The case against attempting to prick bubbles rests on the following arguments.

- Identifying bubbles is hard.

- Even if there is a bubble, monetary policy is not the best tool with which to address it. An asset price bubble will not respond to small changes in interest rates; only a sharp increase will suffice to prick a bubble. However, a drastic increase in interest rates can cause more harm than good by depressing output growth and increasing output volatility.

The claim that an asset price bubble will not respond to a small change in interest rates has been made in the context of stock market bubbles, where the proposition is most plausible. When the stock market is rising by 20 percent a year, a small increase in interest rates will not outweigh the effects of rapid asset price increases.

However, the stock market may not be the best context in which to discuss the financial stability role of monetary policy. The housing market, with its more prominent role for leverage and credit, and markets in the derivative securities associated with housing investment may be more pertinent. Monetary policy stands at the heart of the leverage decisions of banks and other financial intermediaries involved in lending for housing-related investments. In this setting, even small changes in funding costs may have an impact on risk-taking and funding conditions. Financial intermediaries, after all, borrow in order to lend. The spread between borrowing and lending rates is therefore a key determinant of the use of leverage and has important implications for the interaction between banking sector loan growth, risk premia, and any ongoing housing boom.[7]

Focusing on risk taking by banks and other financial intermediaries will lead the policy maker to ask additional questions about risks to the stability of economic activity. Rather than waiting for incontrovertible proof of a bubble in housing markets, for example, a policy maker could instead ask whether benign funding conditions could reverse abruptly with adverse consequences for the economy. Even if policy makers are convinced that higher housing prices are broadly justified by secular trends in population, household size, and living standards, policy intervention would still be justified if the policy maker also believed that, if left unchecked, current loose monetary conditions significantly raise the risk of an abrupt reversal in housing prices and of financing conditions, with adverse consequences for the financial system and the economy.

Not responding in this way has led to a dangerously asymmetric response to credit market developments. Central banks have allowed credit growth to run free, fueling booms, and then flooded markets with liquidity after the crash, bailing out financial institutions and bondholders. This asymmetry has contributed to stretched balance sheets, with faster lending growth and leverage in times of low risk premia, more violent deleveraging when risk premia rise, and frequent booms and busts.

For all these reasons, there is a case for central banks to guard against credit market excesses. An inflation-targeting central bank may argue that it does so automatically insofar as higher asset prices boost aggregate demand through wealth effects and create inflationary pressures. However, some additional leaning against credit market developments would be advisable even in the absence of aggregate demand effects once it is determined that funding conditions and reduced risk premia indicate a nascent credit boom. Put differently, inflation-targeting central banks may want to stray below target when conditions are "boom-like"– when rapid asset price growth is accompanied by substantial credit expansion—since policy would otherwise become asymmetric and execerbate macroeconomic volatility.

[7] See Adrian and Shin (2011) for a discussion of these linkages.