MONETARY POLICY AND “FINANCIAL BUBBLES”

The traditional view of the problem is that monetary authorities should not directly respond to changes in financial asset prices. The following arguments are usually put forward:

- prices for financial assets in the short run are volatile, and they can not serve as determinants of long-term monetary policy;
- in practice, it is almost impossible to find out whether the price increase for financial assets reflects an improvement in the real sector of the economy, or it is just a speculative mania;
- even if the central bank reacts systematically to fluctuations in prices for financial assets, its actions will lead to destabilization of the economy.

Supporters of regulating lead two simple argument in favor of the policy of confrontation “financial bubble”.

The first argument is based on the classic “Poole’s analysis” (named after W. Poole [8], the ex-president of the Federal Reserve Bank of St. Louis). Its
meaning lies in the fact that the central bank should "row against the wind" when revaluing financial assets, if the price increase has no basis. Conversely, if a financial boom has roots in the real economy, the central bank should allow it to develop independently. These recommendations [8] are a typical example of an anti-cyclical economic policy which smoothes fluctuations in market conditions.

The second argument concerns the time of intervention of monetary authorities in the market. It is known that the most destructive effects of the “financial bubble” are in the post-peak period. The government faces problems with inflation and economic growth, when the “financial bubble” was long gone. To prevent such a course of events, the central bank should adhere to countercyclical policies in advance. In other words, it should intervene even at the initial stage of growth of the “financial bubble”. Then the next correction in the financial market will be relatively small, and the loss of the economy in terms of inflation and GDP will be minimal.

The central bank's opponents are concerned that such a policy will provoke unscrupulous behavior of investors. If the monetary authorities take control of the “financial bubble”, then the speculators inflate it even more. They will hope that authorities will compensate potential losses, because they will responsible for the financial boom in in such situation.

The problem of dishonest behavior arises from the asymmetry of the actions of the central bank. After all, it usually reacts not so much to the growth of quotations, but to their fall. Partially such behavior of the authorities is justified by the fact that market prices change asymmetrically themselves: the “bubble” swells slowly, and bursts fast.

However, if the central bank starts to react equally to the rise and fall, then the dynamics of the market may also change. Knowing that the monetary authorities will not allow excessive revaluation of assets and a sharp drop in prices, quotations will change more smoothly, and investors will stop blindly
following the crowd. Thus, the problems of unscrupulous behavior of investors can be avoided if the central bank acts symmetrically, reacting both to growth and to falling prices.

The main problem of the countercyclical policy is the assessment of the adequacy of the growth of prices for financial assets [1, 2], i.e. whether the financial boom corresponds to the improvement of the fundamental macroeconomic indicators or not. Many scientists, including [9], believe that investors are always partial, and during the boom, they misjudge the situation.

The rise in prices for financial assets can be either rational or irrational [4]. It is rational when it leads to an improvement in real sector of the economy: an increase in labor productivity, scientific discoveries, excellent financial results, etc. If nothing like this is observed, and prices are rising, the financial boom turns into a “financial bubble”. There may be several reasons for this: herd behavior of investors (“crowd effect”), imperfect market regulation, financial liberalization, etc.

However, we must find out why the revaluation of financial assets is so dangerous for the economy. “Financial bubble” creates distortions in investment and consumption. This leads first to an economic boom and expansion of business activity, and further to recession and inflation. Intervention of monetary authorities can smooth these cyclical fluctuations and reduce losses of the economy.

The authors of this article suggest to understand more in detail the role of the state in inflating or containing the bubble through monetary policy or the policy of “supporting” investors. Opinions of economists-theorists and regulators-practitioners are similar on the policy of restraining the inflation of a bubble with the help of monetary instruments.

They are unanimous in that interest rate regulation is not a good tool in this case [3, 5, 7]. However, the speed of the formation of a financial bubble directly depends on the rate of credit expansion, which is aimed at the
acquisition of certain assets. In turn, the scale of credit expansion depends on the ratio between the cost of collateral and the amount of the loan.

At present, the distinction between investment and commercial banks has completely disappeared. Sophisticated financial instruments and new ways of not showing assets on bank balance sheets were invented. It was here that the causes of the periodic emergence of "financial bubbles" arose. New financial instruments and technologies of trading and financing had one fatal flaw: they were based on the assumption that financial markets are striving for equilibrium. It was believed that the temporary deviations are random, and the values eventually reach a certain average. Securitization and other innovative tools have allowed the redistribution of risks. The more risks are distributed, the greater risks can be accepted. Worse still, the new methods and tools were so sophisticated that the regulators were not able to assess the risks associated with them. They had to use the methods of risk assessment developed by the organizations that created these tools. The current international agreement on banking supervision allows large banks to rely solely on their own risk assessment systems [9]. Something similar happened to rating agencies, designed to assess the reliability of financial instruments. They had to rely on the calculations of the authors of these instruments.

Proposals to prevent the formation of “financial bubbles” due to credit expansion can be formulated [6]:

– It is advisable to legislatively establish the maximum amount of a blank loan granted to one borrower. This amount should depend on the legal status of the borrower;

– The introduction of a statutory minimum discount to ensure, irrespective of its quality, at 20% for the crisis stage and the stage of economic recovery and up to 95% during the boom. The regulator determines specific discount values in the boom period. At the same time, current provisions relating the cost and quality of collateral to the amount of the
actual provision for possible losses on loans remain;

- If another pledge is made, the loan should be provided solely on the difference between the current security value and the principal balance of previously provided loans for this security;
- The regulator itself should develop risk assessment systems for newly introduced financial instruments, with mandatory application by commercial banks and rating agencies.

References