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What is Financial Stability?

by

Abayomi A. Alawode,
Financial Stability Directorate
Central Bank of Bahrain
email: aalawode@cbb.gov.bh

and

Mohammed Al Sadek,
Financial Stability Directorate
Central Bank of Bahrain
email: malsadek@cbb.gov.bh

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Abstract

This paper surveys different definitions of financial stability advanced by two separate schools of thought: i) those who prefer to define financial *instability* (as the antithesis of financial stability); and ii) those who attempt to define financial stability, rather than its absence. It is shown that definitions vary widely, depending on the working assumptions adopted by different writers. The paper discusses the definition of financial stability adopted by the Central Bank of Bahrain, analyzing the principles and assumptions underlying the chosen definition. We then examine briefly the implications of this definition for the pursuit of financial stability in Bahrain, including the conduct of financial stability analysis as well as the design of an overarching framework for crisis prevention and management.

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1. Introduction

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 (including the Central Bank of Bahrain) 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 (see Cihak, 2006 and Oosterloo, *et al*, 2007).

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, this paper contributes 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 adopted by the Central Bank of Bahrain (CBB). We analyze the principles and assumptions underlying the chosen definition as well as the implications for CBB's work in the area of financial stability.

The rest of the paper proceeds as follows: Section 2 reviews various definitions of financial stability, covering those existing in the academic literature as well as those appearing in Financial Stability Reports published by central banks. Section 3 analyzes the working definition of financial stability adopted by CBB while Section 4 discusses the policy and operational implications of the adopted definition. Section 5 concludes.

2. Definitions of Financial Stability: A Brief Survey

Defining "financial stability" is important for the development of relevant analytical tools as well as for the design of policy and operational frameworks (including relevant policy benchmarks) (see Issing, 2003; Schinasi, 2004 and Chant, 2003). However, as mentioned earlier, defining "financial stability" has so far proven to be a difficult task for many of those interested in the topic. This difficulty is often explained by the relative infancy of the field of financial stability, compared to the analysis of price or monetary stability which has a much longer history (see Crockett, 1997).

Two schools of thought are clearly discernible in the literature: i) writers who prefer to define financial *instability*; and ii) writers who attempt to define 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 (see also 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[1]. Second, there is explicit coverage of the ultimate impact of financial instability on the macroeconomy, 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

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[1] See the discussion of Allen and Wood (2006) below.

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[2]. Finally, Chant points out that financial markets 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

[2] Chant however admitted that aggregate demand and supply shocks also have the potential to affect the financial system through their impact on the financial condition of households and business enterprises.

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[3]. 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 (see also 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 (*ibid*, p. 6). 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 below displays some of these definitions from selected central banks around the world.

[3] There are writers who have discussed the possible conflicts between monetary stability and financial stability (see for example Leijonhufvud, 2007).

Table 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
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

Table 1 (contd.): Selected Central Bank Definitions of Financial Stability

CENTRAL BANK	DEFINITION	SOURCE
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

Table 1 (concl.): Selected Central Bank Definitions of Financial Stability

CENTRAL BANK	DEFINITION	SOURCE
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 – fulfil 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.

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.

Must we have a single, widely-accepted definition?

Our 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[4].

[4] Lionel Robbins defined economics as "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses." See Robbins, L. *An Essay on the Nature and Significance of Economic Science*, 2nd ed., London: Macmillan Co., 1949, p. 16.

3. Defining Financial Stability in Bahrain

As a guide to its task of fostering financial stability in the Kingdom of Bahrain, the Central Bank of Bahrain (CBB) has chosen to define financial stability, rather than its absence. In the preface to its *Financial Stability Report*, the CBB describes financial stability as *"a situation where the financial system is able to function prudently, efficiently and uninterrupted, even in the face of shocks"*. This definition contains various keywords and phrases which are important for understanding CBB's overall approach to analyzing and maintaining financial stability in the Kingdom. This definition also contains implicit sub-definitions which need to be explained.

First, financial stability is viewed in terms of a specific, attainable condition of the financial system. However, the financial system is characterized by constant change and continuously influenced by changes in the domestic, regional and global macro-financial environment. Hence, this definition would also allow for changes in the condition of the financial system, provided it maintains the ability to function prudently, efficiently and uninterrupted. This is similar to Schinasi (2004) proposal that financial stability be seen as a continuum, rather than a single, static condition.

Second, CBB has started from the premise that a definition of the financial system is important for defining financial stability. For the purposes of financial stability work in Bahrain, we deem the financial system as encompassing financial intermediaries (banks and non-banks), financial markets (equity and debt markets) and financial infrastructure (payments and settlement system). This approach takes into account the fact that financial disturbances can originate from different parts of the financial system, despite the overwhelming dominance of the banking sector in Bahrain's financial sector (see Davis, 2001 and Davies, 2005).

Although we have adopted a relatively broad definition of the financial system, it is important to point out that some parts of the system have been deliberately omitted. Notably, the definition of financial infrastructure in terms of the payments and settlement system is a decidedly narrow one, given the fact that other components of financial infrastructure could be included (e.g. legal frameworks, accounting, auditing and financial reporting, or corporate governance). We concentrate on the payments and settlement system because of its central importance to the smooth functioning of any market economy, its importance to inter-bank financial transactions and because of CBB's ability to directly influence this component of financial infrastructure[5].

Third, the definition emphasizes the ability of the financial system to carry out its key functions, including savings mobilization, resource allocation, monitoring resource use, supporting the exchange of goods and services (payments services) and facilitating risk management (Levine, 1997). It is also stated that these functions must be performed in a prudent and efficient manner, suggesting that reckless risk-taking by financial institutions and inappropriate pricing of risk in financial markets would not qualify as situations of financial stability.

Fourth, financial stability requires that the system is capable of performing its functions continuously and uninterrupted even if subjected to shocks (endogenous and exogenous). Financial stability would not obtain if for any reason, the financial system is unable to perform its functions. Indeed, stability of the system requires that the system develops and retains the ability and resilience to absorb shocks. We should note here that shocks could be either positive or negative. While negative shocks have attracted the most attention, positive shocks also have the potential to encourage risk taking and other types of imprudent behaviour, thus laying the ground for subsequent financial turmoil.

Unlike Schinasi (2004) and Allen and Wood (2006), we do not explicitly incorporate the potential real sector impact of instability into our definition. Our view is that it is difficult to determine *ex ante*, whether any financial turbulence (even an isolated one) would have a significant

[5] CBB hosts and operates the principal payments and settlement systems for Bahrain, including the new Real Time Gross Settlement System (RTGS).

impact on the real sector. Real sector data come in with a lag, even in the most advanced economies, making it difficult to detect macroeconomic impact of financial instability in the short-term.

Further, frequent convulsions (even without any visible macroeconomic impact) will tend to undermine confidence in the financial system and may over time increase vulnerabilities and erode the resilience of the system, leading to a large financial "earthquake" (with potentially substantial macroeconomic effects). It is possible for the failure of a small, seemingly inconsequential financial institution to damage confidence and affect sentiments significantly enough to cause wider disruptions in the financial system.

Hence, we argue that the key issue is not whether the disruption will cause macroeconomic effects, but whether it will interrupt the normal functioning of the financial system. It is easier to determine if the normal functioning of the financial system is being impeded than to determine whether a disruption will cause macroeconomic shocks. We therefore define a "systemic" crisis as one with the potential to affect a large part of the financial system, not one with potential macroeconomic or welfare costs.

4. Operational and Policy Implications

Implications for financial stability analysis

Operationally, CBB has used the definition discussed above to delineate the boundaries of its financial stability analysis. Its *Financial Stability Report (FSR)* presents this definition in its preface and the assessment contained in the FSR reflects the broad nature of the definition, incorporating key financial intermediaries, markets and the payments/settlement systems. The FSR also covers developments in the non-financial sector (households, businesses and construction/real estate sector). In addition, CBB has developed a list of Financial Soundness Indicators (FSIs) to be monitored on a regular basis, including indicators for these different components of the financial system. Given the role of shocks in triggering financial crises, macroeconomic and real sector indicators are included in Bahrain's list of FSIs.

It is pertinent to point out that financial stability *does not* mean that the financial system shows absolutely no vulnerabilities. It describes a state where the financial system is able to perform its normal functions even if endogenous vulnerabilities exist or if shocks are experienced. It is inevitable that parts of the system will be functioning below par at different times. The only requirement is that any vulnerabilities (or shocks) are not serious enough to cause a disruption to the normal functioning of the financial system (or are absorbed and managed by the financial system).

This approach views financial crises as extreme cases or the culmination of instability. 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).

Hence, the analysis contained in CBB's *Financial Stability Report* is aimed at identifying vulnerabilities in the system that may grow to cause serious problems down the road. It also tries to identify possible shocks/risks that may force open any identified cracks in the system. In determining whether the Bahraini financial system is stable or not, CBB considers 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?

CBB's analysis strives to evaluate financial stability in a forward-looking context, examining how future endogenous and exogenous developments might impact the financial system, even if current conditions and performance do not give any cause for worry. A key guiding principle is

whether any observed vulnerability is serious enough to warrant policy or regulatory attention. Alternatively, it is possible that the vulnerability is already being managed (or capable of being managed) through the intervention of market participants.

Ultimately, drawing a conclusion on the stability of the financial sector using the above criteria involves a combination of technical analysis and value judgment. Even though we rely to a large extent on information contained in the FSIs to identify threats to safety and soundness, it is possible for FSIs to give conflicting signals, requiring the experience and the judgment of the analyst to reach a meaningful conclusion.

Implications for crisis prevention and management

Further, this definition has provided broad guidance to CBB's policies on crisis-prevention and crisis-management. The development of a detailed *Contingency Plan for Crisis Management* is currently underway and this has been informed by CBB's overall viewpoint on financial stability (and how it can be attained). For instance, a wide range of possible crises is being considered, including banking crises, credit and stock market turbulence, exchange rate crises as well as disturbances to the payments and settlement systems. The contingency plan also pays explicit attention to possible responses to macroeconomic and real sector shocks that may impact the operation of financial intermediaries and markets.

One major challenge to contingency planning is the *identification* of a systemic crisis. This is important because policy responses will vary according to whether the financial distress is isolated or whether there is a danger of contagion to other parts of the system. As evident from the definitions of financial stability surveyed in Section 2, many writers view systemic crisis as one where there are real sector effects. Unfortunately, it is often difficult to determine *ex ante* whether a disturbance would be contained or whether it will spread, with serious macroeconomic effects.

The current era of globalization and financial innovation with close linkages among financial institutions and markets has increased the potential for contagion substantially, meaning that trying to determine whether a disturbance would be contained or not becomes academic. Regulatory and political authorities are under pressure to take action regardless of the nature of the financial disturbance. The 2007 global

financial turmoil is a case in point, where central banks in key markets have been forced to take action even though the macroeconomic impact of the crisis was unknown. The political intervention in the distressed Northern Rock mortgage bank in the UK is another example.

Responsibility for financial stability

Who is responsible for maintaining financial stability? Crockett (1997) makes a strong case for public policy in fostering financial stability. But what is the role of the market players in avoiding crisis (or responding to shocks) without requiring official intervention? Although CBB is renowned for the high quality of its regulatory and supervisory regime, it still recognizes the occasional role of moral suasion in encouraging market participants to take corrective action without resorting to regulatory changes. In addition, the adoption of the Basel 2 framework in Bahrain has focused attention on enhancing risk management practices in banks in particular, to provide a first line of defense against shocks as well as guide against vulnerabilities emerging in the first place.

However, regulatory intervention should be expected in *most* instances given the fact that left to its own devices, the financial system may not have good self-corrective mechanisms when shocks hit (due to inherent coordination problems).

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.

5. Conclusions

Motivated by the lack of a widely accepted definition of "financial stability", this paper surveyed different definitions of financial stability advanced by two separate schools of thought: i) those who prefer to define financial *instability* (as the antithesis of financial stability); and ii) those who attempt to define financial stability, rather than its absence. It is

shown that definitions vary widely, depending on the working assumptions adopted by different writers. We argued that it is not mandatory to arrive at a single, widely accepted definition and a multitude of definitions will not necessarily hamper the ongoing development of a useful analytical and policy framework.

The paper discusses the definition of financial stability adopted by the Central Bank of Bahrain, analyzing the principles and assumptions underlying the chosen definition. We then discuss briefly the implications of this definition for the pursuit of financial stability in Bahrain, including the conduct of financial stability analysis as well as the overall framework for crisis prevention and management.

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