

# **Monetary Policy in Asset-led Business Cycles**

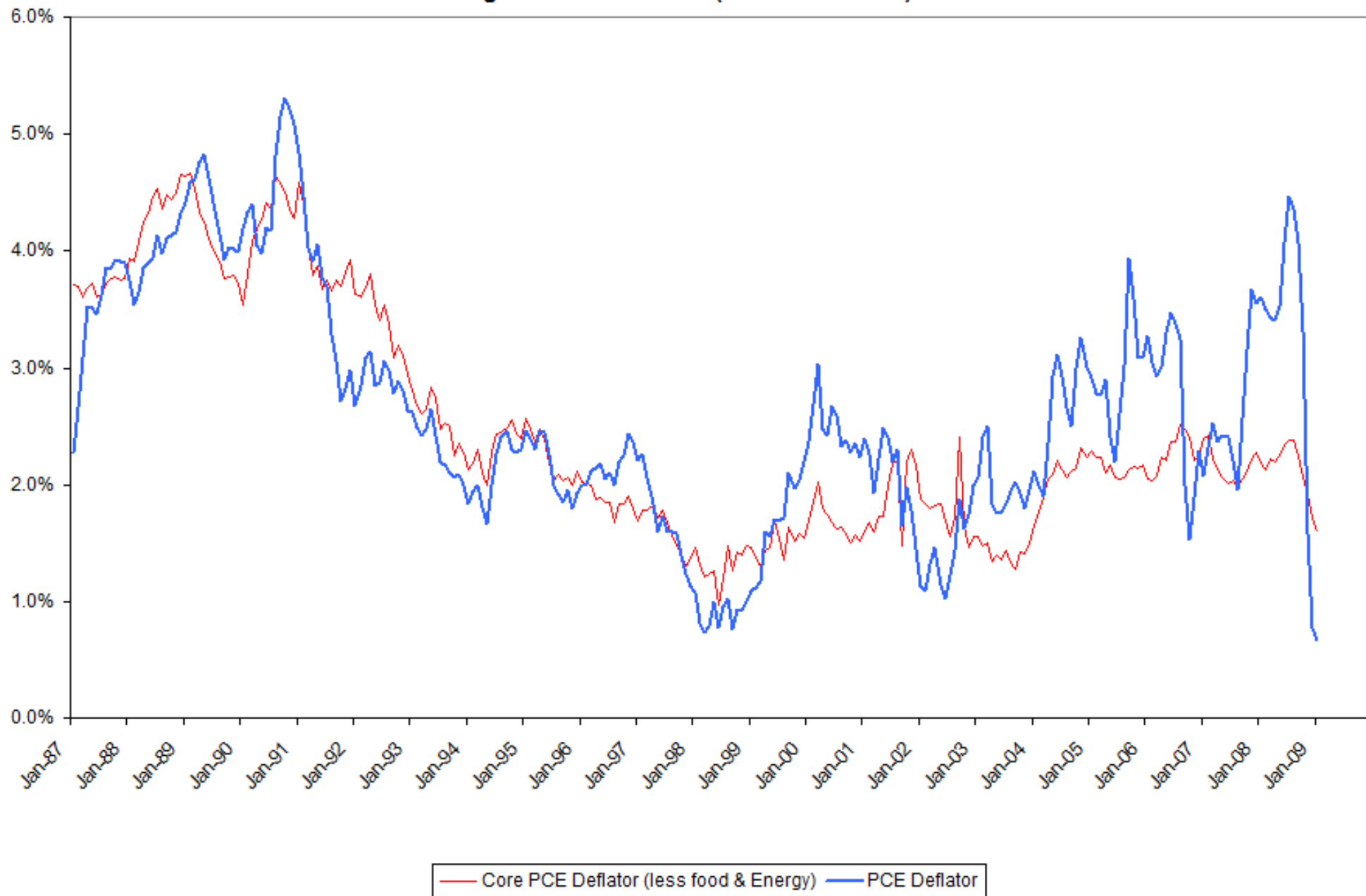
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# Seemingly Successful Central Bank Policy

- Low inflation
  - AVER: 1995-09 1.8%
  - AVER: 1985-94 3.6%
- Low inflation Volatility
  - Vol: 1995-09 0.3%
  - Vol: 1985-94 0.7%
- Same output gap Volatility
  - Vol: 1995-09 1.4%
  - Vol: 1985-94 1.4%

Figure 1: PCE Deflator (Headline & Core)



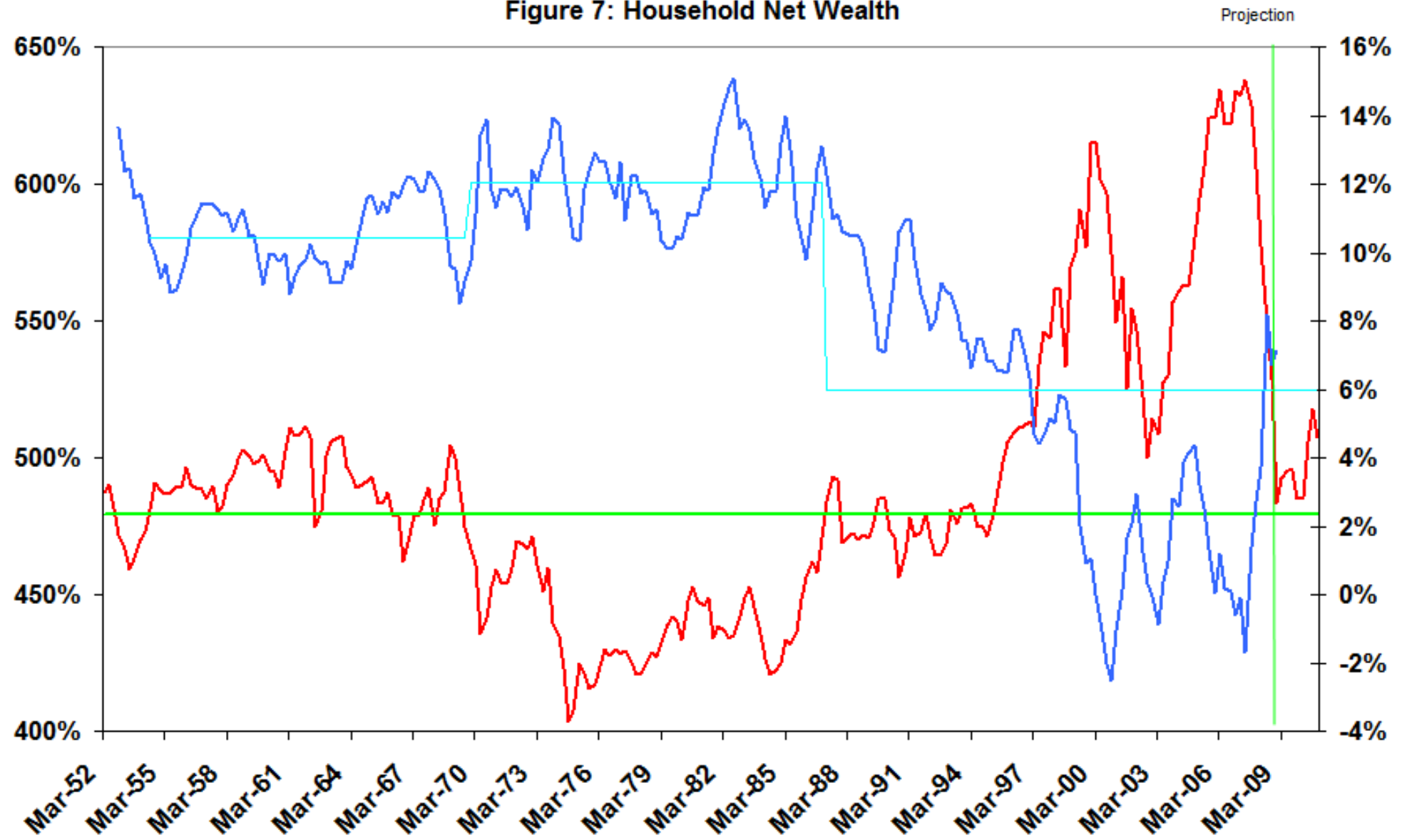
# Not CPI but Asset Inflation

- Internet, Housing, Commodities, Shipping, Private Equity and now US Treasuries
- Too much liquidity
- Liquidity created by:
  - “Bad” Financial Engineering (shadow banking)
  - Mistakes in monetary policy

# Fallacies of Monetary Policy in Asset-led Business Cycles

- Output Volatility  $>$  Inflation Volatility
- Cyclical improvements appear structural
  - Faster Growth appears to boost potential (3.3 vs 2.4)
  - Cyclical Prod Gains Appear Structural
- Asset & debt deflation worsens downturn
- Inflation subdued
  - Higher potential output dampens output gap
  - Higher productivity lowers ULC

Figure 7: Household Net Wealth



— Household Net Worth as a % of Disposable Income  
— Long Term Average Household Net Worth  
— Personal Saving as a % of Disposable Income 4-quarter MA (RHS)  
— Average Savings Ratio (RHS)

# Bubble Burst Consequences

- Falling house prices and an inverted yield curve turned hefty profits in shadow banking into huge losses, spilling over to mother banks
- Widening credit spreads
  - Higher cost of borrowing
- Lower credit availability
- Tightening of lending standards
- Asset & debt deflation

Figure 4: Liquidity and Credit Risk vs Credit Risk (Libor OIS vs Libor Repo)

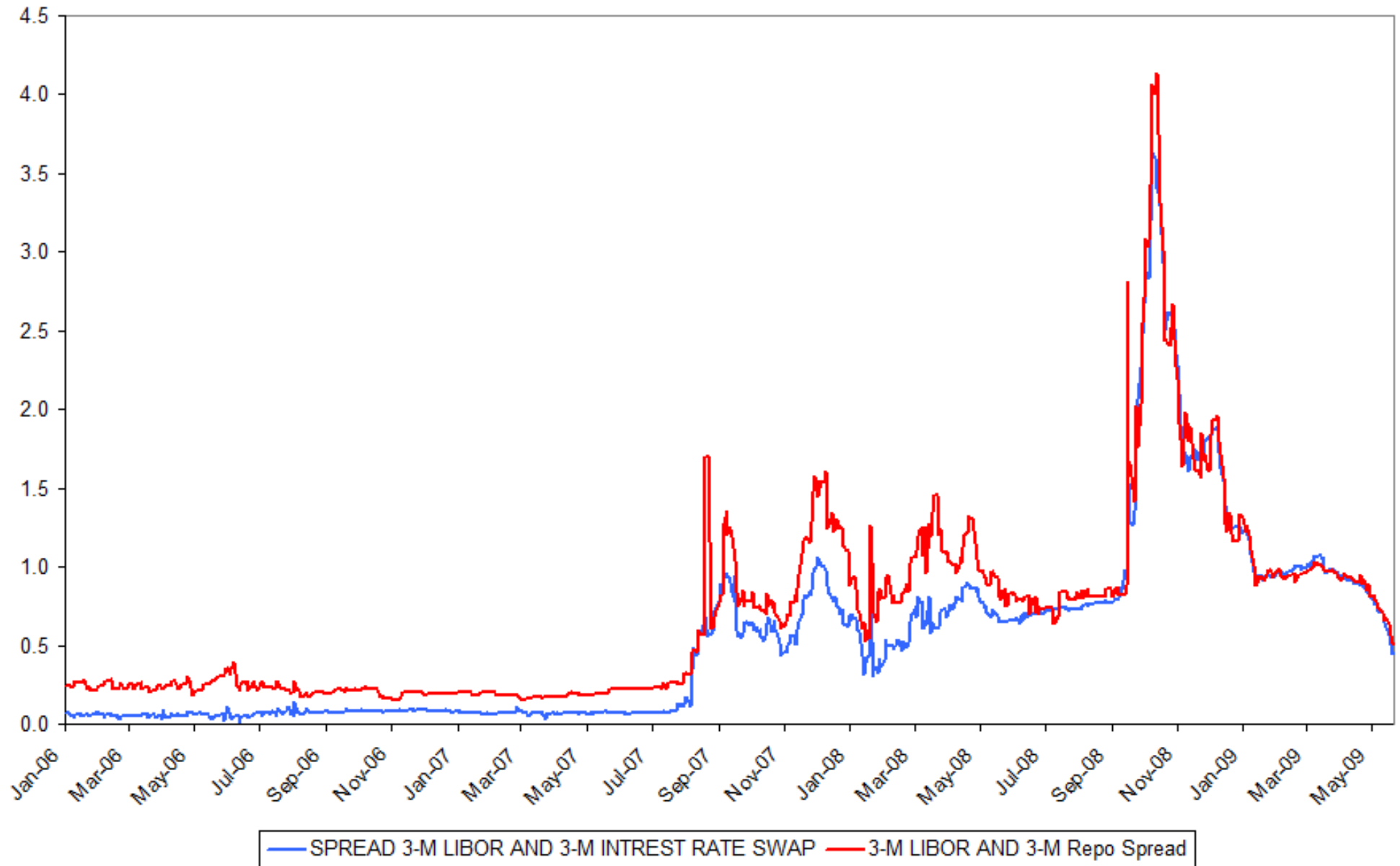




Figure 5: 10-YEAR SPREAD OVER TREASURIES

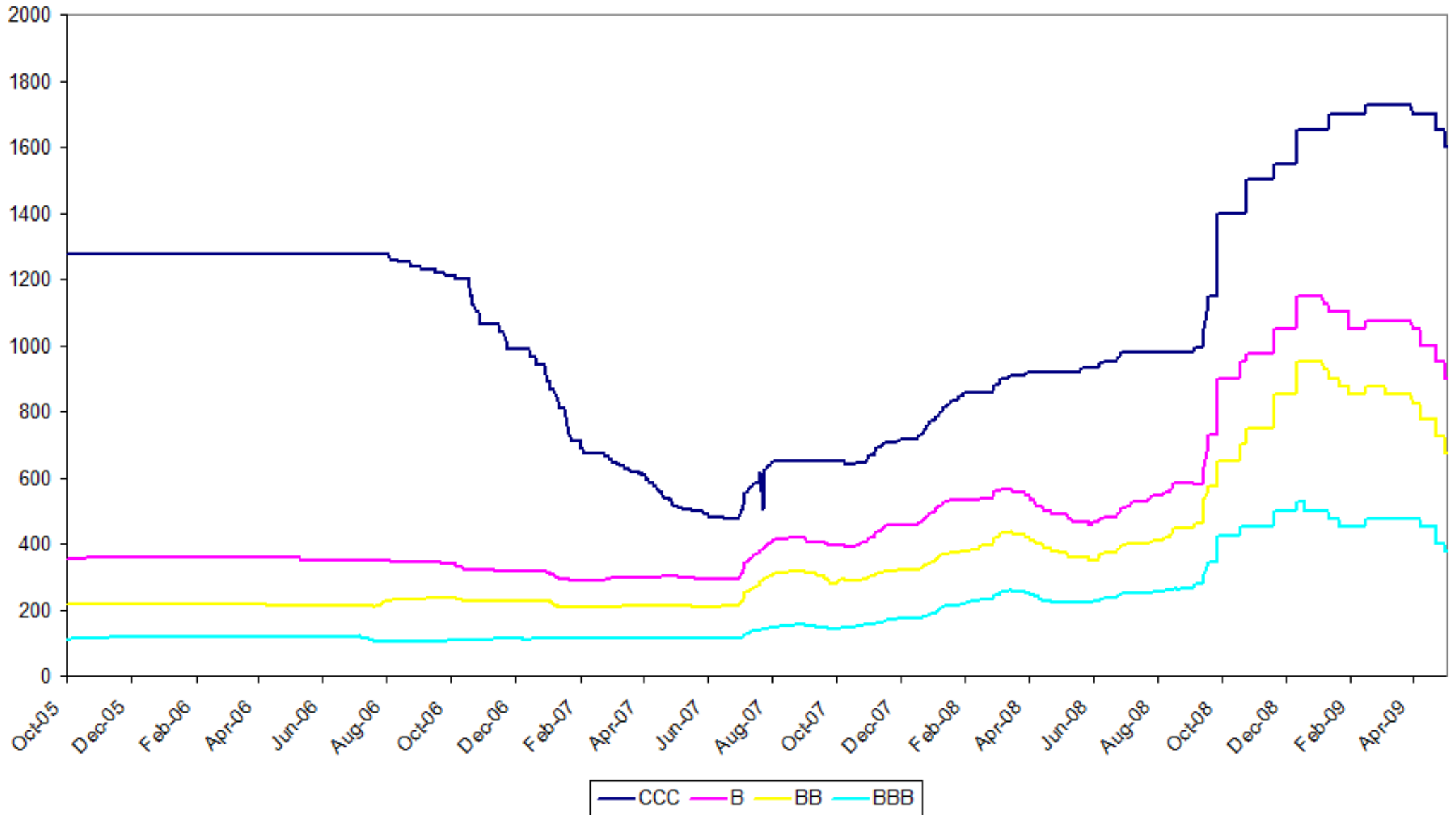


Figure 5b: MEDIAN PRICE - EXISTING HOMES

Projection

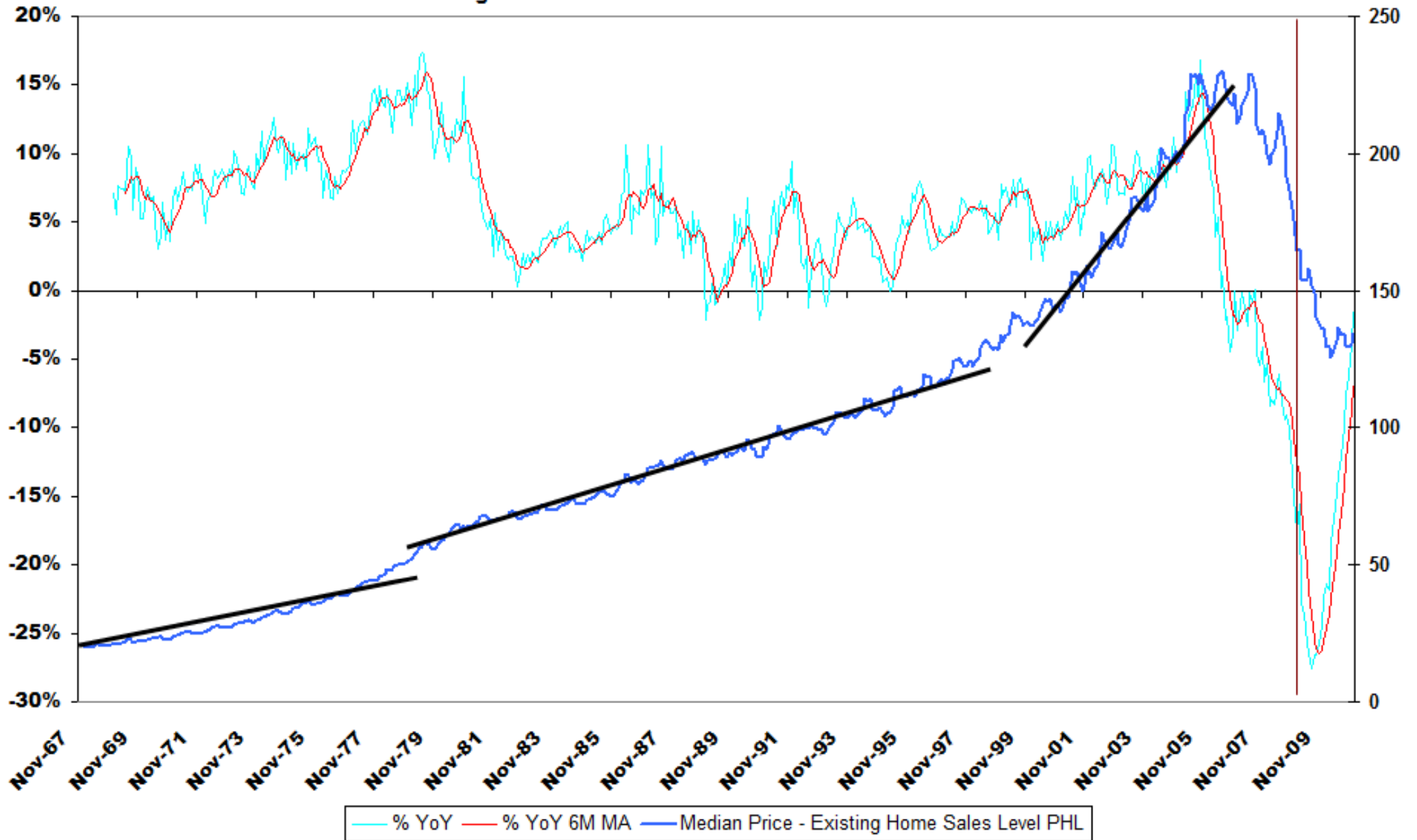


Figure 5a: Gross, Net Real Estate of Households and Mortgage Debt

Projection

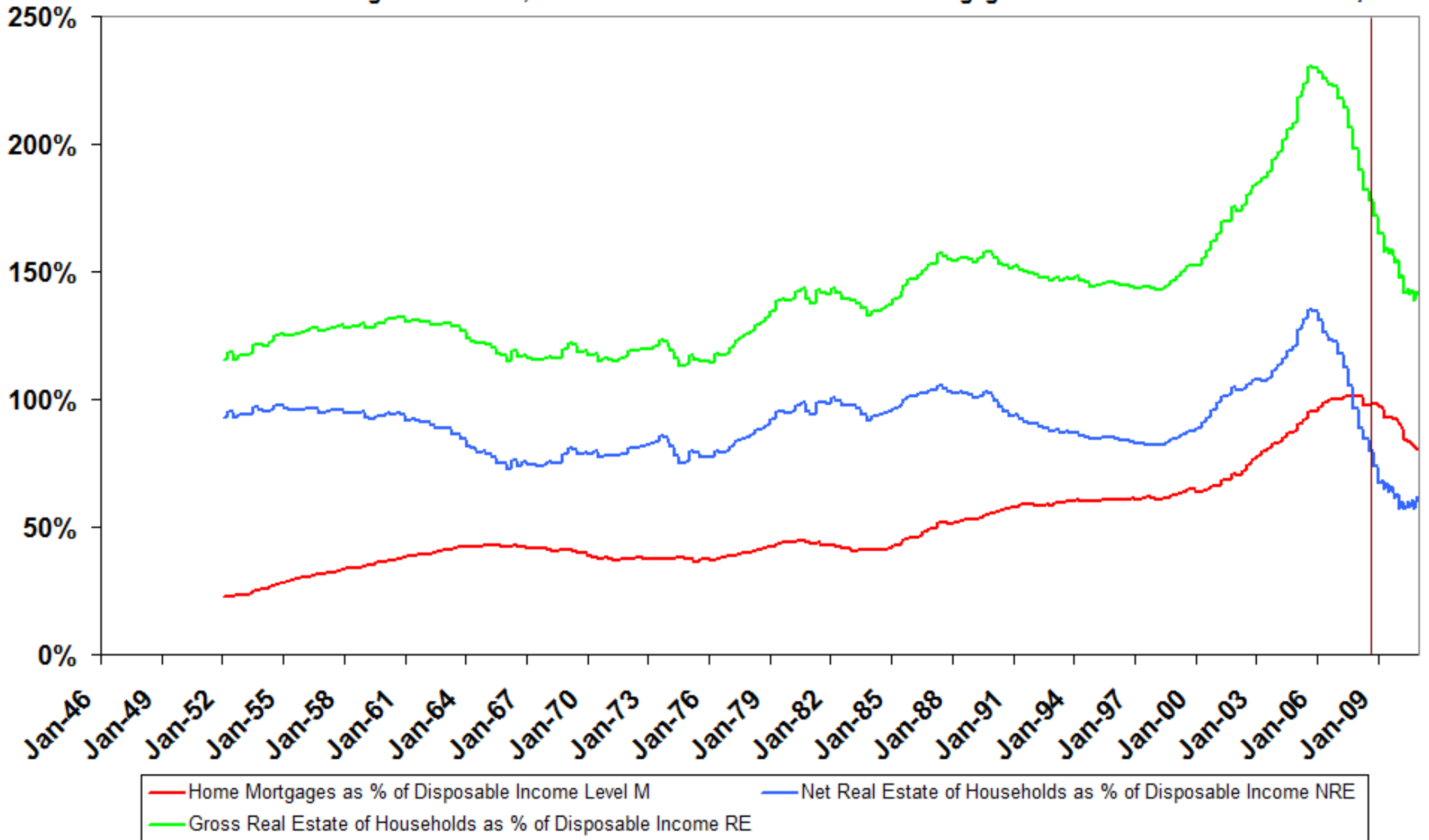


Figure 6a: CONSUMPTION, INCOME, SAVINGS & WEALTH

Projection

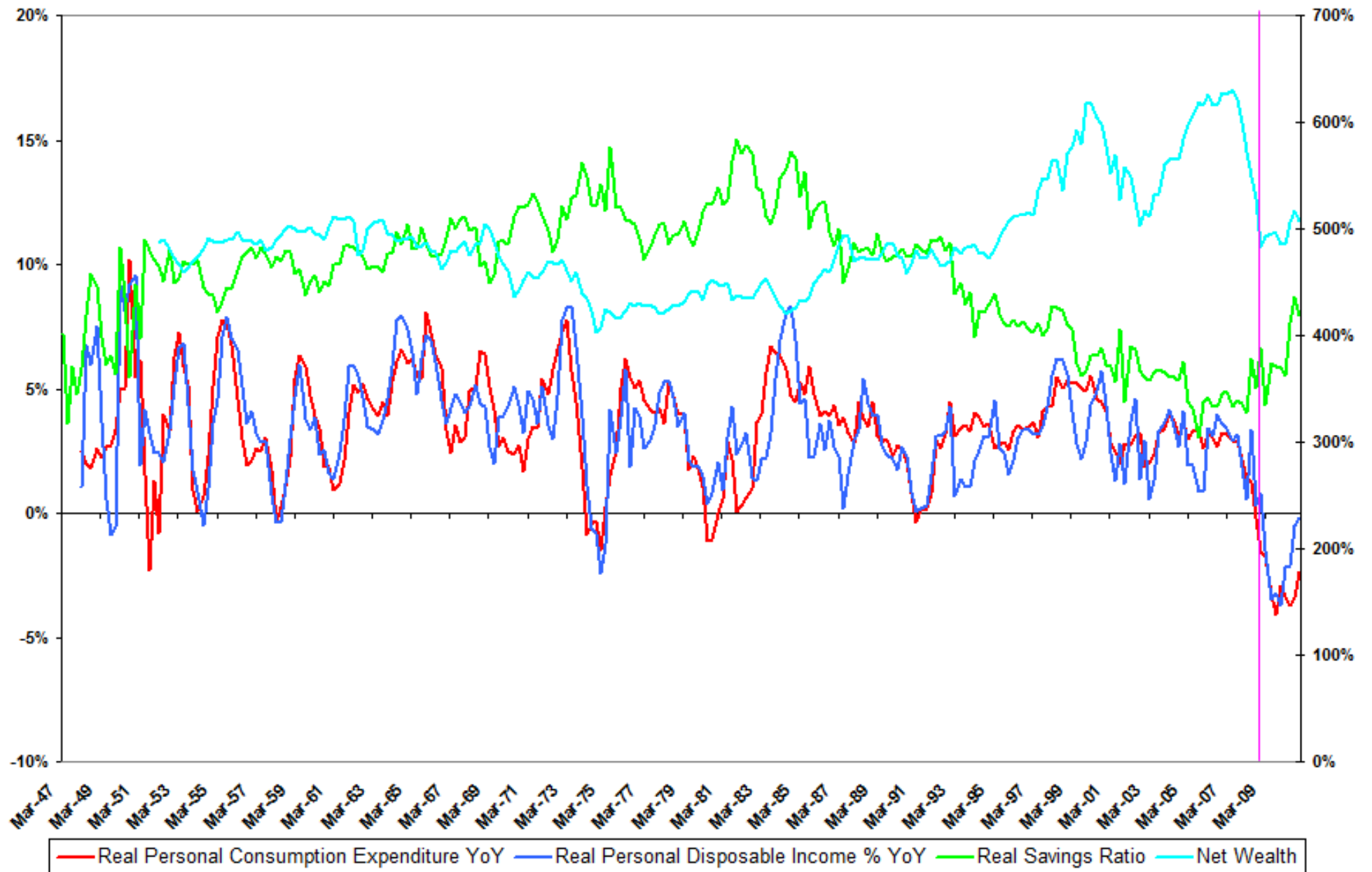


Figure 6b: US EMPLOYMENT SHORT RUN EQUILIBRIUM

Projection

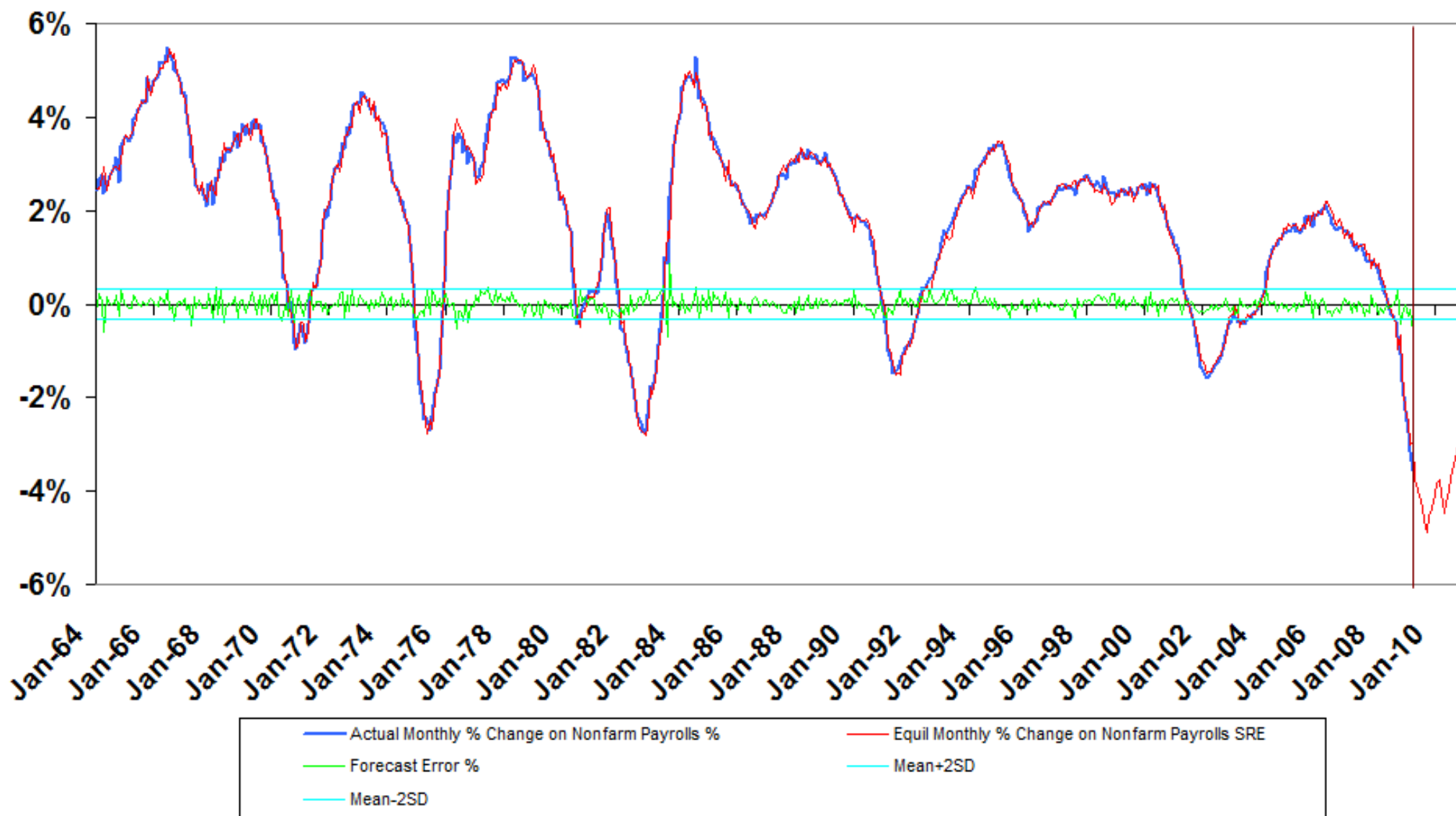
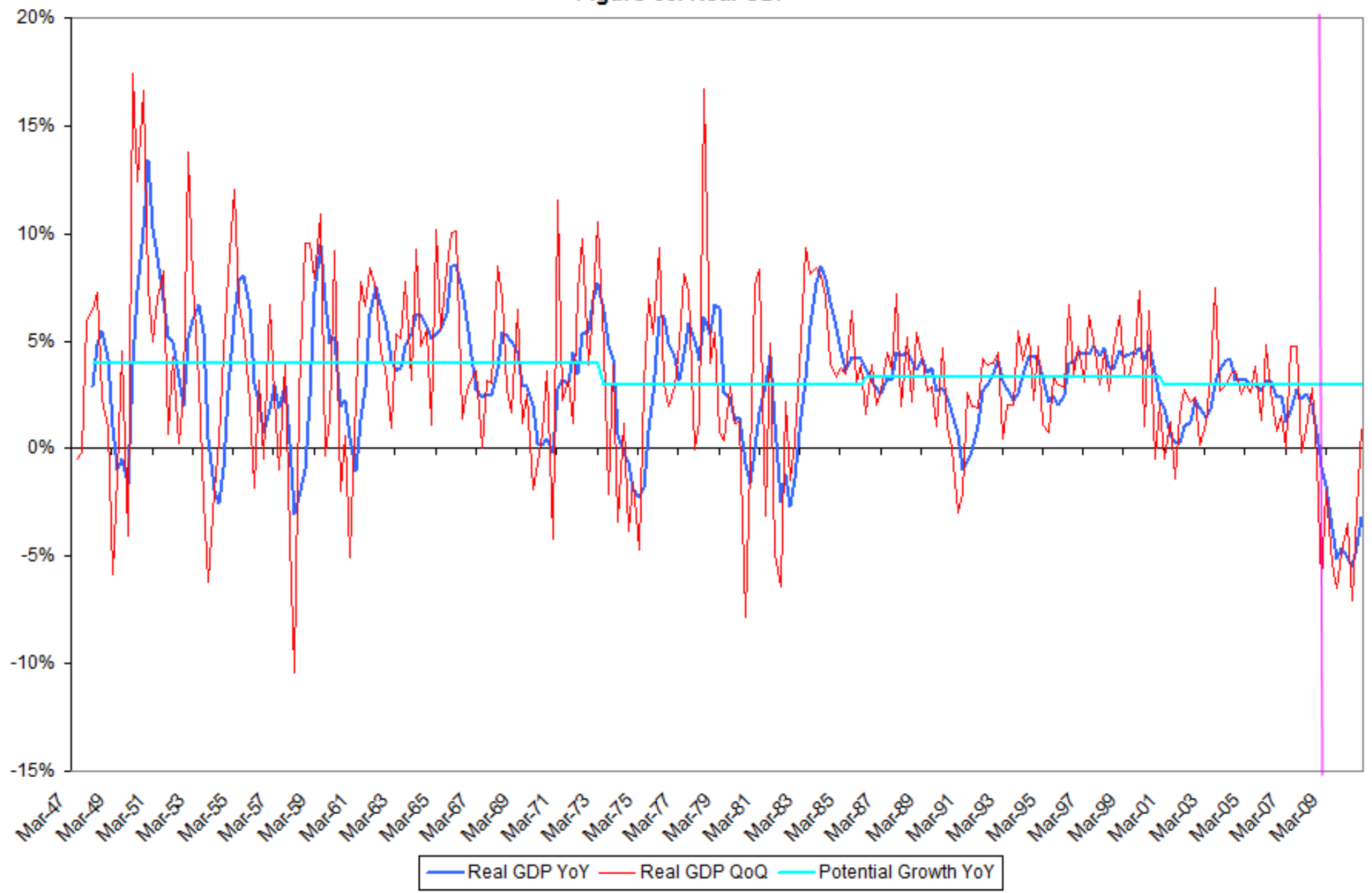


Figure 6c: Real GDP

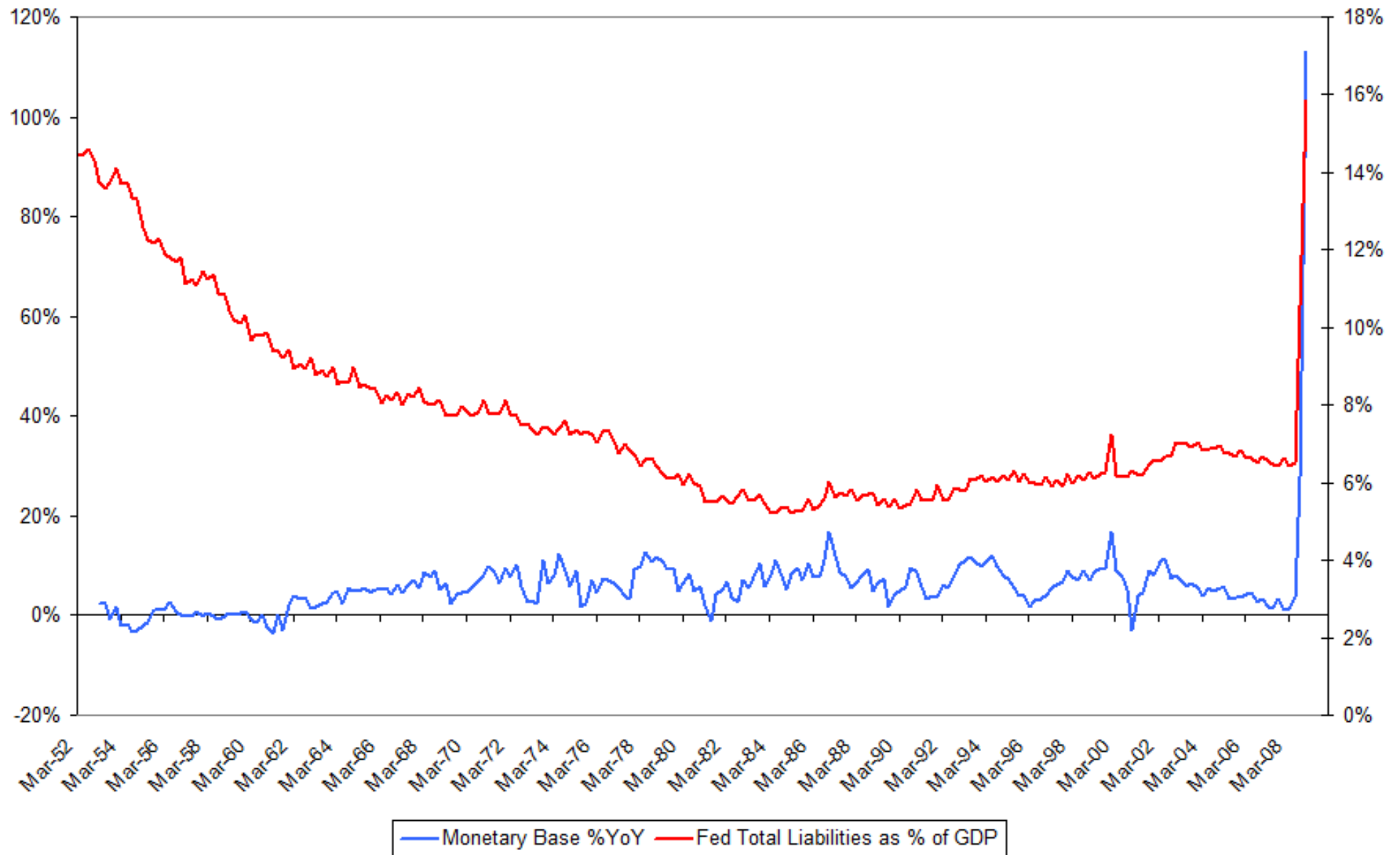
Projection



# Risks to Recovery

- US government and Fed spending, lending & guaranteeing
  - Commitment: \$12.8 trillion (GDP \$14.2)
  - Current allocation: \$4.2 trillion
- Fed balance sheet expansion:
  - \$1.4 trillion to \$2.2 or from 6% to 16% of GDP
  - Monetary base to more than 100%

Figure 7: Fed Balance Sheet and Monetary Base





# Risks to Recovery

- Risks to sustainability of recovery
  - Rising default risk premiums, inflation risk premiums & exchange rate risk premiums
- Issuance of US Treasuries: \$2.5 trillion in 2009
- Rising long term interest rates
- Printing of money: Inflation when economy recovers. Dollar depreciation.

# Policy Challenges & Inconsistencies

- Inflation or Deflation
  - Drain of liquidity (deleverage)
  - Acceptance of lower equilibrium asset prices
- Or
  - Flood the system with liquidity to restore previous levels of asset prices
  - But risk creating new bubbles (US Treasuries)
- Break vicious-cycle: bank losses-house prices
  - \$1.3 trillion rising to \$3 trillion on 40% fall of houses
  - Demand for credit as well as supply

# Policies to Avoid Future Crises

- Mild, but not excessive wealth targeting in addition to inflation and output gap
- Wealth target: corridor around 5-times disposable income
- Hike rates when wealth exceeds upper limit and lower rates when wealth falls below low limit.

# Advantages of Wealth Targeting

- Avoid moral hazard
- Avoid over-regulation
- Enable 'good' financial engineering
- Deal with the consequences of financial engineering
- Avoid policies that appear successful, yet sow the seeds for future bubbles (low volatility of inflation and large volatility of output)

Figure 8: Net Wealth

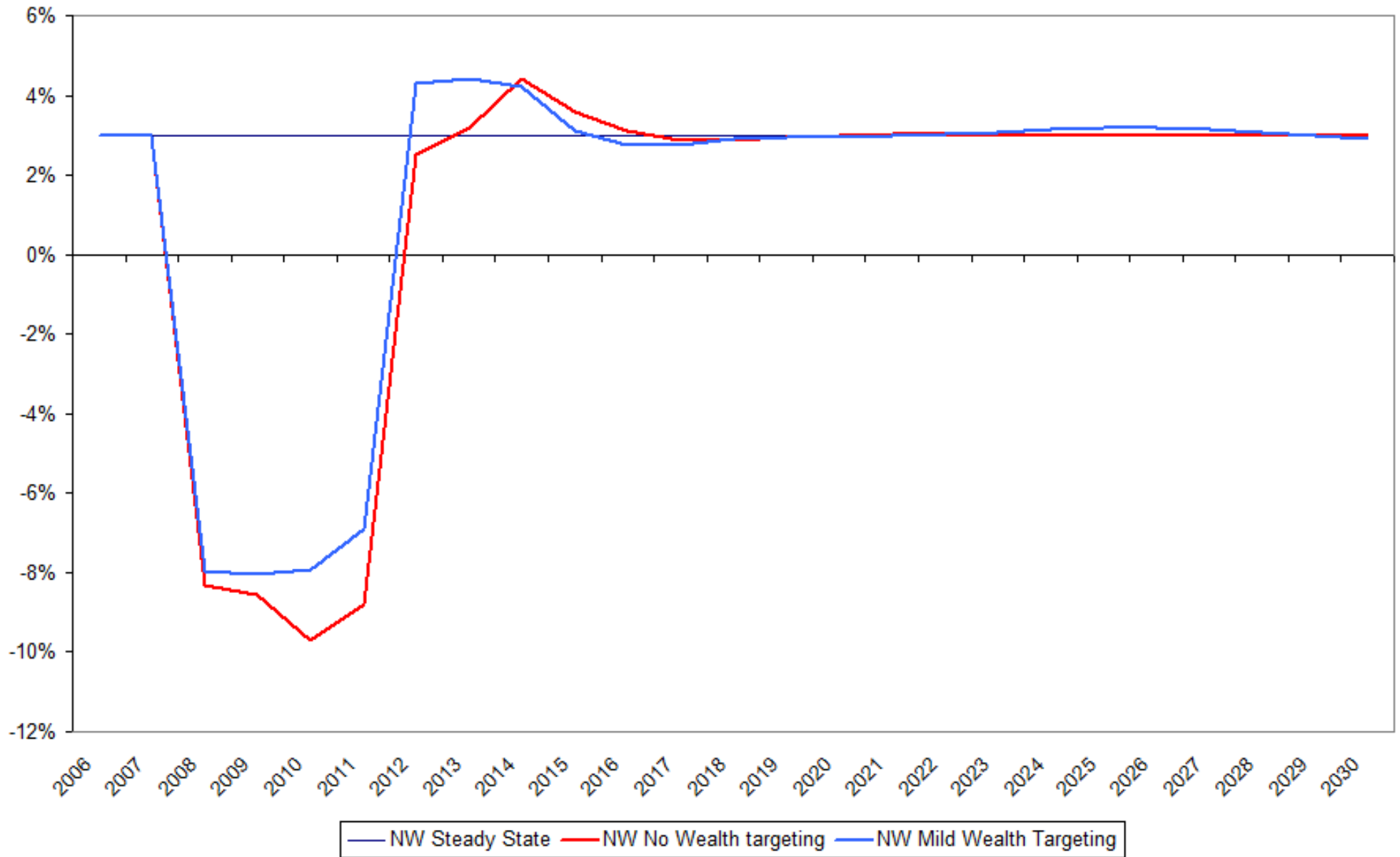


Figure 9: Output Gap

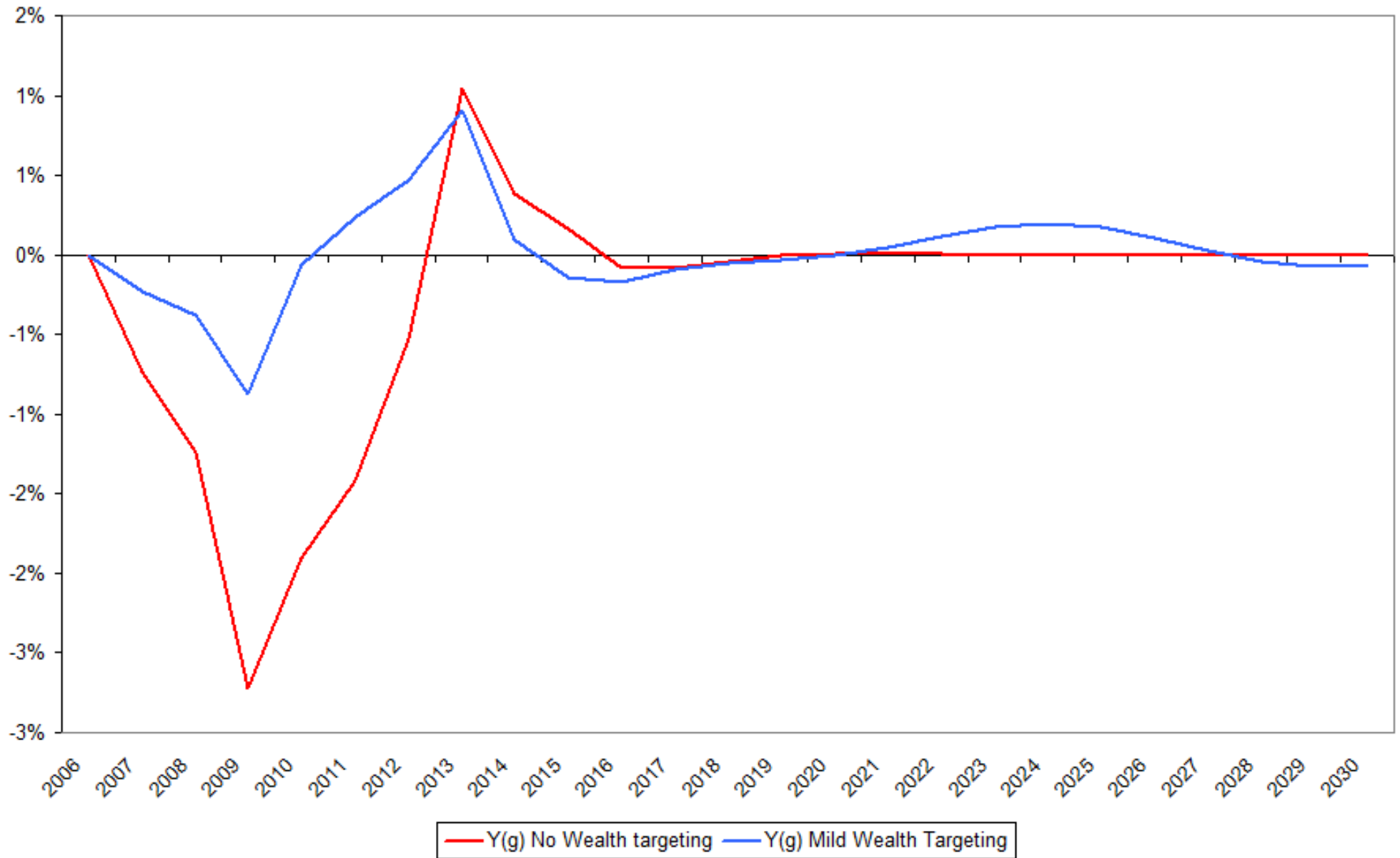


Figure 10: Inflation

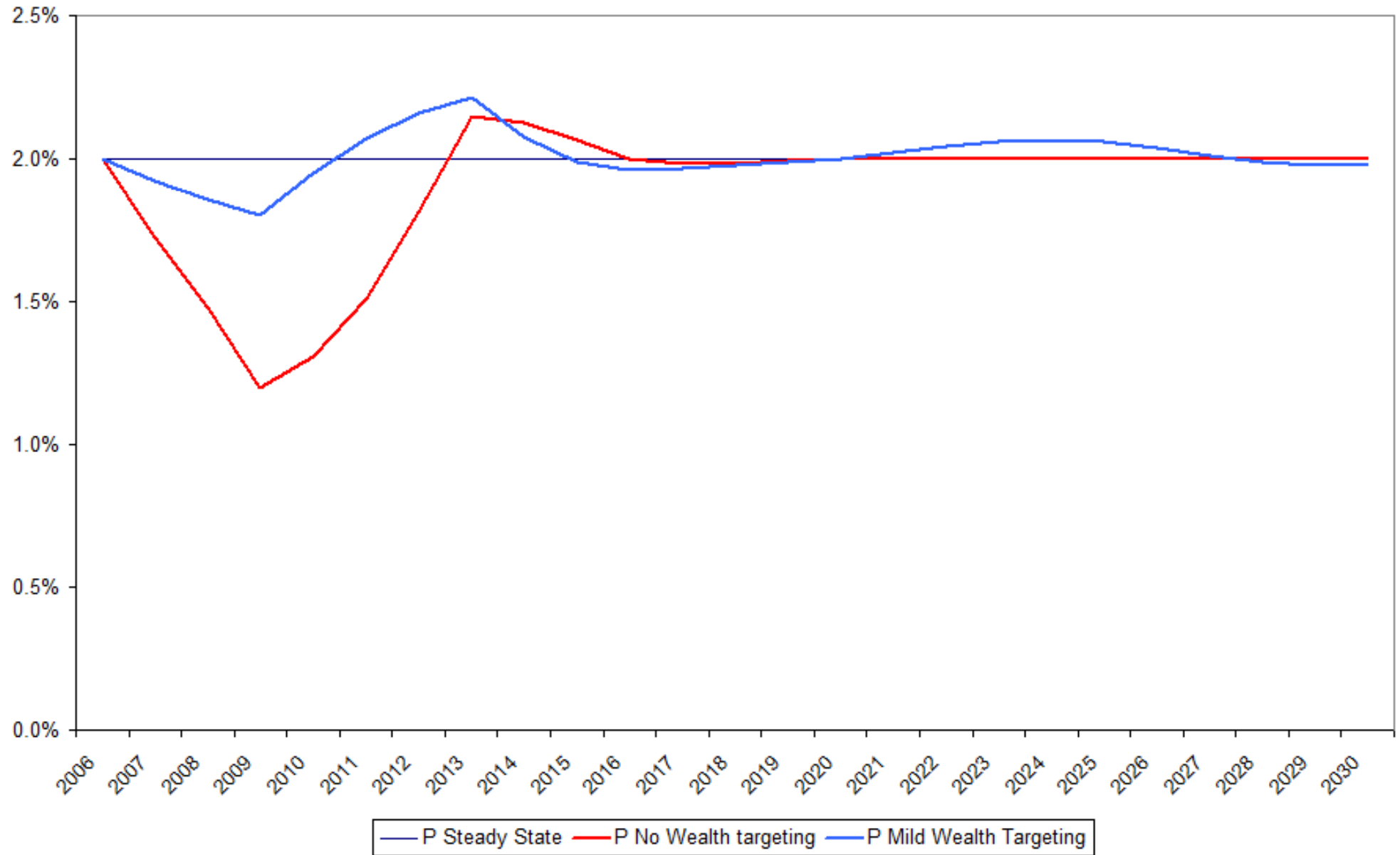


Figure 11: Interest rate

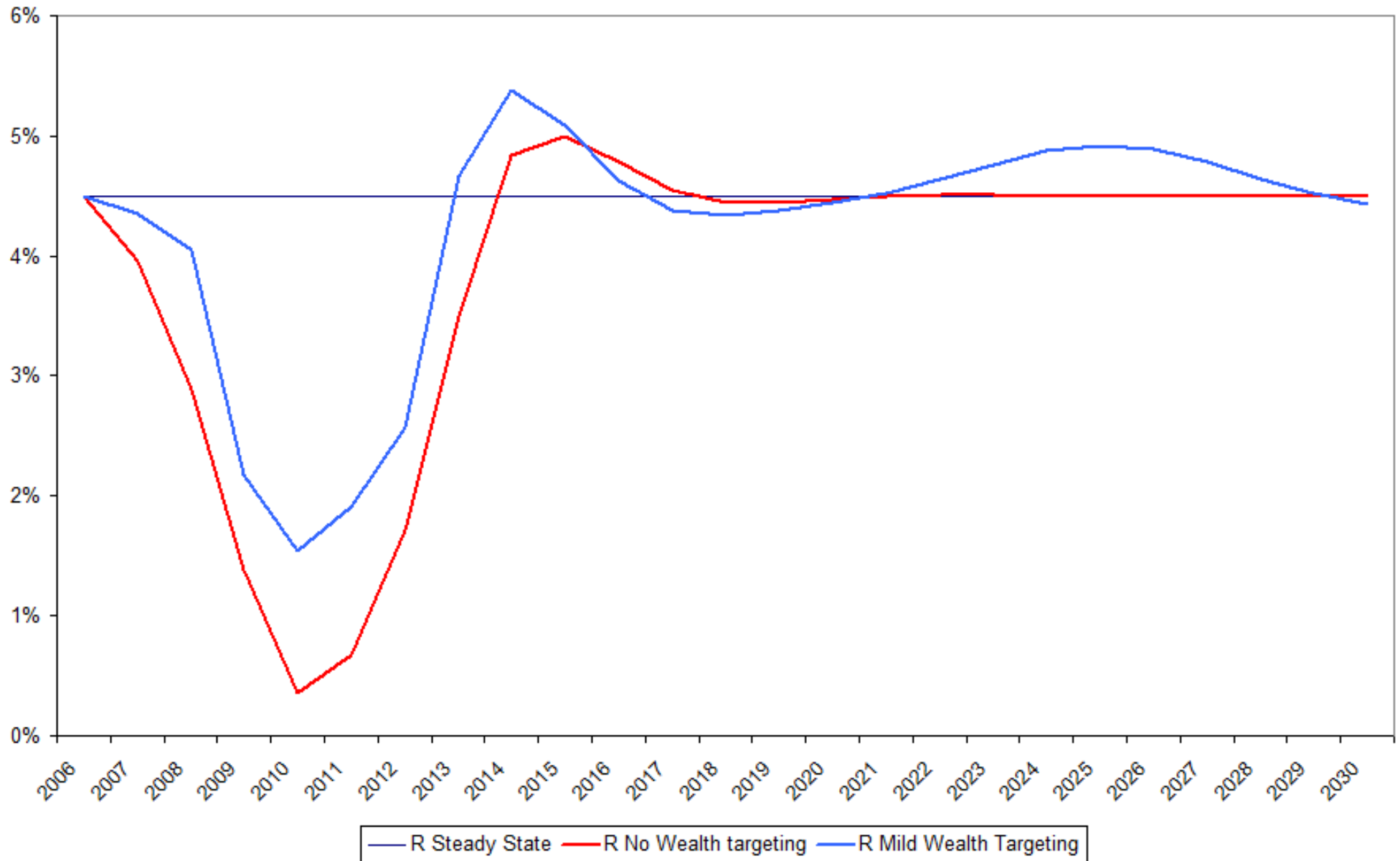




Figure 12: Real Profit Rate

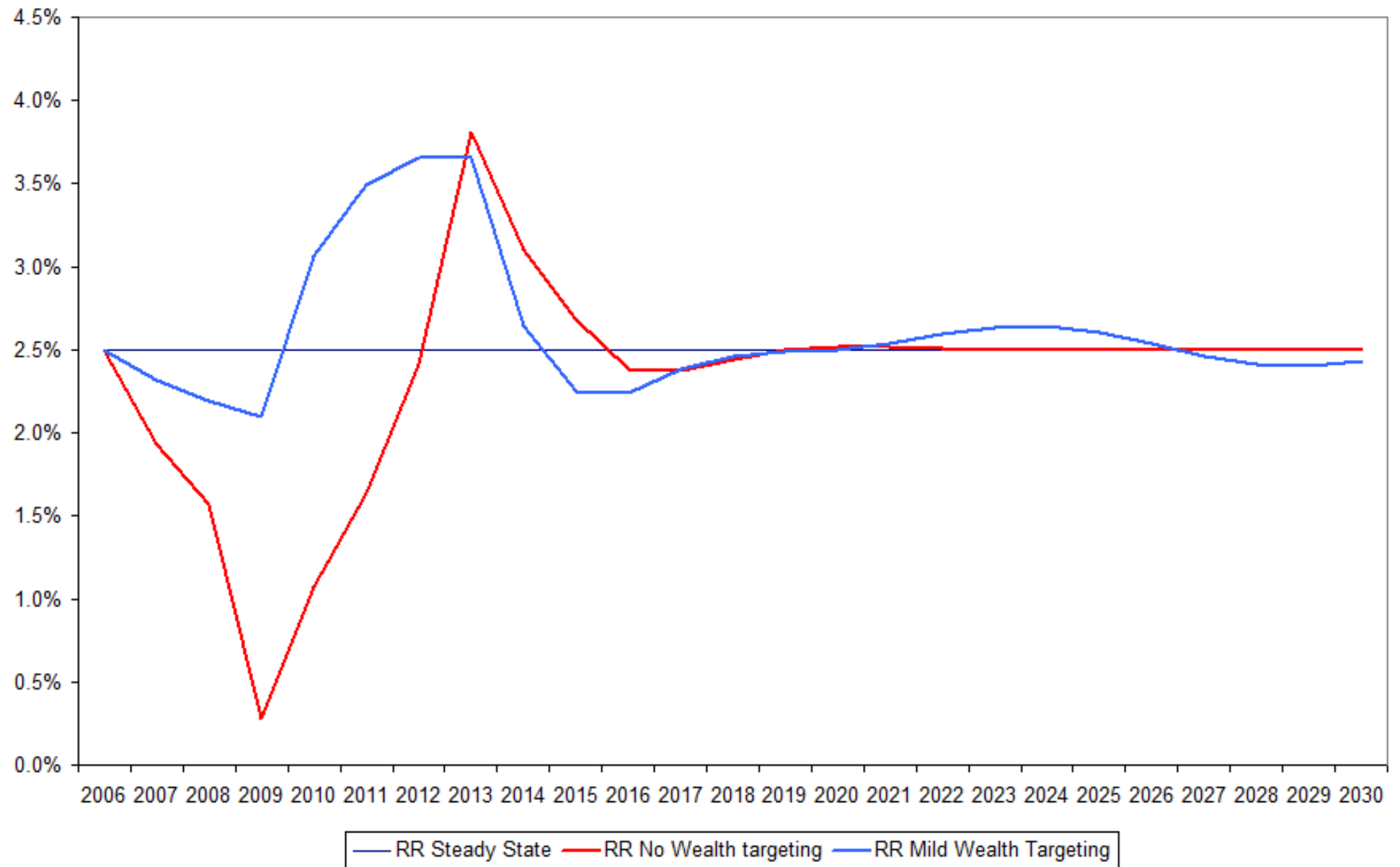


Figure 13: Net Wealth with Excessive Wealth Targeting

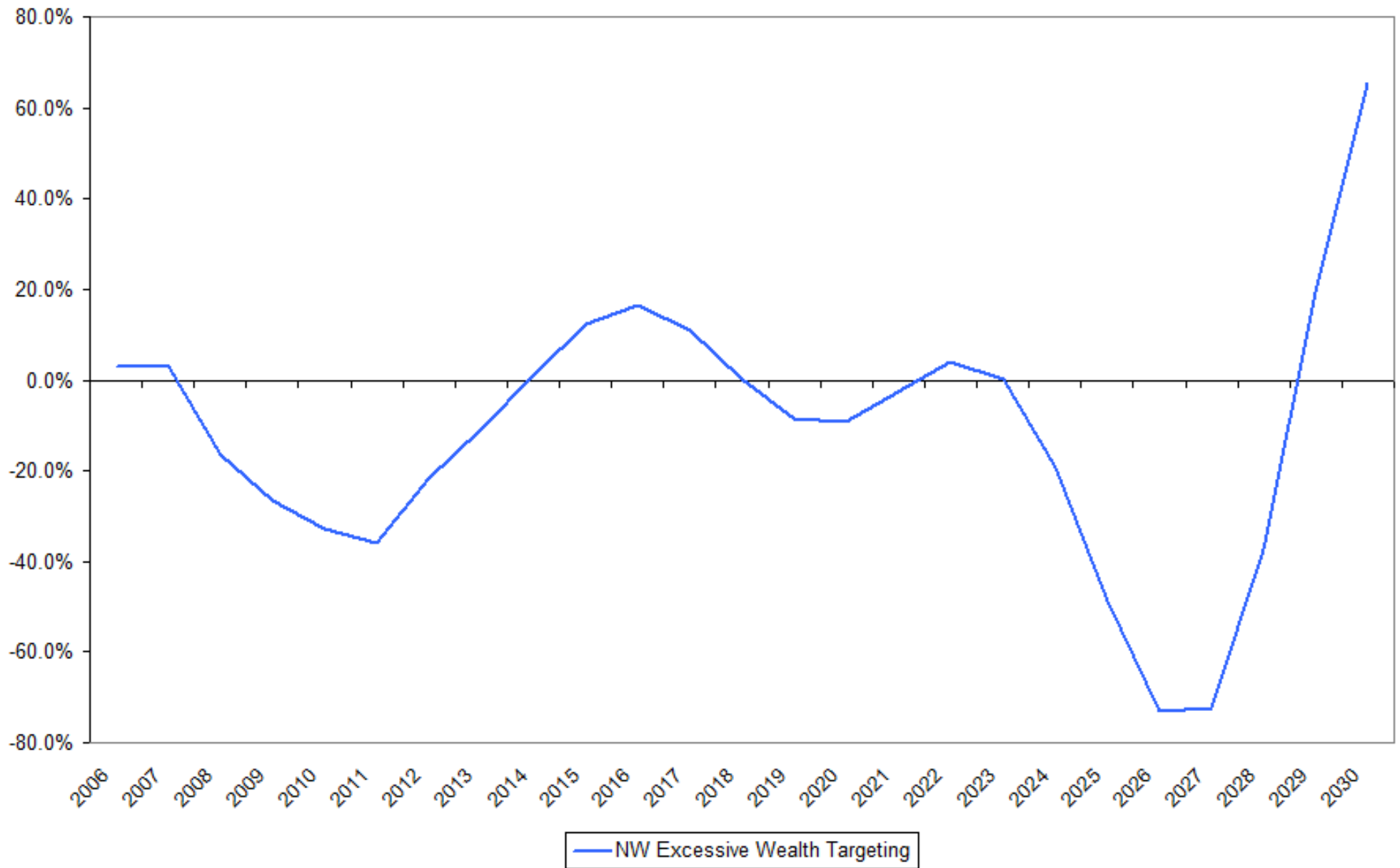


Figure 14: Output gap with excessive wealth targeting

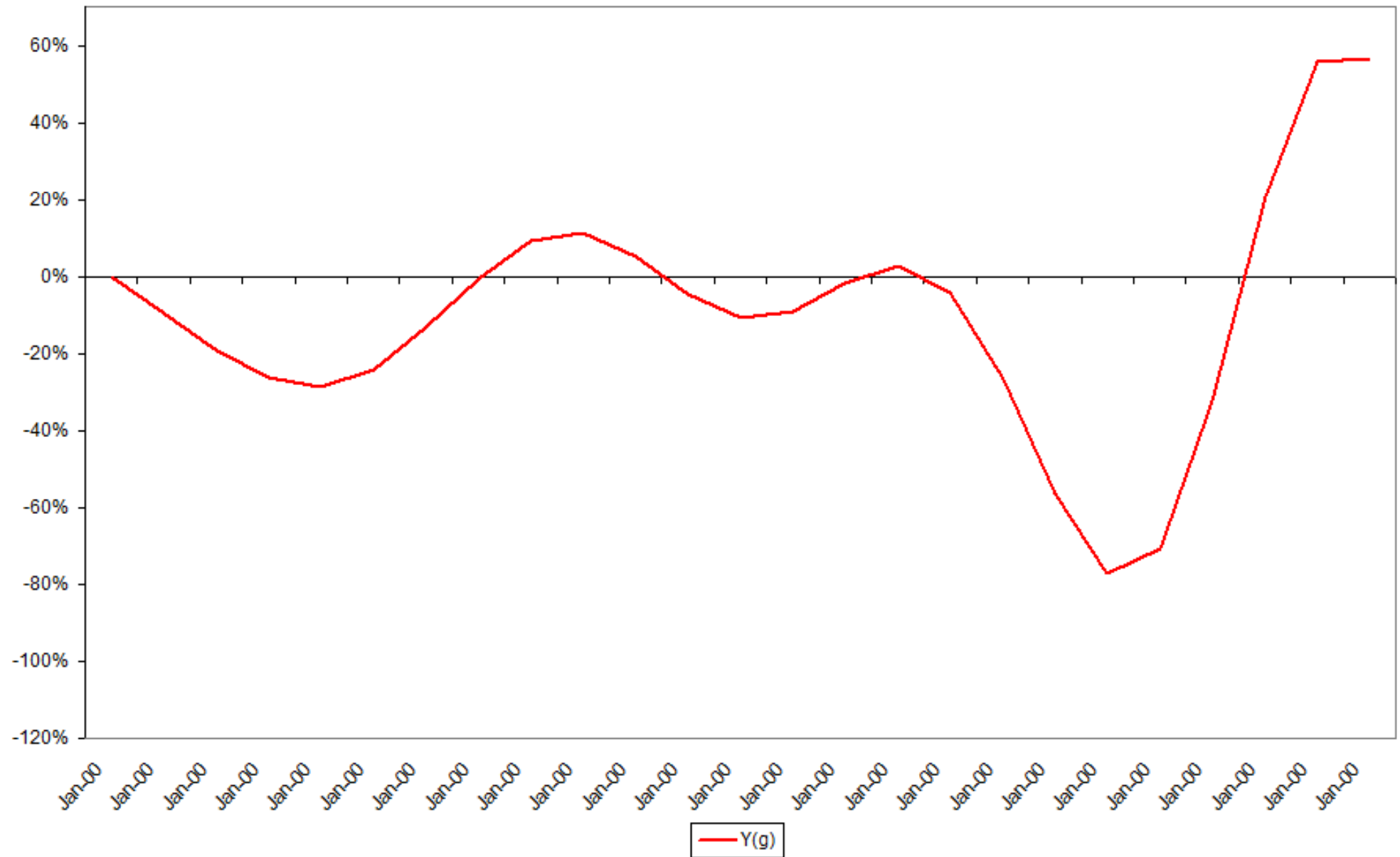


Figure 15: Interest rate, inflation and the natural interest rate with excessive wealth targeting

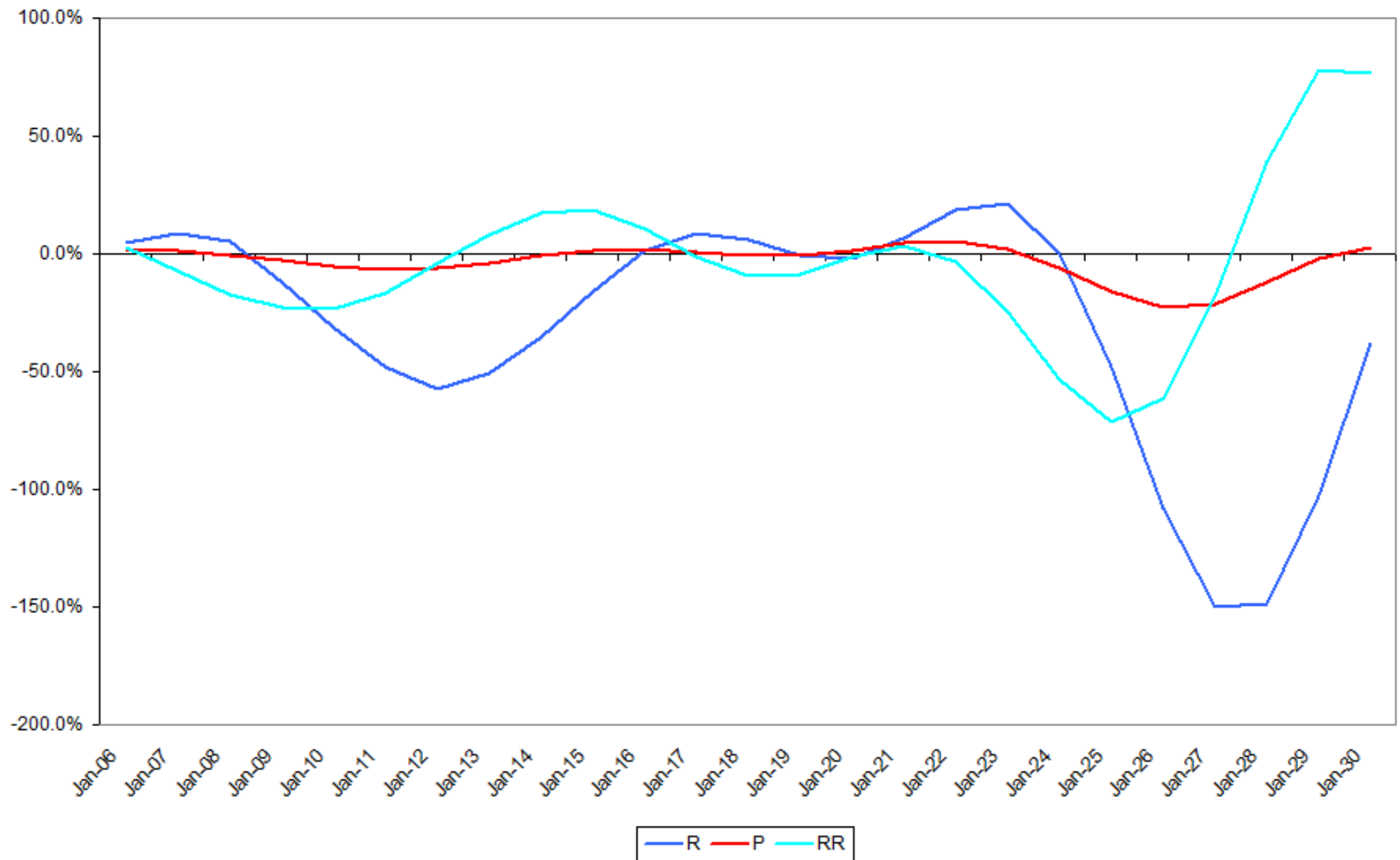


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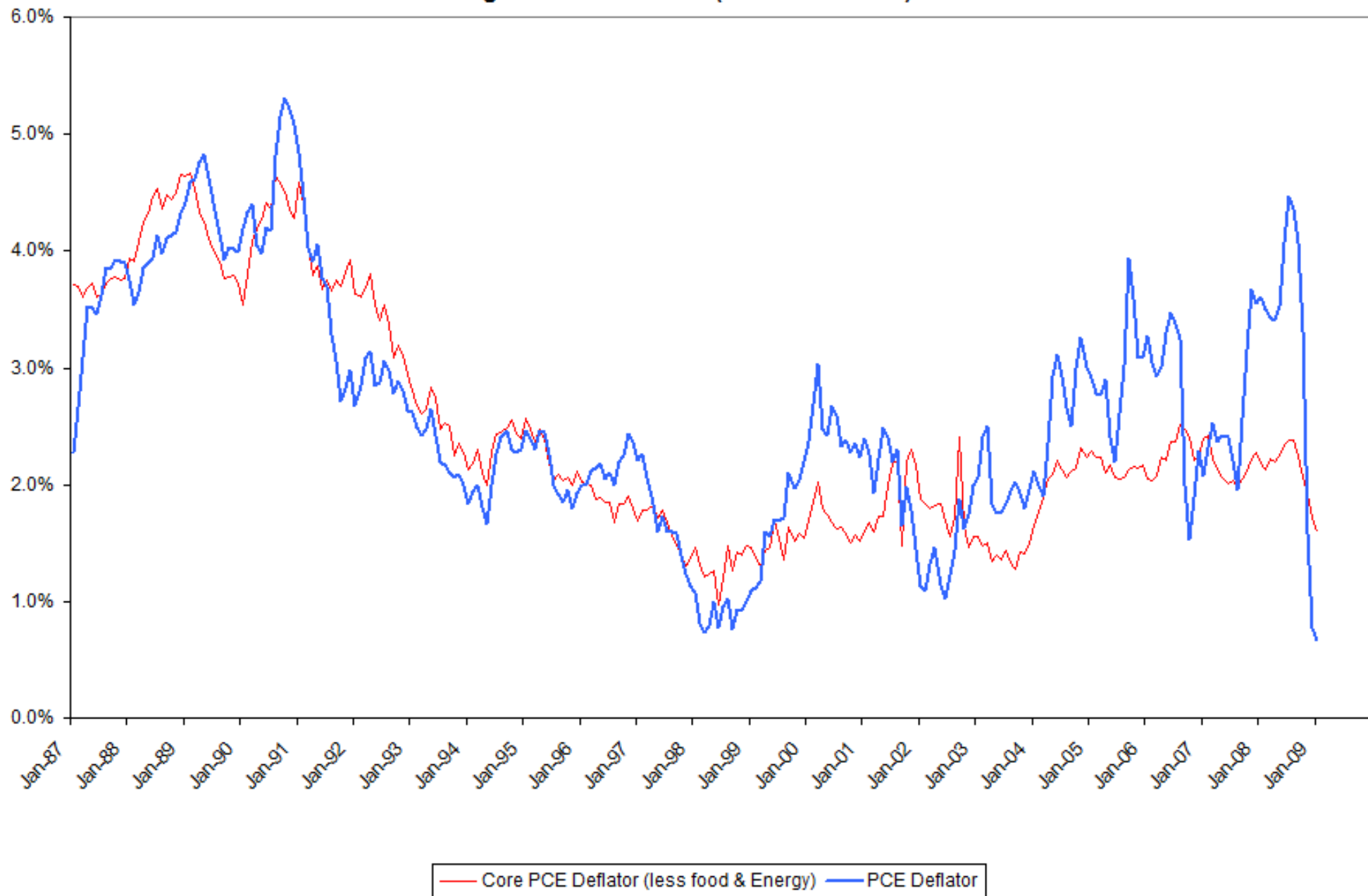


Figure 2: US Business Cycle

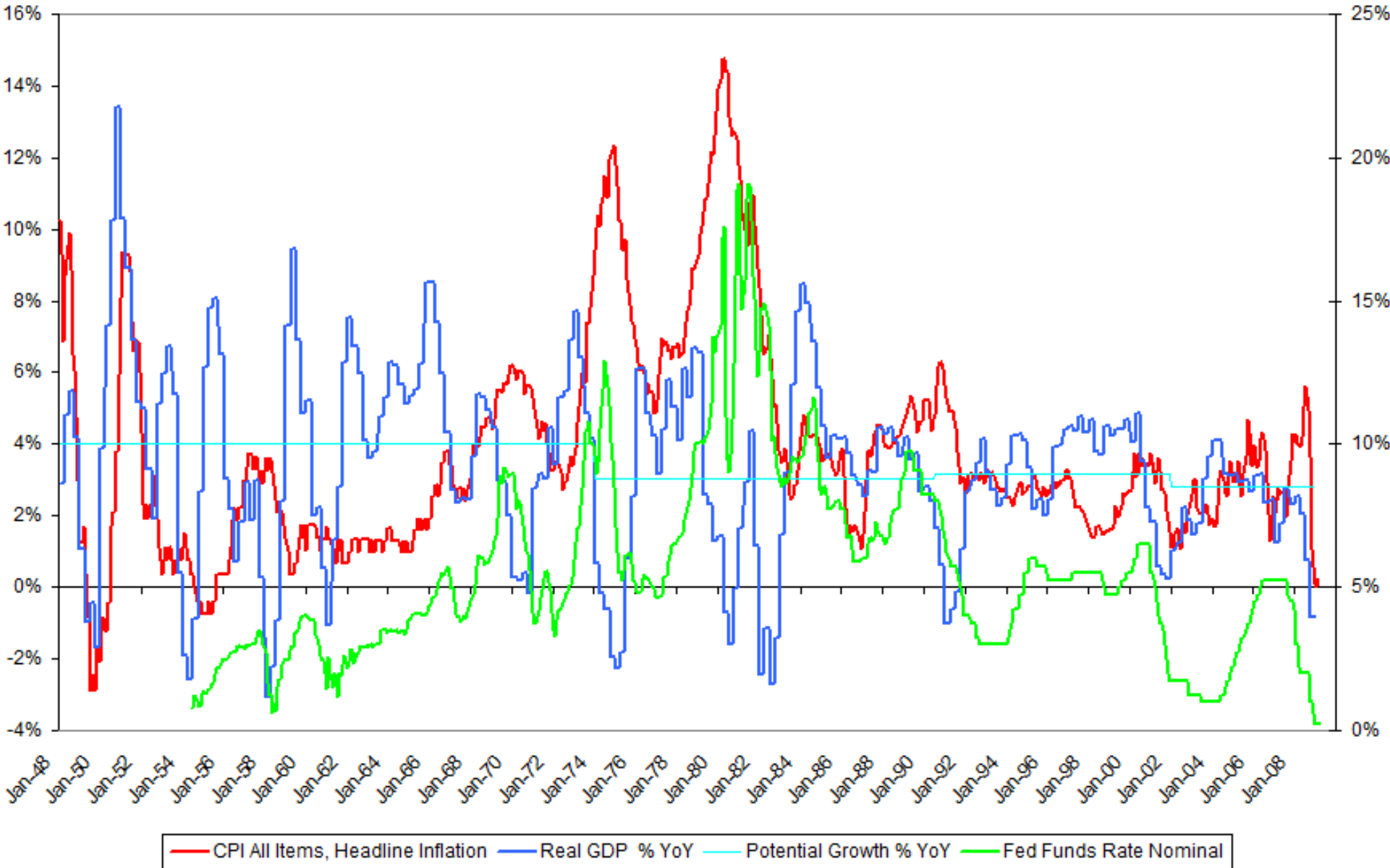


Figure 3: Wages, Productivity & Unit Labour Cost in Nonfarm Business

