Can Monetary Policy Be Used To Extract cues of Financial Instability

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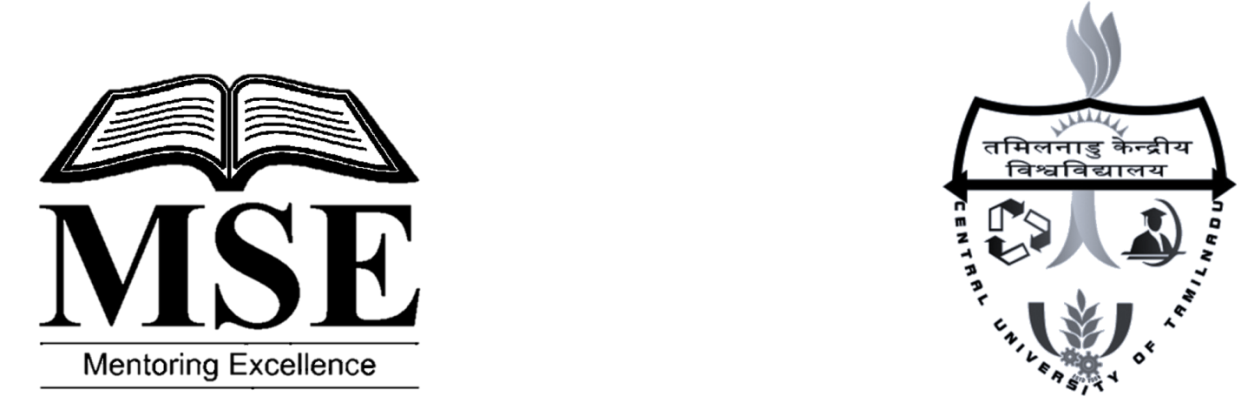
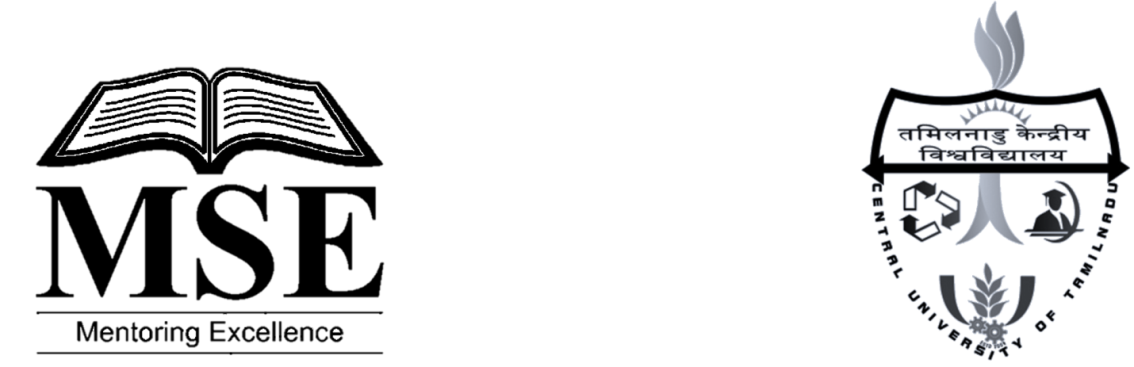
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**BONAFIDE CERTIFICATE**

Certified that this Project Report titled **“Can Monetary Policy Be Used to Extract cues of Financial Instability”** is the bona fide work of **Mr. Bhupesh Joshi** who carried out the project under my supervision. Certified further, that to the best of my knowledge the work reported herein does not form part of any other project report of the basis of which a degree or award was conferred on an earlier occasion on this or any other candidate

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# ABSTRACT

This paper is an attempt to understand the monetary policy during the period leading to the financial crisis of 2007-08 which was eventually converted to the “Great Recession” by 2009. Though unlike the “Great Depression” the federal reserves have continuously rubbished its role in the crisis, but many like John Taylor has continuously held it accountable for the crisis.

There have also been demands by many like Sunil Wadhwani for the FED to explicitly target the asset prices in the Inflation Targeting Framework.

The study shows that indeed the monetary policy were loose during the period leading to the crisis and the FED must be held accountable for this. Though there is no evidence from financial market indicators that could be incorporated explicitly in the policy rule.

Though we do not believe in general that a crisis’s or cycles can be completely removed from an economy but we can surely avoid a crisis as big as to cause a “Great Recession”.

# Introduction

Macroeconomics, in its current form is a combination and interaction of business cycles and monetary policy. The history of business cycles can be traced back from Jevons and Juglar to Mitchell, and monetary theory, building on the work of Hume, Thornton, Ricardo, Wicksell, and Fisher, supplemented by the circular flow analysis of Quesnay and Marx[[1]](#footnote-1).

Business cycles, indigenous part of an economy have for long troubled economists. One of the primary aims of economics is its attempt to explain business cycles and regulate it. Various institutions in an economy work in the direction “*to extend the period of expansion and curb down the effects of contraction*”. The central bank of a country is one such institution.

The Federal Reserve System, often referred to as the Federal Reserve or simply "the Fed" is the central bank of the United States of America.It was created by the Congress to provide the nation with a safer, more flexible, and more stable monetary and financial system[[2]](#footnote-2). One of the five functions as listed by the Fed is “Conducting the nation's monetary policy”.

Monetary theory, dealing with prices, money and output was initially explained by the “Quantity theory of money” and it has evolved long way since then. Monetary theory suggests that how different monetarypolicies can benefit nations depending on their unique set of resources and limitations. However, as Milton Friedman (1968) clearly articulates monetary policy has limits.

The role of monetary policy and its independence has been debated since the establishment of Bank of England in 1694. However, since Paul Volcker, the former chairman of the Fed it has settled; at least in the United States, to keeping inflation low and stable. This produced a prolonged period of stability (both economic and financial) in the economic environment. This period is often referred to as the period of “Great Moderation”[[3]](#footnote-3).

This is the kind of period that Minsky (1974) was referring about when he said “Stability breeds instability”. The financial markets which are heavily influenced by the monetary policies is one of the primary component of instability. The instability in economy originates from the financial market, be it the “Great Depression” or the “Great Recession”.

In this paper we will try to examine the monetary policy rule. Section 2 and 3 briefly deals with the role of central bank and the financial crisis of 2007-08. The policy rule followed by the FED and that proposed by John Taylor (1993) are compared in Section 4 of the paper. Section 5 further analyses the role of monetary policy in stabilizing the financial market and will try to answer the question “Weather monetary policy should explicitly target the asset prices”? Section 6 will provide counterfactual scenario for the housing statistics with various rule proposed. Section 7 concludes the paper by summarizing the main finding of the study.

# Economy, Crisis and Role of Central Bank

Business cycles are integral part to almost every economy on this planet. Every boom is followed by a bust and every trough by a high. Business cycles and financial crisis are not a new phenomenon. The history of financial crisis in an economy can be traced back to 1st Century. It was a “financial panic” caused by mass issuance of unsecured loan by the Roman Banking houses. If we broadly analyse all the financial crisis till date, we will find almost the same reason for a many of them. Weather be it the 1st Century Crisis or the 14th Century Banking Crisis or the Tulip Mania or the 19th and 20th Century crisis, they are all caused by the heard behaviour; usually preceded by a relatively long stability.

The recent housing bubble of 2007 which led to the “Great Recession” can be easily compared to the tulip bubble of the 17th Century. Tulip bubble has been stated by historians as the “history’s most extreme example of a fundamentally irrational speculative fever”. It saw the price of a single tulip bulb rise to the value of a luxury house in 17th Century Amsterdam. It was primarily caused by failed attempts of the conversion of ordinary futures contracts to option contracts by the Dutch burgomasters to bail themselves out of the previously incurred speculative losses[[4]](#footnote-4). On the other hand, the housing bubble, which saw an unprecedented rise in prices of real estate, was caused by the unregulated betting through Mortgage backed security; loose monetary policy; loosely regulated housing and financial sector. Like the 17th century tulip bubble what lied in the heart of the recent housing bubble was also an unregulated financial market which promoted the risk taking behaviour of the investors without strong fundamentals.

Crisis, in form of various events are a part of every economy. It is also the proof of its dynamic nature and need for actors in an economy to continuously react to these events. One such actor or institution that constantly keeps a check on the economy and influences the financial market is the Central Bank of the Economy.

In United States, the Federal Reserve’s System was established in 1913 with the enactment of the Federal Reserve’s Act by the Congress. The five general functions performed by the federal reserves for effective operations of the US economy are:

1. Conducting the nation’s monetary policy
2. Promoting the stability of the financial system
3. Promoting the safety and soundness of individual financial institutions and monitors their impact on the financial system as a whole.
4. Fostering payment and settlement system safety and efficiency
5. Promoting consumer protection and community development

Like the banking panics of 1930s, the financial crisis of 2007-08 is attributed to also the FED by many. In words of J. B. Taylor (2009) “Financial crisis is caused by Excesses-frequently monetary excesses.”[[5]](#footnote-5) and FED is mandated to conduct the monetary policy. It is clear from the financial crisis of 2007-08 that the FED failed in two of its functions. First, it failed to promote the financial stability. Second, it failed to ensure the soundness of financial institution. With the FED mandated to conduct the monetary policy of the US it becomes extremely important to analyse the conduct of FEDs monetary policy to critically comment on the role of FED in the crisis. It is also necessary to analyse the monetary policy because many including Taylor (2007) have argued that the loose monetary policy of the Federal Reserve was one of the reason for the financial crisis. The Monetary policy directly and indirectly affects the financial market therefore also needs to be analysed for the scope of capturing the signals of a crisis.

# FEDs Monetary Policy

The Federal Open Market Committee sets U.S. monetary policy in accordance with its mandate from Congress: to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy. The Federal Reserve conducts the nation’s monetary policy by managing the level of short-term interest rates and influencing the availability and cost of credit in the economy. Monetary policy directly affects interest rates; it indirectly affects stock prices, wealth, and currency exchange rates. Through these channels, monetary policy influences spending, investment, production, employment, and inflation in the United States. Though not officially the FED has moved to a rule based system rather than a pure discretionary policy. However, since there is no public rule for the conduct of monetary policy put forth by FED, there is a scope of discretionary policy. Taylor (2010) called this “well intended” deviation from the policy rule as “discretionary fine tuning”.

* + 1. **Monetary Policy Rule**

Apparently, the Fed in the recent past has settled down to follow the twin objective of stabilizing inflation around its target and keeping the output close to its potential. Though the weights and variable in the monetary policy rule suggested by different authors, have varied from unemployment gap to output gap, the level of output, and the growth rate of output. However, it is consistent of the twin objective in most of the models suggested by academicians and Federal Reserve’s researchers. It is also generally acceptable that there is a trade-off between the inflation and output, however many disagree with the significance of this trade-off.

John B. Taylor (1993) proposed a policy rule which is commonly referred to as the “Taylor Rule” and is since then considered as the optimal policy rule by many. Taylor (1993) argued that the monetary policy instrument which is the federal fund rate[[6]](#footnote-6) must respond to deviation of inflation from its target (which was assumed to be 2%) and percentage deviation of output from its trend.

--***Equation 1***

where

*r is federal funds rate*

That is,

\*100

*Y is real GDP*

*Y` is trend real GDP*

Although not explicitly the FED has followed the Taylor rule particularly under the chairmanship of Paul Volcker and Alan Greenspan. However, the rule is not free from criticism. Some argue for looking at only inflation for the policy rule whereas others propose including additional variables to explicitly capture the financial condition of the market.

Of the five functions of the FED listed above can the first three, particularly the conduct of monetary policy and maintaining the financial stability be clubbed together? Can we capture the cues of financial instability in the monetary policy rule and use the monetary policy instrument to regulate the financial market? Is monetary policy instrument a blunt instrument or twelve people sitting in a room cannot decide better than the markets? All such questions can be answered by critically analysing the monetary policy and creating the counterfactual scenarios.

The financial crisis of 2007-08 provides us with an opportunity to analyse

1. Whether or not we can incorporate the parameters giving cues of financial instability to enhance the Taylor rule.
2. Create a counterfactual scenario to check for the financial stability of the system.

# The “Great Recession”

The “Great Recession” which resulted in general decline in world market is a result of financial crisis of 2007-08 and US subprime mortgage crisis 2007-09. Though crisis started with the with fall of Lehman Brothers but the seed for the crisis were sown long back in late 1990’s. The lack of government regulation for financial institutions, lax lending standards, government intervention with the function of Freddie Mac and Fannie Mae, loose monetary policy by FED are amongst a few widely accepted causes of the crisis.

Housing sector was at the core of the crisis. It all started with popularization of mortgage backed security (MBS) by Lewis Ranieri considered by many as one of greatest innovator[[7]](#footnote-7) and blamed by others for the sub-prime crisis. A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. The mortgages are sold to a group of individuals (a government agency or investment bank) that securitizes, or packages, the loans together into a security that investors can buy.

Since it was a safe investment with a high rate of returns investors flocked to by the MBS in form of Collateral Debt Obligation (CDO), synthetic CDOs etc. The decade preceding the crisis saw an unprecedented growth of 124% in house prices. The year on year house price inflation increased from 0% in 1997 close to 10% by 2005 as evident from Figure 1. The sudden and a continuous rise in house price inflation led to investors and households taking extra risk. This promoted the heard behaviour amongst the investor. Complimenting it was the loose lending standards as well as the affordable housing programme by the Government of United States.

**Figure 1** The quarterly housing price inflation calculated based on the Shiller’s housing price index.

High housing inflation was further supplemented by the low perceived risk in the market. The Ted Spread[[8]](#footnote-8) which captures the perceived credit risk in market was at close to 0% as seen in Figure 2. The low perceived risk also indicate that common perception amongst investors of “everybody pays their mortgages”. The fall in investor sentiment is evident from the abrupt rise in the spread post 2007. This clearly indicates that the problem was indeed of credit risk[[9]](#footnote-9) rather than a liquidity problem.

**Figure 2** The quarterly average of TED Spread

All this along with loose monetary policies led to US housing bubble, which busted in 2007-08. The crisis which originated in US was transferred worldwide and was converted to the “Great Recession”.

# Various variants of Taylor Rule

# Taylor Rule with CPI

To establish the argument of loose monetary policy we will try to estimate the Taylor rule (equation 1) for the period of 1987-2008. It is aimed at capturing the response of the independent variables viz. inflation and output gap during the crisis as well as pre crisis period. The year 1987 is marked as the start of long period of the chairmanship of Alan Greenspan and the period of “Great Moderation”. This allow us to fully capture the dynamics of economy including the period of advent of crisis. Post 2008 the monetary policy instrument viz. the federal funds rate was forcefully kept close to 0% to support the recovery of the economy. Therefore, the period of study seems appropriate to cover most of the aspect of the study. The extended period will allow us to accommodate dynamic i.e. both loose and tight monetary policy.

The estimated Taylor rule for the period with CPI based inflation is:

**1.5** --***Equation 2***

where

*r is federal funds rate*

That is,

\*100

*Y is real GDP*

*Y` is potential GDP as estimated by the Congressional Budget’s Office*

This is in line with the Taylor Rule (1993) in equation 1 with increased weightage to output gap. If we compare the actual federal funds rate to that with estimated rate from equation 2, we see a clear deviation from the policy rule post 2002-Q2.

The difference between the actual Federal Funds rate and from the counter factual scenario i.e. the had the estimated Taylor rule been followed is significant only for a period of 2002-Q2 to 2006-Q3. This estimation is also in line with the estimations of Taylor (2009) despite accounting for a broader period and covering a relatively dynamic period. This clearly indicates of the discretionary nature of policy by the FED. Though there are many competing arguments given by the various researchers included the then chairmen Ben S. Bernanke. Some of the prominent arguments by researchers include the presence of “Saving Glut” and fear of deflation but none of that changes the fact that the monetary policy was loose. The deviation was as high as 3 percentage point particularly after 2004.

**Figure 3** The graph compares Federal Funds Rate i.e. the actual policy rate with the estimated rate as per equation 2. From 1987-2002 the difference between the actual and estimate rate is insignificant.

It was a “well intended”, “purposeful” deviation from the regular course. The FED was clear in its part to inform the market about its “discretionary” policy. According to economic synopsis by FRED[[10]](#footnote-10) at its Aug 12, 2003 meeting the FOMC announced that its current highly accommodative monetary policy could be maintained “for a considerable period”. The FOMCs minutes note that it was to “encourage progress towards closing the economy’s output gap”. These statement by FOMC are a clear indication that there was a deviation from some sort of rule. The credibility gained by the FED in last two decades was put to test at this phrase.

The consequences of this deviation can be logically analysed and argued upon. The loose monetary policy led to excess money supply in the economy and hence investor taking extra risk. The money pushed out by FED due to low interest rate made its way to US economy in form of investment in Freddie Mac and Fannie Mae. The excess investment in perceived “safe” assets like housing let to distortion in the sector which eventually became a bubble and busted in 2007.

# Taylor Rule with Personal Consumption Expenditure (PCE)

However, the erstwhile chairman of the FED Ben S. Bernanke argued that the use of GDP deflator (as used by John Taylor) or CPI is not what the FOMC prefers to target. It has always been clear to target the core personal consumption expenditure (PCE). If we change the measure of inflation from CPI to core-PCE and re-estimate the Taylor rule we get the following result.

The estimated Taylor rule for the period with PCE based inflation is:

--***Equation 3***

where

*r is federal funds rate*

That is,

\*100

*Y is real GDP*

*Y` is potential GDP as estimated by the Congressional Budget’s Office*

***Figure 4*** *The graph compares federal funds rate with the estimated rate from equation 3 and equation 2. The graph for estimated rate with PCE though below the estimate for CPI based Taylor Rule but far above the Federal Funds Rate.*

The results rubbishes Ben Bernanke’s claim that the FED never deviated from the policy. Careful manoeuvring by Ben Bernanke like changing the time period of study[[11]](#footnote-11) etc. though reduced the burden of the loose monetary policy from FED but it is not logical enough to explain the correlation between low perceived risk and monetary policy during the same period (2003-05). Further the biasness problem associated with different inflation indicator is no justification for the rejecting the rule on itself. As clear form above analysis a little increase in time period changes the results.

# Policy Rule with Asset Prices

Till now it is clear that the FED’s monetary loose though the magnitude may be debatable. We will further try to look of cues of the crisis that could be incorporated in the Taylor Rule and change the policy instrument accordingly.

The housing market is generally considered as one of safest market. This “safe haven” of investment was what caused the crisis. Since the housing market was one of the hot sectors during the financial crisis of 2008 it is logical to search for the cues of a crisis in the housing sector.

For this we used the housed price index developed by Robert Shiller. The additional variable added to the Taylor rule is the percentage deviation of house price index from its trend[[12]](#footnote-12).

The estimated Taylor rule for the period with Housing price indicator is:

-- ***Equation 4***

where

*r is federal funds rate*

That is,

\*100

*Y is real GDP*

*Y` is potential GDP as estimated by the Congressional Budget’s Office*

The estimated rule is plotted along with the actual federal funds rate and the rate estimated CPI based Taylor rule form equation 1 in fig 5.

**Figure 5** The graph compares federal funds rate with the estimated rate from equation 4 and equation 2. The graph for estimated rate with house price indicator almost overlaps the estimates for estimates without house price indicator.

Figure 5 clears up a few things

1. Even though the weights for inflation and output gap changes in equation 4 but still there seems be no significant difference between Taylor Rule and Taylor Rule housing price indicator.
2. The Taylor Rule with housing also suggest monetary policy were loose during the period. It calls for half a percentage higher rate than the Taylor Rule from equation 2 after 2005.

Incorporating a measure of perceived risk in financial market like TED Spread or LIBOR-OSI spread also yields similar result. It is clear that it is very difficult to extract cues from the financial indicators and incorporate it the policy rule. Further it would kill the “hunger” amongst investors if the FED directly starts intervening to market signals. Macro prudential norms aimed at correcting the fundamentals of the financial institutions seems to be better way at providing financial stability.

The other important variable like stock market bubble has already been discarded by Bernanke and Gertler in 2001. They argued and simulated that reacting to stock prices results in inferior economic performance.

However, there is a scope of analysing it further with inclusion of various kind of shock and bubbles like technology shock. We certainly believe that the FED should use important information from asset price movement and use it to improve the health of the financial sector by its regulatory powers.

# Counterfactual Housing Scenario

After establishing the fact that monetary policy was loose during the period preceding the housing crisis and leaving a little scope for inclusion of variable giving information of the financial sector we now want to know what if the rule was followed.

To know this, we create a counterfactual scenario for housing price inflation and hence estimate the housing prices if the rule would have been followed. For this we took a straightforward approach and estimated the house price equation with federal funds rate as independent variable. The equation is estimated with quarterly data from 1956-2014. The model shows a statistically strong significance with housing prices being negatively related with federal funds rates.

**---Equation 5**

Where

Since the actual data for house price index is impacted by other variables as well, therefore we cannot directly compare the actual house price index and house price index if Taylor rule was followed. So, we will be simulating two series one with actual federal funds rate and other with rate estimated from equation 2.

**Figure 6** The graph compares house price index actual fed funds rate and suggested rate from equation 2.

This graph is also in line with the counterfactual scenario presented by John Taylor in 2007 though it was with housing starts. It is clear from the figure that had FED followed the Taylor Rule the house prices would not have gone to an extend it went. In terms of housing inflation, it would have been a mere 3% in 2005 instead of 10% with actual Fed funds rate. Hence we can safely assume that a higher federal funds rate weather be it with Taylor (1993) or Taylor Rule with CPI or PCE much of the housing boom would have been avoided.

Though it is a very basic model but gives a cue that the abrupt rise in the housing price would have been avoided, had FED followed the rule.

# Conclusion

Monetary policies are one of the most important aspect of policy making in an economy. They have been blamed more than praised for its actions or its inaction. The scope and role monetary policy have been debated for long. It has settled on its current objective of inflation stability after a long debate. Currently there is a debate going on its scope to regulate and target the asset market. Though this has been out rightly rejected by many including Ben S. Bernanke as early as 2001, but still finds support from many economists.

The result presented above clearly articulates that the monetary policy was loose during the period preceding the crisis. One thing for sure, whatever be the measure of inflation, the policy was not in course of a rule and hence “discretionary” in nature. Though the FED tried to convey this to the market, but a long period of stability made investors “deaf” to understand the language of Federal Reserve. The argument for loose monetary policy does not stand up to the harm caused by them. The “discretionary” policy of FED has led to a considerable loss in credibility of FED. In the recent times, the phrase “for a considerable period” has lost markets believe and many like Philadelphia Fed President Charles Plosser have recommended removing the phrase in “order to brace markets for an eventual rate hike”.

Asset market in particular does not provide any general clues of a brewing crisis that could be incorporated in the policy rule. However, a careful study of the housing market would generate enough evidence of the brewing crisis. Though it is not suggested for a central bank to target each and every sector of economy through monetary policy rule. A better way would be to regulate the health of the financial institutions through regulatory mechanism.

The counterfactual scenario form housing prices help our claim that loose monetary policies were one of the factors in creation of the housing bubble. Though we cannot neglect the role played by government, bankers, regulators and it is very difficult to say that the monetary policy alone would have corrected the mistakes of all these actors but it had a role to play. What it did was supplementing and promoting the behaviour of government, bankers and regulators.

If it was not for the loose monetary policy, the financial crisis would have been avoided or a at least delayed. Surely we would not have experienced a “Great Recession (Placeholder1)” but may be a financial crisis of some other sort, as cycles and crisis are inherent to an economy.

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2. As listed by the Federal Reserve System. [↑](#footnote-ref-2)
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4. Thompson, E.A. Public Choice (2007) 130: 99. doi:10.1007/s11127-006-9074-4. [↑](#footnote-ref-4)
5. Getting off the Track by J B Taylor. [↑](#footnote-ref-5)
6. Fed funds rate is the interest rate at which banks make overnight loans to each other. [↑](#footnote-ref-6)
7. BusinessWeek presented him as the greatest innovators of the past 75 years in 2004. [↑](#footnote-ref-7)
8. Ted spread is calculated as the spread between 3-Month LIBOR based on US dollars and 3-Month Treasury Bill. [↑](#footnote-ref-8)
9. Getting off the Track by J B Taylor. [↑](#footnote-ref-9)
10. Federal Reserve Economic Data (FRED) is a database maintained by the Research division of the Federal Reserve Bank of St. Louis. [↑](#footnote-ref-10)
11. The time period of study by Bernanke was from 1993. [↑](#footnote-ref-11)
12. The trend in housing price index is calculated using HP filter. [↑](#footnote-ref-12)