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Money and the Financial System

1. Asset Price Booms

Problems created by asset price booms and busts (in the housing and stock market):

(i) Consumption rises during a boom and then collapses in the bust.

Case, Quigley and Shiller (2005) using data from 14 countries estimate that a 1 percent increase ín house prices increases consumption by about 0.14 percent, while a 1 percent increase in the stock market increases consumption by only about 0.02 percent.

The rise in consumption in a boom encourages firms to increase investment.

This leads to a misallocation of resources – too many investment projects are undertaken

(ii) The rise in equity prices also makes it easier for firms to raise funds to finance investment

(iii) The collateral used to back loans is overvalued. Hence banks are left with holes in their balance sheets when boom turns to bust.

They may then need government bailouts and will cut back on lending exactly when it is most needed.

(iv) Booms raise fiscal revenue which encourage tax cuts and increases in government spending which are hard to reverse when boom turns to bust.

Just when an expansionary fiscal policy is most needed (i.e., in a bust), the government is least able to deliver it.

(v) Impacts on inequality: a housing boom increases inequality (both within a cohort and across cohorts).

Renters (usually households on lower incomes and/or young) do not benefit from the capital gains earned by owner occupiers and investors.

The bust particularly hurts late entrants to the boom who often are also young and/or on low incomes.

(vi) Busts can lead to periods of deflation and bad recessions.

Real interest rates are high
Households and firms delay purchases

2. How Can Housing Booms and Busts be Prevented?

(i) Monetary policy

Most countries inflation target. Owner-occupied housing (OOH) is the largest component of the consumer price index (CPI).

Neither the rental equivalence or user cost approaches to including the costs of OOH in the CPI were affected much by the last housing boom.

Either a new way of including OOH in the CPI is required to make it more responsive to movements in house prices,

or central banks need to modify their inflation targeting rules to account for asset price movements.

(ii) Banks

Maximum loan-to-deposit ratios may be required for mortgages

Mortgage providers perhaps should be prevented from on selling some portion of mortgages they initiate.

(iii) Fiscal policy

Tax cuts during a boom may exacerbate the boom.

It is easier for the government to deal with the fallout of a bust if it starts from a low level of debt and a budget surplus

3. Threats to the Eurozone

(i) Asymmetric shocks

Are these increasing or decreasing over time?

(ii) Is the variance of optimal interest rates too high?

Countries with optimal interest rates below the actual Eurozone interest rate may be pushed into recession (e.g., the Netherlands, Finland and Germany)

Countries with optimal interest rates above the actual Eurozone interest rate may experience asset price booms (e.g., Greece, Ireland and Spain).

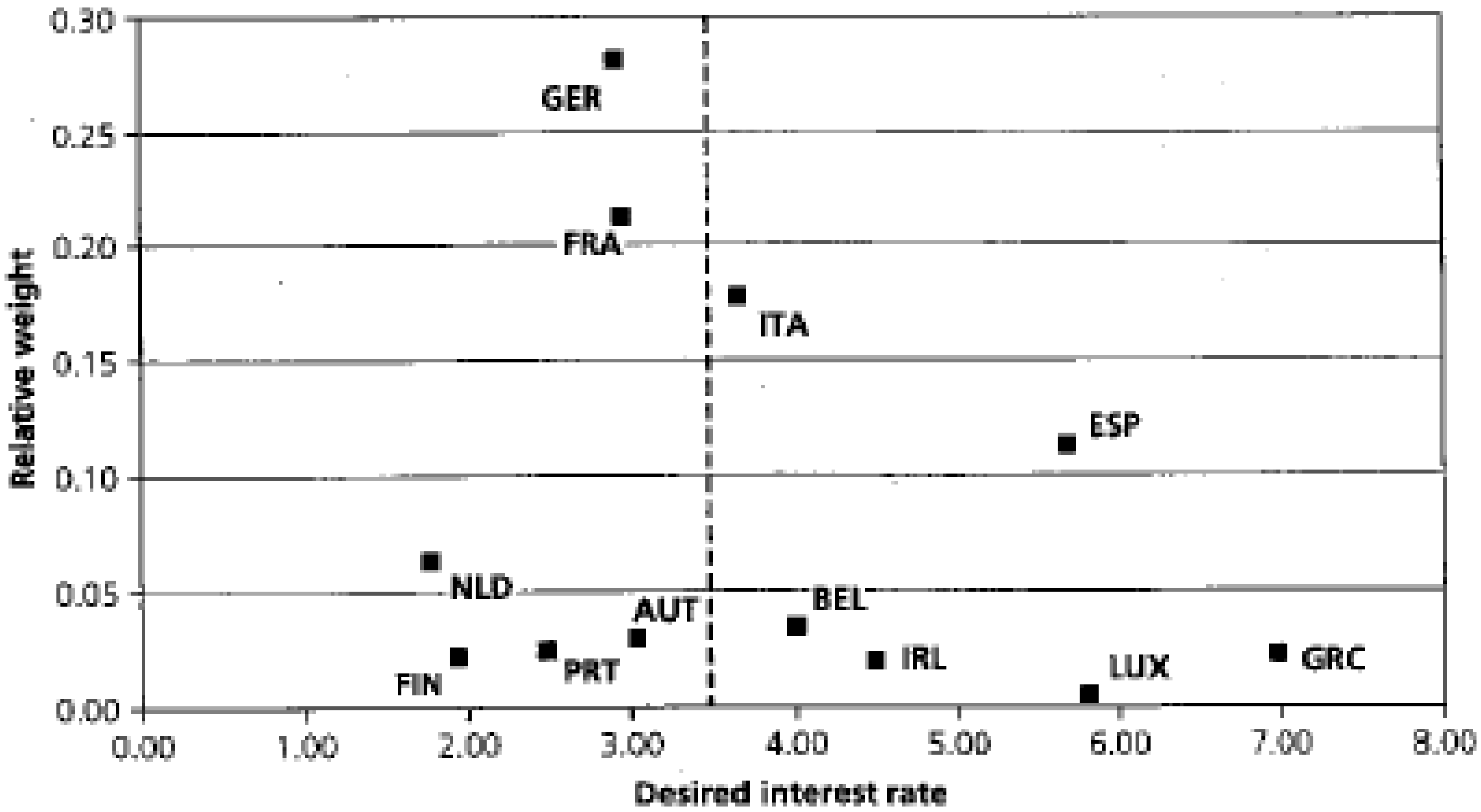

Figure 9.7 Distribution of desired interest rates and country sizes (EU-12) (Taylor rule, 2005)

Source: Inflation and relative country size: European Commission, *European Economy*; Output gap: OECD *Economic Outlook*, for Luxembourg: European Commission, *European Economy*.

Source: De Grauwe P. (2007), Economics of Monetary Union, Oxford University Press, Seventh Edition

(iii) Eastward expansion

Does this increase the variance of optimal interest rates in the Eurozone?

(iv) Large government debts and budget deficits of some member countries (especially Greece)

Greece no longer has the option of inflating away its debt.

A European Central Bank (ECB) bailout would have bad incentive effects.

Default by the Greek government would reduce confidence in the Eurozone.