Response and General Discussion

David Laidler suggested that asset markets might provide data that could help central banks control inflation. Asset-price bubbles, however, are hard to recognize, and hard to do anything about. The lender-of-last-resort function is available if things go terribly wrong.

Laidler cited another aspect of monetary policy: its effect on the intertemporal allocation of resources. The wrong monetary policy can lead to savings–investment distortions. In this body of theory, a price level stabilized by the central bank would be insufficient to ensure monetary neutrality, and asset-price bubbles would be an early warning sign. Asset-price bubbles would be a consequence of central banks not paying enough attention to intertemporal coordination problems. Laidler suggested that there is empirical evidence supporting this argument for the United States in the 1920s and Japan in the late 1980s.

Laidler recommended that some attention be paid to Hayek, Robertson, and others who wrote during the 1930s. He thought that a dim intellectual memory of this analysis underlies some of the popular current analysis of these issues.

Steve Poloz noted a logical inconsistency between what central banks say about asset-price bubbles and what they should do about them—usually nothing. An exception is exchange rates, to which central bankers pay a lot of attention (in some countries more than others).

However, stock prices are just as difficult to model as exchange rates, and we would be just as uncertain as to whether there is a bubble in stock markets as in exchange rates. He concluded that perhaps we should pay as much attention to stock markets as to exchange rates.

John McCallum responded that he tried to make the distinction between a bubble and a stock-market bubble. The latter can be treated with benign neglect. History suggests that this kind of bubble is not very dangerous. However, if real estate prices were to shoot up rapidly as well as stock prices, then central banks would be more justified in raising interest rates.

Charles Freedman drew the distinction between exchange rates and stock market prices largely on the basis of their effects on aggregate demand. He said central banks should respond to those asset-price movements that strongly affect aggregate demand, because they will strongly affect inflation. He noted that exchange rates and interest rates do have such an effect. Real estate prices may have more effect on people's spending than do stock prices. However, if stock price increases were to lead to a massive surge in consumer spending, which in turn would affect future inflation, then clearly there would be something to worry about. In both cases, however, it is not the asset price itself that is relevant, but its effect on future inflation.

Freedman noted a second aspect to this concern. There are times when the Bank worries about extrapolative expectations and what they might do. One of the concerns about the exchange rate, at least in the past, has been that extrapolative expectations that built up in the exchange market subsequently fed into increases in medium- and long-term interest rates.

He argued that another important element is the lender-of-last-resort concern. If an asset-price bubble is being fed by a large surge of credit, and the credit is raising the risk level of banks in such a way that the whole intermediation process would be threatened by a downturn, then there could be legitimate concern. That concern, however, would be one for the supervisory authorities, not the monetary authorities. One must distinguish between price bubbles that have a macroeconomic effect, and consequently an effect on inflation, from those that could pose a problem for the financial system as a whole, perhaps a lender-of-last-resort problem. The latter sort of price bubble, however, is not really a monetary policy issue, but rather an individual prudential problem to be dealt with by bank regulators.

Frank Milne noted that asset-price bubbles make little sense in rational expectations models. As for the factors that may follow stock market crashes, in some cases they are warranted. He did not think that a case had been made for worrying about potential asset-price bubbles.