Opening and Keynote Address at the 25th Meeting of SEACEN Directors of Research and Training*

Asset Price Bubbles: Issues of Concern and Policy Responses

by
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Distinguished Resource Persons,

Ladies and Gentlemen.

On behalf of the Central Bank of China, let me welcome you all to Taipei for the 25th Meeting of Directors of Research and Training. I wish to extend my appreciation to the SEACEN Centre for their ongoing commitment to promoting regional co-operation and the excellent job it has done in arranging this meeting. I am also grateful to the resource persons for sharing your invaluable expertise and experience with us.

I would like to thank the SEACEN Centre for inviting me to share a few thoughts with you on the topic of "Asset price bubbles: issues of concern and policy responses". As there have been many studies in this area, which also will be elaborated in the following seminar, I would like to provide a backdrop to the seminar. I will first focus on some issues of concern that seem particularly relevant to the current international financial situation characterized by asset price booms, ample liquidity and rising level of debt accumulation, and then the possible role for policies.

Issues of concern

As the global economy is showing a rebound, we are seeing a rally in equity markets in many parts of the world and continued housing booms in some countries. This vigor in financial markets clearly benefits from worldwide ample liquidity. In order to add to the more supportive environment for a sustainable economic recovery, major central banks

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including those of the United States, Europe and Japan have lowered interest rates to historic low levels, feeding massive liquidity into markets. In the wake of the collapse of the IT bubble at the beginning of the century, the corporate sector in most of major countries, saddled with too much capacity built up in the second half of 1990s, is still not ready to make big investment yet. With limited amount of productive investment available, waves of capital continue to flood toward inflated asset markets. In the context of greater financial deregulation and globalization of capital markets, many investors are swarming across the border to search for investment outlets to maximize yields. This fuels asset price booms in many parts of the world.

Now a serious question is whether this rally in these asset markets is a rational response to undervalued assets and is sustainable over the long run, or just another bubble in sight.

There is a widely held view that a bubble occurs when an asset's market price far outstrips its fundamental value. Bubbles are basically driven by a speculative frenzy or excessive optimism about the underlying value of the asset. Although there are various ways of estimating so-called fair value to gauge whether there is a bubble, asset price bubbles are very difficult to identify and we could only tell a boom from a bubble until it popped.

We witnessed a bursting in IT stock bubble in early 2000. As many stock prices are still far below their previous peak levels, the recent equity price booms, partly reflecting bargain hunting, do not seem to be a big concern for the moment as long as the economy keeps on growing. However, for some countries such as the U.K., the U.S. and Australia, housing prices have continued to rise for a period of time. These housing booms may face a potential threat of turning into bubbles. The housing sector with high level of borrowing is vulnerable to interest rate and income shocks. If the mortgage rates take an unexpected rise, income decreases or market sentiment suddenly turns sour at some point, the housing markets could come under tremendously downward pressure.

The acceleration in asset prices would help continue to stimulate the economic activity, and low interest rates also ease the debt burdens of the household and corporate sectors. However, asset price booms could lead to massive redundant real investment, and low rates may induce more debts. Liquidity-driven asset booms, coupled with a significant level of debt, tend to create economic and financial distortions.

Role of Policy

An asset price bubble can blow up even in the environment of low inflation in goods and services. The sudden bursting in a protracted asset price bubble could severely damage private sector balance sheets, which tends to pose a potential threat to the financial stability. Now comes another serious question as to whether central banks should respond to the movement in asset prices or not.

As for the role of central banks, there appears to be a broad consensus that an easy monetary stance should be made after the sharp bursting of an asset price bubble. This is justified to the extent that an asset bust brings about a deflationary spiral and worsens financial vulnerability. However, there are more diverse opinions about whether central banks should respond to asset price booms.

Some recommend that a central bank should focus its monetary policy instruments only on its major policy goal to maintain macroeconomic stability and price stability, while taking regulatory and supervisory measures, as well as playing the role of lender-of-last resort to help achieve the stability of the financial system. This view opposes using monetary policy to rein in rapidly rising asset prices. Policymakers take asset price booms into account to the extent that they boost spending and then inflationary pressure in goods and services. Policy tightening may be required to restrain the incipient inflation but not to halt the asset price booms as such.

Several arguments have come to the fore to support the view of not targeting the asset markets. First, different asset prices may give contradictory signals on occasion. Asset prices increasing too fast in one market may call for policy tightening, while other markets with undervalued assets may need policy easing. Second, policymakers are no better than market participants in gauging how much asset prices deviate from fundamentals. The distinctions between booms and bubbles are not straightforward. No one knows for sure whether the acceleration in asset prices represents a bubble until it collapses. Even a bubble can be identified, policymakers are not certain about the exact timing and magnitude of policy tightening required for arresting the bubble. Too early or too late, as well as too little or too much, is not optimal. Third, it would be redundant and

destabilizing for an economy, already adopting the inflation targeting regime, to additionally target asset prices.

However, others argue that it is not appropriate to exclusively focus on price stability. Policymakers should take a proactive approach to put a damper on asset price bubbles. This view adopts what Ben S. Bernanke called the lean-against-the-bubble strategy. Central banks with a longer-term view and different incentives may react in a different way to the same information on many occasions, compared with market participants. In the face of asset price booms, other than the policy tightening called for containing the incipient inflationary pressure, an additional increase of interest rates of around 25 to 50 basis points is required to dampen the rise in asset prices that central banks consider to be unjustifiable. Policymakers need to strike a balance between letting rising asset prices be in line with economic fundamentals and not allowing them to get too high to pose a threat. A protracted asset bubble is likely to foster the build up of excess debt accumulation and investment, and that in turn will further encourage bubble phenomenon. Under these circumstances, a bursting of this protracted bubble later on could turn a mild disruption further into a serious one.

A few of those who agree with the lean-against-the-bubble view even advocate stronger response to bubbles. They recommend central banks aggressively hike interest rates to prick an expanding price bubble. However, this vigorous approach could potentially exacerbate an asset price cycle, and hence is barely adopted by policy makers.

Nowadays, some central banks, adopting inflation targeting regime, advocate that there may be circumstances where monetary policy tightening should be called for to address financial imbalances resulting from surging asset prices even when inflation remains within its target range. For example, the recent housing booms, together with buoyant consumer spending and borrowing fuelled by accommodative monetary policy, increase the danger that consumption may drop significantly later on, which could cause inflation to substantially undershoot its target range at a longer horizon. To avoid a protracted undershooting in inflation later, it may sometimes be better to make an early rate hike. This is justified given that it can help forestall severe longer-term effects of a bigger asset-price bubble and its eventual burst.

In principle, monetary policy instruments alone may not be effective to resolve economic

and financial imbalances arising from asset market excesses. Monetary authorities need to work with other regulatory agencies to be better equipped to minimize adverse effects of asset market excesses. Evidence from international experience has shown that countries with a stable macroeconomic environment and a fundamentally sound financial system are more resilient to shocks from an asset price bust than countries without these attributes.

This points out the importance of building a robust financial system. The adverse impact of asset-price bubbles on financial system stability can be limited through enhancing and coordinating supervision and prudential regulation, upgrading financial infrastructure, improving risk management, strengthening corporate governance, aligning market participants' incentives with the goal of efficient markets, minimizing moral hazard and increasing transparency and disclosure.

Uncertainty and Challenges

The recent rally in Asian stock markets is largely fuelled by foreign capital inflows, which also put upward pressure to the value of our currencies. The 1997-98 Asian crisis demonstrated that capital inflows could be very volatile. Unexpected large outflows of capital could seriously destabilize of our financial markets.

As our financial markets are more globally interlinked and facing more potentially destabilizing capital flows, there is greater risk that a disturbance in one country's financial market can easily spread to elsewhere. It would be in our country's own interest, and also the region's, to enhance the soundness of our domestic financial system to meet the challenges of globalization of capital markets.

Conclusion

These days, monetary authorities are grappling with ever-increasing complexity. Whatever the case may be, monetary policymakers need to closely watch the movements of asset prices and address any imbalance stemming from asset market excesses in a pre-emptive manner. To alleviate the adverse effects of an asset bust, instead of trying to eliminate asset price volatility, we need to focus on enhancing the strength of our financial

system. Although much progress has been made, more remains to be done. Central banks and other regulatory agencies need to continue to work together to facilitate a stable and sound financial system, which is more resilient to external shocks.

Ladies and gentlemen,

The above-mentioned issues will be discussed more in the following seminar for SEACEN Directors of Research. In addition to the seminar, there will be another programme designed for SEACEN Directors of Training at the same time. Tomorrow, a joint meeting of Directors of Research and Training will be held to discuss progress report for this year and propose research and training programs for the next year. This gathering brings together SEACEN economies united in the common interest of promoting regional prosperity and stability. When we are searching for a solution to the problems we faced, we would certainly find the idea of a regional discussion and view-exchanging useful. I look forward to a substantial exchange of opinions on all crucial issues and coming up with more concrete ideas.

Ladies and gentlemen, let me thank you for your attention. I wish you all a successful meeting and a pleasant stay in Taipei in the next couple of days.

Thank you.