

Is Inflation Targeting Guilty of Causing Financial Instability of 2007-09?

Takatoshi Ito

University of Tokyo, NBER, CEPR & TCER

At Federal Reserve Bank of Chicago

November 10, 2011

Conclusions: My views

- Main cause of the 2007-09 crisis was regulatory failures rather than mistaken monetary policy objectives
 - Inflation targeting should not be blamed
- How to prevent a future crisis
 - Look for signs of too much macro risk: asset price increases and bank credit increases
 - Macro prudential measures to reduce speculative activities: LTV, regulate risk concentration, real estate capital gains tax
 - Legal framework to avoid TBTF: Orderly resolution mechanism
- Who should be in charge?
 - FSA with proper independence is better
 - Central banks, who takes in supervision, may suffer from conflict in policy goals; too much political intervention

Now in details

- Causes of the 2007-2009 crisis
 - Blame regulatory agencies ignoring signs of problems
 - Blame FIT ignoring asset price movement
- Flexible Inflation Targeting
- Critics of inflation targeting
- Should the Central Bank Target Asset Prices
- How Could the Central Bank Maintain Financial Stability

The Global Financial Crisis, 2007-09

- Causes

- Failure of supervision and regulation

- Global Imbalances with conundrum

- Capital inflows to US securities

- Too low interest rate (via FIT)

- Taylor's criticism

- The interest rate should have been higher in 2002-05 to prevent housing bubble



- Criticism of inflation targeting

- **Narrow focus on CPI inflation rate** allowed the housing bubble to grow bigger and bigger

Causes of 2007-09 crisis



- **Regulatory Failure** view: Blame regulatory agencies
 - “Originate to distribute” : Moral hazard
 - Financial engineering of CDOs: Risk management failure and supervision failure
 - SIVs: Accounting opaqueness
 - CRAs: conflict of interest
- **Lax Monetary Policy** view: Blame low interest rate policy via FIT, ignoring asset prices
 - Low interest rate, justified by FIT (success of FIT) and global imbalances
 - Too much liquidity causing speculative activity with increasing bank credit (leverage)
 - Bubble burst, causing asset prices to plummet

Flexible Inflation Targeting (FIT)

- Flexible inflation targeting
- “Flexible” = not only inflation rate but output gap in the loss function
- “Inflation targeting” = inflation *forecast* targeting
 - Also medium term target
- Use all present and past information to forecast, and take actions if necessary
- Major benefits: stabilize *inflation expectation*
- *What about asset bubble and burst*

FIT and other goals

- Adopted in
 - UK, Canada, Australia, NZ, Sweden, Norway,
 - Thailand, Korea, Indonesia, the Philippines
 - other many advanced and EM countries
 - Mostly, 2% plus minus 1%
- Not formerly adopted but behaves similarly
 - FRB/FOMC (1.5% - 2%)
 - ECB/Euro zone (below but close to 2%)
 - Much lesser extent, BOJ (0-2%, with majority at around 1%)
- Other objective variables
 - US dual mandate: full employment and price stability
 - ECB two-pillars: price stability and monetary growth control (de-emphasized)
 - All have financial systemic stability, but priority, contents, instruments are not clear

Two views: FIT and asset prices

- (A) The FIT should not react to the asset price increases and decreases,
 - Asset prices are *not a target variable*.
 - Asset prices are part of current variables that are used to forecast future CPI inflation
- (B) The FIT should pay more attention to not only the (projected) CPI but also the asset prices and react to them
 - Burst of asset price bubble causes financial instability and output losses
 - Special role in asset prices
- Questions about (B): Not clear “pay more attention” means. Include as a target variable? Not a target variable but more weight in forecasting? Not a target variable, but important within a room of discretion?

Digression: Japanese bubble and burst

- Japan's asset bubble: 1985-90
 - Stock and land prices tripled in five years
- Burst and lost decade: 1990-2003
 - Stock prices peaked in end-1989
 - Land prices peaked in 1990-91
 - Stock prices lost 60% of values in two years of the peak
 - Land prices continued to decline until 2006
- US housing price movement 16 yrs later is reminiscent of the Japanese experiences

What should/could have done to prevent Japan's bubble

- (A) It was regulatory failure. Asset price bubble should have been countered by
 - Regulation on the loan-to-value ratio
 - Regulation on banks' risk concentration on real estate sector (directly and indirectly)
 - Various deregulation to increase "supply"
- (B) BoJ: Monetary policy should have been tighter
 - Regret: Pressure to keep the interest rate low to prevent yen appreciation
 - Regret: CPI inflation was low so BoJ was complacent
- Question to (B): how high the interest rate should have been to stop the bubble early? Wouldn't the high rate have caused deflation?

Can we call it a bubble in real time?

- Housing price or stock price increases usually start for fundamental reasons
- At some point, those price increases invite speculators into the market
- Are we able to identify when the process transform from “fundamentals” to “bubbles”?
 - Would be very difficult
- Premature end to the asset price increases by causing a recession (interest rate hike) → Loss, and may end up in deflation (much worse)
- But, risk control at financial institutions should be adopted, and prudential measures are recommended

Should the Central Bank Target Asset Prices?

- (A) No special attention to asset prices needed (beyond as a one of the variables for predicting future CPI)
- (B) Asset prices stability should be as important as CPI price stability and output stability in the objective function of a central bank
- (Middle ground=**practical compromise**)

First best, I think

- Strong macro prudential measures at FSA (with right man at the top)
- Strong power at FSA and DIC to make capital injections and nationalization
- Orderly resolution power, example: Japanese DIC law Article 102: Confirmation of Necessity of Measures Taken Against Financial Crises,
 - Prime Minister call the meeting (political involvement)
 - DIC has power to make capital injection (subscription of shares) for solvent but weak institutions
 - DIC can nationalize financial institutions if they are insolvent

The Japanese model (Used to be the UK model)

Bank of Japan:
monetary policy &
LLR

FSA:
micro- and macro-
prudential policy,
resolution

Coordination



Ministry of Finance:
Fiscal funding for capital injection, nationalization

The triangle worked in Japan and It did NOT work in UK

Practical **Compromises**

- (1) [**Lean against within the tolerance band**] FIT has a tolerance band, say 2% plus/minus 1% for CPI inflation rate. Then if asset prices are rising fast, lean against it by choosing near 1% as CPI inflation target
- (2) [**Lexicographical Two pillar approach**] Inflation target and financial stability are two pillars. If no threat to financial stability, act as FIT. If there are concerns about financial stability, addressing financial stability first by suppressing credit growth (to real estate sectors).
 - Does ECB still have this kind of view?

Practical Compromises, con'd

- (3) [Fine tune timing—Riksbank view]
 - “The paths of asset prices and indebtedness can at times be either difficult to rationalize or unsustainable in the long term. This means that there are risks of sharp corrections in the future which, in turn, affect the real economy and inflation. ... In practice, taking risks of this kind into consideration can mean that **interest rate changes are made somewhat earlier or later, in relation to what would have been the most suitable according to the forecasts for inflation and the real economy**”



Asset Bubble without CPI inflation: What to do then?

- FIT considers the channel through wealth effects on future inflation. So, beyond that—
- [First best] Apply supervision and regulation
 - Stress test/special examination of risk concentration
 - Dynamic capital requirements
 - Regulate the Loan-to-value ratio
 - Establish, if not already, an orderly resolution mechanism (even for a large systemically important institution) just in case
- [Second best]
 - Go to Practical Compromises

Political risk of having supervisory and regulatory power in central bank (?)

- Monetary policy wing and financial stability wing: BOE and FRB
- Some powers would need to be coordinated with fiscal authority (and politicians)
 - Nationalization
 - Capital injection
- More important: macro prudential measures, instruments, and appropriate use
 - rather than who should have those powers
 - Giving oversight power without instruments would be a mistake



Recap: Recommendations

- (1) Reliable Housing Data index
 - each country develops the reliable housing price index, either by the hedonic approach or the repeated sales method.
 - Hedonic or repeated sales
- (2) Reliable Housing-related Data
 - create a data base on the housing loan (mortgage) details, including the loan-to-value ratio, how the down-payment is financed, whether it is the primary home, second home, or for rental/lease.
- (3) Orderly Resolution of large systemically important institutions
 - introduce, if not already, a legal framework to take over troubled large financial institutions, when the institution is deemed insolvent.
- (4) Financial supervision institution
 - establish either financial supervision agency (FSA) or a department in charge of financial supervision within the central bank.
- (5) macro and micro prudential policy
 - Preventing the bubble to get bigger with prudential measures is the first best.