Asset Prices and Monetary Policy

Some Analytical Considerations and the Current Global Conditions

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Two issues to be discussed:

I. **<u>Should</u>** Central Banks consider asset price developments—***i.e. volatility and bubbles***—when formulating monetary policy? And, **<u>can</u>** they actually systematically do it?

II. Is the **<u>Current</u>** asset price boom rooted on different causes, compared with previous similar events?

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- "***Bubbles***", should be understood as "***misalignments***", i.e., departures from fundamentals.

- There is no argument about the futility of reacting to "equilibrium" asset price changes <u>unless</u> they impact, in a measurable manner, on the inflation forecast and the outlook for real activity.

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“Conventional View”

- Monetary policy should not respond to changes in asset prices, except if they signal changes in expected inflation or have implications for future output and price developments.

"Conventional View" (2)

- Monetary policy can do little more than deal with the fallout from unwinding of asset price bubbles

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“The notion that a well-timed incremental tightening could have prevented the late 1990’s bubble is almost surely an illusion. Instead, we…need to focus on policies to mitigate the fallout when it occurs.”

Alan Greenspan, Jackson Hole, 2002

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"Inflation targeting central banks need not respond to asset prices, except insofar as they affect the inflation forecast"

Ben Bernanke and Mark Gertler, AER, May 2000

The “*Extra Action*” View

- Central Banks should take action to restrain an “excessive” rise in asset prices, even when inflation forecasts do not deviate from the target rates.

- In order to reduce the likelihood of bubbles, CB reaction to asset prices should be in the normal course of policy making.

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"A central bank pursuing an inflation target will not achieve optimum performance in terms of its inflation objective by setting its interest rate solely in response to shifts in its inflation forecast and reacting to nothing else"

Cecchetti, Genberg, Lipsky and Wadhwani, Geneva Report, 2000

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	Arguments for no intervention	Arguments for “Extra Action”
Identification difficulties	•Misalignment of asset prices are almost impossible to identify.	•No more difficult than “output gap”, “natural rate”, or equilibrium real interest rate.
Credibility issues	• Asset price too volatile & expectation-dependent to be a credible target. •Focus on primary CB objective -- avoid public confusion.	•Reputation at stake, if neglect financial stability (even if inflation objective achieved).
Policy effectiveness	•Interest rate too blunt a tool. •Risk of recession if bubble popped.	•Natural burst can be larger, implying longer recession

3 conditions for "Extra Action"

1. CB should be able to identify the bubble timely and with certainty.

2. CB should be certain that a modest tightening would indeed check the speculative activity behind the bubble.

3. The gains from avoiding the bubble bursting should exceed the current cost of tightening.

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In practice…

- Our survey (CCBS at Bank of England) shows that ***in practice***, asset price volatility <u>does influence</u> monetary policy in an informal and indirect manner but is never incorporated in a systematic CB reaction function.

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Current Asset Price Developments:
A Bubble or Fundamentals?

The Globalization process and its specific characteristics have created conditions that result in a ***new equilibrium set*** of:

*** Commodity, energy and raw material prices**

*** Relative factor prices**

*** Asset prices**

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Commodity Prices

- The acceleration and distribution of world growth have created structural changes in the world supply and demand conditions for commodities, with structural excess demand and low inventories.
- There have been some speculation but real changes are fundamental and lasting.

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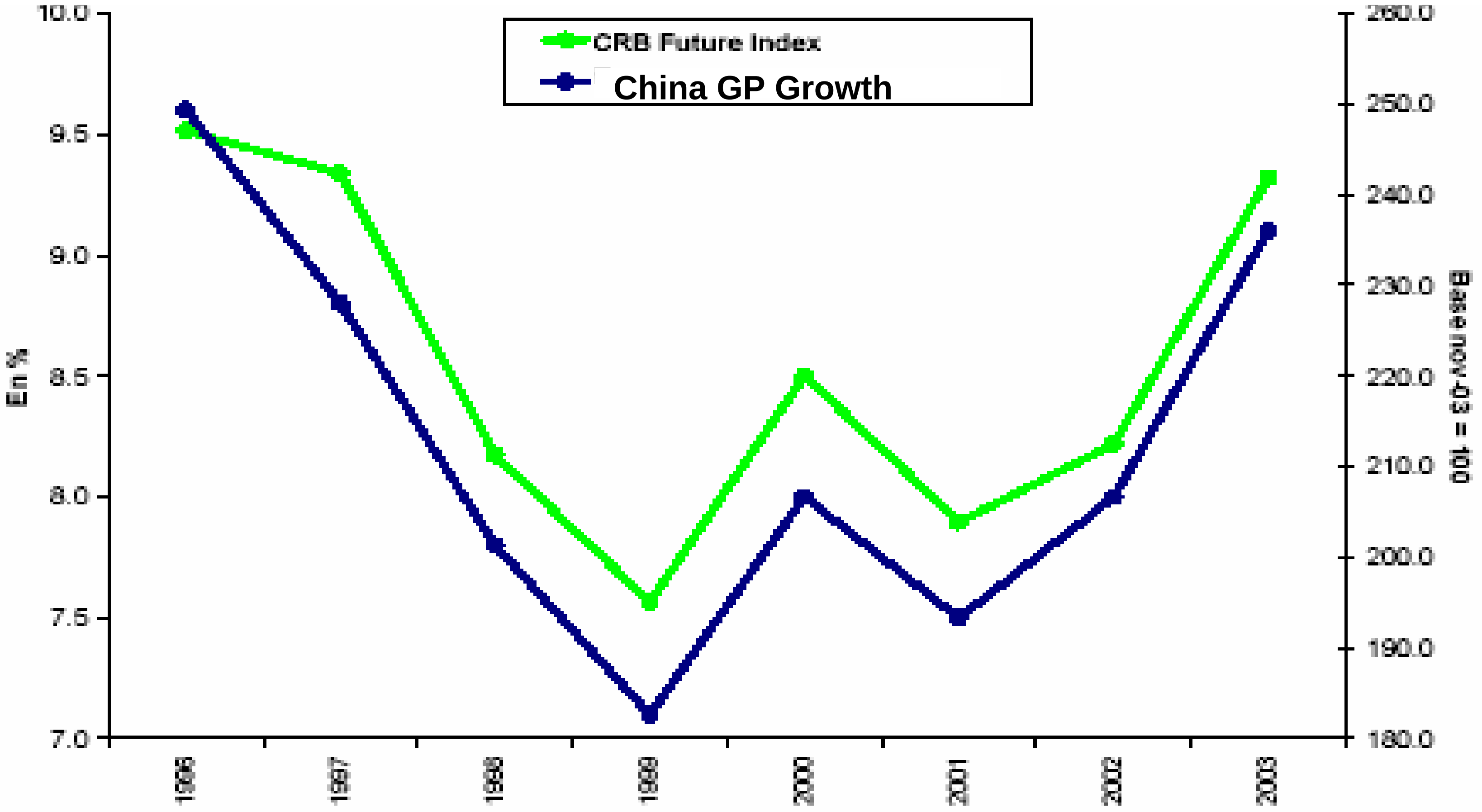
Relationship between China's Rate of Growth and Commodity Prices



Fuente: Perspectiv@s en base a datos del FMI

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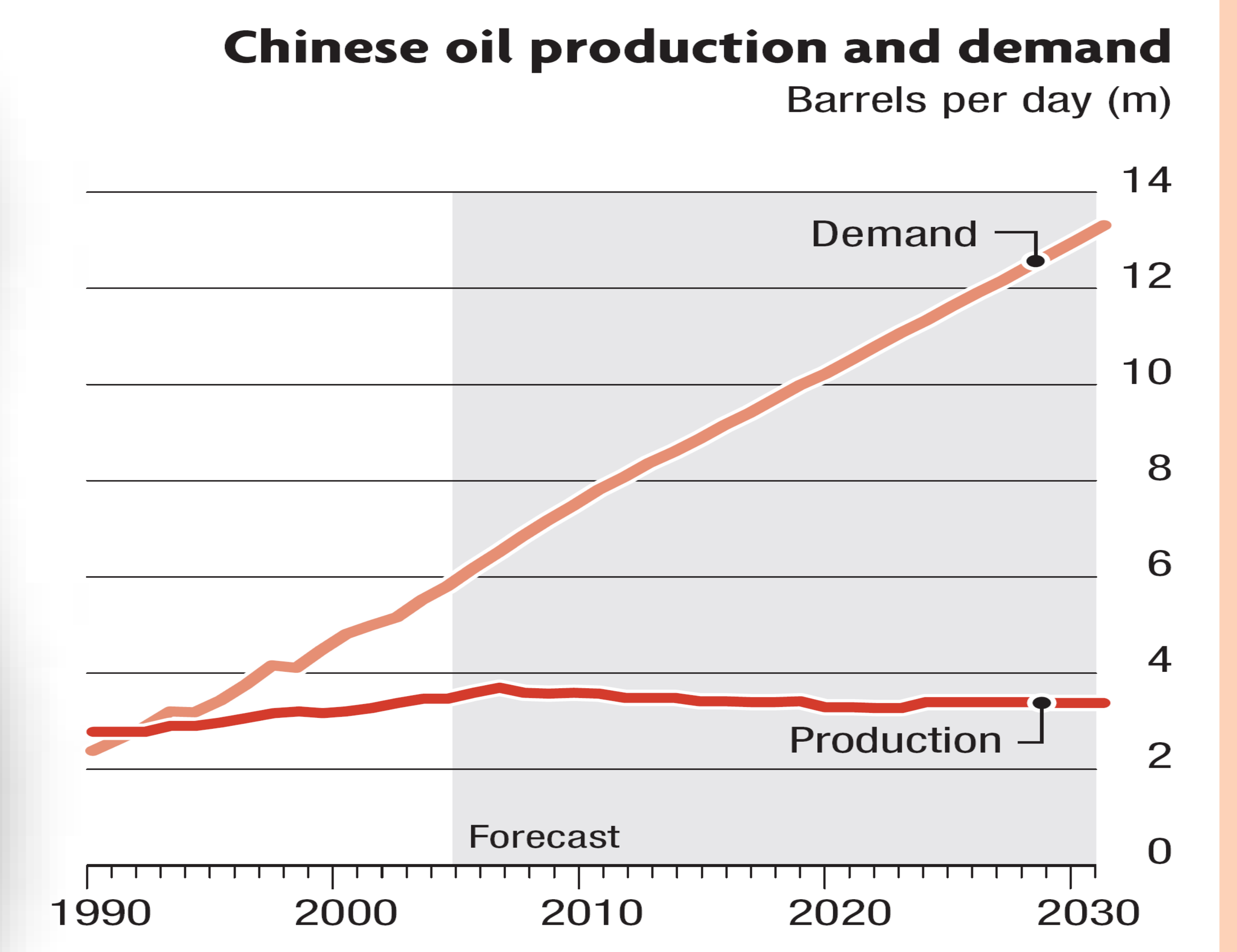

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➢ Monetary Policy could play a modest active role in this case

- In **Importing** countries, this is a supply shock. Monetary policy should not be tightened but rather moderately expansive.

- In **Exporting** countries, monetary policy could be contractive to reduce monetary impact of external surpluses, but main role is for a fiscal stabilization fund.

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What about current asset prices (stocks, bonds, real estate, precious metals, collectibles,etc.)?

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High asset prices do not just reflect excess liquidity but they ***<u>may be close to a new, higher, equilibrium level</u>*** due to:

(a) Well known rapid increase in productivity and corporate profitability

(b) Changes in **demand patterns** arising from persistent changes in **<u>factor income distribution</u>**

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We are Witnessing a Very Rapidly Growing World Labour Force.

- *It is estimated that China, together with India and Russia have duplicated the world labour force over the last 10 years (particularly of low-skilled labour)*

- **This increase in labour supply contains wage pressures at a global level (directly and indirectly)**

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The consequences:

1. **A sustained fall in the price of labour intensive manufactured goods with global CPI inflation contained across the world.**

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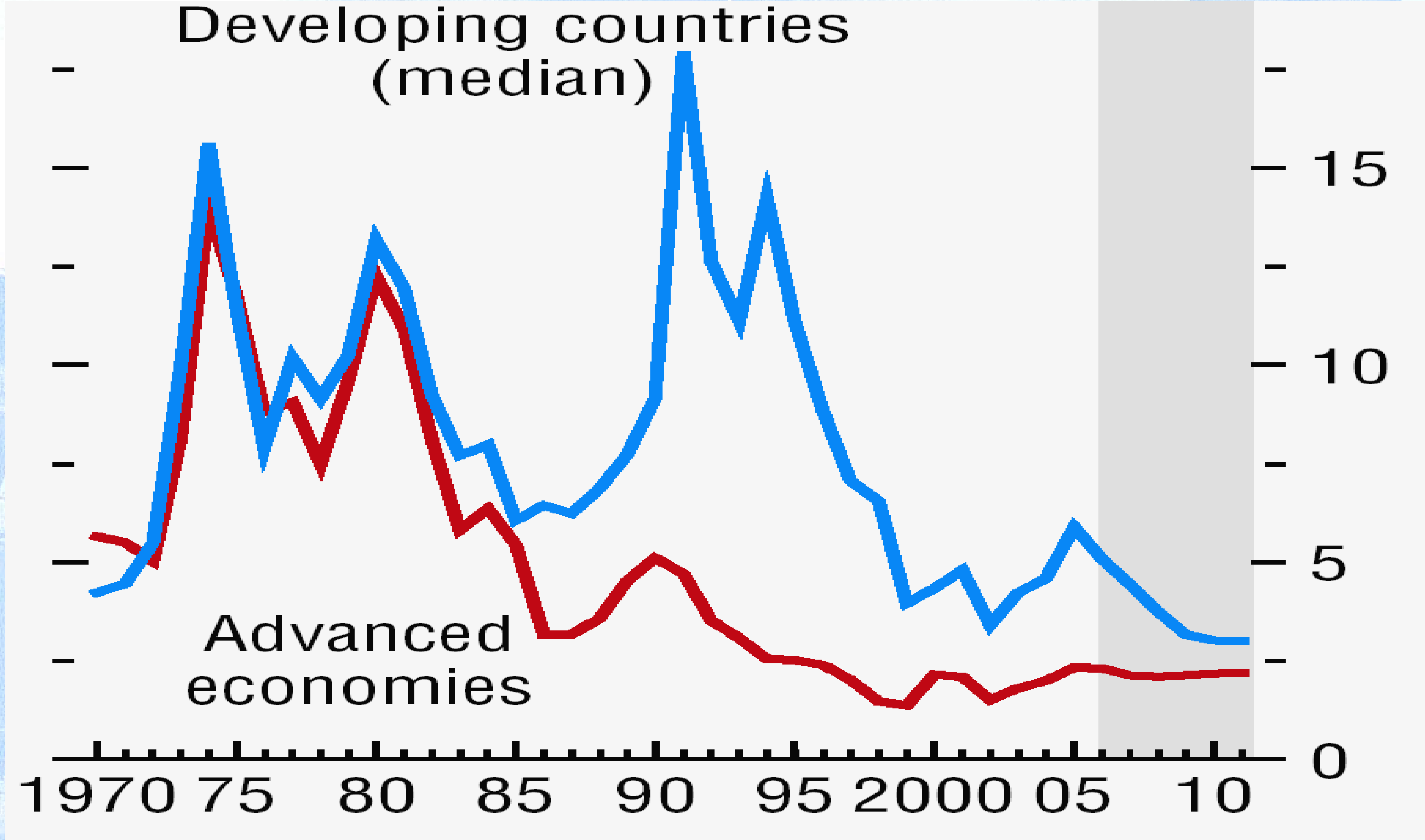
World Inflation



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The consequences:

1. **A sustained fall in the price of labour intensive manufactured goods with global CPI inflation contained across the world.**
2. **The increase in labour supply pulls down global wages pushing up capital returns.**

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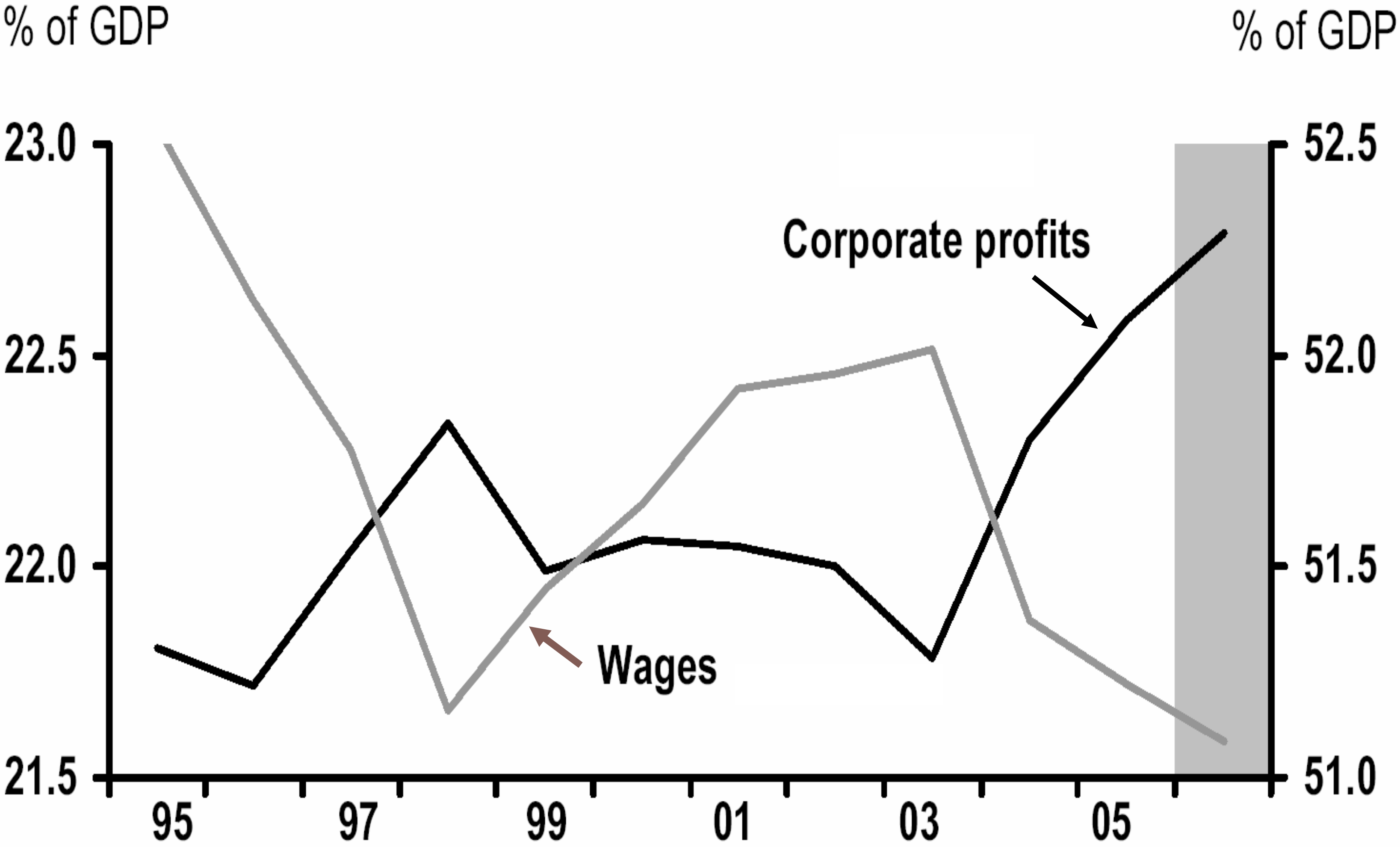
Euro area: wages and profits



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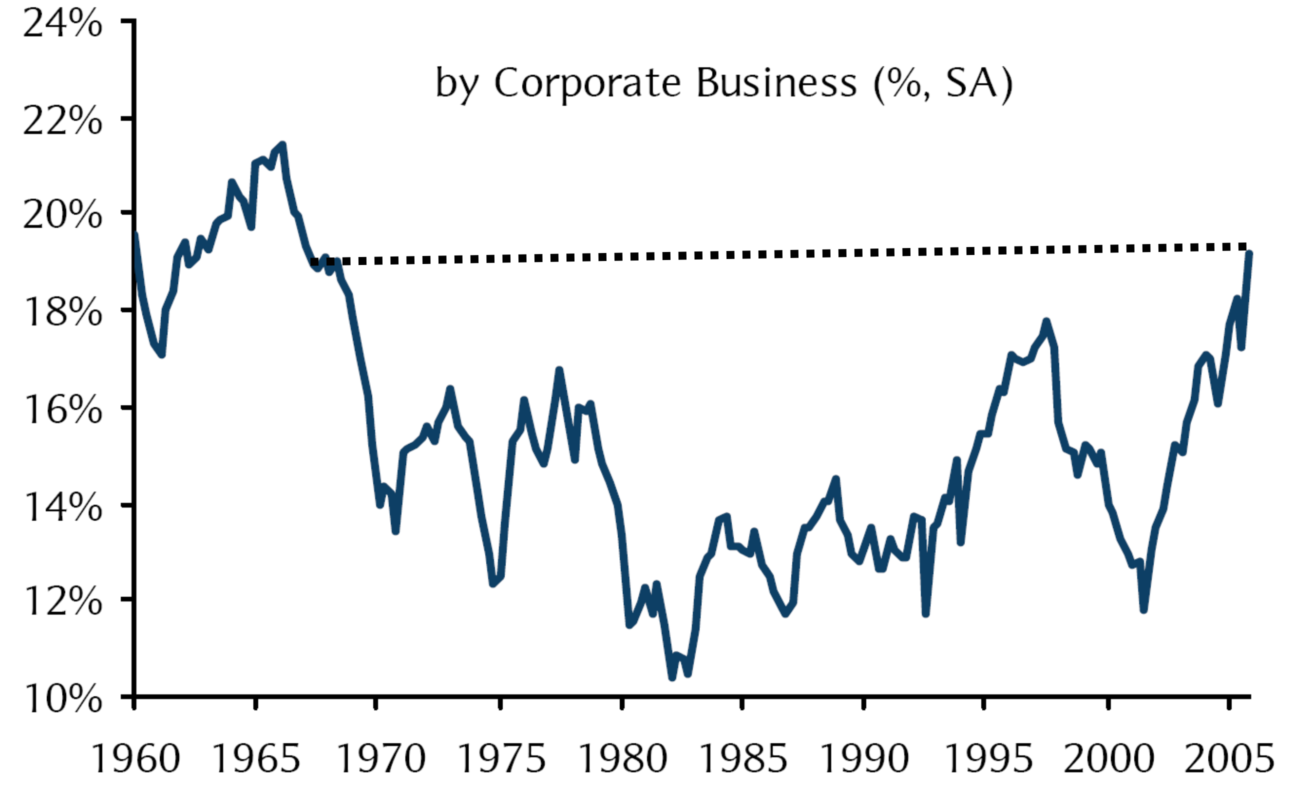
Corporate Profits as % of Gross Value Added by Corporate Business (%, SA) -- UNITED STATES



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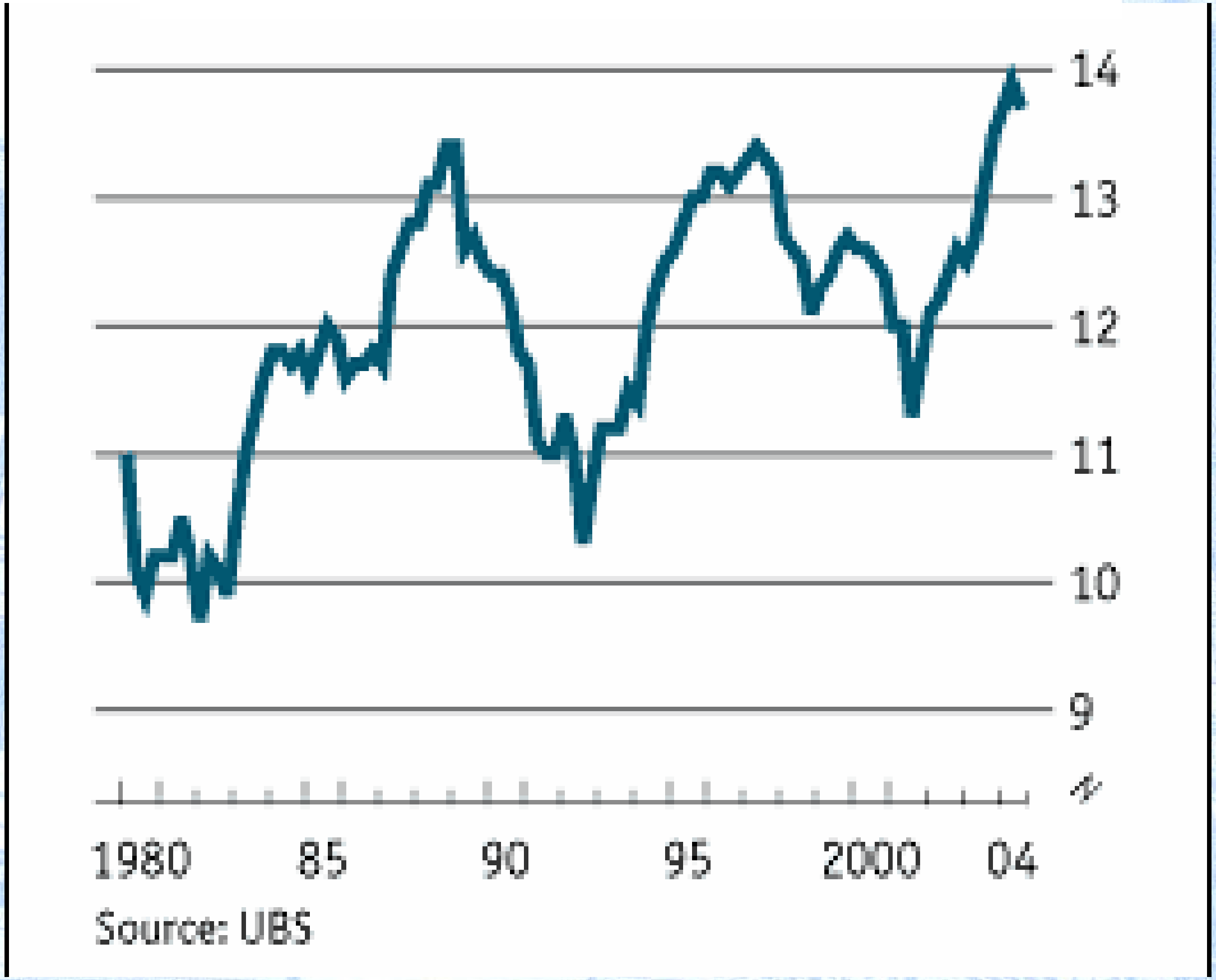
CAPITAL GAINS

G-7 Corporate Profits as % of GDP



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3. The distribution of income among wage earners is also affected due to the so called ***skill-biased technical change***

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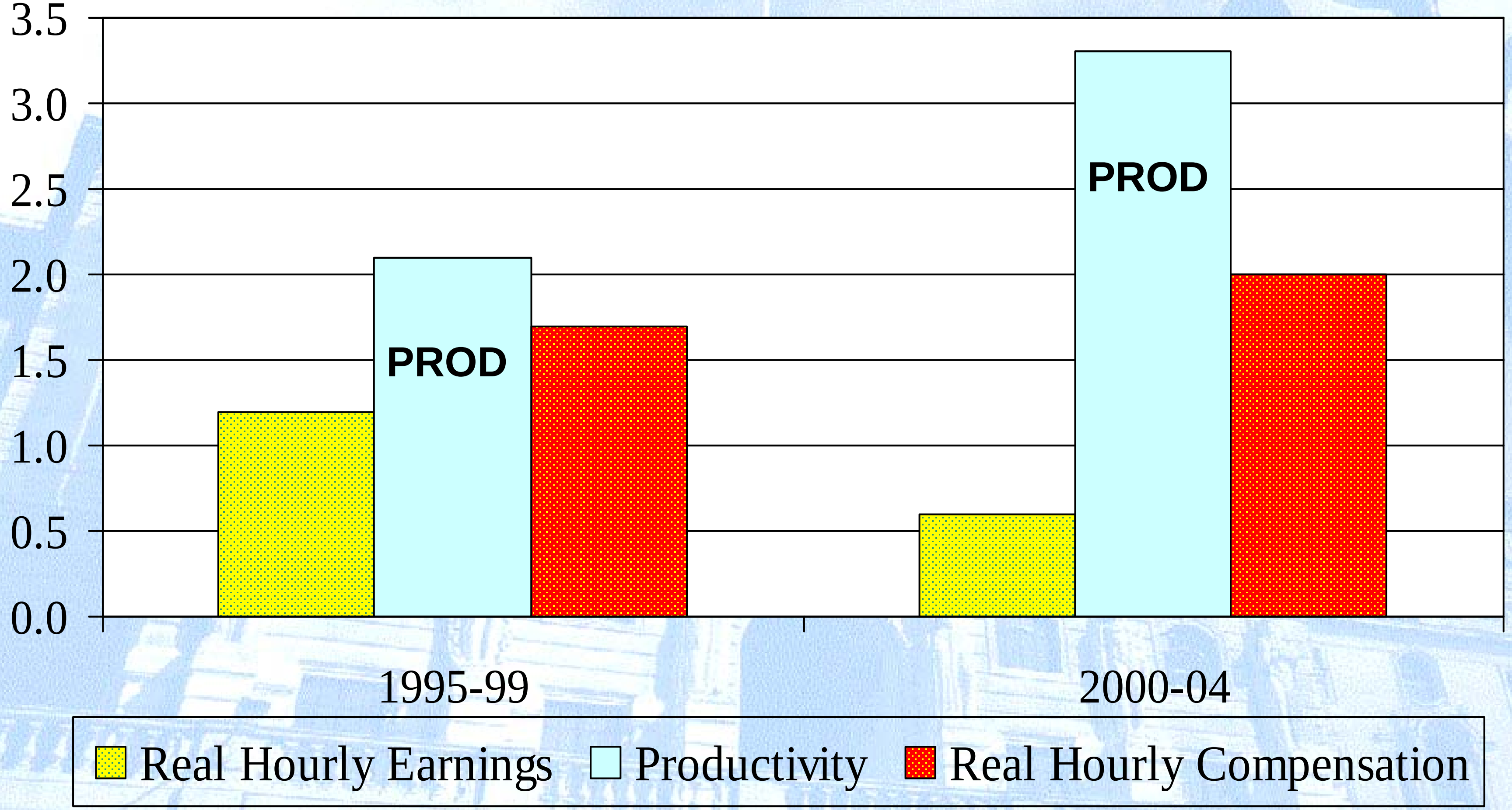
US: Real Salaries and Productivity



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<u>Facts (1)</u>

- **In the United States, over 1997-2001, <u>only the top 10%</u> of the income distribution had a growth of real wage equal or above the average rate of productivity growth.**

- **Median real wage and salary income <u>did not grow at all.</u>**

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Income Concentration - USA

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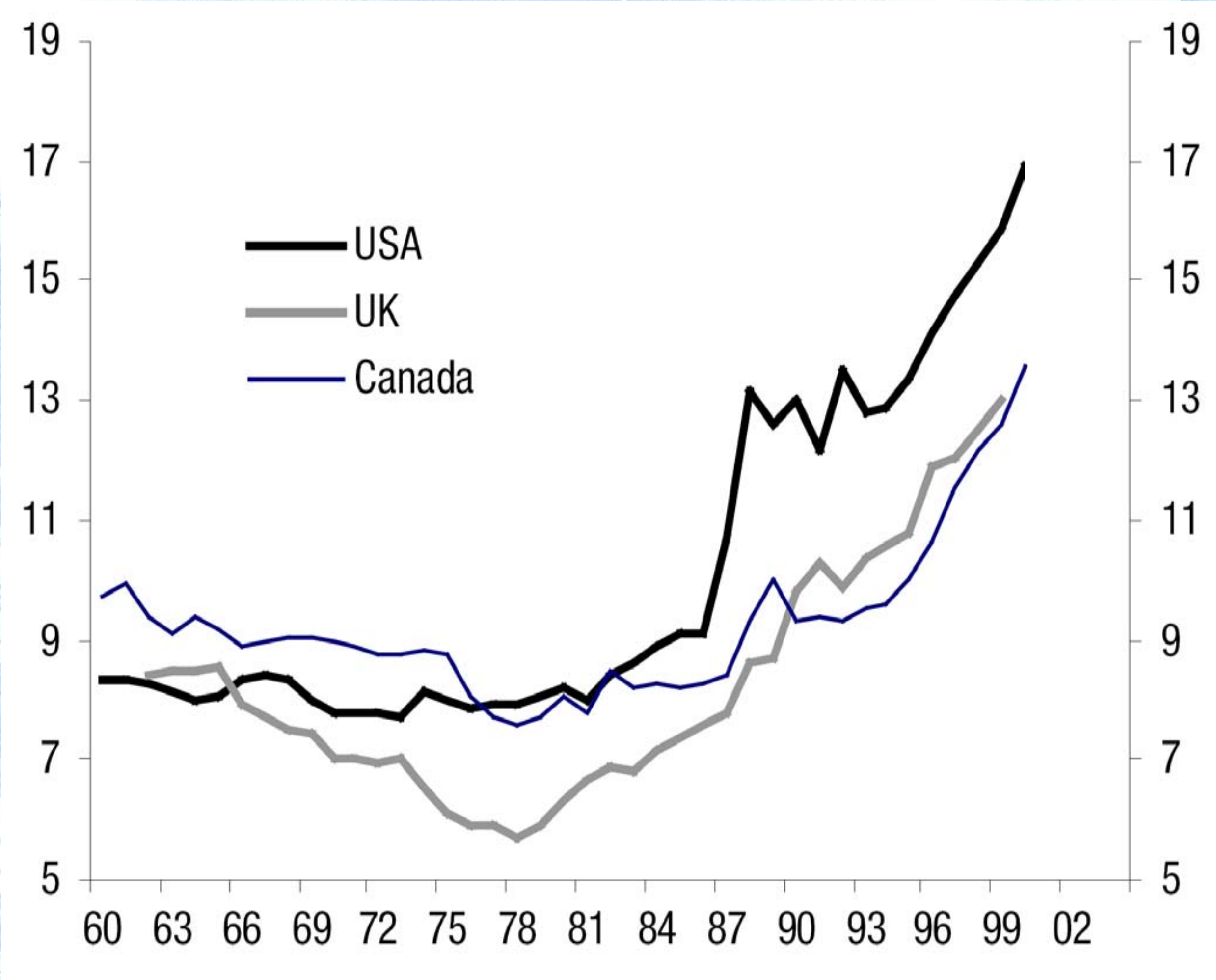
Income Share of the top 1%
USA, UK, Canada



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Facts (2)

- **The top 1% of households account for 33% of net worth (more than the bottom 90% put together)**

- **The top 1% of households account for <u>40% of *financial* net worth</u> (more than the bottom 95% of households put together)**

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Facts (3)

- **According to Merrill Lynch, the number of “millionaires” in the world grew by 6.5% just in 2005.**

- **Their assets, however, grew by 8.5% to an <u>estimated U$S 33.300bn</u>**
  (One in three have residences in more than one country)

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- **Given the different propensities (and ability) to accumulate assets, is this shift in income distribution that explains the increase in asset demand and the rise in asset prices.**

- **This also explains—unlike the IMF WEO claim—the <u>coexistence</u> of low CPI inflation and significant asset price increases.**

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According to the WEO the impact of globalization on inflation is only temporary:

"If policymakers do not change their monetary policy… the impact of the disturbances will only be temporary and…the falling prices in the sectors most affected by globalization will simply be offset by rising prices elsewhere, partly because consumers will use the related increase in purchasing power to boost their spending on other goods"

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However, if indeed asset price inflation coexists with stable and low CPI inflation, there is little role for monetary policy:

-- It is not a bubble

-- Monetary Policy cannot affect income distribution changes arising from global changes.

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Thank you

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