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Boom-Busts in Asset Prices, Economic Instability, and Monetary Policy

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The link between monetary policy and asset price movements has been of perennial interest to policy makers. In this paper we consider the potential case for pre-emptive monetary restrictions when asset price reversals can have serious effects on real output. First, we provide some historical background on two famous asset price reversals: the U.S. stock market crash of 1929 and the bursting of the Japanese bubble in 1989. We then present some stylized facts on boom-bust dynamics in stock and property prices in developed economies. We then discuss the case for a pre-emptive monetary policy in the context of a stylized 'Dynamic New Keynesian' framework with collateral constraints in the productive sector. We find that whether such a policy is warranted depends on the economic conditions in a complex, non-linear way. The optimal policy cannot be summarized by a simple policy rule of the type considered in the inflation-targeting literature.

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