Statement by Mr Lars Heikensten, G 10 Ministers and Governors, September 27, Washington D.C.

Mr Chairman,

I have been asked to introduce a discussion on asset prices, what if anything should policymakers do to influence asset prices? The primary focus of my intervention will be on micro-policies. But I have also been asked to say a few words on the much more analysed and discussed question; what can monetary policy do? This to help spark a general discussion.

The distinguishing feature of asset prices is that they reflect information and expectations about the future. As a consequence, they do change dramatically from time to time. In turn this entails the risk of substantial misallocations. Investment in IT/Telecom during the late 1990's and 2000 is a recent example.

Also, there can be substantial effects on real developments and on inflation. This is particularly so since financial assets now, relative to a few decades ago, are more important in our economies as shares of GDP, households wealth etc.

Finally, there is a strong link via several different channels between asset price developments and financial stability. Unhealthy lending has often been a primary trigger behind asset price bubbles. In particular, there has been a strong connection between boom in property markets and banking crisis.

So, there are, obviously, potential risks for economic and financial developments emanating from asset markets.

1. Let me now turn to the first policy issue; should macroeconomic tools be used to influence asset markets? There is now a vast literature on this issue. One obvious reason for the lively debate is the continuing occurrence of financial crisis despite the success of monetary policy in curbing inflation.

I shall not take your time by going through all the arguments against using monetary policy to influence asset prices. Or all the complications. Let me only mention the difficulties involved in judging if prices are out of line with fundamentals and the potential political problems involved when taking asset prices into account in actual policy. Also, it is an open question how strong the effects of changes in interest would be on asset price markets.

However, coming from where I do, having been in the Ministry of Finance in the early 1990's, right in the middle of a deep real and financial crisis, I agree very much with what Andrew Crockett said recently in a speech in Hong Kong. Let me quote "It seems a counsel of despair to say that nothing can be done. The cost of uncontrolled financial cycles are sufficiently large that avenues for resisting them should at least be explored." "At a minimum", he suggests, "that central banks, when formulating monetary policy aimed at an inflation objective should take explicit account of the impact of financial developments on the balance of risks"

Personally, I believe that we have information today which can guide us in this. It is not necessary to know for sure that asset prices are out of line. History shows that combinations of rapid credit growth and asset prices growing substantially faster than the price of output are dangerous. A useful reference on this is a recent study by Claudio Borio and Philip Lowe of the BIS. Obviously, difficult judgements have to be made. But I am not sure that they are more difficult than other judgements we have to make when shaping policy, for example on how to respond to exchange rate movements.

Also, there is the argument for symmetry. Most of us have been willing to factor in risks of this kind on the downside in e.g. 1998 or last fall.

Let me add that this is a policy that I believe we could have defended in Sweden given our history. On television, in media, I would only have had to refer to what happened in 1990. It is still fresh in people's minds. In other countries it might be easier to defend today, given what has happened recently.

2. Let me now turn to my second topic. Can micro policies play a role?

Regardless of our view on the role of monetary policy actions, we can all agree that using interest rates to influence asset prices is difficult and not without costs. Also, countries within monetary unions do not have a national monetary policy. What is left in their case for macroeconomic stabilisation purposes is fiscal policy, which for well known reasons is probably even more difficult to apply.

Against this background, it would be valuable to find alternative policy tools. Could micro policies – taxes, regulations or disclosure policies – play a role in this context? This was the starting point of our study.

There is not much in the literature on this issue. Hence, we have done a small study, based on cases supplied to us. These cases demonstrated that micro policies have effects on asset prices. Excessive price movements have in many cases been exacerbated or even initiated by abrupt changes or deficient deregulations Typical stories involve combinations of high marginal tax deductions and lax supervision of financial intermediaries. When some or all of these conditions have changed over a short period of time, often as a consequence of policy intervention, subsequent asset price crashes have been unavoidable.

Against this background, the report stresses three issues:

1. Most important, we policymakers should focus on the need to build financial systems where on the one hand incentives to participate in the build-up of price bubbles are small,

and, on the other hand, boom and bust in asset markets have limited consequences for the economies as a whole. Key words are robustness, neutrality and transparency. Nothing new you might say! Still there are even in our countries many examples of policies which are not up to standard in this respect.

2. Secondly, we stress that policymakers, when considering changes in taxes, regulations etc, for what ever reason, should more systematically consider the potential consequences of these changes on asset prices and financial stability. This is something which, historically, often has not been done. Today the lesson is probably most important for countries starting with fairly regulated financial markets and complicated non-neutral tax systems.

3. Finally, there is the question of what to do if worst comes to worst; if there are reasons to believe that financial stability is at risk. The report discusses some measures that have been used in this context and been found not to work. One such example is turn-over taxes of the Tobin kind on equities and derivatives. More promising are measures directly aimed at financial sector participants. Examples of this include raising capital requirements for certain loans or gradually reducing loan-to-value-ratios as asset prices rise. Such measures are obviously not without cost – and the cost tends to increase the longer they are applied – but they appear feasible if the situation is considered pressing enough. In general, there are probably better chances to influence property markets than equity markets since they are less standardised and internationally integrated. Luckily, the most severe examples of financial instability have so far emanated from property markets.

We also note the role of information. Governments and central banks can play a role by pointing out weaknesses in the financial systems and imbalances which are building up. Some of us are doing this regularly in reports on financial stability.

The report concludes by pointing out the risks that these issues are not given sufficient priority on the agenda of policymakers. One reason for this is that they are low frequency events, another that the responsibility is shared between different institutions. Also, continued economic integration makes policy intervention difficult and increases the need for international coordination of financial regulation and supervision.

We thought these reasons were a good basis for having a discussion on this topic with Ministers and Governors – having shared responsibilities – and to do it in the G 10; involving the major financial centres.

Thank you.