Comments: Takatoshi Ito

Optimal Monetary Policy in an Environment of Low Inflation and Rising Asset Prices

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Very important topic

- Periodically asset prices rise rapidly, while
Periodically asset prices rise rapidly, while economic fundamentals don’t obviously warrant the rise, and
Periodically asset prices rise rapidly, while economic fundamentals don’t obviously warrant the rise, and CPI inflation remains modest.
Causes Concern

- If the asset prices are supported by fundamentals, may worry about overheating.

Wealth effects are a key concern
Causes Concern

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  Wealth effects are a key concern

- If asset prices excessive, concern about later collapse, etc.
Excellent paper

- Summarizes vast empirical and theoretical literatures
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- Draws out practical lessons
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- Draws out practical lessons
- I agree with the conclusions
Main conclusions

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  - More uncertain about effects of policy action
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  ♦ More uncertain about effects of policy action
  ♦ More confident bubble-related costs low
Main conclusions

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  - More uncertain about whether a bubble is present,
  - More uncertain about effects of policy action
  - More confident bubble-related costs low
- Rock solid conditional advice
My Concern

- This work like much of the literature may leave the impression that economists understand bubbles.
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May suggest we can contemplate optimal policy in response to bubbles.
My main point

- As applied economists, theorists, economic historians, etc., we have few solid lessons for the conduct of interest rate policy in the face of bubbles.
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- Bubbles here is shorthand for rapid asset price rises not supported by fundamentals.
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Bubbles here is shorthand for rapid asset price rises not supported by fundamentals.

I will try to state in clear terms what things we know and don’t know.
Two clarifications

- Economists know some things about other aspects of bubble policy.

  I will be talking only about the setting of the policy interest rate.
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- Economists know some things about other aspects of bubble policy.
  
  I will be talking only about the setting of the policy interest rate.

- For the most part, what I will say is consistent with Taka’s paper.
  
  The emphasis is a bit different
Situation: Asset prices rising, inflation well-contained.
Asset prices, the normal case

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- Situation: Asset prices rising, inflation well-contained.
- Normal case: no suspicion that asset prices differ from fundamentals.
- Conventional wisdom: Asset prices will play a prominent, role in monetary policy, but...
- This role fully captured in standard analysis of optimal policy.
The Bubbly case

- Situation: CPI inflation is tame; CB believes asset prices exceed fundamental values by growing amount.
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The Bubbly case

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  - Start with two positive results.
The Bubbly case

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- What reliable insights does theoretical and empirical economics offer?
  - Start with two positive results.
  - Then give some negative results.
Result 1: The rationale for action is clear

- Modern rationale for policy action starts with market failures or distortions
  
e.g., sticky prices/wages lead to misallocation of resources.
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- Divergence between asset prices and fundamentals is a distortion.
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- Modern rationale for policy action starts with market failures or distortions
  e.g., sticky prices/wages lead to misallocation of resources.
- Divergence between asset prices and fundamentals is a distortion.
- May lead to excessive consumption, misallocation of capital, etc.
The rationale for a policy response has equal footing with rationale for responding to CPI inflation or output gap.

Speeches by, e.g., Issing and Kohn emphasize this reasoning; illustrated in a recent paper by Bill Dupor.
Is the CB the right agency?

- Given a distortion, we should ask what government body should respond.
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- Bubbles are dynamic, cyclical phenomena.
- Closely intertwined with monetary sector.
- May influence conventional policy goals (output and inflation)
Second positive result

- CBs can end bubbles by raising rates.
CBs can end bubbles by raising rates.

Most everyone would agree that there is some interest rate high enough to cause a collapse in asset prices.

True of any model of rational bubbles

Difficult to imagine not true more broadly
Analogy: Can the CB resist a speculative attack on the currency?
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This says nothing about the cost of doing so.

Same is true in bubble case
sometimes we hear talk of pricking bubbles.

sounds surgical; almost dainty
- Sometimes we hear talk of pricking bubbles.
  Sounds surgical; almost dainty

- Better language: CBs have a sledgehammer. If they hit the entire economy hard enough, the bubble will surely collapse.
Summary of positive results

- CBs have a solid rationale for action in the face of bubbles
Summary of positive results

- CBs have a solid rationale for action in the face of bubbles
- They have a sledgehammer they could use on the economy in order to smash bubbles.
CBs have a solid rationale for action in the face of bubbles
They have a sledgehammer they could use on the economy in order to smash bubbles.
This is not very comforting.
Now turn to negative results
In principle, CB might raise rates when facing the prospect of bubble. Thus, might prevent bubbles.
Can CBs prevent bubbles?

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Can CBs prevent bubbles?

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- But...  
  - We have no theory of how bubbles start.
In principle, CB might raise rates when facing the prospect of bubble. Thus, might prevent bubbles.

But...  
- We have no theory of how bubbles start.  
- Despite descriptive evidence about past bubbles, there is no consensus on empirical regularities of how/when they start.
Can CBs prevent bubbles?

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  - Fundamental asset values are unobserved; our estimates are imprecise.
Can CBs prevent bubbles?

- In particular, we have no evidence that if rates had been a bit higher at start of an empirical bubble, the bubble would have been prevented.
- Further, we have no reliable way to identify bubbles until they become rather large.
  - Fundamental asset values are unobserved; our estimates are imprecise.
  - A wide range of asset values are often consistent with our understanding fundamentals.
We don’t know how/when bubbles start and cannot reliably identify them until the deviation from fundamentals is large.
Bottom Line on Prevention

- We don’t know how/when bubbles start and cannot reliably identify them until the deviation from fundamentals is large.
- Thus, neither theory nor evidence offer any reliable guidance on using interest rates to prevent bubbles.
Reacting to bubbles

- We can’t prevent them, but can we constructively react to them?
Reacting to bubbles

- We can’t prevent them, but can we constructively react to them?
- By raising rates, can we beneficially alter the course of bubbles once they are identified?
Possibility 1: gentle deflation

- Can we facilitate a gentle deflation of bubbles?
Possibility 1: gentle deflation

- Can we facilitate a gentle deflation of bubbles?
- Theory and common sense make us very skeptical.
Deflation, by definition, involves capital losses to holder of bubble assets
Gentle deflation

- Deflation, by definition, involves capital losses to holder of bubble assets.
- Engineering a smooth (hence, predictable) sequence of capital losses flies in the face of theory and common sense.

Asset holders do not accept fully predictable capital losses.
Possibility 2: slowing bubble growth

- Can mildly higher interest rates slow the growth of bubbles?
  
  Leaning against the wind
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- The negative logic is the same as for gentle deflation.
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- Bubble assets must compete with other assets such as bonds.
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- The negative logic is the same as for gentle deflation.

- Bubble assets must compete with other assets such as bonds.

- Higher interest rate raises the required return on bubble assets. Hence, the bubble must grow faster (or pop).
To my knowledge, there is no empirical support for the view that the CB can raise the required return in the economy and thereby slow the growth of a bubble.

In a recent speech, Gov. Kohn mentions a case to the contrary.
Some recent papers impose arbitrary assumptions about the behavior of bubbles.

Reviewed by Taka

Bubble dynamics are simply imposed
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Reviewed by Taka

Bubble dynamics are simply imposed

Despite the ad hoc nature, these papers illustrate a potentially important tradeoff
Costs and Benefits of Raising Rates

- An important tradeoff:
Costs and Benefits of Raising Rates

- An important tradeoff:
  - Higher interest rates put a drag on the economy for conventional reasons. [bad]
An important tradeoff:

- Higher interest rates put a drag on the economy for conventional reasons. [bad]
- But may limit bubble-related distortions. [good]

This is either by popping or by slowing growth through some ad hoc mechanism
What do we know about the tradeoff?

- Different ad hoc assumptions lead to different conclusions on the net benefits of raising rates in the face of bubble.

The negative effects of high rates on the rest of the economy may dominate; the beneficial effects on the bubble may dominate.
What do we know about the tradeoff?

- Different ad hoc assumptions lead to different conclusions on the net benefits of raising rates in the face of bubble.

  The negative effects of high rates on the rest of the economy may dominate; the beneficial effects on the bubble may dominate.

- The literature offers no guidance whatsoever as to which result (if any of these) is relevant in practice.
Theory and evidence (and common sense?) provide no support for the view that one can *prevent*, or *gently* or *smoothly* alter the course of bubbles.
Theory and evidence (and common sense?) provide no support for the view that one can prevent, or gently or smoothly alter the course of bubbles.

Ruthless logic of the market suggests bubbles must grow or pop.
Bottom line, cont.

- Raising the interest rate in response bubble may be the right thing to do.
Raising the interest rate in response bubble **may** be the right thing to do.

This involves certain costs to obtain uncertain benefits.
Raising the interest rate in response to a bubble may be the right thing to do.

This involves certain costs to obtain uncertain benefits.

There is no consensus as to which effect will dominate, or even as to how to determine which effect will dominate.
Bubbles are poorly understood
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Lacking good understanding of bubbles, it is far beyond the scope of current understanding to talk coherently of optimal interest rate policy in response to bubbles.
Message for policy advisor

- Bubbles are poorly understood
- Lacking good understanding of bubbles, it is far beyond the scope of current understanding to talk coherently of optimal interest rate policy in response to bubbles.
- Thus, the clearest advice is to focus on the other types of policy response (regulation, etc.)