Garry J. Schinasi. *Safeguarding Financial Stability: Theory and Practice.* Washington, D. C.: IMF. 2006. xv+311 pages. $28.00.

Financial stability plays an important role in economic growth and leads to sustained development. As such, financial stability is gradually emerging as a distinct policy function. *Safeguarding Financial Stability,* by Garry Schinasi, explains why financial stability matters, what it means, and what challenges are involved in securing it.

The book is divided into three parts and contains twelve chapters. Chapter 1 gives the outline of the book and provides answers to various related questions. It highlights the increasing importance of financial stability issues, pinpoints the need for an analytical framework, and describes the specific objectives and organisation of the book.

Part 1, titled "Foundations" and comprising three chapters, reviews the important logical foundations that show how the process of finance is related to the real economic process and why financial stability is viewed as providing public goods and requiring forms of private-collective public policy actions. An effective process of finance requires extensive private-collective and public policy involvement to capture social economic benefits. The chapters in this part provide a logical foundation for thinking about financial stability issues. Chapter 2 in this part discusses the huge economic benefits provided by an effective process of finance that improves economic efficiency and facilitates resource and risk allocation, wealth accumulation, growth, and social prosperity. It also examines the characteristics of finance that reduce private and social benefits and create financial and economic instability. Chapter 3 explores the public policy aspects of finance. It provides information on the sources of imperfections in finance including externalities, public goods, and incomplete markets. The chapter identifies sources of market imperfections in finance, justifies the role for both private-collective and public policy involvement, and argues that both fiat money and finance have the potential to convey significant positive externalities and the characteristics of a public good. The chapter relates the economics of public sector to finance that is associated with significant positive externalities and requires a balance between maximising social benefits and minimising social costs. Chapter 4 briefly defines efficiency and stability from an economic perspective. The implicit and practical importance of this distinction is that not all market imperfections in finance may necessitate a private-collective or public policy response. Whether intervention is desirable or necessary depends on the size and importance of the imperfection with regard to its impact on efficiency. It concludes that deviation from the efficient outcome should be part of the decision to intervene, though it is difficult to measure in practice. This chapter distinguishes between volatility, fragility, and instability by drawing on the experience in the 1990s and early 2000s marked by market instability and country crises. The chapter briefly illustrates the distinction between inefficiency and instability through supply and demand diagrams.

Part II, titled “Towards a Framework for Financial Stability” and comprising Chapter 5 through 7, presents a comprehensive and practical framework for safeguarding financial stability for both the prevention and the resolution of financial imbalances, problems, and crises. This part provides a set of definitions, concepts, and organising principles that impose discipline on the analysis of financial system. Chapter 5 develops a working definition of financial systems, financial stability, and systematic risk in terms of measurable economic process and identifies several practical implications of the definitions for financial stability work. It discusses the strengths and weaknesses of finance, brings financial system and systematic risk into focus, defines financial stability, and examines its key implications. Chapter 6 provides a generic framework for financial-stability monitoring, assessment, and policy element of financial stability. It develops a comprehensive framework for safeguarding financial stability through resolving financial imbalances and crises. The framework describes all the important aspects of financial systems such as institutions, markets, and infrastructure. Its implementation involves monitoring, analytical assessment, and policy adjustment. This chapter also identifies the remaining analytical and measurement challenges. Chapter 7 discusses the role of central banks in ensuring financial stability by controlling other supervisory and regulatory authorities. It explores what central banks need to do and how far central banks have gone to ensure financial stability through examples from the Euro zone, Japan, the United Kingdom, and the United States.

Finally, Part III, titled “The Benefits and Challenges of Modern Finance”, Chapter 8 through 12, identifies and analyses the ongoing challenges to financial efficiency and stability posed by relatively recent structural changes in national and global finance. Each of these structural changes is improving financial and economic efficiency at the cost of new risks involved. Chapter 8 examines the process and the challenges posed by financial globalisation and its impact on market dynamics and international financial system. The chapter describes the changed nature of threats to financial stability and systematic risk. In Chapter 9, the potential for instability in national and global financial markets related to the growing reliance on over-the-counter (OTC) derivative instruments and markets is examined in detail. It describes exchange versus derivative markets, organisation of markets, sources of volatility and potential fragility in OTC derivatives activities and markets, and the weaknesses in the infrastructure. Chapter 10 discusses market tests during the slowdown of global growth in 2001-2002 and corporate downgrades in 2005. The industry challenges and implications for retail investors are also discussed in this chapter. Chapter 11 examines the supervisory, regulatory, and systematic challenges raised by the greater role of insurance companies in financial and capital market activities. It draws systematic implications of financial market activities of insurance and reinsurance companies that are important for a growing class of financial market participants. Chapter 12 summarises the main challenges to financial stability that are discussed in the book and are likely to be faced in the future. It concludes that further continuous reforms are desirable. The authors rightly maintain that in advanced countries with mature markets, more reliance on market discipline is desirable. However, in developing countries, with poorly developed markets, strong efforts need to be made to improve the financial infrastructure through private-collective and government expenditures.

The book is very useful reading for anyone interested in the subject of financial stability, but it is meant particularly for practitioners as well as policy-makers, and will generate debate, and perhaps further research. It combines a large literature on financial stability with solutions for a number of crucial problems.

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