# MONETARY STABILITY VERSUS FINANCIAL STABILITY

**Glăvan Bogdan**

***Universitatea Româno-Americană, Blv. Expoziției, Nr. 1B, sector 1, Cod 012101, Bucureşti, bogdan_glavan@yahoo.co.uk, 0723177820***

**Anghel Flavia**

***Universitatea Româno-Americană, Blv. Expoziției, Nr. 1B, sector 1, Cod 012101, Bucureşti, flavia.anghel@gmail.com, 0723234814***

**Bucur Cristiana**

***Universitatea Politehnica, Splaiul Independenței, Nr. 313, sector 6, Bucureşti, Cristiana.bucur@gmail.com, 0722267047***

*Abstract*

*Studies on the importance of monetary stability for the achievment of sound economic environment have always been among the most searched economic works. The experience of last decades illustrates the fact that low inflation has not proved to be a hedge against financial instability. The question is if there is a trade off or contradiction between monetary stability and financial stability. Perhaps the most important lesson that need to be drawn from recent episodes of financial instability is that monetary authorities are much more impotent when it comes to prevent crises than we thought they are.*

*Keywords: financial stability, monetary stability, monetary authorities, crises, financial markets, prices*

## 1. Introduction

Studies on the importance of monetary stability for the achievment of sound economic environment have always been among the most searched economic works. More precisely, "the question whether there is a trade-off between monetary and financial stability has been one of the most interesting areas of research for central banking for many years." (Issing 2003, p. 16)

The experience of last decades illustrates the fact that low inflation has not proved to be a hedge against financial instability. Recent banking crises have incurred costs similar to the losses suffered in the periods with high inflation. "In short, the successful war against inflation has not yielded as big a "peace dividend" as we might have hoped." (Crockett, 2003, p. 1)

## 2. Monetary instability and financial instability: conceptual clarifications

Even if notions like "monetary stability" and financial stability" are widely used in the academic literature, some clarifications of their meaning is needed.

*Monetary stability* is currently associated to price stability. In turn, price stability means an inflation rate close to zero, i.e. keeping the price level aproximatively constant.

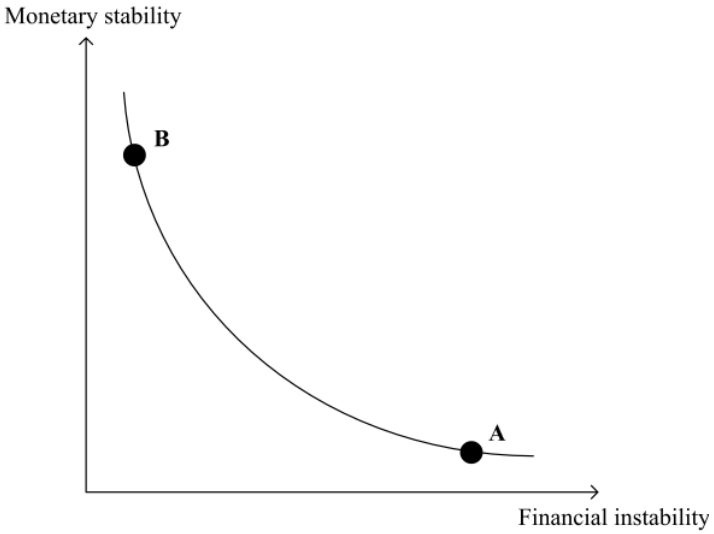
*Financial stability* is a more difficult to define.[47] It points to a monetary and financial system able to support, without systemmatic distorsions, an adecqate alocation of savings toward the most efficient investments projects.[48] To the extent that the financial system vitiates the proper allocation of savings and thus sow the seeds of its own failure, it is characterized by *financial fragility*.

It is important to note that financial stability is not incompatible with the occurrence of sporadic banking failure, or with a major fluctutation of a small group of assets. On the contrary, bankruptcy is the proof that market selection mechanism is working and that only the most efficient financial institutions survive to serve the public. We can speak of financial instability only when financial institutions are systematically endangered by insolvency.

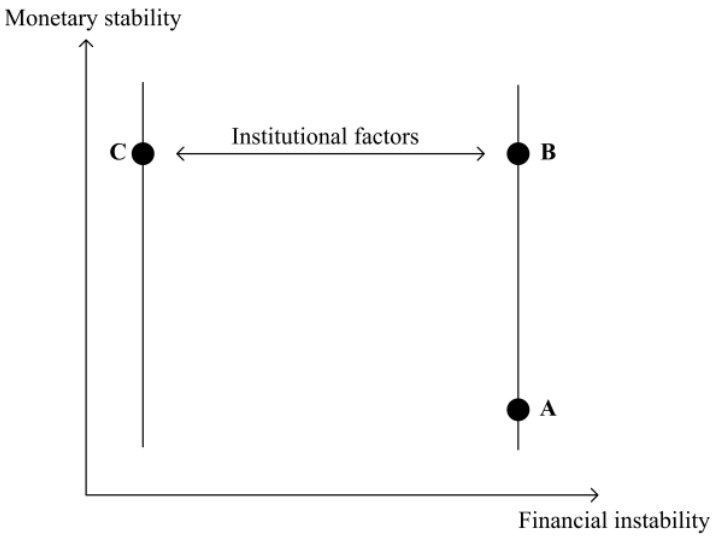
## 3. Prices and financial stability – a complex relation

The conventional view is (or rather was until very recently) that there is no tradeoff between monetary and financial stability. Some economists maintain that price stability represents a sufficient condition for financial stability. Most people hold a slighty different view. They consider price stability as only a precondition for the achievement of financial stability. For example, M. Bordo maintains that a monetary regime that produces aggregate price stability will, as a by-product, tend to promote stability of the financial system."[49]

According to these writers, inflation is an essential ingredient of financial instability. Rising prices, it is argued, affect economic calculation and send to economic agents false signals about the real relative return of various investment projects. By contrast, "stable prices and a monetary policy focused on that objective play an important role for stable financial markets… Price stability and financial stability tend to mutually reinforce each other in the long run. This widespread view is supported by empirical evidence that many financial crises were caused by major shifts in the price level. Moreover, historically most banking crises occurred during recessions often following periods of high inflation… According to the conventional view there is no general trade-off between monetary and financial stability." (Issing, 2003, p. 17-18)




Anna Schwartz, for example, argues that a central bank "that was able to maintain price stability would also incidentally minimize the need for lender-of-last-resort intervention."[50] Persistent inflation, says Schwartz, encourages speculative investments and indebtedness based on the expectation of rising prices. When inflation rate declines suddenly, as it happenned at the beginning of 1980s, debtors' income can be insufficient to sustain the repaymentof past loans. The rising number of bankcruptcies reduces creditors' capital and may lead to a higher rate of failure among financial institutions.




According to most macroeconomists, the value of money is given by the general level of prices. Therefore, the monetary ideal could be achieved by price level stabilization.[51] A monetary policy that maintains price stability in a credible and lasting way will make the best overall contribution to improving economic prospects and raising living standards"[52], therefore the achievement and preservation of price stability is the iron principle of a sound monetary policy[53].

## 4. From monetary stability to financial instability: historical perspective

The most elocquent historical example of financial imbalance that developed in a non-inflationist environment is the Great Depression. In United States, the price level has declined by 10% between 1925 and 1930, a period otherwise characterized by a strong credit expansion.

Although perhaps the most relevant case, because of its magnitude, the Great Depression is by no means the first financial crisis of the type we are discussing here. In 19 century several similar events occurred. We can mention the australian banking crisis of 1893, which represented the turning point of an artificial economic boom fueled by a considerable credit expansion, whose share in GDP has increased by 2/3 in a decade. In that period, despite a marked rise in real estate prices (which doubled), prices had an overall falling trend.

Among the more recent examples, we can mention the case of Japan in 1980-1990. An insignificant inflation rate (zero between 1986 and 1988) has been accompanied by a skyrocketing evolution of stock and real estate prices. In this field, prices tripled in only four years (1985-1989). After this episode, Japan's economy entered a long recession, with numerous bankruptcies and banking failures.

The recession of Japanese economy has been preceded by a similar financial crisis that affected profoundly many south-east asian countries in 1997. In Korea, for instance, 1990s were years of significant disinflation, the rate of inflation declining from 11% at the beginning of the period to 4% before the crisis ocurred.Thailand, Indonesia and Malaysia experienced similar trends of the rpce level, but in all the region credit expanded strongly. The expansion of financial institutions has determined a boom in stock and real estate markets, exactly as it happenned in US during the 1930s and in Japan during the 1980s.

## 5. Causes of financial instability

What all these episodes of financial imbalances have in common is a boom and bust cycle in lending. The idea that credit expansion (and a consequently artificial lower interest rate) is responsible for economic fluctuations is not new. Economists like Irving Fisher, Friedrich Hayek, Hyman Minsky, Charles Kindlberger and others have associated their names to it. A number of reasons explain the instability of lending.

First, the modern financial system is based on fractional reserve banking. Diamond and Dybvig (1983) suggest that the maturity mismatch of bank assets and liabilities provides a source of instability within the banking system. Banks transform illiquid assets into liquid financial assets by offering liabilities with a

different, smoother pattern of returns over time. The illiquidity of bank assets leaves banks vulnerable to depositor runs, however, and only the presence of a lender of last resort or deposit insurance can prevent banking panics.

Secondly, asymmetric information, in which lenders are less informed than borrowers about the potential returns of alternative projects, provides an alternative source of financial instability. Lenders, unable to distinguish good from unsound loans, might ration credit or disproportionately discourage good quality borrowers by adding a lemons premium to interest rates. Heightened uncertainty, perhaps caused by instability of the price level, that makes screening of borrowers more difficult can worsen such adverse selection problems.

Thirdly, central banks may increase the money supply by decreasing the interest rate and thus, they fuel a credit expansion. This process may not lead to open inflation, because deflationary pressures coming from the real economy may offset the effect of monetary stimulus on the price level.

## 6. Challenges for monetary authorities

Perhaps the most important lesson that need to be drawn from recent episodes of financial instability is that monetary authorities are much more impotent when it comes to prevent crises than we thought they are. The merits of inflation targeting have become a myth. The strategy of inflation targeting, widely embraced by central bankers around the world in the last two decades, has managed to deliver low inflation *and* financial instability.

From the fact that monetary stability is not synonymous with financial stability we can derive several ideas.

1. First, the monetary authorities may not be able to identify the financial imbalances sufficiently early and with the required degree of comfort to take remedial action. If so, attempting to respond to financial imbalances could add to the volatility of the economy.

2. Second, the risk of destabilising the economy may be compounded by the unpredictability of the effect of the policy response. Calibration may be exceedingly difficult. On the one hand, for instance, small interest rate increases may not be sufficient to contain financial excesses. It has even been argued that, paradoxically, they could be counterproductive if they help to dispel doubts about the central bank's credibility as a guarantor of price stability, thereby possibly fuelling market participants' optimism about the sustainability of the boom.

3. Third, even if technically possible, any such response may be too hard to justify to the public. Political economy considerations militate against the use of the instrument. It takes a brave central bank to raise interest rates in the absence of obvious inflationary pressures, given the risk of being perceived as undermining prosperity.

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