# FINANCIAL STABILITY

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, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.

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The three parts of the financial system:

- **financial intermediaries**, such as banks, insurance companies and other institutional investors that direct funds from those willing to invest/lend to those who want to borrow.
- **financial markets**, where lenders and borrowers meet. Examples are money markets and stock exchanges.
- **financial market infrastructures** through which money and financial assets flow between buyers and sellers. Examples are payment systems and security settlement systems

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The financial system can be said to be stable if it displays the following three key characteristics:

1. The financial system should be able to efficiently and smoothly transfer resources from savers to investors.
2. Financial risks should be assessed and priced reasonably accurately and should also be relatively well managed.
3. The financial system should be in such a condition that it can comfortably absorb financial and real

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economic surprises and shocks.

If any one or a combination of these characteristics is not being maintained, then it is likely that the financial system is moving in a direction of becoming less stable, and at some point might exhibit instability.

Understood this way, the safeguarding of financial stability requires identifying the main sources of risk and vulnerability such as inefficiencies in the allocation of financial resources from savers to investors and the mis-pricing or mismanagement of financial risks. This identification of risks and vulnerabilities is necessary because the monitoring of financial stability must be forward looking: inefficiencies in

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the allocation of capital or shortcomings in the pricing and management of risk can, if they lay the foundations for vulnerabilities, compromise future financial system stability and therefore economic stability.