

A Critique of the Literature on the US Financial Debt Crisis

Professor Jerry Stein is offering the profession a very thoughtful piece that addresses important aspects of financial instability analytically. The financial crisis of 2007-09 has exposed significant weaknesses in the nation's financial system and in the regulatory system designed to ensure its safety, stability and performance.

Defining financial instability or stability is challenging. Financial stability can broadly be distinguished between 'micro-stability', which involves conditions of individual financial institutions, and 'macro-stability', which focuses on the efficient functioning of the financial system as a whole. In a more intuitive sense, financial stability means the avoidance of financial shocks that are large enough to cause economic loss to the real economy. During 2007-09, financial instability was experienced not only by banks and other financial institutions but it also affected the volatility of asset prices. Domestic financial instability in the US spilled over the global economy with instabilities in capital flows, currency devaluations and excessive volatility in numerous national stock markets.

The relation between monetary policy and financial stability has been long debated in the literature, but there is still no clear consensus on how exactly one affects the other and, in particular, what are the trade-offs and synergies between them. Broadly speaking, monetary policy is propagated to the real economy through financial markets. In this respect, a well-functioning financial system that is robust to shocks is crucial for the effectiveness of monetary policy. Financial globalization has naturally led to new developments in monetary policy instruments and to the way monetary policy is conducted. Some authors have argued that as market-based financing has expanded during the last decade, asset prices have gradually gained in importance and monetary policy transmission mechanisms have become more diversified and complex. As a result, a change in asset prices might have a huge impact on financial system stability and economic activity in general and hinder the effectiveness of monetary policy.

This situation has prompted the authorities to separate the different goals and instruments of economic policy. In this context, monetary policy has been clearly assigned the objective of maintaining price stability through inflation targeting.

How do the objectives of price stability and financial stability fit together? One important lesson of the '70s and '80s has been that price stability contributes to financial stability. Low and stable inflation rates reduce uncertainty and promote sound economic decisions. By helping to remove market distortions in price signals and by anchoring inflation expectations, risk premia in interest rates are reduced, along with the likelihood of misperceptions about future asset returns. Several economists have carefully discussed the interplay among price stability, financial stability and the effectiveness of monetary policy. Greenspan in several speeches during 2004 and 2005 has also reflected on the issue of price stability producing a decrease in real volatility but paradoxically an increase in financial volatility. Furthermore, the more predictable the monetary policy response, the greater its contribution to financial stability is.

However, the issue is more complex. Indeed, the '90s taught us that price stability is necessary but not sufficient condition to safeguard financial stability. Prior to the Asian crisis, large imbalances were built up in the real estate and other asset markets in

Southeast Asia, although inflation was relatively low. This showed that confidence based on sound economic performance tends to drive up credit and asset prices.

This is at the centre of the potential conflict between price stability and financial stability. A credible monetary policy may succeed in achieving its primary objective of price stability, yet it still might facilitate the conditions for financial imbalances to develop, as it creates low inflationary expectations, reducing firms' costs and uncertainty. As a result profits accelerate, as do stock prices, building up financial imbalances. As indicated earlier, Greenspan has acknowledged that "perhaps the greatest irony of the past decade is that the gradually unfolding success against inflation may well have contributed to the stock price bubble of the later part of the '90s."

The reverse is also true: financial instability may reduce the effectiveness of monetary policy. A striking example of this sort has been the asset price bubble in Japan in the late '80s. Plummeting asset prices and rising non-performing loans have undermined the solvency position of banks, making them unwilling to lend. The extremely accommodating policy stance, with interest rates close to zero percent, could not reopen the bank lending channel.

From the above general comments on the issue of financial instability it becomes very clear that financial crises in general and the most recent one in particular are analytically very difficult to conceptualize, analyze and find appropriate policies to prevent future difficulties. Professor Stein considers the important issue of leverage. Many financial institutions carry a "dangerous" amount of leverage. Systemic risk is not identified or regulated until the crisis is imminent. The objective of his paper is to evaluate key aspects of the literature on the US financial debt crisis in terms of how they relate to the following questions. What is an optimum risk in a world where the future development of asset prices is unpredictable? What are theoretically based early warning signals of a crisis? It is shown that the most effective approach is the one that uses stochastic optimal control/optimal dynamic risk management to determine the optimal degree of leverage and which also provides theoretically founded early warning signals of a crisis. His work deserves serious attention.