# FINANCIAL STABILITY - A THEORETICAL APPROACH

**Maria Vasilescu**
Junior Assistant, PhD Student, "Constantin Brîncuşi" University of Tîrgu-Jiu
maria_vasilescu1983@yahoo.com

***Abstract:*** *Central banks have become poles of stability and decisive factors of globalization. Financial stability represents a national issue, a public asset, that requires both an intervention of public judicious authorities and their cooperation with private sector. Given the integration of financial markets during the last decades in both developed and developing countries, as direct result of globalization, liberalization and deregulation processes, and the high degree of innovation they felt over time, a shift in market participants' perceptions on the importance of stable financial systems in economic growth arose. The global context characterized by the interdependence of markets and institutions, emergence of new techniques and instruments, increasing international capital flows stressed the new meanings of the analysis of financial stability.*
***Key-words***: *financial crisis, financial stability, source of risks, price stability*

**Introduction**

The role of central banks in terms of stability is based on a long and lasting tradition that tends to be reconsidered. Their main task is to ensure a framework of financial stability that encourages an increase of trade, financial flows and development. Financial stability is a fundamental condition for sustainable economic growth, at least as important as price stability is. Without financial stability, price stability and growth are affected.

The painful effects and costs of financial crises during the recent years have increased the efforts of authorities and academic experts to identify the tools to prevent the occurrence of these events and to find remedies necessary for their initiation. Ensuring systemic financial stability therefore became a priority.

**An attempt to conceptualize**

Financial stability has become one of the main concerns of financial authorities after successive financial crises of the '90s in Asia and Latin America. Moreover, the sub-prime crisis of 2008 has revealed intertwined nature of modern financial systems.

Although defining financial stability seems, at a first glance, a simple exercise, there is no consensus among experts, so a strict definition is highly debatable. Andrew Crockett (1996) sustains the idea that, in terms of stability of financial sector, one must distinguish between the stability of financial institutions and the stability of financial markets. While the first one refers to the extent to which institutions meet their contractual obligations without interruption or any external support, financial market stability is "a precondition for macroeconomic stability and economic growth" reflected by a "flow of information between borrowers and lenders sufficiently stable to overcome the inherent information asymmetries between both parties" (Weber, 2008).

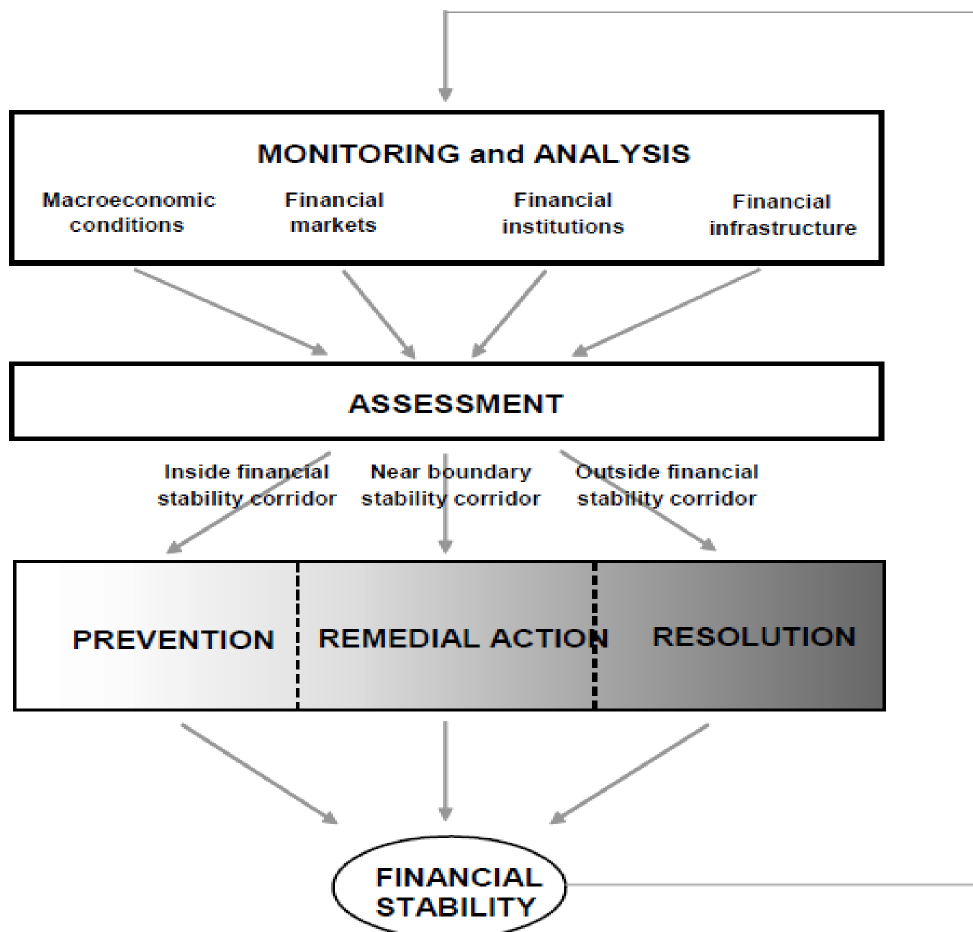
Padoa-Schioppa (2002) defines financial stability, in a study prepared for European Central Bank, as "*a condition where the financial system is able to withstand shocks without giving way to cumulative processes which impairs the allocation of savings to investment opportunities and the processing of payments in the economy*". As one can easily notice, financial stability does not explicitly take into consideration only banking stability, but, on the other hand, its decisive role in the soundness of the financial sector is not denied.

According to Jacobson et al.(2001) financial stability is correlated with banking risk prevention, but it cannot be reduced to this typology of actions. Moreover, a financial system can be instable despite a satisfying allocation of financial resources.

In the same line of ideas, Crockett (1997) defines financial stability as the absence of stresses that have the potential to cause measurable economic harm beyond a strictly limited group of customers and counterparties.

In our opinion, it is important to define financial stability taking into consideration that specific state in which the financial system is able to: (1) allocate resources efficiently; (2) assess and manage financial risks, and (3) absorb shocks (Schinasi et al., 2004). The same author set up five key principles that need to be taken into consideration when trying to define financial stability: (1) financial stability is a wide concept covering various components of the financial system: infrastructure, markets, institutions; (2) financial stability not only involves resources allocation, risk management, savings mobilization, facilitating wealth accumulation, development and growth, but also an appropriate functioning of payment system, (3) the concept of financial stability is connected not only to the lack of financial crises but also to the ability of the financial system to restrain, contain, and cope with the emergence of imbalances before transforming into a threat to itself or economic processes; (4) financial stability should be couched in terms of the potential consequences for the real economy; (5) financial stability must be thought of as occurring along a continuum (Schinasi, 2004, pp. 7-8 ), is dynamic (both inter-temporal and innovative) being composed of many interlinked elements covering the macroeconomy, financial markets, financial

institutions and financial infrastructure (see the Figure 1). The analysis, assessment of financial stability and the gradual policy measures taken, as a reaction to the results obtained, in terms of prevention, remedial action or resolution, illustrate the financial stability framework.




*Source:* Houben, A., Kakes, J., Schinasi,2004, p.17

Figure no. 1 Framework for Maintaining Financial System Stability

Due to a lack of clear delimitation between the concept of financial stability, financial instability or crisis, a great number of specialists consider it easier to choose a negative approach to clarify the term: "...we define financial stability as the absence of instability ... the situation in which economic performance is not undermined by the price fluctuations of financial assets or because financial institutions are unable to meet contractual obligations ... (Crockett, 1997, pp. 55-96) or "... financial instability refers to situations (conditions) in which financial markets affect or threaten to affect economic performance ..." (Chant, 2003). All these conceptual definitions lack a clear benchmark to separate situations of stability from those of instability.

**Central bank objectives**

The role of central banks in terms of stability relies on a long and lasting tradition that tends to come out once again. Price stability objective of central banks is undoubtedly a very important element for a good functioning of economies, characterized by investors confidence and sustainable economic growth. Given that recent studies have shown that financial imbalances appear even in economies with low inflation rates, thus affecting investments and growth, and taking into consideration the evolution of capital markets and their high level of international integration, monetary authorities focused their attention on financial stability that became their second objective.

A literature review shows us the two main approaches of the relation price stability versus financial stability. While according to the conventional approach the two types of stability sustain one another in the long run, the new environment approach suggests that low and stable inflation rates can make the financial system become vulnerable to the evolution of assets prices. This relation is often seen as a potential compromise encouraged by some authors and criticized by others.

Despite a long history of central banking and of the management of financial crises, considerable controversy remains over the role of central banks in guaranteeing financial stability. A natural role of central banks in controlling financial stability is underlined by Paul Volcker in 1984: *A basic continuing responsibility of any*

*central bank – and the principal reason for the founding of the Federal Reserve – is to assure stable and smoothly functioning financial and payments systems. These are prerequisites for, and complementary to, the central bank's responsibility for conducting monetary policy as it is more narrowly conceived…To these ends, the US Congress has over the last 70 years authorized the Federal Reserve (1) to be a major participant in the nation's payments mechanism; (2) to lend at the discount window as the ultimate source of liquidity for the economy; and (3) to regulate and supervise key sectors of the financial markets, both domestic and international. These functions ate in addition to, and largely predate, the more purely "monetary" functions of engaging in open market and foreign exchange operations and setting reserve requirements; historically, in fact, the "monetary" functions were largely grafted onto the "supervisory" functions, not the reverse. (Volcker, 1984, p. 548)*

According to Volcker, the Federal Reserve was firstly the insurer of financial stability and secondly the manager of monetary stability, given the fact that a central bank is the only provider of legal means of payment and of immediate liquidity and banking system is the transmission mechanism of the monetary policy with an effect on the real economy. The interest to maintain the stability of banking system can be explained by the quest for sound financial institutions and stable financial markets.

Central bankers recognize the harmful effects of financial instability, such as: decreased market liquidity, excessive volatility in asset prices or banking and currency crises, reason why they have reconsidered financial stability as an objective complementing the price stability. Policy makers see price stability and financial stability as connected due to the fact that serious disruption in the financial system would affect the implementation and effectiveness of monetary policy, while macroeconomic stability helps reduce risks to financial stability (Houben, A., Kakes, J., Schinasi, G., 2004, p.17). On the other hand, price stability, the final objective of monetary policy, represents a necessary condition, though not sufficient to ensure financial stability.

The achievement of financial stability objective requires a continuous examination of potential risks and vulnerabilities threatening the health of the financial system and economic activity ( a clear typology of risks can be seen in the table below). As one can notice, these risks and vulnerabilities may develop endogenously within the financial system, but may also originate in the real economy. While endogenous imbalances can typically be influenced by the financial authorities through regulation, supervision or adequate crisis management, external disturbances can hardly be influenced.

Endogenous risks and vulnerabilities inside an economy have evolved during time developing in three main categories: financial institutions (related to credit, market, liquidity, interest rates and foreign currency exposures), markets (vulnerable to counterparty risk and asset price misalignments, runs and contagion.) and infrastructure-based vulnerabilities like, for example, operational failures, concentration risk and domino effects or risks in clearing and settlement in payment systems.

*Table no. 1*

**Sources of Risk to Financial Stability**

<table>
<tr><td>Endogenous<br>Institutions-based:<br>• Financial risks<br>  o Credit<br>  o Market<br>  o Liquidity<br>  o Interest rate<br>  o Currency<br>• Operational risk<br>• Information technology weaknesses<br>• Legal/integrity risk<br>• Reputation risk<br>• Business strategy risk<br>• Concentration risk<br>• Capital adequacy risk<br><br>Market-based:<br>• Counterparty risk<br>• Asset price management<br>• Run on markets<br>  o Credit<br>  o Liquidity<br>• Contagion</td><td>Exogenous<br>Macroeconomic disturbances:<br>• Economic-environment risk<br>• Policy imbalances<br>Event risk:<br>Natural disaster<br>Political events<br>Large business failures</td></tr>
</table>

| | |
|---|---|
| ***Infrastructure-based:***<br>• Clearance, payment and settlement system risk<br>• Infrastructure fragilities<br>    o Legal<br>    o Regulatory<br>    o Accounting<br>    o Supervisory<br>• Collapse to confidence leading to runs<br>• Domino effects | |

*Source:* Houben, A., Kakes, J., Schinasi,2004, p.19

Clearly defined or not in the statute of central banks, the objective of financial stability needs to find solutions to cover all these sources of risks and vulnerabilities and requires a continuous monitorization of both financial system and real economy.

**Conclusions**

Despite a lack of an agreement on a general accepted definition of financial stability, several key elements can be identified. Firstly, that financial stability is a large concept, embracing all dimensions of a financial system—infrastructure, institutions and markets. Thus, we can say that financial stability refers to the stability of each financial institution and, in the same time, to the relations between these institutions.

Secondly, financial stability can be referred to not only in terms of absence of financial crises, but also to the ability of the financial system to limit and deal with the emergence of imbalances before they constitute a threat to stability. Thus, financial stability entails both preventive and remedial dimensions (Scinasi G.J., 2009, pp. 20-22).

Thirdly, financial stability is not a synonym to an adequate process of allocating resources, transforming maturities, mobilizing savings and diversifying risks, but also that within this system money can adequately fulfill its role as a means for transactions, a unit of account and a store of value. In other words, financial and monetary stability overlap to a some important extent.

Ensuring systemic financial stability has become a natural concern and a priority objective for central banks, the leaders of national financial systems. Being an extensive, multidimensional concept, stability concerns both the security and solidity of individual institutions, but especially the institutional framework and macroprudential measures necessary for their achievement.

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