

Asset Prices, Financial Stability and Monetary Policy

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ABSTRACT

Controlling inflation has long been the core objective of most of the central banks to attain other macroeconomic goals and sustainability. However, price stability does not guarantee against financial instability. In the past, large asset price movements resulted into financial crises that led to the collapse of the financial institutions and in turn put the economy in recession and disinflation. Controversy exists as to whether or not monetary policy should respond to (or attempt to influence) asset price “bubbles.” In this paper we highlight the links between commodity and asset prices and analyze the arguments in favor or against the use of monetary policy to tackle with asset price bubble.

KEYWORDS: Asset Price Bubble, Monetary Policy, Inflation Targeting, Financial Stability, Monetary Stability

JEL Codes: E31 ; E52 ; E44 ; E58

INTRODUCTION

A decade ago, Central Banks were used to use monetary targeting, with the objective of controlling the supply of monetary aggregate, but then, trend moved toward Inflation targeting and the reason was the instability of the money demand function. Now, most of the Central banks of the world have *Inflation targeting which focuses on price stability as their primary objective*. But price stability is no guarantee that financial instability can be avoided. In the past, large asset price movements resulted into financial crises that led to the collapse of the financial institutions and in turn put the economy in recession and disinflation. Financial stability is of great concern to monetary authorities and there is no dispute on the importance of financial stability. But the episodes of financial instability raised the question whether Central Bank should intervene and use monetary policy, in the case of financial instability and sharp asset price movements. This question opened a debate among monetary policymakers. Controversy exists as to whether monetary policy should respond to (or attempt to influence) asset price “bubbles.” Broadly categorizing, there exist two schools of thoughts: one arguing that monetary policy is not the tool used to tackle with asset bubbles and the second arguing that Central bank should reduce the bubble. In this paper we analyze these alternate views along with the costs and benefits associated with each policy stance so to devise a general framework to deal with asset price bubbles.

2. LITERATURE REVIEW

To understand the concept of financial stability, it is essential to understand financial *instability*. One can define financial instability as a situation characterized by these three basic criteria:

(1) some important set of financial asset prices seem to have diverged sharply from fundamentals; and/or (2) market functioning and credit availability, domestically and perhaps internationally, have been significantly distorted; with the result that (3) aggregate spending deviates (or is likely to deviate) significantly, either above or below, from the economy’s ability to produce¹. On the other hand monetary stability is a synonym for price stability. Price stability refers to a stable price level or a low level of inflation and not to stable individual prices.

An example of an explicit definition of price stability is the one chosen by the European Central Bank (ECB), which refers to a year-on-year increase in the Harmonized Index of Consumer Prices for the euro area of below, but close to, 2%, which is to be maintained over the medium term [1].

There are two concepts of prices in the definition of financial stability and monetary stability. First is the asset price and second is the consumer price.

2.1 Asset prices vs. Consumer prices:

Asset prices refer to the price of something that one buys for future benefits in form of revenue generation or capital gains. Examples include physical assets - like housing, land, other buildings and collectables like

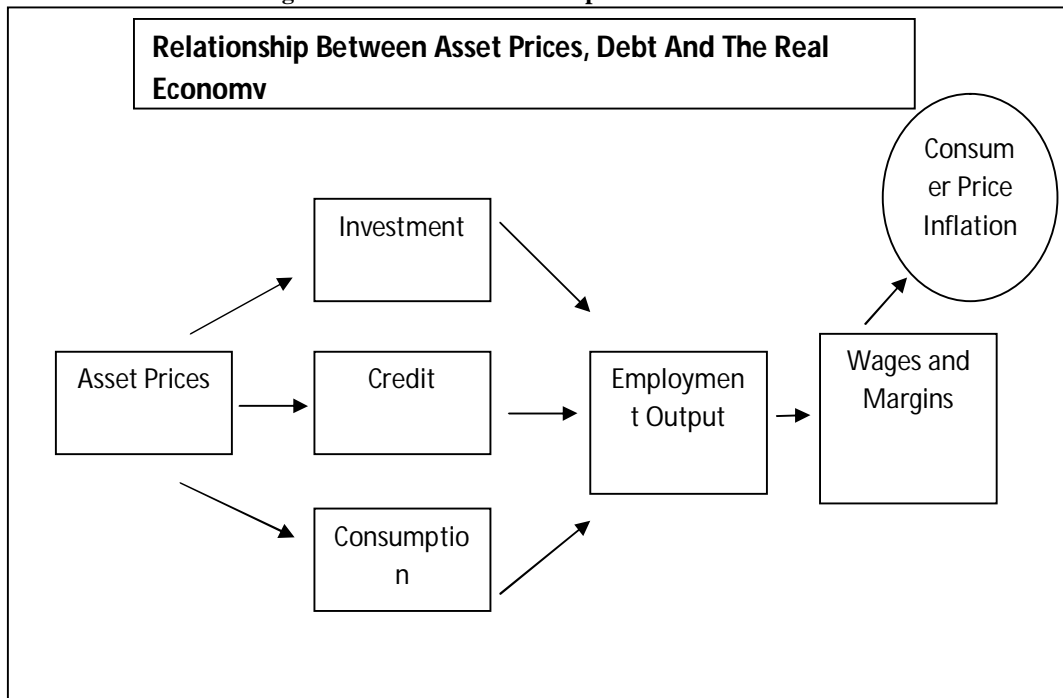
¹ Remarks presented by Roger W Ferguson Jr. , then vice chairman BOG of FED, in IMF conference, 2002

paintings or exotic cars - and financial assets - like shares, bonds and other financial instruments. On the other hand consumer prices are associated with things one buys to consume, like milk, petrol, a visit to the doctor and ordinary cars. Remember also that asset prices often behave more erratically than consumer prices, being slower to react to changes in supply and demand. Prices of, for example, fruit and vegetables move constantly to match up buyers and sellers. Asset prices are seldom that appealing in terms of classic economics [2]. Under the inflation targeting framework as followed by most of the big Central banks in the world, the Central Bank is required to ensure price stability, as measured by the Consumers Price Index (CPI), and, subject to this goal, to avoid unnecessary instability in output, interest rates and the exchange rate. It should be noted again that Asset prices are not included in the CPI. Thus it is rational to ask whether central bank should pay attention to asset prices although it is not included in CPI, or is there any link between asset prices and CPI and is there any justification for Central bank having interest in financial stability. There are different arguments of different economists. We present some view briefly.

2.2 Link between asset prices and consumer prices CPI:

According to [3], the link between asset prices and CPI can be described in three different ways (Figure 1)

Figure 1: How Asset Prices Impact Consumer Prices



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- a. **Direct Impact** is one which is primarily driven by increased demand of final output. For e.g. in the case of physical assets, if their prices are rising faster than general inflation, people try to build or create more, putting pressure on prices [1].
- b. **Wealth Effect:** Asset price movements – physical and financial – also feed into CPI inflation due to the so-called “wealth effect”_by increasing consumption. As asset prices rise, people tend to feel wealthier. Some people go shopping as a result, and in an economy already running at full steam this gives inflation a push. In the INTERNET outburst of 2000 and 2003, real estate assets were increasing, whereas there was a downfall in stock market, so the overall impact on wealth was null and consumption was unaffected, but subprime crisis, there was a downfall both in the real estate market and stock exchange market, resulting into negative wealth effect and reduced consumption. The consumption decreases because the only way to compensate for negative wealth is to reduce consumption and to increase saving.
- c. **Credit Channel Theory:** Asset prices also may also be incorporated into spending and can impact inflation eventually. For example, asset price increases improve balance sheets (*Balance sheet effect*), increasing the borrowing power of firms and individuals (through collateral). Increases in net worth tend to increase the willingness of lenders to lend and borrowers to borrow, facilitating a

general expansion in spending as well as an expansion in spending on the construction of appreciating assets [4].

The above arguments show that there is a link between asset prices and consumer prices. Now the question comes into mind whether there is a trade-off between monetary stability and financial stability. There is indeed no trade-off between financial and monetary stability rather one enforces the other. Financial stability is crucial for the proper transmission of monetary policy to the real economy. This is the reason why Central banks have long had a keen interest in financial stability. Roger W Ferguson Jr. articulates that financial instability poses a severe threat to important macroeconomic objectives such as sustainable output growth and price stability. Largely for this reason, nearly all central banks are empowered and expected to act as a lender of last resort in financial crises. Moreover, monetary policy is implemented largely through operations in financial markets, and the transmission of monetary policy to the real economy depends crucially on the smooth functioning of key financial institutions and markets. Attainment of sustainable real growth with stable prices in turn will make the economy less prone to financial instability. And finally the central banks' interest in financial stability stems from their role in the operation or oversight of payment systems that, in turn, act as the critical "plumbing" supporting activity in financial markets.

The above discussion shows that Central Bank has obvious reason to have interest in financial stability and there is no dispute among economists and researches on this issue. The debating issue is the question whether Central Bank should step in and use monetary policy, in the case of financial instability and sharp asset price movements.

3. ASSET PRICE BUBBLES AND MONETARY POLICY

In this section, we review many plausible arguments of those endorsing and opposing a monetary response. The conventional view was Monetary policy can do little more than deal with the fallout from unwinding asset bubbles.

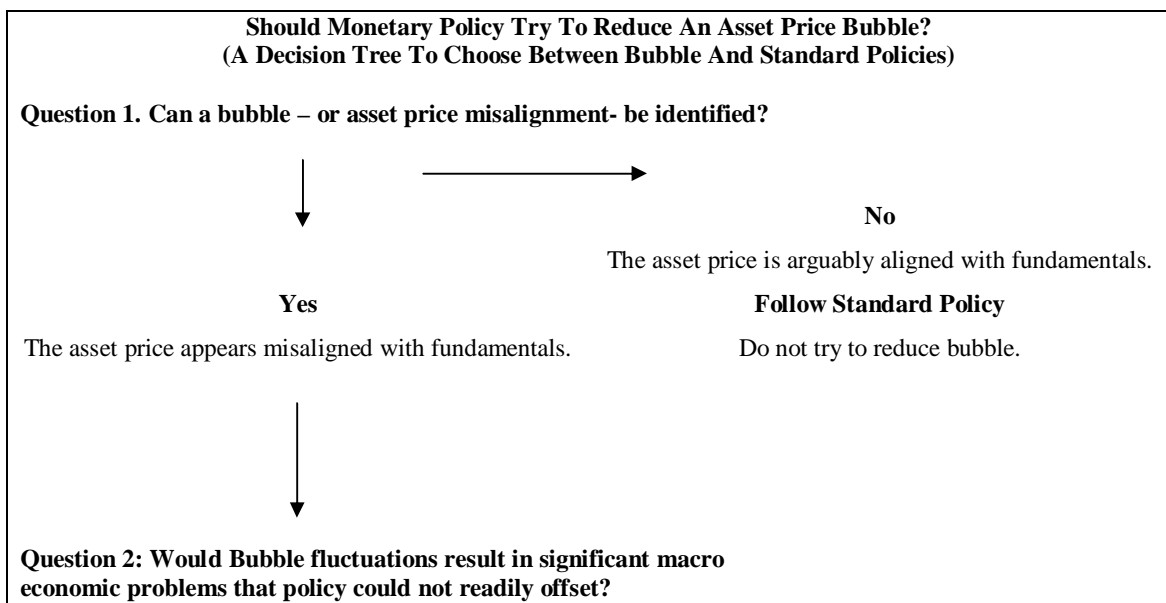
Rejected by [5], the notion that tightening the monetary policy could have prevented the bubble of late nineties. He suggested that instead of incremental tightening, policies should be targeted at controlling the damage of such bubbles followed by remedial steps to ease the economic scene in post crisis period.

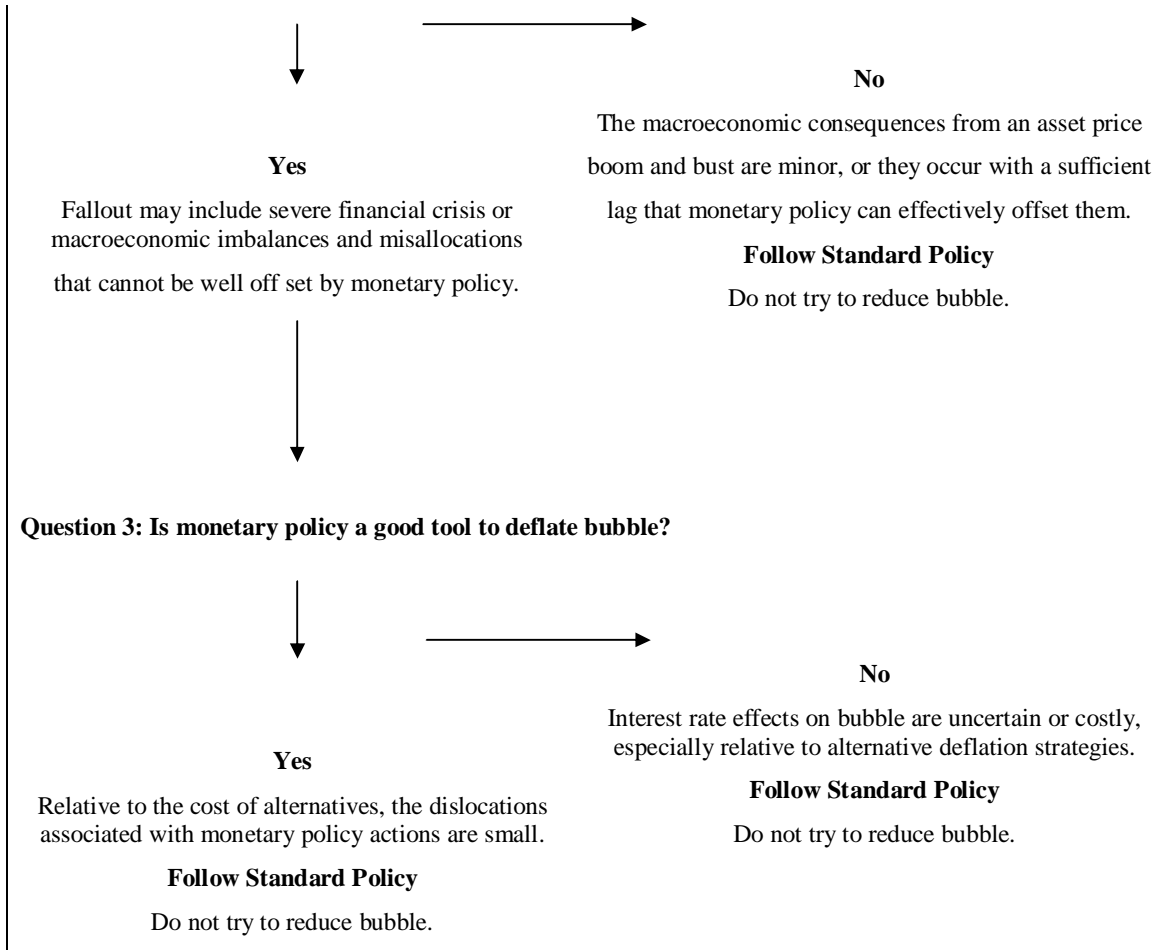
But the above view is not of much importance. The important is the question, whether MP should be used and to what extent against bubbles. Broadly speaking, two general monetary policy responses to movements in an asset price have been proposed. These two schools of thoughts are:

1. The case *against* Monetary Policy, Standard approach, also called pessimistic approach or Use the right tool for the job
2. The case *For* Monetary Policy, Proactive (Bubble) approach, also called optimistic approach that can be further categorized as: Lean-against-the-bubble (Elective approach) and Aggressive bubble popping (Activist approach)

The **general overview** of these approaches as presented in the [6] is provided below in Figure 2.

Figure 2: Pessimistic Vs. Optimistic Approach to deal with Bubbles





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The above hierarchy is the general overview of the two opposing views regarding monetary policy as a tool for asset bubbles. A detailed comparison between these approaches has been made on the basis of literature review provided by some researchers [7]. The comparison states the assumptions and arguments that are given by economists and researches in favor or against the use of monetary policy to endorse asset price bubble. See table 1 below.

Table 1: Arguments in Favor or Against the use of Monetary Policy

The Case for Monetary Response Bubble approach	The Case against Monetary Response Standard Approach
The Stock Market is larger and more widespread	Monetary policy should focus on what it can do.
The equity market plays a larger role in the monetary transmission process.	The causal effects from stock prices to aggregate demand are relatively weak and unreliable.
Asset price bubbles can foist significant financial imbalances on the financial system.	Circumstances mandating a monetary policy response to asset price movements are relatively unusual, rare events.
Asset price volatility and financial imbalances will increasingly proliferate in low inflation, stable economic environments.	The argument that price stability itself fosters asset price bubbles, asset price volatility and financial instability has been neither adequately nor convincingly established.
Asset prices and asset price inflation are important components of general prices and general inflation.	In practice, asset price "misalignments" and "bubbles" are difficult to identify and control.
Asset price bubbles can be identified and controlled.	

4. ECONOMISTS' VIEWS

Standard Approach is associated with [4] who suggested that inflationary pressures must be preempted and ex ante corrective actions shall be taken by the monetary authorities. This inflation targeting approach should be sensitive to the variation in asset prices to the extent of their contribution in expected inflation.

On the other hand the bubble approach in the form of aggressive bubble popping is associated with [8]. They argue that to address inflation, central banks should adjust the policy instruments to account for asset prices in addition to traditional inflation target and output gap. They suggested that accounting for asset prices could

reduce the variation in output by mitigating the possibility of an asset price bubble resulting in more stable investment cycle.

Another very important view is given by [9]. This view seems interesting as it has more relevance in the context of Inflation targeting framework. He is in almost complete contradiction to [8] who say that asset prices should be made a part of Taylor's rule. [10] argues that it would be redundant or unnecessary extension of Taylor's rule as the implications of possible imbalances and misalignments in asset prices must be dealt with while forming an assessment of expectations of growth and inflation and thus should not require the explicit addition in the principal objection function (Taylor's Rule).

The bubble approach in the form of *lean-against-the bubble* is also supported by a large group of economists like [11], [12] and many others, and it is not a very extreme view as compared to aggressive bubble popping. [12] devised a macro solution for the monetary policy. He suggested that relating monetary policy to equity prices beyond targeted macroeconomic outcomes will result in a fundamental tradeoff. The monetary authority could overlook short term stability while trying to cope with systemic macro issues of medium to long term. This could be arguable as central banks from most of industrial countries are not likely to tolerate such tradeoff.

[13] who are also in favor of lean-against-the-bubble argue that a credit and asset markets related monetary response is essential to promote financial and monetary stability. This is triggered by the fact that low levels of inflations could result in a higher excess demand pressures on credit markets and asset prices as compared to goods and services.

5. CONCLUSION

We have provided a literature review regarding the issue whether monetary policy should be used against sharp asset price movements or not. There are two opposing views: One case is AGAINST the use of monetary policy, the other case is FOR monetary policy. Different economists have taken one side or the other with the help of econometric research but the debate is still going on and dispute has not been resolved so far so to attain one feasible solution that can be proposed as a generalized stance to deal with asset price bubble.

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