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PERSPECTIVES

On a New Approach for Analyzing and Managing Macrofinancial Risks

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At the fifth annual CFA Institute European Investment Conference on 19 October 2012 in Prague, Robert C. Merton gave a presentation on analyzing and managing macrofinancial risk. This article is based on his talk and on research he carried out with his coauthors.

Analyzing and managing macrofinancial risk have become increasingly important over time as global markets have become increasingly more connected. Specifically, analyzing and managing sovereign risk, the risks of financial institutions, and the interactions among sovereigns and financial institutions are important for investors and those responsible for financial stability. This topic is also important for those who are responsible for the traditional areas of monetary and fiscal policies because, as we see in a number of cases, monetary and fiscal policies designed to deal with things like stimulus or consumption demand can actually have unintended consequences of some magnitude for financial stability and markets. Therefore, I am going to make the case for why we need an integration of monetary, fiscal, and financial stability policies.

In light of the 1997 Asian crisis, the financial crisis of 2008–2009, and the most recent European banking and sovereign debt crisis, we know the focus of those crises was really in credit, money markets, and, to some extent, the plumbing (structure of the systems). I am going to focus my discussion on credit. One particular item of interest that many have concerns about is the accumulation of debt, particularly in Europe and the United States.

I would like to point out another class of government liabilities that do not appear on balance sheets but are real liabilities—government guarantees. These guarantees are significant; for example, in the United States, the Fed guaranteed trillions of dollars of bank and money market fund assets, including guaranteeing $360 billion of assets for a single bank, Citigroup. It is important to note that these guarantees are insurance policies that have value and are real liabilities of the government, yet they are not on the balance sheet.

To provide an idea of the magnitude of these off-balance-sheet liabilities, **Table 1** lists the liabilities of the U.S. government with respect to credit assets, liabilities, and guarantees. U.S. Treasury debt held by the public was $9 trillion in 2010; that debt is probably closer to $11 trillion today. The rest of the right-hand side of Table 1 consists of all the U.S. government guarantees that are not on the balance sheet. To begin, there is about $1.9 trillion in guaranteed loan financing. Fannie Mae and Freddie Mac are both in receivership; the guarantees relating to

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Editor's Note: Much of the research discussed herein is from the paper "Sovereign, Bank, and Insurance Credit Spreads: Connectedness and System Networks," by M. Billio, M. Getmansky, D. Gray, A. Lo, R.C. Merton, and L. Pelizzon, MIT working paper (forthcoming 2013).

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