General Discussion

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The organizers kindly gave me the liberty to talk about the big theme of this session—asset prices and monetary policy—and I would like to use that liberty! The two interesting papers that we have heard this afternoon have addressed two of the asset prices that central banks worry about—the exchange rate and equity prices—but of course there is a third that has attracted a lot of attention in some countries—including my own—and that is the price of property or real estate.

I would like to reflect on the main points raised in the two papers, but from the perspective of our experience in Australia.

So, the first big issue is how should central banks respond to changes in the exchange rate?

The basic thesis of the Globerman and Storer paper is that inflation targeting has made the exchange rate more volatile and that this volatility has had welfare-reducing microeconomic effects. As a result, the authors raise the possibility that we may need to give some direct weight to exchange rate movements in the formulation of monetary policy.

While I find this thesis interesting, it is not one that I find easy to agree with. At least from an Australian perspective, there is no evidence that inflation targeting has been associated with an increase in exchange rate volatility—if anything, volatility in the decade or so over which inflation targeting has been in place has been lower than in the previous decade. Even if this were not the case, I am not sure that monetary policy should be given the task of attempting to iron out distortions in cross-border prices. But this might simply reflect the fact that I live on an island with no large neighbours close to major population centres!

In my view, the more interesting question is how a central bank with an inflation target should respond to exchange-rate-induced changes in inflation or expected inflation. This is something that we have thought a lot about as we too have had quite large movements in our exchange rate. At a very high level of generalization, these movements are often associated with movements in the terms of trade. And as a result, by and large, they have been stabilizing for the real economy.

They have, however, raised issues for monetary policy. With wage growth and inflation expectations so well anchored over recent years, the inflation outcomes and forecasts have been driven, to a reasonable extent, by changes in the exchange rate. This is despite a significant decline in the speed and extent of pass-through. Our current estimate is that 10 per cent depreciation will ultimately add about 2 per cent to the price level, with the effect in the first year being around one-half of a per cent. Not so long ago, our estimates were roughly double.

It is useful to think about the situation in which the terms of trade decline and the exchange rate depreciates. These developments might be expected to increase the inflation rate above baseline for the first year or so as the depreciation feeds directly into prices, but then inflation might be expected to decline below baseline as the negative income effects of the terms-of-trade decline take hold. What is the appropriate monetary policy response in this situation?

One answer is that interest rates should be increased, because inflation is expected to increase over the relevant policy horizon of, say, eighteen months. It's not clear, though, whether this is the right answer. While higher interest rates would certainly help contain inflation over the forecast horizon, they would then add to the contractionary effects later on. In turn, interest rates would then need to be cut, perhaps aggressively. A more appropriate response may well be to leave interest rates unchanged, or possibly even to lower interest rates, even though inflation is expected to increase in the short term.

If I were to offer a stylized summary of our approach, it is that, where possible, we attempt to look through exchange-rate-induced changes in the inflation forecast when thinking about monetary policy. The exception would be where we thought that the exchange rate was telling us something about monetary policy. This approach means that we need to spend a fair bit of time trying to understand the drivers of exchange rate movements. This, of course, is no easy task.

One reason that we can have such an approach is that pass-through is relatively low. Another critical factor is that inflation expectations are so

well anchored. This means that when inflation either increases or decreases because of movements in the exchange rate, the public have not worried that the Reserve Bank of Australia has changed its objective. This has given us a degree of flexibility that we did not have in the past.

This approach, though, raises two general issues that I will come back to in the context of a discussion about equity and property prices, namely, (i) the importance of setting policy with medium-term considerations in mind; and (ii) the challenges of communicating the policy approach to the public.

So I would now like to turn to the second issue, that of equity and property prices. Robert Tetlow concludes that central banks are probably best off responding to asset-price bubbles only to the extent that they affect inflation and output. Responding directly to misalignments, given the uncertainties involved, is in many situations likely to do more damage than good.

When this conclusion is applied to equity prices, I have considerable sympathy with it. When we are talking about property prices, however, the situation is more difficult and the answers are less clear-cut, although many of Tetlow's arguments are still relevant and provide considerable reason for caution.

This difference between equity and property prices arises for a couple of reasons. The first is that property is a much more important source of collateral for loans than are equities. The second is that property is typically purchased with borrowed funds. Loan-to-value ratios of 90 per cent are not common—especially for house purchases—while, in contrast, equities tend to be purchased with much less leverage.

These two differences are important. They mean that a boom in property prices is likely to be associated with a boom in lending. This raises the possibility of concurrent bubbles—one in property prices and one in credit. The unwinding of these bubbles—although I prefer the less emotive language of financial imbalance—has potentially damaging effects on the economy. Of course, one cannot say with confidence that any imbalances will unwind, and on what timetable any unwinding will take place, but I think it is difficult to argue with the proposition that a big run-up in credit and property prices alters the balance of risks facing the economy.

If one is operating monetary policy in a paradigm that gives weight to the balance of risks, then there may be a case, in some limited circumstances, for policy to respond to these developments, particularly when it is able to affect the evolution of the imbalance. I note that this possibility is strictly ruled out in Tetlow's paper, as it is in Bernanke and Gertler (1999). This seems too great a simplification to me, particularly when one is thinking about debt-financed asset-price booms. When most lending is at variable

rates, higher policy interest rates can have a material effect on borrowing decisions, which, in turn, can have a material effect on asset prices and on property prices in particular.

The other over-simplification seems to be that bubbles are exogenous. Often, the types of booms that I am talking about are initiated by favourable supply-side developments that simultaneously boost growth and lower inflation. This complicates the issue considerably, because one can be simultaneously facing low inflation and booming asset prices and credit. In such an environment, lowering interest rates to ensure that expected inflation is at target is unlikely to be the right answer.

In general, the case for a monetary policy response to an asset-price/credit boom seems clearest in situations in which the boom is posing a threat to the stability of financial institutions. This was the experience of a number of countries, including my own, in the late 1980s and early 1990s. The risk, however, seems less likely these days, given the improvements in risk management practices within financial institutions, better supervisory processes, and better risk allocation within the financial system.

The more challenging case is where the developments do not pose a threat to financial institutions, but nevertheless pose a significant threat to the health of the economy. The concern here is that a debt-financed asset-price boom can sow the seeds for future problems. If at some point, asset prices correct and households and businesses reassess their debt levels, consumption or investment could be very weak as savings are rebuilt. The result could be that an otherwise mild downturn becomes something more serious. In this case, balance-sheet effects work not through distress in financial institutions, but through voluntary adjustments by the private non-financial sector. The effects, though, could be just as severe.

Some of the difficulties of using monetary policy to address asset-price imbalances are discussed in Tetlow's paper. One that he did not talk about, but one that I think is extremely important, is the need to persuade the public that such actions are appropriate and consistent with the central bank's mandate. Central banks have done a good job of persuading the public that they are rightly focused on inflation and have built a bond of trust with the public on that issue. Being seen to respond to credit or asset prices can be seen as a violation of that trust and inconsistent with the central bank's mandate.

Of course, one can argue that responding in this way should not be seen in these terms. In a different world, the public would understand that policy action to rein in a debt-financed asset-price boom, even though there was no immediate threat to inflation, was consistent with inflation targeting.

By reining in the boom, the possibility of a significant undershoot of inflation further down the track owing to a very weak economy could be lessened.

But this is a relatively sophisticated message and one that even many economists would probably not accept. Not surprisingly, the public have trouble with it, particularly as the first effect of any such response might be a fall in the price of the asset that they have just borrowed heavily to buy.

So where does this leave us? I would like to make three observations.

The first is that even if one thought that increasing interest rates to contain an unsustainable boom in credit and asset prices was the right thing to do, it is very difficult to persuade the public that such action is justified, unless there are clear signs of inflation emerging.

The second—and in contrast to the first point—is that if credit and asset prices are booming and inflation is below target, as is perfectly plausible, I think it is possible to persuade the public that lowering interest rates is not the right response. Provided the economy is growing satisfactorily, many people would accept the idea that throwing more fuel on the fire by cutting interest rates, just to bring inflation up to the target, may not be a sensible thing to do. This is not so much a policy of pricking a bubble, but rather one of not unnecessarily adding to the boom with monetary policy.

The third observation is that I think we would be better off, at least at the margin, if central banks were able to persuade the public that inflation targeting is more than simply about ensuring that the inflation forecast is at the target at the policy horizon. What is important is that central banks deliver low and stable inflation over time, with the average rate of inflation being consistent with the stated objective. Clearly what happens beyond the standard forecast horizon of eighteen months to two years is important. While it may be difficult to extend point forecasts beyond this horizon, the same cannot be said for risk assessments. Arguably, these more medium-term risk assessments should occasionally play as critical a role in the setting of interest rates as the shorter-term forecasts. Such an approach would allow central banks to respond flexibly to both exchange rate movements and booms in credit and asset prices. But if central banks are to use this flexibility, they need to do so in a way that does not threaten the public's confidence that they are serious about containing inflation and that they will maintain the bond of trust that they have fought so hard to build. One way of doing this is to discuss frankly with the public the merits of a flexible approach to inflation targeting that focuses on average outcomes and medium-term risks, not just point forecasts. Conferences like this one are an important step in this direction.

Reference

Bernanke, B.S. and M. Gertler. 1999. "Monetary Policy and Asset Price Volatility." In *New Challenges for Monetary Policy*, 77–128. Proceedings of a symposium held by the Federal Reserve Bank of Kansas City, August 1999.