

Financial Stability and Central Banks

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Defining Financial Stability



“Financial stability is the financial system’s ability to perform its key macroeconomic functions well, including in stress situations and during periods of structural adjustment. This embraces the efficient allocation of financial resources and risks as well as the provision of an efficient financial infrastructure.” (*Deutsche Bundesbank*)

“Financial stability is a condition in which an economy’s mechanisms for pricing, allocating, and managing financial risks are functioning well enough to contribute to the performance of the economy.” (*Schinasi, 2004*)

“Absence of financial instability” (*Crockett, 1997*)...

Schinasi, Garry (2004) Defining Financial Stability, IMF Working Paper 04/187

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Defining Financial Instability



“Situation in which economic performance is potentially impaired by fluctuations in the price of financial assets or in the ability of financial intermediaries to meet their contractual obligations.”
(Crockett, 1997)

Qualifications

- Measurable effect on economic performance. Minor fluctuations in asset prices, or difficulties confined to a few financial intermediaries are part of the normal functioning of competitive markets.
- *Ex ante* potential for economic disruption, not the actual damage *ex post*

Crockett, Andrew (1997) The Theory and Practice of Financial Stability, Essays in International Finance, No. 203

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Motivation I



A Historical Perspective on the duration and depth of crises

Sample of 56 countries during 1973 - 97

	Average duration of crises in years	Cumulative GDP loss in %
Currency crisis	2.1	5.9
Banking crises	2.6	6.2
Twin crises	3.8	18.6
All crises	2.5	8.3

Bordo, Eichengreen, Klingebiel, Martinez-Peria (2001) Economic Policy, April 2001

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Motivation II



Selected examples, i.e.

- Collapse of Barings bank (1995)
- Near collapse of LTCM (1998)
- Bursting of the new economy bubble (2000)
- Subprime crisis (2007 -)

...triggered ongoing challenges, i.e.

- Timely regulation
- Moral hazard and lender of last resort
- Financial innovations
- International accounting standards
- Asset price bubbles

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„Sub-Prime“-Definition



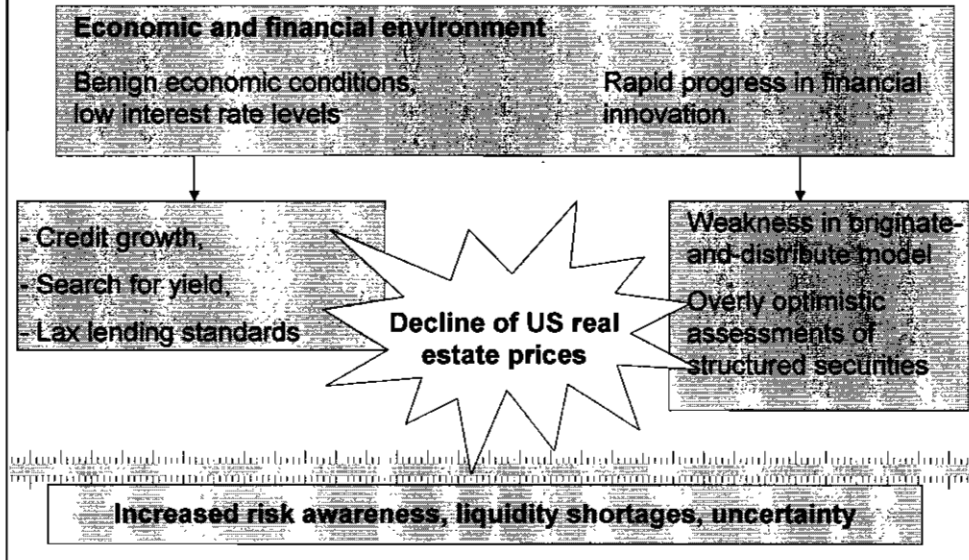
▣▣ Subprime mortgage loans: Loans to persons who do not qualify for borrowing in the prime market segment because of:

- ▣▣ Low income
- ▣▣ Precarious employment conditions
- ▣▣ Endowed with few assets acceptable as collateral
- ▣▣ Problematic debtor performance

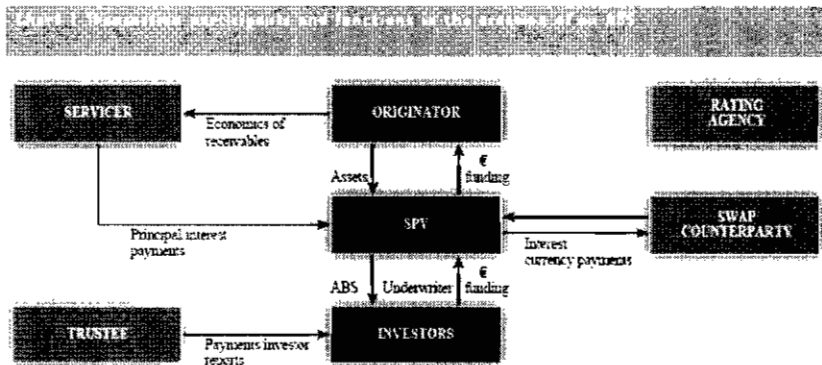
▣▣▣ Accordingly, “sub-prime” loans were also called “Ninja” loans (no income, no job, no assets).

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„Sub-Prime“ and Global Implications



Securitisation



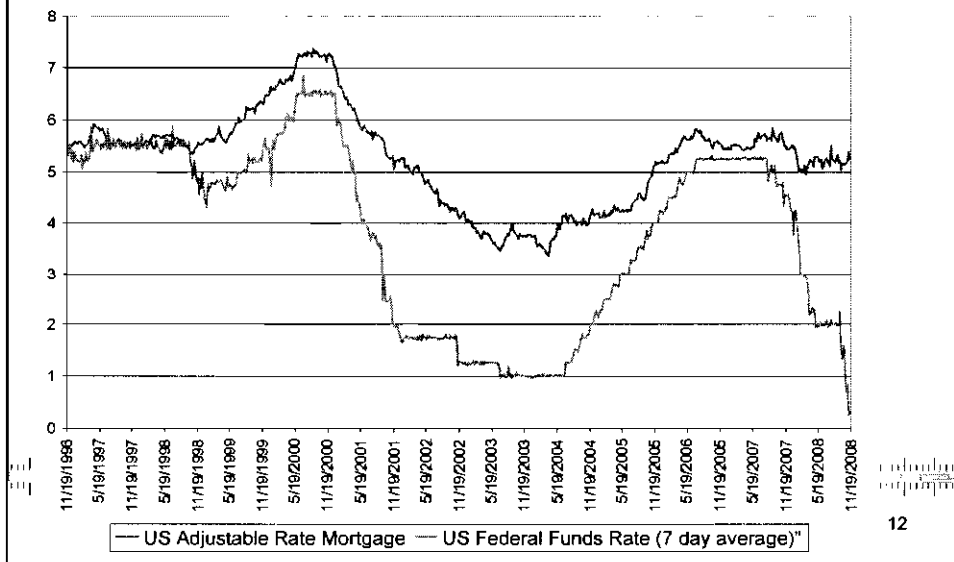
Source: Adapted and simplified version of a chart in "European Securitisation: A Resource Guide" European Securitisation Forum.

Early Warnings?

- I Regime shift:** first to laxity (such as deregulation) which provokes a credit cycle, later to rigour (e.g. monetary tightening) that triggers a crisis
 - I Easing of entry conditions** to financial markets, leading to heightened competition and risk taking (e.g. growth of SPVs that facilitated entry)
 - I Debt accumulation and asset price booms**
 - I Innovation in financial markets**, which increases uncertainty during the crisis
 - I Risk concentration and lower capital adequacy** for banks (at least when adjusted for "contingent liabilities")
- ⇒ Some *early warnings* exist, however, the timing of the crisis remains an open issue.

Davis, E.P., Karim, D., Could early warning systems have helped to predict the sub-prime crisis?
National Institute economic review, 206, p. 35-47

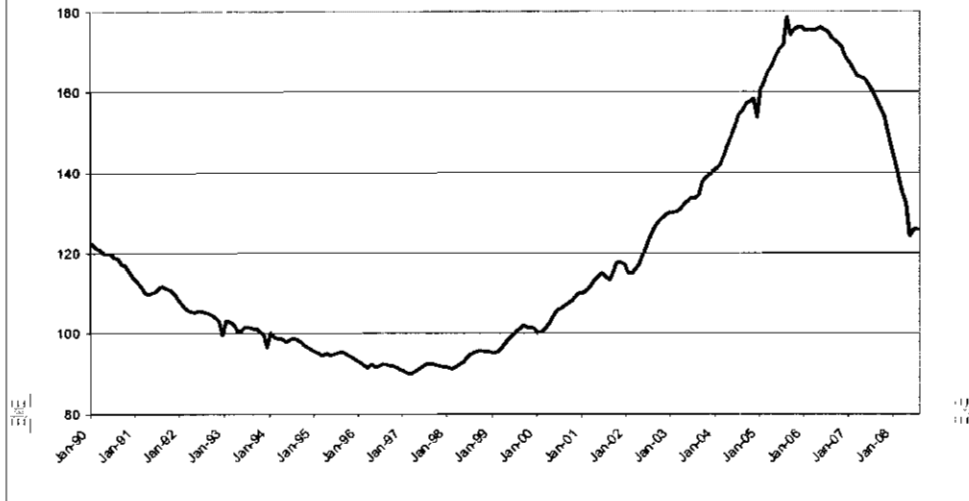
Some Evidence on "Regime Shifts"



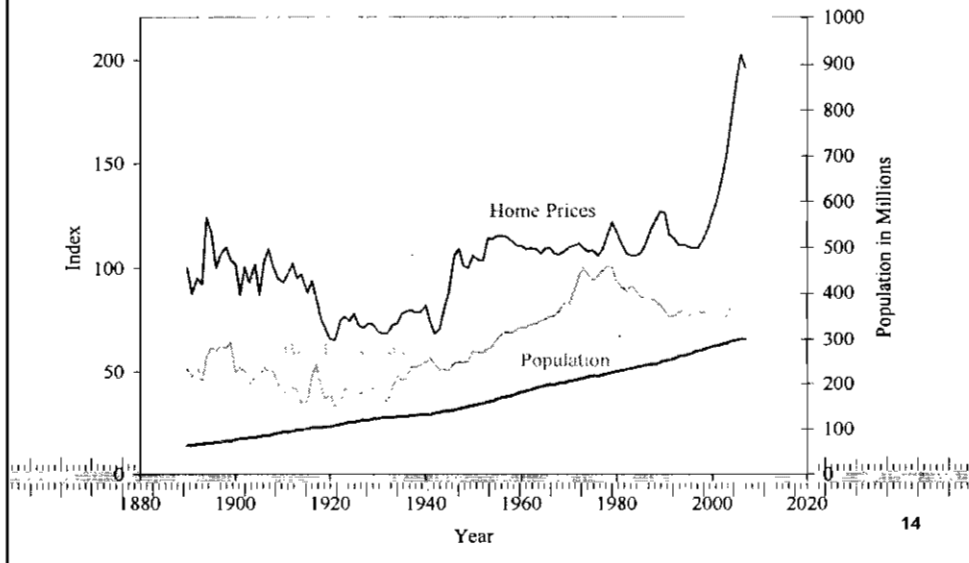
Some Evidence on "Asset Price Booms"



Home price divided by per capita income
(Year 2000=100)



More Evidence on "Asset Price Booms"



Role of Central Banks: Traditional Arguments



- The central bank needs a stable financial system in order to implement monetary policy effectively.
- The largest part of money is issued by banks. Thus, their stability is vital for the functioning of the financial system.
- The health of the financial system is inextricably intertwined with the performance of the economy and its resilience to shocks

<http://www.ecb.int/press/key/date/2004/html/sp041215.en.html>

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Role of Central Banks: New Arguments



- Low and stable inflation promotes financial stability, however, it may not be sufficient any more, as financial imbalances (sustained rapid credit growth and rising asset prices) can emerge in a low inflation environment.
- Risks to international financial stability have increased in a more financially integrated world

Borio, C. (2006) Monetary and Financial Stability: Here to Stay?
Journal of Banking and Finance 30, 3407-3414

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Central Bank Reactions...



➤ ...to financial imbalances:

- Asymmetric central bank reaction can trigger “rolling bubbles”
- A sound policy mix and a proper regulatory framework are important co-factors

➤ ... during a financial crisis:

- Lender of last resort role bears the problem of moral hazard
- Possible alternatives: constructive ambiguity, concerted private sector lending

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International Financial Institutions



- International Monetary Fund (IMF)
- IBRD (World Bank)
- Bank for International Settlement (BIS)
- Organisation for Economic Cooperation and Development (OECD)

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Sector-Specific International Groupings



- Basle Committee on Banking Supervision (BCBS)
- International Organization of Securities Commissions (IOSCO)
- International Association of Insurance Supervisors (IAIS)
- International Accounting Standards Board (IASB)

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Groupings of Central Bank Experts concerned with Market Infrastructure and Functioning



- Committee on Payment & Settlement Systems (CPSS)
- Committee on the Global Financial System (CGFS)

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Others



- National bodies and reports
i.e. committees on financial stability and financial stability reports at central banks
- Financial Stability Forum (FSF)
discusses, coordinates and recommends on financial stability issues

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