The Implications of Speculative Bubbles for Monetary Policy

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Abstract

The question of how monetary policy should respond to asset market bubbles is being hotly debated. Some argue that central banks should prick speculative bubbles while others argue that they should instead be ready to contain the fallout after the bubble bursts. This paper presents evidence that there is a large, time-varying risk premium associated with uncertainty about monetary policy. Attempts to burst asset bubbles will increase this premium, not only causing the bubble to burst but also depressing fundamental values. Thus, attempts to pop a bubble will cause asset prices to fall more than they would otherwise. Pricking bubbles will also redirect investors' focus from forecasting fundamentals to forecasting the forecasts of the central bank. This will dilute the informational content of asset prices and interfere with the allocation of resources. Historical experience also indicates that it is better to use prudential regulations to strengthen the financial sector before the bubble bursts and use expansionary monetary policy to limit the macroeconomic damage after it bursts rather than to pop a bubble pre-emptively.