Economic Insight

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.


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

December 2nd 2016

For important disclosure information see pages 5 and 6

research.commerzbank.com / Bloomberg: CBKR / Research APP available
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

**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

---

**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.

---

In accordance with ESMA MAR requirements this report was completed 02/12/2016 07:56 CET and disseminated 02/12/2016 07:57 CET.

This document has been created and published by the Corporates & Markets division of Commerzbank AG, Frankfurt/Main or Commerzbank’s branch offices mentioned in the document. Commerzbank Corporates & Markets is the investment banking division of Commerzbank, integrating research, debt, equities, interest rates and foreign exchange.

If this report includes an analysis of one or more equity securities, please note that the author(s) certify that (a) the views expressed in this report accurately reflect their personal views; and (b) no part of their compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or views expressed by them contained in this document. The research analyst(s) named on this report are not registered / qualified as research analysts with FINRA. Such research analyst(s) may not be associated persons of Commerz Markets LLC and therefore may not be subject to FINRA Rule 20401. Restrictions on communications with a subject company, purchase or sale of securities held by a research analyst account. It has not been determined in advance whether and in what intervals this document will be updated. Unless otherwise stated current prices refer to the most recent trading day’s closing price or spread which may fluctuate. 

Conflicts of Interest
Disclosures of potential conflicts of interest relating to Commerzbank AG, its affiliates, subsidiaries (together “Commerzbank”) and its relevant employees with respect to the issuers, financial instruments and/or securities forming the subject of this document valid as of the end of the month prior to publication of this document**.

Please refer to the following link for disclosures on companies included in compendium reports or disclosures on any company covered by Commerzbank analysts: http://research.commerzbank.com/web/commerzbank-research-portal/public-page/disclosures**

"Updating this information may take up to ten days after month end.

Disclaimer
This document is for information purposes only and does not take into account specific circumstances of any recipient. The information contained herein does not constitute the provision of investment advice. It is not intended to be and should not be construed as a recommendation, offer or solicitation to acquire, or dispose of, any of the financial instruments and/or securities mentioned in this document and will not form the basis or a part of any contract or commitment whatsoever. Investment decisions should be based on independent professional advice and draw their own conclusions regarding suitability of any transaction including the economic benefits, risks, legal, regulatory, credit, accounting and tax implications.

The information in this document is based on public data obtained from sources believed by Commerzbank to be reliable and in good faith, but no representations, guarantees or warranties are made by Commerzbank with regard to accuracy, completeness or suitability of the data. Commerzbank has not performed any independent review or due diligence of publicly available information regarding an unaudited or reference asset or index. The opinions and estimates contained herein reflect the current judgement of the author(s) on the date of this document and are subject to change without notice. The opinions do not necessarily correspond to the opinions of Commerzbank. Commerzbank does not have an obligation to update, modify or amend this document or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. This communication may contain trading ideas where Commerzbank may trade in such financial instruments with customers or other counterparties. Any prices provided (other than those that are identified as being historical) are indicative only, and do not represent firm quotes as to either size or price. The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favourable investment results. Any forecasts or price targets shown for companies and/or securities discussed in this document may not be achieved due to multiple risk factors including without limitation market volatility, sector volatility or corporate actions, the unavailability of complete and accurate information and/or the subsequent transpiration that underlying assumptions made by Commerzbank or by other sources relied upon in the document were inapprate.

Commerzbank and or its affiliates may act as a market maker in the instrument(s) and or its derivative that has been mentioned in our research reports. Employees of Commerzbank and or its affiliates may provide written or oral commentary, including trading strategies, to our clients and business units that may be contrary to the opinions conveyed in this research report. Commerzbank may perform or seek to perform investment banking services for issuers mentioned in research reports. Neither Commerzbank nor any of its respective directors, officers or employees accepts any responsibility or liability whatsoever for any expense, loss or damages arising out of or in any way connected with the use of all or any part of this document.

Commerzbank may provide hyperlinks to websites of entities mentioned in this document, however the inclusion of a link does not imply that Commerzbank endorses, recommends or approves any material on the linked page or accessible from it. Commerzbank does not accept responsibility whatsoever for any such material, nor for any consequences of its use.

This document is for the use of the addressees only and may not be reproduced, redistributed or passed on to any other person or published, in whole or in part, for any purpose, without the prior, written consent of Commerzbank. The manner of distributing this document may be restricted by law or regulation in certain countries, including the United States. Persons into whose possession this document may come are required to inform themselves about and to observe such restrictions. By accepting this document, a recipient hereof agrees to be bound by the foregoing limitations.

Additional notes to readers in the following countries:

**Germany:** Commerzbank AG is registered in the Commercial Register at Amtsgericht Frankfurt under the number HRB 32000. Commerzbank AG is supervised by both the German regulator, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), and the European Central Bank and is subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details on the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. This document is directed exclusively to eligible counterparties and professional clients. It is not directed to retail clients. No persons other than an eligible counterparty or a professional client should read or rely on any information in this document. Commerzbank AG, London Branch does not deal for or advise or otherwise offer any investment services to retail clients.

**United Kingdom:** This document has been issued for or approved for issue in the United Kingdom by Commerzbank AG London Branch. Commerzbank AG, London Branch is authorised by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), and the European Central Bank and is subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details on the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. This document is directed exclusively to eligible counterparties and professional clients. It is not directed to retail clients. No persons other than an eligible counterparty or a professional client should read or rely on any information in this document. Commerzbank AG, London Branch does not deal for or advise or otherwise offer any investment services to retail clients.

**United States:** This document has been approved for distribution in the US under applicable US law by Commerz Markets LLC (‘Commerz Markets’), a wholly owned subsidiary of Commerzbank AG and a US registered broker-dealer. Any securities transaction by US persons must be effected with Commerz Markets, and transactions in swaps with Commerzbank AG. Under applicable US law, information regarding clients of Commerz Markets may be distributed to other companies within the Commerzbank group. This research report is intended for distribution in the United States solely to "institutional investors" and "major U.S. institutional investors,” as defined in Rule 15a-6 under the Securities Exchange Act of 1934, Commerz Markets is a member of FINRA and SIPC. Commerzbank AG is a provisionally registered swap dealer with the CFTC.

**Canada:** The information contained herein is not, and under no circumstances is to be construed as, a prospectus, an advertisement, a public offering, an offer to sell securities described herein, solicitation of an offer to buy securities described herein, in Canada or any province or territory thereof. Any offer or sale of the securities described herein in Canada will be made only under an exemption from the requirements to file a prospectus with the relevant Canadian securities regulators and only by a dealer properly registered under applicable securities laws or, alternatively, pursuant to an exemption from the dealer registration requirement in the relevant province or territory of Canada in which such offer or sale is made. Under no circumstances is the information contained herein to be construed as including, or as providing independent advice in any province or territory of Canada and is not tailored to the needs of the recipient. In Canada, the information contained herein is intended solely for distribution to Permitted Clients (as such term is defined in National Instrument 31-103) with whom Commerz Markets LLC deals pursuant to the international dealer exemption. To the extent that the information contained herein references securities of an issuer incorporated, formed or created under the laws of Canada or any province or territory of Canada, any trades in such securities may not be conducted through Commerz Markets LLC. No securities commission or similar regulatory authority in Canada has reviewed or in any way passed upon these materials, the information contained herein or the merits of the securities described herein and any representation to the contrary is an offence.