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The Federal Reserve Bank of St. Louis
St. Louis Little Rock Louisville Memphis

For release:
November 4, 1998

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Price Stability and Financial Stability: The Historical Record

ST. LOUIS — Countries that pursue a monetary policy of controlling wide swings in the inflation rate tend to also encourage financial stability, according to a study from The Federal Reserve Bank of St. Louis.

The authors of the study are Michael D. Bordo, a professor of economics at Rutgers University, and David C. Wheelock, an assistant vice president of the Federal Reserve Bank of St. Louis. Their work appears in the September/October issue of ***Review***, a bimonthly journal of economic and business issues published by the St. Louis Fed.

During the past decade, many countries have set explicit inflation targets and mandated inflation control as the paramount objective of their monetary policies. Some critics of that approach argue that such a narrow focus compromises a monetary authority's ability to protect the stability of the financial system. A central bank with price stability as its sole objective, so goes their argument, might not respond to financial instability unless its inflation goal was threatened. As a result, the financial system and the economy as a whole might then suffer.

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Bordo and Wheelock examined an alternative view by economist Anna Schwartz, who argued that a monetary policy directed at maintaining inflation stability would lessen both the incidence and severity of financial instability.

"The Schwartz Hypothesis says that sustained inflation encourages speculative investment and borrowing because there exists an expectation that prices will continue to rise," said Bordo. "When inflation abruptly declines, however, as it did in the early 1980s, borrower incomes may prove insufficient to repay loans that that had been made with the expectation of continued price increases. As a result, there is a rise in borrower defaults, reducing the equity of lenders and possibly causing an increase in the failure of financial institutions."

The two economists noted that testing the Schwartz hypothesis presented several challenges. For example, the hypothesis doesn't address the underlying causes of financial instability and argues only that price level instability will contribute to financial distress — that is, situations in which banks or other financial institutions suffer unusually high losses as a result of borrowers defaulting.

As part of their research, Bordo and Wheelock reviewed episodes of serious financial instability in U.S. financial history, supplemented by the experiences of the United Kingdom and Canada. "Regardless of what triggers financial distress, be it monetary or nonmonetary forces, the historical record shows that most severe episodes of instability have typically occurred in disinflationary environments," said Wheelock. "The exception to this was the late nineteenth

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and early twentieth centuries, when severe banking panics occurred in the United States in spite of a comparatively stable price level."

Wheelock said that the results of their research may have implications for current U.S. monetary policy. "A monetary policy that makes price stability its primary objective," he said, "will tend to enable the economy to better weather the financial disturbances that arise from time to time."

Subscriptions to ***Review*** are free and can be obtained by calling (314) 444-8809. The publication is also available on the Federal Reserve Bank of St. Louis' website: www.stls.frb.org.

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