Key points

- Monetary policymakers should put more emphasis on macrofinancial risks. This would imply tightening monetary conditions earlier and more vigorously to try to prevent dangerous excesses from building up in asset and credit markets, even if inflation appears to be largely under control.

- The chapter shows that past asset price busts were often foreshadowed by rapidly expanding credit, deteriorating current account balances, and large shifts into residential investment. With inflation typically under control, central banks effectively accommodated these growing imbalances, raising the risk of damaging busts.

- Taking a broader approach to monetary policy will be challenging. Expanded mandates and new sets of policy tools may be required. Policymakers will need to employ judgment to look at what is driving asset price movements and discretion to avoid costly policy mistakes. Crucially, expectations will need to be realistic, as it is inherently difficult to distinguish between unsustainable and sustainable asset price movements.

The chapter seeks lessons for monetary policy from recent experiences of asset price busts. It studies historical evidence to see whether there are consistent macroeconomic patterns leading up to asset price busts (see Figure 1), examines the role of monetary policy in the build-up to such busts, including the latest crisis, and asks whether monetary policy should be responsible for more than just the stability of goods price inflation, how this could be done, and what the potential trade-offs are.

It finds that monetary policy was not the smoking gun behind the current crisis. There is some evidence for loose monetary policy in the years leading up to the current crisis in some countries, but it is not likely to have been the main systematic cause of the
booms and consequent busts across the global economy. Differences in monetary policy settings across countries do not correlate well with differences in house and stock price growth (see Figure 2).

However, there were warning signs ahead of the current crisis that monetary policymakers could have heeded. Central banks fulfilled their mandates—inflation in advanced economies stayed within a narrow range in the lead-up to the current crisis. But central banks accommodated the relaxation in financial conditions, raising the risk of a damaging bust. Credit, shares of investment in GDP, current account deficits, and asset prices typically rise ahead of asset price busts, providing useful leading indicators of asset price busts. By contrast, inflation and output do not typically display unusual behavior (see Figure 3).

Thus, monetary policymakers could usefully place greater emphasis on avoiding asset price busts. Model-based analysis suggests that stronger-than-usual monetary reactions to signs of overheating or of a credit or asset price bubble could be warranted to reduce macroeconomic volatility. This would imply tightening monetary conditions earlier and more vigorously to try to prevent dangerous excesses from building up, even if inflation appears to be under control.

Introducing time-varying “macroprudential” instruments designed specifically to dampen credit market cycles could help monetary policy. Some proposals include so-called “dynamic provisioning”, in which financial institutions automatically set aside more capital as leverage rises, or for policymakers to have discretion over required reserves. For best effect, the setting of monetary policy and macroprudential instruments should be tightly coordinated.
Central banks’ mandates may need to be expanded to include explicit concerns for macrofinancial stability. But policymakers working under a broader approach to monetary policy would need to explain very carefully why actions are being taken, what the immediate objective is, and how actions are consistent with longer-term objectives of macroeconomic and financial stability.

But expectations should be realistic about what can be achieved with such broader approaches. Credit and asset price surges can sometimes be justified by positive productivity developments, and it is hard to tell ex ante whether booms are driven by benign or malign circumstances. Empirical evidence confirms that even the best indicators of financial vulnerability are noisy, sometimes sending false signals and raising the risk of policy errors. Inflexible use of macroprudential policy tools could lead to policy mistakes, so some discretion is needed.