

Asset Prices, Financial Imbalances and Monetary Policy: Are Inflation Targets Enough? Charles Bean

Comments by Sushil Wadhvani, Discussant

I would like to thank the organisers for inviting me. I have known Charlie for a long time, and it is a great privilege to be given the opportunity to comment on this paper.

Before moving on to substantive issues, it is important that I clarify a possible misunderstanding first. Essentially Charlie sets up a “straw man”, which he then sets about knocking down. Since Stephen Cecchetti, Hans Genberg and myself are associated with the “straw man” view – you might call us the “straw men” – it is obviously important that I set the record straight.

Charlie repeatedly emphasises that, in a flexible inflation-targeting framework, if you look at the entire future path of expected inflation and growth, there is no independent role for asset prices. He asserts that we argue otherwise.

To quote our paper:

*“It is also important to emphasise that our proposal is wholly consistent with the remit of inflation-targeting central banks, as we are recommending that while they might **react** to asset price misalignments, they must **not** target them”.* (Cecchetti, Genberg, and Wadhvani [CGW hereafter] (2002) abstract)

*“This paper is **not** about what the central bank objective should be. Instead, we are concerned with how an inflation-targeting central bank can most effectively fulfill its objectives.”* (CGW (2002), p2)

So what then is the controversy about?

The key issue in the debate, in my opinion, is that, in practice, much of interest rate setting is not driven by looking at inflation and growth forecasts at all horizons, but is based on rules of thumb. In particular, inflation-targeting is usually based on inflation forecasts 1-3 years out, often with a focus on a fixed horizon such as two-years. This can have the effect that asset price misalignments get an insufficient weight in policy-making.

At the Geneva conference when we first presented our work three years ago, Ueda-san argued that a Japanese central banker who was looking 10 years out would have been raising rates in 1987-8. But, given that the central bank was focused on inflation only one or two years out, it was more difficult to justify raising rates (see Cecchetti, Genberg, Lipsky and Wadhvani [CGLW hereafter] (2000), pp. 111-112).

We are simply proposing that, where the reaction function includes fixed horizon inflation forecasts, it also should incorporate asset price misalignments.

As we said in 2000:

“A purist might argue that the central bank should really look at inflation forecasts at several (all) future time periods such a policy might not be easy to implement...The proposal for incorporating asset price misalignments can be interpreted as an alternative way of allowing for considerations relating to longer time-horizons” (CGLW (2000) p.51).

Hence, our views was simply that including asset price misalignments would help us to do better than existing rules of thumb.

But why focus on rules of thumb?

There are those like Charlie, who argue that improving on existing rules of thumb is not interesting or relevant. Instead, one should just use the theoretically “optimal” policy rule. Recall that, in this case, that might involve reacting to a ten-year ahead inflation profile. My heart sinks at the thought of having to attempt to implement such a rule.

(1) Practical considerations. It is very time-consuming to agree on a two-year profile for inflation, let alone going out many years into the future. Also many of the econometric models that underlie such forecasts perform particularly badly at longer horizons.

(2) It is what most central banks do in practice. Therefore, unsurprisingly, for most of the period I was on the Bank of England Monetary Policy Committee (MPC), the emphasis was on the two-year ahead horizon. This was reflected in the substantial time spent on deciding whether the inflation forecast was 2.4, 2.5 or 2.6 per cent at the two-year ahead horizon. Of course, towards the end of my term on the MPC, the relationship may have become a little less tight. But, even then, for the majority of members of the committee, the two-year ahead point forecasts remained central.

In many other inflation-targeting countries, the central bank also relies on a fixed-horizon element in the target set for the central bank (for example, Sweden and New Zealand).

(3) Ease of communication. Both internally and in terms of how policy is communicated to the public, simple rules are much easier to work with. In particular, if the inflation target is more easily understood, inflation expectations will be better anchored, providing crucial support to the success of monetary policy.

(4) Accountability. If the framework is vague, it is difficult to make the central bank accountable.

Avoiding Bubbles

Charlie asserts that:

“... the design of monetary policy does not require a change in the rhetoric of inflation targets.” (p.28).

I disagree.

A clear role for asset prices in the inflation-targeting framework has the advantage that bubbles will be discouraged. Having a transparent reaction function consisting of the two-year ahead inflation forecast plus an asset price misalignment adjustment could potentially make bubbles less likely to occur.

One key point is that the simulation work in the literature significantly understates the benefits of including asset price misalignments in the reaction function. It doesn't allow for the Kent-Lowe (1997)/Allen-Gale (2000) effect – ie the impact that the central bank can have on the probability of the bubble growing, by signalling that it will respond.

For example, in the UK in the last two years, the Bank of England has provided no clear steer on the housing market, with different members expressing different views. A transparent rule of thumb would have made it easier to affect expectations, and might have reduced the degree of the house price misalignment.

Charlie seems sympathetic to the “conventional view” that monetary policy can do little more than deal with the fall-out from the unwinding of asset price bubbles and explicitly quotes Chairman Greenspan on this issue. But, this is potentially dangerous as it is asymmetric, and, more importantly, no attempt is made to affect expectations during the period that the bubble is inflating.

Other Work

Of course, many people have done interesting work on why the reaction function should be modified – not just to include asset price misalignments but to make it richer more generally. Andrew's address at the beginning of this conference summarised much of this work (e.g. Borio and Lowe (2002), and Bordo and Jeanne (2002)).

I believe that it is important that central banks use richer reaction functions than the existing ones that seem to feed off fixed horizon inflation forecasts, and Charlie's paper does not do enough justice to the need for such modifications.

Lack of Clarity of current UK framework

While the current UK framework has many advantages, there is a lack of clarity on asset prices and imbalances. The “flexibility” of the framework in this area has meant that MPC members have, in the last two to three years had a whole host of views on how they should react to the imbalances. This is therefore been confusing to the public.

In particular some members have reacted differently to the exchange rate “misalignment” and the house price/consumption “misalignment”. According to our suggested rule of thumb:

- (1) Since unsustainable house price growth could lead to a crash and very low inflation three to four years out, interest rates should initially have been higher than warranted by the two-year ahead forecast to prevent a build-up of debt and house prices.

- (2) But, acting in the opposite direction, since the exchange rate was higher than warranted, interest rate should have initially been set lower than otherwise. This would have helped keep the exchange rate lower, thereby reducing the size of its eventual crash.

However, some members did not apply this same logic to both misalignments. The same members argued for higher interest rates because of the housing market, in line with our proposed rule of thumb. But, at the same time, these members argued that the strength of sterling also argued for higher interest rates. The reasoning was that this meant there was a risk of future exchange rate falls, stimulating inflation at some uncertain point.

So, the so-called flexible inflation targeting allows people to be inconsistent in their treatment of misalignments in different asset markets. It would be much better to have a transparent and consistent rule of thumb in that case.

Conclusion

I enjoyed reading Charlie's paper, and am grateful for the opportunity of being here today. However, I do hope that the Bank of England and other central banks decide to adopt superior rules of thumb (which include asset price misalignments) when setting policy.

References

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