

Asset Price Bubbles and Monetary Policy

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Summary

The purpose of this paper is to discuss if and how monetary policy should react to an asset price bubble. The challenge with targeting an asset price bubble is that such bubbles are very difficult to identify and measure. Furthermore, any attempt to burst an asset price bubble is likely to face a great deal of criticism and resistance from politicians and the public.

The main argument of the paper is that it is practically very difficult to target an asset price level or react to changes in asset prices. Instead, the paper proposes an alternative instrument where the monetary policy and regulatory authorities target credit growth. Credit growth is easy to define, less likely to face resistance from the public and politicians, and is closely linked with (serves as a good proxy for) asset prices. More importantly, an asset price bubble will cause much more economic damage if the asset purchases involved leverage. Thus, targeting credit growth is a more realistic and more effective tool to contain asset price bubbles, to minimize the economic impact of such bubbles, and to maintain financial stability. The paper discusses how targeting credit growth can be incorporated into the Taylor rule, and adds that, in addition to the policy interest rate, central banks can use reserve requirement ratios to contain credit growth. It is noted the effectiveness of monetary policy can be strengthened significantly with the help of appropriate regulations and macro-prudential measures.