Swedish House of Finance
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The causes of the financial crisis:

Comments on Justin Lin, *Against the Consensus*

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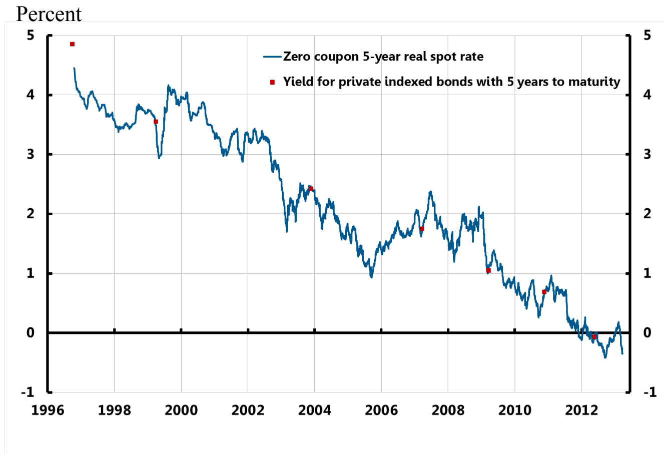
What caused the financial crisis?

- *Macro conditions*: Global imbalances, low world real interest rates, Great Moderation, underestimation of risk, very low risk premia
- *Distorted incentives*: Lax regulation and supervision, missing bank resolution, US housing policy (subprime lending, lending standards), securitization, regulation arbitrage, increased leverage
- *Information problems*: Hidden risk in complex securities, underestimation of correlated systemic risks
- Resulted in an extremely fragile financial sector
- These causes had little or nothing to do with monetary policy!

Was US monetary policy too expansionary during 2001-2004?

- Ex ante: Expansionary policy right given genuine threat of deflation and liquidity trap
- Real interest rates low because of global imbalances

Swedish 5-year real interest rate



Sources: The Swedish National Debt Office and the Riksbank

Was US monetary policy too expansionary during 2001-2004?

- Ex ante: Expansionary policy right given genuine threat of deflation and liquidity trap
- Real interest rates low because of global imbalances
- Ex post: US inflation not too high, the US economy not overheated (except construction and housing boom)
- Monetary policy can only stabilize the aggregate economy, not specific sectors

Would tighter US monetary policy have prevented the crisis?

- To prevent housing boom, substantially higher interest rates needed: recession, deflation, deteriorating balance sheets, eventually liquidity trap?
- Fed funds rate little impact on sub-prime incentives (Bernanke 2010)
- No impact on regulatory problems, distorted incentives, information problems

Conclusion for monetary policy and financial policy?

- It was regulation and supervision that failed, not monetary policy
- Price stability is not enough for financial stability
- Monetary policy (interest-rate policy) cannot achieve financial stability

Conclusion for monetary policy and financial policy?

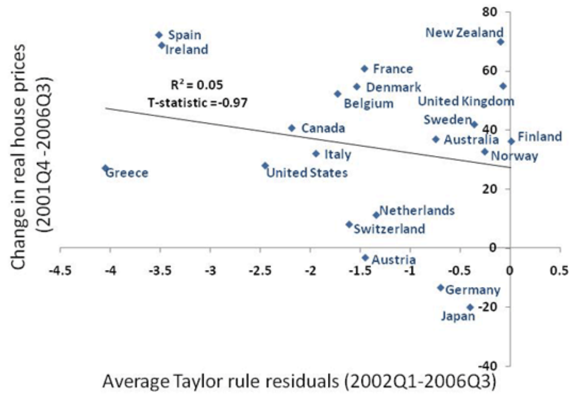
- "Leaning against the wind" may be counterproductive in affecting household real debt and debt-to-GDP and debt-to-income ratios (Svensson 2013, Ekonomistas, Voxeu.org)
  - Total nominal debt is sticky and falls very slowly
  - Price level, nominal GDP, and nominal disposable income fall faster
  - Real debt and debt-to-GDP and debt-to-income ratios *rise* (not fall)
- "Debt deflation" (Ekonomistas)
  - Average inflation lower than target and expected
  - Lower price level than expected
  - Higher real debt than if average inflation had been on target
  - A mortgage taken out in 2003 has a real value today that is 9 percent higher than if average inflation had equaled 2 percent

Conclusion for monetary policy and financial policy?

- It is financial policy (micro- and macroprudential policy) that needs to be improved and reformed, not monetary policy
- Financial stability is mostly about sufficient **resilience** to disturbances (capital, buffers, liquidity, net stable funding)
- Financial policy, not monetary policy, is required for this
- Let financial policy focus on financial stability
- Let monetary policy focus on stabilizing inflation around the inflation target and unemployment around the long-run sustainable rate
- The new strengthened framework for financial stability is in line with this

Source: Bernanke, Ben S. (2010), "Monetary policy and the housing bubble", AEA meeting, January 2010.

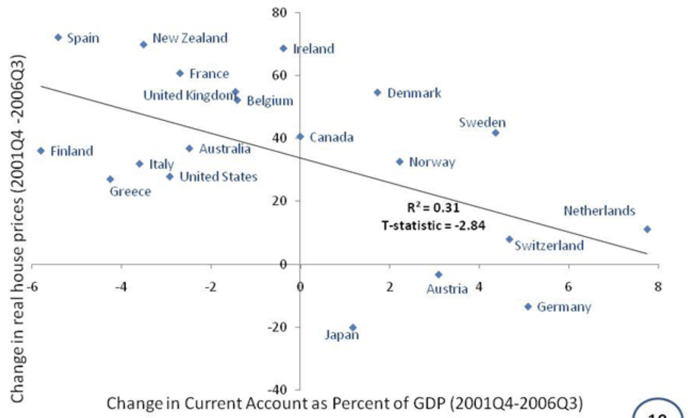
Monetary Policy and House Prices in the Advanced Economies



Source: International Monetary Fund.

Source: Bernanke, Ben S. (2010), "Monetary policy and the housing bubble", AEA meeting, January 2010.

Current Accounts and House Prices in the Advanced Economies



Source: International Monetary Fund, Haver Analytics, and Federal Reserve staff calculations.

Sources: Bernanke, Ben S. (2010), "Monetary policy and the housing bubble", AEA meeting, January 2010.