

Referee report on:

“Monetary Ease – A Factor Behind Financial Crises? Some Evidence from OECD Countries?”

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This paper looks at the relationship between monetary policy and asset market bubbles. The evidence tends to suggest that periods of “excessively” low interest rates – according to a Taylor rule – are associated with fast rising housing market prices. The paper concludes that lax monetary policy in a period of financial innovation may have contributed to the housing market bubbles that have ended up in the current financial crisis.

I find the overall story – which has indeed been discussed in policy and academic circles – compelling: excessively low real interest rates lead to “return chasing” and contribute to creating asset market bubbles (in equity market, in housing market). But the paper needs to provide more evidence to substantiate the story. Moreover, the wording “financial imbalances” reminds of the debate on global imbalances, and the global “savings glut”. Some reference to this debate may be necessary, in particular a discussion of how large current account deficits (and associated capital inflows) in some countries may have contributed to the housing bubbles.

I understand the need to use a normative benchmark for the appropriateness of policy rates, however one issue with using a Taylor rule is that the rule chosen is arbitrary – many central banks in the sample (most noticeably the ECB) follow different rules for policy rates. There is a discussion of this issue for example in paragraph 10, but in my taste, the author should dwell into this a bit more. For example, it is interesting to note that, in recent years, for the Euro area as a whole (and for the two largest Euro countries, France and Germany), the policy rate tracks the Taylor rule rate quite well, even though the ECB (at least quite officially) does not follow a Taylor rule; on the contrary, in the case of the US, the policy rate seems to have deviated from a Taylor rule even though the US Fed presumably follows a Taylor rule. How should we think of this?

More evidence is needed to substantiate the claim that housing market bubbles and crisis are also associated with periods of financial liberalization and/or financial innovation. Section 3 provides suggestive evidence that credit booms occur during episodes of low real interest rates. But a credit boom does not necessarily end up in a crisis, and is not evidence of financial innovation or of financial liberalization. On this, I have two suggestions: (1) broaden the sample of countries to see if, in the past, periods of low real interest rates *and* financial liberalization have been associated with housing market booms (the author could use indicators of financial liberalization that are publicly available (for instance, Abiad, Detragiache and Tressel, 2008)); (2) focusing on the current period, create a measure of financial innovation in asset backed securities markets and of the originate-to-distribute model (such as: issuance of mortgage backed securities relative to total mortgage lending)

and/or of regulation of mortgage lending to see if the boom was larger in countries with more financial innovation. The link between monetary policy and the current financial crisis should also be illustrated in section 3 by showing a correlation between the measure of lax monetary policy, financial innovation and, for example, some current estimates of the losses/bail-out costs of domestic banking systems in advanced countries.

Reference: Abiad, Abdul, Detragiache, Enrica, and Thierry Tressel, 2008, "A New Database of Financial Reforms", IMF Working Paper 08/266 (data available online).