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Joseph Stiglitz and Bruce Greenwald
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Towards a New Paradigm in Monetary Economics presents a fundamentally new approach to monetary economics, derived from the authors' pioneering work in the Economics of Information, for which one of the authors was awarded the Nobel Prize in 2001. Unlike the prevailing theory, it focuses not on the role of money in facilitating transactions but on the role of credit in facilitating economic activities more broadly. The "new paradigm" emphasizes the demand and supply of loanable funds, which in turn requires an understanding of how banks and other institutions in the economy process information to evaluate creditworthiness. It explains the factors which determine the willingness and ability of banks to provide credit, explores the consequences of credit interlinkages within the economy, describes the implications of the new paradigm for the conduct of policy, and analyzes how changes in the structure of the economy, such as those associated with the New Economy, are likely to impact the effectiveness of monetary policy, and thereby the stability of the economy. The book identifies the circumstances in which monetary policy alone is likely to be ineffective in restoring the economy to full employment, and suggests that those circumstances are likely to be more prevalent in the future.

The book consists of two parts. The first develops the basic theory, using a portfolio approach to explain how banks decide on how much to lend, and how changes in regulations as well as economic circumstances, both the balance sheets of banks and firms and perceptions of risks within the economy, affect the supply of credit. The second part is dedicated to the policy implications. It argues that the new paradigm provides a far better guide for addressing issues that range from financial market liberalization to how to handle the East Asia crisis than does the standard theory.

JOSEPH STIGLITZ is Professor of Economics and Finance at Columbia University, holding a joint appointment in the Graduate School of Business, the School of International and Public Affairs, and the Economics Department. In 2001 he was awarded the Nobel Prize in Economics for

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his work in the Economics of Information. Earlier, he was awarded the John Bates Clark Award, awarded biennially by the American Economic Association for the economist under 40 who has made the most significant contribution to economics. Formerly, he was Chairman of the President's Council of Economic Advisers and a member of President Clinton's cabinet, and Senior Vice President for Development Economics and Chief Economist of the World Bank.

BRUCE GREENWALD is Robert Heilbrunn Professor of Finance and Asset Management at Columbia Business School. Professor Greenwald has done pioneering work in the Economics of Information, especially the consequences of asymmetries of information for equity and labor markets. His recent co-authored work on value investing is already on its way to becoming a new classic in the field.

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THE RAFFAELE MATTIOLI LECTURE SERIES

Towards a New Paradigm in Monetary Economics

Joseph Stiglitz
and
Bruce Greenwald



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Contents

<i>List of figures and table</i>	page vii
<i>The Raffaele Mattioli Lectures</i>	xi
<i>Preface</i>	xiii
Part I The principles of the new paradigm	1
1 Reflections on the current state of monetary economics	7
2 How finance differs	26
3 The ideal banking system	43
4 Restricted banking (or, the banking system of today)	90
5 Market equilibrium	104
6 From the corn economy to the monetary economy	117
7 Towards a general equilibrium theory of credit	137
Part II Applications of the new paradigm	151
8 Monetary policy	154
9 Regulatory policy and the new paradigm	203
10 Financial market liberalization	234
11 Restructuring the banking sector	239
12 Regional downturns and development and monetary policy	251
	v

Cambridge University Press
0521810345 - Towards a New Paradigm in Monetary Economics
Joseph Stiglitz and Bruce Greenwald
Frontmatter
[More information](#)

vi CONTENTS

13	The East Asia crisis	261
14	The 1991 US recession and the recovery	276
15	The new paradigm and the “new economy”	284
16	Concluding remarks	293
	<i>Bibliography</i>	303
	<i>Index</i>	320

Figures and table

FIGURES

1.1 Average annual yield rates for 3-month T-bills and a cash management account, 1992–2001	<i>page</i> 13
1.2 Stock value traded as a percentage of GDP, various countries	15
1.3 Velocity	17
1.4 Regression of velocity on nominal interest rates	18
1.5 Movements in real interest rates	23
2.1 The interest rate which maximizes expected return to the bank	28
2.2 Effect of recession on real lending interest rates	32
2.3 The optimal interest rate charged by one bank may depend on that charged by others	33
2.4 Effect of recession on aggregate demand and supply curves	41
2.5 Junk Treasury spread, 1988–2000	42
3.1 Loanable funds model, no credit rationing	45
3.2 Loanable funds model with credit rationing	47
3.3 Impact of changing economic conditions on the equilibrium interest rate with credit rationing	48
3.4 Determining the equilibrium lending activity with bankruptcy	57

viii LIST OF FIGURES AND TABLE

3.5	Traditional model with no bankruptcy	58
3.6	Interest rate determination with credit rationing and bankruptcy	59
3.7	Loan opportunity set (mean–standard deviation frontier)	63
3.8	Mean–variance model with interest rate fixed and variable	64
3.9	Mean–variance model, credit rationing, with and without reserve requirement	65
3.10	Mean–variance model, credit rationing, diminishing returns to lending	67
3.11	Mean–variance model, no credit rationing	68
3.12	Effects of change in cost of capital when there are two or more groups in the population	73
3.13	Impact of lower bank wealth on interest rate charged, bankruptcy model	75
3.14	Impact of lower bank wealth, mean–variance model	76
3.15	Impact of mean–preserving spread (increase in risk) of the borrower’s return on lending, bankruptcy	79
3.16	Effect of mean-preserving increase in risk	80
3.17	Impact of increase in reserve requirements, bankruptcy model	82
3.18	Impact of increase in reserve requirements, mean–variance model	82
3.19	Impact of increase in interest rates	84
3.20	Impact of increase in capital adequacy requirements	85
3.21	Impact of capital adequacy requirements	87
4.1	Opportunity locus, mean–variance model, restricted banking	97
4.2	Impact of reduced bank wealth, restricted banking	98
4.3	Impact of increased interest rates, restricted banking	100
4.4	Impact of increased reserve requirements	102
5.1	Equilibrium interest rate in the corn economy	115

LIST OF FIGURES AND TABLE ix

6.1	Monetary equilibrium	124
6.2	Shift of $IS-L^*M^*$ curves within business cycles	126
6.3	Open market operations	129
7.1	General equilibrium credit relations model	139
7.2	Model of credit interlinkages with three firms	143
8.1	General equilibrium effects of an increase in reserve requirements	159
8.2	Impact of higher opportunity cost of funds (expected rate of return on lending rates charged)	161
8.3	Impact of increased reserve requirements, credit rationing with excess liquidity	163
8.4	Asset effect of monetary policy	169
8.5	Risk effect of monetary policy loans marketable	172
8.6	Risk effect of monetary policy, no secondary market for loans	173
8.7	Impacts of monetary policy on aggregate demand and supply	182
8.8	Liquidity trap, traditional version	188
8.9	Liquidity trap, new version	189
8.10	Liquidity trap, corner solution	190
8.11	How lowering interest rates can sometimes have large positive effects	191

TABLE

12.1	Regression results, industry percentage growth in employment by state in each year	255
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The Raffaele Mattioli Lectures

The Raffaele Mattioli Lectures, in which many prominent economists have taken part, were established in 1976 by Banca Commerciale Italiana in association with Università Commerciale Luigi Bocconi as a memorial to the cultural legacy left by Raffaele Mattioli, for many years chairman of the bank.

The aim of the new series of Lectures, which was not only promoted by the then Banca Commerciale Italiana and Università Commerciale Luigi Bocconi but also supported by Università Cattolica del “Sacro Cuore” (Milan), Università degli Studi di Milano and Politecnico di Milano, was to create an opportunity for reflection and debate on topics of particular current interest, thus providing stimuli and ideas for the increasing challenges of a continually changing worldwide economic scenario.

The present initiative is therefore dedicated to the analysis of the effects of important changes which are now taking place in the world economy: the globalization of markets, the continuous evolution in the field of information, technology and communications and the convergence of economics and international relations.

It is evident that these changes, coupled with the European Monetary Union, provide many complex subjects that will be best dealt with from an interdisciplinary perspective.

Cambridge University Press
0521810345 - Towards a New Paradigm in Monetary Economics
Joseph Stiglitz and Bruce Greenwald
Frontmatter
[More information](#)

xii THE RAFFAELE MATTIOLI LECTURES

Distinguished academics and researchers of all nationalities concerned with all kinds of economic problems will be invited to take part in this enterprise, with the intention of contributing to the debate interconnecting economic theory with practical policy.

Preface

These lectures were presented in Milan in abbreviated form on November 9, 1999 at Banca Commerciale Italiana and on November 10, 1999 at Bocconi University as the biannual Raffaele Mattioli Lecture. We are grateful to the staff at BCI and Bocconi, and for the useful comments from the discussants: Patrick Artus, Giovanni Barone-Adesi, Giampio Bracchi, Marco Pagano, Luigi Spaventa, Mario Saranelli, and Gianni Toniolo. In addition we would like to acknowledge the contribution of Barbara Rindi from the Scientific Committee of Bocconi University. We used the occasion to try to summarize a line of research that we had been pursuing for the past fifteen years. Our theoretical work in this area was interrupted by Stiglitz going to Washington, as a member and then Chairman of the President's Council of Economic Advisers, and then as Chief Economist of the World Bank and its Senior Vice President for Development. While the seven years in Washington had interrupted our formal research program, the events surrounding that tumultuous period provided what could not have been a better testing ground for the ideas that we had been developing. We became increasingly convinced not only that our ideas were right, but that they were important and relevant: that had the perspectives on monetary policy that we had been developing been widely adopted, for instance, the IMF might well have managed the global financial crisis of 1997–1999 far better.

Cambridge University Press

0521810345 - Towards a New Paradigm in Monetary Economics

Joseph Stiglitz and Bruce Greenwald

Frontmatter

[More information](#)

xiv PREFACE

We have attempted to present these ideas here simply, with words, diagrams, and simple mathematics, illustrated by examples drawn from recent experiences.

In developing these ideas, we are indebted to a large number of co-authors, who have participated with us actively at various stages in our research program. The ideas of one of our longest-term collaborators, Andy Weiss, with whom we developed the theory of credit rationing, and one of our youngest collaborators, Jason Furman, with whom we analyzed the East Asia crisis, will be especially apparent. We should also like to thank Barry Nalebuff, Carl Shapiro, Arik Levinson, Michael Salinger, Meir Kohn, Amar Bhattacharya, Alan Blinder, Michael Rothschild, Mark Gersovitz, Jonathan Eaton, Marcus Miller, Marilou Uy, Raj Sah, Yingqi Qian, Steve Salop, Ian Gale, Dwight Jaffee, Kevin Murdoch, Thomas Hellman, Andreas Rodriguez, Richard Arnott, and Giovanni Ferri, who co-authored one or more of the papers that provided the backdrop to the results reported here. The notion that capital markets were imperfect, and that cash flows might therefore limit investment, was a conventional assumption in much of macro economics before neo-classical models came to predominate. Such an assumption played an important role in some of Stiglitz's earlier work in macro economics, some of which was done with Robert Solow, George Akerlof, Hirofumi Uzawa, and Peter Neary.

We have discussed the ideas presented in this book at universities and central banks throughout the world, and the innumerable comments and criticisms have been invaluable – and though too numerous to mention by name, whether friendly or hostile, they have helped improve the book immensely.

Research assistantship in preparing the manuscript was provided by Monica Fuentes, Noémi Giszpenc, Niny Khor, Anton Korinek, Nadia Roumani, Ravi Singh, Marco Sorge, Maya Tudor, Kelly Wang, and to all of these we are greatly indebted.

At various stages, the research on which this book is based has been supported by the National Science Foundation, the Ford Foundation, the Rockefeller Foundation, Bell Labs (now part of Lucent), Princeton University, Oxford University, and the World Bank. We are particularly indebted to Stanford University and

Cambridge University Press
0521810345 - Towards a New Paradigm in Monetary Economics
Joseph Stiglitz and Bruce Greenwald
Frontmatter
[More information](#)

PREFACE XV

Columbia University for their support during the period in which this book was written.

The usual disclaimer that the ideas presented here are those solely of the authors, and not of the institutions with which they are currently or were previously affiliated, applies with particular force. We would be remiss not to acknowledge the vibrant intellectual atmosphere inside the World Bank, in which the ideas presented here were debated, challenged, and adopted and adapted as we confronted the most dramatic set of economic events of the last half of the twentieth century – the global financial crisis; but we would also be remiss if we did not express our sense of frustration at the attempts by the US Treasury and the IMF to suppress open discussion of these ideas. What was at stake was more than issues of intellectual freedom or professional integrity, but what we mean by meaningful democracy. There cannot be meaningful democracy without transparency and without open public discourse of vital issues that affect the lives and livelihoods of the citizens. The ideas presented here do represent a major change in thinking about certain aspects of policy, and as such they represent a challenge to the established orthodoxy. The policy implications are important – not only for the aggregate performance of the economy but for specific groups within our societies. It is our hope that in presenting these ideas, in an imperfect form as they are at the current state of development, they will stimulate debate and discussion, and that on the basis of these ideas alternative policies will be formulated which will spare those facing crises in the future from the policies that so ravaged the countries of East Asia.

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