

Financial Stability Concept: Main Characteristics and Tools

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Abstract: Different approaches and methods of defining “Financial Stability” by different schools and economists and the tools used to approach it. Definitions of “Financial Stability” tools and description of its characteristics.

Key words: Financial stability % Research schools % Sovereign Debt Crises % Financial Stability Reports % Outside assistance % Financial Stability Reports

INTRODUCTION

According to the executed research of existing literature on financial stability issues it has become apparent that in recent years the questions related to the maintaining of financial stability have been receiving priority attention from both academics and policy makers around the world. The reason of increased concern on financial stability issues comes from severe consequences of the recent East-Asian financial crises of late 1990's, the Global financial crises of 2007-2008 and the current Eurozone Sovereign Debt Crises. These crises have demonstrated that fiscal, economic and social costs are too high and thus it is strictly needed to scrutinize and develop effective policies in order to prevent such economic failures. After the East-Asian financial crises the World Bank and the International Monetary Fund (IMF) introduced the Financial Sector Assessment Program (FSAP) in 1999, the goal of which is to assess the strengths and weaknesses of financial systems at regular basis. In addition to this several international forums devoted to financial stability issues have emerged, including bodies such as the Financial Stability Forum, Basle Committee on Banking Supervision, Financial Stability Institute, Committee on the Global Financial System and others. Moreover many regulatory authorities mostly represented by central banks have begun to differentiate the financial stability issues from those of macroeconomic and price stability thus establishing Financial Stability Departments and introducing regular publications of Financial Stability Reports, focused on assessing potential risks to financial stability.

Interestingly that despite this increased focus on financial stability issues, there is not a widely accepted definition of “financial stability” and each central bank and academics as well give their own interpretation of financial stability. Thus in the process of analyzing the financial stability concept this paper has explored different approaches to it presented by different bodies in order to completely and fruitfully discover all aspects of this concept. Thus financial stability is difficult to define and even more difficult to measure. But it is crucial for present studies to explore the importance of financial stability. Clear definition of “financial stability” is important for the development of relevant analytical tools and for the design of policy and operational frameworks essential for economic policy implementation.

There are two schools of thought surveying the financial stability issues. The approaches of these schools are clearly discernible. The representatives of the first school prefer to define financial instability while the second school' economists attempt to define financial stability. Among the representatives of the first school of thought are: F. S. Mishkin who states that “financial instability occurs when shocks to the financial system interfere with information flow so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities”[1]. This definition emphasizes the intermediation role of the financial system in providing credit to the real sector and stresses the central role of asymmetric information in causing financial instability. Davis defines systemic risk and financial instability as “a heightened risk of a financial crisis”. A financial crisis is then described as “a major

collapse of the financial system, entailing inability to provide payments services or to allocate credit to productive investment opportunities" [2]. Davis further pointed out that financial crises would have major adverse effects on economic activity and fostering financial stability is equivalent to managing systemic risk. Ferguson described financial instability as "a situation characterized by three basic criteria: 1) some important set of financial asset prices seem to have diverged sharply from fundamentals; and/or 2) market functioning and credit availability, domestically and perhaps internationally, have been significantly distorted; with the result that, 3) aggregate spending deviates (or is likely to deviate) significantly, either above or below, from the economy's ability to produce" [3]. Interestingly, but here Ferguson emphasis two features which were out of Davis's and Mishkin's sight. Ferguson incorporates the distortion of asset prices into his definition of financial instability and there is explicit coverage of the ultimate impact of financial instability on the macro economy, in terms of the impact on aggregate spending. It is worth to note that other representatives of this school such as Allen and Wood do not consider episodes of asset price bubbles as financial instability [4]. In order to have the complete understanding of financial stability concept we will apply to economist which prefer to define financial stability rather than its absence. Among these are the following:

Crockett which expresses financial stability as requiring "that the key institutions in the financial system are stable, in that there is a high degree of confidence that they continue to meet their contractual obligations without interruption or outside assistance; and that the key markets are stable, in that participants can confidently transact in them at prices that reflect the fundamental forces and do not vary substantially over short periods when there have been no changes in the fundamentals"[5]. Here we can clearly delineate some specific aspects of the definition: the statement considers periods of asset price volatility as evidence of instability and it argues that financial stability exists if the financial system can continue to function normally without "outside assistance". Thus it becomes evident that if leading by this definition the current sovereign debt position of some Eurozone countries and banks could be interpreted as being in state of financial instability. According to Foot "...we have financial stability where there is: (a) monetary stability; (b) employment levels close to the economy's natural rate; (c) confidence in the operation of the generality of key financial institutions and markets in the economy; and (d) where there are no

relative price movements of either real or financial assets within the economy that will undermine (a) or (b)" [6]. If to analyze this definition it will become clear that this is one of the few definitions which comprise monetary stability as an integral part of financial stability. Here we can observe the linkage with the real sector in terms of proximity to the natural rate of employment levels. It also highlights the importance of "confidence" in the operation of the financial system. Padoa Schioppa argues that "...financial stability is a condition where the financial system is able to withstand shocks without giving way to cumulative processes, which impair the allocation of savings to investment opportunities and the processing of payments in the economy"[7]. Here we can see that the author stresses the resilience of the financial system, so that it can continue to carry out its essential functions of resource allocation and provision of payments services. And to the sustainability of payment system is given an important role as disturbances to the payments system have the capacity to inflict adverse effects on the level of economic activity.

As we have mentioned above many central banks established financial stability departments and began publishing Financial Stability Reports, thus they have also adopted specific definitions in order to provide some guidance to their objective of safeguarding financial stability. Here we are applying to the definition provided by the European Central Bank (ECB) as the pivotal concept while the analyzing the financial stability problems of some EU countries submerged into the debt crises is the central axes of this thesis paper. So, financial stability can be defined as a condition in which the financial system-which comprises financial intermediaries, markets and market infrastructures-is capable of withstanding shocks and the unraveling of financial imbalances. This mitigates the likelihood of disruptions in the financial intermediation process that are severe enough to significantly impair the allocation of savings to profitable investment opportunities [8]. According to the ECB the financial stability safeguarding requires identifying the main sources of risk and vulnerability. Such sources contain inefficiencies in the allocation of financial resources from savers to investors and mispricing or mismanagement of financial risks. The identification of risks and vulnerabilities is necessary because the monitoring of financial stability must be forward-looking: inefficiencies in the allocation of capital or shortcomings in the pricing and management of risk can, if they lay the foundations for vulnerabilities, compromise future financial system stability and therefore economic stability.

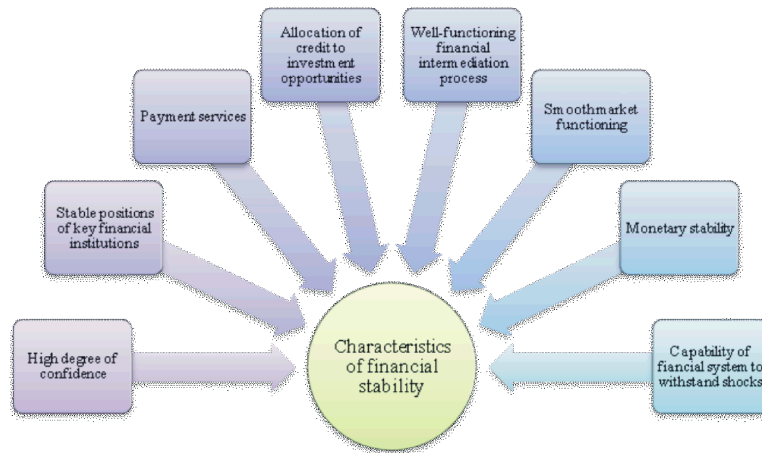


Fig. 1: Components of financial stability

Thus having explored several approaches to financial stability concept we can ascertain that despite their wide diversity there can be observed significant convergence of views on financial stability. And thus we can outline main characteristics inherent to the financial stability. They are the following: capability of the financial system to provide payments services or to allocate credit to productive investment opportunities, capability of boosting economic activity by providing an economy with well-functioning financial intermediation processes, smooth market functioning and credit availability, stable positions of key institutions in the financial system, bolstering a high degree of confidence in their capability to meet contractual obligations, elimination of relative price movements of either real or financial assets, monetary stability, capability of financial system to withstand shocks without outside assistance (Figure 1).

Generally speaking, financial system stability can be characterized as stable in the absence of excessive volatility, stress or crises. But this definition is too narrow and it fails to capture the contribution of a financial system to overall economic performance. In effect, more complex definitions of financial stability encompass the relationships among financial markets, infrastructures and institutions. Such definitions include not only financial markets but also macro-economic dimension of financial stability and interactions between the financial and real sectors. That is why we will observe the financial stability in the framework that will incorporate both the financial and real sector functioning. However as the study makes significant emphasis on the European Union sovereign debt problems and thus on its financial stability the analysis will be based on the financial stability definition developed by the European Central Bank (ECB) as the pivotal concept of this study.

In order to make analysis of financial stability we need to know what are the main risks and vulnerabilities threatening the sustainability of the financial system.

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