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PRESS RELEASE

Share prices, house prices and monetary policy

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The recent developments in share prices and house prices have re-ignited the debate on the role of asset prices in the conduct of monetary policy. Although the central banks do not set any target for the prices of assets such as shares or property, they do monitor the development of these prices because they can serve as a leading indicator of financial and monetary instability. However, there is no consensus as to exactly how a central bank should take account of asset price fluctuations.

The first part of this article highlights the complex relationships between asset prices, macroeconomic variables and monetary policy. Firstly, the possible causes of fluctuations in asset prices are considered, i.e. macroeconomic developments, monetary policy and excessive optimism or pessimism. Asset prices can be seen as the discounted value of income or service flows expected in the future. On the one hand, these expectations are based on fundamentals. Share prices, for instance, are positively correlated with the economic outlook (through the expected development of dividends) and negatively correlated with inflation expectations and the interest rate level (through the discount rate). House prices, however, are driven up not just by favourable growth prospects (through disposable income) and low interest rates, but also by high inflation. This distinction compared to share prices also explains why share and house prices sometimes react differently to a monetary policy easing. While house prices will usually respond positively to a lowering of short-term interest rates, this is only true of share prices if the easing of monetary policy is seen as non-inflationary. On the other hand, expected income and service flows can also be subject to excessive optimism or pessimism. However, it is extremely difficult, particularly in real time, to distinguish speculative euphoria (a financial bubble) from a price rise based on fundamentals.

Next, the main channels are described through which a rise in asset prices can stimulate aggregate demand (and possibly fuel inflation). This happens as a result of increased demand for new assets (Tobin's q), because of the wealth effects on consumer spending and as a result of easier credit (financial accelerator).

Finally, the first part of this article deals with the question of whether monetary policy should react to sharp fluctuations in asset prices. Evidently, a central bank will respond to a rise in asset prices to the extent that it appears to be a leading indicator of the business cycle and impending inflationary pressure, although this is not easy to specify. Moreover, a central bank will also react to a crash, in proportion to its impact on activity and inflation. Rarely, however, will a central bank take decisive action in order to counter rapidly rising asset prices in the absence of inflationary pressure, as the ideal conditions for pre-emptive action aimed solely at preventing a bubble from forming, are clearly never met.

The second and third parts deal with recent developments in share prices (in the United States and the euro area) and house prices (in the euro area, in the countries that have experienced the biggest price increases and in Belgium) and then examine whether a bubble has formed on these markets. A bubble is described as a rise in prices fuelled by spiralling price expectations which, based on the fundamentals, do not appear to be justified. To assess whether shares are overvalued or undervalued, financial ratios such as the price/earnings ratio or the price/dividend ratio are often used in practice. Such ratios specifically signal the possibility of a price correction, rather than the exact timing of the trend reversal. Based on the price/earnings ratio, share prices in the euro area do not appear to be markedly overvalued at present.

To assess whether the housing market is overvalued or undervalued, affordability measures such as the ratio of disposable income to the monthly cost of mortgage repayments are often used. When applied to the average house price in the euro area and in Belgium, they indicate that the sharp price rises in recent years do not appear to be excessive. That said, there are certain risks inherent in the historically low level of mortgage interest rates and in the developments seen in a number of countries in the euro area.

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
BE-1000 BRUSSELS
phone + 32 2 221 46 28
www.nbb.be
VAT BE 203 201 340

For the ECB’s Governing Council, the recent developments in asset prices in the euro area are not, in themselves, a good enough reason to tighten monetary policy. However, the Council keeps a vigilant eye on the consequences for liquidity, credit and asset prices of maintaining interest rates at a low level. Thus the regular macroeconomic projections, as part of the economic analysis which constitutes one of the pillars of the ECB's monetary policy strategy, take account of the «normal» effects of the movement in asset prices, such as wealth effects. In addition, as part of the monetary analysis, the development of a number of indicators regarding money and credit is monitored, along with indicators of any overvaluation of assets. In this way, it is possible to asses the risk, if any, of financial imbalances building up.

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National Bank of Belgium Ltd.
boulevard de Berlaimont 14
BE-1000 BRUSSELS
phone + 32 2 221 46 28
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VAT BE 203 201 340
TRB 22 300