

ETH Zurich Lecture Series

Hyun Song Shin, Princeton University
26 – 28th October, 2009, 10:00 – 12:00

Title: **Liquidity, Leverage and Financial Stability**

In this series of three lectures, we explore the hypothesis that financial intermediaries are the engine that drives the financial cycle through the fluctuations in the price of risk. We sketch a theoretical framework where intermediaries use Value-at-Risk to manage their balance sheets. Then, balance sheet quantities stand in a one-to-one relationship with the price of risk and risk appetite. The framework suggests that the traditional focus on the money stock for the conduct of monetary policy may have more modern counterparts, and highlights the importance of tracking balance sheet quantities for the conduct of monetary policy.

In a dynamic framework, financial intermediaries drive the volatility of asset returns, also. Risk is endogenous. Equilibrium risk is the fixed point of the mapping that takes perceived risk to actual risk. The framework generates countercyclical volatility – i.e. volatility being low when bank capital is high and risk appetite is high.

In order for balance sheet quantities to be more useful, an accounting framework for the financial system is needed that takes account of the double-counting of assets when one intermediary lends to another intermediary, as when a securities firm holds MBSs. The aggregate balance sheet identity for the financial system is a useful framework to discuss alternative policy responses to the financial crisis, such as countercyclical capital rules, leverage caps, and the Spanish style forward-looking provisioning. The framework is also useful for discussing structural innovations in financial intermediation that enhances the resilience of the financial system.

Readings: Hyun Song Shin, 2009, *Risk and Liquidity*, Clarendon Lectures in Finance, Oxford University Press, forthcoming. Draft chapters 1, 2 and 3.
<http://www.princeton.edu/~hsshin/ClarendonLectures.htm>

Jon Danielsson, Hyun Song Shin and Jean-Pierre Zigrand (2008) “Risk Appetite and Endogenous Risk”
<http://www.princeton.edu/~hsshin/www/riskappetite.pdf>

Hyun Song Shin (2009) “Securitisation and Financial Stability”
<http://www.princeton.edu/~hsshin/www/securitisation.pdf>