

# **Rethinking Inflation Targeting: Some Lessons from Israel**

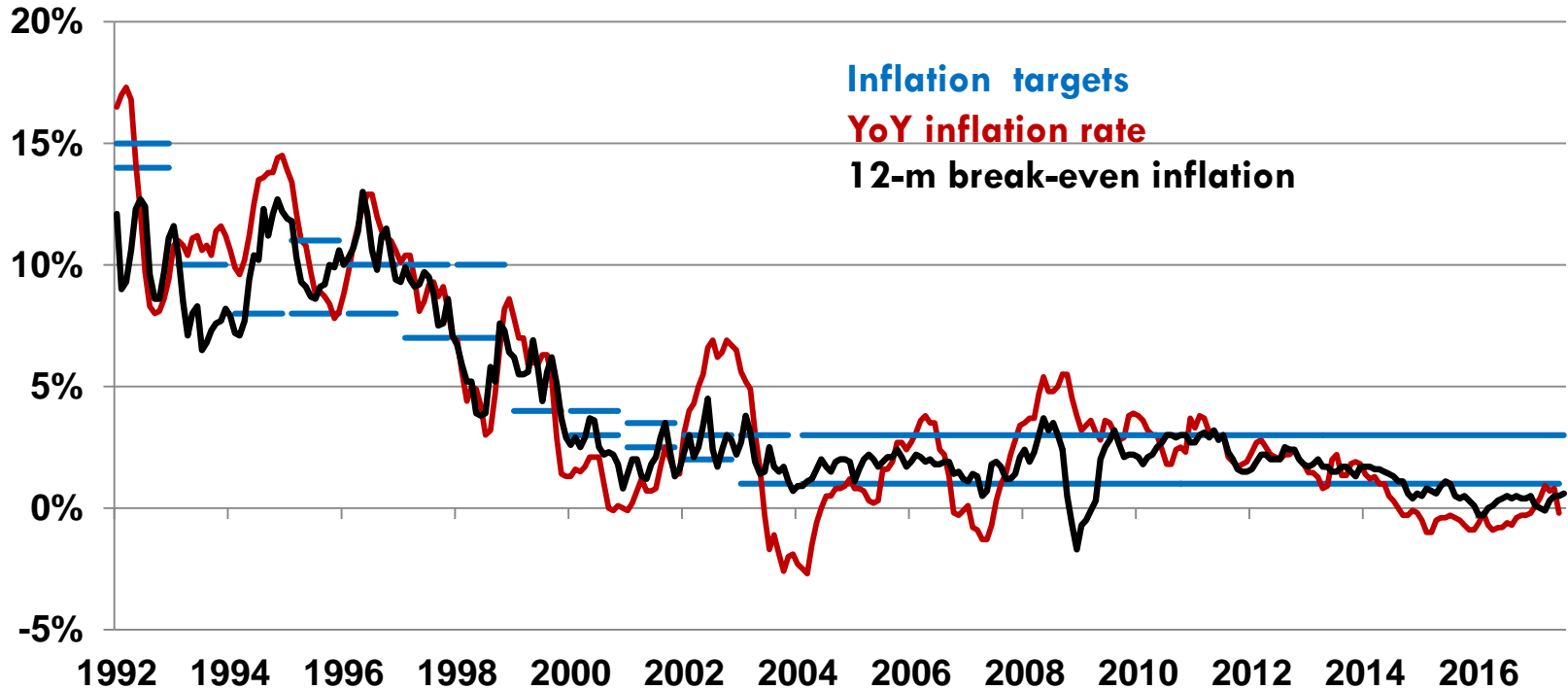
**Leonardo Leiderman  
Tel Aviv University**

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# The bottom line

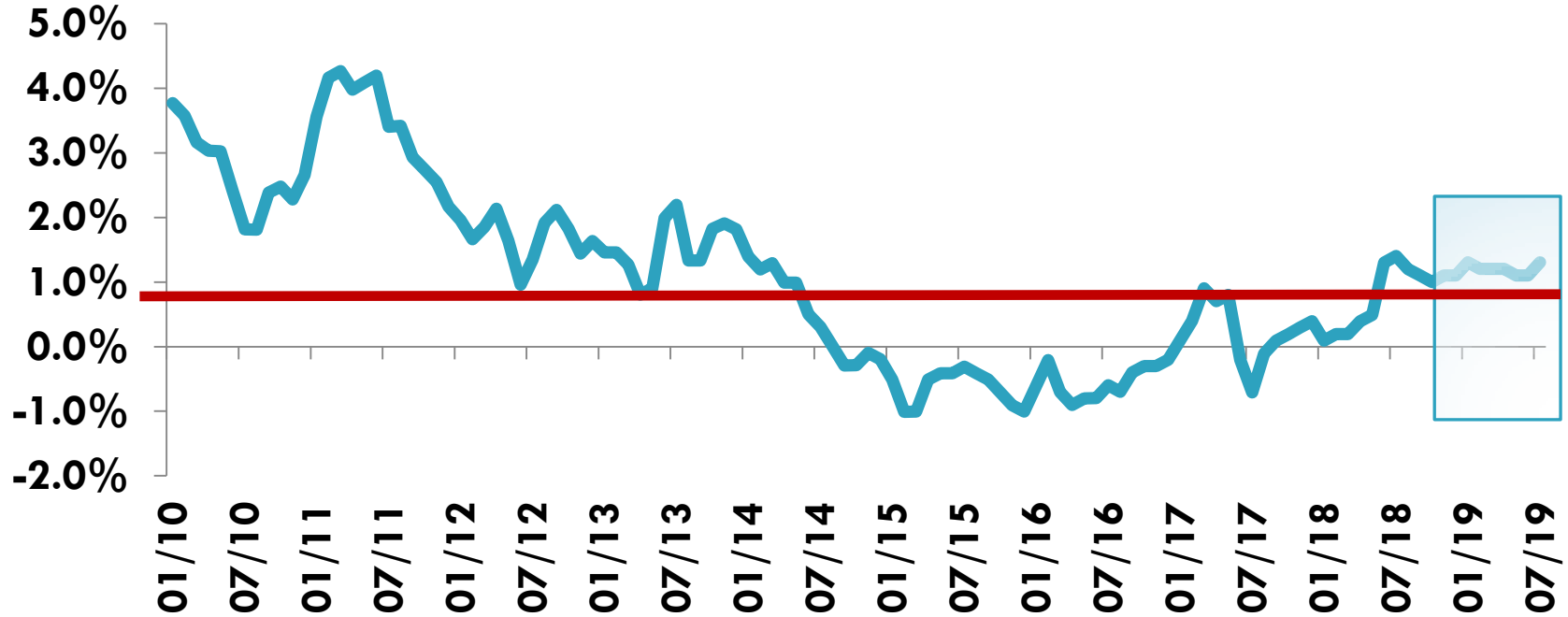
- ❑ **The typical legal mandate for an independent central bank includes three main goals: price stability, support of real economic activity, and financial stability**
- ❑ **Ever since its introduction, flexible inflation targeting regimes have focused mainly of the first two foregoing goals**
- ❑ **A 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**

# Twenty five years under an IT regime in Israel



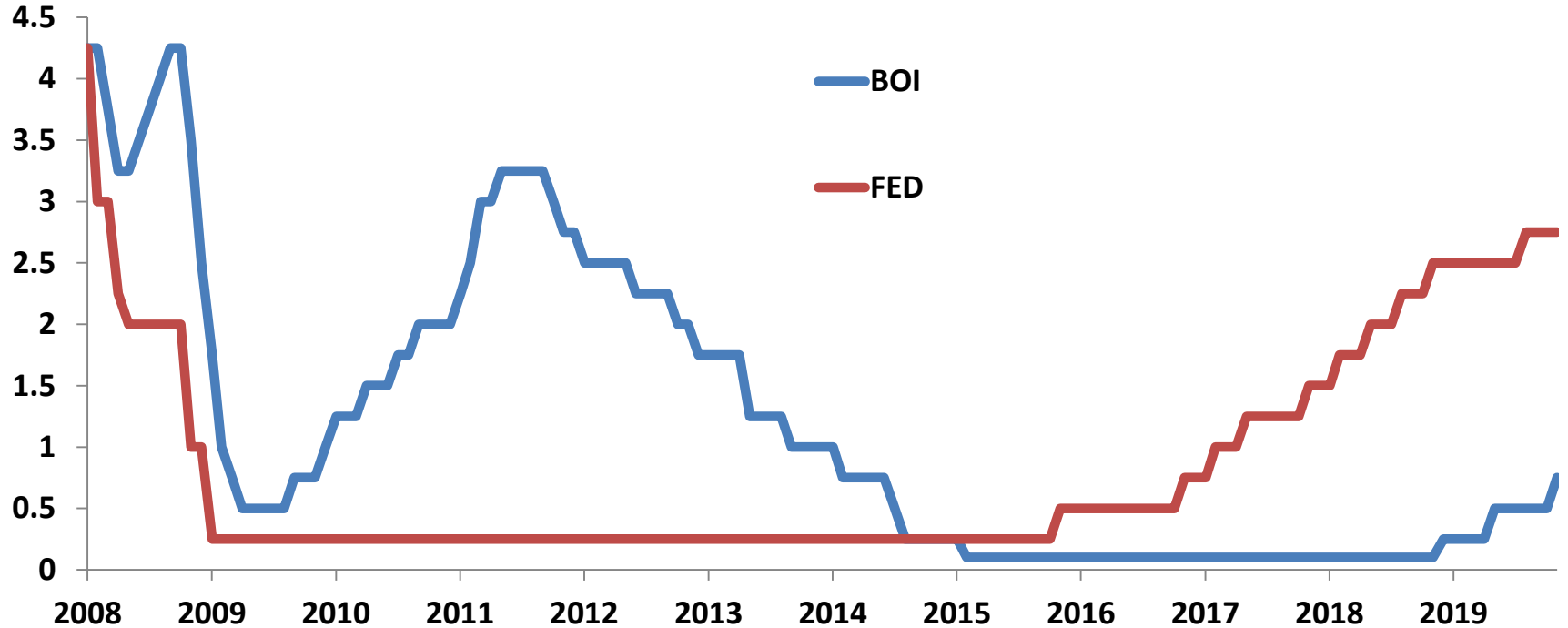
# In recent years, inflation has been lower than the target...

Annual inflation rate in Israel, in percents per year

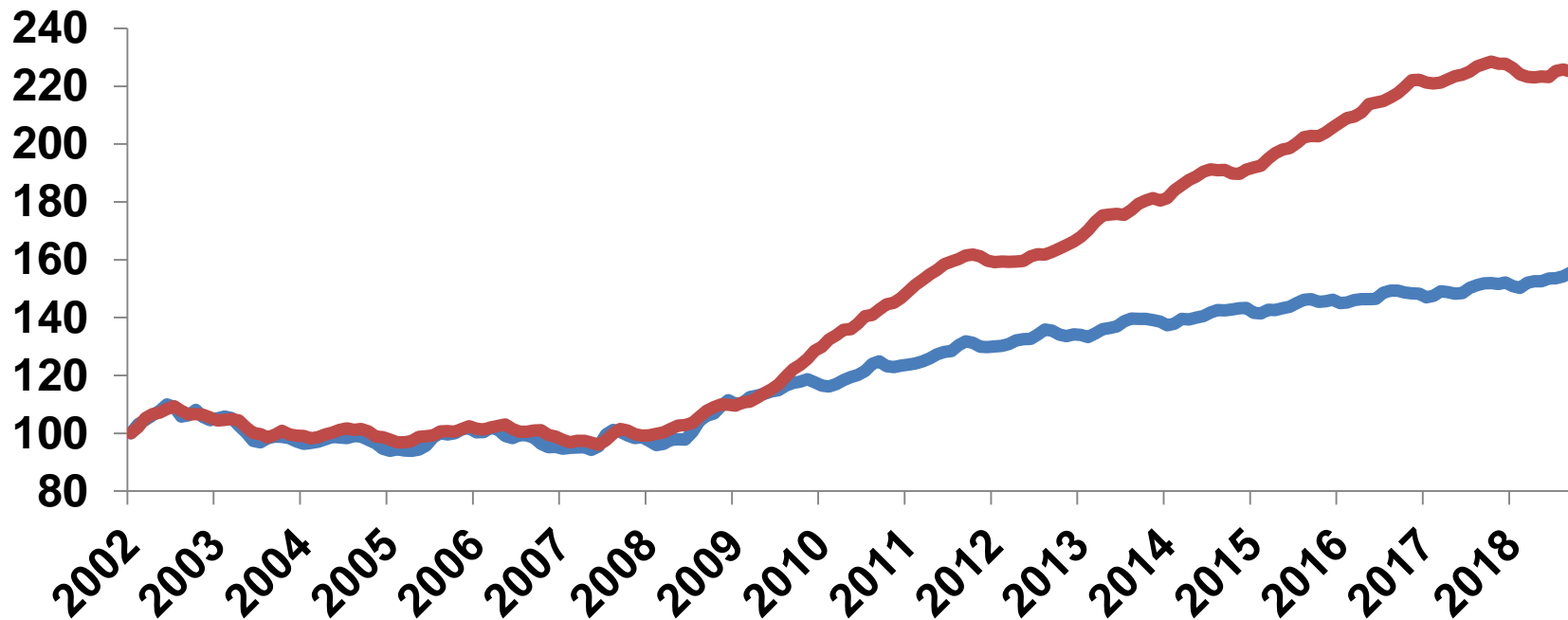




...to a level even below the Fed funds rate...



...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...

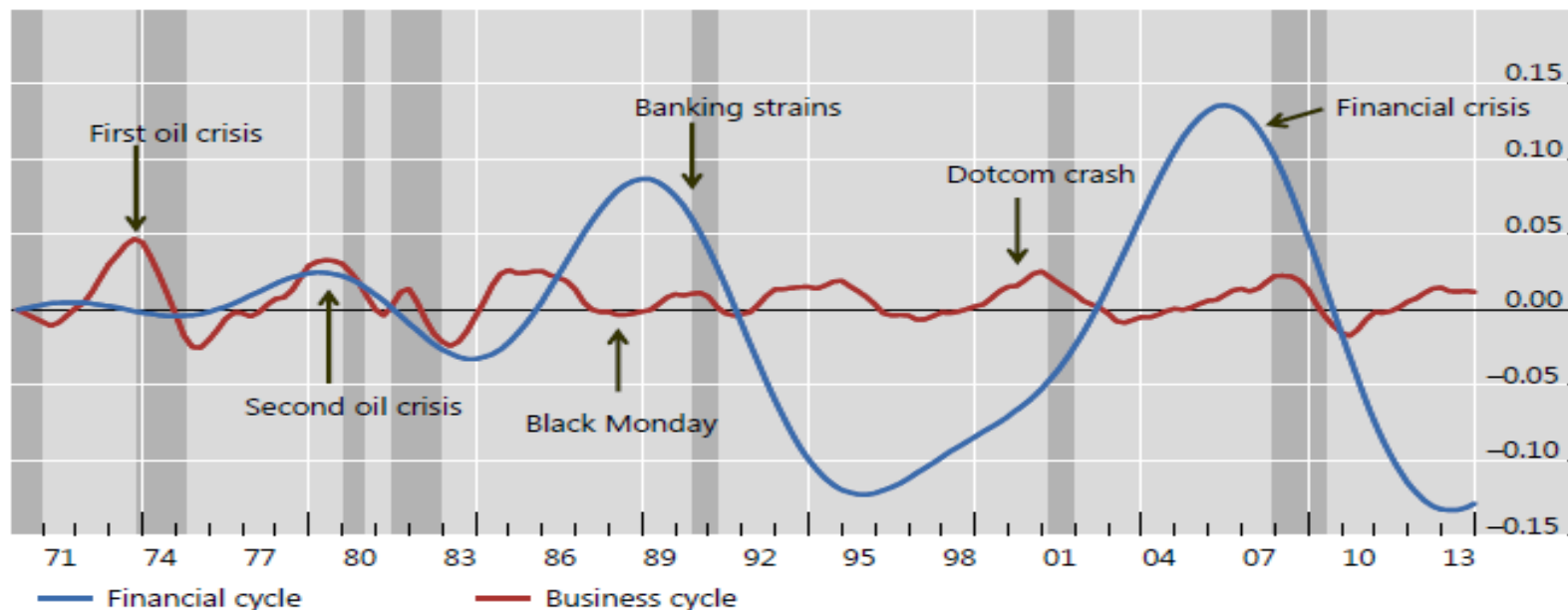
US S&P CASE-SHILLER HOME PRICE INDEX





# 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.



# **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**

