European Bank
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Framework for Assessing Financial Stability?

Comments on Prof. Goodhart's Paper

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Main points

1. Key messages of the paper

2. Problems with defining financial stability (FS) “positively” and associated “lack” of FS instruments

3. Would the proposed ‘macro/macro’ FS provide a satisfactory solution?

1. Key messages of the paper

- Central banks can fulfil their monetary policy mandate not least because they have a clear definition of monetary stability, with associated clear target; framework for analysis; and good accountability.

- Financial stability does not have these and this is a major problem.

	Monetary stability	Financial Stability
Definition	Precise	Only negative – defined by absence
Can you control it?	Yes, with lags	Questionable – no clear instruments
Focus of analysis	Central tendency	Extreme outcomes
Forecast technique	Projections	Simulations, stress tests via macro/micro self test & without interlinkages (general equilibrium).

- What is needed is a ‘macro/macro’, ie system-based assessment in a general equilibrium framework, focussing on stress testing of shocks from
  - oil prices;
  - external demand;
  - productivity;
  - labour militancy;
  - and shifts in equity risk appetite or in exchange rate preferences.

2. Only ‘negative’ definitions of FS and therefore no clear instruments?

- Not quite true:
  - ECB definition (2002) (also Mishkin (1997)):

    “A condition where the financial system is able to withstand shocks without giving way to cumulative processes, which impair the allocation of savings into investment”
  - Large (2003): “Think of financial stability in terms of maintaining confidence in the financial system”

But it is difficult to “operationalize” these

Crockett's positive definition (1997) helps with this, by introducing a <u>distinction</u> between:

- <u>Stability of financial **INSTITUTIONS**</u>:
  Institutions can meet their contractual obligations without interruptions or support

- <u>Stability of financial **MARKETS**</u>:
  Asset prices reflect fundamentals and do not oscillate without relation to those fundamentals

Stability of INSTITUTIONS

- Problems with instability:
  - Erodes confidence
  - Induces disintermediation
  - Weakens payments system → increases transaction costs
  - Closing FIs have negative informational effects → increases cost of borrowing and allocational efficiency

- Policy instruments to be used

  Foster INSTITUTIONAL stability
  - Market forces
  - Financial safety nets (deposit insurance, LOLR)
  - Financial sector regulation

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Stability of MARKETS

- Problems with instability:
  - Tends to increase real interest rates → intensifies adverse selection, leading to misallocation of resources and lower credit volumes
  - Shortens length of debt contracts
  - In forex markets: “dollarization of debt contracts” increasing vulnerabilities

- Policy instruments to be used

  Preserve MARKET stability

  - Predictable macro policies (aggregate price stability)
  - Contingent regulation (“circuit breakers”)
  - Direct intervention

3. Will the proposed “macro/macro” stress-testing be sufficient?

- It is a very good idea
- But this will only “perfect” one dimension of the FS framework, the macro leg
- This is not enough, because financial crisis can be triggered not only by marco events but institutional weaknesses/failures (#1 leading cause for bank crisis is old-fashioned fraud/operational failure)
- Moreover, crises is usually caused by a combination of factors

What needed is a multi-dimensional approach

- It would combine the results of
  - <u>macro-tests</u> (Goodhart macro/macro, Borio-Lowe (2002) model, etc) with
  - <u>micro</u>, individual banking system strength indicators of sytemically important banks

What needed is a multi-dimensional approach