

Defining and achieving financial stability

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Abstract

We discuss the thorny issue of how to define financial stability, and conclude that the best approach is to define the characteristics of an episode of financial *instability*, and to define financial stability as a state of affairs in which episodes of instability are unlikely to occur. We then discuss public policies to achieve financial stability, distinguishing between preventive and remedial measures, and explore the costs and benefits of such policies. We conclude with some comments on current issues in financial regulation, including Basel 2.

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1. Introduction

The phrase ‘financial stability’ has in the past decade come to signify an important function of central banks and certain other public authorities. The Bank of England used the term in 1994, to denote those of its objectives which were not to do with price stability or with the efficient functioning of the financial system. We are not aware of any earlier usage of the phrase. Ten years on, there is still no widely accepted definition of ‘financial stability’ and therefore, equally, no consensus on what policies should be pursued in the interests of financial stability. In the words of the Governor of the Swedish central bank, ‘the concept of stability is slightly vague and difficult to define’.¹

It is, however, clear what kind of thing financial stability is about. It is about institutions not suddenly collapsing and causing economic damage to people who could not reasonably have been

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¹ See Heikensten (2004).

expected to anticipate the collapse. The purpose of this paper is to try to articulate a definition of financial stability, and to discuss what kind of public policies should be adopted in pursuit of financial stability.

Before proceeding to that, however, is worth remarking that although use of the term “financial stability” is fairly new, central banks’ concern with one very important aspect of the subject is not. For many years, until the issue faded from view after the Second World War, central banks were concerned with the stability of the banking system. The Bank of England and the Banque de France had both accepted this duty well before the end of the 19th Century, and the Banca d’Italia accepted it explicitly in its report and accounts for 1905. Further, a major reason for the founding of the Federal Reserve was concern with the stability of US banking.

2. An analogy—price stability

As a starting point, it is useful to explore the definition of the other main objective of central banks, namely price stability. Nearly all central banks have price stability among their statutory objectives, and many countries have found it useful to define price stability. The definitions are not all the same. Some of them specify a particular rate of increase of a particular price index as constituting ‘price stability’²; others specify a range of rates of increase. The Federal Reserve has several statutory objectives, including price stability. However, there is no statutory definition of ‘price stability’, and in framing its own definition, the Fed has eschewed numbers, preferring to define price stability as a state of affairs in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behaviour.³

There are many contentious issues in defining price stability, going well beyond the issue of whether a numerical definition is desirable. For example, there is the question of whether ‘price stability’ means just stability of prices of goods and services for immediate consumption, or whether it also includes stability of prices of future consumption, in which case some degree of stability of asset prices is additionally required.⁴ But, despite these differences of view about the appropriate definition of price stability, there is plenty of common ground. In each currency area, it is clear what the objective of price stability is; and the definitions that different currency areas use are close enough for the policies that they adopt in pursuit of price stability to be recognisably similar.

It is not clear that there is comparable clarity and uniformity as regards financial stability.

3. Desirable features of a definition of financial stability

The definition of something which is a public policy objective is a matter of great importance, since a good definition is a prerequisite for a good policy. We begin the process of identifying

² For example, the Bank of England Act of 1998 gives the Chancellor of the Exchequer the power to decide what is to be taken as the definition of price stability for the purposes of monetary policy. He or she must make such a decision at least once a year, and may change the definition at any time. Since the Act came into force, price stability has been defined in a way about which there has been widespread agreement in principle, namely in terms of the behaviour of a price index. The chosen price index was changed in December 2003, from the Retail Price Index excluding mortgage interest payments (RPIX), for which the target was 2½%, to the EU Harmonised Consumer Price Index (CPI), for which the target is 2%.

³ This definition is due to former Fed Chairman Paul Volcker, and it has been endorsed by his successor Alan Greenspan (see Poole, 2004).

⁴ There is an enormous literature on this issue, stimulated by Alchian and Klein (1973).

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