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Central banks and financial stability: a survey

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Abstract

This study examines which financial stability responsibilities have been delegated to central banks (CBs), how these responsibilities are executed, and whether democratic accountability arrangements are in place. The results of our survey among all CBs in the OECD area suggest that there is no unambiguous definition of financial stability or systemic risk, and that, generally, the responsibility for financial stability is not explicitly formulated in laws. Moreover, there is considerable heterogeneity in the way CBs pursue the financial stability objective. Our results also suggest that the democratic accountability of the financial stability function of central banks is often poorly arranged.

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Keywords: Financial stability; Accountability

1. Introduction

Modern central banks (CBs) have two core functions: (i) maintaining monetary stability, and (ii) maintaining financial stability. While the monetary function of CBs has been discussed extensively in literature, the financial stability function has been relatively unexposed. The aim of this study is therefore to get a better understanding of which financial stability responsibilities have been delegated to CBs, how these responsibilities are executed, and whether accountability measures are in place.[1] For this purpose, we designed a

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[1] See also Sinclair (2000).

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questionnaire (see Oosterloo and de Haan, 2003) and sent it to all CBs in the OECD area.[2] We received answers from 28 out of the 30 OECD CBs.[3] The answers refer to the situation in 2002.

The literature does not provide an unambiguous definition of financial stability.[4] To quote Duisenberg (2001, p. 38): "monetary stability is defined as stability in the general level of prices, or as an absence of inflation or deflation. Financial stability does not have as easy or universally accepted a definition. Nevertheless, there seems to be a broad consensus that financial stability refers to the smooth functioning of the key elements that make up the financial system."[5]

We distinguish five different elements that make up a framework for the financial stability function:

(i) the *objective* of maintaining financial stability,
(ii) the *assessment* of risk to financial stability,
(iii) the *instruments* that can be used in case of a misalignment between the assessment and the objective,
(iv) the *decision-making process*, and
(v) the *accountability* of the institution that is responsible for maintaining financial stability.

Both the design of our questionnaire and the set-up of this paper are based on this framework. Where financial stability arrangements are formalized, individual CBs are identified in this paper, otherwise references are general. The remainder of the paper is organized as follows. Section 2 first examines the role of CBs in maintaining financial stability. Section 3 discusses the financial stability objective of the CB and its legal basis. Section 4 deals with the assessment by CBs of financial stability risks. Section 5 discusses the instruments available to maintain financial stability, while Section 6 addresses the decision-making process between the different authorities involved in safeguarding financial stability. Section 7 reviews the accountability measures in place. Finally, Section 8 offers our conclusions.

[2] Since the European Central Bank (ECB) itself is not directly involved in financial stability and supervision, the survey was sent to the National Central Banks within the European System of Central Banks (ESCB).

[3] Only the central banks of Korea and Iceland did not respond. The Bank of Greece commented on a few basic questions, but did not answer the full questionnaire.

[4] Different definitions of financial stability have, for example, been provided by Crockett (1997), Davis (2002) and Mishkin (1997).

[5] Another concept often used in the discussion about financial (in)stability is the concept of "systemic risk". Like financial stability, the literature does not provide a clear view on the concept of systemic risk. Summer (2002, p. 7) mentions that "despite of the fact that systemic risk is one of the most popular catchwords in the debate about banking regulation, it is fair to say that there does not exist a precise definition of this notion except of a vague understanding that there are special problems in the banking industry arising from the linkages of different banks." His view is supported by the essays in Kaufman (1995), which show that all contributions by experts in this field stress the fact that it is unclear what systemic risk actually means and give definitions that differ substantially. Schwartz (1995, p. 20) even regards the term as useless: "the term systemic risk could be dispensed with, with no loss to the analysis of putative disruptions of the payments and settlements system, the essence of a financial crisis."