

## Monetary Targets

Credit and asset-price booms can leave an awful lot of wreckage behind them. The casualty list after America's housing crash includes: an overhang of unsold property; a huge fall in construction; the risk of weakening consumer spending as house prices fall; a trail of bankruptcies; big write-downs among the investment banks; and the unprecedented seizing-up of some financial markets on both sides of the Atlantic.

You might conclude from this that central banks would try to stop asset prices getting out of hand in the first place. But you would be wrong. Ask a central banker what his job is—on a day when he's not busy trying to save the financial system—and he will probably say he must “maintain price stability” or “control some measure of inflation”. Decoded, that means he cares about the rate of increase in consumer prices, not the prices of houses, shares or other financial assets.

More than 20 central banks have explicit inflation targets. Others, such as the ECB, act as if they do even if technically they do not. The Fed has no formal target, but in practice it has a “comfort zone” for inflation. Mr. Bernanke would doubtless like a formal goal. He praised the idea in a book he wrote a few years ago with Mr. Mishkin, now on the Fed's board, and two other economists.

A central bank's target may be “core” inflation—which leaves out especially volatile prices, such as those of food or energy—or it may be “headline” inflation, which includes the bouncy stuff too. Or it may be a mixture. The Fed, for instance, concentrates on core inflation because it thinks that it predicts future headline rates better than today's headline rate does.

Asset prices, though, are not included. Housing costs do enter the Fed's calculations, via a measure called owner's equivalent rent, which makes up around 15% of the central bank's favoured measure of inflation. But the price indices targeted by the ECB and the Bank of England have no role for housing at all.

Although they do not target asset prices, central banks still have to take their effects on the economy into account. These are uncertain even by the standards of monetary policymaking. For example, a rise in house prices may make people feel wealthier. They may therefore spend more, lifting GDP and putting upward pressure on inflation. But

how much wealthier? Quite a lot, if they are old folk thinking of trading down. Not at all, if they are young couples thinking of buying their first home, or a bigger one.

### **Questions**

1. Why should central banks target inflation?
2. Does it matter if different economies have different target rates?
3. Is it sensible to concentrate on core, rather than headline inflation rates?