IMF MACRO CONFERENCE
ISSING PRESENTATION

During my time at the European Central Bank, I had a number of stimulating discussions with Olivier Blanchard, and when we disagreed—and this has happened from time to time—I always thought twice before continuing with my dissenting view. Since I no longer have responsibility for monetary policy actions, I will now reduce my rethinking to once.

The chairman has encouraged us to come up with controversial statements, so I feel obliged to do what I would have done anyway. I would like to refer to what I see as a flawed post-crisis consensus.

Consider a statement by Lars Svensson, whom I have chosen not only because he is one of the gurus of the concept of inflation targeting but also because his statement shows how you can immunize a strategy against any critique."In the end, my main conclusion so far from the crisis is that flexible inflation targeting, applied the right way and using all the information about financial factors that is relevant for the forecast of inflation and resource utilization at any horizon, remains the best-practice monetary policy before, during, and after the financial crisis." His statement is that if it hasn't worked as you had expected, either it was not applied properly, or you missed some information. But the strategy was fine. In this way, you can continue with such concepts indefinitely, having made mistake after mistake.

Is there something in this concept that is fundamentally flawed? To avoid any misunderstanding, let me first say that inflation targeting was highly instrumental in bringing down inflation worldwide, especially in emerging countries. Inflation targeting comprises elements that are and should remain in consensus among all the central banks in the world, namely, the commitment to a quantitative definition of low inflation or a definition of price stability; to adopting a forward-looking policy; to presenting your views, your strategy, your actions in a transparent way; and to communicating those to the markets and to the public in general. These are important elements that are part of inflation targeting, but they are also important elements in all those cases in which there is no explicit inflation targeting strategy.

What are the open questions? One of the open questions is this: What is the role of the inflation forecast? I will come back to that later, but if you look into the history of the concept of inflation targeting, it started with a very simple concept, and the beauty of that was that you would look into your inflation forecast and know what to do. This was the starting point. Over time, though, it turned out that it's not so simple. The term changed to "inflation targeting with judgment," and later to "flexible inflation targeting." If you define flexible inflation targeting as Lars Svensson has done, I think it's a nirvana approach.

Another problem is that the inflation forecast really is supposed to be a comprehensive summary of all the elements that are relevant for inflation in the future. And I would doubt that is possible. Another issue concerns the time horizon of inflation targeting. I am reminded of a conference at the Bank for International Settlements (BIS), where inflation targeters were discussing how far to extend the time horizon of the inflation forecast. It was initially one and a half years. Then, they said two years, probably. And Lars Svensson asked, why not six or seven years? But then I wonder what an inflation forecast with such a time horizon could really turn into.

The major issue is that all concepts of inflation targeting are based on inflation forecasts in which money and credit don't play an active role. They are a passive part of the forecast, but irrelevant once it comes to monetary policy decisions.

Another issue related to this is the question of to what extent monetary policy should react or try to deal with asset price developments. I call this the Jackson Hole conference issue because it was presented in Jackson Hole, time and again. The three key points are: central banks should not target asset prices, should not prick a bubble, and should follow a "mop up" strategy after a bubble has burst. I think this is evident, and no central bank would act differently.

My question is—always, and not only from hindsight–whether this is all. Because if this is your position, that monetary policy should deal with asset prices only on the way down, it is a totally asymmetric approach. It implies that as long as asset prices go up, the central bank is saying, it's not our business. If asset prices collapse after a bubble bursts, then the central banks have to come to the rescue. They are the savior. I think this asymmetric approach implies the risk of a series of ever-increasing bubbles, because you never correct the causes that have led to the bubble.

You add as much liquidity as needed, of course, I don't dispute that. We should not repeat the mistakes of 1929 and the following years. Once we are in such a situation, of course, we have to provide the liquidity needed. But the question remains: Is this all? Is a totally asymmetric approach, which is implying a kind of guarantee of the central bank to come to the rescue of failed financial institutions, *et cetera*—is this not creating moral hazard?

The reaction I got when I asked about the asymmetry of this approach was always the question: How can you identify a bubble? Can central banks know better than markets? But this is not the issue of identifying the appropriateness of the stock price of a company, *et cetera*, but rather one of assessing macroeconomic developments. Quite a number of studies now—libraries, almost—from the Bank for International Settlements (BIS) and also from the European Central Bank, have clearly shown that there is hardly any bubble in history that was not accompanied if not preceded by strong growth in money and/or credit.

Looking into money and credit will help you to identify a risky macroeconomic situation. This leads to the question that Olivier Blanchard has raised: To what extent should monetary policy contribute to containing financial instability? A major contribution would be to avoid the emergence of unsustainable developments in money and credit.

Leaning against the wind might have two conceptual consequences. One is trying to identify asset price misalignments, financial imbalances. The other is just to lean against unstable developments in money and credit. Both lead to the same concept.

One argument against such an approach has been that the central bank has only one instrument, which is the interest rate. It was said that for dealing also with asset price developments, the instrument of the interest rate was too blunt a tool. You would have to raise interest rates substantially, which would create immense costs for the real economy.

But that is not a consequence of the concept of leaning against the wind. If you start early enough, even small changes in the interest rate might have a substantial impact. In situations of emerging strong credit developments and unsustainable developments in asset prices, typically quite a number of financial actors are confronted with misalignments in maturity. Therefore, you have a maturity mismatch situation in which leveraging is going up. So even small increases in interest rates might have a substantial effect. And it's also a communication device. The central bank would be signaling that it does care, and it would support its communication by its publications, speeches, and so on.

With this kind of early action, true, it’s not simple to know when to trigger. I'm fully aware of this risk. But we also have to be aware of a risk of not acting soon enough. Acting early might also work against herding behavior.

"I worry that we have been lulled—or we have lulled ourselves—into a sense of complacency which is not warranted. There are still many issues we do not understand, and these may come back to bite us with a vengeance in the future". One of the organizers of the conference, Olivier Blanchard, made this remark at the conference for my farewell. He said that in 2006, and unfortunately, he was so right.

In his introductory presentation here, he made a remark about the elegance or beauty of models, and I think this beauty has contributed to the complacency. The initial concept of inflation targeting, for example, looked so elegant. I've left the European Central Bank, but even more than before I am convinced by its strategy. We were criticized when we started with monetary policy in 1999 by academics across the board who didn't like our concept. One of the reasons, I discovered very early, was that it was not really elegant. It was not seen as state-of-the-art. How can you frame this approach in one model? We said to them, we can't. I am not responsible for that, but I promise a Nobel prize to anybody who can do that, combining money and credit quantities with the usual concept of inflation targeting. We are still looking for such a solution.

I think "inflation targeters" are aware of that. They are trying to include financial sectors in the model, talking about frictions. Probably this is a research concept that will lead, finally, to better approaches. But for some time to come, it will not help central banks at all. If the inflation targeting approach is augmented with market frictions, what is the result? What is the advice for monetary policy decision makers?

I think an approach that tries to bring in analysis of money and credit is the answer. To be very clear, we called it the monetary analysis. But from the beginning –not just from hindsight—we, the European Central Bank, understood by monetary analysis not just a comparison of M3 with its reference value. We examined all aspects of monetary developments and credit. This was extended over time, and I can only recommend a volume which was recently published by the ECB demonstrating how far the broadening and deepening of monetary research has led.

Let me conclude with a few remarks on the question of what other lessons we have to take from the crisis. One is dealing with the zero bound by raising the inflation target. For me, this is not a convincing approach for quite a number of reasons. Olivier and his colleagues in a paper have dealt with the costs of inflation, and they have argued in favor of indexing the tax system and so on. From experience we know that this is very difficult to implement, and it certainly is not as efficient as stable money.

But my main concern is the unavoidable loss of credibility of the central bank. Why should people believe that the upper limit of 4 percent would not be increased again next time? How can inflation expectations be anchored with such an approach? The widening of the range would increase volatility. It would foster short-term activism. Finally, you might need even more leeway for reducing interest rates than you would with a smaller range. But this is an aspect, of course, that has to be discussed further.

This debate also leads to the issue of dual versus single mandate, which is a hot topic debated here. I think no central bank in the world would ignore developments in the real sector, such as unemployment. But what the central banks can deliver in the end is price stability and nothing else. Responsibility for financial stability is in the first place in the hands of regulatory and supervisory authorities.

Price stability and financial stability must not be seen as a trade-off. We have to deal with financial stability in the context of monetary policy that is geared to maintain price stability.

Thank you.