Asset and Commodity prices: Implications for monetary policy

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A Distinctive Characteristic of Current Economic Times

The coexistence of low CPI inflation with significant asset price increases and with high and rising commodity prices.
World Inflation (CPI)

Source: IMF, WEO
US equities
Dow Jones Industrial Average ('000)

Source: Thomson Datastream

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MSCI Emerging Markets Equity Index
2000-2007

2000 = 100

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GOLD
U$S per Troy Ounce – January 05/Sept. 06
House prices
Annual percentage change

UK lagged five quarters, Australia seven quarters

Source: Financial Times

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“Inverted Jenny” (1918)
Price: U$S 200,000.-
Goldman Sachs Commodity Index
2000-2007

2000 = 100

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Commodity Prices
(1/1/2004 = 100)
Two issues arise in this context:

I. **Should** Central Banks consider asset and commodity price developments—*bubbles*—in formulating monetary policy?

II. Is the **Current** asset price boom rooted on different causes, compared with previous similar events?
• “Bubbles”, should be understood as “misalignments”, i.e., departures from fundamentals.

• There is no argument about the futility of reacting to “equilibrium” asset price changes unless they impact, in a measurable manner, on the inflation forecast and the outlook for real activity.
“Conventional View”

• Monetary policy should not respond to changes in asset prices, except if they signal changes in expected inflation or have implications for future output and price developments.
“Conventional View” (2)

- Monetary policy can do little more than deal with the fallout from unwinding of asset price bubbles
The “Extra Action” View

- Central Banks should take action to restrain an “excessive” rise in asset prices, even when inflation forecasts do not deviate from the target rates.

- In order to reduce the likelihood of bubbles, CB reaction to asset prices should be in the normal course of policy making.
<table>
<thead>
<tr>
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<th>Arguments for no intervention</th>
<th>Arguments for “Extra Action”</th>
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<tbody>
<tr>
<td><strong>Identification difficulties</strong></td>
<td>• Misalignment of asset prices are almost impossible to identify.</td>
<td>• No more difficult than “output gap”, “natural rate”, or equilibrium real interest rate.</td>
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<tr>
<td><strong>Credibility issues</strong></td>
<td>• Asset price too volatile &amp; expectation-dependent to be a credible target.</td>
<td>• Reputation at stake, if neglect financial stability (even if inflation objective achieved).</td>
</tr>
<tr>
<td></td>
<td>• Focus on primary CB objective -- avoid public confusion.</td>
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<tr>
<td><strong>Policy effectiveness</strong></td>
<td>• Interest rate too blunt a tool.</td>
<td>• Natural burst can be larger, implying longer recession</td>
</tr>
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<td></td>
<td>• Risk of recession if bubble popped.</td>
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3 conditions for “Extra Action”

1. CB should be able to **identify** the bubble timely and with certainty.

2. CB should be certain that a modest tightening would indeed **check** the speculative activity behind the bubble.

3. The gains from avoiding the bubble bursting should exceed the current cost of tightening.
Current Asset Price Developments:  A Bubble or Fundamentals?

The Globalization process and its specific characteristics have created conditions that result in a *new equilibrium set* of:

* Commodity, energy and raw material prices
* Relative factor prices
* Asset prices
Commodity Prices

• The acceleration and distribution of world growth have created structural changes in the world supply and demand conditions for commodities, with structural excess demand and low inventories.
CHINA: Commodity Imports
(in U$S bn.)

Source: The Economist
Metals: Inventories
(Inventories in the LME-thousands of tons)

Fuente: EcoWin

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Monetary Policy could play a modest active role in this case

- In **Importing** countries, this is a supply shock. Monetary policy should not be tightened but rather moderately expansive.

- In **Exporting** countries, monetary policy could be contractive to reduce monetary impact of external surpluses, but main role is for a fiscal stabilization fund.
What about current asset prices (stocks, bonds, real estate, precious metals, collectibles, etc.)?
High asset prices do not just reflect excess liquidity but they *may be close to a new, higher, equilibrium level* due to:

(a) Well known rapid increase in productivity and corporate profitability

(b) Changes in **demand patterns** arising from persistent changes in **factor income distribution**
Two elements explain the long term, structural, change in factor income distribution


2. Fast technological change in the advanced economies with extraordinary productivity gains (especially in the United States)
1. Growing World Labour Force

- It is estimated that China, together with India and Russia have duplicated the world labour force over the last 10 years (particularly of low-skilled labour)

- This increase in labour supply contains wage pressures at a global level (directly and indirectly)
The consequences:

- A sustained fall in the price of labour intensive manufactured goods with global CPI inflation contained across the world.

- The increase in labour supply pulls down global wages pushing up capital returns.
Wage Share
G-10 – As % of Total Value Added

Fuente: BIS Annual Report 2006
An historical record: 13 straight quarters of double-digit gains in corporate earnings in the USA – More of the same is expected this and next year.
CHINA

[Graph showing industrial profit margins as a % of sales revenue from 1990 to 2006, comparing total industry to state-owned enterprises.]
In addition, the distribution of income *among wage earners* is also affected due to labour saving technical change.
2. Productivity Gains

Output per hour in the USA had increased (almost without pause) at a rate of about 3% a year since 1994.
US: Productivity Gains

<table>
<thead>
<tr>
<th>Period</th>
<th>Productivity</th>
<th>Real compensation</th>
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<tbody>
<tr>
<td>1948–1960</td>
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<td>1960–1969</td>
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<tr>
<td>1995–2005</td>
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Facts (1)

• In the United States, over 1997-2001, only the top 10% of the income distribution had a growth of real wage equal or above the average rate of productivity growth.

• Median real wage and salary income did not grow at all.
Income Share of the top 1%
USA, UK, Canada
Facts (2)

- The top 1% of households account for 33% of net worth (more than the bottom 90% put together)
- The top 1% of households account for 40% of *financial* net worth (more than the bottom 95% of households put together)
Facts (3)

- According to Merrill Lynch, the number of “millionaires” in the world grew by 6.5% just in 2005.
“Millionaires” of the World, and their Assets

Merrill Lynch: WWR
• Their assets, however, grew by 8.5% in 2005 to an estimated U$S 33.300bn and doubled (!) since 1997.
How much is U$S 33tn.?

- $33tn. = $ 33.000.000.000.000
- The GDP of the USA is about $ 13tn. a year
- The World GDP is estimated to be $42tn. a year.
- The complete universe of Hedge Funds manage about $1.5tn
World Millionaires by Region

- Europe: 2.8 million
- Asia-Pacific: 2.9 million
- Latin America: 0.3 million
- Middle East: 0.3 million
- Africa: 0.1 million

Merrill Lynch: WWR

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In which countries the number of millionaires is growing faster?
## CHINA: Hurun Report Rich List

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<tr>
<th>Name</th>
<th>Firma</th>
<th>Net Wealth</th>
</tr>
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<tbody>
<tr>
<td>2. Huang Guangyu</td>
<td>Gome (electronics)</td>
<td>US$ 2.6 bn.</td>
</tr>
<tr>
<td>5. Shi Zhengrong</td>
<td>Suntech Powersolar</td>
<td>US$ 1.9 bn.</td>
</tr>
</tbody>
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In 1998 a cut-off US$ 6 m. was enough for a top 50 listing. In 2006, to qualify for a top 500, a person must be worth at least US$ 100m.
• Given the different propensities (and ability) to accumulate assets, is this shift in income distribution that explains the increase in asset demand and the rise in asset prices.

• This also explains the coexistence of low CPI inflation and significant asset price increases.
• Real Estate remains the leading alternative investment for the world’s wealthy:
One in three “millionaires” have residences in more than one country.
• Credit Suisse reports that wealthy clients have 15-20% of investables in international real estate (5-7% in private equity, hedge funds and structured products)

• A huge variety of real-estate based products have developed (REITs, Funds of RE funds, RE mutual funds, etc.)
Commodity mutual fund assets under management ($mn)

- Credit Suisse Commodity Return Strategy Fund
- Merrill Lynch Real Investment Fund
- Oppenheimer Real Asset Fund
- PIMCO Commodity Real Return Strategy Fund

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If indeed asset price inflation coexists with stable and low CPI inflation, there is little role for monetary policy:

-- It is not a bubble

-- Monetary Policy cannot affect income distribution changes arising from global changes.
Thank you