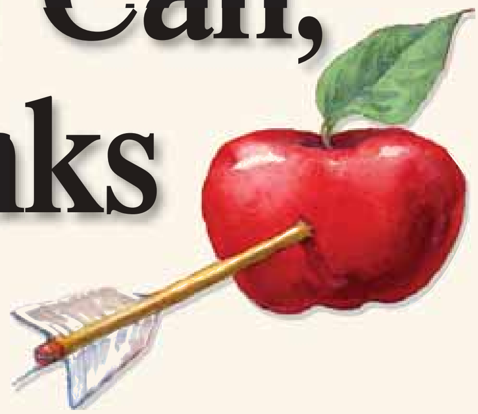
A SYMPOSIUM OF VIEWS

Should, or Can, Central Banks Target Asset Prices?



Should, or can, central bankers target asset prices in their conduct of monetary policy? Over the past year, central bankers have engaged in a financial fire brigade in the aftermath of the bursting of the U.S. subprime mortgage bubble. But how difficult is it to identify bubbles and to avoid moral hazard without, from time to time, engaging in a fool's errand? In 1996, for example, Alan Greenspan in a famous speech before the American Enterprise Institute called the stock market "irrationally exuberant." The level of the Dow was 6,500 (compared to over 10,000 today in the aftermath of the worst financial crisis since the 1930s). As White House economic advisor Larry Summers has noted, "Greenspan's declaration was of a bubble that wasn't." Of course, years later Americans became irrationally exuberant about housing. That turned out to be a bubble that was. To what degree should central banks attempt to target asset prices? Is effective asset price targeting even possible?

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

Twenty experts offer their views.

Yes, it probably means a compromise between consumer price objectives and asset prices.

SAMUEL BRITTAN
Columnist, Financial Times

The need to monitor assets is almost a cliché. But it is still correct.

Two specious arguments against are: "How do you recognize a bubble?" and "How do you fix a target?" There may be no mechanical method of doing either. We may just have to rely on fallible human judgement, as in so many other walks of life.

Too many economists are in thrall to the dictum of a Dutch econometrician of seventy years ago who pronounced that you need as many weapons as objectives. By all means, try to develop a new weapon from bank capital ratios—in which I have little confidence. At the end of the day, normal monetary policy may have to be used too. This may mean a compromise between consumer price objectives and asset prices. So what?

A more important objection is that borrowers may go abroad to circumvent national borrowing restraints. But I do not believe that an agreed approach by G7 countries will be totally circumvented.

But how would central banks resist pressures to prevent declines?

ALLAN H. MELTZER
Allan H. Meltzer Professor of Political Economy, Tepper School of Business, Carnegie Mellon University, and Visiting Scholar, American Enterprise Institute

Why have central banks resisted adjusting policy to limit alleged asset price bubbles or sustained movements? Many who urge them to do more avoid discussing the costs. First, how high would interest rates have to rise to prevent (say) a sustained 15 percent increase in stock exchange averages? Most policymakers in 1929, 1968, and 1988–89 thought the required rate increase would cause a deep recession. Second, should the authorities raise margin requirements instead? Much research is properly skeptical that margin borrowing rules are effective. Credit comes in many forms. Third, giving central banks multiple objectives is likely to achieve none of them. Policy should remain focused on at most a small number of attainable objectives. The Federal Reserve's record of achieving the dual objectives of stable growth and low inflation is not so successful that it makes adding other targets a good idea. And fourth, if the central bank agrees to respond to asset prices, how would it resist pressures to prevent declines?

In several papers, the late Karl Brunner and I included asset prices and the expected return to capital, along with output and prices in the demand for goods and money. Classical monetary theory teaches that if the central bank produces more money than the public desires to hold as real balances, the excess spills over into asset and output markets. Asset and output prices will rise if the excess continues. And the reverse is true if the central bank reduces real balances below the public's desired holdings. Asset prices are an essential part of monetary transmission in classical economics and in our models. Central banks that can separate the increase in asset prices that results from expected growth from the part resulting from expected inflation should use the information on expected inflation to reduce money growth. That would lower the speculative heat and keep the central bank concentrated on its dual mandate.

No and yes.

MARTIN WOLF
Chief Economics Commentator, Financial Times

The answer is both "no" and "yes." The answer is "no" because no central bank should try to achieve specific targets for any asset or asset class. Nobody can know the "correct" prices. Moreover, it is impossible to target the prices of many different assets. The only assets whose prices have frequently been targeted by central banks are gold or foreign currencies. A case can be made for this, within the context of a return to fixed exchange rates. But that is irrelevant for big countries, such as the United States.

The answer is also "yes," because it is a mistake to treat asset price movements as important only to the extent that they affect the central bank's ability to hit a target for prices (or rate of rise of prices) of goods and services.

First, huge movements in asset prices, particularly if they induce swings in credit, may destabilize the economy. There is little benefit from stabilizing inflation if trying to do so mechanically destabilizes the economy. Second, if an asset price bubble does destabilize the economy, the central bank may find its ability to hit its inflation target, or stabilize the public's inflationary expectations, compromised. In a post-bubble situation, uncertainty about future inflation can increase dramatically, with some people expecting deflation and others expecting accelerating inflation. The central bank will then have lost some of its ability to hit its targets, partly because it has lost control over the economy and partly because it has lost the ability to anchor expectations.

It should, in short, be an aim of central banks to avoid huge asset price bubbles, particularly those accompanied by credit booms. They should not target prices precisely. But they should "lean against the wind." They do not have to use interest rates if they have other effective means at their disposal, such as targeted controls over borrowing or lending. But no central bank should ignore big swings in asset prices, even if it these movements do not indicate any immediate threat to its ability to target inflation. They are too dangerous for stability in the longer run.

Without new tools, central banks cannot be responsible for financial stability.

LORENZO BINI SMAGHI
Member of the Executive Board, European Central Bank

First, a monetary policy which has price stability as its primary objective is a necessary condition for avoiding asset price bubbles and promoting financial stability. With the benefit of hindsight, it seems that some of the financial imbalances that built up prior to the crisis resulted from monetary policies which were not fully in line with the objective of price stability. Either the policies were also pursuing other goals, such as supporting economic activity and employment, or they were not focusing on the appropriate indicators of inflationary pressures, attaching, for instance, too much importance to output gaps and too little to monetary and credit developments. The first steps to take are to put monetary policy back on track—so that it focuses primarily on price stability—and to improve the underlying analytical framework. In particular, monetary and financial variables can provide the signal that the policy stance might be too loose with respect to the objective of ensuring price stability over the medium term.

Second, a monetary policy that is appropriate for price stability might not suffice to ensure financial stability. Indeed, given that asset prices react more rapidly than other prices, they may overshoot their long-term equilibrium value and have undesirable effects on the financial system. If this were to happen, should monetary policy react, even if price stability is not at risk? I personally think that a case has not yet been made for such a course of action. It would imply that monetary policy follows two objectives with only one instrument, that is, the policy interest rate. Other instruments are needed and they belong more to the realm of macro-prudential supervision. Unless central banks are explicitly equipped with the appropriate macro-prudential supervisory instruments, they cannot be considered responsible for financial stability.

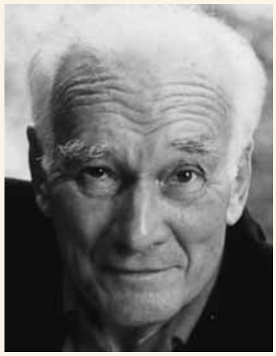
Why not watch asset prices?

HELMUT SCHLESINGER
Former President, German Bundesbank

A reaction by a central bank to a dangerous development in asset prices certainly cannot be triggered when asset prices—share prices, house and land prices, and so forth—pass a prefixed target. But this is no reason that central banks should not pay strict attention to developments in the asset markets, not at least because of the consequences when a bubble bursts.

If central banks focus only on consumer prices and their expected developments, central bankers can lose insight into growing problems in the asset markets. In Japan during development of its great bubble at the end of the 1980s, there was no consumer price inflation, and consumer prices did not increase strongly in the United States in 1999–2000 and in 2006. Consumer prices gave no signal about the inflation of asset prices. But even this particular inflation has a strong monetary component. It can be seen in an analysis of monetary aggregates and in the magnitude of overall credit expansion. In the current situation, this means not only the credit expansion of banks, but also of non-bank financial institutions.

In my opinion it is not true that the development of asset prices and its consequences cannot be judged. Some semi-official institutions like the Bank for International Settlements in Basel have stressed this point early and often. The problem for central banks is that it is not popular to take measures when the market participants feel they are getting richer and richer every day. But waiting until the bubble bursts and then letting a money-creating helicopter fly over the economy should not be a policy option for the future. Central banks have their independence so they may act when it is necessary, withstanding all pressures they must expect from politicians and mighty interest groups.



It is inexcusable to avoid the subject.

MARTIN MAYER
Nonresident Scholar in Economic Studies, Brookings Institution

When Thomas Carlyle heard that the great American feminist Margaret Fuller had said she accepted the universe, his comment was, “By God, she’d better.” One has much the same reaction to central bankers asking whether they should pay attention to asset prices.

Indeed, asking the question simply demonstrates that if you have a black box blinking on your desk long enough you will forget that you never knew what goes on inside it.

Karl Marx, explaining the gold standard in *Das Kapital*, noted that it worked because whenever the Bank of England needed gold it sold consols, raising British interest rates until the sacrifice of holding a sterile asset like gold was so great that gold flowed to England to buy British paper.

Nothing could be more obvious than the fact that when the central bank raises its interest rates it reduces the price of financial assets, and when it lowers rates it increases the price of financial assets. And changing interest rates is the only weapon that remains in the hands of the central banks, now that Cash Management Accounts and Home Equity Lines of Credit enable householders to monetize even very long-duration assets (including housing).

The painful truth of the matter is that when it acts to reduce interest rates, the Fed puts itself at the mercy of its black box. The lights blink and things happen, but in all honesty nobody knows why. There is no menu of indicators to predict whether this particular stimulus will play out in increased economic activity, higher consumer prices, higher commodity prices, boom in the stock market, deterioration in foreign exchange value, or real estate bubble. You push the button, and you hope.

Charles Goodhart—historian, economist, and member of the Court of the Bank of England—told a Levy Institute conference ten years ago that "Monetary policy has its real effects by its influence on asset prices. But the effect of interest rates on asset prices is the result of a whole chain of attitudes, and the relations of interest rates to asset prices are highly uncertain."

Uncertainties of that kind are not susceptible of elegant mathematical presentation, so they get swept aside. What is inexcusable is the avoidance of the subject by the thousand-strong research staffs of the Federal Reserve System. The central bank should not and cannot fine tune the prices in any market—but it can build libraries of analyzed experience to help its decision makers understand what they are doing.

Send me the answer on a postcard.

JIM O'NEILL
Head of Global Economic Research, Goldman Sachs International

This is a great question, and I look forward to many seminars debating it, and listening to the central bankers themselves debating it. It is quite clear that the general European view is not only "yes," but also, "We told you so," while the U.S. view remains "No, as it is not our job to interfere with market prices, it is our job to respond to bubbles that we can't identify."

What the crisis has demonstrated is that inflation targeting, whether it be very specific as practiced by the United Kingdom, or indirect via output gap targeting such as in the United States, while necessary is not sufficient. Policymakers must somehow develop a supplementary role for indicators of financial market conditions, including especially, although not only, the role of "credit." This is clear, and in my guess, this will emerge as the new consensus, although perhaps begrudgingly in Washington.

What is much less clear, as is already becoming a market dilemma and therefore a policy issue, is what happens if the current perceived "output gap" suggests inflation is likely to remain low, or even undershoot for some time in the future, while at the same time financial conditions are extremely accommodative? Send answers on a postcard to Messrs Bernanke, Trichet, King, Zhou, Meirelles, and of course, we must not forget, Mr. Shirakawa (except for the fact, that financial conditions are still tightening in Japan!), and before all of them, to me.

No.

DAVID M. JONES
President and CEO, DMJ Advisors, and Executive Professor of Economics, Lutgert School of Business, Florida Gulf Coast University

Unquestionably, asset price bubbles (stocks, real estate), commodity bubbles (oil) and, in particular, the massive credit bubble supporting the U.S. housing boom of 2002–06 make the job more difficult for our central bankers. Globalization and deregulation over the past two decades or so have encouraged destabilizing leveraged speculation not only impacting prices of assets such as stocks and real estate, but also commodities such as oil even at the early stage of recovery when aggregate demand is still weak and slack in resource utilization remains substantial. Also destabilizing and destructive have been property bubbles appearing not only in the United States but elsewhere such as Spain, Ireland, the United Kingdom, Hong Kong, Singapore, and China.

It is my view that despite their usually destabilizing impact, central banks should not target asset prices. The targeting of asset prices is not only difficult, but it conflicts with the Fed's dual objectives of maximum employment and stable prices (goods and services). Other central banks have the single hierarchical objective of stable prices alone. To be sure, central banks must take asset prices into account in their conduct of monetary policy. If, for example, soaring stock prices and real estate values operate through the wealth effect to boost aggregate demand and output above the economy's growth potential, thereby reducing slack in resource utilization and threatening increased wage and price pressures, the monetary authorities should respond by tightening their policy stance. If, however, asset price increases do not pose the threat of increased prices, central banks should not tighten merely to prick an asset price bubble.

In assessing the damage from the bursting of asset price bubbles, monetary officials should distinguish between types of bubbles and whether related financial intermediation is direct or indirect. In the case of the late 1990s U.S. high-tech stock price bubble, for example, there was direct capital market intermediation from end investors into high-tech stocks. Moreover, the high-tech stock price bubble was not associated with accelerating prices of goods and services. In that case, monetary authorities should not necessarily tighten merely to deflate the stock price bubble, especially since such bubbles tend to be difficult to identify until after they burst.

In contrast, the credit bubble supporting the U.S. housing boom was created mainly off bank balance sheets in a "shadow" banking system. In this "shadow" banking system, there was indirect intermediation through nonbank financial intermediaries such as finance companies, investment banks, insurance companies, mutual funds, hedge funds, and pension funds. These nonbank financial intermediaries typically leverage their own capital as well as client funds to invest in securitized loans. Structurally, this "shadow" banking system was an accident waiting to happen with longer-term, illiquid mortgage-related assets being financed by short-term liquid liabilities. We have seen that the collapse of such a credit bubble can threaten the entire financial system.

Perhaps rather than trying to deflate such a massive credit bubble with outsized Fed interest rate hikes, our central bank might seek to limit the size of future credit bubbles through stronger regulatory and examination measures. Greater transparency and disclosure would be appropriate. Also, especially in the United States, the larger non-bank financial intermediaries should be subject to leverage limitations and more stringent liquidity and capital requirements. The bottom line is that the housing credit bubble posed a much greater threat to the financial system and the economy than the high-tech stock price bubble. Nevertheless, even in the case of the more dangerous credit bubble, government authorities might favor tougher regulatory and examination measures over outsized monetary policy restraint in dealing with future credit bubbles.

Asset prices should be factored into policy decisions.

MARTIN NEIL BAILY

Senior Fellow, Brookings Institution, Former Chairman, Council of Economic Advisers, and Co-Chair, Pew Financial Reform Project Task Force

No to the narrow question, but yes to a broader question. Central banks do not know the correct level of asset prices and hence they should not commit themselves to setting specific target values for stock price indexes or house price indexes or exchange rate indexes. Such target setting would be a form of price controls, out of line with the rules of our market economy.

Traditional monetary policy has taken asset prices into account when interest rates are set by estimating the impact of increases or decreases in asset prices on expected growth. Asset prices matter for aggregate demand and they should be factored into policy decisions in the future just as they have in the past.

In response to the financial crisis, central banks should gain a new tool for stability. While no one knew the correct prices of residential housing in all the diverse regions of the United States, it became obvious by 2005 that a housing bubble was developing, driven by excessive leverage and lax lending standards. Adjusting the federal funds rate was not an adequate response to the situation and something more was needed.

The Federal Reserve should have the power to require an adjustment of minimum capital, leverage, collateral, and margin requirements generally in response to changing systemic risks (it has been able to adjust margin requirements in stock trading since the Great Depression). Micro-prudential regulators would continue to set basic minimum standards and supervise company risk management strategies. The Fed, after consulting with the micro-prudential regulators, could decide to adjust a "leverage or capital multiplier" up or down as systemic circumstances required. The multiplier could be applied to one specific class of assets or a broad range, and would be enforced by the prudential regulators. This additional power should be used rarely and in small increments, but it would provide a powerful new tool to increase financial stability by slowing the rapid rise of asset prices when they are driven by excessive borrowing. It could also be used to ease conditions when asset prices are falling.

No, there are both conceptual and practical problems.

RICHARD N. COOPER

Maurits C. Boas Professor of International Economics, Harvard University

If the question is taken literally, no. There are both conceptual and practical problems. A single instrument, call it "monetary policy," cannot pursue two targets simultaneously, except by happy coincidence. Thus targeting asset prices would mean abandoning a focus on the prices of goods and services. For example, if asset prices were rising above the target rate, the Fed would tighten monetary policy even if the consumer price index were stable or declining, leading to unwanted deflation.

There is moreover the practical problem that we have no good index of "asset prices," and it would be extremely difficult to create a satisfactory one. What assets should be included? Housing, now on everyone's mind? Stocks, art work, gold, or bonds (which the Fed targeted in the 1940s)? If it is to be stocks alone, what should be the coverage? All traded stocks in national markets, or only a selected list—and if the latter, which list? Should the index be unweighted (like the Dow-Jones), weighted by market cap (like the S&P 500), or weighted by some other factor, such as revenues or employment? Should the composition of the index change over time? There is no ideal answer to any of these questions.

Altogether a different matter is whether the Federal Reserve should pay attention to asset prices when framing monetary policy. Of course it should, and it should act when irrational exuberance seems to dominate important markets, perhaps using specialized instruments such as margin requirements for borrowing against stock or setting minimum down-payment requirements on mortgage lending by banks.

Yes, central banks must be concerned.

JOSÉ DE GREGORIO

Governor, Central Bank of Chile

Central banks should be concerned about asset prices. Severe misalignments from fundamentals may jeopardize financial stability. However, this concern does not justify that monetary policy should target asset prices. Indeed, this question arises from the wrong perception that the crisis was caused by monetary policies that did not take into account the soaring asset prices.

In countries with an inflation targeting regime, asset prices affect monetary policy decisions to the extent that they affect inflationary perspectives. Going beyond this seems unwarranted for three reasons. First, it is not clear that an increase in interest rates would be capable of stopping an increase in asset prices and the required adjustments might be too large. Second, central banks should safeguard financial stability, and a large interest rate hike to prevent asset prices from rising could trigger financial instability. Finally, under inflation targeting, any interest rate movement that is inconsistent with the target may undermine credibility of monetary policy and weaken its effectiveness.

In addition, a monetary policy excessively concerned about asset price collapses can create moral hazard. The strategy of monetary policy of turning a blind eye during the period of soaring asset prices and then, when the bubble bursts, reducing interest rates aggressively, provides an implicit insurance that makes bubbles more likely.

In emerging markets, fighting bubbles via interest rate increases could be particularly damaging, because bubbles take the form of exchange rate appreciations. Tightening monetary policy during an asset price boom may induce further capital inflows and strengthen the currency.

Adequate regulation of the financial system is crucial for preventing crises, and central banks should have a clear mandate on financial stability and the appropriate tools at their disposal to conduct macroprudential regulation. The challenge is to continue allowing financial innovation without inducing vulnerabilities such as those that caused the recent collapse.

Central banks must ensure financial stability.

BERNARD CONNOLLY
Managing Director, Connolly Global Macro Advisers

The point of central banks is not to achieve a particular rate of inflation but to ensure financial stability. The 2002 Bernanke doctrine—that the Fed should use interest rates for price stability and regulatory/supervisory policy for financial stability—was catastrophically wrong. The best way of ensuring financial stability is to avoid bubbles and Ponzi games. And the best way of doing that is what monetary theorist Henry Thornton recommended two centuries ago and the Radcliffe Committee recommended fifty years ago: keep the long rate of interest in alignment with the rate of return on capital. Neither of those two variables is directly observable. But one can observe their result (in conjunction with the equity risk premium): the ratio of equity and housing market valuations to nominal GDP. Monetary policy should keep that ratio stable: if Greenspan had acted on "irrational exuberance," the still-unfolding Greek tragedy begun in the mid-1990s could have been avoided.

But it wasn't. And there are two linked problems with the prescription. Where is the nominal anchor? And what happens if the starting point is, as now, a state of intertemporal disequilibrium? In equilibrium, the nominal anchor would involve setting interest rates to keep asset valuations in line with a target rate of growth of nominal GDP. But, starting from where we are now, preventing a prolonged recession requires, as in 2001, a policy that reinflates bubbles. There are only four possibilities for getting away from that: socialist control of the intertemporal allocation of resources (ugh!); reinvigorated entrepreneurial capitalism to get the rate of return up to a level consistent with "normal" interest rates (clearly the best, but not in the eyes of governments around the world); a reduction in the economy's capital ratio to increase the rate of return (implying a "lost decade" if one were very lucky, and another Depression if one weren't); and a further very large effective depreciation of the dollar (but where are the counterpart currencies?). The choice among renewed bubbles and the other alternatives is not a technical matter of central bank targets—nor can it be made one jot easier by yet more financial regulation, irrelevant at best and more likely damaging—it is a political choice.

No!

ALLEN SINAI
Chief Global Economist and Strategist, Decision Economics

Central banks should *not* target asset prices!

If the objectives of monetary policy are price stability, or as in the United States, maximum sustainable growth and price stability, the linkages between the price(s) of any asset(s) chosen and measures used for the objectives such as output, employment, or inflation, would be too uncertain as to what the linkages were, how they work and their timing, to think that under such a regime monetary policy could be successful.

And, targeting an asset price is tantamount to fixing prices, almost certainly to cause misallocations and dislocations that could destabilize asset markets and perhaps the economy. Also, which asset price(s) to target and effects and interactions with other asset price(s) that could bring unintended and undesirable consequences are yet additional issues.

However, monitoring the financial markets, the behavior of market participants, and market prices, particularly the prices of assets such as equities, gold and precious metals, real estate, the dollar, and long-term U.S. government interest rates, would be advisable. All have the power to affect the economy and inflation.

And, at times, adjusting monetary policy in response to the signals given by these asset prices could provide considerable help in affecting and stabilizing the volatility, and perhaps levels, of output, employment and inflation.

Using the information content embodied in asset prices and becoming more knowledgeable on how asset prices work through and affect the economy, inflation, and unemployment, and with what lags, very likely would make monetary policy more forward-looking, effective, and efficient in achieving the goals of sustainable maximum growth and price stability.

Some asset prices can't be ignored.

YVES MERSCH
President, Luxembourg Central Bank

Recent events demonstrated that some asset price bubbles carry real costs that cannot be ignored. Asset price targeting would add assets (in particular housing) to the price index defining the central bank objective, so that policy would respond automatically. However, our knowledge of asset price determinants is limited. In practice they have been a poor proxy for future prices, so explicit asset price targeting could actually disrupt medium-term price stability. Moral hazard would also increase risk-taking among private agents who anticipate the policy response. Finally, not all bubbles threaten stability, so policy should not respond mechanically.

A more cautious response to asset price bubbles known as "leaning against the wind" may be preferable. Whenever policymakers identify potentially harmful bubbles, interest rates could rise by more than required to maintain price stability. It is true that asset bubbles are difficult to identify in real time, but the current crisis was anticipated by monetary analysis at the European Central Bank, which focused on under-pricing of risk and excessive credit expansion. Early warning indicators for bubbles also show some promise. In any case, policy already requires judgment under uncertainty to assess potential growth or excess capacity.

Some fear the interest rate increases required to control asset prices would imply heavy output losses. However, even small increases may be enough if they trigger large adjustments in the banking sector, break private sector herding behavior, or signal central bank intentions.

Such a strategy cannot be applied mechanically but must incorporate significant judgment within a rule-based policy framework. The medium-term orientation of ECB monetary policy always reconciled financial stability concerns with the price stability objective. The creation of the new European Systemic Risk Board under the auspices of the ECB guarantees a shared approach to macro-prudential supervision. ESRB recommendations and early warning indicators will provide a new means to address asset price bubbles.

Don't target asset prices; monitor them.

JEFFREY A. FRANKEL
James W. Harpel Professor, Kennedy School of Government, Harvard University

Alan Greenspan was right to raise the question "How do we know when 'irrational exuberance' has unduly escalated stock prices?" which is what he actually said in 1996. But he, and many others, were wrong to conclude subsequently that monetary policy should ignore asset prices (or even that it should take asset prices into account only to the extent that they contain information about future inflation). More specifically, and contrary to common claims, identifying in real time that we were in a stock market bubble by 2000 and a real estate bubble by 2006 was not harder than forecasting inflation eighteen months ahead. Central bankers do have tools that can often prick bubbles. The "Greenspan put" policy of mopping up the damage (only) after the run-ups abruptly ended probably contributed to the magnitude of the bubbles, while yet being insufficient to head off the worst recession since the 1930s.

As Claudio Borio and Bill White pointed out at the Bank for International Settlements before the financial crisis, many of the worst economic collapses of the last one hundred years have occurred after excessively easy monetary policy had shown up in asset prices but not in inflation: the United States in 1929, Japan in 1990, East Asia in 1997, and now the United States 2007.

Final point: "Targeting asset prices" is the wrong phrase. The word "target" (for example, with respect to the money supply, exchange rate, or inflation) implies a number, or at least a numerical range. I don't know any-one who thinks that the central bank should contemplate setting a numerical range for the stock market. Rather, the claim, which I think the evidence now supports, is that central bankers would be well advised to monitor asset prices and to speak out, and eventually to act, on those rare occasions when asset prices get very far out of line.

We should reexamine central banks' reticence to prick asset bubbles.

SUSAN M. PHILLIPS
Dean and Professor of Finance, George Washington University School of Business, and former member, Board of Governors of the Federal Reserve

Although I remain skeptical of any agency's ability, including that of central banks, to identify with reasonable certainty asset price bubbles, the recent fallout from the housing bubble should prompt a reevaluation of central bank reticence to preemptively prick suspected bubbles.

The difficulty in identifying bubbles is well known, but perhaps more troublesome is the public, political, and market participant resistance to government or central bank intervention to prick a suspected bubble. When prices are high and going up, people are making money and do not want an external government or quasi-government agency to take away the proverbial punch bowl. Even if there are warnings, many often believe this time is different or the social purpose of the asset market (for example, wider ownership of housing) outweighs the risk of an unsustainable bubble. Moreover, in point of fact, even if the central bank knew for certain a bubble were building, the severity of the actions required to burst it would likely be so great that central banks might hesitate. That is, interest rates might have to be ratcheted up so high to burst a bubble in one asset market that considerable collateral damage may be inflicted on the rest of the economy via credit costs and constraints.

Nevertheless, the damage wrought by the bursting of the recent housing bubble has alerted financial regulators and central banks to the need to develop new approaches to targeting some classes of asset prices. In view of the risk of overreacting to or misdiagnosing potential bubbles, more research should be pursued to identify reliable indicia of bubbles and develop models to help evaluate the cost/benefit tradeoffs of intervention to minimize excessive or unnecessary economic damage outside of the suspected bubble market. In addition, appropriate cost effective regulatory safeguards should be considered to prevent the formation of asset price bubbles.

Yes.

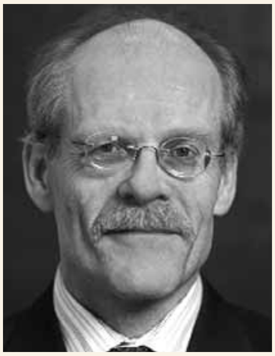
JOHN WILLIAMSON
Senior Fellow, Peterson Institute for International Economics

Yes. And they should continue to target consumer prices. There are two ways of targeting two variables: to target one instrument at a compromise ("trade-off") between them, or to deploy two instruments to pursue the two variables. The second solution is preferable where it is feasible: the discussion of the past year has indicated how to do it, though many observers seem unaware of this.

The additional instrument would be a macroeconomic-prudential figure for bank capital, to be determined by host-country central banks and then multiplied by the existing micro-prudential figure determined by home-country authorities to calculate the total capital requirement of a "bank." This macro-prudential capital requirement should be low in a time like the present and raised when there is a possibility of an asset price boom. This would avoid the nonsense of having to suffer high interest rates in a period when there is no price pressure, and the other nonsense of imposing high capital requirements on banks that are lending too little, and would give the central bank an effective instrument with which to fight asset price bubbles.

Fighting asset price bubbles presupposes that one can identify (roughly) an equilibrium level of asset prices.

This does not seem impossible, and a primary test of someone wishing to be a central banker should be his or her ability to make that call. See the recent book by Andrew Smithers (*Wall Street Revalued*) for how such an equilibrium can be calculated for the stock market, see the annual calculations of William Cline and myself for an attempt to calculate equilibrium exchange rates (Peterson Institute, PB09-10), and if you did not know that house prices were overvalued in 2007, then you deserved to lose money. (Incidentally, if a Dow of 6,500 was in equilibrium in 1966, then the present equilibrium value of the Dow—allowing for growth in nominal GDP over the intervening thirteen years—would be some 11,500. So either the Dow was already becoming overvalued in 1996 or it still has a way to go in recovery mode.)



Don't target asset prices, but react to them.

STEFAN INGVES
Governor, Sveriges Riksbank

The short answer is no, central banks should not target asset prices, but they should react to them. More importantly, this might occasionally involve greater judgement than is usually the case in monetary policy—perhaps greater than many are comfortable with.

The debate on monetary policy and asset prices is sometimes confusing. I believe, however, that most people would agree with the following general propositions:

■ There is no reason to target the development of asset prices *per se*. In the end, what matters is what happens with regard to inflation and the real economy.

■ Our understanding of the relationships between financial factors, monetary policy, and the economy at large is not complete. This makes it difficult to make good forecasts, in particular when asset prices follow paths that are difficult to rationalize and appear unsustainable in the long term.

■ Regulation and surveillance bear sizeable responsibility for preventing unsound developments in asset markets; monetary policy cannot target individual markets.

■ Monetary policy can play some role. After all, it affects the cost of credit and, at the very least, higher interest rates can function as a signal that the central bank is concerned over what is going on.

When I put these pieces together, my somewhat longer answer is: Central banks should react to asset price developments—and indeed developments at large in asset markets, not least lending—to the extent that they expect these developments to affect inflation and the real economy. Under normal circumstances, "conventional" developments in asset markets feed into the "conventional" forecasting framework, generating "conventional" forecasts of inflation and real activity. However, when financial conditions are not so normal, for instance when house prices and lending increase unexpectedly rapidly, the conventional forecasting framework might be less appropriate. Then one must think outside the box and rely more on judgement.

That said, one should not overestimate what monetary policy can achieve when it comes to fostering sound asset markets. Regulation and surveillance are the first line of defense. In particular, the recent crisis points to the need to strengthen the macroprudential framework. But one shouldn't be too defeatist about the role monetary policy can play. One of the challenges for the future is to try to find an appropriate mix between monetary policy on the one hand, and regulation and surveillance on the other.

Yes, but it's too soon for any fixed formula.

NORBERT WALTER
Chief Economist, Deutsche Bank Group

This very old discussion in monetary economics has re-emerged in the course of the financial crisis and the following recession. Before the turbulence, we had a broad consensus that central banks must focus on stability of consumer prices, and, if possible without threatening the key target, help to stimulate the economy. Targeting asset prices would mean a third target, and with only one instrument a wide set of conflicts between targets is set to arise. This is particularly true in the case of regionally limited bubbles within a currency union, and takes into account that central banks are also not able to construct the perfect model capable of calculating the true value of any kind of asset.

But the size of the financial crisis should lead us to reconsider this consensus at least with regard to two important elements. First, central banks can and should play a more active role in analyzing asset price movements and potential implications for the financial system. They should present their findings more openly to the public, to market participants, and most importantly to politicians and market regulators. We have learned many lessons during this crisis, and one concerns the careful evaluation of market indicators that point to an overvaluation.

This leads to the second important element. In the case of a significant risk of asset price distortions, central banks should assist politicians and regulators in developing instruments that help to deflate the potential bubble. However, it is too early to ask central banks to use monetary policy for asset prices as a third target. We need a better understanding of which assets on which to focus, and how to determine thresholds upon which monetary policy should act with which instruments. But all these questions are worth asking, since the current crisis reveals that we need to have more instruments at hand before a bubble inflates to unmanageable levels.

Asset prices can't be ignored.

JOHN H. MAKIN

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The experience of the last fifteen years suggests strongly the need for central banks to take account of asset prices when setting monetary policy. As with inflation targeting, the target should be judgmental, that is a deviation of the path of asset prices from an underlying trend, just as most central banks target inflation relative to an underlying desirable long-run trend.

If central banks ignore asset prices, declaring that they cannot identify a bubble, the result is to encourage too much risk taking. This became clear after then-Fed Chairman Alan Greenspan's assertion in a 2002 speech to the Jackson Hole Symposium (among others) that bubbles can't be identified and so central banks can only focus on dealing with their aftermath. The message to risk-takers was: Add substantially to risk because if a bubble develops and bursts, the Fed will be there to bail you out. Any person heading a large bank or investment bank was forced to go along or lose out to the competition. One of the results was a serious housing bubble. Banks and investment banks sought return by ignoring risk on mortgage-backed and related securities and thereby enabled a credit-fueled rise in house prices far above any reasonable underlying trend line. When the bubble burst, "too big to fail" institutions were rescued—this time in the face of tangible systemic risk.

Now central banks face the formidable task of containing excessive risk-taking after having rescued institutions that, *ex post*, took on far too much risk while simultaneously turning out to be too big to fail. The Fed and the Treasury need to work out a viable resolution mechanism whereby, in the future, institutions that assume too much risk can be given a burial that does not jeopardize systemic stability. Articulating the presence of asset prices relative to trend in a Taylor Rule-type specification would help to forewarn financial institutions not to risk dissolution in a future financial crisis. ◆