BOE Posen Doubts Central Banks Can Spot Asset Bubbles In Time

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LONDON (MNI) - Central banks cannot reliably identify asset bubbles early enough to be able to tackle them, Bank of England Monetary Policy Committee member Adam Posen says in a speech at the Cato Institute in Washington D.C..

The speech sets out the second leg of Posen's attack on the new, post credit crunch mantra that central banks should be ready to "lean against the wind" and prevent asset bubbles. It contains no reference to the current UK economic and monetary conjuncture.

Prior to the credit crunch, central bank orthodoxy was that policy should not be set to tackle asset bubbles. Central bankers simply tried to deal with the, often messy, aftermath if they occurred.

The spectacular fallout from the bursting of the US real estate bubble, and the shock of the global credit crunch, has sparked a rethink of central bank orthodoxy but Posen thinks the new "lean against the wind" mantra is not supported by the evidence.

Posen points out a necessary condition for central banks to tackle asset bubbles is that they can reliably identify them in time to act, but he says research looking at a large number of bubbles suggest this is simply not true.

"It is currently beyond the ability of policymakers to discern in real time which booms are harmful and merit pre-emption, and which are not, even taking recent horrible events into account," Posen said. The challenge is for central bankers to come up with methods that allow them to "distinguish dangerous from safe asset price booms and reliable advance indicators which warn them sufficiently far ahead of booms (and busts) emerging." Posen says future researchers may be able to come up with ways of doing this, but the research he has been involved in does not show it is possible.

Looking at equity price booms, for example, Posen cites the work of Brad de Long, who points out that "historically equity booms have been associated with technological advances, and cutting them off can do lasting damage to productivity growth."

Posen says that either policymakers will end up cutting off helpful asset booms, or will have to come up with ways of differentiating between benign and malignant booms.

The MPC member also highlights the time consistency problem. Changes in monetary policy have, as the mantra has it, long and variable lags before they take full effect.

With many asset bubbles lasting for relatively short periods of time, changes in policy could well come too late to impact them.

"Unless one believes that the first rise in interest rates, or the initial announcement of a commitment to raise rates as much as necessary to stop the boom in question, would be sufficient to cut off the boom quickly, even pre-emptively oriented central banks would be intervening on average after the expected lifetime of the average boom had passed," Posen says.

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