

Comments to “**Defining financial stability and a framework for safeguarding it**” by Garry J. Schinasi  
Rodrigo Cifuentes, 6/11/2008

Thanks for the opportunity to comment this paper. This is certainly a very relevant topic for us central bankers and it is an honor to contribute a few thoughts to somebody that has thought about these issues for a long time.

Let me start by giving a brief overview of it.

As motivation, the author says that the current crisis proves that we do not have a reliable, effective **framework for safeguarding financial stability**

The author states that the current **Policy framework** failed dramatically.

Relied too heavily on:

- Private risk management
- Market discipline,

And not on

- Appropriate incentives,
- Effective rules of the game, and
- Well designed and rigorously implemented official oversight.

A prerequisite for more effective official oversight is the development and implementation of a more **effective framework for assessing** the ability of the financial system to perform its key economic functions.

To develop this framework is the main purpose of the paper.

The paper aims to build this framework around a definition of financial **stability**, rather than one of financial instability, which has been the most common approach until now.

This is certainly a big challenge: it is not due to lack of imagination that the more common approach to financial stability analysis has come from the instability side. It is because this is the harder road.

To highlight the differences, the paper describes the current policy framework as one focused on “containment” (this is my word) of problems through a number of “lines of defense”. Following the author’s example, we can call this a “Finance as disease” approach.

The paper puts forward the concept that it should not be only **stability** what we should care about, but also **efficiency**. So it builds efficiency into the framework of analysis as an antidote to financial repression. In other words the paper proposes a framework that puts the efficiency-stability trade-off at its core. It says, it is not only the absence of crisis, but the efficient use of finance what should be considered when analyzing financial stability.

How is this done in practice? The paper proposes that by **building models** we can assess the efficiency gains and the stability costs (or gains) of financial innovation.

The next step is to build around it a framework similar to that of monetary policy. (Define a financial stability tolerance corridor).

So, all of us here should be happy because we have an agenda for the next 10 years.

My Comments

1. At least in the way it is proposed in the paper:

First, it requires a big reliance on modeling. Reliance on models, in parenthesis, has been one of the issues mentioned as problematic in the current episode. Modeling finance in **general equilibrium** is quite difficult as I understand; more so if one is aiming at assessing specific instruments or policies. I guess the right model should also include scenarios of default which is also challenging.

Leaving incentive problems aside, part of the problems we have been through in the recent period, has been the lack of appropriate models to assess the true characteristics of instruments under different scenarios. And this is because typically these assessments are done using past, observed, correlations among variables, leaving a wide range of possible scenarios unconsidered. It may be argued that the lack of proper modeling was another manifestation of the broader incentive problem, but my guess is that this is more related to real modeling difficulties.

One could do some kind of back test **of the proposal** and ask whether we would have been able to rightly assess the risk scenario we are in now, say, three years ago. I am not sure what the results would have been. But even if you could have, that assessment would not have gone uncontested, which leads me to the next point.

Second, implementation issues: Models are not unique

What would be in this proposed framework the context for policy decisions? Analysis by a public agency will be contested, alternative models may arise. Where will the burden of the proof lie, i.e. will financial innovation be assumed harmless unless otherwise proved or the other way around?

Thirdly, it proposes that the mandate for stability should include an active search for efficiency. Maybe my reading is extreme, but there is a “central planning” flavor to this. Possibilities of expanding or improving the current financial environment should be large at any moment in time, but who should address them? A government agency or the financial intermediaries themselves?

2. But let's go back to the “Finance as disease” world and see how is the efficiency – stability problem solved there.

I guess it would be something like: **Set the lines of defense and allow all innovation that market wants as long as it does not break those lines.**

Of course there are challenges, to define the appropriate lines of defense for example, but these seem to me a more approachable task. We have learnt the hard way the

problems of opacity and the non-existence of such a thing of entities which are big in certain markets but not a systemic or not a public policy problem.

So start from simple principles like, the bigger the size, the lower the mismatches and leverage allowed (i.e. higher capital required).

If lines of defense are too strict you may lose efficiency. Lines of defense can be changed with an analysis similar to that proposed in this paper. The difference on where lies the burden of the proof. It seems to me that it is possible to find more private benefits in fostering efficiency than stability. Therefore, if considered equally as proposed in this paper, there may be a bias against stability. Therefore, leaving the burden of the proof on the safe side, i.e. that lines of defense will be loosened only when it is clear that there is no impact on stability may counter the that bias.

3. My view – for what is worth – is that we should not see finance as any market. Larry Summers used to make fun of finance as a field in economics saying that it was like developing a field about “ketchup economics” meaning that there was nothing particular to it, just a re-labeling of things you see in any other market.

But I think there is more to finance than to ketchup. At a minimum, there is an issue of confidence, public confidence, confidence that is not based on **faith** but **backed by taxpayers money**. So, Moral Hazard issues should be one of the elements at the core of the analysis. And at least in my view when you do this, the “Finance as disease” approach seems to follow quite naturally.

I should stop here.