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Asset Price Booms and Monetary Policy-The
Israeli Perspective Discussion Based on Detken
and Smet: Asset Price and Monetary Policy

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Asset Price Booms and
Monetary Policy-The Israeli Perspective
Discussion Based on Detken and Smet:
Asset Price and Monetary Policy
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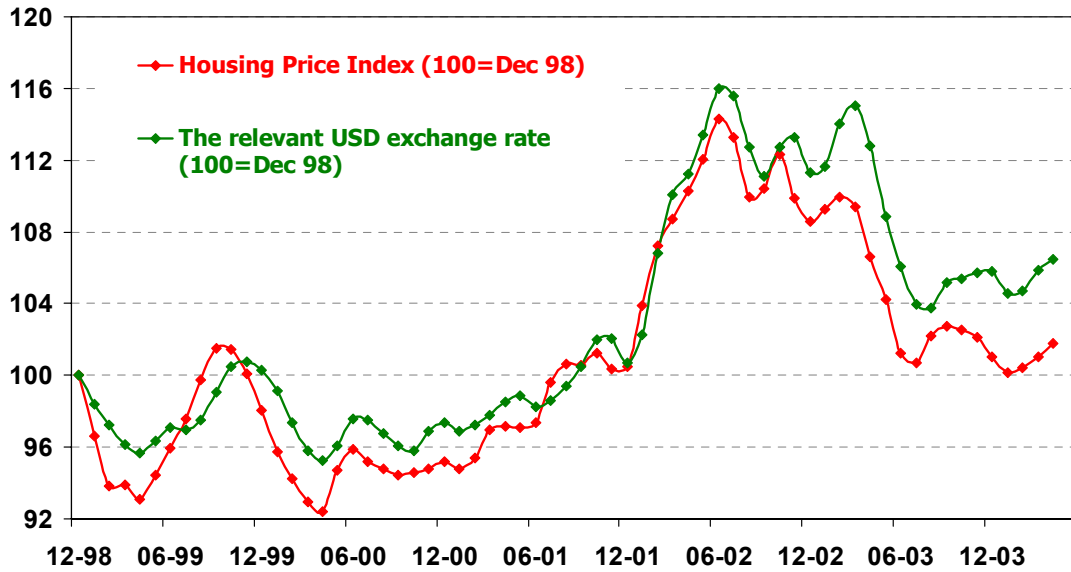
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In Israel monetary policy is conducted within a forward-looking inflation targeting regime. In its monthly deliberations prior to deciding on its key rate (a daily interest rate), the Bank of Israel (BOI) relies on information from assets markets, among other sources, and is thus obliged to take note of and assess the conditions in those markets.

For example, a great deal of attention is paid to expected behavior of the exchange rate as it is an important variable affecting price developments as well as being the price of an important financial asset. It is important to note that since June 1997 the BOI has not intervened at all in the FX market.

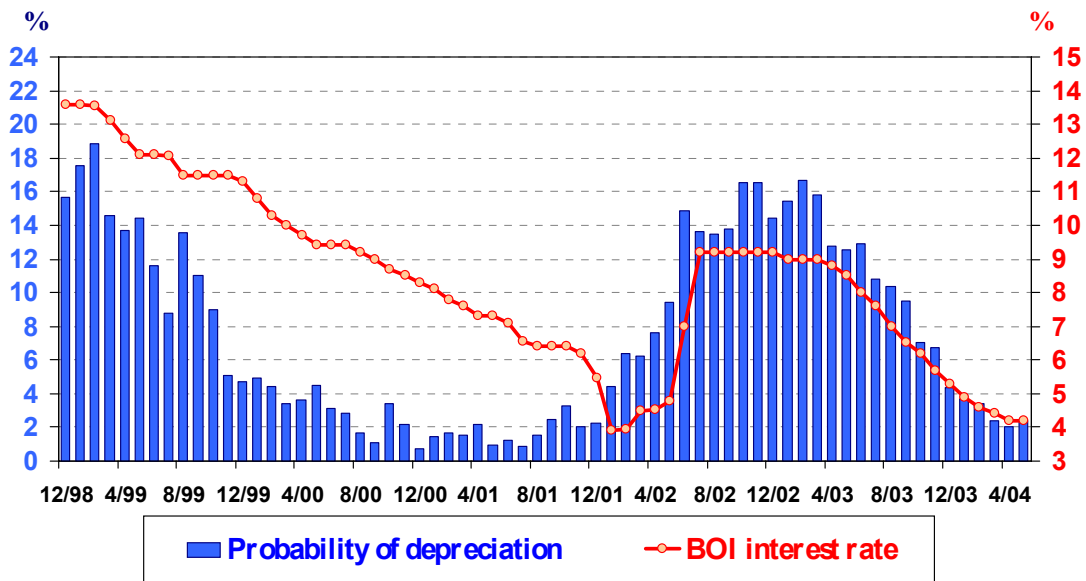
For historical reasons related to the long legacy of inflation in Israel, the price of housing (which is over 20 percent of the CPI, the measure relevant for the inflation target) is strongly linked to the dollar exchange rate (see diagram 1).

Diagram 1: The Linkage Between the Housing Price Index and the Foreign Exchange Rate

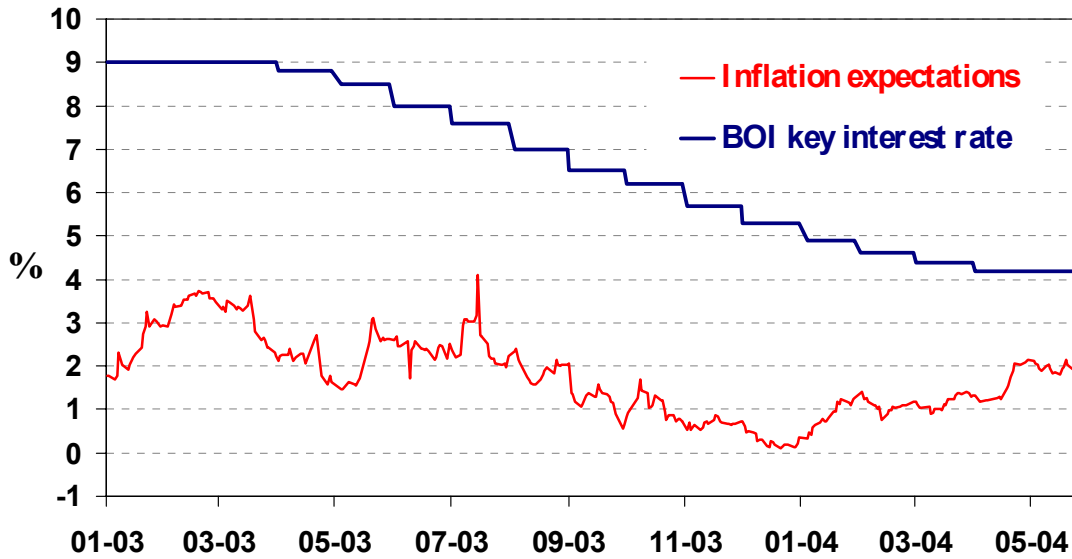


A second example of the relationship between monetary policy decisions and asset prices is the information derived from the FX options market and used to assess the FX probability distributions. One such statistic is the probability of large depreciation (appreciation) of the NIS against the dollar.

Diagram 2: Probability of 10 Percent Depreciation in 6 Months and the BOI Interest Rate

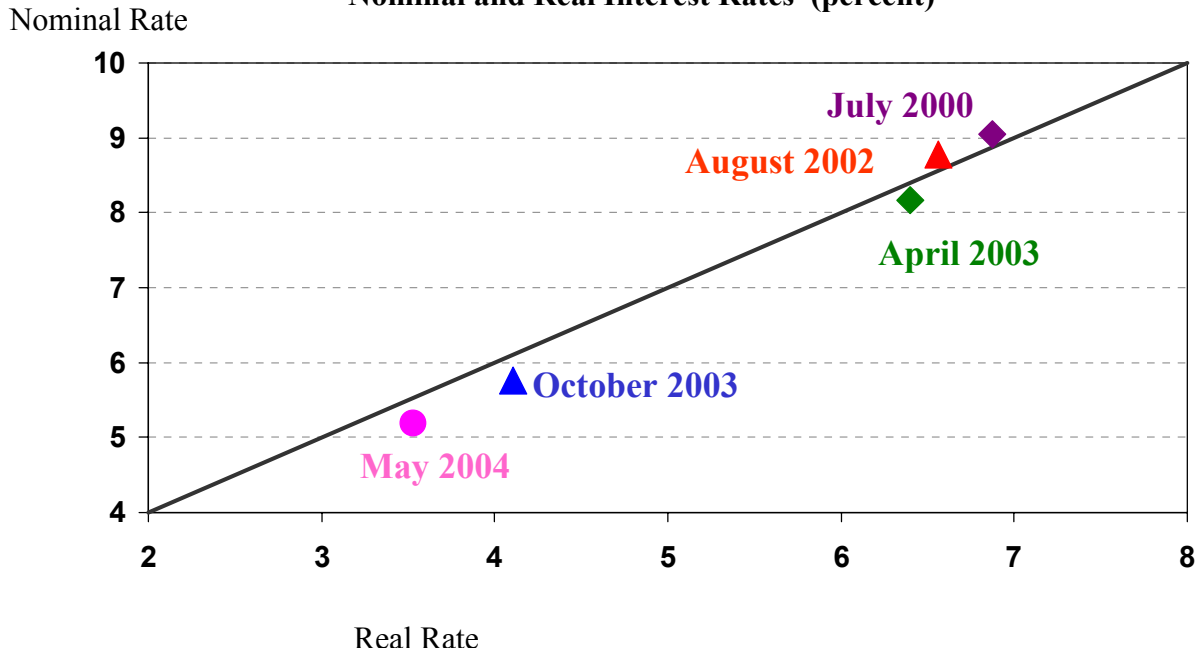


Even if the inflation forecast and inflation expectation are below the lower limit of the inflation target (1-3 percent), which calls for a reduction in the key rate, the pace of the decline will take into consideration the above mentioned probabilities.

Diagram 3: Inflation Expectations and the BOI Key Interest Rate

A third example of how monetary policy in Israel is affected by financial stability considerations is through gradual changes in the key rate. Such changes, as pointed out by Bernanke (2004), enhance financial stability. Through gradualism it is easier to manage expectations regarding the course of future short key rates and thus to influence the entire term structure of yields. Thus, for instance, while the BOI looks at the spread between regular and CPI-indexed bonds in assessing the market's inflation outlook, it is not indifferent to the level of these spreads. In assessing inflation expectations derived from the market (say 2 percent as per the example in Diagram 4), based on yield differentials between regular and CPI-indexed bonds, the actual level of the yields is also important, i.e., is the level of yields in Israel similar to or very different from yield levels abroad?

Diagram 4: Inflation Expectations of 2 Percent with Different Structures of Nominal and Real Interest Rates (percent)



I agree with the authors that the policy response to asset price increases depends very much on the source of the increase. It is very difficult to know in real time whether the increase in the price of shares is a result of improved productivity or over-optimistic expectations. They can both easily occur simultaneously.

I also agree with Detken and Smets statement that shocks to the price of financial assets tend to move in the same direction as the output gap and inflation. These considerations bring me to be more supportive of the view that "the inflation targeting approach dictates that central banks should adjust monetary policy actively and pre-emptively to offset incipient inflationary and deflationary pressures and should not respond to asset prices except insofar as they signal changes in expected inflation" (Bernanke and Gertler, 1999, 2001), than of the view of Checcetti (2000) that monetary policy should respond also to excessive movements in asset prices.

It might be possible to bridge these different approaches by considering price level targeting as an alternative to inflation targeting. Price level targeting versus inflation targeting have been considered in assessing the trade-offs between inflation and output variability, but not in the context of which one is better for avoiding financial bubbles. My intuition is that in price-level targeting regime, where bygones are not bygones, it is easier (if the regime is credible) to induce the right sort of movements of expectations. But this subject still needs to be explored.

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