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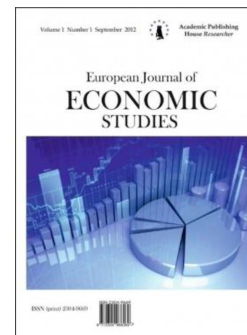

The Financial Cycles and Their Importance to the Economy

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Abstract

In this paper, we address the issue of the financial cycles and their influence to the function of the economy and stability. Financial cycles have mainly become an issue of interest among economists. Despite the fact that most research on cyclical trends in economy was associated with fluctuations in business cycles, the significance of the financial cycle has recently become more apparent, because of the dominance of the financial sector in the economy and also the emergence of financial crises. Recent researches imply that financial cycles are less frequent than the traditional business cycle and are related to credit and property prices. However, the existence of the financial cycles is evident and perhaps unavoidable to the economy, but what eventually matters is the extent of their fluctuations and their severe consequences during the contraction period. Considering ergo their importance, prudential policies need to be adopted to abate their sway in the stability of financial system and in real economy.

Keywords: financial cycles, business cycles, stability, fluctuations, financial sector.

1. Introduction

The notion of financial cycles has become increasingly important particularly during the last decades. Cyclical movements in the economy have been observed in the past and have been referred as business or economic cycles. Considering the significance of the financial sector to the economy in the recent era though, the examination of the financial cycles constitutes an alternative manner to comprehend various fluctuations in the economy. Following in this paper, we highlight the main literature and research in economic and financial cycles, and hence, we deduct the main conclusions concerning their implications to real economy and also some prudential prevention measures.

2. Discussion

2. Literature in Economic Cycles

We could easily notice that financial cycles compose a cyclical movement of the economy. In general, until the mid-20th century, research on cycles has been pivoted around business cycles or economic cycles. It is interested thus to briefly highlight some historically studies about cyclical movements.

J.S. Mill's (1826) approach to economic cycles sketched more the psychological factor of agents. He stated that speculation is sensitive to price increases and consequently any shock that will lead prices to rise constitutes a dynamic potential impetus to speculation and instability. French economist Juglar (1862) identified the relation between credit cycle and the economic cycle.

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He insisted on the excessive speculative behavior and its contagion effects. When agents turned to more speculative but short term profitable choices, more capital is being accumulated for speculative reasons and not for sound investments. Therefore, the cycle is described as time of investments on machinery, raw materials, equipment and lasts from 7 to 11 years. Pigou (1927) argues that cycles depend upon agents' profit expectations, which may be real, psychological or monetary. Frisch (1933) suggested that economy has deviated from equilibrium because of time accumulation of exogenous shocks which induced cyclical moves of the economy. Burns and Mitchell (1946, p.3) noted that "a cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions and revivals which merge into expansion phase of the next cycle". They deemed the duration of the cycles varies from one to twelve years and their frequency is recurrent.

Haberler (1946) attempted to explore the causes of cycles by examining most relative theories. He regarded as inadequate the notion of explaining cycles through a single view and therefore he conducted a detailed critical analysis of various theories of cyclical movements. He consolidated a table of causes and factors of the cycles with its booms and busts and he concluded that there is a need for integration of real and financial sector in economy theory in order to comprehend the nature of the cycles. Joseph Kitchin (1923) had observed a short term cycle which is linked to investment expenditures for inventory capital or consumer goods. He gathered that the business cycle depends on the production. Simon Kuznets (1930) identified a cycle of 16 to 18 years based on his studies on national income and capital formation data. Kuznets distinguished his cycle both in long and short run. He argued that in the short run cycle is linked with credit, whilst in the long run he incorporated the notion of demographic population. In the prosperity period, when employment and wages increase, family sizes will increase too, leading to a higher demand for housing and property. As soon as property prices reach the ceiling that will be the turning point of the cycle.

Russian economist Kondratieff (1926) studied a super duration cycle between 45 and 60 years. In his attempt to prove that capitalism will eventually fail he studied interest rates, foreign trade, prices, productivity from 1789 of the main Western capitalism countries[*]. His cycle from prosperity to recession repeated itself almost every 55 years but during this period, smaller phases of expansion/contraction were also observed. He stated that the component that launches new expansion is technology or a main innovation that will boost economy again. Unlike his initial intention, he found that capitalism offers the advantage of freedom to agents to innovate in the market providing thus to the economy a way out of depressions. Schumpeter, Fisher and Minsky, all of them with common perceptions on financial cycles, were influenced from Kondratieff framework.

Irving Fisher with his Debt Deflation Theory (1933) had described financial cycles to be contingent on the ability/inability of agents to pay off their debts. He recognized that debts could not always be paid and that market was seldom in equilibrium. Equilibrium was a stable period of the economy but once it departs away, then instability ensues. By enhancing debt rates that entails a serious threat of financial crises. If many debtors break down then a crisis emerges and what follows is a deflation spiral process which also means a fall in aggregate demand. That is when debt deflation begins. Therefore, he argued that financial cyclical movements trigger the booms and the busts of the economy.

Schumpeter (1939) stressed the significance of innovation in terms of entrepreneurism and technology, without their existence, the economy would hardly shift from its equilibrium. Entrepreneurs, agents in general, are in need to innovate driven by the highly global competitiveness and profit maximization. They require credit to finance such innovations by banks, eventually urging the economy to move from its equilibrium position. Schumpeter states that cycles are created only by innovation and the cycle "seems to be the statistical and historical form in which what is usually referred to as 'economic progress' comes about" (Schumpeter 1944, p. 7). Thus, there is a mobilization of resources and when new products make their appearance in the market, economy's equilibrium has been changed and it will returned to its original position, or perhaps to a different one, in the phase of recession. Schumpeter distinguishes four stages of a cycle: prosperity, recession, depression and recovery. In Schumpeter's view, cyclical fluctuations do

[*] He examined USA, Great Britain, Germany and France.

not necessarily have a negative meaning but they are being produced by innovation which is the driving force of economic growth.

Likewise Schumpeter, Keynes, and Fisher, Minsky also saw cycles as the outcome of an endogenously process in an inherently unstable capitalist economic system, where self-interest behavior prevails in complicated financial relations. He argued that "in order to understand the short-term dynamics of business cycles and the longer-term evolution of economies it is necessary to understand the financing relations that govern, and how the profit seeking activities of businessmen, and portfolio managers lead to the evolution of financial structures" (Minsky 1993, p.106). According to Minsky (1992) the financial system is unstable and becomes even more fragile in prosperity times. There are units of hedge, speculative, Ponzi where the financial instability hypothesis implies that the economy could easily shift from hedge to speculative in times of euphoria. This phenomenon takes place in forms of risk aversion, reductions in margins of safety since profits are created, as long as short term credit is easily accessed and there is a strong incentive of refinancing interest and positions, rather than the option of getting rid of the debt burden. Hence, the financial system swings and shifts from stability to instability. When highly indebted firms and agents cannot longer meet their payments' obligations and break down, contagion effects are applied, triggering thus the recession.

Following Fischer on his debt-deflation theory, Schumpeter and Minsky with his financial instability hypothesis, we focused more on financial cycles or credit/debit cycles where the main idea is the enhanced power of banks and other financial institutions to cyclical movements. According to Minsky (1986) financial instability and cycles are congenital in a capitalist economy. However, he recognized that cycles are not simply fluctuations within a fixed economic structure, but represent both a cause and consequence of changes to that structure. As long as financial agents' expectations become overoptimistic and the financial system constraints smooth, then credit and investment expand. The outcome is the fragility of the financial system to emerge until bubbles and debt rates reach to their higher levels and then crisis ensues.

The Financial Cycle

The concept of financial cycle constitutes a matter of debate by economists who were not included in the mainstream economic theory (e.g. Minsky 1982 and Kindleberger 2000). A definition of financial cycle is closely related to the well-known connotation of the "procyclicality" of the financial system (e.g. Borio et al., 2001; Danielsson et al., 2004; Brunnermeier et al., 2009; Adrian, Shin 2010). The financial cycle is less frequent than the traditional business cycle, with an approximate duration of 16 years with much larger amplitude, by contrast to business cycles lasting from 1 to 8 years (Borio et al., 2001). However, the length of the financial cycle could never be accurately reckoned, since it depends upon government's policy regulations. Other factors need to be taken into account are the financial, monetary and real-economy regimes (Borio, Lowe 2002). Financial cycles encapsulate the booms and the busts, prosperity and crisis, where one precedes the other. In other words, it is argued that the main cause of crisis is the previous prospered period (Borio et al., 2001). The most common description of the financial cycle is in terms of credit and property prices, where the top of the financial cycle is closely associated with financial crises (Drehmann et al., 2012).

Contemporary Research in Financial Cycles

The aspect of financial cycle has been an interesting way in our attempt to comprehend financial fluctuations. Claessens et al. (2011) examined the financial cycle and their relation with business cycles. They used a database of 44 countries for the period 1960-2007. They reached to the conclusion that recessions linked with financial distortions, in particular in housing market which are more severe and last longer than other recessions. On the other hand, they found that growth is augmented mostly with a rise in credit supply and also in the house prices. In the upswing phase of the cycle, credit is available and relatively in attractive rates. As a result, households are encouraged to borrow, driving up property and collateral prices and eventually tax revenues. In the downward phase though, when credit is expensive and unaffordable house prices are being reduced, past loans are not easily met, then there is a contraction in the construction sector and all the relative business sectors, leading eventually to a fall in consumption, investment, employment and tax revenues. What we remark is a fall in aggregate demand and a recession. All the above factors

depict a positive correlation between the financial and business cycles, entailing fluctuations in the GDP. Regarding the global dimension of the financial cycles, they stressed the fact that cross-country bank lending is a major contributor to the rise in domestic credit.

Drehmann et al. (2012) studied seven advanced economies over the period 1960-2011. They deduced that financial cycle lasts between 15 and 20 years, much longer than the traditional business cycle that lasts approximately 8 years. As long as the cycle reaches the top, it verges to concur with financial turbulences periods, due to households and firms inability to pay off their debts. Another interesting finding was that some economically dominant countries lead the financial cycle in global level, which frequently coincides among other countries. Stremmel (2015) suggests that an efficient measure of the financial cycle should include the credit-to GDP ratio, credit growth and house prices. Runstler and Vekkle (2016) have also gathered at same results, noting the significance in cycles in credit and house prices. They mostly gave emphasis in Germany showing again that the financial cycle has longer duration and larger amplitude in comparison to the business cycle. Kalemli-Ozcan et al. (2013) pointed out the role of international factor income. They suggested that in cross-country transactions the international income contributes more to financial shocks during the crisis, rather than in risk sharing between countries.

More recently, Borio et al. (2016) endeavored to discover the relation between financial cycle and public debt. They include credit and house prices and exclude equity prices and aggregate asset prices, which usually tend to move in line with credit and asset prices[*]. They commenced by gathering the empirical evidence that linked financial crises with a large increase in public debt. According to the research, fiscal expansion is inevitable during the busts of the cycles for a numerous of reasons, such as the sustainability of the aggregate demand and employment, the bailout rescue programs for problematic financial institutions and so on. As a result the paper proffers the calculation of a finance-neutral gap in order for a country to assess accordingly its proper financial position in the financial cycle.

As far as the European Union is concern, Alcidi (2017) conducted an analysis about financial cycles within EU countries over a period of 41 years and infers that each cycle lasted about 15 to 17 years. Also, the main financial cycle coincides almost perfectly with the introduction of the euro. The ascending part matches with the euro adoption in 1999 and the descending approximately in 2016. Member states highlight vast differences in the size of their financial cycle and this is a characteristic of the periods both before and after the introduction of the euro. Alcidi advocates for the role of fiscal policy at a more central level despite the insistence of conventional policies on monetary action. The bottom line of the analysis is that financial cycle fluctuated more before the introduction of the euro than after, adding an argument that within monetary union the difference between countries in terms of the financial cycles' features is less.

3. Conclusion

The debate of the financial cycle has been emerged since the second half of the 20th century and in particular by non-mainstream economists. However, the outburst of financial crises gave ground for further analysis. The key issue is not the acceptance or rejection of the presence of financial cycles in our economy. Certainly, financial cycles can be traced and they do exist. They include ups and downs and also, are related to sovereign debt. The size of their expansion/contraction side, notwithstanding, is hard to be predicted and thus the implications that might have in the real economy.

Furthermore, large financial cycles do not coincide with financial stability. A world financial crisis is likely to be emerged from the downfall of a cycle in a dominant world economy. Most research suggests that fluctuations in financial cycles influence aggregate demand, employment, tax revenues and GDP growth. A matter of great consideration though is the limitation of the size of the financial cycle to a minimum point at which no significant effect in real economy could be spread. The upshot is that financial cycles, apart from public debt, financial turbulences and distortions, are associated with financial instability even at the global level and that is in our opinion the most unquiet issue.

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[*] Other important variables that could provide supplementary insights in terms of risk perception and distortions are the spreads of credit, default rates, but their available data is not adequate for a empirically sufficient time period

The purpose to examine the financial cycle is significant, so as to identify them, in order to propose necessary policies to prevent the cycle from excessive fluctuations, causing serious distortions to the financial stability and hence to real economy. Financial cycles cannot be totally avoided, but the important challenge remains in reducing the probability of their large oscillations. Thus, prudential macroeconomic policies at national level are required. Indeed, in cases of prolonged financial instability, national fiscal policy is inadequate and a centralized fiscal insurance mechanism delegated with the power to transfer the necessary resources is essential. As Borio (2012) stressed the importance of credit and property prices, we could empirically notice that when there is an increase in credit[*], there would be also a rise in property and asset prices and overall an increment in private sector credit. Thus, collateral values rise in line with borrowing, tax revenues increase as well and generally the economy grows. Nevertheless, is this growth real and long lasting?

From EU lesson, we infer that the financial cycle could upwardly expand through cross-border bank lending at national level for countries exposed to some financial integration. However, this financial integration will accordingly start to decompose during the bust phase of the cycle since international credit will start to withdraw. Therefore, there is a positive correlation between financial integration and financial cycle. However, in European Union, the introduction of the euro seems to have moderated the fluctuations of financial cycles that member states had experienced before the common currency.

Finally, the function of the financial sector is well known. It serves to provide the required liquidity to finance investment and buying on real assets and commodities. Industries, entrepreneurs are seeking to finance their activity and all of them, including financial institutions, target in future profits. Speaking on numbers, the majority of capital inflows is managed and often generated by financial institutions[†]. The traditional examinations of economic cycles had been concentrated on business cycles but it seems that in the current era, cyclical movements in economy have been mostly related to financial cycles. It is evident that the financial sector has already prevailed on other branches of the economy such as agricultural, industrial, commerce, trade, services, in terms of capital accumulation. Hence, it could be contended that in the 21st century the circular flow of the economy depends on the financial sector. Consequently, the stability and the proper function of the financial system are essential. There are financial innovations that accelerate the speed of financial cycle and increase the size of the financial sector. It could be argued that an international agency to assess, regulate, test the implications of financial innovations is necessary considering the dominance of the financial sector and most of all the consequences financial crises have over the lives of millions people. Besides, those agencies of authorization do exist in other sectors[‡], why then the financial sector is excluded? Observing all the implications, we therefore see that global financial stability is not simple an anchor of refraining from having distortions and crises but also a perquisite of peoples' lives. It is a right of people.

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[*] By credit we mean the provision of credit in all the possible sectors, but mainly we concentrate on mortgage credit since it's the most commonly granted by institutions.

[†] By the term financial institutions we not only mean the concept banks but also the markets of stocks, bonds, equities, derivatives and all other financial products offered not only by banks, but from any kind money managers.

[‡] pharmaceuticals, energy, aeronautics, nuclear, chemical etc.

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