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Monetary policy and the stock market in the euro area☆

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Abstract

In this paper we study the role of the stock market in the transmission mechanism in the euro area and evaluate whether price stability and financial stability are mutually consistent and complementary objectives. Four major conclusions can be drawn from our work. First, stock prices and, more generally, relative asset prices seem to play an important role in the transmission mechanism in the euro area. Second, we do not find any significant, direct impact of stock prices on inflation. These two findings taken together support the view that stock market prices may be important for monetary policy, independently of their direct impact on inflation. Third, permanent productivity shocks are the driving force of the stock market in the long-term and contribute significantly to its cyclical behaviour. Nevertheless, the bulk of cyclical dynamics in the stock market is explained by transitory shocks. Fourth, a monetary policy focused on maintaining price stability in the long-term can contribute also to stock market stability.
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1. Introduction

Recent world wide stock market volatility has revived interest in understanding the possible role of central banks in preventing or reducing the disruptive effects of financial shocks on the economy. In fact, beyond the need to better understand the role of stock prices in the transmission mechanism, monetary policy should take stock prices into account as large swings in stock prices, either related or unrelated to fundamentals, may have a destabilising impact on the economy. This idea and its implications for monetary policy has been formalised and discussed in a recent paper by Bernanke and Gertler (1999), who recommend that price stability should be the overriding long-run goal of monetary policy, in order to avoid stock market volatility. This conclusion is challenged by Cecchetti, Genberg, Lipsky, and Wadhwani (2000) who recommend that central banks should react directly to equity price movements. However, according to Cecchetti et al. (2000), central banks should not include asset prices in the objective of monetary policy. Goodhart (1999) considers asset prices directly in a broader measure of price stability along the lines of Alchian and Klein (1973). In fact, these authors suggest that a central bank concerned with price stability should be preemptive and take explicitly into account asset prices, as well as other economic indicators, when making monetary policy decisions. This strategy should improve macroeconomic performance (reduce the variability of output and inflation), avoiding large asset price misalignments, boom and bust investment cycles, inflation and employment instability.

In this paper we make a contribution to the current debate on these policy issues. We analyse within the framework of a small macroeconometric model for the euro area, the interactions between nominal variables (nominal interest rates and inflation) and real variables (output, real M3 balances and real stock market prices). The purpose is twofold. First, to improve our understanding of the role of the stock market in the monetary transmission mechanism in the euro area. Second, to assess whether a monetary policy oriented towards medium-term price stability is consistent with smoothing stock market developments in the euro area.

Four major conclusions can be drawn from our empirical work. First, stock prices and, more generally, relative asset prices seem to play an important role in the transmission mechanism in the euro area. In fact, real output reacts to the slope of the yield curve and to deviations of stock market prices from equilibrium. Second, we do not find any significant, direct impact of stock prices on inflation. These two findings taken together support the view that asset market prices may convey information for monetary policy even though no direct link to future inflation could be found. Third, permanent productivity shocks are the driving force of the stock market in the long-term and contribute significantly to its cyclical behaviour. Nevertheless, the bulk of cyclical dynamics in the stock market is explained by transitory shocks. These facts illustrate the difficulty inherent in conducting a monetary policy oriented directly towards stock market price stability.

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