

1. Summary

The paper analyses whether and how expansionary monetary policy may cause excesses in financial and real asset markets. The analysis is based on a group of 21 OECD countries and basically consists of – in the first step – a comparison between actual short-term interest rates and Taylor-rates calculated on the basis of equal weights for inflation and output gap. The author assumes that central banks have constant inflation targets since 1985 and that estimates of current neutral rates can be used for the complete sample period which covers 1985-2007. The author defines an episode as characterized by expansionary monetary policy if the cumulated deviation from a Taylor rule amounts to at least 12 percentage points. According to the paper, the robustness of the identified periods of excessive monetary policy is tested by several variations. In a second step of the empirical analysis, the author checks whether the identified periods of excessive monetary policy can be associated with excesses in financial and real asset markets.

The author finds that (1) “below Taylor periods” have generally been associated with the built-up of financial imbalances in housing markets, and in some instances also in credit markets; (2) that such episodes were not associated with episodes of imbalances when at the same time severe recessions and a credit crunch occurred; and (3) that excesses in financial and real asset markets occurred even without monetary ease, e.g. in periods of financial deregulation and/or innovation.

2. Discussion

The key question of the paper is whether excessive monetary policy leads to excesses in financial and real asset markets – which may later lead to respective crises like the one we currently witness. However, the methodology applied in the paper is rather simple, and - on the basis of the information that is given in the paper - I find it difficult to assess whether this simplicity may pose a problem. I must admit that I have some doubts and I would like to elaborate on this in the following.

In a more traditional setting, excessive monetary policy is expected to increase output and thereby inflation in consumer prices. Not at least because of this “mechanism” some models therefore imply feed-back rules from (expected) inflation and/or the output gap to the monetary policy instrument. The Taylor rule is an example for such a monetary policy rule and it is usually deemed to have stabilizing effects as long as the “Taylor principle” is satisfied, that is, as long as real interest rates react sufficiently.

More recently, there is a discussion among economists as to whether an excessive monetary policy may not (only) lead to higher consumer prices but (also) to higher asset prices. More specifically, it is argued that due to some developments (globalization, financial development...) consumer prices may – at least for some time – be rather insensitive to monetary policy. In such an environment, a monetary policy that concentrates solely on consumer prices may for some time be too expansionary without causing inflationary pressure with respect to consumer prices. Instead, the monetary stimulus shows up in other markets, notably in real and financial asset markets, leading to excessive developments there, possibly triggering a financial crisis in later periods. From a monetary policy perspective, some proponents of this view (see, e.g., several papers by Borio with varying co-authors) draw the conclusion, that a Taylor rule may imply too low an interest rate if it ignores asset prices. The paper at hand however takes the traditional Taylor rule as the benchmark for monetary policy and compares the respective Taylor-rates with the actual short-term interest rates in a

group of countries. While the approach I sketched above would argue that monetary policy could be too expansionary even if the actual interest rate equals the Taylor rate, the author restricts this interpretation only to periods in which the Taylor-rate exceeds the actual rate. It could therefore in principle be the case that there have been periods of excessive monetary policy which are not indicated by the author's methodology. This has important consequences especially for result (3) in which the paper argues that excesses in asset markets also occurred without an excessive monetary policy. It could well be that his indicator is simply not precise enough. This shows that the author uses and applies the term "excessive monetary policy" only in a very specific way, which – I think – could be too narrow. This becomes also clear if one looks more closely at result (3) and the related qualification given in the paper, that is, that excesses in financial and real asset markets occurred even without monetary ease, e.g. in periods of financial deregulation and/or innovation. In that case, one could argue, monetary policy has been too easy because it has not adequately reacted to the changes in the financial environment. But this is exactly the drawback of using a Taylor-rule as the (only) benchmark, because it ignores such developments.

But even if one accepts the Taylor rule as the adequate benchmark for judging monetary policy (others have done so as well, not at least Taylor himself) there are of course many different ways to calculate it. Usually, the results depend heavily e.g. on the chosen price indicator, on the assumed inflation target (which refers not just to the quantification of the target, but also to the reference period) on the estimated output gap, on whether a lagged interest rate is included, on the weights given to inflation and output, on the level of the neutral real rate and on many other assumptions. The author is aware of this and argues that he has checked robustness of the resulting periods with respect to some of the factors listed above. However, I find it hard to imagine that the results are really completely invariant to such variations. Varying only one of these factors while keeping all others constant (like e.g. in figures 2 and 3) is probably insufficient to get a reliable idea of the robustness. Some more detailed information would be helpful here.

The next step in the analysis is to connect the identified periods of excessive monetary policy to "excesses in financial and real asset markets". Certainly, this requires some idea of a "healthy" development in asset prices that is, some measure of the fundamental values of asset prices. Unfortunately, the author is not very precise here. If I understand it correctly, then he assumes that asset price increases are excessive if they (either) grow very strongly (see figure 4) or if they grow faster than GDP (figure 5). But this is a fairly rough measure which is certainly open to further discussion...

Besides these general remarks, there are some more specific questions that arise. For instance, it is not clear, why the author uses M2 as the monetary aggregate. Moreover, the author is very vague on his decision to define an episode of expansionary monetary policy as a period in which the cumulated deviation from the Taylor rule amounts to at least 12 percentage points.

3. Overall assessment

Against the background of the current financial crisis, the subject of the paper is certainly of highest relevance. However, besides some more specific shortcomings that I see, I find that both, the estimation of the stance of monetary policy and of the degree of "excessive asset price developments" are not very convincing. What one would rather wish to see would be a more systematic (and nested) analysis of the relationship between asset prices and monetary policy which also controls for additional variables and relationships as well (e.g. in terms of a panel-VAR analysis).