through interest-rate changes and associated movements in exchange rates.

- Flexible inflation targeting makes reserve accumulation unnecessary, since exchange-rate intervention is rare and limited to short-term responses to market disruptions and to a signaling role in cases of serious misalignments.

- The combined policy stance of the countries following this strategy is supposed to ensure an appropriate level of aggregate demand at the global level.

The generalization of inflation targeting *cum* floating exchange rates could thus be regarded as the triumph of the "own house in order" doctrine in the international monetary field. National macroeconomic stability was seen as sufficient for international macroeconomic stability. The domestic and international aspects were essentially regarded as two sides of the same coin.[2]

An added benefit of flexible inflation targeting, according to the emerging orthodoxy, was that it allowed the objectives of price stability and financial stability to be pursued through separate tools —monetary policy for the former and micro-prudential regulatory and supervisory measures for the latter. Tinbergen's separation principle, i.e. the idea that each goal should be pursued with a separate and dedicated instrument, was widely invoked in this context.

In this orthodox view, monetary policy focuses on controlling inflation and works by managing expectations of future policy rates, which by the expectations theory of the yield curve determine the long-term interest rates that influence aggregate demand. Financial stability is attained by microprudential regulation of bank capital that counteracts the moral hazard generated by deposit insurance, together with periodic supervisory assessments and the necessary strictures meant to prevent excessive risk taking and malfeasance. Regardless of whether the microprudential regulator is situated in the central bank or a separate specialized regulatory agency, financial regulation is seen as a separate activity.

Central bankers nowadays often observe that flexible inflation targeting was never as straightforward as this framework suggests and that issues of financial stability and spillovers were always on their minds. Still, it remains accurate to say that the basic theoretical framework sketched above did much to shape their thinking. Its clarity and simplicity enabled it to gain adherents in academia and financial markets as well as in central banks.

Rethinking the Framework

Some of the practical achievements of the flexible inflation targeting framework are indisputable. The adoption of price stability objectives by countries at different levels of economic development was a major step forward after decades of domestically-generated instability. This framework can be credited, at least in part, for the drop in global inflation and the abatement of exchange-rate controversies among the advanced economies.[3]

Now, however, there is growing recognition that the conventional approach to central banking needs to be rethought. Critics reach this conclusion for several related reasons:

- The conventional approach fails to account adequately for financial-sector risk and is therefore too narrowly focused.

- The conventional framework assumes limited or nonexistent cross-border spillovers

[2] Looking ahead, some even regarded this regime as the solution to perennial international monetary controversies (Rose, 2007).

[3] To what extent IT can be credited for the disinflation of the 1990s and the early 2000s is a matter for discussion. Another important factor was the disinflationary pressure coming from the emerging countries' exports. We return to the issue below.