Vol.05 Issue-08, (August, 2017) ISSN: 2321-1784
International Journal in Management and Social Science (Impact Factor- 6.178)

WHAT IS FINANCIAL STABILITY?

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ABSTRACT

The increased focus on financial stability issues the definition of "financial stability" has generated a fair amount of debate among academics, market participants and policy makers. Within this context, we will try to the search for a useful definition of financial stability by first reviewing the existing literature on the subject before proceeding to discuss the definition of financial stability we analyze the principles and assumptions underlying the chosen definition as well as the implications for different work in the area of financial stability.

Keywords; Financial Stability, Financial Instability, Systemic Risk.

INTORDUCTION

The global financial crisis has changed the way policy makers' view and approach the issue of financial stability. The crisis has shown that even with price and macroeconomic stability, financial instability is a distinct possibility. Financial stability, therefore, needs to be pursued as an explicit policy variable. The emerging paradigm, post-crisis, is aimed at a more holistic approach to financial sector regulation with focus on systemic interconnectedness among various financial sector entities, apart from micro prudential surveillance of individual institutions and use of macro prudential instruments to address the systemic risks. Many countries are in the process of redefining the regulatory objectives and mandates of various regulators. The nature and intensity of the impact of the global crisis on India was very different from those in some of the developed economies. The financial sector remained resilent and functioning, despite some volatility. There was no material stress on the balance sheets of banks and non-banking financial companies on account of toxic financial instruments. There were no solvency issues with any of the financial institutions requiring direct financial support from the Government.

Though the direct impact of the crisis on India was relatively muted, the knock-on effects on the Indian economic and financial system were discernible, indicative of India's rapid and growing integration into the global economy. The economy experienced a significant slowdown in 2008-09 in comparison with the robust growth performance in the preceding five years. Widening credit spreads and higher liquidity premia reflected the tightness of the domestic financial market conditions reflecting stress in the

international financial market during Q3 2008 and Q1 2009. The Indian rupee also weakened significantly and the equity markets experienced sharp corrections However, quick and aggressive policy responses both by the Government and the Reserve Bank in the post-Lehman scenario mitigated the adverse impact of the global financial crisis. A number of conventional and unconventional measures were swiftly taken to improve domestic and foreign exchange liquidity and to contain excessive volatility. The domestic markets returned to normalcy much ahead of the global markets with a significant reduction in risk and a rebound in market activity. There was also an early recovery in economic growth.

The immediate challenge for the Indian economy and the financial sector is to reclaim the pre-crisis configuration with minimal efficiency loss. The process of exiting from an accommodative fiscal and monetary stance will be a test of the resilience of the system. In the above backdrop, the stability of banking sector means that the banks should remain well capitalized in terms of regulatory capital adequacy ratios, with higher core capital and sustainable financial leverage, and this contributes to financial stability. Stress tests for credit and market risk should reveal banks' ability to withstand unexpected levels of stress. The balance sheets of households and corporate should suggest that the financial system is not exposed to the risk of large leverages. The financial infrastructure should be robust and markets well functioning.

WHAT IS FINANCIAL STABILITY?

In recent years, financial stability issues have been receiving priority attention from policy makers around the world. One main catalyst for this trend was the East Asian financial crisis of the late 1990s. Following that turmoil, the World Bank and the International Monetary Fund (IMF) introduced the Financial Sector Assessment Program (FSAP) in 1999, aimed at assessing regularly the strengths and weaknesses of financial systems in their member countries.

In addition, several international forums devoted to financial stability issues have emerged or become more active, including bodies such as the *Financial Stability Forum*, *Basle Committee on Banking Supervision*, *Financial Stability Institute, Committee on the Global Financial System, Committee on Payment and Settlement Systems, International Association of Insurance Supervisors, International Accounting Standards Board, International Organization of Securities Commissions and the International*

Association of Deposit Insurers. There is also the *Counterparty Risk Management Policy Group*, a private sector organization devoted to fostering financial stability.

Well aware of the fiscal, economic and social costs of financial crises, many of these bodies have devoted large amounts of time and energy to developing various International Standards and Codes, which are essentially compilations of best practices in different areas related to the objective of fostering financial stability. A substantial portion of these efforts has been directed towards reinforcing different aspects of financial sector infrastructure (e.g. legal framework, financial supervision, accounting, auditing and financial reporting).

At the country level, many central banks and regulatory authorities have also taken financial stability more seriously, establishing Financial Stability Departments and introducing the regular publication of Financial Stability Reports, focused on assessing potential risks to financial stability.

Despite this increased focus on financial stability issues, it is notable that a widely accepted definition of "financial stability" does not exist and the concept has generated a fair amount of debate among academics, market participants and policy makers. Within this context, we will try to the search for a useful definition of financial stability by first reviewing the existing literature on the subject before proceeding to discuss the definition of financial stability we analyze the principles and assumptions underlying the chosen definition as well as the implications for different work in the area of financial stability.

DEFINITIONS OF FINANCIAL INSTABILITY

Mishkin (1999) 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".* 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 (Mishkin, 1997 and Mishkin, 2000). Mishkin suggests that financial stability arises when shocks cause disruptions to the flow of information. However, since information failures pervade *all* financial transactions (even without shocks), it is better to interpret this definition in terms of shocks acting to aggravate existing information asymmetry up to the point where normal financial intermediation ceases.

Davis (2001) 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"*. Davis further pointed out that financial crises would have major adverse effects on economic activity and fostering financial stability is tantamount to managing systemic risk. Although he contends that episodes of asset price volatility should be excluded from this definition, it is acknowledged that systemic risk may be manifested in the form of the failure of market liquidity and a breakdown of market infrastructure. Finally, this definition also emphasizes the role of the financial system in supporting the real sector through the provision of credit and payment services.

Ferguson (2003) described financial instability as *"a situation characterized by …three basic criteria: i) some important set of financial asset prices seem to have diverged sharply from fundamentals; and/or ii) market functioning and credit availability, domestically and perhaps internationally, have been significantly distorted; with the result that, iii) aggregate spending deviates (or is likely to deviate) significantly, either above or below, from the economy's ability to produce"*. This definition has a couple of interesting features. First, unlike Davis (2001), Ferguson incorporates the distortion of asset prices into his definition of financial instability. Second, there is explicit coverage of the ultimate impact of financial instability on the macro economy, in terms of the impact on aggregate spending.

Chant (2003) argues that financial stability could best be understood by considering its absence, i.e. financial instability. He defined financial instability as *"…conditions in financial markets that harm or threaten to harm an economy's performance through their impact on the working of the financial system".* He pointed out that the term "financial instability" encapsulates several different kinds of such instability, ranging from banking crises to stock market crashes. Hence, different forms of instability affect different parts of the financial system and may also differ in their consequences. Further, Chant proposed that financial instability should be distinguished from other forms of instability such as macroeconomic instability. The primary difference is that financial instability has its immediate source in financial markets (broadly defined) while macroeconomic instability is often due to aggregate demand or supply shocks. Finally, Chant points out that financial market are characterized by constant changes in prices and conditions, all of which would not qualify as financial instability. He therefore proposes that financial instability should be viewed in terms of the potential impact of changes in financial conditions on the real economy.

Allen and Wood (2006) referred to financial instability as *"episodes in which a large number of parties, whether they are households, companies or (individual) governments, experience financial crises which are not warranted by their previous behaviour and where these crises collectively have seriously adverse macro-economic effects".* Financial stability is then described as *"a state of affairs in which an episode of financial instability is unlikely to occur…."* Allen and Wood include the non-financial sector in this definition, explaining that financial institutions are not the only entities which experience financial stress. Although it has some validity, this viewpoint results in a rather broad definition of financial stability, as it incorporates institutions which the central bank cannot expect to influence directly to promote financial stability. In addition, Allen and Wood do not consider episodes of asset price bubbles as financial instability and they introduced the concept of "innocent bystander", suggesting that households and companies suffer unduly in a financial crisis, "even though they have learned how to behave in such a way that they are not afflicted by financial crises". This concept of "innocent bystander" is somewhat simplistic, as many cases of financial distress have involved households and businesses behaving imprudently. While some "innocent" households and businesses will suffer from the adverse effects of financial crises (even though they have strong balance sheets), many more will be culpable as we have seen in past episodes of financial crises.

DEFINITIONS OF FINANCIAL STABILITY

Crockett (1997) 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"*. Implicitly, this definition takes account of the condition of financial intermediaries and markets, but not financial infrastructure. Also, in contrast to some other writers (e.g. Davis 2001 and Allen and Wood, 2006), the statement considers periods of asset price volatility as evidence of instability. Finally, it contends that financial stability exists if the financial system can continue to function normally *without* "outside assistance". Hence, it excludes situations where financial instability is only avoided through the provision of financial or other kinds of support to financial institutions by the regulatory or political authorities.

Lager (1999) posits that *"the objective of financial system stability could therefore be defined, in broad terms, as the avoidance of disruptions to the financial system that are likely to cause significant costs to*

real output”. He went on to say that *“such disruptions might have their origins in difficulties facing financial institutions or in disturbances in financial markets”*. Again, there is emphasis on the impact of financial instability on the real economy and recognition is also given to disruptions in financial markets (in addition to cases of distress in financial intermediaries).

According to **Foot (2003),** *“…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)”.* This is one of the few definitions which mention monetary stability as an essential part of financial stability. Foot’s definition is notable in interpreting 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, a position similar to the arguments of Large (2003) who described financial stability mainly in terms of maintaining confidence in the financial system.

Padoa-Schioppa (2002) contends 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”*. The emphasis here is on the shock-absorbing capacity or resilience of the financial system, so that it can continue to carry out its essential functions of resource allocation and provision of payments services. The reference to payments services here is important because like disruptions to the intermediation function, disturbances to the payments system have the capacity to inflict adverse effects on the level of economic activity (Davis, 2001).

Schinasi (2004) offers the following definition: *“A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events”*. This statement is unique in viewing financial stability as a continuum, rather than a single, static condition . This implies that financial systems operate within a corridor, with stability and instability at opposite ends. Movements towards the “unstable” end of the corridor could then be due to an accumulation of imbalances (or vulnerabilities) within the financial system or because of exogenous shocks. Like some writers cited earlier, Schinasi points out that instability should refer to cases where the financial system impedes the normal functioning of the real economy.

As many central banks established financial stability departments and began publishing *Financial Stability Reports*, they have also adopted specific definitions in order to provide some guidance to their objective of safeguarding financial stability. Table 1.1 below displays some of these definitions from selected central banks around the world.

TABLE 1.1 Selected Central Bank Definitions of Financial Stability

CENTRAL BANK	**DEFINITION**	**SOURCE**
CENTRAL BANK OF ARGENTINA	"Financial stability is a state of affairs in which the financial services sector can channel the savings of the population and provide a nationwide payments system in a manner that is efficient, secure and sustainable over time"	Financial Stability Bulletin Second Half 2007
THE CENTRAL BANK OF BAHRAIN (CBB)	"financial stability is a situation where the financial system is able to function prudently, efficiently and uninterrupted, even in the face of shocks"	Financial Stability Report
RESERVE BANK OF AUSTRALIA	"A stable financial system is one in which financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors and by doing so, helps promote growth in economic activity"	http://www.rba.gov.au
AUSTRIAN NATIONAL BANK	"In its most concise definition, financial stability refers to a situation in which the financial markets fulfill their allocation function in a satisfactory manner, even in the case of shocks"	http://www.oenb.at/
DEUTSCHE BUNDESBANK	"The Bundesbank defines financial stability as the financial system's ability to perform its key macroeconomic functions well, even in stress situations and during periods of structural adjustment".	http://www.bundesbank.de

CZECH NATIONAL BANK	"The CNB defines financial stability as a situation where the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, while showing a high degree of resilience to shocks'	Financial Stability Report
EUROPEAN CENTRAL BANK	"Financial stability can be defined as a condition in which the financial system—comprising of financial intermediaries, markets and market infrastructures—is capable of withstanding shocks and the unraveling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities"	Financial Stability Review
BANK OF FINLAND	"The financial system is stable and reliable when it is able to smoothly conduct its core tasks—including the intermediation of financing, transmission of payments, pricing of financial instruments and allocation of risks. In addition, the risk-bearing capacity of major financial institutions and infrastructure must be sufficient to withstand even severe disruptions in the environment"	Financial Stability Report
NORGES BANK (CENTRAL BANK OF NORWAY)	"Financial stability implies that the financial system is robust to disturbances in the economy and can channel capital, execute payments and redistribute risk in a satisfactory manner"	Financial Stability Report

BANK OF JAPAN	"Financial system stability" refers to a state in which the financial system functions properly, and participants, such as firms and individuals, have confidence in the system"	http://www.boj.or.jp
RESERVE BANK OF SOUTH AFRICA	"Financial stability can be described as the absence of the macroeconomic costs of disturbances in the system of financial exchange between households, businesses and financial-service firms"	http://www.reservebank.co.za/
CENTRAL BANK OF SRI LANKA	"Financial system stability means a safe and secure financial system which is able to withstand external and internal shocks".	http://www.cbsl.gov.lk
SWISS NATIONAL BANK	"A stable financial system can be defined as a system whose individual components – financial intermediaries and the financial market infrastructure – fulfill their respective functions and prove resistant to potential shocks."	http://www.snb.ch/
CENTRAL BANK OF ICELAND	"Financial stability means that the financial system is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments and to redistribute risks appropriately".	Financial Stability Report

An examination of these definitions indicates a gradual convergence of views on financial stability, at least among the central bankers charged with its attainment:

- Many central bank definitions attempt to define financial stability (rather than instability).
- Many of them place emphasis on the key functions of the financial system (e.g. provision of credit and payment services).
- There is emphasis on shocks that disrupt the functioning of the financial system and by extension, on the resilience of the financial system to these shocks.

- Many of them highlight the importance of confidence in the financial system.
- Financial system is also a cumulative process.

COMMONALITIES AND DIFFERENCES IN DEFINITIONS

Our review of the academic literature has revealed the wide diversity in definitions of financial stability (and *instability*). Nonetheless, some common elements could be identified.

First, there is frequent reference to the *functions of the financial system* including its role in channeling savings into productive investment (e.g. Mishkin, 1999; Davis, 2001; Padoa-Schioppa, 2002) or its central role in the payments system (Davis, 2001; Padoa-Schioppa, 2002). Second, there is recognition that instability often arise from unforeseen shocks impacting the financial system (e.g. Mishkin, 1999; Padoa-Schioppa, 2002; Schinasi, 2004). Third, many definitions recognize explicitly, the possible impact of financial instability on the economy at large (e.g. Lager, 1999; Ferguson, 2002; Foot, 2003; Chant, 2003; Schinasi, 2004; Allen and Wood, 2006). Lastly, there is reference to financial stability as entailing confidence in the financial system (e.g. Crockett, 1997; Foot, 2003; Large, 2003)

Aside from the aforementioned division between those defining financial stability and those defining instability, there are additional differences in the definitions we have reviewed. For instance, Mishkin (1999) is unique in emphasizing the role of asymmetric information in financial crises while Schinasi (2004) stands out in its view of financial stability as a continuum. Foot (2003) also explicitly incorporates monetary stability into his definition of financial stability.

SHOULD WE HAVE A SINGLE, WIDELY-ACCEPTED DEFINITION?

The brief survey of definitions suggests that a widely accepted definition of financial stability is still far away (if it will ever be found!). Is this likely to have any implications for the conceptual and operational development of this topic? We are of the view that the practical impact would be minimal. While a definition would help in the continued development of an analytical framework or for determining the operational parameters for financial stability work, the absence of a single, widely-accepted definition would not necessarily prevent the development of such frameworks. As shown above, central banks are increasingly settling on individual definitions which should provide sufficient guidance to operational work at the country level. In addition, central bank definitions show certain commonalities, raising the probability of identifying common grounds among policy makers.

On a more general note, it is worth noting that the discipline of economics itself is replete with concepts and topics for which the search for a single consensual definition has been virtually futile. For instance, "econometrics" is a well developed subject matter, combining economics with statistical and

mathematical methods, despite the fact that no widely-accepted definition exists. Commenting on the definition of econometrics, Kennedy (1995, p.1) writes: "*Strange as it may seem, there does not exist a generally accepted answer to this question. Responses vary from the silly "Econometrics is what econometricians do" to the staid "Econometrics is the study of the application of statistical methods to the analysis of economic phenomena", with sufficient disagreements to warrant an entire journal article devoted to this question"*. More tellingly, "economics" has no single, widely-accepted definition, despite the popularity of Lionel Robbins' definition among many students (and teachers) of introductory economics.

The lack of financial stability could be seen along a range of possibilities, including:

♦ *Financial fragility*, where vulnerabilities are evident but the financial system is somehow managing to carry out its functions

♦ *Financial instability,* where vulnerabilities are beginning to impede the delivery of financial services

♦ *Financial crisis,* where the normal functions of the system cease. This is the most serious form of instability (see Chant, 2003).

In determining whether the financial system is stable or not, we should consider four key issues:

- What is the current financial condition and performance of the different components of the financial system?
- What is the current financial condition of the non-financial sector (households and business enterprises)?
- What are the vulnerabilities in the balance sheets of both the financial and non-financial sectors?
- How are these vulnerabilities being managed and how resilient are the financial and non-financial sectors to shocks?

CONCLUSION

Finally, it should be acknowledged that it is impossible to establish a foolproof framework for financial stability. Financial markets will always experience volatility and individual financial institutions will fail now and again. Hence, the goal of financial stability is not to prevent the failure of individual financial institutions. The goal of financial stability is to ensure that such failures do not result in a significant disruption of the normal functioning of the financial system.

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