Govts and bubble trouble : Should monetary policy be concerned with assets prices?

Phurichai Rungcharoenkitkul

Senior Economist

Monetary Policy Department

Bank of Thailand

FINANCIAL CRISES in modern history often share on common trait: a precipitous run-up in asset prices followed by a sudden and deep decline, resulting in severs damage to the balance sheets of banks, households and corporations.

These "bubble and crash" episodes pose a serious threat to financial stability and can in turn compromise long-term economic wellbeing. The issue clearly belongs at the top of economic policy agendas and is one that central banks around the world need t contend with: to what extent should assed prices play a role in monetary policy formulation?

Before the onset of the sub-prime crisis, the conventional wisdom was that asset prices had little direct bearing on monetary policy. The key reason for this was that it was difficult or near impossible to detect bubbles in real time. Given such a constraint, the role of monetary policy was limited to 'cleaning up" after the bubble had burst.

In the aftermath of the crisis, critics have challenged this view, pointing to ample evidence of excessive movements in asset prices plus signs of a housing bubble preceding the crash. Some have urged that monetary policy lean harder against the wind of financial excess.

Even if one was able to detect asset price misalignments with reasonable accuracy, it is by no means clear if monetary policy should be used to fine-tune asset prices.

Monetary policy is a powerful tool that ahs a broad effect on all parts of the economy, Using the policy interest rate to steer certain asset prices risks destabilising the prices of other assets, as well as the prices of goods and services and indeed economic activity as a whole. Thai is why most central banks still place most emphasis on the outlook for growth and inflation when adjusting their main policy instrument.

Meanwhile, there is also a growing consensus that asset price misalignments and financial imbalances in specific sectors are better addressed by a separate set of policy instruments. In particular, the regulatory role of central banks can be utilised to curb the excessive credit extension that threatens to fuel a bubble. This "macro-prudential" approach to financial stability is now received wisdom for practitioners and academics alike.

Does this mean then that financial stability has no implications for monetary policy? Nothing could be farther from the truth.

Although the jury is still out on the use of monetary policy as a "corrective" tool, prudent policy course can still play a "preventive" role. A prolonged monetary accommodation, for instance, can certainly find its way through to asset markets and help sustain an existing asset price bubble, if not create one.

Indeed, a painful lesson from the sub prime crisis is that this causative linkage between monetary policy and financial imbalances cannot be dismissed.

Going forward, central banks will be acutely aware of the need to ensure that their unusually accommodative monetary policy stances do not overstay their welcome, otherwise they risk more bumpy rides down the road.

(The views expressed are the author's own.)

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