Rethinking Inflation Targeting: Some Lessons from Israel

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The bottom line

- 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 on 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.
Twenty five years under an IT regime in Israel
In recent years, inflation has been lower than the target...
...and the central bank sharply lowered the policy rate...
…to a level even below the Fed funds rate…
...and this, in turn, contributed to housing and asset price inflation -- (Housing price index, Rentals)
The evidence is similar to the US, where Fed fund reductions were followed by higher housing prices…
Studying these types of developments, the BIS (e.g. Claudio Borio) provided evidence of how ample financial cycles can be compared to real sector business cycles.

Source: BIS

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. The business cycle as measured by a frequency-based (bandpass) filter capturing fluctuations in real GDP over a period from one to eight years.
Globally, very low policy rates have been followed by a sharp rise in debt and leverage, which complicates now the process of interest rates’ normalization.

Source: BIS
In conclusion: a broader form of IT is needed

• 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 e.g. the 86th Annual Report of the BIS)
• These are promising and well needed lines of research in monetary economics, with quite significant policy implications