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From Monetary Stability to Financial Stability: Theoretical Linkages

Fadoua JOUDAR

Laboratory of Management Economic and Social Sciences (LAMSES), Private University of Marrakech, Marrakech, Morocco

Research Laboratory in Economics, Management and Business Management (LAREGMA), Faculty of Economics and Management, Hassan 1er University, Settat, Morocco

Abstract. The relationship between monetary stability and financial stability has become a central issue in modern macroeconomic debates, especially since the global financial crisis. This paper examines the theoretical and historical linkages between these two dimensions of economic stability. The objective of the study is to analyze whether monetary stability is sufficient to ensure financial stability and how the relationship between the two has evolved over time. The paper adopts a qualitative and historical approach based on a review of major economic theories and historical episodes of financial instability. In particular, the analysis focuses on three key periods of financial history (1790–1933, 1980–1997, and the post-2000 period) to highlight how monetary regimes and financial structures have interacted. The results show that while monetary stability can contribute to financial stability, it is not sufficient on its own to prevent financial crises. Financial stability requires complementary regulatory and macroprudential frameworks. The main contribution of this paper lies in clarifying the theoretical linkages between monetary and financial stability and highlighting the need for an integrated policy framework combining monetary and financial regulation.

Keywords: *Monetary stability, Financial stability, Price stability, Credit cycles, Debt-deflation, Inflation, Macroprudential policy, Historical analysis.*

1. Introduction

The relationship between price stability and financial stability occupies a central place in macroeconomic analysis and in the conduct of monetary policy. Long considered self-evident, the idea that price stability constitutes a sufficient condition for ensuring the stability of the financial system has shaped the conventional approach to monetary policy, particularly in advanced economies. This view assumes that controlling inflation reduces uncertainty, improves credit allocation, and prevents the accumulation of financial imbalances.

However, the repeated occurrence of major financial crises, notably those of 1929 and 2008, has profoundly challenged this conception. These episodes have shown that significant financial imbalances can develop in environments characterized by low and stable inflation, thereby revealing the limitations of an approach exclusively focused on price stability. This reassessment has fostered the emergence of alternative analytical frameworks, grouped under the so-called “new environment” approach, which emphasize the role of credit, asset prices, and indebtedness in the genesis of financial instability.

In this context, this article contributes to a theoretical and empirical reflection aimed at examining the robustness of the link between monetary stability and financial stability over the long term. Through an in-depth review of the literature and a comparative analysis of several historical case studies, it seeks to highlight how this relationship evolves across monetary regimes and macrofinancial configurations. The originality of this paper lies in its attempt to bridge theoretical perspectives with historical analysis in order to better understand the evolving relationship between monetary stability and financial stability. While many studies analyse

these concepts separately, this paper proposes an integrated reading of the two dimensions across different historical monetary regimes.

This leads to the following central research question: To what extent does monetary stability contribute to financial stability, and can it be considered a sufficient condition for preventing financial crises?

The remainder of the paper is organised as follows. Section 1 reviews the theoretical foundations linking monetary stability and financial stability. Section 2 analyses the historical evolution of this relationship through three major periods (1790–1933, 1980–1997, and the post-2000 era). Section 3 discusses the implications of these findings for contemporary monetary and financial policies. The final section concludes and highlights the main policy implications.

2. Literature Review

a. Monetary Instability: Milton Friedman & Anna Schwartz

Given its devastating consequences, numerous researchers have sought to identify the factors that can trigger financial instability. Alongside war, budget deficits, and credit expansion, inappropriate monetary policy is widely considered a major cause of instability episodes.

In this context, Friedman and Schwartz (1963), as well as Friedman (1959, 1969, 1972), emphasized the central role of monetary factors in financial instability, arguing that crises stem from excessive money supply growth driven by uncontrolled credit expansion. They consequently inferred a direct link between financial stability and the money supply, suggesting that maintaining money supply growth at a stable rate of 2–3% could ensure the stability of the financial system.

b. Creation and Destruction of Money: Maurice Allais, Léon Walras, Irving Fisher

Maurice Allais (1999) assigns a central role to money creation in explaining financial instability. He interprets the Great Depression as a direct consequence of credit expansion, which operates through several mechanisms: the creation and destruction of money ex nihilo by the banking system, fractional reserve banking, the financing of long-term investments with short-term borrowed funds, the use of credit for speculative purposes, and the resulting fluctuations in the real value of money and economic activity.

According to Allais, the credit mechanism— which he describes as a “cancer”—constitutes the fundamental source of financial system imbalances. Indeed, it enables purely fictitious monetary creation through simple accounting entries, leading to a situation where two agents, the depositor and the borrower, simultaneously believe they hold real cash. However, this apparent duplication of money relies solely on the bank deposit that serves as collateral for the granted loan. This dual function granted to the credit system thus contributes to its structural instability.

Moreover, the principle of “buying without paying and selling without owning” directly stems from the creation of payment means ex nihilo, fueled by credit and speculation. This process is precisely what Galbraith (1992) identifies as having led to the Great Depression.

On this issue, Walras (1898) adopts an unambiguous position. He argues that banks should not have the capacity to create money due to the destabilizing role this creation plays in the economy. He notably states that “a banknote is not money; but it serves as money or a medium of exchange, and this addition of a certain quantity of paper money to the amount of metallic money in circulation depreciates the latter, raises prices, and disrupts exchange relations.”

Walras's (1898) general equilibrium theory relies on the hypothesis that market efficiency is closely linked to the stability of fiat money. Any disruption of this monetary framework is likely to generate harmful effects on the stability of the financial system as a whole. Thus, banknotes are seen by Walras as responsible for periods of instability, leading him to advocate strict banking regulation and the prohibition of any form of debt-money substitute to prevent crises.

In the same vein, Fisher (1935) argues that the process of money creation and destruction fosters episodes of financial instability. He aligns with Walras in seeking to eliminate banks' ability to create and destroy money, advocating a 100% reserve system. According to Fisher, the essence of this plan lies in separating money from credit, strictly dissociating monetary creation from banking activity. Such a reform would not only secure the banking system but also prevent phases of excessive expansion and depression by eliminating the instability of demand deposits linked to bank lending.

The proposed solution, already discussed by Walras (1898), consists of removing the banking system's ability to create and destroy money by imposing a full 100% reserve requirement on demand deposits. The application of this rule would eliminate money creation ex nihilo, considered a major factor of inflation and crises.

Finally, to permanently separate money from debt, Fisher (1935) proposes restricting banks to the mere safekeeping of demand deposits, while lending operations would be exclusively financed by savings collected in the form of term deposits. In this framework, demand deposits would be fully backed by money, thereby ensuring their stability.

c. The Two Interest Rates and Inflation: Henry Thornton

Indeed, Thornton provides one of the earliest analyses of cumulative processes fueled by the credit mechanism, thereby laying the theoretical foundations for financial and banking instability that were later developed by Wicksell, Keynes, and Minsky.

To explain instability, Thornton (1802) establishes a close link between interest rates and inflation by distinguishing between two fundamental concepts: the market interest rate and the natural interest rate, the latter ensuring the equality between savings and investment. Any divergence between these two rates constitutes, according to him, a triggering factor for rising inflation.

The emergence of a cumulative expansion process in demand and credit results from a market interest rate that is lower than the marginal rate, a situation that promotes a persistent increase in inflation.

Conversely, Thornton (1802) also examines the impact of inflation on interest rates. In the face of rising inflation, the central bank may be forced to raise the interest rate. However, if the real interest rate remains non-negative, it may still remain permanently below the marginal rate, thus maintaining excessive demand for bank credit.

Finally, controlling inflation through a restrictive monetary policy based on quantitative control of monetary aggregates mechanically leads to a sharp rise in interest rates. This mechanism then marks the starting point of a financial crisis.

d. Cumulative Process and Financial Cycles: Knut Wicksell

Knut Wicksell (1898, 1906) analyzes the dynamics of capitalist economies through the distinction between two fundamental interest rates: the natural interest rate and the monetary interest rate.

The natural interest rate corresponds to the level that equalizes desired savings and investment, or alternatively, that ensures equality between aggregate real production demand and available

supply. In contrast, the monetary interest rate refers to the rate applied to bank credit by financial institutions. As long as the monetary interest rate equals the natural interest rate, savings correspond to desired investment, which ensures stability in the general price level.

If the monetary interest rate is lower than the natural interest rate, investment exceeds desired savings; the resulting gap is financed through bank credit, leading to an expansion of the money supply and consequently triggering inflation.

Conversely, when the monetary interest rate exceeds the natural interest rate, bank borrowing and the money supply contract. This situation leads to a reduction in aggregate demand relative to supply, thereby causing a decline in prices.

Thus, for Wicksell (1898), instability originates from monetary authorities' willingness to maintain an artificially low monetary interest rate, often favorable to certain economic sectors. Such a policy encourages excessive indebtedness, which can ultimately lead to a financial crisis.

Wicksell's approach therefore provides a relevant framework for understanding episodes of financial instability. It highlights capitalist development as a succession of cumulative expansion and contraction phases affecting the entire economy. A cumulative expansion phase, triggered exogenously, gradually generates increasing fragility and instability, which must eventually be resolved. It is followed by a cumulative contraction phase that, when sufficiently pronounced, leads to systemic imbalances within the financial system.

e. Over-Indebtedness and Debt-Deflation: Irving Fisher

According to Fisher (1988), the emergence of crises results from the interaction of multiple factors within the economic system. He emphasizes that elements such as overproduction, underconsumption, price disturbances, mismatches between industrial and agricultural prices, excessive confidence, overinvestment, excessive saving, overspending, and the gap between savings and investment are not sufficient on their own to explain major economic crises.

Although these factors can contribute to the onset of instability episodes, they remain secondary in Fisher's analysis. The fundamental causes of financial crises, in his view, lie in over-indebtedness and deflation, which play a central role by amplifying the effects of other imbalances. As he explains, over-indebtedness and deflation affect a set of key variables, including debts, the money supply and its velocity, the general price level, net worth, profits, trade, economic agents' confidence, and interest rates.

When over-indebtedness is the primary source of imbalance without immediate intervention on the price level, it leads to a process of debt liquidation and forced sales. This dynamic triggers a monetary contraction that disrupts price stability, causes economic losses, deteriorates commercial and productive activity, and worsens unemployment. It also fosters interest rate instability and encourages hoarding, driven by a loss of confidence in means of payment.

Fisher (1988) argues that crises would be less severe if over-indebtedness were not accompanied by deflation. Similarly, deflation in isolation, without over-indebtedness, would produce less severe imbalances. However, it is the combination of over-indebtedness and deflation— the latter largely induced by the former— that forms the core of major episodes of financial instability.

Thus, over-indebtedness appears as the primary cause of financial instability, fueled by the pursuit of profits facilitated by what Fisher (1988) describes as "easy money."

f. Monetary Stability and Financial Stability: Theoretical Approaches

The succession of two major crises, those of 1929 and 2008, represented a decisive shock that led public authorities to pay increased attention to financial stability, linking it more closely to

the monetary policies implemented by governments. These policies indeed play a central role in reducing risks that could weaken the financial system.

Primarily responsible for conducting monetary policy, the central bank's mission is to ensure price stability and limit economic fluctuations. Economic activity evolves in a continuous dynamic, marked by permanent adjustments, to which the central bank cannot systematically respond when it comes to minor disturbances in the financial system.

However, preserving financial stability constitutes a fundamental objective for the central bank, insofar as it complements the goals of monetary policy. Price stability, in particular, encourages rational economic decisions by firms, households, and financial institutions, thereby contributing to the maintenance of the stability of the financial system. This stability depends closely on the quality and efficiency of monetary policy transmission channels, even though monetary stability alone remains insufficient, which justifies the use of macroprudential policies.

The recurrence of financial instability episodes has fueled a significant debate regarding the relationship between monetary stability and financial stability. In this context, the literature distinguishes two main approaches: the so-called "conventional" approach and the "new environment" approach. The former postulates that monetary stability and financial stability evolve together and reinforce each other in the long term. In contrast, the "new environment" approach considers that the sustained control of inflation at low levels creates an economic environment in which financial stability is not necessarily guaranteed.

i. Conventional Approach

From the monetarist perspective, as outlined by Schwartz (1995), price stability constitutes an indispensable condition for the stability of the financial system. He recalls that during the 1970s, banks expanded their investment and lending portfolios in an inflationary context, while the subsequent decline in the price level led to a sharp increase in bank failures.

This example illustrates the crucial role of price stability in banking stability, due to its influence on credit allocation conditions. As Schwartz (1998) emphasizes, unexpected variations in the price level or inflation rate can undermine the initial assumptions on which lending decisions were based. More concretely, banks assess credit risk based on collateral and the borrower's financial situation, while integrating inflation expectations over the loan horizon.

Moreover, investments based on erroneous expectations of monetary policy are likely to fail, exposing financial institutions, as intermediaries, to significant risks and losses. In this perspective, Schwartz (1995) asserts that monetary stability is a prerequisite for price stability, which itself represents a necessary condition for financial stability.

Following this analysis, Bordo and Wheelock (1998) empirically tested Schwartz's hypothesis. Their results confirm the existence of a positive relationship between price instability and financial instability, without establishing a direct causal link between these two dimensions.

More in-depth, Bordo, Dueker, and Wheelock (2002) examine the impact of price fluctuations on financial instability by developing two annual indices of financial conditions in the United States over the period 1790–1997. Their work shows that price shocks were associated with episodes of financial instability during the period 1790–1933, while inflation shocks contributed to financial instability between 1980 and 1997. They conclude that monetary policies oriented towards price stability tend to promote financial stability.

ii. "New Environment" Approach

In recent literature, Goodfriend (2001) is among the first authors to develop the concept of credible monetary policy and analyze its role in financial stability. He argues that a persistently low inflation rate contributes to establishing a generalized climate of confidence, which may, in turn, foster the emergence of financial imbalances. According to him, monetary policy credibility not only anchors inflation expectations but also enables the anticipation of deflationary risks and supports economic recovery following a deflationary shock.

Building on this reasoning, Borio and Lowe (2002) examine the link between monetary stability and financial stability through the "new environment" approach. They highlight several mechanisms explaining why financial stability does not necessarily follow from price stability. First, an accommodative monetary policy can generate excessive optimism among economic agents, leading to rising real estate asset prices and fueling a credit boom, thereby potentially weakening the financial system.

Second, the combination of sustained economic activity, low inflation, and rising asset prices fosters optimistic expectations, leading to a self-reinforcing expansion of asset markets and credit. The strong credibility of monetary policy thus stabilizes inflation expectations and reduces their volatility, without preventing the accumulation of financial imbalances.

Finally, Borio and Lowe (2002) stress that monetary policy credibility reduces overall uncertainty in the financial system but may also lead authorities to underestimate latent inflationary pressures associated with financial imbalances, thereby favoring the emergence of instability.

Other authors more radically question the ability of monetary policy to ensure financial stability. Svensson (2017) argues that financial stability should not be a target of monetary policy, as the latter cannot guarantee the stability of the financial system. The global financial crisis illustrates, in his view, the limits of monetary action, which can ensure price stability without preventing financial imbalances. Indeed, monetary policy cannot guarantee adequate levels of capital or liquidity within the financial system.

Nevertheless, financial stability influences financial markets, the banking sector, and the housing market, thereby indirectly affecting the inflation rate. Monetary policy, in turn, acts on interest rates, credit, and asset prices, indirectly influencing financial stability. Thus, there is an interaction between monetary stability and financial stability, without their evolutions necessarily being systematically synchronized.

Krugman also adopts a critical position towards the conventional approach. He refers to the experience of expansionary monetary policies implemented during the last financial crisis, which did not lead to a resurgence of inflation. According to him, regardless of the orientation of monetary policy, it cannot guarantee financial stability, and sensitivity to inflation fluctuations is not sufficient to eliminate the risks of instability. The global financial crisis is a clear illustration of the development of financial imbalances in a context of strong price stability.

In the same perspective, Blot, Creel, Hubert, and Saraceno (2015) empirically analyze the relationship between price stability and financial stability in the United States and the euro area. Their results show the absence of a lasting link between these two dimensions, challenging the conventional approach and confirming that financial instability can develop in an environment characterized by low inflation, notably during the Great Moderation.

Finally, Issing (2003) adopts a more nuanced position by acknowledging that price stability supports financial stability while highlighting potential short-term conflicts between these

objectives. He argues that it may be relevant to temporarily deviate from the short-term inflation target to ensure price stability in the medium term. According to him, the "new environment" approach does not deny the beneficial effect of monetary stability on financial stability but emphasizes that a decline in inflation becomes a source of instability only in the case of strong disinflation, particularly during transitions between monetary policy regimes.

3. Methodology

This paper adopts a qualitative and indirect empirical approach based on a comparative analysis of existing empirical findings from the economic literature on the link between monetary stability and financial stability. The objective is not to produce new econometric estimates, but to examine, compare, and interpret recognized empirical results in order to assess the robustness of the relationship between price stability and financial stability over time and across different economic contexts.

The methodology relies on three historical case studies selected from widely cited reference works in the literature (Bordo, Dueker & Wheelock, 2002; Blot et al., 2015). These studies cover distinct periods and contrasting macrofinancial environments, enabling a diachronic analysis of the relationship between price fluctuations and financial instability.

First, the period 1790–1933 is used to analyze the American economies characterized by unstable monetary regimes and recurring financial cycles. The empirical findings of Bordo, Dueker, and Wheelock (2002) are employed to examine the historical correlation between shocks to the general price level and episodes of financial instability in a context of limited monetary stability.

Second, the period 1980–1997, corresponding to the Great Moderation, allows the relationship to be evaluated in an environment marked by low and controlled inflation, developed financial markets, and increased credibility of monetary policies. The comparative analysis for this period also relies on the results of Bordo, Dueker, and Wheelock (2002) to identify potential breaks in the relationship between price stability and financial stability.

Third, the post-2000 period is examined through the work of Blot, Creel, Hubert, Labondance, and Saraceno (2015), who compute correlation coefficients between the Consumer Price Index and financial stability indices for the United States and the euro area. This study allows an empirical assessment of the relationship between monetary stability and financial stability in a contemporary context marked by the 2008 financial crisis and the use of unconventional monetary policy tools. The choice of the three historical periods analysed in this paper is motivated by major transformations in the global monetary and financial architecture. The period 1790–1933 corresponds to the development of modern banking systems and the experience of recurrent financial crises under the gold standard and early central banking regimes. The period 1980–1997 reflects the era of financial liberalisation and deregulation, which significantly transformed financial markets and increased systemic vulnerabilities. Finally, the post-2000 period captures the emergence of new financial dynamics culminating in the global financial crisis of 2008 and the subsequent rethinking of monetary and macroprudential policies. The analysis focuses particularly on the United States and the euro area because these two economic areas play a central role in the global financial system and provide relevant institutional frameworks for analysing the interaction between monetary policy and financial stability.

This comparison enables the identification of the evolving nature of the link between price stability and financial stability, while clearly distinguishing between correlation and causality.

4. Results and Discussion

This section presents historical case studies that illustrate the relationship between price stability and financial stability across different economic periods. The objective is to highlight, based on empirical analyses, the limitations of the conventional approach and the insights of the "new environment" perspective.

a. Period 1790–1933

Table 1 summarizes the main characteristics of monetary and financial regimes during the period 1790–1933.The study of this period conducted by Bordo, Dueker, and Wheelock (2002) shows that fluctuations in the general price level in the United States were frequently associated with episodes of financial instability. In a context marked by recurrent financial cycles and unstable monetary regimes, price shocks appear as factors that accompany, and even amplify, financial tensions. This observation highlights a positive correlation between price instability and financial instability, which partially supports the conventional approach linking monetary stability and financial stability. However, these results are based on historical correlation and do not allow for the establishment of a direct causal relationship, which represents a significant limitation of this study.

Table 1. Period 1790–1933 (Bordo, Dueker & Wheelock, 2002)

Element	Description
Context	Pre- and post-war American economies, characterized by multiple financial cycles
Observation	Shocks to the general price level were often followed by episodes of financial instability
Conclusion	A positive correlation exists between price fluctuations and financial instability, partially supporting the conventional approach
Limitation	Historical correlation only, without direct evidence of causality

1.1.Period 1980–1997

Table 2 presents the main features of financial liberalisation and regulatory changes during the period 1980–1997.The analysis of this period conducted by Bordo, Dueker, and Wheelock (2002), corresponding to the Great Moderation, highlights the persistence of episodes of financial instability in a context of low and relatively stable inflation. Despite the success of monetary policies in terms of price stability, financial imbalances did not disappear, suggesting a decoupling between monetary stability and financial stability. These findings support the so-called "new environment" approach, according to which controlling inflation is not a sufficient condition to ensure the stability of the financial system. Nevertheless, the interpretation remains limited by the specific nature of the period studied and by the institutional context characteristic of developed economies.

Table 2. Period 1980–1997 (Bordo, Dueker & Wheelock, 2002)

Element	Description
Context	Great Moderation, controlled inflation, developed financial markets
Observation	Despite low and stable inflation, episodes of financial instability continued to occur
Conclusion	Price stability does not ensure financial stability, supporting the "new environment" approach
Limitation	Specific context; results cannot be generalized to all economies

1.2.Post-2000 Period: United States and Eurozone

Table 3 highlights the main policy responses and institutional developments observed in the post-2000 period. The post-2000 study conducted by Blot, Creel, Hubert, Labondance, and Saraceno (2015), focusing on the United States and the euro area before and after the 2008 crisis, highlights a weak or even non-existent relationship between price stability and financial stability. The correlation coefficients calculated between the consumer price index and a financial stability index are weak or statistically insignificant in both regions studied. These results indicate that monetary stability does not guarantee financial stability and that the latter depends more on variables such as credit, asset prices, and indebtedness. However, the analysis remains limited by the use of aggregated indices and does not allow for the identification of precise causal relationships.

Table 3. Post-2000 (Blot, Creel, Hubert, Labondance & Saraceno, 2015)

Element	Description
Context	United States and Eurozone, before and after the 2008 crisis
Observation	Correlation coefficient between the Consumer Price Index (CPI) and the financial stability index: United States → weak or null; Eurozone → weak and not significant
Conclusion	The relationship between price stability and financial stability is unstable over time; other factors (credit, asset prices, debt) play a crucial role
Limitation	Data limited to aggregate indices; causality is not established

The case studies show that the relationship between price stability and financial stability varies across periods. Between 1790 and 1933, a positive correlation appears, partially supporting the conventional approach. During the Great Moderation (1980–1997) and the post-2000 period, this relationship is weak or insignificant, confirming that price stability does not guarantee financial stability and that other financial factors play a central role.

5. Conclusion

The theoretical and empirical analysis conducted in this article highlights the evolving and contingent nature of the relationship between price stability and financial stability. Classical approaches to financial instability, from Friedman and Fisher to Allais and Wicksell, already emphasize that mechanisms of money creation, credit expansion, and indebtedness play a decisive role in the emergence of crises, beyond price dynamics alone.

The historical case studies analyzed confirm that, in contexts characterized by unstable monetary regimes and underdeveloped financial markets, fluctuations in the general price level are frequently associated with episodes of financial instability. However, this relationship tends to weaken, or even disappear, in more recent periods marked by low and stable inflation, such as during the Great Moderation and the period following the 2008 financial crisis.

These results highlight the limitations of the conventional approach, which equates monetary stability with financial stability, and provide empirical support for the "new environment" approach. They show that while controlling inflation is necessary, it is not sufficient to prevent the accumulation of financial imbalances. Financial stability depends more strongly on macrofinancial variables such as the credit cycle, asset price dynamics, and the level of indebtedness.

Ultimately, this analysis argues for a broader conception of economic policy, in which price-stability-oriented monetary policy must be complemented by macroprudential instruments specifically designed to prevent systemic risks. It also underscores the importance of not conflating correlation with causality when assessing the link between monetary stability and financial stability, to avoid excessive normative conclusions regarding the role of monetary policy in crisis prevention.

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