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Characterising the Financial Cycle: Don't Lose Sight of the Medium Term!

BIS Working Paper No. 380

44 Pages
Posted: 18 Jun 2012
Last revised: 13 May 2014

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Date Written: June 1, 2012

Abstract

We characterize empirically the financial cycle using two approaches: analysis of turning points and frequency-based filters. We identify the financial cycle with the medium-term component in the joint fluctuations of credit and property prices; equity prices do not fit this picture well. We show that financial cycle peaks are very closely associated with financial crises and that the length and amplitude of the financial cycle have increased markedly since the mid-1980s. We argue that this reflects, in particular, financial liberalization and changes in monetary policy frameworks. So defined, the financial cycle is much longer than the traditional business cycle. Business cycle recessions are much deeper when they coincide with the contraction phase of the financial cycle. We also draw attention to the "unfinished recession" phenomenon: policy responses that fail to take into account the length of the financial cycle may help contain recessions in the short run but at the expense of larger recessions down the road.

Keywords: financial cycle, business cycle, credit, asset prices, financial crises, medium-term

JEL Classification: E44, E61, G21

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