

# Asset Price Bubbles (*Introduction*)

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The financial crisis has turned the attention of economists to asset price bubbles, or, more generally, to financial instability. It has become clear that these phenomena can appear even in a low-inflation environment and that they are highly detrimental to the real sector of the economy. The question has been logically raised to what extent central banks should – and can – change their previous attitude of “benign neglect” toward asset price bubbles and financial instability. A consensus on the need for a new paradigm of monetary policy is clearly emerging among many monetary policy experts (see, for example, Bean et al., 2010, or Woodford, 2010).

Inflation targeting, which has been adopted by the vast majority of central banks in advanced countries in the last two decades, has been very successful in keeping inflation at low levels and affecting inflation expectations. However, several bubbles that have emerged in that period have raised the question of whether central banks should, in addition to curbing inflation, pay attention to asset price bubbles and try to “prick” them in time (Roubini, 2006).

The economic mainstream, represented, for example, by Ben Bernanke even before he became chairman of the Fed, argues that central banks should focus primarily on underlying inflationary pressures and that asset prices can only be relevant to the extent that they represent a threat to inflation (Bernanke and Gertler, 2001). In addition, it points to the difficulty of identifying a bubble in asset prices and to the lack of special instruments that monetary policy can use without jeopardizing its main goal – the inflation target. It sees no way of pricking a bubble without decelerating the whole economy. Another problem is the timing of the central bank reaction and the time delays involved. Given the time lag between interest rate hikes and their effect on the real economy, there is a high probability that a policy rate change will be mistimed and make the situation worse.

Another group of economists, nevertheless, was, and is, proposing a more active monetary policy approach to asset bubbles (Cecchetti et al., 2000). They argue that central banks should take account of the implications of asset price changes for inflation and for hitting the target, and should try to lean against the bubble. Central bank policy that takes into account not only inflation and output gaps, but also the movement of asset prices, could, in their opinion, exist and would even be superior in controlling inflation. Specific recipes, however, are still missing or less clear (with the possible exception of micro-prudential regulation of financial institutions).

In the last financial crisis it became obvious that the problem of asset price bubbles should be seen rather as a broader problem of financial instability, and that its solution would require an innovative way of including the behavior of the financial sector in the framework and models of monetary policy (Mishkin, 2010). The opinion is gaining ground that central banks should guarantee not only low inflation, but also financial stability, as financial stability is no less vital for prosperity in the real

sector of the economy. The snag is that everybody can see what financial instability is, but nobody can define it in a precise way.

This issue of the *Finance a úvěr-Czech Journal of Economics and Finance* focuses on the topic of asset price bubbles and financial instability by presenting several papers by Czech authors examining these problems from various points of view. Special attention is paid to the effects on a small open economy and to specific implications for monetary policy. At the same time, the papers present and evaluate the existing literature on this topic, including the main empirical research results published to date.

In the first paper “Monetary Policy in a Small Economy after the Tsunami: A New Consensus on the Horizon?” *Jan Frait, Zlataše Komárková, and Luboš Komárek* focus on the debate concerning the relationship between monetary policy, asset prices, and financial stability in the last 20 years. Besides surveying the literature from both the academic and central banking communities, they attempt to extend the debate to the small open economy context, building extensively on the writings of the Bank for International Settlements economists such as Borio, English and Filardo (2003). They conclude that we are in the middle of a shift from benign neglect to “leaning against the wind” and that such a shift may institute fundamental changes to the existing monetary policy paradigm. The new consensus can be illustrated as an amended model of flexible inflation targeting in which the central bank “should sometimes lean and can clean”. Financial stability becomes a separate objective of the central bank, affecting its short-term behavior without changing its long-term commitment to price stability. Until the new consensus becomes embodied in both the macroeconomic models and monetary policy frameworks of central banks, those responsible for monetary policy-making may occasionally need to work in a creative way above and beyond the currently available models.

In the second paper “The Classification and Identification of Asset Price Bubbles” *Luboš Komárek and Ivana Kubicová* summarize approaches to and options for identifying disequilibrium asset price movements in the economic literature (see, for example, Brunnermeier, 2007). The paper takes into account mainly stock prices, real estate prices, and exchange rates. Further, it focuses on theories relating to the emergence, dynamics, and persistence of asset price bubbles, and it also theoretically discusses mainstream methods for identifying such bubbles. Finally, the authors offer an effective procedure for monitoring and early identification of asset price bubbles. They recommend using all the available tools, from charting methods via one-equation fundamental-based models, to complex and structurally rich models.

The third paper, by *Petr Zemčík*, is entitled “Housing Markets in Central and Eastern Europe: Is There a Bubble in the Czech Republic?” The paper analyzes the relation between Czech real estate prices and rents using panel data stationarity techniques. The data used span the period from 2001 to 2008. Regardless of the specification employed, the price-to-rent ratios are not stationary. This indicates evidence of overpriced real estate in the Czech Republic. However, the degree of overpricing seems small. Therefore, one can expect a minor decline of prices in some locations, and stagnation in others, and not the type of collapse observed in the U.S., Spain, or Britain.

The next paper – “Regional Analysis of Housing Price Bubbles and their Determinants in the Czech Republic” by *Michal Hlaváček and Luboš Komárek* – is based

on an empirical analysis. It tries to identify periods of property price overvaluation by three alternative approaches. The analysis identifies overvalued property prices in 2002/2003 and partly also in 2007/2008. However, the size of the housing price overvaluation in 2007/2008 was relatively low. From the regional perspective, there is a tendency for a higher degree of overvaluation in regions with higher property prices. The exception is Prague, which seems to be a specific region. The recent decline in apartment prices in the Czech Republic is seen as a return to equilibrium. Nevertheless, a further worsening of the impacts of the global financial crisis on the Czech economy could lead to renewed inflation of the asset price bubble “from below” via weakened fundamentals. An overview of empirical studies related to housing price bubbles can be found in Girouard, Kennedy, Noord, and André (2006).

In the final paper, “Real Implications of Bursting Asset Price Bubbles in Economies with Bank Credit”, *Alexis Derviz* studies the consequences of equity mispricing (a bubble) and the correction thereof (the bubble bursting) for the real sector of the economy. Producers financed by both bank credit and equity face a mix of systemic and idiosyncratic uncertainty from which bubbles can arise. The paper explores the ability of a macroprudential policy instrument to dampen the consequences of a burst bubble. The author finds that such policies are more successful in suppressing equity price swings than output fluctuations. At the same time, the use of such policies may entail tangible welfare costs. The fine-tuning of capital charges as a function of corporate governance on the borrower side would be less costly.

We hope that this issue will be useful. The reader might appreciate the fact that besides presenting the latest research results, it also defines the open questions as a challenge for future research. We invite readers to supply their papers on this topic, as well as other valuable contributions on topical problems of economics and finance.

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