

Asset Price Bubbles and Monetary Policy

Dr. Sushil Wadhvani, CBE

Wadhvani Asset Management LLP

Asset Prices and Monetary Policy

- Key Issue:
 - Should inflation-targeting central banks attach some weight to asset price misalignments over and above a fixed-horizon inflation forecast?
 - NOT advocating targeting asset price misalignments directly

Theory

- Poole argued that 'Leaning against the wind' of interest rate changes is useful when disturbances originate in the money market, but not the goods market
- CGLW show that 'Leaning against the wind' (LATW) reduces output/inflation volatility when you have a shock originating in the asset market, but not if it originates elsewhere

Another argument - make bubbles less likely

- If bubbles are endogenous, payoff to pre-emptive policy that is not captured by these simulations
- Central bank can affect the probability of the bubble growing, by signalling that it will respond. Effect present in models of Kent-Lowe (1997) and Allen-Gale (2000)

Theory vs. Practice

- Bernanke (2002) argues:

“...it is rarely the case in economics that the optimal amount of insurance in any situation is zero. On that principle, proponents of leaning against the bubble have argued that completely ignoring incipient potential bubbles, if in fact they can be identified, can't possibly be the best policy...

...I believe that, nevertheless, “leaning against the bubble” is unlikely to be productive in practice.”

Can central banks identify bubbles (1)?

- Often asserted that central bankers have neither more information nor greater expertise in valuing an asset relative to private market participants
- Cannot forecast aggregate demand reliably if you can't estimate asset price misalignments
- Do not see any significant informational difference between monetary policy that requires an aggregate demand forecast and a LATW rule

Can central banks identify bubbles (2)?

- During bubbles, not unusual for private market participants to believe an asset is overvalued, but yet unable/unwilling to bet against it
- Central bankers find it easier to respond to long-lived bubbles, as less subject to short-termist performance pressure

The difficulty of “safe popping”

- Bernanke/Greenspan argue that we might need a very large increase in interest rates to prick a bubble
- However, LATW is not about pricking a bubble, it is only about improving overall macroeconomic stability

Federal Reserve in the 1920's

- That particular historical experience is used to argue against a LATW tilt
- However, they were not practising LATW
- They were bubble-poppers

Greenspan policy on bubbles

- Given the difficulty of identifying bubbles and stopping them without inducing recession, Alan Greenspan has argued that it is better to deal with bubbles after they have burst

“..we noted in the ...mid-1999 congressional testimony the need to focus on policies "to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion." (Speech, Aug 30, 2002)

Problems with “mopping up” after (1)

- The problem with this strategy is that it is dangerous, as asymmetry reinforces the pro-cyclicality of the financial system
- “Mopping up” can be costly and risky, and potentially sow the seeds of the next bubble
- We have seen this in practice, with the sustained low US interest rates in the years following the bursting of the stock market bubble in 2000, which fuelled the US housing boom, now seen to have been unsustainable

Problems with “mopping up” after (2)

- Unable to mop up because:
 - An external inflation shock
 - Credit crunch makes monetary policy less effective

Potential changes to the regulatory framework

- LATW not enough, regulatory tools also needed
- LOLR, deposit insurance and “too big to fail” are all pro-cyclical
- Need to explore other counter-cyclical tools e.g.
 - Pro-cyclical bank capital
 - Max loan value ratios

Appropriate policy after a bubble bursts

- Liquidity provision
- Protecting financial intermediation
- Lehman, Northern Rock were questionable decisions

Monetary policy after a bubble bursts

- Need to be aggressive and pre-emptive
 - Between August 2008 – September 2008,
 - Fed had cut by 325bp
 - BoE had cut by 75bp
 - ECB had increased by 25bp

Monetary policy after a bubble bursts

- If we look at the pre-Lehman shock period;
 - US economy had been more resilient than the UK
 - Inflation expectations had fallen more in the US than in the UK
 - US dollar had gone up, British pound had depreciated

The outlook – duration and magnitude

IMF Analysis Shows Recessions are longer and deeper when linked to Banking Crises

	Slowdown or recession	
	DURATION	OUTPUT LOSS
	<i>Quarters</i>	<i>Cumulative (% GDP)</i>
Recession preceded by financial stress	6.8	-13.8
Banking related	7.6	-19.8
Recession not preceded by financial stress	3.1	-5.4

Source: IMF World Economic Outlook October 2008 Financial Stress, Downturns, and Recoveries, Table 4.2
<http://www.imf.org/external/pubs/ft/weo/2008/02/index.htm>

The current situation versus the 1930s

- Blanchard (Chief Economist of IMF):
 - Chance of a Great Depression is “nearly nil”
 - “we’ve learned a few things in 80 years”
- Likely to be correct as:
 - Bank bail-out packages are in place
 - Significant fiscal and monetary stimulus
 - Automatic fiscal stabilisers
- However, note that:
 - 1929-32 initially about a shortage of liquidity, this time a shortage of solvency (Mankiw)

The current situation versus Japan's “lost decade”

- Japan:
 - Monetary and fiscal policy were too timid/slow to react
 - Now, the US has eased aggressively. However Europe and the UK were slow
 - In Japan, stringent conditions for assistance to the banks impeded recovery. It is important that we don't repeat this mistake now

IMPORTANT NOTICE

- This document is issued by Wadhvani Asset Management LLP, which is authorised and regulated by the Financial Services Authority. The investment fund referred to in the document (the “Fund”) is an unrecognised collective investment scheme for the purposes of the Financial Services and Markets Act 2000 of the United Kingdom (the “Act”) and its promotion is accordingly restricted by law.
- This document is being issued inside and outside the United Kingdom only to and/or is directed only at persons who are of a kind to whom the Fund may lawfully be promoted by a person authorised under the Act (an “authorised person”) by virtue of Section 238(6) of the Act and The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (including other authorised persons, certain persons having professional experience of participating in unrecognised collective investment schemes, high net worth companies, high net worth unincorporated associations or partnerships, the trustees of high value trusts and certified sophisticated investors) or Section 4.12 of the FSA’s Conduct of Business Sourcebook (including persons who are professional clients or eligible counterparties).
- In order to qualify as a certified sophisticated investor a person must (i) have a certificate in writing or other legible form signed by an authorised person to the effect that he is sufficiently knowledgeable to understand the risks associated with participating in unrecognised collective investment schemes and (ii) have signed, within the last 12 months, a statement in prescribed form declaring, amongst other things, that he qualifies as a sophisticated investor in relation to such investments.
- This document is exempt from the scheme promotion restriction in Section 238 of the Act on the communication of invitations or inducements to participate in unrecognised collective investment schemes on the grounds that it is being issued to and/or directed at only the types of person referred to above. To the extent that this document is issued by Wadhvani Asset Management LLP, shares or interests in the Fund are only available to such persons and this document must not be relied or acted upon by any other persons.
- The information and opinions contained in this document are for background purposes only and do not purport to be full or complete. No reliance may be placed for any purpose on the information contained in this document or their accuracy or completeness. No representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this document by either of Wadhvani Asset Management LLP or the Fund and no liability is accepted by such persons for the accuracy or completeness of any such information or opinions.
- This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase, any shares or any other interests nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract therefore. Recipients of this document who intend to apply for shares or interests in the Fund are reminded that any such application may be made solely on the basis of the information and opinions contained in the prospectus or other offering document relating thereto, as and when they become available, which may be different from the information and opinions contained in this document.
- Past performance is not necessarily indicative of future results. The price of investments can go down as well as up and may be affected by changes in rates of exchange. An investor may not get back the amount invested. If you are in any doubt about the suitability of investing, you should seek independent advice. Please refer to prospectus or other offering document relating thereto for further details of the financial commitments and risks involved in connection with an investment in such funds.
- This information is strictly confidential and may not be reproduced or redistributed in whole or in part, nor may its contents be disclosed to any other person under any circumstances.