Should policy makers control bubbles?

In the aftermath of the dot com crash in the early 2000s there was much talk as to whether policy makers should have acted sooner to prevent stock prices from rising to the extent that they became over-valued. There are several reasons why intervention to prevent a bubble from forming and then gathering pace may be considered beneficial.

First, the larger the bubble becomes the more likely that the economy will suffer a harder landing when the bubble finally bursts. If air can be let out gently, then any output loss or recession generated by falling asset prices would be correspondingly milder.

Second, the longer the bubble is allowed to persist, the more likely it becomes that there is a build up of other imbalances in the economy. The most prominent of these is investment. High asset prices give firms the signal that investment is expected to yield greater future profits. The large rise in US business investment during the bubble years tends to confirm this. However, if asset prices are dictated by a bubble factor rather than fundamentals about future cash flows generated from the firm's capital stock then over-investment equilibrium is produced. Following a collapse in asset prices there is then an investment over-hang, where firms realise that their current capital stocks far exceed the optimal or efficient levels. Weak investment can then persist for several years.

A second form of imbalance can arise in the household or personal sector. Strong growth in asset prices can justify a fall in the saving ratio. When the rate of return on equities is high (due to strong capital gains) lower initial investment is required to generate a given level of future income, which in turn frees up more resources for current consumption. However, if asset price growth slows, or even becomes negative due to a bursting bubble, then households will revaluate the balance of saving and consumption. A rise in the saving ratio would be the likely outcome, and thus a fall in consumer expenditure which is the counterpart to saving. Given that most pension funds are heavily invested in equities this effect may have longer-term consequences.

In both cases, controlling the extent to which a bubble develops will limit the potential for any imbalances to adversely affect the economy going forward. So why didn't policy makers intervene sooner? The obvious response would have been for a tightening of monetary policy. Raising interest rates leads to future asset returns being discounted more heavily, putting downward pressure on current market prices. During the late 1990s many commentators acknowledged that US asset prices might be rising far in excess of recognised fundamentals, but there was no interest rate response from the US Federal Reserve.

The chairman of the Federal Reserve at the time- Alan Greenspan- offered two defences for the passive reaction of monetary policy. Firstly, it was not evident that the rise in share prices during the 1990s was a bubble. There were many structural factors that led to the belief that a step change in US asset prices was rational. US productivity growth picked up substantially during the late 1990s, largely attributed to the influence of 'New

Economy' technologies, or the ICT (information and communication technologies) revolution. Also, the war against inflation that raged vehemently in the 1970s and 1980s appeared to have been won. With inflation comfortably anchored at low levels a new era of low interest rates was foreseen. It is only with the benefit of hindsight that we can be sure a bubble existed.

Secondly, even if a bubble was detected what should the Fed do? A small increase in interest rates may have little or not affect. However, if interest rates are raised too aggressively then instead of letting steam out the bubble monetary policy-makers may precipitate a worse crash than if the bubble was just left to burst under its own natural causes. Due to the inherent uncertainties in detecting and then prescribing the right interest rate dosage there is a good justification for doing nothing.

The issue of whether and how central banks should respond to asset price bubbles though remains. Following the collapse in share prices in the early part of the new millennium, a second bubble appears to have developed in global housing markets. The UK experienced strong growth in house prices, with the ratio of average house prices to income levels reaching record levels. House prices are a highly sensitive issue in the UK, where owner occupation is relatively large. Also, the boom in house prices during the late 1980s and subsequent crash in the early 1990s sticks in the memory, especially due to the severe recession, numbers of repossessions and the extent of negative equity that resulted.

The large recent increase in UK house prices has seen some pressure put on the Bank of England to try and prevent a bubble from forming so as to guarantee a soft landing in the housing market. However, the same justification for doing relatively little used by the Fed in the late 1990s has been used by the Bank of England in response.

Is this reaction likely to change? The priority of most central banks is to hit an inflation target and interest rates are the policy directed to achieve this. It is therefore difficult to justify an increase in rates at a time where inflation has been maintained at relatively low levels and within the bounds determined by inflation targets. Most inflation targets though are long run targets, and there is a recognised lag in the effect of interest rate changes feeding trough to the real economy. The key is often to set interest rates today so that the inflation target is reached in 1-2 years time. If an asset price bubble is allowed to persist and then burst, it could lead to a substantial undershoot of inflation from target in the future. Therefore, within the mandate of central banks there is some imperative to try and deal with bubbles as and when they occur. As a result, several central banks have incorporated bubble scenarios into the macroeconomic models used to generate inflation forecasts. However, this remains a difficult task and it remains to be seen whether central banks will intervene more rigorously in the future to dissipate perceived bubbles in asset prices.