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CENTRAL BANKS SHOULD WIDEN THEIR SCOPE AND CONSIDER WEALTH TARGETS TO STABILIZE THE ECONOMY DURING A CREDIT CRISIS, NEW STUDY FROM THE LEVY ECONOMICS INSTITUTE SAYS

ANNANDALE-ON-HUDSON, N.Y.—As unemployment surges and leading indicators continue to show the credit crisis exacting a heavy toll on the U.S. and global economies, many have argued that central banks should not rescue the speculators, careless investors, and banks that encouraged the proliferation of risky assets that triggered the crisis. A new study from The Levy Economics Institute of Bard College suggests that central banks should widen their scope and target the wealth of the personal sector by using interest rates in both the upswing and the downswing of a cycle to avoid moral hazard, and to cushion the economy from the consequences of the rise and fall of asset prices. In their Policy Note, *What Role for Central Banks in View of the Current Crisis*?, Levy Senior Scholar Philip Arestis and Elias Karakitsos, director and CIO of Guildhall Asset Management, contend that focusing solely on inflation is not enough to prevent asset booms from becoming asset bubbles that ultimately burst, with huge adverse consequences for the economy.

"If monetary policy is guided solely by inflation, then the central bank is unlikely to deal adequately with a credit crisis because the volatility of the output gap is greater than the volatility of inflation in an asset-led business cycle," write the authors. They also note that, the more a central bank keeps prices stable, the more likely that signs of an overheating economy will show up first in asset bubbles. The way to avoid these problems, they say, "is to monitor and target the implications of asset prices for consumer spending patterns. A primary candidate for this purpose is the net wealth of the private sector." Arestis and

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Karakitsos define net wealth as assets (financial and tangible) less personal sector liabilities, which include mortgage debt and consumer credit.

Looking at the U.S. economy, they assert that average net wealth for the personal sector since the end of World War II is around five times annual disposable income (ADI). At the peak of the recent equity bubble, net wealth hit a postwar high of 6.2 times ADI, making the bubble transparent. It deflated as equity prices fell, but a new (housing) bubble of the same magnitude emerged. They recommend that the Fed can have a target range of net wealth of approximately 4.3–5.3 times ADI in the same manner as it has an implicit target of 1–2 percent for core inflation. "The target range could be revised to account for demographics or to anchor expectations of asset price inflation. Furthermore, monetary policy should be tightened or relaxed to maintain this particular threshold," the scholars write. "This action would not only allow asset price booms but it would also prevent bubbles, and their huge adverse economic consequences."

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Policy Note 2009/2: *What Role for Central Banks in View of the Current Crisis*?

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