Deflation, Credit and Asset Prices

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Summary

The experience of historical episodes of financial crises in the late 19th and early 20th century, and also more recent episodes of boom and bust cycles in credit markets suggest that the build up of financial imbalances is reflected in asset prices, especially property prices, rather than in consumer prices. Based on a simple VAR impulse response analysis for a sample of twelve countries we assess the nature of the close empirical correlation between bank lending and asset prices. The results suggest that innovations to property prices have a significant effect on bank lending in the large majority of countries. For most countries we do not find evidence of a significant effect of credit on property prices or of significant dynamic interaction between share prices and credit in either direction. Interest rate innovations are found to have a significantly negative effect on asset prices in some countries, while bank lending is in general found to be rather unresponsive to interest rate movements. This finding suggests that the usefulness of interest rate policy as an instrument to smooth boom-bust cycles in asset and credit markets is questionable.