Asset Price Booms
How Can They Best Be Managed?

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Unfinished development in Maryland, United States.

Not all booms are alike—making the right call on which policies to deploy depends on how assets are held and who is exposed to a possible bust

ASSET price booms are fairly common occurrences in market economies. One of the first to be documented was the tulip mania of 1637 in Holland, when, at its peak, contracts sold for more than 10 times the annual income of a skilled craftsman. One of the most recent was the U.S. housing boom of the past decade, whose bust triggered the current global economic crisis.

But not all booms are alike. Some booms have been associated with crises and episodes of financial distress. But others have led to growth and the creation of tangible long-term assets, such as during the "railway mania" that took place in the 1840s in Britain. The scope and severity of the current crisis have reignited the debate over whether economic policy should be concerned with asset price booms and increases in leverage. If so, does this fall under monetary policy or should the burden be on regulatory measures? What, if any, should be the role of fiscal policy? This debate will continue to occupy economists and policymakers for a while, but a few preliminary conclusions can be drawn.

Leveraged booms more dangerous

What matters may be not so much the asset price boom in itself, but who holds the assets and the risk, how the boom is financed, and how an eventual bust may affect financial institutions. The degree of leverage associated with the funding of a boom and the degree of involvement of banks and other financial intermediaries will determine the magnitude of balance sheet effects and the dangers to the supply of credit in a bust.

As we have learned in recent months, busts are far more costly when banks are implicated in the boom and prices are supported through credit from highly leveraged institutions. This is because when asset prices deflate, the balance sheets of borrowers, and thus those of banks, deteriorate sharply (especially when maturity mismatches are pervasive), resulting in a credit freeze that can have a severe impact on economic activity. During an upswing, higher collateral values relax credit constraints. The resulting increase in credit in turn contributes to fuel the rise in asset prices. The opposite spiral can ensue in a downswing, as falling collateral values prevent borrowers from obtaining credit, further depressing asset prices (Kiyotaki and Moore, 1997).

In contrast, booms with limited leverage and bank involvement tend to deflate without major economic disruptions. For example, the bust of the dot-com bubble in 2001 was followed by a relatively mild recession. In that boom, banks played a minor role. The sharp fall in stock prices did have a wealth effect, but it didn't result in the kind of negative feedback between deteriorating borrower and lender balance sheets that has characterized the current crisis. For this reason, it did not result in the weakened banking system and impaired supply of credit we are witnessing now.

Assuming that policymakers have decided a dangerous boom is building and want to deflate it before it wreaks havoc on the real economy, what tools are at their disposal?

Stronger focus on macrofinancial stability

The first approach has traditionally been monetary policy. But central bankers are cautious people, and most of them remain wary of using interest rates to deflate asset price booms. Those in favor of benign neglect argue that central banks should focus on inflation (and, if so mandated, on growth). Asset prices can be monitored for useful information on the state of the economy (for example, quickly rising asset prices can signal more generalized inflationary pressures), but should not be targeted in themselves.

This view rests on four main arguments:

- The role of monetary policy is to control inflation.
- It is difficult to identify asset price booms.
- Monetary policy may be too blunt a tool.
- Policy intervention can do more harm than good.

For these reasons, the argument goes, monetary policy is better suited for picking up the pieces after a bust than preventing a boom from building up in the first place.

But as the current crisis has shown, boom-bust cycles can be very costly. And it has shown us that the traditional policy levers—reducing interest rates and pumping liquidity into the economy—don't work well when the financial system is seriously impaired. Furthermore, although speculative booms may indeed be difficult to identify with certainty, this task can be made easier by narrowing the focus to episodes involving credit and the banking system. In addition, even if spotting "bad" booms is difficult, it may be best to undertake policy actions on the basis of a judgment call (as with inflation) if there is a real risk that inaction could result in a catastrophic scenario. It follows that—to the extent that the buildup of systemic risk can portend a sharp economic downturn, and to the extent that regulation cannot fully prevent such a buildup—central banks cannot follow a benign neglect approach to asset price and credit booms. Price stability should be an objective within a wider mandate for macrofinancial stability.

Yet monetary policy alone may be too blunt to deal effectively with speculative booms. Would you want to put a million people out of a job because your banks are too highly leveraged? In addition, during booms, the expected return on assets is much higher than what can be affected by a marginal change to the interest rate. Capital account openness further limits the effectiveness of interest rates—people and companies seeking loans can, for instance, just take their business to the branch of an international bank. This is especially true in small open economies and in countries with more advanced financial sectors, where banks have easy access to foreign credit. Tighter monetary conditions are also likely to attract foreign capital and further fuel the demand for coveted assets.

So because the main problem with booms is the potential for widespread bank failures, prudential and administrative measures may offer a more targeted solution. They should, therefore, be a central element of an integrated policy response.

Better regulation can help

A major problem is that existing regulatory tools do not dampen the procyclicality of financial markets and the build-up of leverage. In fact, quite the opposite.

Prudential regulation has largely failed to prevent the buildup of systemic risk during good times and tends to aggravate economic downturns. Existing regulations require banks to hold more capital during downturns as risk measures increase, when capital is already depleted. The internal-ratings-based approach under Basel II contributes to this problem because default probabilities are likely to be countercyclical (Repullo, Saurina, and Trucharte, 2009). This forces banks to cut back on lending and thus contributes to a worsening of the downturn.

To be effective, regulations should provide incentives to firms to smooth the impact of macroeconomic shocks. But the question of how to design effective countercyclical prudential policies is one economists and policymakers have only recently started to address.

In designing such policies (IMF, 2009), authorities should consider the following:

- ***Introducing shock absorbers.*** Countercyclical capital regulation and loan loss provisioning requirements could play an important role in fighting booms.
- ***Limiting leverage.*** To prevent excess leverage during upswings, risk-weighted capital requirements could be accompanied by relatively simple, but explicit, limits on leverage.
- ***Limiting property lending volatility.*** The volatility of property lending could be reduced through countercyclical loan-to-value limits. These could be based, for instance, on output growth, house pricing dynamics, or aggregate house-related lending. Stricter loan requirements could restrain the rapid growth of unhedged foreign currency credit.
- ***Limiting risk taking.*** Policies could target specific sources of risks, for instance, by requesting tighter eligibility and collateral requirements for certain types of loans and imposing limits on foreign exchange exposure.
- ***Discouraging excessive lending and borrowing.*** This could be done by eliminating implicit foreign exchange guarantees or fiscal incentives for particular types of loans and through public risk-awareness campaigns (Enoch and Ötker-Robe, 2007).
- ***Monitoring problem banks.*** Finally, measures that improve the economy's ability to withstand busts should be introduced. Such measures include more intensive surveillance of potential problem banks and stronger disclosure requirements of risk-management policies. It's worth remembering that before the crisis, the widespread belief was that securitization had transferred risk outside of the banking system.

Designing and implementing such rules will not be easy (see "Europe under Stress," in this issue), especially in a globalized world. Financial integration limits the effectiveness of unilateral measures because individuals and companies can circumvent restrictions by transferring their money to offshore centers and foreign parent banks.

What is needed, of course, is more international cooperation. Measures will be more effective if supervisory agencies work together to close loopholes, for instance, by preventing people from switching from domestic lending in foreign currency to direct foreign credit. This type of cooperation will be increasingly vital as financial systems become more integrated.

Taxing away the boom

The last tool at the disposal of policymakers is fiscal policy. Fiscal measures can help contain booms. By reducing overall demand, a tightening of fiscal policy can stem the buildup of vulnerabilities. Taxes can, in particular, impact asset prices, but they are blunt instruments, and it remains controversial whether tax increases should be used to contain booms.

Still, the current crisis should prompt policymakers to reexamine long-standing measures favoring leverage, such as allowing deductions for mortgage interest payments. Even though most observers believe that fiscal policy played little role in the current crisis, tax rules in many countries have clearly been conducive to high levels of household and corporate debt, possibly increasing macroeconomic vulnerabilities. Tax provisions may also have affected the level, growth, and volatility of key asset prices, raising questions as to whether discretionary tax policy could have a role in dampening or supporting such prices. The effect of mortgage tax relief is a case in point.

The way forward

An emerging boom can be hard to spot, and coming up with an effective policy response is difficult, which explains why policymakers have tended to shy away from firm policy action.

Bank-financed booms can lead to busts that can disrupt the supply of credit to the economy, as we have learned the hard way. Other booms, such as stock market booms, can more safely be left to take care of themselves. The lesson from the current crisis is clear: if the boom is being inflated through increased leverage provided through the financial system, policymakers should think twice before deciding to stay on the sidelines.

The case for policy intervention depends on how a boom is financed and how risk is held. Boom episodes with limited leverage and financial intermediary involvement tend to deflate without major economic disruptions. The risks for the economy are greater when the asset price upswing is fueled through leverage and risk resides primarily within the banking system.

A mix of policy tools is likely to be the best way of deflating a boom. In future, monetary policy will have to take asset price booms and financial stability more into account. But the policy response has to involve greater recourse to new flexible prudential measures aimed at limiting the procyclicalities of financial intermediation. ■

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