CASE Network E-briefs

11/2009 November 2009

No, the central banks didn't do it

By Charles Wyplosz

Lately, a popular view has emerged that the global financial crisis was caused by lax monetary policy in the U.S. (and elsewhere). Although, lax monetary policy can be attributed to the bout of inflation that preceded the crisis, it cannot be blamed for the housing price bubble and the ensuing subprime debacle.

A popular narrative of the crisis goes as follows; central banks kept interest rates too low for too long. As a result, credit expanded sharply, which explicit or closet inflation-targeting central banks failed to notice. Easily available credit created and fed a housing price bubble as households sought to fulfill the American (British, Spanish, Irish, etc.) dream of home ownership. Abundant liquidity also led investors to create and feed generalized asset price inflation. Worse, the prospect of durably low interest rates forced investors to hunt for higher yields and take on more risks, which they themselves did not even recognize. The conclusion of this story is straightforward: central banks should never have kept interest rates so low, they should have looked at credit expansion and other monetary aggregates and realize that their policies were far too expansionary.

Shifting Narrative

This story is widely accepted as the correct narrative of the crisis, unfortunately, it only fits the facts superficially. A milder version of this view suggests that maybe monetary policy played a secondary, even supporting role, as an aggravating factor. An alternative view holds that lax monetary policy is neither a necessary nor a sufficient condition for the crisis. Monetary policy was lax and eventually caused inflation, but not the financial crisis itself.

The two figures below should inject doubts about the story as told above. They show the evolution of housing prices (normalized at 100 in early 2000) in the two currency areas at the heart of maelstrom: the dollar (a.k.a. the U.S.) and the euro area. The leftmost figure shows the average housing price index across the euro area member countries, along with the lowest and the highest values of the index in each period.[1] The rightmost figure does the same across the 21 cities included in the Standard and Poor's (S&P)/Case-Shiller database.[2] In both cases, we have a single central bank and a single nominal interest rate. Real interest rates do differ across each area because price inflation is never uniform in a large currency area. However, these were the times of the " Great Moderation", with generally low inflation rates, meaning low inflation differentials within each currency area. Whatever effect is to be retrieved from these differentials is clearly second-order and cannot account for the remarkable message that the figures convey.

The interesting observation is that in both currency areas the same interest rate has led to sharply different outcomes. For instance, housing price bubbles have emerged in several regions (e.g. Spain, France and Ireland in the euro area, the Southern and Southwest belt in the U.S.) but not all; in fact prices declined in a number of euro area countries. This implies that lax monetary policy alone cannot explain the crisis (i.e. it is not a sufficient condition for the crisis).

[1] Curious readers will ask which are the countries at each end of the spectrum. At the top, we briefly have Finland, then even more briefly the Netherlands, with Spain at the top since 2002q1. The bottom is mainly occupied by Germany, with sporadic competition from Austria

[2] In the US, Detroit and Cleveland share the low position while San Diego and Miami are alternating at the top.

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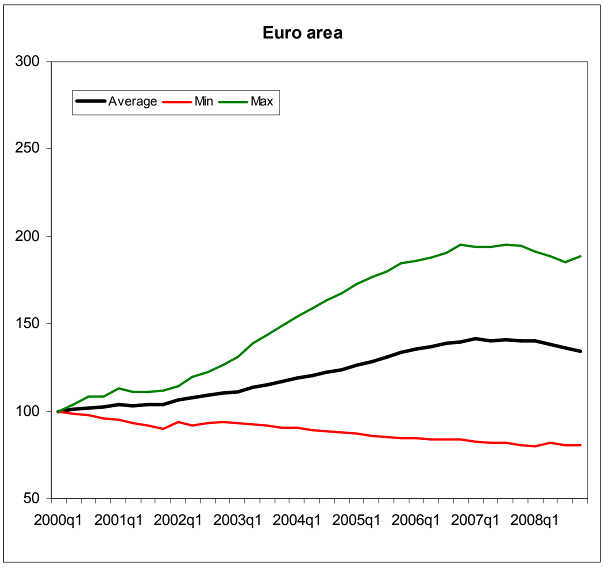
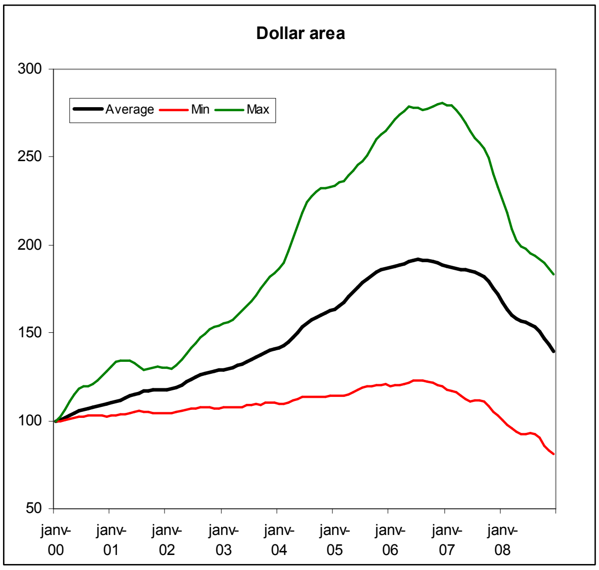
Housing Price Indices (2000 = 100)





Source: IMF, S&P/Case-Shiller

The Role of Monetary Policy

Was lax monetary policy a necessary condition for bubbles to appear? The U.S. experience suggests that the answer is negative. Housing prices started to take off around 1998. Since then, we have seen several monetary policy cycles, including periods when the Fed's stance favored tighter monetary policy. Yet, this did not prevent the continuation of rising housing prices.

The conclusion that monetary policy cannot be blamed for the housing price bubble does not fully exonerate central banks. The narrative also includes the securitization of mortgage loans, including but not limited to subprimes. The commercial success of asset-backed securities is associated with the view that abundant liquidity and low money market rates pushed investors to seek higher yields, accept greater risks, and thus venture into asset categories that they were not familiar with.

First, investors did not have to accept more risk in return for higher yields. These were individual decisions and, when carried out by banks and financial institutions, it was the responsibility of supervisors to determine whether or not excessive risk was being taken. True, in some countries central banks are in charge of bank regulation and supervision. In these instances, central banks may have failed their duties as regulators and supervisors, but that does not imply in any way that monetary policy was inappropriate.

Secondly, if interest rates had been kept too low for too long, we would have seen a spike in inflation. Well, we did, following the commodity price boom of 2006. Excess demand did not materialize in the developed countries but on commodity markets, similar to previous oil shocks.[3] Central banks responded by raising the interest rate sharply, which prompted the collapse of the housing price bubble. Inflation was very short-lived probably because the financial crisis effectively quashed it, not as a direct impact of monetary policies.

A final observation suggests that monetary policy only directly affects the short end of the yield curve. The longer end, which matters for maturities of interest to most investors, is set by the markets, presumably on the basis of expectations regarding future policy rates (as well risk assessment). Did central banks offer an implicit promise that the short-term policy rates would remain very low for very long periods of time? I am not aware of such explicit statements. Those central banks that publish forecasts of short-term rates (the Reserve Bank of New Zealand, the Bank of Norway, the Riksbank in Sweden) indicated prior to the crisis that they intended to "normalize" upward their low interest rates.

Actions if the U.S. Federal Reserve

The case of the U.S. is crucial, however. Long-term rates did decline during the period of very low interest rates, but very moderately, and started to rise long before the Fed actually started to tighten up its policy stance. This means that markets must have expected an end to the period of low rates. It also means that the "hunt for

[3] The case of China would deserve a long discussion. In brief, by pegging to the dollar, China adopted an expansionary monetary policy that fed the demand for primary commodities.

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yield" could not be as desperate as the narrative makes it out to be, certainly not enough to "force" investors to take huge risks. Some investors did take risks to reap better returns. Many probably underestimated the risks because they believed in the lasting power of the "Great Moderation".

The only way one can blame central banks in this respect is that they did not send signals that the "Great Moderation" was not necessarily a permanent fixture. Perhaps, they shared the markets' excessive optimism in believing that the "Great Moderation" would indeed last forever:

> "Three types of explanations have been suggested for this dramatic change; for brevity, I will refer to these classes of explanations as *structural change*, improved macroeconomic policies, and good luck. [...] My view is that improvements in monetary policy, though certainly not the only factor, have probably been an important source of the Great Moderation. In particular, I am not convinced that the decline in macroeconomic volatility of the past two decades was *primarily* the result of good luck."
>
> Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, D.C., February 20, 2004

Taking Chairman Bernanke at his words, one could be tempted to assert that the surge in macroeconomic volatility of the past two years was not *primarily* the result of bad luck. Overconfidence in the quality of monetary policy played a role without being the only factor.

Failure to Intervene

So, in the end, who is to blame?

Responsibility for the housing price bubbles that eventually triggered the global financial crisis does not lie with the long period of low interest rates. It lies squarely with the lenders who lowered standards and the consumer protection agencies that failed to intervene. The responsibility also lies with the investors who bought the securitized assets while underestimating the risks that they were taking. Importantly, the bank supervisors let the party go on without serious warnings.

Yet central banks cannot be fully absolved. They probably grew too self-confident and failed to detect the global nature of inflation. So, yes, interest rates were kept too low for too long, but without the deeply dysfunctional mortgage markets and the failures of bank regulation and supervision, we would have "only" undergone a nasty commodity price shock. Rising inflation would have forced central banks to bring about a significant slowdown. This would have meant the end of "Great Moderation", which was neither a structural change, the result of perfect monetary policy-making, nor good luck. The "Great Moderation" was simply an intertemporal substitution. As second best principles would have it, the substitution became catastrophic because of profound market and regulatory failures.

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