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# CENTRAL BANKS AND FINANCIAL STABILITY

Literature review

**Keywords**
*Central banks*
*Financial stability*
*Price stability*

**JEL classification**
*G30, G32, G38, G39*

## Abstract

*Financial stability is a feature of the financial system, reflecting its ability to determine an efficient allocation of the resources and to manage financial risk by its own self-regulating mechanisms. Since the condition of financial systems changes over time, due to various shocks that components suffers, financial stability is a dynamic feature, but the system itself is constantly attempting to recover under the action of specific auto regulatory mechanisms. It is generally accepted that central banks play an important role in ensuring financial stability, there are a number of specific features that can help them achieve financial stability. Recent phenomena such as deregulation, globalization, the intensification of innovation, and so on, have supplemented the functions of central banks and at the same time, led to an intensification of links between banking and other large sectors of the financial system: insurance and financial markets.*

*The objective of this article is to present the different views in the literature on the role of the central bank in ensuring financial stability and the new challenges that she must confront in assuming this new mandate. The role of central banks in ensuring financial stability is in the forefront and should be expanded beyond the traditional functions of stability, which determined that monetary and stability policies to converge. Moreover, due to vulnerabilities manifested by the financial markets in recent decades and that capital flows have become more intense, these vulnerabilities may spread rapidly, increasing the fragility of all markets and, for this reason, ensuring financial stability has become a key objective of public policies. Especially, since the stability of financial systems stimulates economic development and improved living standards, the competent authorities pays a particular attention to these issues.*

Regarding the content of the concept of **"financial stability"** researchers and central bankers have not yet reached a common view, however, the notes about this notion starts from the opposed notion - "financial instability".

The opinions of various authors such as **J. Chant**, believe that "financial instability refers to conditions in the financial markets that affect or threaten to affect economic performance through the impact they have on the financial system" *(Chant, 2003, p.3-4).* The definition given by *A. Crockett* of financial stability is the "absence of instability" and "the situation in which economic performance is not affected by the fluctuations in asset prices or the inability of financial institutions to fulfil their obligations" *(Crockett, , 1997, p.1-2).*

Along with these authors, in some official publications appeared defined "the term of **financial stability** as reflecting the status in which financial system works effectively, being able to allocate efficiently the resources, to dissipate risks and ensure the settlement of debts, even in situations of shock, crisis or major structural changes" *(official publication under the Bundesbank* **-** *Deutsche Bundesbank, 2003, p.8).*

The statements of the *National Bank of Romania* on financial stability define this concept as "a situation where the financial system is able to attract and place funds effectively and to withstand shocks without hurting the real economy" *(Isărescu, 2006, p .8).* In the same vein, the first "Financial Stability Report" prepared by BNR appears the definition of financial stability at large "as the feature of the financial system to withstand systemic shocks on a sustainable basis and without major disruption, to allocate efficiently the resources in economy and to identify and manage risks[1] *"(BNR, 2006, p.7).*

Defined in relation to the situation in the financial markets, **financial stability** refers to the situation in which the transactions in financial market are affected by prices normally established according to demand and offer, and financial instability occurs when are registered big variations in financial asset prices.

On the same line of ideas, **Mishkin** believes that financial stability is recorded when financial systems are able to provide efficient and uninterrupted allocation of savings to meet investment opportunities[2] *(Mishkin, 1991, p.30).*

All these views allow us to conclude that *"financial stability is a state in which the economic mechanisms of price formation, valuation, and financial risk management division work effectively well to help increase economic performance."*

**Financial stability is a feature of the financial system**, reflecting its ability to determine an efficient allocation in space and time of the resources and to assess and manage financial risk divided by their correctional mechanisms. The financial system is considered stable if it satisfies **two fundamental requirements** namely: is able to conducive to improving economic performance and allows the elimination of imbalances caused by endogenous factors of the unanticipated or adverse events.

Thus defined, within the concept of **"financial stability"** are included financial markets and their infrastructure, and since they are in constant interrelation and connection, any imbalance in the operation of one propagate over the other and vice versa. Whereas the status of financial systems change over time, due to various shocks that components suffer, **financial stability is a dynamic feature,** but the system itself is constantly attempting to recover under the action of specific autoregulatory mechanisms.

From a practical point of view, ensuring financial stability is important because this state has **beneficial effects on economic and social life**. A stable financial system reduces information and transaction costs for all participants in economic life. All of the

[1] Cerna, Siviu; Donath, Liliana; *"Stabilitatea financiară"*, Editura Universității de Vest, Timișoara, 2008, p.1-4;

[2] Căpraru, Bogdan; *"The central bank and the financial stability"*, Faculty of Economics and Business Administration "Al. I. Cuza" University of Iasi , 2009, Iasi, Romania, http://anale.feaa.uaic.ro/anale/resurse/fin1capraru.PDF;

foregoing helps to define **financial stability** "as the feature of the financial system, which consists in its ability to absorb financial imbalances that occur due to endogenous or exogenous events, significant and unanticipated, thereby facilitating the achievement of economic performance". A stable financial system **does not necessarily imply the absence of crisis**, but suppose the prevention of imbalances that could affect the integrity of the financial system, with consequences for real economic processes[3].

It is widely accepted that **central banks** play an important role in ensuring financial stability, there are a number **of specific features** that can help them achieve financial stability as the payment system, management and monitoring, regulation and banking supervision, deposit insurance, function of lender of last resort.

Recent phenomena such as deregulation, globalization, the intensification of innovation, and so on, **have supplemented the functions of central banks** and at the same time, led to an intensification of links between banking and other large sectors of the financial system: insurance and financial markets. What prompted the central bank to take on new tasks and functions is the defragmentation of the capital markets and of these new assignments, those that require a greater involvement of central banks in ensuring financial stability is the monitorization of financial asset prices and the supervision of financial conglomerates *(Patat, 2000, p.17).*

In the literature it is stated that, in achieving the two objectives, namely price stability and financial stability, there is some compromise because in medium and long term this objectives converge, being compatible. Opinions on this compatibility stated that once the stabilization of inflation is at low levels, it creates a new economic environment in which financial stability is not guaranteed - "New environment hypothesis*" (Isărescu, 2006, p. 10).* It is also widely accepted that both financial instability and, in particular, the banking crisis may be accompanied by significant macroeconomic costs, which require the involvement of the central bank *(Hoggar, Reis, Saporta, 2002).*

Despite to what is stated, there still exists authors who consider that the **only objective of the central bank should be price stability** and that between financial stability and price stability exists incompatibility *(Mishkin, 1997 Goodhart, 2000; Jacobson, Molin, Vredin, 2001).* Despite the fact that the authors **Franziska Richter and Peter Wahl** named one principal objective of central banks being price stability, they believe that central banks are able, through their respective mandates, to conduct bilateral objectives such as supporting economic growth, job creation work **-** maintaining a stable exchange rate and financial stability *(Richter, Wahl, 2011, p.6).*

A strong argument that makes us to subscribe to the idea of complementarity between price stability and financial stability is that experience has shown that banking crises were due to unfavourable macroeconomic situation, combined with bad macroeconomic policies pursued by the authorities *(Kindleberger, Laffargue 1982, Schwartz, 1986; Goodhart, Sunirand, Tsomocos, 2004).* Moreover, *Bardsen and other authors (2006)* argue about the role of central banks in achieving **financial stability**, which requires an analysis of potential threats to stability assessment, of the current situation, making predictions and action in the direction of risk management[4]. Achieving both objectives should ensure solid economic growth and sustainable development.

**The role of central banks in financial stability returns to the forefront** and has expanded beyond the traditional functions of stability, which determined the conversion of the monetary and stability.

According to **BIS reports**, there are **three important reasons** why central banks should intervene in financial stability policy namely: financial instability could affect the macroeconomic environment, with important

[3] Cerna, Siviu; Donath, Liliana; *"Stabilitatea financiară"*, Editura Universității de Vest, Timișoara, 2008, p.9-14;

[4] Albulescu, Claudiu, Tiberiu; *"Stabilitatea sectorului financiar în condiţiile aderării României la U.E.M."*, Editura Universităţii de Vest, Timişoara, 2010, p. 106;

consequences for economic activity, price stability and monetary policy transmission process, central banks as lenders of last resort which provide liquidity in the economy and a liquidity adequacy is essential for financial stability. In addition, the development of functions of central banks in the monetary policy provides a macroeconomic perspective and knowledge of financial markets, institutions and of infrastructures necessary for the exercise of prudential functions[5]. The exercise by the central bank of supervisory function is essential not only to ensure of financial stability, but also to ensure monetary stability.

New circumstances cause some economists to say that a central bank should deal primarily with ensuring financial stability and only secondly with the development and implementation of monetary policy *(Volcker, 1984, p. 548).* The reason behind this statement is that monetary policy cannot be fully effective if it is based on predictable transmission mechanisms, which require a sufficiently stable financial environment. Mutually, price stability - the ultimate objective of monetary policy is necessary but not sufficient to ensure financial stability[6].

**Tommaso Padoa-Schioppa** states that the objective of financial stability is absolutely normal to be listed in the responsibilities and concerns of central banks because, over time, maintaining stability of the financial sector, banking supervision and monetary policy formed only one composite of the central authority functions *(Padoa-Schioppa, 2002, p. 2).* The author considers that there should be **no conflict** between price stability and financial stability, but only some compromises in the short term and only in certain circumstances. Although long-term synergies between the two objectives and an effective monetary policy should prevent financial instability, this is not guaranteed[7].

**Liisa Halme,** Bank of Finland, also believes that one of the priority responsibilities of the central banks is to **maintain financial market stability**, although there are differences in the implementation of this task. The differences arise mainly because of the basic functions of central banks and the supervisory institutional structures. The author believes that **corporate governance** plays a crucial role in the stability of the financial sector and that is why central banks should pay special attention to this area[8].

Endorses the view of the authors above, **Martin Čihák** believes that the main **reasons** why central banks should pay a special interest to the stability and solidity of the financial sector, are high costs emergence of a potential crisis, the increasal of their apparition frequency, the explosive growth in the volume of transactions and the complexity of the instruments which exist in market *(Čihák, 2006, p.6).*

In his opinion, the development of **Financial Stability Report** by central banks in each country **can contribute to ensure financial stability** that helps to improve awareness of the risks to financial intermediaries in the economic environment; alert financial institutions and market participants of a possible collective impact generated by their individual actions; this is a way of establishing a consensus on financial stability and improving financial infrastructure and clarifies the role of central banks to protect financial system[9].

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[5] Bank for International Settlements (BIS), Raportul *"Banca Centrală şi Stabilitatea Financiară"*- http://www.bis.org/publ/othp14_es.pdf, p. 1-3,

[6] Cerna, Siviu; Donath, Liliana; *"Stabilitatea financiară"*, Editura Universității de Vest, Timișoara, 2008, p.9-14;

[7] Tommaso Padoa-Schioppa; "*Central Banks and Financial Stability:Exploring a Land in Between*", Central Banking Conference, p.44; http://www.ecb.de/events/pdf/conferences/tps.pdf;

[8] Halme, Liisa; *"Bank Corporate Governance and Financial Stability"*, Bank of Finland; p.68-73; https://www.bankofengland.co.uk/education/ccbs/publications/pdf/finalaw3book.pdf#page=34;

[9] Cihák, Martin; *„How Do Central Banks Write on Financial Stability"*, International Monitory Found; p. 13; http://www.imf.org/external/pubs/ft/wp/2006/wp06163.pdf;

**Michael Bordo and David Wheelock** believe that a central bank which has as sole objective price stability, could not respond in effective situations of financial instability, unless the inflation target is threatened. Their vision states that the direction of monetary policy to maintain price stability would decrease only to a certain level the incidence and severity of financial instability *(Bordo, Wheelock, 1998, p.41).*

On the other hand, **Anna Schwartz** argues that a central bank which is able to maintain price stability will ensure and financial stability through its function of lender of last resort *(Schwartz, 1988, p 53.).*

**Peter Spicka** states also that central banks are interested in developing the financial system because they require individual participants in the financial markets for liquidity proportionality with which to cope financial imbalances (*Spicka, 2007, p.7).*

According to the previous afirmations most of the authors stop to specify the objectives held by central banks to price stability and financial stability, but some authors extend their attributions in terms of ensuring sustainable economic growth and employment work.

Central banks can perform a **variety of functions** that can differ depending on the degree of economic and institutional development of the country. These are not all limited to achieving and maintaining price stability **can be extended** to provide macro-prudential supervision, counseling and representation functions, conventionally established among all central banks.

Regarding financial stability, there is not existing a symmetry of central bank's role in the crisis stage outburst not its posterior. Thus, **before** a severe financial disturbance, the central bank can only issue **warning signals**, but can not avoid expanding credit market, and on the other hand, **post-crisis**, the bank can **provide liquidity** in the economy as a lender of last resort.

Although it is known the importance of financial stability in the economy, there are still differences on what constitutes the contribution of central banks in this regard[10].

**Erlend Walter Nier** believes that expanding the roles of central banks beyond the traditional ones can increase the overall efficiency of the financial system for the development of new tools and regulator methods that can reduce the systemic risk. In his opinion, if central banks have an important role in financial stability, they will have a stronger influence in the prudential regulation of individual institutions and will benefit robust mechanisms to ensure transparency, accountability and independence in financial stability *(Nier, 2009, p.45).*

**Masaaki Shirakawa** argues that a central bank who does not have responsibilities in financial regulation and supervision and has no direct access to information on individual institutions may not be able to ensure financial sector stability *(Shirakawa, 2010, p. 12).* This issue becomes more discussed with the economic crisis because this class of information from macroeconomic has delayed the adoption of decisions to macroeconomic level and awareness of the close connection between financial stability and price stability.

**Transparency and accessibility** to information are intended to increase investor access to the market and reduce risks from financial market, mainly as a result of financial innovations in recent years. But the publication of data and statistics is insufficient if not accompanied by effective analysis which reveal the shape of reality and avoid different opinions creator of hazard[11].

*Igvnes* states that regardless of their positions in this new target, central banks should have **the instruments, skills and mechanisms of action**, that this objective should be compatible with the duties held in **the monetary policy** and it is important for the delimitation of

[10] Gheorghe, Carmen-Adriana; *"Financial stability and the role of central banks"* , Bulletin of the *Transilvania* University of Brasov , Vol. 4 (53) ,No. 2 – 2011; http://webbut.unitbv.ro/Bulletin/Series%20VII/BULETIN%20VII/05_2%20Gheorghe.pdf;

[11] Shirakawa, Masaaki; *"Macroprudence and the Central Bank"*, Bank of Japan, p. 1-16, 2009, http://www.bis.org/review/r091223a.pdf,

functions of each authority involved in financial stability policy in order to facilitate the decision making[12].

The crisis has exposed the limits of preventive policy held by central banks and macroeconomic models supported by them and therefore they will have to expand an important role in financial regulation and supervision and exercising **macroprudential function** *(Caruana, 2011, p.10).* In 2012, **Choongsoo Kim** said that the most important lesson drawn from the recent financial crisis was that the monetary authorities have analyzed their **ability to choose options** in monetary policy to counteract the negative effects of the crisis, and to avoid future risk and financial disturbancesand; all this correlated with a profound awareness of the link between the real and financial sector. This link requires the creation of a new international architecture and a new economic policy framework *(Kim, 2012, p.3).*

Economic and financial crisis was the main outcome attaching a new mandate of the central bank with price stability namely the responsibilities that must be met in terms of financial stability. Awareness of the importance of financial sector soundness held in the economy determined some authors to express their views saying that the ultimate goal should be to replace the first, or to be the central banking authorities powers, respect the two objectives alike.

However, extending the powers of central banks should be accompanied by a series of appropriate monetary policy instruments, whereas handling the interest rate is insufficient in the current conditions. At present, it places special emphasis on the powers of the central bank in the activities of micro-and macro-prudential supervision, relationship with government institutions and reform of institutional framework which facilitates future action. However, it is widely accepted that central banks play an important role in ensuring financial stability.

[12] Ingves, Stefan; *"El buen gobierno de los bancos centrales y la estabilidad financiera"*, Bank of International Settlements, May 2011, http://www.bis.org/publ/othp14_es.pdf;

## CONCLUSIONS

In light of the globalization of financial flows and the increasing degree of integration of financial markets, financial stability has become an increasingly discussed topic among researchers in the economic and specialists in financial institutions.

**Financial stability** is a **feature of the financial system**, reflecting its ability to determine an efficient allocation in space and time of the resources and to assess and manage financial risk divided by their correctional mechanisms. Within the **concept of "financial stability"** are included financial markets and their infrastructure, and since they are in constant interrelation and connection, any imbalance in the operation of one propagate over the other and vice versa. Whereas the status of financial systems changes over time, due to various shocks that suffer elements components, **financial stability is a dynamic feature**, but the system itself is constantly attempting to recover under the action of specific autoregulatory mechanisms.

From a practical point of view, ensuring financial stability is important because this state has beneficial effects on economic and social life. A stable financial system reduces information and transaction costs for all participants in economic life. All of the foregoing helps to define financial stability "as the **feature of the financial system**, which consists in its ability to absorb financial imbalances that occur due to endogenous or exogenous events, significant and unanticipated, thereby facilitating the achievement of economic performance".

It is widely accepted that **central banks play an important role in ensuring financial stability,** there are a number of **specific features** that can help them achieve financial stability as the payment, system management and monitoring, regulation and banking supervision, deposit insurance, function of lender of last resort. Recent phenomena such as deregulation, globalization, the intensification of innovation, and so on, **have supplemented the functions** of central banks and at the same time, led to an intensification of links between banking and other large sectors of the financial system: insurance and financial markets.

Since the **price stability is recognized as the main objective of central banks** in the literature it is discussed the relationship between this goal and the stability of the financial system. Thus, it is noted that in achieving two objectives, namely price stability and financial stability, there is some compromise because in medium and long term objectives, these converge, being compatible. Opinions on this compatibility stated that once the stabilization of inflation is at low levels, it creates a new economic environment in which financial stability is not guaranteed. Despite to what is stated, there still exist authors who consider that the only objective of the central bank should **be price stability** and between this and financial stability exists incompatibility.

The interest of central banks in financial stability is explained by the fact that monetary policy cannot be fully effective unless if it is based on expected transmission mechanisms, which requires a sufficiently stable financial environment. Mutually, price stability, the ultimate objective of monetary policy is a necessary but not sufficient to ensure financial stability. It is believed that **between price stability and financial stability exists complementary**, since many banking crises were caused by unfavorable macroeconomic situation, combined with bad macroeconomic policies pursued by the authority. Thus, a monetary policy which have as objective price stability, reduces this risk. Central banks have a variety of instruments which allow achieving the objective of price stability and financial sector stability.

Although it is true that **financial stability is not usually an explicit objective** of modern central banks, systemic financial instability can cancel their performance in achieving price stability. That because it creates the need to inject additional liquidity into the banking system, a banking crisis may directly affect financial stability. Hence there exists **complementarity between price stability and financial stability,** although achiving the first one does not necessarily imply achieving the latter objective.

**The role of central banks in financial stability returns to the forefront** and has expanded beyond the traditional functions of stability, which determined the conversion of the monetary and stability. Moreover, due to vulnerabilities exhibited by financial markets in recent decades and that capital flows through more intense, these vulnerabilities can spread rapidly, increasing the fragility of all markets, **financial stability** has become a key objective of public policies. Especially since the stability of financial systems stimulate economic development and improved living standards, the competent authorities shall take particular attention to these issues.

In order to ensure financial stability, central banks have a number of traditional features **called financial stability functions.** The contents of these functions relate to the ability of central banking whith the deposit-guarantee operation of payment systems, the function of lender of last resort, supervision and regulation of the banking sector. Poor exercise of these functions can lead to adverse economic phenomena and thus to submitting financial system risks and vulnerabilities.

The recent financial crisis has called into question the role of central banks in the prevention, management and combating serious financial imbalances. As the evolution of the crisis, several central banks had to deal with unusual situations calling for a strong **expansion of tranditional intervention measures** and the introduction of new tools. At the same time, it has intensified public debate, on the role of central banks in financial stability and their relationship with other authorities.

In achieving its **objective in financial stability**, the central bank is subjected to the action of various factors and at the same time, we must assume some cost, especially since their attributions in financial stability are extinding. Although the measures taken by central banks to ensure **financial stability had satisfactory results**, there is a need for improvement in quantitative methodology used for risk identification and an evaluation of financial stability disruptive potential effects resulting from these risks materialize. To do this, it **requires indicators, models and appropriate methods of analysis** whose development is more difficult to achieve as the financial system is in constant transformation and financial innovation.

**Looking ahead** and considering new challenges to central banks to respond, it is expected that they **will have defined an explicit mandate in financial stability** coupled with playing a large number of tasks and responsibilities, and the ability to manipulate instruments to facilitate the accomplishment of this mandate and achieving expected results. Defining such an explicit mandate of central banks may reduce the risk of divergence between the different authorities involved in financial stability, and a strategy would facilitate this objective.

Also, the central bank aims to develop skills in conducting macro-prudential policy, which needs full information and analytical capacity. Achieving common micro-and macro-prudential policies can have advantages in acquiring and using information, providing an overview of the system. Due to recent events it aims to an increase in the coordination of the central bank and governmental agencies arising to be necessary under normal conditions due to other fiscal risks and the influence of others public policy.

Regarding to the monitoring and assessment of financial stability it is important the understanding of the financial system, which is complex and subject to rapid change and active participation in improving quantitative approaches. Also, measures should be adopted to allow a more comprehensive analysis of the interdependence between economic and financial sectors, as well as advances in techniques of macro stress tests.

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