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## ON THE CONCEPT OF FINANCIAL STABILITY IN THE PUBLIC INTEREST

### Abstract

In this text, the author examines the concept of financial stability and its importance in the public interest, particularly in the context of the European Union (EU). He mainly outlines the core measures in the EU set for maintaining financial stability, including regulation and supervision, supervisory bodies and institutions, financial assistance funds, and monetary policy. The author emphasizes the critical role of financial stability in ensuring households' and businesses' access to credit and promoting economic growth, job creation, and rising standards of living. He argues that maintaining financial stability is the key responsibility of central banks and financial regulators and is necessary for achieving broader goals. The author concludes that further multidisciplinary research is needed to fully understand the complex interactions among the various components of the financial stability framework in the EU and to develop more effective policies for maintaining financial stability.

### KEYWORDS

financial stability, public interest, regulation, supervision, prudential requirements, macroprudential measures, financial assistance funds, extraordinary tools, monetary policy, financial market participants, providers of financial services

## SŁOWA KLUCZOWE

stabilność finansowa, interes publiczny, regulacja, nadzór, wymogi ostrożnościowe, środki makroostrożnościowe, fundusze pomocy finansowej, narzędzia nadzwyczajne, polityka pieniężna, uczestnicy rynku finansowego, dostawcy usług finansowych

### 1. INTRODUCTION: BACKGROUND AND CONTEXT OF FINANCIAL STABILITY AS PUBLIC INTEREST

Over the past two decades, a series of crises, including the US financial crisis of 2008,<sup>1</sup> the euro debt crises of the early 2010s,<sup>2</sup> and, more recently, the higher inflation and issues facing several European banks have brought financial stability to the forefront of concern for lawmakers, regulators, and central bankers. Financial stability is an economic term that describes a state of the economy in which the financial system is robust, resilient, and capable of withstanding shocks and disturbances without significant disruption, while maintaining a relative balance among the core players in the financial markets. Financial stability is widely regarded as a prerequisite for the financial system to provide credit, which supports sustainable economic growth. A stable financial system is essential for promoting the well-being of individuals and households, as well as supporting economic growth. An unstable financial system can lead to financial crises, which can have broad consequences, including widespread economic disruption and hardship for individuals and firms. There are many examples of financial instability throughout history, including:

- **Banking crises**, which are characterized by widespread failures of banks, are frequently accompanied by a loss of faith in the financial system, resulting in a decline in credit extension and an economic slowdown. Notable examples of such crises include the 2008 global financial crisis, the savings and loan crisis that plagued the United States in the 1980s, and the banking crisis that struck Greece in the early part of the 2010s.<sup>3</sup>
- **Stock market crashes**, marked by a sudden and significant drop in stock prices often lead to financial instability by investors' loss of confidence in

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<sup>1</sup> For more, see, e.g. H. Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, 2010; or A. R. Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System-and Themselves*, 2010.

<sup>2</sup> For more, see, e.g. J. Pisani-Ferry, *The Euro Crisis and Its Aftermath*, Oxford: Oxford Press, 2014.

<sup>3</sup> For more, see, e.g. Y. Varufakis, *Adults in the Room*. London: Penguin Random House UK, 2017, p. 562.

the financial system, connected with a decrease in the value of assets, and leading to a decrease in spending and investment. Examples include the 1929 stock market crash and the 2000 dot-com bubble.

- **Sovereign debt crises** are instances where a country is unable to meet its debt obligations or refinance its debt, which can trigger financial instability and cause losses for holders of sovereign debt. These situations are often connected to banking crises, as the banking sector is often a major holder of sovereign debt. Notable examples include the eurozone sovereign debt crisis of the 2010s.<sup>4</sup>
- **Currency crises** are characterized by a sharp and considerable depreciation of a particular state's currency, which can trigger financial instability and erode confidence in the currency, assets denominated in the currency, and the financial system as a whole. The severity of the impact depends on the relative importance of the currency and can include reduced access to credit and a decline in economic activity. Examples of currency crises include the UK's crisis of 1992 and the collapse of the Bretton Woods system in the 1970s.

These are just a few examples of financial instability, and there may be other types of financial disruptions leading to widespread instability, such as real estate bubbles or asset price bubbles in many sectors of the financial market.

To achieve financial stability, new bodies/authorities may be established or existing ones may be given additional powers to oversee and regulate the financial system as a whole or its individual participants in areas that could affect stability. In this paper, my focus will be mainly on outlining the overall network of measures designed to help achieve financial stability, rather than concentrating on a particular measure. Financial stability is maintained through a combination of regulation, supervision, and the establishment of new entities, often in the form of funds.

Although the term 'financial stability' has been used in the economic and financial fields for several decades, the approach to how to achieve the stability has evolved over time, reflecting changes in the financial system, such as technology, level of interconnectedness among the key participants, the ups and downs of cross-border capital flows, and some other significant changes in the broader economy. Hence, although an economic concept, the meaning of the term is important from the legal perspective as it is the objective to be achieved for the well-being of individuals, firms, and the proper functioning of states. Maintaining financial stability is currently considered the key goal of central banks and financial regulators in many countries, who monitor the financial system and take actions to prevent or mitigate financial crises.

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<sup>4</sup> For more, see, e.g. N. Nevečeřalová, J. Schweigl, *Právní aspekty evropských fondů finanční asistence*, Brno: Masarykova univerzita, 2020.

The use of the term became more widespread in the 1990s and early 2000s, following a number of financial crises. To name a few, the savings and loan crisis in the USA, the Asian financial crisis of late 1990s, and the dot-com crisis of the new millennium. As a result of these events, policymakers began to focus more attention on the need for a stable financial system and the importance of financial stability for economic growth and prosperity. These efforts were further reinforced by the two more recent crises mentioned earlier, i.e., the US financial crisis of 2008 and the following euro debt crisis.

In the next chapter, I will detail the key measures that are implemented to establish or maintain financial stability in the European Union. Then, in the final chapter, I will present the main arguments that are commonly put forward to demonstrate the clear public interest in achieving and preserving financial stability.

## 2. FINANCIAL STABILITY IN THE EU

### 2.1. REGULATION AND SUPERVISION

The first category of measures aimed at strengthening the financial system are **legislative measures**, which involve passing laws or issuing ordinances to establish rules for market participants to follow.<sup>5</sup> These rules set strict standards for **entry** into the financial sector, including requirements for obtaining a license and regulations related to organizational structure, equity maintenance, risk management, board membership, liquidity, and financing. The licensing requirements vary based on the provider's importance to the sector, risks posed to the stability of the sector, and potential impact on clients' money in the event of misconduct or failure. For example, it is relatively easy to become an independent mortgage or insurance broker, but obtaining a bank license requires meeting numerous requirements. Once a provider **has entered** the financial sector, they are required to meet a range of regulations in order to ensure that they are providing services in a safe and secure manner. Generally, regulations become more complex and strict for services that are more intricate, risky or have a higher impact on other people's funds. Prudential requirements are typically imposed to limit the providers in taking on too much risk, while other requirements focus on maintaining certain levels of organizational and control structures, as well as contributing to certain funds such as deposit insurance or resolution funds in case of emergency. Providers are typically required to report to supervisory authorities, which brings us to the area of supervision.

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<sup>5</sup> M. Janovec, *Finanční trh a jeho stabilita*, Praha: Wolters Kluwer ČR, 2023, p. 23.

Supervisory authorities typically have multiple powers. In addition to ensuring that financial service providers comply with legal requirements, they often have the authority to issue ordinances or decrees to implement laws enacted by lawmakers. Financial markets are highly complex, so laws may not always contain detailed regulations but rather core principles on which technical rules are established by the supervisory authorities. These authorities possess extensive knowledge and expertise in the particular sector of the financial market to which they apply these rules. Nonetheless, the authority of supervisory authorities to issue implementing ordinances or decrees must be established by law and the obligations imposed on the addressees of these ordinances cannot exceed the general obligations established by the law or be in conflict with the law.

In addition to regulations and supervision that target individual financial service providers, there are also efforts to regulate and supervise the financial system as a whole. However, these areas often overlap and it is not always clear whether a particular regulation aims to promote the stability of an individual provider or the entire financial system. For example, if a law or regulatory agency imposes limits on how much one institution can be exposed to another, such a measure can be seen as addressing both individual and systemic stability concerns.

This approach aiming at the entire financial system has to be reflected not only in the area of regulation but also in the area of supervision, where the notion of ‘**macroprudential**’ supervision is used for it.<sup>6</sup> The term ‘macroprudential’ originated from unofficial documents drafted by the BIS and the Bank of England in the late 1970s. It was initially used to refer to a regulatory and supervisory approach that was focused on the macroeconomy and the overall financial system, rather than on the supervision of individual market participants.<sup>7</sup> In the 1980s, the BIS started publicly discussing macroprudential policy as a means of ensuring the safety and soundness of the financial system and payment mechanisms. The concept gained renewed attention in the early 2000s due to the widespread use of macroprudential policies in emerging markets and growing concerns about financial stability in advanced economies. After the financial crisis of 2008, the use of the term ‘macroprudential’ became more common and establishing an effective macroprudential policy framework became a top priority for organizations like the G20, EU, and IMF.<sup>8</sup>

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<sup>6</sup> For more on macroprudential policies, see, e.g. BIS. Macroprudential policy. BIS Papers No. 86, 2016, p. 169, <https://www.bis.org/publ/bppdf/bispap86.htm> (accessed: 21 April 2023).

<sup>7</sup> T. Kenç, *Macroprudential regulation: history, theory and policy*, BIS Papers No. 86, 2016, pp. 1-15.

<sup>8</sup> T. Kenç, *Ibid.*

## 2.2. FINANCIAL STABILITY AUTHORITIES

Having introduced the system of regulations and supervision, I will now outline the role of the key authorities and institutions responsible for maintaining financial stability in the EU. The first institution to mention is the **European Central Bank (ECB)**. The ECB has a dual mandate: to maintain price stability in the eurozone and to supervise the largest banks in the eurozone. In both of these areas, the ECB plays a vital role in contributing to the stability of the financial system. Maintaining price stability is primarily achieved through monetary policy instruments, including setting key interest rates, establishing eligibility criteria for credit, and conducting direct asset purchases on financial markets.<sup>9</sup>

The ECB employs the strategy of setting key interest rates to achieve its target inflation rate of 2 percent as the extremes of high inflation or deflation can adversely affect economic growth and financial stability. Through its implementation of monetary policy tools, the ECB regulates the quantity of money in circulation, ultimately affecting the availability of credit. The primary objective of the ECB's monetary policy is to maintain price stability, which fosters a steady and foreseeable economic climate that supports growth and financial stability. Additionally, as part of its supervisory mandate, the ECB carries out macroprudential supervision of the financial system to identify and address systemic risks that could threaten financial stability.

Another important authority to mention is the **European Banking Authority (EBA)**. The EBA is an independent EU body having the power to oversee the stability of the banking sector of the EU member states. In addition, it can implement some of the EU banking rules and issue guidelines. The EBA frequently coordinates its policies with the **European Securities and Markets Authority (ESMA)**, which is also an EU body targeting the stability of the securities markets and trading. The EBA and ESMA sometimes issue joint guidelines. The ESMA is responsible for implementing EU securities rules. These two EU bodies are accompanied by the **European Insurance and Occupational Pensions Authority (EIOPA)**. The EIOPA is an independent EU body responsible for overseeing the stability of the European insurance and pensions sector. Its main responsibilities include supervising the implementation of EU insurance and pensions rules, as well as monitoring and addressing risks to the stability of the insurance and pensions sector.

Apart from the aforementioned regulatory bodies, the EU introduced several other institutions that have the duty and powers to monitor financial stability. Among these are the **European Systemic Risk Board (ESRB)** and the Euro-

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<sup>9</sup> J. Schweigl, *The Monetary Policy of the European Central Bank in the 2020s*, (in:) A. Powałowski, *Economy in the Synergy of Economic, Financial and Environmental Law*, Warszawa 2022, pp. 121-128.

**pean System of Financial Supervision (ESFS)**, which are responsible for maintaining a stable financial system.

The ESRB is an EU institution that was established in 2010, based on a Council regulation<sup>10</sup> as a response to the global financial crisis and as a result of the findings made by a group of experts (called after its chair Mr Jacques de Larosière – de Larosière Group) established by the Commission. It operates independently and is based in Frankfurt, Germany. Among other powers and responsibilities, the ESRB is responsible for the macroprudential oversight of the EU financial system. It takes measures to identify and evaluate any potential systemic risks to the stability of the financial system in the EU, mainly by means of analysis. In addition to this mandate, the ESRB provides recommendations to the EU and national authorities on measures to be taken. It is led by the General Board, consisting of senior representatives from the ECB, EBA, ESMA, as well as some other authorities and national central banks. The General Board sets the overall strategic direction of the institution. The ESFS is rather a network of institutions centred around EBA, ESMA, EIOPA, ESRB, and national supervisors. Its primary objective is to ensure consistent and appropriate financial supervision across the EU.

Although this text is primarily focused on EU measures and financial stability authorities, it is important to acknowledge the role of the **Financial Stability Board (FSB)** in promoting financial stability worldwide. The FSB was established in 2009 following the global financial crisis, with the aim of promoting global financial stability. It is based in Basel, Switzerland, and is composed of representatives from central banks, regulatory authorities, international organizations, and the private sector from around the world. The FSB's primary role is to facilitate and encourage international cooperation in the development and implementation of financial stability policies, including monitoring and analysing risks to the financial system at the global level. They also can give recommendations to national supervisory authorities.<sup>11</sup> The FSB cooperates on a regular basis with ECB and the European Commission, as both are members of the FSB.

### 2.3. FINANCIAL ASSISTANCE FUNDS

In addition to regulation, supervision, and financial stability authorities, another essential component of the overall framework of financial stability is provided by financial assistance funds. These funds have the general objective of providing financing to countries experiencing difficulties in raising funds

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<sup>10</sup> Council regulation (EU) No. 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.

<sup>11</sup> For more on FSB, see, e.g.: R. Douady, C. Goulet, P. Pradier, *Financial Regulation in the EU*, Zürich: Springer International Publishing AG, 2017.

through the financial markets or, in some cases, offering capital to the banking sector in these countries. Since 2010, several of these funds have been established in various forms.<sup>12</sup> This chapter will focus on two of the most significant funds in the EU, namely the **European Stability Mechanism (ESM)** and the **European Financial Stability Facility (EFSF)**.<sup>13</sup>

The establishment of the two financial assistance funds in response to the sovereign debt crisis of the early 2010s in the eurozone represents a significant step towards financial stability in the region. The ESM and the EFSF have been given certain tools to provide financial assistance to euro area member states having difficulties obtaining funds on the financial markets. These funds play a crucial role in promoting financial stability by serving as a safety net for member countries in crisis. However, it is worth noting that the provision of financial assistance is often contingent upon the implementation of specific economic and structural reforms aimed at ensuring greater financial stability. Nonetheless, there remain concerns over the level of integration of these funds into the legal framework of the EU, given that they currently operate as independent entities rather than EU bodies.

#### 2.4. PROS AND CONS OF THE CONTEMPORARY FINANCIAL STABILITY MEASURES

Having discussed the key components of the EU's legal framework for ensuring financial stability, I will now outline some of the potential benefits and drawbacks associated with these measures. The following analysis provides a broad overview of areas that may warrant further interdisciplinary research. The potential pros include:

- **Broad oversight:** The EU's framework covers numerous institutions and bodies with different areas of focus (macroprudential and microprudential oversight, fiscal measures and monetary policy). Together, the system can provide a comprehensive view of the financial system with the ability to identify potential risks to stability.
- **Coordination:** The various institutions within the EU's financial stability framework are designed to create one system and work together. This can help promote better coordination between national authorities and across borders.

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<sup>12</sup> P. Mrkývka, J. Schweigl, *Public Finance and Financial Assistance Funds*, (in:) P. Mrkývka, J. Gliniecka, E. Tomášková, E. Juchniewicz, T. Sowiński, M. Radvan, *The Financial Law Towards Challenges of XXI Century*, Brno: Masaryk University Press, 2020, pp. 822-833.

<sup>13</sup> For more on ESM and EFSF, see, e.g., P. Mrkývka, J. Blažek, E. Tomášková, J. Schweigl *et al.*, *Vybrané právní otázky fiskální odpovědnosti státu*, Brno: Masarykova univerzita, 2020.

- **Stronger confidence:** A broad network of institutions trying to maintain financial stability in the EU can help promote greater confidence in the system.

The potential cons include:

- **Being too complex and fragmented:** The framework for financial stability is very complex, involving a large number of institutions with different roles and responsibilities. This complexity can make it difficult to understand the overall system and lead to delays in decision-making. The large number of participating authorities and bodies can create situations where inconsistencies or even contradictory tendencies can appear.
- **Having limited resources:** There may still be limits to resources or capabilities of the institutions or funds involved in ensuring financial stability, which could potentially limit their ability to effectively identify and address risks.

### 3. CONCLUDING REMARKS ON PUBLIC INTEREST IN HAVING FINANCIAL STABILITY

Financial stability is widely recognized as being in the public interest. A stable financial system facilitates access to credit for households and businesses, promoting investment, growth, job creation, and consumption. Conversely, financial instability may render financial transactions and bank deposits more risky, given the potential impact of economic slowdowns on government expenses and sovereign debt, which in turn may cause a drop in bond prices and losses for banks. A stable financial system is, therefore, crucial for the proper functioning of the economy, the development of a thriving society, and the attainment of higher living standards. Consequently, financial stability is widely regarded as a public good, and central banks and financial regulators play a critical role in promoting and safeguarding the stability of the financial system.

Moreover, financial stability is not only important for households and businesses and job creation but also for the wider society. It lowers the possibility of social unrest and political instability. It is also essential for the smooth functioning of financial markets and for maintaining the trust of investors and consumers. It is also in the public interest, as it promotes fairness and allows states to function properly.

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