

ASSET PRICES AND MONETARY POLICY

Otmar Issing

Crisis: Time to Ponder on Traditional Wisdom

Beyond dealing with the immediate problems, any crisis raises questions of why and how we got there and what lessons should be drawn to avoid a repetition of past developments—without laying the ground for a new disaster. This line of inquiry also applies to the current crisis in financial markets. Even during the heaviest turbulence a discussion has started on obvious deficits in the system of regulation and supervision and on badly needed improvements. In this article, I concentrate on monetary policy but that does not mean regulatory measures are irrelevant in this context, quite the opposite.

For central banks the relation between monetary policy and asset prices has gained new interest and the dominant view has come under critique.

The Consensus View

There is a broad consensus around the world that central banks should maintain price stability—keeping inflation low and stable. This objective is reflected in the mandate given to the central banks in many countries. Price stability is normally specified in terms of stabilizing an index of consumer prices in one form or another. There are very good reasons for this practice. The purchasing power of money is undermined by an increase in consumer prices; a constant index of consumer prices maintains the real value of money over time. With stable prices, money serves society best as a unit of account, medium of exchange, and store of value.

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Otmar Issing is a former member of the Executive Board of the European Central Bank.

Any index of consumer prices covers only a segment of prices in an economy—although an important one. Prices of assets like real estate or equities are excluded by definition. Most of the time this omission is not seen as a problem, quite the opposite. Monetary policy can only control the development of goods prices over the medium to long term. But, in times of large movements of assets prices, the debate always starts on whether this concentration of monetary policy on consumer prices alone is appropriate or not.

Asset price developments have an influence on spending decisions by companies and households. A rising value of one's house makes people richer and might encourage additional consumption. Higher stock prices reduce the cost of equity financing and might help increase investment. The opposite will happen with falling asset prices. This so-called wealth effect will finally, via changes in expenditures, have an influence on the development of consumer goods prices and should therefore be included in inflation and growth projections by central banks. The strategy of inflation targeting comprises this effect beyond which asset prices should not play a role in the conduct of monetary policy.

On the role of asset prices there is wide consensus on the following principles:

(1) central banks should not target asset prices; (2) central banks should not try to prick a bubble; and (3) central banks should follow a “mop up” strategy after the burst of a bubble, which means injecting enough liquidity to avoid a macroeconomic meltdown. The first two principles are uncontroversial. A central bank has no instruments to target successfully asset prices and creating a macroeconomic disaster by pricking a bubble would ruin the standing of a central bank. (The role of a central bank as a regulator and supervisor is a separate issue.) On the third principle, there is also broad agreement—once a bubble has burst the central bank has to take all necessary steps to avoid the propagation of the consequences of a collapse of asset prices.

However, restricting the role of the central bank to a totally passive role in the period of the buildup of a bubble and practically pre-announcing its role as the “savior” once the bubble bursts represents an asymmetric approach that risks creating moral hazard with actors driving the development of asset prices.

What can be called the “Jackson Hole Consensus” (Greenspan

2002, Blinder and Reis 2005, Mishkin 2007) is exactly that. Efficient markets incorporate all relevant information and reflect the market's best assessment. How could central bankers pretend to know better? However, this strand of argumentation may be misleading. Central bankers are not traders, nor are they actors in financial markets who might for business reasons be forced to follow a market trend which, in their own judgement, is not sustainable. Central bankers have a different position and responsibility. They must not pretend that they have better knowledge on the "true valuation" of specific assets. Yet this fact does not hinder central bankers from communicating their concerns on the sustainability of strong increases in asset prices over an extended period of time in an appropriate form, thereby contributing to a more sober assessment of such developments. As central bankers are not subject to business incentives, their position should get special attention.

But, beyond proper communication, central bankers did not need the present financial crisis to understand that simply committing to the third principle—that is, announcing that they would provide enough liquidity in case of a crisis—might not be the panacea to the problem of an asset price bubble. In some financial crises, this policy might seem to work, but because of the moral hazard problem this "success" may lay the ground for even bigger problems in the future.

The Jackson Hole Consensus follows a different philosophy. In a paper presented at the Jackson Hole Conference in 2005, Blinder and Reis state,

The "mop up after" strategy received a severe real world stress test in 2000–2002, when the biggest bubble in history imploded, vaporizing some \$8 trillion in wealth in the process. It is noteworthy, but insufficiently noted, that the ensuing recession was tiny and that not a single sizable bank failed. In fact, and even more amazingly, not a single sizable brokerage or investment bank failed either. Thus the fears that the "mop up after" strategy might be overwhelmed by the speed and magnitude of the bursting of a giant bubble proved to be unfounded. Regarding Greenspan's legacy, then, we pose a simple rhetorical question. If the mopping up strategy worked this well after the mega-bubble burst in 2000, shouldn't we assume that it will also work well after other, presumably smaller, bubbles burst in the future? Our suggested answer is apparent [Blinder and Reis 2005: 67–68].

Asymmetric Approach

The Jackson Hole Consensus seems to be based on unconvincing arguments. Even if the mop up strategy might work initially, by exactly doing “its job” in a financial crisis of limited dimension, the strategy’s asymmetric character may lay the ground for the next bubble and crisis.¹

The asymmetry in this monetary policy proposal is strengthened by the practice of what has been called the “risk management” paradigm. This can be seen as an approach to deal with low-probability events and severe outcomes against which a kind of “insurance” (e.g., via interest rate cuts) has to be applied (Greenspan 2004). It seems that this approach so far has been referred to or applied only in dealing with risks of recession or deflation—that is, in a rather asymmetric way.

The greatest macroeconomic risk is apparently a broad collapse of asset prices (including real estate) after a big bubble, destroying balance sheets of banks and other financial institutions, nonfinancial companies, and households. If such a disaster emerges, there may be no alternative to a mop up strategy. Yet, there is no reason to believe such a policy would be a fast and satisfying solution.

Should not risk management also be applied by looking forward and trying to mitigate, if not avoid, the risk of building up a bubble that sooner or later might burst? A forward-looking approach would call upon the central bank to lean against the wind.² Such a strategy is far from simple, and there is no guarantee it would work. But the central bank cannot just let things go and keep interest rates low when the economy is robust. Under such circumstances, it would be risky to ignore the impact of low interest rates on the financial industry, on innovations, on the decline in spreads across different types of risk, and on asset prices (especially for housing). There is evidence that overly low interest rates encourage too much risk-taking by banks, threatening financial stability (ECB 2007).³

The question “Is price stability enough?” (White 2006) goes to the core of the problem. Highest attention has to be paid to ensure that the big achievement of low and stable inflation is not endangered.

¹For a “counterfactual exercise,” see Taylor (2007). Also see Cechetti et al. (2000) and Bordo and Jeanne (2002).

²Kohn (2007) is very critical of what he prefers to call “extra action,” arguing that high (and certain) costs would outweigh potential benefits.

³On the relation between the level of interest rates and the riskiness of bank loans in Spain, see Jiménez et al. (2007).

Central banks must not lose sight of their main objective—(goods) price stability. Fortunately, there is no lasting trade-off between price stability and financial stability (Issing 2003).

If the central bank applies a medium-term horizon for the definition of price stability and adopts an encompassing approach that integrates money and credit in an appropriate way, financial imbalances will implicitly obtain attention. This is true even if financial stability is not considered a general objective of the central bank and monetary policy aims at maintaining the objective of price stability. This does not rule out the existence of a short-term conflict. In most cases price stability would foster financial stability. In rare circumstances though, a short-term conflict is possible. By “short-term conflict,” I refer to a situation where it is optimal to deviate from the desired rate of inflation in the short run to best maintain price stability over the medium run. Therefore, in the context of an appropriate definition of price stability and financial stability, and in particular an appropriate concept for the horizon to which the policy objective should apply, the conflict disappears.

Conclusion

A monetary policy strategy that monitors closely monetary and credit developments as potential driving forces for consumer price inflation in the medium to long run has an important positive side effect: it may contribute at the same time to limiting the emergence of unsustainable developments in asset valuations. As long as money and credit remain broadly controlled the scope for financing unsustainable runs in asset prices should also remain limited. Corresponding changes in asset prices also help to support the analysis of the character of the development of money and credit.⁴ In the meantime, an impressive number of empirical studies have demonstrated that hardly any asset price bubble has not been accompanied if not preceded by strong growth of money and credit (Borio and Lowe 2004, Detken and Smets 2004).

The obvious advantage of the ECB monetary policy strategy is the fact that taking information from the monetary analysis into account avoids the need to be specific about mispricing of assets. The widening of the time horizon for the conduct of monetary policy functions as a kind of “integrated risk management” that works symmetrically

⁴For an approach including house prices in the money demand function, see Greiber and Setzer (2007).

in both directions: leaning against “headwind” (asset price declines) as well as against “tail wind” (increases). This approach is in contrast to the mop up strategy that comes into play only in cases of supposed risks of deflation or a general downturn of the economy.

Monitoring money and credit continuously and taking the results of the analysis into account via “cross-checking” when it comes to monetary policy decisions guarantees the symmetry of the approach and its permanent application. “Ultimately, this cross-check leads to a better assessment of the correctness of the policy stance. Early indications that a process of surging equity or house prices in the euro area might be interacting with conditions of abundant liquidity would lead to heightened vigilance” (ECB 2005). There are many examples of the application of vigilance. As ECB President Jean-Claude Trichet (2006) stated, “Monetary developments, therefore, require careful monitoring, especially in light of the strengthening of economic activity and, in particular, of strong asset price dynamics, especially in housing markets.” That advice now seems prescient.

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