
Why price stability is not enough

The current fashion for inflation targetting ignores the perils of asset bubbles, and cannot react adequately to the fallout. A much longer view is needed, contends Stephen King.

For the most part, central banks have pursued the goal of price stability, typically defined as a low and stable rate of inflation, over the last few years. For some countries and regions, this goal has been made explicit through the use of an inflation target. For others, the goal has been more implicit but has nevertheless been given a particularly high priority. In the hierarchy of possible macroeconomic policy objectives, price stability comes right at the top.



Stephen King

The underlying assumption is, of course, that the achievement of price stability is the best single way that a central bank can contribute to maximising the economic performance of a country or region. Developments over the last 15 years, however, suggest that this view may be overly simplistic. Countries that have successfully delivered a low and stable rate of inflation for a sustained period of time have not always delivered sustainable economic health. It appears that even if low inflation itself is desirable, its achievement in no way guarantees a desirable economic performance. Yet policymakers have often regarded low and stable inflation as the ultimate sign of economic success.

Of course, this desire to control inflation stems in part from the history of price instability that began in the late 1960s and which became the major economic challenge of the 1970s and 1980s. Faced with the problems of that period, it is hardly surprising that price stability has become the *sine*

**Inflation's
downsides**

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qua non of economic aspirations. And it is also not surprising that

consideration of other economic objectives has been systematically accorded a relatively low weighting. So, when policymakers are asked whether they should take into account the performance of asset prices, the answer has typically been in the affirmative but only if it can be shown that changes in asset prices have an impact on inflation.

From my perspective, this approach is rather odd. It is, of course, true that unexpected changes in the rate of inflation potentially have serious economic consequences. Savers are penalised to the benefit of debtors leading to an unwarranted redistribution of income. Resources are misallocated because it becomes difficult to assess whether a change in prices is simply a reflection of changes in the rate of inflation or whether, instead, there is a genuine change in relative supply or demand conditions. The true level of interest rates becomes uncertain, threatening an inefficient allocation of capital over time.

And asset prices too

Equally, however, many of the same charges could be applied to unexpected movements in asset prices. If there is an asset price bubble, consumers and companies may borrow too much, and live to regret their decisions later on. Rises in asset prices may also lead to a misallocation of resources through time; too much capital accumulation in the short term, for example, followed by an extended period of over-capacity thereafter. And it may be difficult for the central bank to set monetary conditions in a way that deals with changing expectations with regard to the future return on capital. As a result, there may be a greater risk of policy error.

It seems to me that there are two obvious lines of defence against this comparison. The first is simple: inflation can be targetted in a practical fashion whereas asset prices cannot be. Which asset prices should you aim for? Housing? Equities? Moreover, does it matter whether asset prices alone are rising or, instead, whether asset price gains are accompanied by increases in liabilities as well? What degree of asset price inflation is acceptable and at what point should alarm bells start to ring?

The second is also simple but, in effect, is a question of philosophy or politics rather than economics. Central banks and governments can, in tandem, create inflation and may be incentivised to do so if, as a result, government debt levels can be stabilised or brought down as a share of nominal GDP. A pre-commitment to an inflation target is a declaration of intent that the government will not resort to an “inflation tax” of this sort. An asset price bubble, in contrast, is likely to reflect changing expectations within the private sector. If so, it might not seem appropriate for the government or the central bank to exert any particular influence.

In my view, this second distinction is false. It is certainly true that governments have the capacity – and sometimes, perhaps, the incentive – to manipulate the inflation rate. But government influence is not the only factor affecting the inflation rate. Actions within the private sector – sometimes revealed through changes in asset prices – can also have an impact on inflation. Moreover, these actions may in time undermine the ability of the monetary authority to meet its inflation objective. The idea that asset prices can be ignored unless there is a direct link to the rate of inflation seems to be inconsistent with recent economic experience.

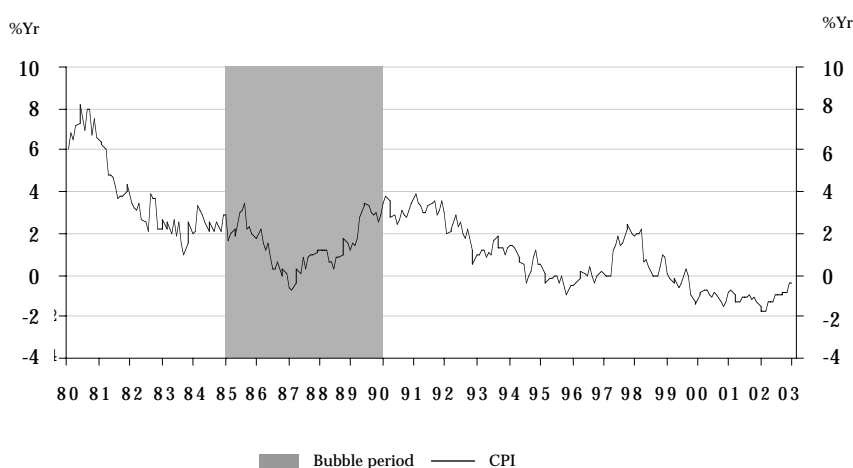
In a paper produced in 1999 (“Bubble Trouble”) I looked at the symptoms

associated with bubbles in a number of different countries over the last 15 years. One symptom stood out: in all the countries, inflation was either low in absolute terms or was low relative to its earlier history. In each case, the development of an asset price bubble was closely correlated with apparent success on inflation.

Bubbles and low inflation

Of course, the arrival of low inflation was sometimes only a temporary phenomenon associated with a beneficial external shock. The UK's experience in the late 1980s, when a bubble in house prices eventually gave way to a more generalised rise in the rate of inflation, was partly associated with the collapse in oil prices and the rise in sterling against the dollar in the second half of the 1980s. But bubbles appear to be able to develop in conditions when inflation itself remains under control. Japan's inflation rate in the late 1980s remained at very low levels for a number of years and, even when it did rise at the end of the decade, Japan's inflation performance remained superior to that of Japan's major competitors. The US experience in the late 1990s is a more recent, but also very good, example of this effect.

Figure 1: Japan's inflation experience, 1980-2003



Put another way, for much of the late 1980s, Japan would easily have met the majority of inflation targets that are in use today. Figure 1 shows Japan's inflation experience on an annual basis from 1980 through to the present. Japan pursued a policy of very low interest rates in the second half of the 1980s, in part an attempt to appease American concerns over the size of Japan's trade surplus. Throughout this period, however, this approach to interest rates appeared to be consistent with the maintenance of low and stable inflation, despite rapid gains in equity and land prices.

Table 1: Inflation objectives

Japan average inflation rate 1985-89	1.5%
Current inflation target	
Australia	2-3% over the medium term
New Zealand	0-3%
Sweden	2% with margin of +/-1%
United Kingdom	2.5%
EMU	0-2%
United States	No formal target
Canada	2% mid-point of 1-3% target range

Dangers on the way down Moreover, when asset prices started to decline, there was a failure to recognise the potential risks to the macroeconomic environment. Ultimately, declining asset prices and the associated collapse in expectations with regard to future economic growth left companies with excessive debt levels that prompted the slow but sure move into a world of deflation. The relative stability of inflation at the time, however, provided policymakers and other observers with an unjustified level of confidence in the underlying health of the economic system in Japan.

Four conclusions can be drawn from this episode. Firstly, the Japanese experience shows that, ultimately, asset price bubbles can be inconsistent with the pursuit of a given inflation objective. In Japan’s case, the bubble itself did not lead to significantly higher inflation: rather, the post-bubble environment, one associated with imploding balance sheets, triggered a move into deflation. And it was asset prices alone that provided the clue to subsequent broader economic dangers.

A longer horizon Secondly, the time horizon for an inflation objective may have a huge influence on the stability of economic performance over the medium term. In Japan’s case, a two-year ahead inflation target in the late-1980s would have proved inadequate in stabilising activity over the medium term. A ten-year ahead target that recognised the deflationary risks associated with the aftermath of an asset price bubble, might have justified a more aggressive anti-bubble policy stance.

Central banks stymied Thirdly, post-bubble worlds that trigger deflation may make it difficult for central banks to influence economic developments in the customary manner. Standard monetary policy changes typically work through the supply side via changes in the slope of the yield curve and through the demand side by changing the cost of credit. In a world of deflation, neither mechanism is likely to work so well. If nominal GDP growth expectations are very depressed, it may be difficult to generate a yield curve slope positive enough to persuade banks to extend credit. If inflation and interest rates are very low, it may be difficult to generate a negative real interest rate sufficient to persuade companies and consumers to borrow

again. Under these circumstances, central banks risk a loss of control over policy that would seem to undermine their medium term commitment to price stability. Asset price inflation may, therefore, ultimately undermine the power and influence of central banks.

Fourthly, it may be the case that the achievement of low inflation in itself has encouraged excessive risk taking which, in turn, has contributed to the emergence of financial and economic bubbles. If, through the 1970s and 1980s, inflation was seen to be the biggest single threat to economic stability, its virtual eradication would seem to make the world a safer place from an economic perspective. Indeed, by the second half of the 1990s, it became popular to argue that the economic cycle had, perhaps, been abolished, leading to a more predictable world with less risk to the value of financial assets, thereby driving asset values up to levels that, ultimately, proved to be unjustified.

Low inflation – a bubble cause?

Many of the advantages of inflation targetting – simplicity, transparency, immediacy – may simply downplay the true economic challenges that face policymakers. In this discussion, I hope to have demonstrated that pursuit of a simple two-year ahead inflation target might reduce a central bank's ability to meet its inflation objective over the medium term. Inflation targets are perhaps at their best when a country wants to reduce its inflation rate from an unacceptably high level to something more appropriate over the medium term. Once countries have got to this position, however, it may be less obvious that pursuit of an inflation target on its own provides all the macroeconomic answers.

Inflation target: too simple

One way in which policy could, perhaps, evolve is to shift away from a standard inflation target towards a ten-year ahead target for the price level. In the first year, the implications for policy under either a standard inflation target or a price level target would be identical. If, however, inflation unexpectedly undershot target in the first year, the implications of these two regimes would begin to differ. An inflation target regime would simply require a return to the inflation target. A price level regime would require the undershoot of inflation in the first year to be offset by modest overshoots in inflation in subsequent years.

The advantage of this second approach is that it would pre-commit central banks to avoid permanent, undesirable, shifts in the price level and, at the same time, would force them to take into account the implications of changes in asset prices for inflation not just in the first two years but over a whole decade. This approach would have forced Japan to have taken the late-1980s asset price bubble more seriously, not because of the short-term inflationary threat but rather because of the medium-term deflationary threat. And, by the same token, it would have forced the Federal Reserve to have been less accommodating on monetary policy in the second half of the 1990s, an approach that, in hindsight, might have avoided the ongoing problems associated with economic activity over recent years. □

Taking the longer view