Economic Insight

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Towards a monetary policy of comprehensive stabilisation

The ECB looks at short-term inflation targets and does not address the most urgent issue, namely to stop new bubbles forming on the housing and financial markets. The ECB needs a new monetary policy strategy which ensures not only long-term price stability but also financial stability. It needs a strategy of comprehensive stabilisation.

The bursting of speculative bubbles on the housing and financial markets is the economic scourge of our times – with far-reaching consequences for the real economy. In the eurozone alone, some eight million people have lost their job since the outbreak of the financial crisis in 2007. Many people have a growing mistrust of the market economy and are turning against free trade, which is making the economic problems worse. New financial bubbles could even pose a threat to democracy.

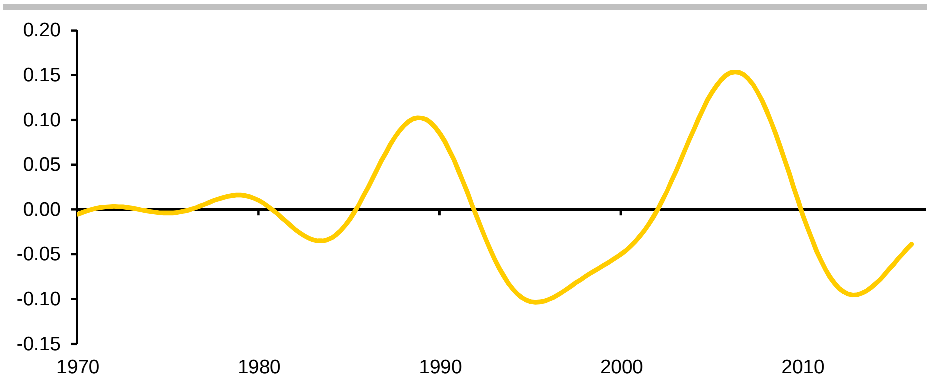
Financial bubbles much more dangerous than low inflation

But the monetary policymakers at the European Central Bank (ECB) clearly do not feel responsible. ECB president Mario Draghi keeps referring to the banking supervisors. They should prevent possible bubbles from developing on the housing markets for example through higher capital requirements, although this has not proven enough in many countries. And the ECB is saying that there is no danger at present because there are no signs of bubbles forming. The ECB is turning a blind eye to the risks.

ECB needs a new monetary policy strategy

The central bank is mainly worrying instead about the fact that consumer prices are not rising as quickly as their target rate of just under 2%. It has therefore pumped over 1000 billion euros of excess liquidity into the banking system. A monetary policy that is de facto oriented at short-term inflation targets is preventing the ECB from addressing the more urgent issue, namely to prevent new bubbles on the housing and financial markets. It is quite obvious: the ECB needs a new monetary policy strategy that not only ensures long-term price stability but also financial stability. It needs a strategy of comprehensive stabilisation.

CHART 1: **The US financial cycle has shown stronger fluctuations since the mid 1980s**
Financial cycle determined as the average of the long-term cycles of real lending volume, the quotient of the lending volume and GDP and real housing prices in the USA



Source: Commerzbank Research, BIS

Author:
Dr Joerg Kraemer
Chief Economist
+49 69 136 23650
joerg.kraemer@commerzbank.com

A key element of such a monetary policy strategy is the so-called financial cycle. Like the economic cycle describes the fluctuation of economic activity, the financial cycle depicts the ups and downs on the financial and property markets. Typical in the financial cycle is a long phase of rising asset prices. It leads people to buy houses or stocks "on tick". Once prices have risen too sharply, they suddenly slump. This often destabilises the banking and financial system and an exceptionally sharp recession begins – like in 2009 after the US housing bubble burst and Lehman Brothers went bankrupt.

Economists at the Bank for International Settlements (BIS) in Basle – the central bank of central banks – measure the financial cycle mainly on the basis of housing prices and bank loans to companies and private households (see box at the end of the document). Financial cycles calculated in this way are very long, in the USA they last 16 years on average (chart 1, front page). The financial cycle has been much more volatile since the mid 1980s. This was mainly due to the looser regulation of financial markets, riskier business models of banks, and US monetary policy. After all, ever since Alan Greenspan entered office, the Federal Reserve has encouraged exaggerations by always cushioning price falls through rate cuts and then only gradually increasing interest rates.

Making the financial cycle part of the monetary policy strategy

But back to Europe: a monetary policy strategy of comprehensive stabilisation means taking account of the financial cycle in addition to the economic cycle not only in some cases – when things gets critical – but rather on a permanent basis and at any point in time. If the central bank only reacts with higher interest rates when there are already exaggerations in the financial cycle, i.e. when bubbles have already formed, it is too late. It is not enough to prick financial bubbles, as financial risks build up over many years – and, with them, the risks of a severe recession. To avoid or at least reduce the economic damage, the ECB should use its interest-rate policy more systematically. It should do its utmost to contain the swings in the financial cycle, it should undertake comprehensive stabilisation. It must take its foot off the accelerator at the moment property prices start to rise again after a slump, i.e. when the financial cycle is on the upturn again.

Calculations of the Bank for International Settlements show that a monetary policy strategy of comprehensive stabilisation has substantial economic advantages. According to these estimates, US GDP could be 12% higher today if the US central bank had begun to increase their key interest rate to a stronger degree in 2003 amid rising house prices. It would have dampened the rise of property prices and mortgage debts and there would not have been such a deep recession in 2009, which has also weighed on growth in the years thereafter.

Interpreting the inflation target more flexibly

A monetary policy strategy of comprehensive stabilisation requires the ECB to interpret its inflation target differently. At the moment it is concerned with achieving the inflation target of just under two percent. The ECB sees the risk of the decline of inflation solidifying and leading to an economically disastrous deflation. Based on such a dramatic interpretation, it has no choice but to concentrate on the alleged greater risk, namely a possible deflation. But in so doing, it is effectively switching off the effect of the financial cycle on its monetary policy and encouraging the development of new bubbles. However, to take account of the financial cycle at all times, it must force itself to follow a more flexible interpretation of its inflation target. It should accept that inflation will deviate more strongly from 2% at times. Low or even slightly negative inflation rates do not harm economic growth. This applies both to the era of the gold standard and to the past twenty years. Deflation in America in the 1930s, which is always used as the counter-example, is an exception because consumer prices had not fallen moderately but hugely at that time, and this was not the cause but the consequence of enormous bank insolvencies that the US central bank just let happen.

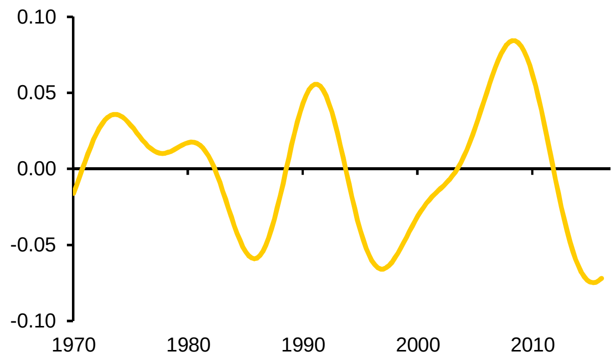
Some would argue against the introduction of a monetary policy strategy of comprehensive stabilisation by saying that EU countries would then have to change the ECB's mandate. After all, the EU Treaty obliges the ECB to maintain only price stability and not financial stability as well. However, financial stability contributes long term to stable consumer prices. A financial cycle of little volatility stabilises the economy and thus also inflation. If a debt bubble hadn't emerged and then burst in 2007, the eurozone economy would not have experienced such a slump in 2009 and inflation would not be as low as it is today.

If the ECB switches to a strategy of comprehensive stabilisation, it would presumably not be able to maintain its current negative interest rate policy. Our calculations show that the financial cycle in the eurozone is already pointing upwards again (chart 2). This is mainly due to house prices, which are no longer falling on a broad front, but actually picking up significantly again in Germany, Spain, Holland and Portugal (chart 3). Furthermore, an upturn is also emerging for corporate and private-sector lending. All these factors speak against an expansionary monetary policy – and therefore in favour of slightly positive key interest rates.

If the ECB were to increase its key interest rates to ensure financial stability, government bonds of highly indebted peripheral member states would undoubtedly come under huge pressure; the causes of the sovereign debt crisis have not been resolved on a broad scale. If the finance ministers do not increase the safety net of the European Stability Mechanism (ESM) – which is to be assumed – then the ECB would probably unfortunately be forced to maintain the de facto unlimited bond buying programme of autumn 2012 (OMT). But it should pay this price in order to be able to pursue a better monetary policy strategy.

CHART 2: **Eurozone: Financial cycle has turned upwards**

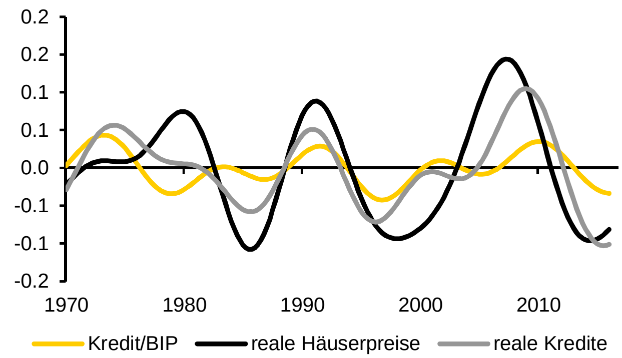
Financial cycle determined as the average of the long-term cycles of the real lending volume, the quotient of the lending volume and GDP and real housing prices in the eurozone



Source: Commerzbank Research, BIS

CHART 3: **Eurozone: The housing bear market is over**

Long-term cycles of real lending volume, the quotient of the lending volume and GDP and real housing prices in the eurozone



Source: Commerzbank Research, BIS

The financial cycle of the BIS

We have empirically estimated the financial cycle in the eurozone. In general, a financial cycle describes common fluctuations of a multitude of financial variables, for example of lending volumes, property prices or share prices.

In our estimate, we follow the research results of the Bank for International Settlements (BIS), which in the last few years under the influence of the financial crisis has intensively looked at the empirical measurement of financial cycles.[1]

Real loans, the ratio of lending volume/GDP and property prices are the smallest possible selection of variables to describe the financial cycle adequately.

In technical terms, the BIS filters cycles of 8 to 10 years out of the three series of data using a so-called band pass filter according to Christiano and Fitzgerald and then determine the financial cycle by forming a simple average.[2]

The BIS has estimated the financial cycle for countries including the USA, Japan, the UK and Germany but not for the eurozone. We have firstly followed the BIS estimate for the USA and then applied the method to the eurozone. The biggest problem lies in the fact that there are no long-term data series for loans and property prices available for the currency area. Due to the lack of alternatives, we have determined euro data for periods in which no original eurozone data were available by aggregation of country data from Germany, France, Italy, Spain, the Netherlands, Austria and Portugal. We have largely drawn on time series that the BIS publishes.

[1] BIS 84th Annual Report, S.74 et seq.

[2] M. Drehmann, C. Borio und K. Tsatsaronis, “Characterising the financial cycle: don’t lose sight of the medium term!”, BIS Working Papers, No. 380, June 2012.

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Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000	Tel: +852 3988 0988