

Monetary Policy and Asset Prices

The housing market crisis is the latest reminder that asset prices can and do run wild at rates capable of negative effects on real economic activity. Not surprisingly, this has reinvigorated debate over whether central banks should respond to asset price bubbles. Economists' views on this subject are divided. Some argue that the central bank should react to asset price misalignments (see, for example, Cecchetti, Genberg, and Wadhvani, 2002). Those opposed to this idea say that monetary policy focused exclusively on stable inflation achieves better long-run outcomes (see Bernanke and Gertler, 2001).

The volatility and unpredictability of asset prices are well-known problems. As Mishkin (2007) notes, however, there are assumptions under which monetary policy could be effective in responding to asset price bubbles. First, the central bank must be able to identify that a bubble truly exists, which is a strong assumption since no rule exists to assess the presence of a bubble. Hindsight is 20/20, and some episodes that at first look like bubbles in retrospect are not.

Second, the central bank must apply the right policy to deflate the bubble. This is not as straightforward as it seems. Bubbles are episodes in which people do not behave in a predictable way. Thus, predicting the consequences of an interest rate increase is difficult. The question is whether no action is better than the wrong action. For example, a central bank response that increases interest rates but results in a recession when no bubble was present is clearly not desirable.

Selecting the correct policy response is further complicated by the difficulty in identifying a clear pattern between monetary policy and asset prices across countries. The chart uses deviations from the Taylor rule to plot the relationship among real house prices, real stock prices, and the monetary stance for 20 industrialized countries.¹ Countries on the upper half of the figure had larger increases in asset prices than the rest of the sample during the recent bubble. Countries on the left-most side practiced looser monetary policies with respect to the Taylor rule. Interestingly, more than half of the countries implemented tighter monetary policy but had higher housing price increases than the United States (these are plotted above and to the right of the United States).

Most countries practiced tighter monetary policy and saw higher stock price increases than the United States.

The solid black trend line suggests that looser monetary policy is associated with higher housing prices, but this relationship is weak. The pattern is less clear for stock prices (dashed green line). This suggests that even if the central bank could identify a bubble and apply the best policy, it might not be able to deflate the bubble if the link between interest rates and asset prices is weak.

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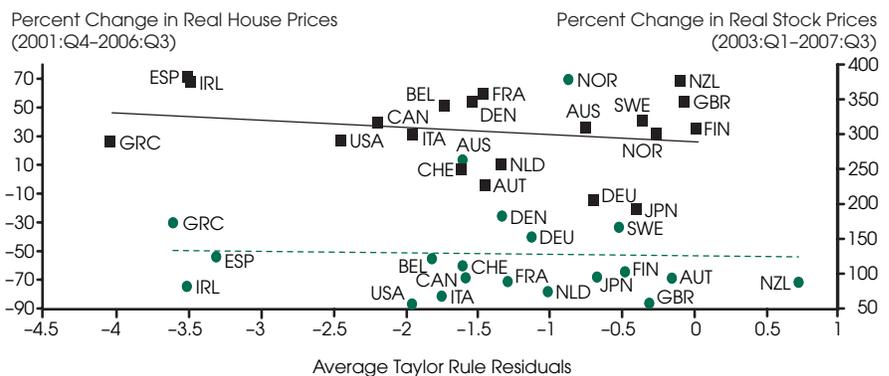
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¹ The Taylor rule says that if gross domestic product (GDP) is in line with the economy's potential output and inflation is equal to the central bank's target, then interest rates will be at a neutral level and the economy will neither accelerate nor decelerate. If GDP grows above the economy's potential output, or if inflation is higher than the central bank target, then interest rates will be above the neutral level. The effect of below-capacity GDP or below-target inflation is symmetric but opposite.

Taylor Rule Residuals Plotted Against Change in Real House Prices and Change in Real Stock Prices



NOTE: Changes in house prices are plotted against the average Taylor rule residual between 2002:Q1 and 2006:Q3 and appear as black squares; changes in stock prices are plotted against the average Taylor rule residual between 2003:Q2 and 2007:Q3 and appear as green circles. AUS, Australia; AUT, Austria; BEL, Belgium; CAN, Canada; CHE, Switzerland; DEN, Denmark; DEU, Germany; ESP, Spain; GBR, United Kingdom; GRC, Greece; FIN, Finland; FRA, France; IRL, Ireland; ITA, Italy; JPN, Japan; NLD, Netherlands; NOR, Norway; NZL, New Zealand; SWE, Sweden; USA, United States.
SOURCE: International Monetary Fund. *World Economic Outlook: Crisis and Recovery*, April 2009.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.