

FPAS Mark II Financial-Cycle Gaps

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Abstract

All financial crises are preceded by the combination of an excessive credit expansion and asset price bubble. The second criteria was clearly established with an astronomical increase in asset prices during the COVID-19 pandemic in the US. Soon after the collapse in equity prices in the initial phase of COVID and its uncertainties, equity prices shot off to Mars and housing prices shot to the moon.

These, in combination with an increase in financial savings, led to an expansion of the household balance (including non-profit organizations) sheet of \$36 trillion between the end of 2019 and the end of 2021. On the liabilities side, the U.S. household balance sheet does not seem to have been associated with excessive leverage in response to the rise in asset prices, in contrast to the pre-GFC era. However, as COVID-19 uncertainties diminish and precautionary savings decline, conditions may be ripe for households to consume part of this accumulated wealth via the credit market (driven by historically low real interest rates). Macroprudential policymakers need to be more concerned about this dangerous mix of high asset prices and excessive credit well before they emerge, highlighting the need for a framework to assess safe levels of debt. This paper is devoted to the estimation of financial cycle output gaps (FCMOD) that can help analyze these issues, albeit in a simplistic manner that does not try to capture the full complexity of the financial system. FCMOD projections are used as inputs into the monetary policy model (MPMOD) medium-term forecasts of potential output in the associated sister paper as FCMOD tends to outperform the traditional monetary-policy-relevant specification in predicting the medium-term projected level of GDP. This paper provides updates of a parent paper for the United States and pulls together analysis from

the Global Forecasting School during the COVID-19 pandemic.

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