

**ASSET PRICES AND MONETARY POLICY – THE IMPACT OF A
HOUSING MARKET BUBBLE**

by

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Paper delivered at the Biennial Conference of the Economic Society of South
Africa, Durban, 7-9 September 2005

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1. INTRODUCTION

During the past two to three decades the monetary policy environment has changed significantly in many countries. Central bank independence has been recognised, price stability has been adopted as the most important objective of central bank policy, and the monetary policy operating procedures have evolved to constitute short-term interest rates as the principal operating target.

As a result many central banks have been largely successful at bringing inflation under control. Although it is premature to suggest that inflation is no longer an issue for concern, it is conceivable that the major challenges expected to confront central banks in future will originate from a different source. One development with which policymakers, and particularly central banks, has been confronted recently is the apparent increase in financial instability. An important dimension of financial instability is the increased volatility of asset prices and the subsequent development of asset price bubbles¹. The emergence of several major boom-bust cycles in the prices of equity and real estate has been documented widely in the literature².

The bursting of several of these asset price cycles was followed not only by instability in financial systems of countries, but also by significant contractions in real economic activity. According to Bernanke and Lown (1991) at least some part of the 1990 recession in the United States of America (US) could be attributed to the preceding decline in commercial real estate prices, which

¹ The most usual definition of a bubble used in economic research defines it as the part of asset price movements that is unexplainable based on fundamentals. See Garber (2000).

² See Borio, Kennedy and Prowse (1994), Bernanke and Gertler (1999), Clareida, Richard, Gali and Gertler (2000), Borio and Lowe (2002) and Pastor and Veronesi (2004).

weakened the capital positions of banks and the balance sheets of corporate borrowers. More recently we have also seen asset price crashes in East Asia and Latin America. With these experiences in mind, many view the remarkable rise in real estate prices during the past two years as ominous developments.

This paper focuses on whether and how central banks should take cognisance of asset prices in determining monetary and regulatory policy. It begins with an analysis of real estate price developments domestically and comparisons with international real estate price growth. It then discusses the consequences of real estate bubbles. This is followed by a discussion of whether central banks should consider and respond to asset price developments, and specifically to real estate prices, when formulating monetary policy. Finally, possible central bank policy response strategies are highlighted.

2. LOCAL PROPERTY MARKET DEVELOPMENTS³

2.1 House price growth

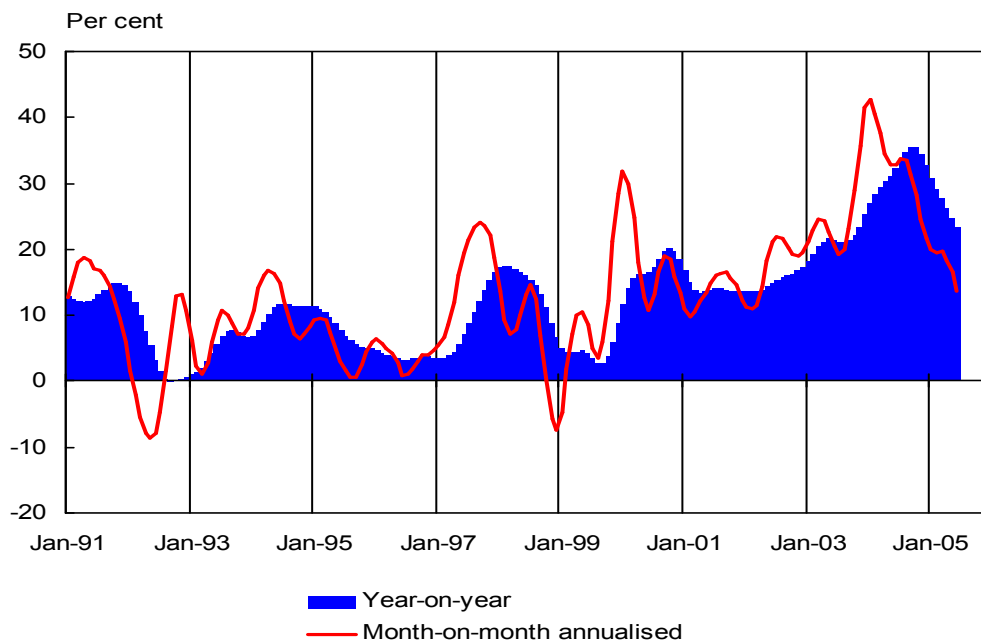
Over the past three years the average house price in the South African residential property market has more than doubled. Factors that are believed to have fuelled the surge in house price growth included strong economic growth, the low inflation and interest rate environment, strong credit growth, increases in disposable income, the improved investment status of property compared with other asset classes, the emergence of a Black middle class and the influence of foreign buyers.⁴

³ The analysis in this section is based on data from Absa, which is supplemented by data computed by First National Bank (FNB) and Standard Bank. Apart from analyzing house price growth, the data from the latter also covers other aspects of residential property market activity.

⁴ For additional background reading, see Topical Briefing No. 9 of 2003 entitled *An Overview of House price developments in the South African residential property market*, Topical Briefing No. 6 of 2004 entitled *recent Developments in the Real Estate Sector*, September 2004 *Financial Stability Review* and Discussion Paper No. 5 entitled *House Price Developments, Macroeconomic Fundamentals and Financial Stability in South Africa*.

However, the annual growth in house prices began to moderate in the last quarter of 2004, and continued this trend through June 2005. According to Absa, house price growth slowed for an eighth consecutive month in June to an annual growth rate of 23,3 per cent, down from a revised 24,9 per cent in May 2005. For the six months to June 2005, prices rose at an average of 27 per cent compared to average growth of 30 per cent for the first six months of 2004. Although house prices remain strong, the major factor affecting the downward trend in house price growth is the fact that housing has become less affordable. The strength of the housing market going forward will be supported by the low interest rate and low inflation environment, as well as the increasing number of new entrants (first-time buyers) in the market.

Figure 1: House price index



* The house price index is based on the total purchase price of houses in the 80m²-400m² size category, valued at R2,2 million or less in 2004, in respect of which loan applications were approved by Absa. Prices are smoothed in an attempt to exclude the distorting seasonal factor and outliers in the data.

Source: Absa Bank

An analysis of the conventionally used Absa house price index and Standard Bank's residential property index reveals that there was strong house price growth in 2004. Differences in the growth rates of the two indices are due to

differences in the methodologies used by the two banks.⁵ The indices show that house price growth peaked a month apart, with the Absa house price index reaching a peak of 35,4 per cent in October 2004, while the Standard Bank residential property index peaked at 36,2 per cent in November 2004. The latest data for both indices shows that annual house price growth is moderating.

Table 1: House price growth comparison

Source	2003	2004	Peak	Latest
	Per cent (average of the annual growth rates for 12 months)		Per cent (year-on-year)	
Absa	21,4	32,1	35,4 October 2004	23,3 June 2005
Standard Bank	7,0	28,0	36,2 Nov 2004	28,6 June 2005

Source: Absa and Standard Bank

Apart from the measures of house price growth discussed above, First National Bank (FNB) computes other measures of residential property market activity that

⁵ The Standard Bank's residential property index, which was developed in collaboration with Econometrics (Pty) Ltd., involves the derivation of a reasonable national median property price (NMPP). The NMPP is composed of the individual weighted contributions from 17 regions (Johannesburg, Gauteng Ekurhuleni, Tshwane, Cape Town, Durban, East London, Port Elizabeth, Eastern Cape excluding East London and Port Elizabeth, Western Cape excluding Cape Town, Northern Cape, North West Province, KwaZulu-Natal excluding Durban, Free State, Mpumalanga, Limpopo, Vaal and Gauteng West Rand). The weights are based on the observed individual trends for the 17 different regions. Because homes of the same size and type (sectional title or freehold) can differ in terms of, for example, location and fixtures, there are vast differences in value. This forms the basis for the bank to look at price movements within bands by volume. The median price (the price that separates the number of transactions into two halves) of each band is then tracked using a three-month moving average. Prices of all property transactions recorded in the Deeds Office in a month are ranked from lowest to highest. They are then grouped into bands by ranking the bottom 15 per cent by volume, the next 30 per cent, then 30 per cent, then 15 per cent, and, lastly, 10 per cent. The bands were chosen to be representative of broad market segments for mortgage loans. Deeds Office data is used because it represents transactions in the entire property market and not just within Standard Bank, which makes it more representative. The residential property index is published monthly in the Residential Property Gauge, which analyses house prices not only on aggregate level, but also for different price bands and different regions.

are published in its Residential Property Barometer (RPB).⁶ The primary measure of the RPB is the Residential Property Confidence Indicator (RPCI), which records the level of activity in the property market.⁷ The RPCI shows that there has been a drop in market activity from 7,4 in the first quarter to 6,8 in the second quarter of 2005. The latest reading shows that the market is gradually getting more stable. According to FNB, the major driving force behind the decline in property market activity in the latest quarter was seasonality, as the survey was conducted in the run-up to the winter months. The latest reading also meant that the 50 basis points reduction in interest rates in April 2005 did not have a significant impact on the views of property professionals. This corroborates the continued decline in house price growth in May and June 2005, as shown in Figure 1 above.

Table 2: Residential Property Confidence Indicator

Period	03Q4	04Q1	04Q2	04Q3	04Q4	05Q1	05Q2
Level of Activity	7,6	7,7	7,5	6,7	7,3	7,4	6,8

Source: FNB

Other signs that the residential property market is cooling off are the fact that the number of properties sold below asking price increased from 29 per cent in the first quarter to 44 per cent in the second quarter of 2005. Over the same period, the average length of time properties stay in the market has increased from 5 to 7 weeks. Furthermore, the number of properties bought-to-let remained constant at 25 per cent. Despite the signs of cooling off, the FNB RPB shows that the market was driven mainly by first-time buyers, who increased to 32 per cent in

⁶ The FNB RPB began measuring property professionals' sentiments in the fourth quarter of 2003. It determines, on a quarterly basis, the market sentiment of 150 real estate professionals employed by the top estate agents, who are active in major metropolitan areas. It measures existing market perceptions and expectations and as such, provides both a current and forward looking short term assessment of the market at a particular point in time – effectively a measure of market confidence.

⁷ The RPCI measures activity on a scale of 1 to 10, where 1 to 3 indicates 'Not Very Active', 4 to 6 indicates "Stable", 7 to 8 is "Active" and 9 to 10 indicates a "Very Active" market. Activity is defined as 'feet through doors', which translates into the number of potential homebuyers visiting show houses.

the second quarter of 2005, compared to 26 per cent in the fourth quarter of 2004.

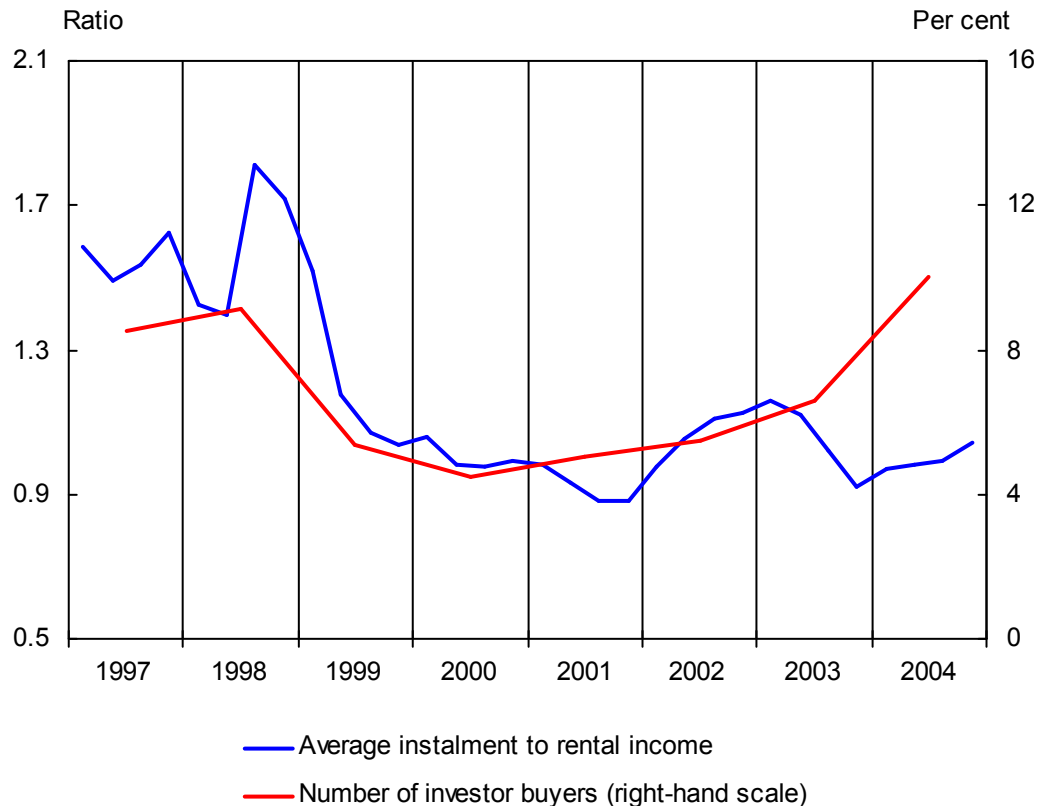
2.2 Buy-to-let market and investor activity

The participation of investors in the residential property market provides the market with momentum and can fuel the trend in house price growth. Investors are more likely than homeowner-occupants to sell their property when they expect or see a fall in house prices.⁸ A simultaneous selling-off by investors to avoid or limit capital losses can exacerbate the decline in house prices. Over the past four years the percentage of home buyers that are investors has been rising steadily, increasing mildly from 5 per cent in 2001 to 6,6 per cent in 2003 and was 10 per cent last year (see Figure 2 below). This moderate increase in investor activity can be attributed to the increasing number of first-time buyers, especially from the emerging Black middle class. This view corroborates the argument alluded to above that the market was driven by first-time buyers in the first and second quarters of the current year.

One major factor that investors consider is the gap between rental income and mortgage instalments or the ratio thereof. A decrease in the ratio of mortgage instalment to rental income means that rental income is growing at a faster pace than mortgage instalments and that the return on investment will be positive, and vice versa. This ratio has been improving since 1998 but it steadily rose in 2004, an indication that rental yields are slowly being eroded by the sharp and high growth rate of house prices since the second half of 2003.

⁸ Investors are distinguished from homeowner-occupants by the fact that they own more than one property.

Figure 2: Mortgage instalment to rental income and number of investors



Source: Standard Bank

2.3 Drivers of house prices

One widely used measure of the cost of housing is the affordability index. Absa computes this measure by taking the index of the ratio of mortgage repayments to remuneration/income. A comparative measure from Standard Bank is the unindexed ratio of mortgage instalment to household income. In this manner the two measures of affordability combine the impact of income, interest rates and house prices and, therefore, give a better measure of the affordability of residential property than measures such as the ratio of house prices to income. An increase in both measures of affordability indicates that the mortgage instalments/repayments to income ratio is rising and hence households are using a larger fraction of their income on their property so that the affordability of housing is seen to be deteriorating. The reverse is also true.

The measures of affordability declined between the second and fourth quarters of 2003 in response to the reduction in interest rates in mid-2003, which showed that housing was relatively more affordable compared to the earlier period. A fall in interest rates impacts favourably on affordability of housing by lowering the monthly mortgage instalment/repayment. In 2004 the affordability ratio and index have been rising despite low interest rates, an indication that the affordability of housing is gradually deteriorating, probably because of escalating home prices. (See Figure 3 below).

Figure 3: Housing affordability

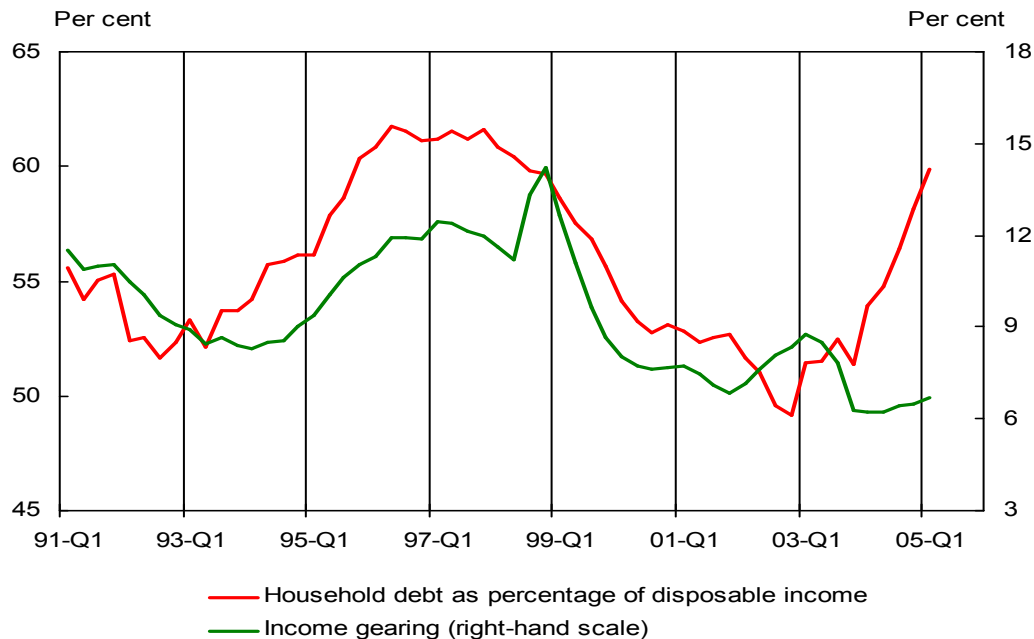


Source: Absa and Standard Bank

The affordability of housing is, however, not the only factor upon which the sustainability of buoyant conditions in the residential property market depends. Such conditions also depend on households' total indebtedness and the

affordability of their total debt burden. Household debt has been on an upward trend since the beginning of 2004. The ratio of household debt to disposable income increased from 58,2 per cent in the fourth quarter of 2004 to 60 per cent in the first quarter of 2005, and is now only slightly below the peak of 62 per cent recorded during the fourth quarter of 1997. However, the reduction in interest rates over the past two years means that, despite the rise in household indebtedness, the proportion of their income spent on debt financing has increased only marginally. The reduction in interest rates resulted in an initial decline in income gearing (financing costs of household debt to income), from 8,5 per cent in the second quarter of 2003 to 6,2 per cent in the fourth quarter of 2004. Since then, income gearing has only increased marginally and was 6,7 per cent during the first quarter of 2005.

Figure 4: Household debt and income gearing



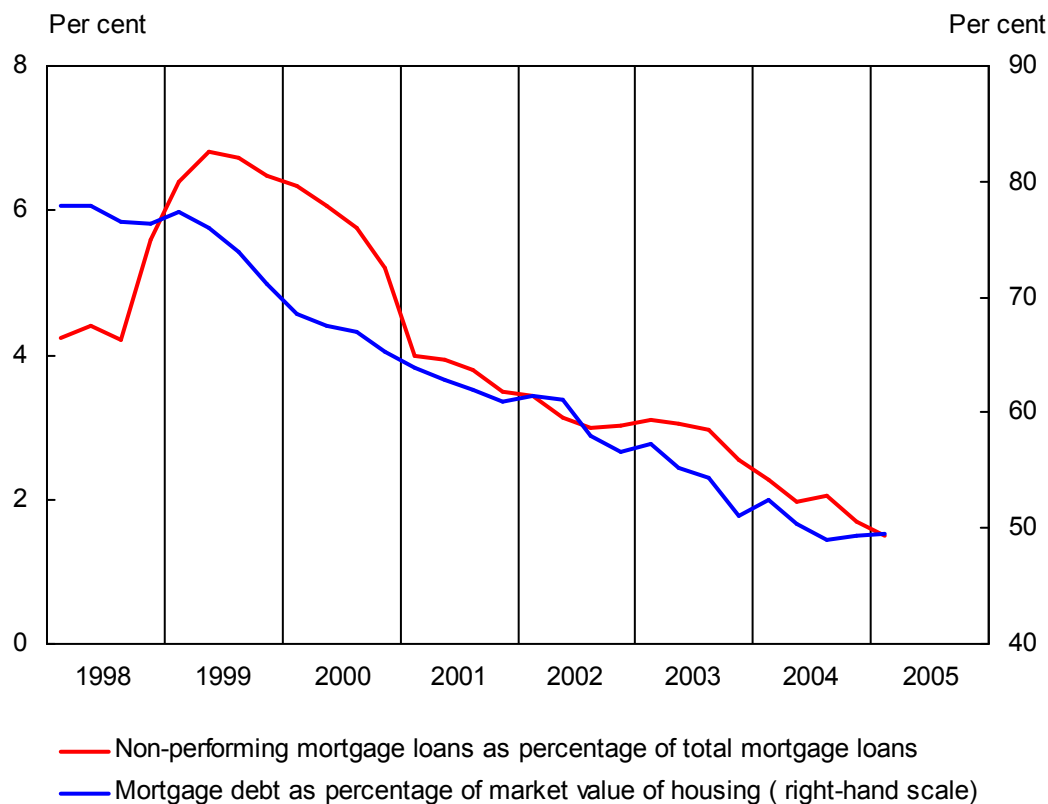
Source: South African Reserve Bank

The analysis of household debt and its affordability shows that households' balance sheets are still relatively healthy and that households should be able to afford their debt. The demand for housing will continue to be supported by

strong consumer demand, which is underpinned by firm rises in disposable income, favourable financial conditions and structural changes in the economy.

Measures of household mortgage liabilities show that mortgage debt continued to decline in the first quarter of 2005. The ratio of non-performing mortgage loans to total mortgage advances declined further to 1,5 per cent in the first quarter of 2005 from 1,7 per cent in the fourth quarter of 2004. Despite the marginal increase in the ratio of mortgage debt to market value of housing in the first quarter of 2005 to 49,6 per cent (from 49,4 per cent in the fourth quarter of 2004), the historical trend in the ratio is still declining.

Figure 5: Non-performing mortgage loans and mortgage debt



Source: South African Reserve Bank

In summary, available measures of residential market activity point to a correction or a cooling-off phase following above-trend growth in house prices. This phase also indicates that the impact of previous interest rate cuts is

gradually fading away and households are getting accustomed to the low interest rate environment. There is no clear evidence that the property market has reached a bubble phase. The recent developments do not pose a serious risk to the banking sector and overall financial stability as there are no indications of rising defaults in mortgage repayments.

2.4 Global residential housing markets

As noted in the IMF's September 2004 *World Economic Outlook*, over the past two years house prices have been increasing unusually rapidly in many countries and the surge appears to have been highly synchronised. The synchronisation can be attributable to global factors, which reflect co-movements in interest rates, economic activity and other macroeconomic variables. These, in turn, result from common underlying shocks. The global boom in house prices has been driven by two common factors namely: the historically low interest rate and low inflation environment, and households' loss of faith in equities or the improved status of housing as an investment asset class. The IMF noted that as the upswing in house prices has been a global phenomenon, the likelihood is that the downturn would also be highly synchronised, with corresponding implications for global economic activity.

A comparison of house price growth in selected countries reveals that house prices grew at double-digit rates in 2004, especially in developed economies. However, signs of cooling off are evident in several countries including the United Kingdom, Ireland and Australia.

In both 2003 and 2004 house price growth in the local market topped the list. However, a differentiating factor of the local property market is that this growth is supported by strong economic fundamentals and some country-specific factors, which include the newly empowered Blacks, the participation of foreign buyers as well as the fact that the housing boom occurred during a period of strong economic growth.

Table 3: Annual house price growth – selected countries

Country	2003	2004	Latest
South Africa	21,4	32,1	23,3
United Kingdom	19,4	18,8	2,2
New Zealand	19,2	18,5	12,2
Australia	18,2	10,4	2,3
United States	7,0	10,9	12,5
Sweden	6,7	9,3	8,0
Ireland	14,3	11,6	7,5
Norway	1,7	10,2	7,9
Denmark	5,0	10,0	8,0

Source: Central banks, National Statistics Offices, Halifax and Office of Federal Housing Enterprise Oversight

The rapid increase in global house prices has led to some observers suggesting that a house price correction is imminent and could be triggered by the tightening of monetary policy as economic recovery takes hold in some industrialised countries. The IMF has warned that, in those countries where house prices are very high, central banks face the challenge of containing inflation pressures while, at the same time, seeking to minimise the risk of house price bursting.⁹

3. CONSEQUENCES OF A HOUSING BUBBLE

A housing market bubble occurs when house price increases are not justified by macroeconomic fundamentals and other underlying factors.¹⁰ Generally, a housing market bubble is characterised by a sharp and unsustainable rise in house prices, thereby creating expectations of further price increases and luring

⁹ See IMF's September 2004 *World Economic Outlook*.

¹⁰ These include interest rates, the contraction or expansion of the economy, consumer confidence, income levels, population trends and changes in tax laws.

more buyers keen on securing huge returns on capital over the short-term, rather than those with a long-term investment motive. Typically, a high short-term investors' participation rate in the housing market gives the market more momentum and fuels the trend in house prices in either direction.

An inflating bubble boosts the economy through the household wealth effect and investment which, if coupled with a high investor participation rate, may result in over-investment in the property sector. The opportunity cost of over-investment in property would manifest in a low savings rate. As house prices rise, creating the expectation of further house price increases, lending institutions tend to relax their credit-granting criteria in the face of prevailing boom conditions. As mortgage advances grow, the balance sheets of lending institutions expand, albeit with inherent potential fragility.

When a real estate boom begins to collapse, banks may sharply tighten their lending policies so as to limit exposure to the property sector. Indirect exposure to the residential property sector may ensue if banks have lent heavily to non-bank financial intermediaries or finance companies that engage in real estate lending, thereby taking substantial additional exposure to the property sector. Herring and Wachter (1999) argue that another important source of indirect exposure derives from the practice of using real estate collateral for mortgage and other kinds of lending. As house prices collapse, households and banks may experience negative equity as property values fall below the amount of outstanding loans. Other kinds of loans that may have been collateralized by real estate may result in negative equity as the value of collateral falls, creating an incentive for borrowers to default. This increases the banking sector's non-performing loans and weakens their balance sheets.

A combination of price expectations and underlying demand may alter the perceptions of households towards viewing existing house prices as simply too high to allow further growth, causing the market to crash on its own. This in itself could be a trigger for a weakening economy. The possibility of such a self-crashing residential market is minimal in the South African case since the market

is driven by new entrants as well as the favourable financial conditions that prevail. A housing market crash would lower the growth in consumer spending, impact negatively on the construction industry and lead to a decline in investment in residential property. In combination, these factors may drive the economy into a recession.

Case, Quigley and Shiller (2001) found that a change in house prices has a much bigger effect on consumer spending than a change in share prices of the same magnitude. The bigger wealth effect of house prices on consumption is due to the fact that more households own homes than shares. Another reason for the bigger wealth effect is that households are more likely to acquire loans to buy property than to buy shares.

4. ASSET PRICES, MONETARY POLICY AND THE ECONOMY

Asset prices are endogenous variables and often remarkably volatile. There are, however, periods when asset values are closely connected to the current state of the economy. According to Bernanke and Gertler (1999) central bankers would have no reason to concern themselves with asset price volatility when movements in asset prices simply reflect changes in underlying economic conditions. Under such circumstances central bankers would only pay attention to asset prices through their normal focus on consumption prices.

Central banks also pay attention to asset prices under normal circumstances because they contain useful information, like perceptions of future income streams, when setting monetary policy. Also, interest rate changes by central banks partly constrain rising or falling asset prices in a desirable way. In most cases asset and consumer prices track together and asset prices present no particular problem for monetary policy or the economy.

Under certain conditions, however, asset price volatility becomes an independent source of economic instability, of which policymakers should take account. This is, firstly, when non-fundamental factors underlie asset market volatility.

Potential sources of non-fundamental fluctuations in asset prices are poor regulatory practice and imperfect rationality on the part of investors. Poor regulatory practice could be evidenced by financial reforms that dramatically increase access to credit by firms or households. Such reforms contributed to asset price booms in Scandinavia, Japan, the Netherlands and the United Kingdom in the 1980s (Borio, et al, 1994). Imperfect rationality is when investors behave irrationally as a result of excessive optimism, short-termism or herd-behavior.

Asset price volatility also becomes an independent source of economic instability when booms and busts in asset markets have important effects on the real economy. Historical experience from the Great Depression of the 1930s to the most recent events of financial crises supports the view that large asset price fluctuations can have important effects on the economy (Bernanke and Gertler, 1999). Asset prices feed into the economy through the so-called wealth-effect, according to which people feel wealthier as asset prices rise and consumption spending, and consequently inflation, increases. Quantitatively the most important connection between asset prices and the real economy operates through improved balance sheets where credit is extended more freely and at a lower cost to borrowers. The condition of balance sheets is an important determinant of the ability to borrow and lend.

Asset prices can have serious implications for real economic activity. Asset price booms always carry the risk of a bust (i.e. a bubble) that destroys the value of bank-held securities, creating a collateral-induced credit crunch. Furthermore, asset price bubbles distort financial decision-taking and complicate the process of credit-risk management.

When asset price swings occur for non-fundamental reasons and these swings have the potential to destabilise the real economy, it has implications for monetary policy. Although monetary policy is not by itself a sufficient tool to contain the potentially damaging effects of booms and busts in asset prices, asset price crashes have historically done sustained damage to the economy

only in cases where monetary policy remained unresponsive or actively reinforced deflationary pressures (Bernanke and Gertler, 1999).

5. POSSIBLE CENTRAL BANK RESPONSE TO ASSET PRICE BUBBLES

The central issue to be considered is whether central banks should respond to asset price volatility, and if they do, how. As was mentioned before, monetary policy is not by itself a sufficient tool to counter or correct the effects of booms and busts in asset prices. Well-designed and transparent legal and accounting systems, a sound regulatory infrastructure and prudent fiscal policies are vital components of an overall strategy to insulate the economy from financial disturbances. These measures help to limit the risk exposure of banks and corporations and instill public confidence in economic fundamentals.

5.1 The conventional view

The debate in the literature on a suitable response of central banks to asset price volatility swings around two opposing views. The conventional view is that central banks should not respond to changes in asset prices through monetary policy actions, except if they signal changes in expected inflation. The main arguments against reacting directly to asset prices are:

- 5.1.1 Asset prices are endogenous variables and remarkably volatile.
- 5.1.2 Misalignment of asset prices (bubbles) is difficult to identify. It is difficult to distinguish between asset price movements that are warranted by underlying fundamentals and those that are not.
- 5.1.3 Reaction to asset price volatility may be destabilising and create moral hazard. Expectations of central bank action when prices are perceived to be too high might lead to self-reinforcing price drops, and soft landings may not be easy to achieve.
- 5.1.4 Should the central bank decide to “prick” the bubble in asset prices it could provoke the economic downturn it was hoping to avoid.

- 5.1.5 The monetary policy instrument is a blunt tool which may have disproportionately large effects on sectors of the economy that are not experiencing asset price inflation.
- 5.1.6 With economic performance otherwise satisfactory, raising interest rates in reaction to an asset price bubble is not an easy policy to articulate and explain to markets, to the public at large, or to governments.
- 5.1.7 Interest rate changes have limited power to affect the perceptions which move asset prices in the first place and might require a large move to have the desired effect.
- 5.1.8 Asset price misalignments may have their roots in underlying structural imbalances. In such cases policies designed to effectively deal with these structural causes such as prudential regulation (e.g. counter-cyclical capital standards and stabilising provisioning rules) or fiscal policy (increases in taxes) would be optimal and preferred over monetary policy tools.

Bernanke and Gertler (2000) are strong proponents of this view, motivating it as follows: “Changes in asset prices should affect monetary policy only to the extent that they affect the central bank’s forecast of inflation. Once the predictive content of asset prices has been accounted for, there should be no additional response of monetary policy to asset price fluctuations.” They incorporated non-fundamental movements in asset prices into a dynamic macroeconomic framework and applied a large positive bubble to the model. In the absence of an appropriate policy response, the resulting economic contraction was quite large, weakening balance sheets, widening bond market spreads, inducing financial distress and causing further declines in asset prices.

The framework suggested to respond to such a situation is one of explicit flexible inflation targeting¹¹ where price stability and financial stability are viewed as highly complementary and mutually consistent objectives to be pursued within a unified policy framework. Central banks should therefore adjust monetary policy

¹¹ Explicit flexible inflation targeting depicts a framework where monetary policy is committed to achieving a specific level of inflation in the long run and does not exclude significant attention to conventional stabilisation objectives in the short run.

actively and pre-emptively to offset incipient inflationary or deflationary pressures. If asset price swings occur for non-fundamental reasons and these swings have the potential to destabilise the real economy and signal changes in expected inflation, a monetary policy reaction can be justified.

5.2 The alternative view

The opposing or alternative view is that central banks should take action to restrain an excessive rise in asset prices, even when inflation forecasts do not deviate from the target ranges. By reacting to asset price volatility in the normal course of policymaking, the likelihood of misalignments (bubbles) can be reduced. According to Cecchetti, *et al*, (2000) "...a central bank pursuing an inflation target will not achieve optimum performance in terms of its inflation objective by setting its interest rate solely in response to shifts in its inflation forecast and reacting to nothing else." The proponents of this alternative view feel strongly that a central bank is likely to achieve superior performance by adjusting its policy instruments not only to inflation and the output gap but also to asset prices.

The main arguments for central banks to react directly to asset prices are:

- 5.2.1 Asset prices contain information about future inflation that can, and should, be incorporated into inflation forecasts.
- 5.2.2 Asset prices are important in the transmission of inflationary impulses and sometimes constitute a source of such impulses themselves.
- 5.2.3 Asset price inflation is usually correlated with other forms of financial imbalances, particularly with credit booms and the rapid build-up of unsustainable levels of debt.
- 5.2.4 Excessive debt accumulation is associated with activity above natural rates that tend to show up relatively soon in accelerating inflation.

One extreme view attributing a more prominent role to asset prices in the conduct of monetary policy is to include asset prices in the targeted index used to

define the policy objective. There seems to be general consensus among economists and central bankers, however, that targeting asset prices is a bad idea. The main arguments against asset price targeting are:

- That asset prices are bad proxies for future inflation,
- It would increase risk taking in anticipation of monetary policy actions,
- It would amount to double-counting inflationary pressure derived from asset prices,
- The weight for asset prices in a combined price index would be ambiguous, and
- Central banks lack sufficient control of asset prices as they are mainly driven by fundamental factors.

6. THE PROBABLE VIEWS OF SELECTED CENTRAL BANKS

6.1 Federal Reserve Board

By virtue of its mandate, the Federal Reserve Board focuses on price stability utilising a framework which has been described as an “implicit flexible inflation targeting regime”. Monetary policy does not, however, aim at any particular relative price, nor is the mandate thought to refer to prices beyond consumer prices, such as those for assets. “Ordinarily, however, asset prices are among the many factors that the Federal Reserve assesses when we evaluate present economic and financial conditions and the outlook. And when asset prices exhibit large, systematic and persistent deviations from fundamentals, the implications of those deviations inevitably get more prominence” (Ferguson, 2005).

According to Bernanke and Gertler (1999), the Federal Reserve Board has reacted in a strong stabilising manner to changes in the inflation forecast and the expected output gap over the past two decades. They did not react to changes in real estate and equity prices, except to the extent that they contained information about inflation and output.

6.2 European Central Bank

The European Central Bank's (ECB) primary objective is unambiguously the maintenance of price stability. The ECB, however, monitors carefully unusual asset price developments at an early stage, allowing some short-term deviation from price stability in order to better ensure price stability over more extended horizons. "This should, however, not be misunderstood as a systemic reaction to asset price booms, but rather as a selective response based on the careful analysis of all the available information" (Trichet, 2005). The important point is that the ECB's monetary policy strategy enables boom developments to be taken into account without any amendments to the strategy and without assigning any additional role to asset prices.

The ECB's two-pillar strategy rests on a broad analytical framework, well suited to detect risks to price stability and to the economy as a whole. It also helps to identify the underlying distortions in asset prices. The ECB singles out money in its monetary analysis but it also assesses the extent to which excess creation of liquidity and over-extension of credit can be a driving force behind excessively valued assets. Detecting and understanding this link helps the ECB to form an opinion on whether an observed movement in monetary aggregates and their counterparts might already reflect the inflating of an asset price bubble. According to Trichet (2005), a case-by-case analysis based on sound information on the monetary variables, on the counterparts of monetary aggregates and on the related functioning of the asset market is indispensable.

6.3 Bank of Japan

According to Bernanke and Gertler (1999), monetary policy in Japan actively fuelled the increase in equity prices during the 1987-1989 period. After the equity market crashed in 1990, Japanese monetary policy appeared to make some attempt to support equity prices but failed to react sufficiently aggressively to the declining rate of inflation. Consequently, Japanese monetary policy was

too tight from 1992 to 1996. This is reflected in the very slow rate of adjustment of nominal interest rates in the face of changing macroeconomic conditions.

6.4 Bank of England

The Bank of England (BoE) uses an inflation targeting regime in pursuing price stability as its primary objective. The BoE raised its repo rate by 0,25 percentage points on five occasions between November 2003 and August 2004. Following these decisions, the BoE was one of the first central banks to refer to the real estate market in its news releases issued subsequent to the meetings of its Monetary Policy Committee.

In each of these news releases the Monetary Policy Committee refers to either “a buoyant housing market”, or “unexpectedly strong house price inflation”, or “a strong housing market”, adding to rising inflationary pressures as an explanation for the decision to increase interest rates.

7. CLOSING REMARKS

The current global property market has been described as the biggest financial bubble in history. As a result of a long period of historically low interest rates and an aversion to other poorer performing asset classes, real house prices in many parts of the world have peaked. House prices are at record high levels in relation to both rentals and income, and there is growing concern that a synchronised massive sell-off could be triggered, resulting in macro-economic costs.

The world’s central banks are clearly not indifferent to this situation, although there is no consensus about how central banks should respond. An emerging view seems to be that only asset price bubbles that occur for non-fundamental reasons, that impact the real economy and that signal changes in expected inflation, justify a monetary policy reaction. Otherwise regulatory responses and close monitoring of the situation would probably suffice.

In South Africa, notwithstanding the fact that our average house price increases have topped the list, there is less concern over a bubble condition. This is so because there were unique fundamentals supporting what was essentially a “catch-up” phase. In addition, there are already clear signs of a gradual flattening of prices growth due to lower investor activity.

2005-08-31

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