

Report on “Monetary ease - a factor behind financial crises?” by Rüdiger Ahrend

This paper examines the history of short-term interest rates in 21 OECD countries over the past 25 years through the prism of a standard Taylor rule. It identifies periods of monetary ease as periods in which these short-term interest rates were substantially lower than the Taylor rule would have prescribed, and finds that most of the periods of monetary ease so defined were followed by housing booms. While the paper argues that other factors, such as financial deregulation and innovation, played an important role, monetary ease did systematically contribute to the development of house price booms.

The paper is a nice complement to a few other recent studies that have also – persuasively to this reader’s mind – argued that monetary policy in the sense of short-term interest rate settings exacerbated the house price boom in the United States. Taylor (2008) emphasizes the correlation between departures of policy rates from Taylor rule prescriptions and the boom in residential investment, both in the US and a number of other OECD economies, as shown in Figures 2 and 3 of this paper. Buiter (2008, especially section III.1) is taking the analysis a step further by asking which elements of the Fed’s policy conduct (such as the Greenspan Fed’s risk management approach or its focus on core inflation) explain these departures. The particular contribution of the current paper is to demonstrate how close is the correlation between periods of monetary ease and housing booms in the experience of OECD economies over the past quarter century.

There are two messages to take away from this paper. The first is the one emphasized by the author: It is difficult to avoid the conclusion that monetary ease did play an important role in past housing booms, even though financial innovation and gaps in regulation undoubtedly made important contributions as well. There is a second message, however, that is not examined in this paper but is critical if a repeat of periods of financial instability caused by monetary ease is to be avoided. The question is whether the periods of monetary ease identified in the paper would have been recognized as such in real time.

In illustrating this point I will focus on the US experience since 2000, as this is the one that is currently of greatest interest. The paper shows in Figure 1 that by late 2001 a substantial gap between the actual Federal Funds rate and the Taylor rule had opened up, and that this gap persisted until about 2006. This result is similar to Figure 1 in Taylor (2008) which shows that by late 2003 the gap between the two rates had grown to about 2.5 percentage points. What remains unclear in these calculations is the extent to which this assessment is made with the benefit of hindsight. In the third quarter of 2003, core inflation measures had declined to below 1.5 percent and real GDP and employment growth remained anaemic despite two years of near-zero real short-term interest rates and massive fiscal stimulus. House prices, though still rising at an annual rate of about 6 percent, had been decelerating since the middle of 2001. In short, by the middle of 2003

the macroeconomic situation resembled in many respects the situation it had been in 1992. And, as the paper notes (p. 12), the period from 1990-93 was exactly the one example in which an extended period of monetary stimulus had *not* been followed by a housing boom.

A different way of illustrating this point is to ask what a *real-time* estimate of the neutral real short-term interest rate might have been by the middle of 2003. As the paper shows in Annex figure 2.A, it would have taken a neutral rate estimate close to zero to reconcile the funds rate setting during the period 2001-2004 with a Taylor rule. In fact, given assessments about the weakness of the US recovery at the time it would not have been difficult to arrive at such an estimate. In hindsight it is fairly evident that monetary ease contributed to the housing bubble and the development of financial imbalances. But in 2003, a Taylor rule combined with a time-varying neutral real rate would *not* have signalled that monetary policy was excessively stimulative. Although it is certainly beyond the scope of this paper to investigate what other indicators could have reliably warned in real time that monetary policy was too stimulative, the paper should be clearer that the very framework that is being used now to measure monetary ease would have been much less reliable in real time.

In summary, this paper is thought-provoking in that it provides evidence across several countries and episodes supporting the view that monetary ease can have costly consequences in terms of housing booms and subsequent financial instability. This evidence calls into question an approach to risk management which would hold that, when faced with a situation of low and declining inflation and weak real activity, a central bank should err on the side of monetary ease so as to minimize deflation risks. The paper also calls for future research to investigate in detail whether periods which in hindsight appear clearly as periods of monetary ease would have been recognized as such in real time. If, for example, a Taylor rule in real time would not have indicated that monetary policy was unusually stimulative, then the search is on for alternative strategies that would have sent the right signal about incipient financial imbalances in real time.

References:

Buiter, Willem (2008). "Central banks and financial crises," at the Jackson Hole Symposium on "Maintaining stability in a changing financial system," August 2008, available at <http://www.kc.frb.org/publicat/sympos/2008/Buiter.09.06.08.pdf>

Taylor, John (2008). "The financial crisis and the policy responses: An analysis of what went wrong," available at <http://www.stanford.edu/johntayl/FCPR.pdf>