# Bubbles and monetary policy

How should monetary policy respond to a potential financial bubble? The answer given by economists and central bankers has evolved in recent years but the debate is far from over.

Before the financial crisis that triggered the Great Recession, the standard approach (what might be called the Greenspan doctrine) advocated a very narrow mandate for monetary policy whose essential aim was to stabilise inflation around a particular target.

According to this approach, central banks should only respond to fluctuations in asset prices (such as equity or real estate) insofar as they affect economic activity and inflation. The logic applied by central banks did not distinguish between temporary fluctuations in asset prices and bubbles, understood as excessive, persistent deviations. It was believed that, following the bursting of a bubble, monetary policy would be able to react quickly and forcefully enough to offset any impact on economic activity and inflation.

But the crisis came and the Greenspan doctrine fell apart. We have learned that the costs incurred by some bubbles are difficult to manage after the event. As bubbles grow, resources are misallocated with the consequent negative effects, and when bubbles burst they result in financial instability.

This doctrine has evolved in the light of recent events and the main central banks now recognise the importance of financial stability. Nevertheless, those who believe that monetary policy should try to deflate or prick bubbles are still in the minority. The general opinion is that the interest rate hikes required to affect bubbles would be too large and cause huge damage to the real economy.

More or less explicitly, the responsibility of combating bubble formation have largely been given financial regulation and supervision, for example through macroprudential policy, which may impose capital surcharges on certain activities. Bank regulations have also been tightened, ensuring the sector is better prepared to absorb any losses brought about by a bubble bursting.

This strategy, however, is not without its risks. For instance, whether macroprudential policy is effective enough in practice still remains to be seen as it would require making potentially unpopular decisions (most people own property and they would not want a housing bubble to be pricked). Moreover, a part of the financial system (so-called «shadow banking») would be able to avoid the stricter regulations and supervision.

And finally, we have learned that, albeit indirectly and involuntarily, a central bank can end up encouraging bubbles if it focuses solely on meeting its inflation and economic activity targets. In fact, managing monetary policy can ultimately become a Sisyphean task (inflate the bubble, deflate the bubble, inflate the bubble...).

A more prudent approach makes monetary policy jointly responsible, together with regulation and supervision, for ensuring financial stability. Monetary policy decisions must therefore go beyond the price of goods and services that make up the CPI and also take asset prices into account.

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