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"Financial Instability, Credit Cycles and Monetary Policy"

Abstract

This paper is focused on the relations between monetary policy, credit growth and financial instability. From the two theoretical views on financial instability; the money view and the credit view, the paper does a cointegrated VAR analysis of essential macroeconomic mechanisms between house prices, money and credit growth, and the related influence of monetary and structural policy. The analysis uses US data from 1984 to 2010; especially focused on the period preceding the global financial crisis starting in 2008. Consistent with the credit view, the empirical results suggest persistent mutually reinforcing cycles of house prices and leverage. Importantly, a prolonged boom period from the middle of the 1990s - with an excess house price inflation from 2003 - seems to be terminated with the bust of the global financial crisis in the beginning of 2008. While the busts of these cycles are related to the financial crisis periods, the initializations of the booms seem both theoretically and historically related to exogenous shocks of financial deregulation and innovation. Monetary policy has an important, though minor, influence on these cycles through the short term interest rate. The results also suggest a stabile money demand-supply balance, in accordance with the money view. Here, the expansionary monetary policy preceding the global financial crisis seems to have resulted in a period of excess money supply. However, the influence on house prices from this channel is found relatively small. Generally, the analysis suggests a direct focus on leverage and asset prices cycles, both from the view of monetary policy makers and especially from a structural policy point of view.