Forum

Tackling asset-price bubbles

Central Banking asked a select panel of former central bankers and advisors if the current crisis calls for a re-evaluation of the policy response to asset prices.

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Few topics in the theory and practice of central banking are as hotly debated as the relationship between monetary policy and asset prices. While most observers agree that fluctuations in stock prices, real estate values, and other asset prices can typically be managed within the conventional neo-Keynesian framework as one of many factors that affect the outlook for real activity and inflation, the treatment of more pronounced asset-price "bubbles" is a more contentious matter.

The argument of those who believe asset-price bubbles demand special attention from policymakers – be it through monetary policy, regulation or some other public-policy channel – is that their unwinding can be so messy and unpredictable that central banks have a hard time coping with the fall-out. As the current crisis has forcefully demonstrated, when empires of modern finance have been build on top of spectacular booms in certain asset classes,

the collapse of the underlying asset classes can have significantly wider and deeper consequences than the more or less predictable contraction of aggregate demand. When the entire modern financial system is threatened and credit extension is brought to its knees, can central bankers really say the impact is felt exclusively through a contraction in aggregate demand?

Even though the brutal evolution of the current crisis and the unwinding of asset prices have caused previously unimaginable headaches for central bankers, a consensus on the key policy questions that stem from the debate is far from obvious. Can policymakers, in particular monetary policymakers, identify bubbles early enough to do something about them without destabilisation the real economy? Should bubbles be pricked or should policymakers "lean against the wind"? Which tools should be used? Which institutions should be responsible? How can policies be coordinated?

Revist Ben Bernanke, the chairman of the Federal Reserve and long-time critic of the idea that monetary policy should attempt to affect asset prices directly, recently suggested that the entire topic of the policy response to bubbles should be revisited in the aftermath of the crisis. "The last decade has shown that bursting bubbles can be an extraordinarily dangerous and costly phenomenon for the economy and there is no doubt that as we emerge from the current crisis that we are all going to look very hard at that issue and what can be done about it," Bernanke said during remarks at the Economic Club of New York on 15 October.

But Bernanke's prelimary conclusion was that the task of addressing asset-price bubbles – or at least reigning in their proximate causes – should rest with those responsible for regulation, rather than monetary-policymakers. Regulation, he said, does have "a significant role to play in constraining excessive leverage, excessive risk taking and the other elements that lead to bubbles." He added: "And I believe that one of the elements of our reform as we go forward and look at the financial system as a whole will be to think about a more macro oriented or more macro prudential regulatory system that takes into account the broader issues of financial stability as well as the issues related to the safety and soundness of individual institutions."

Central Banking asked an exclusive panel of central bankers and academics, with extensive and varied backgrounds in policymaking, research and advising, whether the painful adjustment in house prices – particularly in the United States – and its relation to the financial crisis that started in August 2007 calls for a reconsideration of the debate on monetary policy, regulation and asset prices.

Frederic Mishkin

Former member of the Board of Governors, Federal Reserve

Has the crisis breathed new life into this debate and fundamentally changed it?

Absolutely. The old position, as followed by the Federal Reserve under Alan Greenspan for example, has really come under serious question. Essentially that position was: we cannot identify bubbles and even if we could, there really is not much we can do about them anyway – therefore we should not act.

I would argue that the view that we cannot identify bubbles is true for one type of bubble, but that in fact we need to distinguish between two types of bubbles. In both types we are talking about a situation were you get away from economic fundamentals.

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The first type of bubble is driven purely by "irrational exuberance" and is frequently a stock-market phenomenon. Here, there is no reason to believe that government officials and central bankers have any informational advantages over market participants. So there is no case for government officials to act.

The second type of bubble, in contrast, is driven by a credit boom. When a credit boom begins, it can spill over into an asset-price bubble because the easier credit can be used to purchase particular assets and thereby raise their prices. The rise in asset values encourages further lending for these assets, which can increase demand for them further and hence raise their prices even more. This feedback loop – in which a credit boom drives up asset prices, which in turn further fuels the credit boom, which again drives asset prices higher, and so on – can generate a bubble in which asset prices rise well above their fundamental values.

Credit-driven bubbles are particularly dangerous, as the current crisis has demonstrated, because when asset prices come back down to earth and the bubble bursts, the collapse in asset prices then leads to a reversal of the feedback loop in which loans go sour, lenders cut back on credit supply, the demand for assets declines further and prices drop even more. This is exactly the dynamics in housing markets during the subprime crisis. Driven by a credit boom in subprime lending, housing prices rose way above fundamental values; but when they crashed, credit shrivelled up and housing prices plummeted.

Given that there is a case to do something about credit-driven bubbles, should monetary policy be used to prick bubbles?

There are three strong arguments against having monetary policymakers try to prick bubbles by raising interests more than is necessary for achieving price stability and minimising economic fluctuations.

First, even if an asset-price bubble is of the credit-driven variety and so can be identified, the effect of higher interest rates on asset prices is highly uncertain. Although some economic analysis suggests that raising interest rates can diminish rises in asset prices, tighter monetary policy may be very ineffective in restraining the bubble, because market participants expect such high rates of return from buying bubble-driven assets. Furthermore, raising interest rates has often been found to cause a bubble to burst more severely, thereby increasing the damage to the economy. Another way of saying this is that bubbles are departures from normal behaviour, and it is unrealistic to expect that the usual tools of monetary policy will be effective in abnormal conditions.

Second, there are many different asset prices. At any one time, a bubble may be present in only a fraction of assets. Monetary policy actions are a very blunt instrument in such a case, as such actions would be likely to affect asset prices in general, rather than the specific assets that are experiencing a bubble.

Third, monetary policy actions to prick bubbles can have harmful affects on the aggregate economy. If interest rates are raised significantly to curtail a bubble, the economy will slow, people will be thrown out of work and inflation can fall below its desirable level. Indeed, as the first two arguments suggests, the rise in interest rates necessary to prick a bubble may be so high that it can only be done at great cost to workers and the economy.

This is not to say that monetary policy should not respond to asset prices per se. The level of asset prices does affect aggregate demand and thus the evolution of the economy. Monetary policy should react to fluctuations in asset prices to the extent that they affect inflation and economic activity. However, although controversial, the strong conclusion from the above reasoning is that monetary policy should not be used to prick bubbles.

What other types of policy response are appropriate for dealing with bubbles?

As argued above, there is a case for responding to credit-driven bubbles because they are more identifiable and can do great damage to the economy, but monetary policy does not seem to be the way to do it. Regulatory policy to affect what is happening in credit markets in the aggregate, so-called macroprudential regulation, on the other hand, does seem to be the right tool for the job of reigning in credit-driven bubbles.

Financial regulation and supervision, either by central banks or other government entities, which has the usual elements of a well-functioning prudential regulatory and supervisory system, can prevent excessive

risk-taking that can trigger a credit boom, which in turn leads to an asset-price bubble. These elements include adequate disclosure and capital requirements, prompt corrective action, close monitoring of financial institutions' risk-management procedures, and close supervision to enforce compliance with regulations. More generally, regulation should focus on preventing future feedback loops from credit booms to asset prices, asset prices to credit booms, credit booms to asset prices, and so on.

As the subprime financial crisis demonstrated, the rise in asset prices that accompanied the credit boom resulted in higher capital buffers at financial institutions, supporting further lending in the context of unchanging capital requirements. In the bust, the value of the capital dropped precipitously, leading to a cut in lending. Capital requirements that are countercyclical might help eliminate the feedback loops that promote credit-driven bubbles.

A rapid rise in asset prices accompanied by a credit boom provides a signal that market failures or poor financial regulation and supervision might be causing a bubble to form. Central banks and other government regulators could then consider implementing policies to reign in credit growth directly or implement measures to make sure credit standards are sufficiently high. An important lesson from the subprime financial crisis is that central banks and other regulators should not have a laissez-faire attitude and let credit-driven bubbles proceed without any reaction. Appropriate macroprudential regulation can help limit credit-driven bubbles and improve the performance of both the financial system and the economy.

Kohn "revisits" the bubble question

On 19 November, Donald Kohn, the vice chairman of the Fed, made a speech entitled, *Monetary Policy and Asset Prices Revisited*, in which he asked whether the conclusion that monetary policy should not attempt to deflate bubbles (in his words, "check speculative activity on a regular, systematic basis"), still holds."

Kohn started by admitting that he and "other observers underestimated the potential for house prices to decline substantially, the degree to which such a decline would create difficulties for homeowners, and, most important, the vulnerability of the broader financial system to these events." He added: "mopping up after this asset price bubble has turned out to be much harder because of its greater magnitude, the centrality of residential housing and finance to our economy and financial system, and the surprising ways obscure and complex financial transactions have exposed banks and other financial institutions to heavy losses."

But, despite this admission Kohn concludes: "I still have serious questions about whether trying to use monetary policy to check speculative activity on a regular, systematic basis would yield benefits that outweigh its costs." Although "the recent experience may have made us a bit more confident about detecting bubbles…it has not resolved the problem of doing so in a timely manner." Further, it remains unclear that "small-to-modest policy actions will reliably and materially damp speculation." And finally, the aggressive monetary policy response that would be required to deflate bubbles, would run the risk of inflicting even more damage on the real economy that the eventual fallout from the collapse in asset-price bubbles.

The vice chairman concluded with a call for a through review of regulatory structures, and three more modest lessons for monetary policy. First, central bankers need to consider the consequences of their actions for a longer horizon. Second, they "need to improve their understanding of the workings of the financial system, its vulnerabilities, and its links to the real economy" – including the increasingly global dimensions thereof. Finally, "more effort needs to be spent on further investigation of the financial accelerator and other credit-channel effects, given the accumulating evidence that such effects can give rise to an adverse feedback loop between financial markets and the real economy."

Christopher Ragan

Former advisor at the Bank of Canada

Has the crisis breathed new life into the debate on monetary policy and asset prices, and fundamentally changed it?

My view has not changed on this particular point: I have always had the view that monetary-policymakers should look at asset prices, but that asset prices are just one of the many things that they should look at. It is not clear to me that policymakers should now build asset prices into a policy-response rule in a mechanical way. If I look back at the past 12 months – or indeed at the past seven years – I would not say that the growth in asset prices was the most important thing going on. It was certainly one of the things to consider, but there were a number of things that contributed to the ensuing crisis in housing and financial markets.

We also need to consider the effects of loose monetary policy, the different regulations facing commercial banks and investment banks, the behaviour of Fannie Mae and Freddie Mac, the various types of mortgages that were being offered, and of course the securitisation of these mortgages. There were a great number of things going on. Asset prices may have played a leading role in the crisis, but the supporting roles were certainly crucial as well. So I do not see a compelling argument for placing asset prices above the other factors that policymakers need to keep in mind when setting monetary policy.

Should the responsibility for addressing specific asset-price misalignments rest with the regulatory authorities?

We have to be clear about what kind of regulation we are considering. I think if you are going to have regulation that affects asset prices it should not be at the point of market outcomes, such as the level of house prices. Any new regulations we introduce should rather be directed towards specific behaviour in the marketplace – behaviour that eventually may lead to undesirable outcomes. And hopefully we can design new regulations that will influence behaviour in a way that avoids such outcomes.

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As a result of this crisis, we are likely to see increased regulation directed at things that contributed to the bubble in the housing market. These regulations should address questions like: will there be minimum down payments on mortgages? Will there be a maximum amortisation period? Will there be interest-only loans? On what basis will securitisation of mortgages be permitted, and how will their risk levels be assessed? These questions speak to things that occur at the time and place of the initial market transaction. By regulating

behaviour at that point, we can then influence the final outcomes, on house prices and other economic or financial variables. But I would not want to see regulations that attempt to directly control the aggregate level of house prices, or indeed any other asset prices.

I think it will be fascinating to see which individual elements of the financial process (in place for the past few years) will be retained and which we will decide are unacceptable. The crisis really resulted from a remarkable confluence of processes that have been collectively in place for six or seven years – many of which would have been easily manageable on an individual basis if they had not co-existed with other processes. Even the concentration of subprime mortgages would not have presented an unmanageable problem if it were not for many of the other things that were going on at the same time. We might still have experienced a large and sudden decline in house prices, leading to foreclosures and bankruptcies, but we have been through that situation before and know how to deal with those developments. So I think we need to look at individual processes, think about how they interact with other processes going on at the same time, and then decide what is acceptable and what is not. This would be the best way to prevent the policy pendulum from swinging too far back in the direction of too much or inappropriate regulation.

Assuming the economy recovers over the next few years, do you expect the Fed and other leading central banks to take as a lesson from the current crisis that they need to "lean against the wind" when asset prices start rising faster than you would expect given the fundamentals?

I think asset prices have always been part of the range of things that monetary policymakers take into account, or should take into account. A consideration of asset prices is just part of the more nuanced thinking that invariably takes place around discussions of a typical Taylor Rule process. Policymakers look at the level and composition of aggregate demand, changes in relative prices, inflation dynamics, and the current and likely future gap between expected output and potential output.

What this crisis has emphasised – and hopefully this will be reflected in the thinking of policymakers and academics in the future – is that dramatic changes in some asset prices have important implications for the functioning of modern financial markets. Lately we have obviously become aware of the fact that the importance of asset prices goes far beyond the more traditional wealth effect that links asset prices to aggregate demand. But, again, we need to ask ourselves: if we had had different regulation in place and the financial markets had not been allowed to become as fragile and dependant on asset prices, would we have been able to deal with the fall in house prices in the same way we have in the past? I think the answer is yes – we would have been able to simply reduce policy interest rates to compensate for the shortfall in aggregate demand. As it turned out, the reactions by central banks had to be more aggressive, more creative and more complex because of the need to keep financial markets functioning properly.

Dino Kos

Former executive vice president at Federal Reserve Bank of New York

Has the crisis breathed new life into the debate on monetary policy and asset prices, and fundamentally changed it?

The debate should not be about the role that asset prices play in decisions on monetary policy. The debate should instead focus on the linkage between leverage and monetary policy.

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Greenspan argued, persuasively in my view, that central banks could not identify a bubble, and even if they did, central banks could not surgically deal with bubbles with a small, calibrated increase of the overnight lending rate.

However, perhaps looking at asset prices is the wrong starting point. Instead, let us focus on leverage in the financial system. Assets inflate when credit grows rapidly and is channelled into a given asset class or sector. Central banks and regulators may not have an interest in the value being placed on homes or equities, but they should have a view on how credit is expanding, on what terms that credit has expanded, and what risks are being taken on by financial institutions.

This removes the central bank from the uncomfortable position of judging whether equity markets are overvalued or not. Instead the central bank would be making assessments whether leverage is increasing, among which participants, and in what products or sectors.

There are significant data deficiencies that would have to be corrected and the central bank would still be left with the problem of how to respond to an increase in leverage. They would need to define excessive leverage and have the tools to counter budding leverage trends without adversely affecting the rest of the economy. In any case, as with all monetary-policy decisions, significant judgement would need to be applied.

Should the responsibility for addressing specific asset-price misalignments rest with the regulatory authorities?

As I have already noted, identifying asset-price misalignments is a losing proposition for the central bank and other regulators. They will be attacked by politicians, market commentators, and investors for opposing prosperity and wealth creation. Greenspan received a very unwelcome reception from Congress in 1996 after his "irrational exuberance" comments.

Identifying excessive leverage is equally difficult, especially since financial institutions will seek to shift debt into the so-called shadow banking system. However, regulators must respond to this crisis by closing off and shutting down the shadow banks that provided much of the marginal credit. Any meaningful provider of credit must be adequately and responsibly regulated.

Two suggestions come to mind necessary to guard against excessive leverage. First, regulators must guard against a weakening of lending standards. In this cycle, leverage was built up partially because credit went to sectors at generous terms with inadequate due diligence. Lenders successively degraded underwriting standards (no money down, no-doc loans, option adjustable-rate mortgage, and so on) at a time when standards should have been maintained or tightened. Such actions will both protect the financial system while also reducing the arc of any bubble that may be forming. Ideally such bubbles will be prevented outright.

Second, regulators and central banks need to have the tools to monitor leverage and counterparty exposures. As volatility and risk rises, margin requirements need to rise as well. Futures exchanges have long used such a model to ratchet up margin requirements to protect the clearinghouse. The difficulty and challenge is to increase such requirements when volatility is low and measures of VAR suggest risk is small. Ultimately, judgement needs to be applied. Would the late 1990s have differed if the Fed has raised equity margin requirements in 1996?

Assuming the economy recovers over the next few years, do you expect the Fed and other leading central banks to take as a lesson from the current crisis that they need to "lean against the wind" when asset prices start rising faster than you would expect given the fundamentals?

I expect many central banks will indeed take this as one lesson of this crisis and "lean against the wind" by raising interest rates when asset prices rise. That does not mean they should. Such a framework may well be a mistake.

Instead of focusing on asset prices, they should develop data gather capabilities to capture leverage trends in the system; they should better understand the link between leverage and monetary policy (see for example the recent papers by Tobias Adrian and Hyun Shin); and they should develop regulatory tools and a monetary policy approach to rapidly changing trends in leverage.

Perhaps the correct response to rising asset prices might be tighter monetary policy. I would not rule that out. However, assuming asset price growth is accompanied by rapid credit growth, there should be a wider set of tools regulators could implement. Such tools might include regulatory responses (are lending standards being maintained?), a review of margin requirements (are dealers degrading counterparty risk management to gain business?), and others that no doubt would be developed with the right focus.

Marvin Goodfriend

Former senior vice president at the Federal Reserve Bank of Richmond

Has the crisis breathed new life into the debate on monetary policy and asset prices, and fundamentally changed it?

I would still argue that interest-rate policy is not a good tool for directly addressing extreme asset-price fluctuations. The current crisis is hardly the first time that this issue has been actively discussed. In the late-1990s, for example, the Fed's Federal Open Markets Committee was concerned that the stock market boom was unsustainable. The stock markets had been rising since 1991, and after a brief fall following the Asian financial crisis, the markets really started taking off in 1999. By mid-1999 the feeling was widespread amongst policymakers that what was going on was not sustainable. But the question then, as is always the case with asset price booms, was: what do we do now? Having sat in on those policy meetings, I recall that the issue of raising interest rates was intensely debated at the time. The most important problem with taking action at that stage and raising interest rates was that it was difficult to know how aggressive the interest-rate action would have to be. The stock markets had already generated such momentum that the rate increase required to cool the market down would likely have been quite large. Having interest rates only slightly higher than you would have had otherwise would not have had a material impact on the stock markets.

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That episode neatly captures the extent of the problem policymakers face in trying to use interest-rate policy to address asset price booms. You might say tighter monetary policy during the initial phase of an asset price boom would require interest-rate increases of a smaller magnitude, but it is even harder to decide how interest-rate policy should react to asset prices at an earlier stage. Asset price bubbles are notoriously difficult to identify and agree on, and this is likely to be even more so in the initial phases of an upswing. Also, the early stage of an asset-price appreciation is very likely to coincide with a general improvement in the economic fundamentals, so it is especially difficult to know when to raise interest rates against an asset-price boom thought to be moving beyond fundamentals. Finally, generating an agreement on this in the context of a policy committee is very difficult to achieve.

Should the responsibility for addressing specific asset-price misalignments rest with the regulatory authorities or can central banks do the job?

Regulation has a role to play, but I would emphasise a different role for financial authorities than has commonly been discussed in the media and

political circles in the aftermath of the crisis. Ultimately, the best way for the authorities to help protect households, firms, and the economy against the excesses and instability associated with extreme asset-price fluctuations is to help customers of financial products – whether they are investors, borrowers or lenders – to be more demanding of suppliers of financial instruments. Financial authorities are well-placed to provide reliable consumer information and financial education, and they should do this more effectively. In so doing, the authorities help customers judge the risks against the apparent opportunities present in financial markets. Of course, regulation of the activities of financial firms themselves also has a role to play, but we need to be careful that regulation is not oversold as a means of protection. This is especially important in the context of an asset-price boom, when financial firms and their customers can get swept up in the emotions of getting rich quick and perhaps do not take the care they would otherwise.

Assuming the economy recovers over the next few years, do you expect the Fed and other leading central banks to take as a lesson from the current crisis that they need to "lean against the wind" when asset prices start rising faster than you would expect given the fundamentals?

Given the difficulties of using interest-rate policy to address extreme asset-price fluctuations, I would not expect much of a move in this direction. As mentioned above, this is even more difficult than the question of what to do when asset prices clearly look unsustainable. But I would emphasise another central bank policy option that has been used widely during this year's credit turmoil, which is credit policy. We have seen that credit policy can be an important policy tool, particularly during a credit crisis and a period of extreme asset-price depreciation. It is important to distinguish credit policy from the central bank's conduct of monetary policy. Monetary policy is about choosing the quantity of bank reserves and currency to provide to the economy, usually to achieve a desired target for short-term interest rates. However, a central bank puts the chosen quantity of base money into the economy by buying assets or by making loans. Credit policy is about choosing the composition of the asset side of the central bank's balance sheet. For instance, the Fed has usually pursued an asset-acquisition policy known as "Treasuries only," by purchasing primarily US Treasury securities or those securities deemed to have the explicit backing of the US Treasury. This past year, however, the Fed has sold hundreds of billions of dollars worth of Treasury securities from its portfolio in order to make loans to banks and other entities to address the credit turmoil.

Of course, some would say that credit policy has not been particularly successful given the friction in the interbank markets, but the fact is that we do not know the counterfactual, what would have happened if the Fed had not pursued credit policy as aggressively. The situation may have been much worse. In any case, credit policy has emerged this past year as an important policy tool for central banks, available to address credit-market stress associated with an unsustainable appreciation and subsequent depreciation of asset prices.

Alice Rivlin

Former vicechair of the Federal Reserve

Has the crisis breathed new life into the debate on monetary policy and asset prices, and fundamentally changed it?

Yes. The bursting of the housing bubble has had such extraordinary and unexpected consequences for the financial and the global economy that this question about asset-price bubbles – and who can do something about them – has to be reopened. It is not just confined to "what should the central bank do?" It is a case of "what should somebody do, and who should that somebody be?"

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The housing bubble is hardly the only part of the story explaining why we had a global financial crisis. But it did play a big part, and we had better discuss and analyse the various things that could have been done to avoid it. In the United States, I think we will see a lot of proposals from the Congress. But I do not expect Congress to explicitly thrust responsibility for asset-price bubbles on the Fed, unless there is a really fundamental rethink of the role of the Fed. And I do not think that is likely.

Should the responsibility for addressing specific asset-price misalignments rest with the regulatory authorities?

That is an open question – indeed, to me, that is indeed the question. Central banks, at present, typically have only one policy tool: they can influence short-term interest rate. They do not even have a very good tool for influencing long-term interest rates. So if the Fed is to have responsibility for both the macroeconomic stability and asset-price bubbles, it is going to need more than one tool. The problem for central banks – and certainly for the Fed – is not only identifying an asset-price bubble, but also trying to figure out how much punishment to inflict on the rest of the economy in addressing bubbles, once they are detected and deemed to be serious.

In the late-1990s, for example, it was perfectly clear that we had a stock-market bubble in the United States. But we also had a number of other problems affecting the macroeconomy – after all, we were just working through the Asian financial crisis. Raising interest rates in 1998 to control the domestic stock market would have made the effects of the crisis much worse on both the American and the global economy. So, if fact, we did the opposite: we cut rates in 1998. If we wanted to really affect the stock market, we would have had to raise interest rates substantially, which would have had dire consequences for the real economy world wide.
So the question is: should we have had another tool? One tool is

jawboning – Greenspan tried that once and never tried it again. The only other thing we could have done was to raise the margin requirement. With hindsight we probably should have done that, but that too would probably have had limited effects.

I think there is a lot of room for discussion about whose responsibility it is to address asset-price bubbles. It need not be the central bank, and it need not be a regulatory authority. One option that I think is worth looking at is to create an independent board, consisting of people with strong credentials, whose job it is to issue warnings about asset prices if they get out of line – essentially an official "jawboner". Of course, it is hard to identify a bubble and to agree on its magnitude, but with regard to both the stock prices (particularly for technology stocks) in the 1990s and the housing up to about 2005, it become obvious that we had a bubble in the United States.

Assuming the economy recovers over the next few years, do you expect the Fed and other leading central banks to take as a lesson from the current crisis that they need to "lean against the wind" when asset prices start rising faster than you would expect given the fundamentals?

It all depends on what happens to the underlying forces in the real economy. Unfortunately, I do not think we have seen the last of this crisis. Further, I am not sure we know quite what a "normal recovery" is anymore. If the assumption that the real economy picks up again after, say, 18 months does materialise, I would expect policymakers to be more cautious and tend towards higher interest rates.

David Laidler

Former advisor at the Bank of Canada

Has the crisis breathed new life into the debate on monetary policy and asset prices, and fundamentally changed it?

It certainly will breath new life into the debate, but the unravelling of the crisis has not fundamentally changed the way I look at it. First of all, I have no doubt that asset prices create problems for policymakers and for the functioning of the monetary and financial system. From past – and indeed current – experience we know that asset-price bubbles are rarely an economy-wide phenomenon (if they are, they are only a part of a much larger inflation problem). Rather, they tend to be located in a specific sectors, whether it is high-tech stocks or housing, or somewhere else. And it remains clear to me that monetary policy, which currently typically takes some form of control of the overnight interest rate, is just too blunt an instrument to address bubbles in specific sectors. I think something that has not been mentioned enough is that central banks let inflation get out of hand prior to the bursting of the housing bubble. The Federal Reserve allowed inflation to get up to 4%, given their focus on core

inflation rather than the broader Consumer Price Index (CPI). And in the United Kingdom, inflation in the Retail Price Index got up to 5%, while CPI inflation was around 3%. If you are going to target a price index that gives zero weight to owner-occupied housing costs in a country where 70% of the population are owner-occupiers, I think you are looking for trouble. You do not need to engage in sophisticated debate over "flexible inflation targeting" when you are, quite simply, making basic mistakes by targeting the wrong index and allowing over-expansionary policy to get going.

Should the responsibility for addressing specific asset-price misalignments rest with the regulatory authorities?

Certainly, there is a very important role for regulation, over and above the mistakes that were made on the monetary-policy front. It is clear that regulation alone can not do the job – monetary policy needs to play its part by ensuring the overly expansionary policies do not take root.

Even having both sound regulation and sound monetary policy in place is no cast iron guarantee, which brings me to be central banks' lender-of-last-resort function. I think central bankers need to rethink what their stance and response is to the provision of lender-of-last-resort support when bubbles burst and lead to the seizing up of markets. It is an absolute given that there will be many international discussions on and changes to the regulation of the global financial system. But I really do hope that central bankers pay sufficient attention to issues in the coordination of the provision lender-of-last-resort facilities, rather than simply go for a set of half-baked regulatory schemes aimed at preventing bubbles.

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Assuming the economy recovers over the next few years, do you expect the Fed and other leading central banks to take as a lesson from the current crisis that they need to "lean against the wind" when asset prices start rising faster than they would expect given the fundamentals?

My answer would be "yes" and "no". I do hope that if we were to find ourselves in the same position as we were in a couple years ago, when the economy was recovering following the collapse of the technology bubble, central banks would pursue tighter monetary policies – or at least pay closer attention to the dangers of over-expansionary policies taking root. I would also expect policymakers to pay close attention to ensure that the inflation indices they target or monitor are capturing developments in various asset markets. That said, I do not believe it is desirable for monetary policy to respond to price misalignments in specific asset markets. But I do believe that being more careful in ensuring that interest rates are tightened before you find yourself in an overly expansionary position will give you a reasonable chance of avoiding very big asset-price bubbles. ❑