FINANCIAL CYCLES: New evidence on their characteristics and policy implications

Financial cycles are long – on average twice the length of business cycles. At the same time, there is substantial heterogeneity of national cycles across G-7 countries, ranging from very similar financial and business cycles in Germany to markedly different cycles in the United States and Italy. These are among the findings of research by Yves Schüler, Paul Hiebert and Toumas Peltonen, to be presented at the annual congress of the European Economic Association in Geneva in August 2016.

Their study concludes that policies targeting financial cycles (such as countercyclical macroprudential policies) can act as a powerful complement to traditional stabilisation policies targeting the business cycle (such as macroeconomic policies, including monetary policy) – particularly in periods when there may be a considerable disconnect between financial markets and the real economy.

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Attenuating financial cycles is an essential goal of macroprudential policy, the so-called ‘time series dimension’ of systemic risk. Despite the associated elevated prominence of curbing financial cycles as a policy objective, the research literature on empirical measurement of financial cycles remains in its infancy – particularly when compared with business cycle counterparts. This study sets out to fill this knowledge gap on financial cycle measurement and understanding.

The research proposes a novel spectral method to capture financial cycles at the country level, applied to over 40 years of quarterly data for each of the G-7 countries (1970 Q1 to 2013 Q4).

In a first step, frequencies common to a set of indicators summarising financial and business cycles, respectively, are separately identified using spectral methods – providing insights on financial and business cycle length and volatility.

In a second step, composite measures of the financial and business cycle are constructed using time varying aggregation for each G-7 country – which can be compared to better understand within and across country cycle interaction.

Results are obtained using both a narrow measure of the financial cycle (comprised of credit and house prices) and a broad measure (completing portfolio choice amongst all asset classes, bringing in equity and bond prices).

Four key results emerge from the research:

• First, credit and asset price indicators for G-7 countries exhibit considerable cyclical cohesion. This cohesion is most evident over the long term for most countries; that is, 8 to 20 years. A narrow measure of the financial cycle tends to be at the long end of that range, approaching 20 years, in all G-7 countries with the notable exception of Germany. Bringing in financial asset prices, broad measures of the financial cycle exhibit fluctuations also at shorter frequencies of less than 8 years – commonly associated with business cycle fluctuations.
• **Second**, the derived composite financial cycle measures are strong predictors of financial crises – being the best single early predictors of past financial crises compared with standard metrics of leverage and asset price imbalances. Specifically, the composite cycles have been 10 percentage points or 16% better in predicting historical cycles up to one year ahead.

• **Third**, financial cycles tend to differ from business cycles – being on average *twice* as long as business cycles. At the same time, there is substantial heterogeneity of national cycles across G-7 countries, ranging from very similar financial and business cycles in Germany to markedly different cycles in the United States and Italy.

• **Fourth**, financial cycles exhibit some similarity across G-7 countries, with the strongest contributor to co-movement of *broad* cycles relating to equity and, to a lesser extent, bond prices – explaining close to *half* of cross-country cyclical commonalities. Once these international financial asset prices are excluded, the co-movement of narrow financial cycles across G-7 countries is far less pronounced, not surprising given a stronger domestic component of credit and house prices developments at the national level.

Taken together, these findings have at least two policy implications. First, they suggest a case for a differentiated application of macro policies. Policies targeting financial cycles (such as countercyclical macroprudential policies) can act as a powerful complement to traditional stabilisation policies targeting the business cycle (such as macroeconomic policies, including monetary policy) – particularly in periods where there may be real and financial disconnect.

Second, the results present a strong case for a differentiated national application of macroprudential policies, amid a far from complete convergence of country financial cycles.

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