Information in Financial Asset Prices

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Central Bank Policy, Inflation, and Stock Prices

Ronald Giammarino

General Discussion

David Laidler noted that the Peso Problem nullifies the assumption that asset prices in the most recent period can be used to generate expectations of asset prices in the next period. He also said that not much can be learned from the Japanese experience with an asset-price bubble in the late 1980s because agents expected to be bailed out; this fact turned the situation into a one-way bet. He argued against bailouts.

Giammarino agreed with the Peso Problem argument, and noted that asset mispricing is more likely in the presence of subsidies and risk-shifting.

Charles Freedman noted that as much as central banks might want to include asset prices as part of their target, they back away from this idea because of uncertainty about the formation of asset prices and their relationship to central bank behaviour. The Japanese case at the time was represented as stemming from special factors. The real cost of capital was 1 per cent, but investors expected 14 to 15 per cent. He noted that we may have had a level shift in the price of assets. He also remarked that pricking an asset-price bubble may be beyond the capacity of central banks. If they are successful, they would be blamed for a collapse in asset prices; if they were unsuccessful, they would lose credibility.

In response, Lussier said that he does not expect the stock market to rise by 20 per cent over the next two years, but believes that, because of low inflation, risk premiums are low and will stay low.

Barker noted that 85 per cent of the money in mutual funds today has come in since the last bear market. Most investors have not seen a substantial correction, and may pull out if equity prices take a sudden tumble. Thus, the risks are high of being wrong about the existence of an asset-price bubble and the need to prick it.

Steve Oliner noted that corporate profits in the U.S. relative to GDP are the highest in 25 years.

John Grant said that there is a need to tell "fad managers" that they will not be bailed out.

In closing comments, Giammarino urged more work in the area by central banks and academics, and said he would like to see central banks evaluating Type I and Type II error costs. He expressed concern for pricking an asset-price bubble when it is not fully understood, and agreed that demographics are important worldwide for asset prices but starting values of wealth are also important.