Pursuing Financial Stability Under Inflation Targeting*

There is a general view that the global economy was able to sustain the Great Moderation with low prices from the early 1990s thanks not only to fiercer competition resulting from improved productivity and the progress toward globalization but also to the adoption and implementation of inflation targeting among many countries. It is held that, thanks to the successful implementation of inflation targeting, the expected inflation among economic agents has been anchored at a low level, the effect of exogenous shocks on inflation decreased, and as a result, the inflation and business cycle volatilities declined remarkably.

After the recent global financial crisis, however, the criticism arose that inflation targeting was of almost no use in preventing financial imbalances from accumulating and proliferating. Although price stability serves as the foundation for financial stability, the successful implementation of inflation targeting does not automatically guarantee financial stability, given that the imbalances accumulated during the period of price stability were largely responsible for the global financial crisis.

Recently, it has been increasingly argued among academic circles and by global financial institutions that central banks need to take into a serious consideration not only price stability but also financial stability in implementing monetary policy. In this regard, this paper sets out policy directions that a central bank adopting inflation targeting should take in order to pursue financial stability.

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According to the results of an analysis using DSGE models, macroeconomic stability increases when a policy rate is determined with not only prices and economic conditions but also the movements of indicators of financial stability such as asset prices and aggregate credit being taken into consideration. In other words, it is advisable to set financial stability, together with price stability, as a central bank's policy goal. However, since frequent response of the central bank to highly volatile asset prices might increase the need for frequent adjustment of the Base Rate, central bank should adjust the rate according to different rules in normal times and in times of financial instability, and the tolerance range of the inflation target should accordingly be set in two different ways.

In addition, the policy horizon for inflation targeting should be lengthened in a bid to minimize the room for conflict between the two policy goals of price stability and financial stability. This means that if inflation deviates from the target in the process of responding to financial stability indicators that change dramatically within a short period of time, it should be induced to return to the target level after a time lag to reconcile the two goals.

In this connection, it is important that the fundamental framework of inflation targeting should remain intact so that the increased discretion arising from joint pursuit of price stability and financial stability may not reduce the credibility of price stability. This implies that monetary policy should be implemented based on the principle that its priority is to maintain medium term price stability and that financial stability variables need to be addressed only temporarily when signs of financial instability are detected. To this end, the rule-based characteristic of inflation targeting should be maintained in such a manner as to set in advance the conditions for monetary policy to respond to financial stability variables. In addition, the transparency and accountability of monetary policy operations should be augmented so that the temporary deviations from the inflation target do not lead to instability in inflation expectations.