

Urban Bäckström: Asset markets and monetary policy

Speech by Mr Urban Bäckström, Governor of the Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, at a conference organised by the Riksbank and the Stockholm School of Economics, held in Stockholm, on 16 June 2000.

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Ladies and gentlemen, it gives me great pleasure to welcome you to this conference on Asset Markets and Monetary Policy that the Riksbank and the Stockholm School of Economics are jointly organising. The Riksbank has the ambition to host a conference every other year on a topical subject. Two years ago we organised a conference jointly with the Institute for International Economic Studies on Monetary Policy Rules. This year I am very pleased to announce that we will again be able to present a set of papers written by scholars of the highest international academic standard and on a subject matter that is extremely topical: asset markets and monetary policy.

In my opening remarks two years ago I suggested that the question of monetary policy and asset prices should be a topic for a future conference. The interaction between asset prices, the real economy, and monetary policy is by no means a new matter for central bankers and economists, but the development of asset markets in the last few years has brought the question to the forefront of the policy debate.

For a practitioner of monetary policy like myself, this area contains a number of difficult issues. I shall be raising some of them this morning and they will also be discussed during the conference. By the end of the conference I hope we will be able to look back on a fruitful discussion and have a better understanding of the issues and problems involved.

How should monetary policy respond to movements in asset prices? This depends on how the central bank chooses to use the information contained in asset prices.

In a regime that explicitly targets inflation, asset prices are taken into account via the effects on aggregate demand. Rising share prices increase household wealth and that would raise consumption for a given level of income if these increases in wealth are considered to be of a permanent nature. At the same time, consumer confidence boosted by higher share prices could potentially make individuals more prone to spend their increased wealth.

An increase in share prices also makes investment more attractive to firms since it increases collateral values and lowers the cost of new capital relative to existing capital. If share prices predict higher expected output growth, this could also lead to more investment.

If the asset prices on which households and firms base their consumption and investment decisions prove to be too optimistic, this would create inflationary pressure in the short term. An important question in this context is how sensitive households' and firms' consumption and investment responses are to changes in asset prices.

Via the effects on inflation, asset prices are thus taken into account in the formulation of monetary policy, although they do not feature explicitly in the target variable.

However, the simple use of financial asset prices as indicators is not a panacea for the central banks' forecasting problems. Asset prices can move for a variety of reasons. Understanding those reasons is important in determining the appropriate monetary policy response. For example, if a rise in share prices stems from increased productivity and thus from expectations of higher future profits, the implications for monetary policy would be very different from a case with no such fundamental reason for the higher share prices.

This raises a number of questions. The first pertains to the relative informativeness of different kinds of asset prices. The second is how to integrate the information obtained from asset prices with other macroeconomic information. Notwithstanding the empirical evidence of the indicator properties of asset prices, the *causal* relationships between asset prices and real macroeconomic variables have

proved to be more difficult to understand and model. But, as I have just illustrated, the answers to these questions can be very important for monetary policy. It seems quite clear that central banks cannot afford to adopt a view of asset markets as merely “side-shows”.

There can be other, sometimes less straightforward, situations where monetary policy has reason to react to movements in asset prices even though the effect on inflation is negligible. One such reason is the central bank’s responsibility for the stability of the financial system.

If asset prices have been driven up to unsustainable levels that do not correspond to the underlying fundamentals, we are faced with a special kind of problem. We know from experience that speculative asset price bubbles eventually burst. When they do, collateral values will fall and balance sheets deteriorate, potentially threatening the stability of the banking system. To avoid this kind of development, the central bank needs to closely monitor the potential for excessive credit growth and the possibility of asset price bubbles building up.

It seems that historically the forming of speculative price bubbles has been closely linked to an excessive expansion of credit. But we need to operationalise both the concept “excessive” and the difficult concept of an asset’s “fundamental value”. As history has shown us, judging to what extent rising asset prices reflect strong fundamentals, rather than the “irrational exuberance” of investors, is easier said than done. How does a speculative asset price bubble get started and how do we spot it? And if we spot it, what do we do about it?

In most countries the risks associated with a property price bubble would probably be considered to be greater than in the case of an equity price bubble. This is because in most countries banks are more exposed to risks in the property market, since real estate is used as collateral for a considerable amount of bank loans. The bursting of a large property price bubble can have serious effects on financial intermediation. This could motivate an early monetary policy response.

The cost of this pre-emptive strike strategy would have to be weighed against the fact that inflation and real activity will be lower than desired in the short term. Is this a price worth paying to maintain stability in the financial system? In order to answer that question, we need to know how sensitive the financial system is to a severe fall in property prices? Another problem with trying to act pre-emptively is, how do we spot the price bubble in time? So even though in a conflict between short-run price stability and financial stability, the latter were to be viewed as the more important, implementing such a policy could be fraught with substantial practical problems.

The grounds for a pre-emptive strike against an equity price bubble are perhaps less compelling than for a property price bubble. The US experience from the 1987 stock market crash seems to be that, with an appropriately conducted monetary policy, the effects on real activity can be relatively small. With New York Stock Exchange order flows grossly out of balance on 19 October 1987, with the solvency of brokerages and clearing houses in doubt, banks were growing nervous and reluctant to lend. This was a clear case of *systemic* risk and before the market opened on 20 October the Fed affirmed its responsibilities to serve as a lender of last resort and also substantially eased monetary policy. A financial meltdown was avoided and the effects on the real economy seem to have been negligible.

In the 1990s, the global monetary policy picture has in many countries been very different compared to the 1980s. Low inflation seems to have become the norm rather than the exception. If monetary policy is successful in providing price stability, does that mean that the risk of financial instability will be smaller? In order for a financial crisis to have severe effects on the real economy, substantial financial imbalances must have been allowed to build up during the preceding period. In other words, monetary policy makers must have seen no reason or been unable to prevent these imbalances from building up.

Thus, an important question is whether a monetary policy for price stability will indirectly prevent excessive debt accumulation in the economy? In other words, how likely is it that large imbalances will have time to build up before the central bank judges that its inflation target is threatened and therefore raises interest rates? Can large imbalances materialise without inflationary pressure building up?

A related question is whether the choice of monetary policy strategy has a bearing on the risk of financial imbalances and financial crises? For example, will a monetary policy based on a simple policy rule lead to a lower or higher risk of financial imbalances building up compared to a more discretionary policy? Will an inflation targeting regime lead to a larger or smaller risk of imbalances building up compared to a monetary targeting regime? These highly relevant questions are being asked by a number of central banks in emerging markets that have recently been forced to abandon a fixed exchange rate policy that was no longer sustainable.

The papers to be presented at this conference will hopefully throw some light on a number of the questions I have raised here this morning. I look forward to learning what our distinguished guests have to say on these matters.