

Central Bankers and Asset Price Misalignments

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Central bankers do not like being told how to do their jobs. The advice that they should take more explicit account of asset price bubbles in their deliberations has been particularly unwelcome. But the recent experience tells us that performance could be improved if policymakers were to pay closer attention when share valuations and housing prices take unjustified trips into the stratosphere, and exchange rates make moves that are clearly impossible to sustain. Such was the case in Japan a decade ago when stocks and housing prices skyrocketed, in the U.S. during the internet bubble that peaked two years ago, and in the U.K. housing market today. Central bankers ignore these at their peril.

It is easy to see the consequences of policymakers averting their eyes in the face of asset price bubbles. When they are allowed to develop, significant asset price misalignments create distortions in the decisions of both companies and consumers. For firms, it becomes too easy to obtain financing. What happens is simple. The feeding frenzy of a bubble allows people to sell shares for prices that are impossible to justify. It is not much of a challenge to find examples of internet companies that were able to raise staggering sums of money in equity markets, only to crash and burn several years later. The funds they used could clearly have been better invested elsewhere. Not only that, but this episode has made it extremely difficult -- arguably too difficult -- for high-tech startup companies to obtain any financing at all. The structure of the economy takes years to get back to where it should be

The impact of stock and housing price bubbles on consumer behavior is equally damaging to the stability of the economy. Rising share and house prices increase individual wealth. And the richer we are the more of our income we spend and the less we save. When the bubble eventually bursts, wealth is recomputed and consumers are left with houses and mortgages that are too large for their paychecks, and investment accounts that are shadows of what they once were.

Central bankers know all of this. They are aware of the pathology of asset price bubbles, and the costs they extract when they burst, and yet they avert their eyes. Instead, policymakers take comfort in the advice that they should keep their eyes on inflation forecasts and ignore everything else. Doing otherwise, they say, would do more damage than good.

Policymakers marshal three arguments to justify their inaction. First, they say that there are times when different asset prices give conflicting signals. Housing prices may be rising too rapidly, requiring policy tightening, while the exchange rate may be overvalued, requiring policy easing.

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Interest rates can't be increased and decreased at the same time. This clearly complicates matters, but it does not imply that one should ignore them. Instead, it means that one should look at *all* relevant asset prices.

Second, the critics of this activist view argue that asset price misalignments may be a consequence of developments elsewhere and that policy actions may be unable to alter. My view is that, regardless of their source, bubbles are destabilizing. I am not arguing that policy should target any particular level of asset prices, and so the fact that these are determined abroad does not prevent reacting to them.

Finally, there is the most common argument, that responding to bubbles means estimating the extent to which asset prices deviate from fundamentals. How can anyone think that policymakers know better than the market what level of share and housing prices are warranted by long-term conditions?

I find this argument wholly unconvincing. Just because asset price misalignments are difficult to measure is no reason to ignore them. The normal response to noisy data is to use statistics to try to improve its quality, and barring that to respond with caution taking the uncertainties into explicit account. If central bankers threw out all data that was poorly measured, there would be very little information left on which to base their decisions. The proponents of the standard view do not make the same argument about the estimation of maximum sustainable growth or potential GDP, something that is equally difficult.

Central bankers should not willfully ignore developments in asset markets when there is a reasonable chance that they will create gross distortions in the investment and consumption decisions. People point to the property and equity bubbles in 1980s Japan as a clear case where policy did too little too late. I would add the U.S. in the 1990s to the list of missed opportunities for central bankers. Even as it was happening, there was really no question that the American equity prices were rising too fast and too far. Simple calculations suggested that share valuations implied an equity risk premium near zero. Put differently, the only explanation for the stratospheric prices was that future returns would be very low. The result was significant investment in ventures that even at the time looked fairly ridiculous.

What should the Federal Reserve have done? The answer is that they should have followed through on what they clearly believed at the time, and raised interest rates. With hindsight we can see that the crucial decision was in the spring 1997. Importantly, this would have meant going into the Asian crisis several months later, and the Russian default a year after that, with a higher interest rate base from which to ease slightly. But even more importantly, policymakers would not have given markets the green light that they would not stop the revelry that on the horizon. The price for this inaction will be low growth for some years to come.

Raising interest rates is never popular. This is particularly so when the rationale is that asset prices have risen to levels that central bankers view as unwarranted. Who are these people to say that our riches are undeserved? The answer is that the policymaker's job is to look out for the long-term welfare of society as a whole, and if that means raising interest rates in the face of high and rising equity or housing prices, so be it.