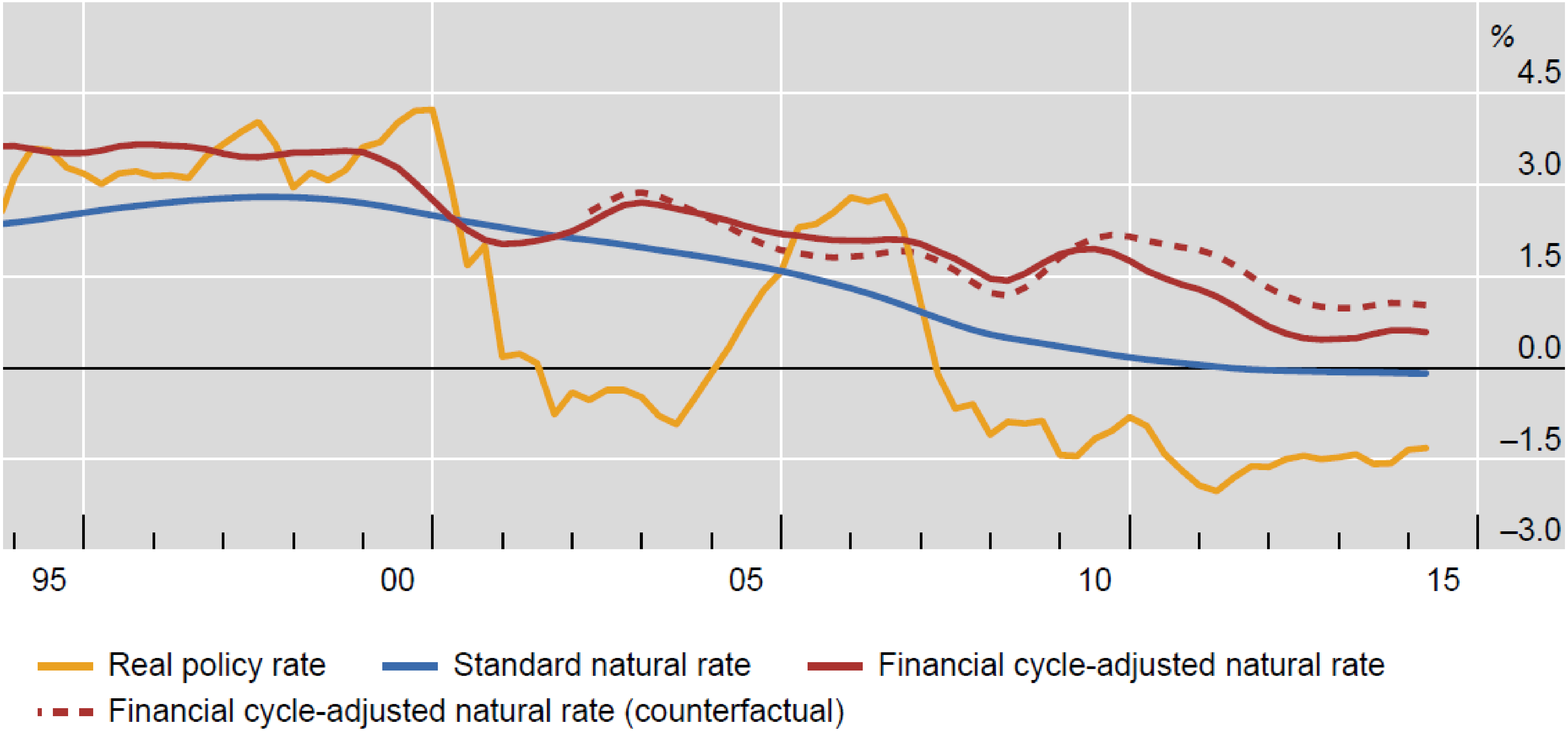
[1] The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. [2] The business cycle as measured by a frequency-based (bandpass) filter capturing fluctuations in real GDP over a period from 1 to 8 years.

The graph compares the financial cycle with traditional measures of the business cycle. The picture would be similar based on other common methodologies (eg turning point (peak/trough) analysis).

Source: Drehmann et al (2012), updated.

Comparing interest rates: standard and financial cycle-adjusted

(Graph 7)



The standard natural rate estimate follows a common procedure, which assumes that inflation provides the key signal. The financial cycle-adjusted estimates allows, in addition, financial cycle proxies to play a role. The dotted line traces what the natural rate could have been in a counterfactual exercise in which monetary policy had leaned systematically against the financial cycle in addition to output and inflation as opposed to following its actual historical path.

Sources: Juselius et al (2016); based on US data.

Conclusions

- Although flexible inflation targeting remains the main analytical anchor for monetary policy analysis, it is well to recognize that de-facto most central banks have moved to a broader policy framework, one that puts more emphasis on financial stability and on foreign-exchange market considerations
- Back in 2011, Eichengreen, Prasad, and Rajan, together with a committee comprised of additional well-known economists, stressed the need to move to a broader framework, one in which financial stability is made an explicit mandate of central banks
- Research work by Borio and other economists at the BIS over the years has produced a very useful augmented framework for what they call "a financial stability-oriented monetary policy" (See the recent 86th Annual Report of the BIS)
- These are promising and well needed lines of research in monetary economics