

Discussion

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This paper addresses the issue of low inflation and rising asset prices over the last two decades as experienced notably in the US in the second half of the 1990s and in Japan from mid 1980s to early 2000s. More recently, there have been housing booms over the last several years in some cities in the US and Europe.

More specifically, this paper raises the following questions. First, should the monetary policy react to the asset prices even though the general prices inflation rate is low and stable? Second, should the monetary policy react to the asset prices even if it may cause a temporary recession with a view that a cost of "bubble and burst" exceeds a temporary recession?

The author answers these questions by reviewing historical experiences of Japan in the 1980s and the US in the 1990s. In the US, when Chairman Greenspan warned of the "irrational exuberance" in December 1996, no measurable tightening was applied and the Dow Jones went on to exceed 11,000 by December 1999. These asset price increases turned out to reflect positive supply shocks or structural changes, referred to as a "New Economy." More importantly, bubble bursting in the US in 2000-2001 did not cause any financial crisis.

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In Japan, however, the asset price increases turned out to be mostly bubbles. There was a limit to what monetary policy can do: a few percentage point of interest rate would not dampen the expected returns from stock/housing prices typically ranging in more than 10%.

As a result, unlike in the US, bubble bursting in the 1990s caused major banking crisis due to non-performing loans and under-capitalization of banks.

Experiences in both Japan and the US point to the difficulties in reacting to asset prices. Even if it may be desirable to prevent a bubble and burst, the central bank has difficulty in credibly identifying a bubble as opposed to fundamental changes. When the bubble is in force, it would take very high interest rate to "pop" the bubble, which would throw the economy into a recession.

For example, according to Rigobon and Sack (2004), an unanticipated 25-basis point increase in the "policy rate" results in a 1.7% decline in S&P 500 index (1994-2001). This implies that, in order to dampen the expected stock return during a strong bubble process which typically ranges in more than 10%, the policy rate should go up by more than six times of 25-basis points. Lee (2006) also applied the same estimation method to Korea and found that an increase in the call rate results in an increase in the KOSPI, but statistically insignificant.

From the historical overviews of the experiences in the US and Japan, the author draws the implication that the central bank should NOT respond to the asset prices if the followings are the case:

- It is less certain whether asset price increases are due to a bubble vs. favorable supply shocks;
- It is less certain about the monetary policy (interest rate) influence on the bubble bursting probability;
- Welfare losses from volatility of inflation and output due to a "boom and bust"

are low;

- Financial institutions' balance sheets are robust against the asset price fluctuations;
- Regulatory measures are in place with minimum distortions

Then, how general is the proposition that it is not necessary for monetary policy to react explicitly asset prices? First, as properly pointed out in the paper, there is a well-known "fundamental" principle that one cannot pursue two policy objectives (CPI and asset price stability) with only one policy instrument (interest rate). The pursuit of both general price and asset price stability with the interest rate as the single policy instrument would yield time inconsistency or credibility problem. So interest rate policy (e.g. a Taylor-type rule) can be used for CPI stability, whereas financial supervision policy is used to strengthen the financial system (so that some volatility in asset prices can be endured without serious problem).

Further, there have been theoretical examinations of the proposition in models of financial frictions, asset prices, and monetary policy such as Bernanke-Gertler-Gilchrist (1999) and Kiyotaki-Moore (1997). In the presence of private information on the return of borrowers' investment projects, endogenous agency costs arise in the contract between lenders and borrowers (typically entrepreneurs). An increase in asset prices raises the value of entrepreneurs' capital stock and hence improve their balance sheets. This will then lower the external finance premium, generating countercyclical finance premium.

In the context of these models, Bernanke-Gertler (1999, 2001) and Iacoviello (2005) showed negligible stabilization gain from including asset prices as independent arguments in the interest rate rules. On the other hand, Cecchetti, et al (2002) claimed a contending view that gain from including asset prices as independent arguments in the interest rate rules depends on the underlying source of

shocks. However, these results have limitations in the sense that they abstract from strict welfare considerations.

More recently, Faia and Monacelli (2005) investigated, absent bubbles, optimal monetary policy based on the evaluation of household's welfare under alternative Taylor-type interest rate policy rules. They found that strict inflation targeting is the optimal rule, whereas strict asset price targeting performs worst. Intuitively, this is because asset prices influence monetary policy through their effects on general prices. Suppose there is a positive productivity shock. This will increase asset prices as the asset demand increases, which then lowers external finance premium due to higher collateral values of assets. This will cause an (over)acceleration in investment, followed by a rise in inflation due to expanding demand. Hence, the proper policy response would be an increase in interest rates.

Faia and Monacelli (2005) also examined whether the policy response to asset prices yields an independent effect on welfare. They found a positive but minor effect on welfare when the policy response to inflation is relatively weak. This is because, for a weak policy response to inflation, responding to asset prices is a way to implement a "leaning against the wind" policy that allows to complement the only partial inflation targeting response.

Finally, most of these theoretical discussions abstract from asset price bubbles mainly because they are difficult to identify credibly. In order to prevent potentially substantial welfare losses from bubble and burst, it will be crucial to have sound and stable financial system equipped with credible monetary policy, prudent financial supervision, lender of last resort and deposit insurance, and efficient risk management of financial institutions.

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