International Conference KNOWLEDGE-BASED ORGANIZATION
Vol. XXX No 2 2024

FINANCIAL STABILITY – A PRIORITY OBJECTIVE OF THE CENTRAL BANKS

Leontin STANCIU

"Nicolae Bălcescu" Land Forces Academy, Sibiu, Romania
leontinstanciu@yahoo.com

Abstract: *In a national financial system, any imbalance in the functioning of one or another of its components affects the functioning of all the others. The financial crises have proven, every time, that the financial instability entails important economic and social costs. Therefore, preventing them must be a permanent concern of the relevant authorities in all states of the world. In this framework, the author of this paper aims at reviewing a part of the approaches to the financial stability and highlighting, with arguments, the role of the central banks in ensuring and maintaining the financial stability.*

Keywords: financial system, central banks, financial stability, macroprudential policy, systemic risk

1. Introduction

After 1990, the interest shown to financial stability as a major objective of the central banks' policy has continuously increased, due to the awareness of its role in ensuring a sustainable economic development. Thus, at present, most central banks regularly publish reports on financial stability, and their officials also participate in forums dedicated to the development of policies promoting financial stability.

The last global financial crisis has been the starting point for a profound change of the regulatory and prudential supervision framework, as a result of its scope, severity and duration. Although the literature is extensive, the negative events, such as the financial crises, could not be avoided and are a constant topic of analysis, policy and specific regulations development, both at national and international level.

The major interest in the issue of financial stability is the result of becoming aware of the importance of ensuring and maintaining it for the sustainable economic development and the social well-being.

The objective of the financial stability is not new for the central banks. It has been one of their goals since the 19th century, but it received less priority than other goals [1]. Financial stability is conceptually linked to the objective of monetary stability - the dominant objective in the 1980s and 1990s. This, too, can contribute to an environment which leads to economic growth and efficiency. However, the objective of financial stability in itself, the criteria for its success and the means to achieve it are quite different from the other objectives and must be approached separately.

2. What is Financial Stability?

In the literature, at the moment there is neither an established definition of the concept of financial stability nor a generally accepted evaluation model or analytical framework.

DOI: 10.2478/kbo-2024-0055

Most definitions of the financial stability have three common elements, as follows:

- *they present a macroprudential approach* (since it targets the financial system as a whole and does not treat the financial - banking institutions individually);
- they do not assess the costs and the benefits of the financial stability in isolation (but in relation to the economic activity);
- they often *refer to the financial instability and its risks*, finding it easier to observe and quantify [2].

Over time, in the search for an operational definition for the financial stability that can guide the policies intended for this purpose, numerous approaches have been considered, which were influenced mainly by the historical experiences of the different economies and the problems that the economic policy makers have to deal with in time.

Mishkin F.S. defines financial stability as the prevalence of a financial system capable of ensuring, sustainably and without major interruptions, an efficient allocation of capital to the investment opportunities in the economy [3].

Schinasi G.J. argues that a financial system is stable whenever it is able to facilitate rather than hinder the performance of an economy, as well as to dissipate the financial imbalances that arise endogenously or as a result of significant and unforeseen adverse events [4].

In its turn, the European Central Bank defines financial stability as a condition for the financial system – the intermediaries, the markets and the market infrastructure - to be able to face shocks, without major dysfunctions, while providing financial intermediation and financial services. According to ECB, financial stability can be ensured by increasing the capacity of the financial system to respond to shocks and by identifying and correcting, in due time, all the vulnerabilities that could threaten its efficient operation.

Also, the definition of the financial stability can be found in the reports developed by the central banks of different states (some of these definitions are shown in Table 1). Most central banks, trying to define financial stability, highlight the key functions of the financial system (such as: the financial intermediation, the payment system, etc.) and, at the same time, focus on the ability of the financial system to withstand shocks.

As a conclusion drawn from the definitions presented above, we could say that financial stability is that state of the financial system in which it performs without fail its role of financial intermediary and self-regulates when disrupted by adverse events, without affecting the real economy.

3. The Role of the Central Banks in Ensuring Financial Stability

In recent decades, financial stability has been a fundamental monetary policy objective of the central banks. Through their representatives, they organize and participate in forums dedicated to the development of policies to promote and ensure financial stability, and through their periodically published reports, through the delivered presentations and the interviews, they transmit messages intended towards increasing the confidence in the financial system and reducing the occurrence of events with an increased potential to create instability [5].

In order to ensure financial stability, the central banks promote and apply a series of policies to limit the financial instability. These policies are anticipatory measures which are taken in order to reduce the probability of occurrence or to minimize the damage caused by an episode of instability.

Also, in addition to the implemented preventive measures, the central banks have a solid legal infrastructure that applies to the financial transactions, an adequate prudential regulatory framework applicable to the financial institutions, a solid legal framework which is necessary for insuring against risks for the clearing and settlement mechanism, securities and currency exchange, as well as a deposit insurance system [6].

The central banks, through the adopted measures in terms of ensuring and maintaining price stability, as a fundamental objective, as well as through the activities of inspecting and monitoring the safety and soundness of the banks in the system, ensure the systemic financial stability with major benefits for the positive and sustainable evolution of the main macroeconomic indicators.

We also believe that a central bank has not only a concrete role in ensuring financial stability, but also a natural one, which derives from the fundamental features of this type of institution. Thus, the central bank:

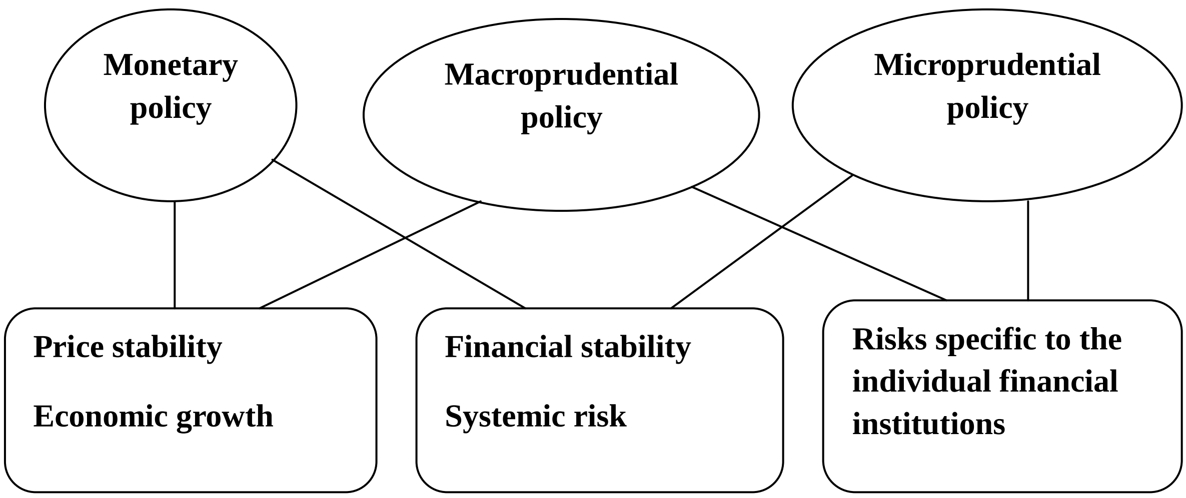
- according to the law, it is the sole provider of legal means of payment, ensuring the finality of payments, being fully involved in the organisation and functioning of the national payment system;
- it has a major interest in a healthy and viable banking system, as the mechanism for transmitting monetary impulses is through it;
- through the money multiplier (i.e. the ratio of money supply to monetary base), there is an intrinsic connection between financial stability and the central bank, and between financial and monetary stability.

In conclusion, the role of the central banks in ensuring financial stability consists in establishing prudential rules that define a stable prevention and intervention framework in order to avoid the occurrence and the propagation of the financial crises.

4. The Macroprudential Policy vs. the Microprudential Policy

The macroprudential policy addresses the issue of the financial system and its interconnectivity with the real economy. Through it, the central bank aims to prevent the emergence of the systemic risk by reducing the probability of the occurrence of certain events likely to generate systemic risks within the financial institutions, markets and the infrastructure of the financial system.

Unlike the macroprudential supervision, whose major objective is to ensure financial stability at the level of the national financial system by limiting the systemic risk, the microprudential supervision aims at limiting the risks at the level of the individual financial institutions (see the figure below).



Source: International Monetary Fund, Global Financial Stability Report, 2019

Within the macroprudential approach, it is considered that the systemic risk depends on the collective action of the financial institutions in the system. However, this approach cannot replace the micro-prudential one, since the strength and reliability of the financial institutions are a prerequisite of ensuring a system-wide financial stability. Therefore, the microprudential supervision is a prerequisite of an effective macroprudential policy [7].

The table below highlights the main characteristics of the macroprudential and microprudential approaches.

Table 1 Characteristics of the macroprudential and microprudential policies

Specifics	Macroprudential	Microprudential
Initial objective	Limiting the adverse developments capable of generating systemic crises	Limiting the risk within the individual financial institutions
Final objective	Avoiding the economic and social costs of the financial instability	Protecting the investors and the depositors
Particularities of the risk	Endogenous risks (depend on the collective behavior and the inter-institutional relations)	Exogenous risks (depend on the individual behavior of the financial institutions and not on the relationships between them)
Exposure to systemic risk	Very important	Irrelevant
The manner of prudential control	Downwards	Downwards

Source: Dandara-Tăbăcaru, D., op.cit. p.33, apud Borio, C.,The Great Financial Crisis: setting priorities for new statistics, BIS working paper, no.44

5. Conclusions

In general, economic policies, promoted by the countries of the world, have succeeded in ensuring a higher level of price stability. However, the achievement of this fundamental objective does not guarantee the stability of the financial system, and tensions may arise between the two types of stability.

Economic globalisation, in general, and the free movement of capital, in particular, have a major influence on the complementary emphasis between price stability and financial stability. In the context of open economies, financial stability has become a major component of macroeconomic stability, with capital flows speculating on the vulnerabilities of national financial systems in order to punish the errors of economic policies pursued.

In this context, we believe that price stability is not the only public good that a society expects from a central bank, which, in addition to being responsible for monetary policy, has many other duties. Thus, the Governor of the National Bank of Romania, academician Mugur Isărescu, highlighting the importance of financial stability in ensuring the effectiveness of monetary policy, believes that central banks cannot limit themselves to fighting inflation, but must also have, as a priority objective, ensuring financial stability at macroeconomic level.

References List

[1] John Chant, Alexandra Lai, Mark Illing, and Fred Daniel, Essays on Financial Stability, Bank of Canada, Technical Report, No.95, September 2003, pp.19-20.

[2] Popescu, D.I., Definirea stabilității financiare, Bucharest,”Costin C. Kirițescu” National Institute of Economic Research, Economic Information and Documentation Center, Biblioteca economică collection, Studii și cercetări economice series, vol.102., p.7.

[3] Mishkin, F.S., Asymmetric Information and Financial Crises: A Historical Perspective in Hubbard G. R.(ed.) Financial Markets and Financial Crises, University of Chicago Press, 1991, pp.69-70.

[4] Schinasi, G.J., Defining Financial Stability, working paper no. WP/04/187, IMF.

[5] Born, B., Ehrmann, M., Fratzscher, M., Central Bank Communication on Financial Stability, European Central Bank, working paper, nr.1332, 2011.

[6] Dandara-Tăbăcaru, D., Supravegherea bancară și rolul acesteia în asigurarea stabilității financiare, Bucharest, Pro Universitaria Publishing House, 2022, pp. 29-30.

[7] Dardac N., Barbu T.C., Instituții de credit, Bucharest, ASE Publishing House, 2012.