

DEFINING “FINANCIAL STABILITY”

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Abstract: After the Global Financial Crisis (GFC) of 2008 the term “financial stability” rose to prominence in financial regulatory circles. The paper employs methodological tools from political economy, discourse analysis and comparative legal analysis to track the trajectory of this rise in the narratives of scholarship on financial law, policy documents and relevant European legislation and finds that the meaning of the term is subject to change and malleable. It is argued that the substance of financial stability can only be deciphered once the broader ideas about the functioning of financial markets and roles of central banks are taken into context. It is then established that these ideas were redefined in the aftermath of the GFC in line with the new macroprudential paradigm, and how they came to inform subsequent policies and legislation in the European Union.

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1. Introduction

In one of his most-known pronouncements, the great British economist John Maynard Keynes once wrote that:

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The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.¹

Keynes lived to experience the battle of ideas he described in this passage himself, as a delegate to the Bretton Woods conference which shaped the architecture of the global financial system for decades to come. At the Bretton Woods conference, despite surging support for Keynesian ideas and policies among policymakers and regulators of the era, Keynes suffered a qualified defeat². The threat of the international community returning to the gold standard, which Keynes blamed for the economic catastrophe of the interwar period, was fended off. However, his proposal for an international currency unit – a Bancor – was rejected in favor of instantiating the American dollar, exchangeable for gold, as the global reserve currency. Since then the ideas of Keynes ideas suffered mixed fortunes, adopted widely in the postwar period in a form which his former academic colleague Joan Robinson named “bastard Keynesianism”³ within the domain of fiscal policy, they soon gave way to other conceptions of the economy, pushed by Milton Friedman and other thinkers who did not share Keynes’s concerns for endogenous market instability.⁴ However, the ideas of the Cambridge economist were vindicated during the global financial crisis of 2008 (GFC)⁵, and came to inform the regulatory and policymaking efforts of global and European players: the Bank for International Settlements (BIS) and the European Union (EU), respectively.

¹ J.M. Keynes, *The General Theory of Employment, Interest and Money*, San Diego-New York-London 1964, at p. 383.

² See B. Steil, *The Battle of Bretton Woods. John Maynard Keynes, Harry Dexter White and the Making of a New World Order*, Princeton University Press 2013.

³ See chapter 5 *Why traditional mainstream Keynesian theory is not Keynes’s theory* [in:]: P. Davison, ‘Post Keynesian Theory and Policy. A Realistic Analysis of the Market Oriented Capitalist Economy’, Cheltenham 2015, at pp. 41–53.

⁴ See A. Burgin, *The Great Persuasion. Reinventing Free Markets since the Depression*, Cambridge 2012.

⁵ One of many accounts of the GFC which stresses the renewed relevance of Keynes and is an example of this renewed relevance is R. Skidelsky, *Keynes – the Return of the Master*, New York 2010.

The rest of this paper is an indirect assessment of this vindication, since the global reforms in financial regulation after GFC, while rarely drawing directly on Keynes’s body of work, were certainly Keynesian in spirit.⁶

This paper attempts to track the ideological sources of post-crisis financial regulation by analyzing the evolving nature of the concept of financial stability, which can be described as the most important value and the guiding principle of financial regulation. It proposes a thesis that financial stability is in itself a void concept, whose substance is largely dependent upon preconceptions about the functioning of financial markets held by those who are in a position to define this concept. The wider, theoretical underpinnings of regulators’ and other relevant players’ ideas about the functioning of the economy determine the way in which they understand the concept of financial stability and institutional measures necessary to secure the stability of financial markets, notably the tasks they assign to central banks. This argument draws on the work of theorists of social and ideological *embedness* of markets (Polanyi, Blyth but also Hayek) who argued that the markets themselves are socially constructed and contingent on the legal and institutional framework which shapes their functioning. The line of influence thus follows from the beliefs policymakers hold, to the legal institutions they establish, which in turn influence the functioning of the market itself. This methodology, relevant for certain strands of international political economy is then supplemented with legal analysis.

The structure of this article is as follows. Part One sets the relevant contextual framework for analyzing financial stability while reiterating and elaborating the claim about the void and malleable meaning of the term. Furthermore, it establishes the introduction of financial stability as the goal of contemporary financial regulation and its international recognition as a public good. Part Two consists in a chronological survey of the definitions of financial stability. The evolution of these definitions is then compared, in Part Three, to the evolution of the term ‘macroprudential’, and the GFC is pinpointed as the trigger for the rejection of the former paradigms of financial stability and the adoption of a new paradigm in the midst of the crisis. Part Four tracks the reflections of this change of paradigm

⁶ J. Kregel, *Keynes and Minsky on Financial Regulation and Financial Fragility in the Context of International Economic Coordination*, accessible online at: <http://www.ier.hit-u.ac.jp/extra/16.Kregel.pdf> (accessed on 13.2.2018).

in the legal and institutional solutions implemented in the EU, especially with regards to the functions of the European Central Bank (ECB).

2. Importance of financial stability in post-crisis narratives of financial regulation

“Financial Stability” is *the* buzzword in post-crisis regulatory and supervisory strata. As two prominent regulators note:

[...] today it would be hard to find a speech on the financial system, by a central banker or regulator, which was not peppered with references to financial stability. New international organizations have been created that are exclusively devoted to its pursuit. For a time, finance ministers around the world talked of little else⁷.

“Financial stability” thus became a term so ubiquitous that it risks becoming what Friedrich von Hayek once famously called a weasel word, while referring to the adjective “social”, which – in his view – just as a weasel can empty an egg without cracking its shell, can suck out the meaning of any term attached to it.⁸

In a similar fashion, the term “financial stability” is very often invoked as the justification for the regulation of financial systems or for bestowing additional tools upon regulators, despite being so vague a concept. For instance, one Polish scholar, while lamenting the problems of the delimitation of the tasks of the ECB notes that this “can sometimes give an impression of blurring of functions of normative boundaries between activities undertaken within particular policies of ECB (...) which are collectively labeled with a *simplifying* adjective »stabilizing«” [emphasis added].⁹

⁷ H. Davies, D. Green, *Banking on the Future. The Fall and Rise of Central Banking*, Princeton-Oxford 2010, at p. 5.

⁸ See note 12 in R. Ptak, *Neoliberalism in Germany. Revisiting the Ordoliberal Foundations of the Social Market Economy*, [in:] P. Mirowski, D. Plehwe (ed.), ‘The Road from Mont Pèlerin. The Making of the Neoliberal Thought Collective’, Cambridge-London 2009, at p. 128.

⁹ M. Fedorowicz, *Nowe zadania i funkcje Europejskiego Banku Centralnego w zapewnianiu stabilności finansowej w świetle regulacji Europejskiej Unii Bankowej* [New tasks and functions

This attests to the fact that financial stability is nowadays quite liberally invoked while speaking about objectives of financial regulation, with little concern about its precise meaning. In this contribution we seek to challenge the seemingly straightforward and unproblematic nature of this term and to uncover not so much the content of its definition as the fact that such a definition can never be settled once and for all, but rather it necessarily varies alongside other factors which give the term its proper meaning in a given context.

These factors are, as was highlighted in the introduction, first and foremost the theoretical conception of the functioning of financial markets which informs policymakers’ actions and serves as an intellectual grid with which they make sense of the events unfolding in the area they regulate. What is argued in this paper is that following the crisis a radical break occurred within this theoretical framework among policymakers worldwide, which resulted in prompt changes in the institutional and legal architecture of the supervisory structure in EU and many changes to material regulations dealing directly with obligations imposed on financial institutions. This shift had not been possible if there had not been a coherent and workable paradigm, alternative to the one hegemonic before the GFC. This paradigm will be referred to as the macroprudential paradigm. Tracing the history of the macroprudential paradigm is then considered another relevant factor for understanding the substance of “financial stability” after the crisis. Thirdly, the central bank and the evolving nature of its functions is a mirror which reflects the preconceptions about the ways in which the securing of financial stability is conceptualized, but – in a positive feedback loop – some realizations about the roles of central banks shed, in turn, light on what can and what cannot be considered a stable financial oversight system.

Let us now make the case for the systemic importance of financial stability in post-crisis financial regulation. Many authors have pointed out its centrality to the new narratives shaping financial law and financial regulation. Nevertheless, its importance is asserted in different ways.

of the European Central Bank in assuring financial stability in light of the European Banking Union regulation], “Zeszyty Natolińskie” 2016, no 62, p. 179.

Joanna Benjamin¹⁰, drawing on Robert Cover's concept of legal narratives¹¹, identifies three narratives fundamental to financial law prior to the GFC. The first one is "the arm's length narrative" in which the parties to a financial contract are viewed as relatively equal, and a conscious choice to limit any non-contractuary obligation is made on the part of legislation. Another one is a "fiduciary narrative", where the relation between parties contracting on financial market is interpreted in light of agency theory and duties of care are imposed on the agent in the name of protection of the principal. Lastly, there is the "consumerist narrative" which seeks to recognize relative inequalities in contracting parties' economic standing and restore balance by safeguarding the weaker. Benjamin finds these narratives "inconsistent in practice and inherently limited in their ability to deliver virtuous outcomes, and thereby to command the imaginative assent of the regulated community".

Applying this theoretical framework of "narratives" to post-crisis international financial law Andenas and Chiu argue that a different narrative has ascended: the stability narrative, which does not discard these classic narrative altogether, but rather gives them new purposes. "Increasingly, the transaction-based narratives in financial regulation are being fused with these wider financial stability concerns beyond the issues of agency or market discipline", they contend¹². Although still present, the classic narratives had to make room for the newly emerging financial stability narrative which, they argue, "punctuates post-crisis law reforms" and that "financial stability concerns are excreting a fundamental influence on other objectives of financial regulations".¹³

The most common way for these new narratives to assert the importance of financial stability is to define it as a "public good". This concept is developed in two distinct approaches.

Firstly, as early as 1999 authors have theorized financial stability as a public good, in a rather technical, economic sense of the term. As Charles Wyplosz poignantly put it: "Financial stability can be seen as

¹⁰ J. Benjamin *The Narratives of Financial Law*, "Oxford Journal of Legal Studies" 2010, vol. 30, no 4, at pp. 787-814.

¹¹ R. Cover, *The Supreme Court, 1982 Term – Foreword: Nomos and Narrative*, Faculty Scholarship Series 1983. Paper 2705 accessible online at: http://digitalcommons.law.yale.edu/fss_papers/2705 (accessed on 13.2.2018).

¹² M. Andenas I. Chiu, *The Foundations and Future of Financial Regulation*, London-New York 2014, at p. 19.

¹³ M. Andenas I. Chiu, op. cit., at p. 15 and p. 21.

an international public good because financial instability is a potential public bad that spreads across countries”.¹⁴ This ‘public bad’ manifests itself in the effects of contagion, trans-border market failures, risk arbitrage and other well-known ills which perturb the normal functioning of the market thus depriving it of a vital good essential for all of its participants. Drawing on classic definitions of the term in economic theory, a public good can be defined as a “good the inherent quality of which requires public production”.¹⁵ Or, as defined by more recent studies, it is a good which “it is beneficial to everyone, but it cannot be provided for by private entities or by any one single state”.¹⁶ Thus the role of the state is vital from this point of view, but it acts as a provider of critical market infrastructure rather than an arbiter intervening in the market in the name of social purposes or some other non-economic rationale.

A justification for upholding financial stability as a public good is often – at least in the relevant Polish literature – made with reference to the costs of bail-outs during financial crises, which are often borne by state budgets, and indirectly by taxpayers at large.¹⁷

However, as argued by Mandenas and Chiu, this economic metaphor is not the sole conceptualization of financial stability, since the concept “may actually mean something different from the economic understanding of ‘public goods’ and refers more closely to the importing of sociopolitical dimensions in construing the needs of financial stability from citizens’ point of view”.¹⁸ In this sense, the status of financial stability as an economic

¹⁴ C. Wyplosz *International Financial Stability*, [in:] I. Kaul, I. Grunberg, M. Stern (ed.), ‘Global Public Goods: International Cooperation in the 21st Century’, Oxford-New York 1999, at p. 156.

¹⁵ R. Musgrave, *The Theory of Public Finance: A Study in Public Economy*, New York 1959, at p. 44.

¹⁶ B. van der Eem, *Financial Stability as a Global Public Good and Private International Law as an Instrument for its Transnational Governance—Some Basic Thoughts*, [in:] H. Muir-Watt, D. P. Fernández Arroyo (ed.), ‘Private International Law and Global Governance’, Oxford 2014, at p. 294.

¹⁷ T. Knepek *Rola Europejskiego Banku Centralnego w zapewnieniu stabilności rynku finansowego Unii Europejskiej* [The role of the European Central Bank in assuring financial stability of the EU’s financial market], Warszawa 2017, at p. 97; B. Dudkiewicz, *Europejski Bank Centralny i nadzór finansowy w Unii Europejskiej a stabilność finansowa* [The European Central Bank and financial supervision in the European Union and the financial stability], Warsaw 2016, at p. 42.

¹⁸ M. Andenas, I. Chiu, op. cit., at p. 9.

public good is similar to the legal general clause of public interest¹⁹, known from administrative law or public law in general. It shares its “protean nature” with the public interest clause since, as one prominent scholar of administrative law notes, “there is no one general, all-encompassing descriptive substance to the public interest (...) Its interpretation depends on political conditions”²⁰ which is also true to some extent with regards to financial stability, yet due to the more technical nature of the subject matter there seems to be less politicization of the contest over the term’s meaning and less democratic involvement in the concept of defining it.²¹

Voices similar to those of Andenas and Chiu can also be found in Polish literature on the subject. For example Tomasz Nieborak notes that “any analysis of the nature of financial stability (and as a consequence the financial market) should start by stating, that it has become a subject of special interest of both theory and practice during last dozen or so years”²² The author then goes on to highlight the importance of retrieving the meaning of this term given its ubiquitousness in legal texts:

Even if the term [financial stability – S.S.] is commonly understood, included in legal paragraphs (...) it must be treated as an element of legal language with all the consequences thereof, especially with regards to the process of application of law.²³

A brief survey of popular handbooks will also show that financial stability is often cited as the core principle of financial regulation. In one of the leading handbooks of public commercial law (*prawo gospodarcze publiczne*) we read that “One of the main goals of regulation [of financial markets by the state – S.S.] is ensuring the stability of the financial system through elimination of risk.” The authors acknowledge that “financial stability is a term for which a commonly agreed-on definition does not exist”.²⁴

¹⁹ In fact, some authors use these terms interchangeably, see e.g. T. Nieborak, *Creation and enforcement of financial market law in the light of the economisation of law*, Poznań 2016, at p. 122, footnote 111.

²⁰ J. Zimmerman, *Prawo administracyjne* [Administrative law], Warsaw 2016, at p. 38.

²¹ M. Andenas, I. Chiu, *op. cit.*, at p. 38.

²² T. Nieborak, *op.cit.*, at p. 121.

²³ *Ibidem*.

²⁴ M. Wierzbowski, H. Gronkiewicz-Waltz (ed.), *Prawo gospodarcze. Zagadnienia administracyjnoprawne*, Warsaw 2017, at p. 443.

Handbooks for financial law also reference this concept a great deal. “The general role of the state is maintaining the domestic stability of the financial system. Financial Stability is a public good; it constitutes a necessary condition for ensuring a sustainable economic development in the long run”²⁵ one of them states, while elsewhere we read that “the supervision of the financial market (financial institutions) is one of the links in the financial safety net, which serves to protect financial stability and the clients of financial institutions from the effects of economic crises”.²⁶

To conclude this part, financial stability, whether couched in the language of public good or not, is perceived as a guiding principle for the regulation and supervision of financial reform. As put by Black:

*Although there is broad consensus on the normative goals of financial regulation, namely financial stability [emphasis added], investor protection, and prevention of market abuse, there is far less agreement as to just what these mean in different instances, and even less as to what measures should be taken to attain them.*²⁷

Thus, notwithstanding its widespread use and centrality to the post-crisis reforms, the meaning of this term is seldom problematized or explained at all. The following part deals with definitional issues regarding financial stability.

3. Survey of definitions

The definitions of financial stability are multiple. A study by the International Monetary Fund (IMF) found that 73% of central banks

²⁵ E. Chojna-Duch [in:] (ed.) M. Bitner, E. Chojna-Duch et. al., ‘Prawo finansowe. Prawo finansów publicznych. Prawo podatkowe. Prawo bankowe’ [Financial law. Public finances law. Tax law. Banking law], Warsaw 2017, at p. 106.

²⁶ D. Wojtczak-Samoraj, [in:] R. Mastalski, E. Fojcik-Mastalska (ed.), ‘Prawo finansowe’ [Financial law], Warsaw 2013, at p. 564.

²⁷ J. Black, *Restructuring Global and EU Financial Regulation Character, Capacities, and Learning in Financial Regulation and Supervision: A post-crisis analysis*, [in:] E. Wymeersch, K. Hopt, G. Ferrarini (ed.), ‘Financial Regulation and Supervision: A post-crisis analysis’, Oxford 2012, at p. 5.

around the world have their own definition of financial stability.²⁸ These definitions are similar at first sight, but a different distribution of accents in them reveals the wider, theoretical assumptions which inform them. Moreover, a definition adopted by an institution can evolve over time. The survey of definitions presented below refers to those most commonly found in the literature on the subject.²⁹

Definitions of financial stability are usually divided into “positive” and “negative” ones, depending on whether they seek to directly define features of a stable financial environment or rather directly define financial instability, defining stability only indirectly, as a lack of instability. This division, while not trivial³⁰ is not the only line along which definitions of financial stability can be grouped. The selection hereafter seeks to present and contrast definitions which on the one hand, perceive a lack of stability through neo-Keynesian lenses of information asymmetries, and a second group, beginning to recognize the importance of asset prices, the interconnectedness of the financial system and its relations with the so-called real economy thus professing a somewhat more classically Keynesian vision, whose renaissance during the GFC, this paper insists, informed much of the response to it and redefined the very term “financial stability”.

Frederic Mishkin defines financial stability with reference to financial instability: “Financial instability occurs when shocks to the financial system interfere with information flows so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities”.³¹ This definition, together with the whole analysis

²⁸ IMF, *Macroprudential Policy. An Organizing Framework*, March 2011, at p. 5, cited in B. Dudkiewicz, *op.cit.*, at p. 41.

²⁹ See: M. Zygierewicz, *Stabilność Finansowa* [Financial stability], “*Annales Universitatis Mariae Curie-Skłodowska. Sectio H, Oeconomia*” 2013, no 47/3, at pp. 685-695; M. Kiedrowska, P. Marszałek *Stabilność finansowa – pojęcie, cechy i sposoby jej zapewniania. Część I* [Financial stability – notion, features, and ways of assuring. Part I], “*Bank i Kredyt*” 2002, no 6, at pp. 20-34. See also T. Knepek, *op.cit.*, at pp. 28-33; B. Dudkiewicz, *op. cit.*, at pp. 37-42

³⁰ Attempts at defining a stable system usually consist of proposing a list qualities such a system needs to have. If quantified, such a vision of financial stability risks becoming a one-size-fits-all approach, similar to the EU criteria of convergence, often criticized for their arbitrary and inflexible nature in face of divergent European national economies.

³¹ F. Mishkin, *The Causes and Propagation of Financial Instability: Lessons for Policymakers*, [in:] C. Hakkio (ed.), ‘Maintaining Financial Stability in a Global Economy’, Federal Reserve Bank of Kansas City, Kansas City 1997, p. 62.

of the issue he provides in the article cited is symptomatic of a specific, neo-Keynesian orientation, which sees markets as generally efficient but suffering from a range of informational asymmetries which perturb its smooth functioning.

For Padoa-Schioppa (ECB), financial stability means maintaining an “orderly functioning” of the financial system, which is a “condition where the financial system is able to withstand shocks without giving way to cumulative processes which impairs the allocation of savings to investment opportunities and the processing of payments in the economy”.³²

Andrew Crockett (BIS) makes a clear distinction between monetary stability and financial stability and defines the latter as a “situation in which economic performance is potentially impaired by fluctuations in the price of financial assets, or in the ability of financial intermediaries to meet their contractual obligations”³³. This definition is a good example of new thinking about financial stability, since it draws attention to asset prices (as opposed to the general level of prices in the economy) and treats the interconnectedness of financial institutions as a vehicle for the spread of financial turbulences. As we shall see below this is a somewhat Minskyian approach.³⁴

For Schinasi (IMF):

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.

The view of financial stability as a range is especially noteworthy here, as well as the endogenous nature of instability. Along these lines,

³² T. Padoa-Schioppa, *Central Banks And Financial Stability: Exploring A Land In Between*, Second ECB Central Banking Conference Frankfurt am Main (2002), at p. 20 online: <https://www.ecb.europa.eu/events/pdf/conferences/tps.pdf> (accessed on 13.2.2018).

³³ A. Crockett, *Theory and Practice of Financial Stability*, “De Economist 1996, no 4, at p. 532.

³⁴ Although it should be made clear that Crockett cites Minsky, he distances himself from Minsky’s theories as they “leave an uncomfortable burden to be borne by irrational or disequilibrium behaviour” which cannot be aligned with the microeconomic model of rational agent used in neoclassical economy. See A. Crockett, *op. cit.*, at p. 533. While this commentary constitutes a fundamental misreading of Minsky, more importantly, it testifies to the faith that was still put in the rationality of financial markets before the GFC, and before the bursting of the dotcom bubble in 2001.

Schinasi stresses “the ability of the financial system to limit, contain, and deal with the emergence of imbalances before they constitute a threat”.³⁵

According to Michael Foot (FSA):

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).³⁶

This is a wide definition that includes indicators from the so-called “real economy” to measure financial stability and clearly identifies monetary stability as a subset of financial stability: a necessary yet not sufficient condition.

Finally, one cannot complete a review of the definitions of financial stability without referencing Hyman Minsky’s financial stability hypothesis (FIH). The GFC has been famously dubbed a “Minsky moment” by many commentators³⁷ and Minsky’s ideas were *the* vehicle for the renaissance of Keynesian ideas about risk and the (in)stability in financial markets, hinted at in the opening passages of this paper. For these two reasons alone it is worthy to at least briefly discuss this heterodox economist’s ideas on financial stability.

Minsky does not offer a succinct definition of either financial stability or financial instability, but his theory can be summed up in the catchphrase: “stability is destabilizing”³⁸. For according to Minsky, “the fundamental instability of capitalism is upwards”³⁹. Over the run of “good times” financial intermediaries become overleveraged and make even more risky bets on the future returns on their investments. It is in this period

³⁵ G. Schinasi, *Defining Financial Stability*, “IMF Working Paper” 2004, WP/04/187, at p. 8.

³⁶ M. Foot, *What Is ‘Financial Stability’ and How Do We Get It?*, The Roy Bridge Memorial Lecture (United Kingdom: Financial Services Authority), April 2003

³⁷ Most notoriously by John Cassidy in the very wake of the crisis, see: J. Cassidy *The Minsky Moment*, “The New Yorker”, 4.01.2008, online at: <https://www.newyorker.com/magazine/2008/02/04/the-minsky-moment> (accessed on 13.2.2018).

³⁸ L.R. Wray, *Minsky Crisis*, “Levy Economics Institute of Bard College Working Paper” 2011, no 659, online: http://www.levyinstitute.org/pubs/wp_659.pdf (accessed on 13.2.2018).

³⁹ H. Minsky, *Capitalist Financial Processes and the Instability of capitalism*, [in:] ‘Can “It” Happen Again? Essays on Instability and Finance’, New York 2016, at p. 79.

of the business cycle that financial entities move from internal borrowing, to hedge finance, to speculative Ponzi schemes. However, when the good times end and the flow of money to validate the debts incurred the whole system faces a liquidity crunch that may result in a fire sale of assets, and Fisher-style debt-deflation⁴⁰. However, this scenario can be avoided and the major economies did in fact avoid it for most of the time after the Great Depression. For Minsky “this is due to two phenomena: the willingness and ability of the Federal Reserve [central bank – S.S.] to act as a lender of last resort; and the deficits incurred by the government”.⁴¹

The choice of definitions presented in this part of the paper is not accidental. Most of them were coined by leading academics and/or senior staff of international and national institutions involved in financial governance around the turn of millennia and have been used as guidance in the reorientation of the global regulatory net in the aftermath of the GFC. This led one author who conducted a similar survey to assert that “the last crisis in financial markets did not contribute much new substance to the discussion around the term at hand [financial stability – S.S.]. A vast majority of definitions were formulated at the turn of millennia, before the crisis hit”.⁴²

Although this stance is technically correct, the influence of the GFC and the regulatory response which ensued cannot be overstated. As was pointed out above, theories of financial stability similar to those presented above had been developed for decades by Minsky, Kindleberger⁴³ and others⁴⁴ yet did not get mainstream recognition until very recently. Similarly, the fact of there having been definitions of financial stability prior to the GFC, while crucial in enabling a swift response to the crisis, does not mean that the crisis changed nothing. The author cited goes on to state that “the current debate centers, to a far greater extent on practical aspects of limiting the size of systemic risk and desired macroprudential policy towards the financial sector than on the definition of financial

⁴⁰ I. Fisher, *The Debt-Deflation Theory of Great Depression*, “Econometrica” 1933, vol. 1, no 4, at pp. 337-357.

⁴¹ H. Minsky, *Introduction. Can “It” happen again? A reprise*, [in:] *Can “It” ...*, at p. 7.

⁴² M. Zygiertowicz, *op. cit.*, at p. 692.

⁴³ C. Kindleberger, R. Aliber, *Manias, Panics and Crashes. A History of Financial Crises*, Hoboken 2005.

⁴⁴ See J. Toporowski, *Theories of Financial Disturbance. An Examination of Critical Theories of Finance from Adam Smith to the Present Day*, Cheltenham 2005.

stability”.⁴⁵ Yet this shift in emphasis does constitute, in itself, a change in the understanding of financial stability and a serious reorientation of framework thought best to deliver financial stability. This reorientation will be dealt with in the following section.

4. Macroprudential ideational shift – abandoning the Basel II conceptual framework

As the main argument of this paper goes, the meaning of financial stability can never be settled once and for all. It is always up for grabs in the political and ideological struggles which play out in lawmaking and the actions of supervisors and regulators and its primacy in current discourse on financial regulation is a relatively recent phenomenon.

To substantiate this point once more, let us consider an article by Milton Friedman, published in 1948, aptly titled “A Monetary and Fiscal Framework for Economic Stability”.⁴⁶ To be sure, Friedman does not use the phrase “financial stability” in his writings, as the potential negative effects of financial flows did not concern most economists and policymakers until the liberalisation of these flows themselves and financialization of the economy more generally.⁴⁷ But the word “stability” appears a dozen or so times, in various context e.g. “cyclical stability” which does not seem to be that far from what the authors of post-crisis reforms have in mind.

Milton’s “framework” however is strikingly different from what today is commonly prescribed as means for achieving stability. His proposal, “eliminates discretionary action in response to cyclical movements as well as some extraneous or perverse reactions of our present monetary and fiscal structure. Discretionary action is limited to the determination of the hypothetical level of income underlying the stable budget” and should be carried out by relying “as far as possible, on a market mechanism within a ‘competitive order’ to organize the utilization of economic resource” with an exception for the “monetary framework for the competitive order” which the government should put in place and control, since the stable supply

⁴⁵ M. Zygiertowicz, op. cit., p. 692.

⁴⁶ M. Friedman, *A Monetary and Fiscal Framework for Economic Stability*, “The American Economic Review” 1948, vol. 38, no 3, at pp. 245-264.

⁴⁷ B. Dudkiewicz, op. cit., at p. 35.

of money is a prerequisite for a well-functioning market but something the market cannot guarantee itself. The resemblance to an ordoliberal commitment to price stability at all costs (from which all the other features of a thriving economy should follow) and which still guides the thinking of most German policymakers is uncanny.⁴⁸

We therefore get a radically different framework for stability than the one we know from the current architecture of European – or, more generally, global – financial markets. But one does not need to search that far into the past to find a different approach to maintaining stability. At the annual Federal Reserve Bank of Kansas City symposium in Jackson Hole in 1997, where many of the definitions of financial stability cited above were presented⁴⁹, the opening speech was given by Alan Greenspan, Chairman of the Federal Reserve.

Greenspan started by asserting that “there is a key policy issue that we must confront in the process of maintaining financial stability in a global economy. That is the division of responsibilities for containing systemic risk between the public and private sectors”.⁵⁰ Even if these opening remarks do sound at odds with what was later presented by Mischkin and Crockett it is worth bearing in mind that it was still Greenspan’s approach that was dominant at the turn of the millennia. This idea of self-regulation by financial sector at the level of individual financial institution was precisely what was echoed by the bulk of pre-crisis financial regulation. The New Basel Capital Accord (Basel II) is an outstanding example of such an approach.

The measures provided for in Basel II consisted mostly in the implementation of value-at-risk (VaR) models for the calculation

⁴⁸ S. Dullien, U. Guérot, *The long shadow of ordoliberalism: Germany’s approach to the euro crisis*, “ECFR Policy Brief” 2012, online: http://www.ecfr.eu/page/-/ECFR49_GERMANY_BRIEF.pdf (accessed on 13.2.2018).

⁴⁹ See the participants and their speeches at: <https://www.kansascityfed.org/publications/research/escp/symposiums/escp-1997> (accessed on 13.2.2018).

⁵⁰ A. Greenspan, *Opening remarks*, online: <https://www.kansascityfed.org/publicat/sympos/1997/pdf/s97green.pdf>, p. 1 (accessed on 13.2.2018). It would be uncharitable to characterize his speech as oblivious to the need for public intervention and supervision in financial markets or as a declaration of the need to abandon any interference in them completely. Greenspan stresses the unique function of the central bank as the lender of last resort, but contends that precisely because this function is so unique it should be exercised with great care. The weighting, measuring and managing of risk should be left to private banks so as not to distort the incentives they face in capital markets (moral hazard).

of adequate capital holding ratios and other internal ratings of risk, which were supposed to be constructed and implemented by the banks themselves, and subject to little or no supervisory scrutiny. Alternatively, the soundness of financial institutions was to be guaranteed by credit rating agencies.

There is, however, no need to dwell on the details of the Basel II regulation at length here. For the purposes of this paper it serves rather as a stand-in for the general philosophy of financial regulation in the pre-crisis era, a synecdoche for the regulatory framework in which markets are efficient, market discipline is superior to the enforcement of rules and financial stability is of rather minor concern. For example, The European Financial Services Action Plan of 1999⁵¹ cites stability only 7 times (“financial stability” is cited 3 times), the same as the Lamfalussy report of 2001, where the term “financial stability” does not appear at all, but “systemic stability” is invoked a couple of times⁵². There is, then, little concern with the issue of financial stability in the language of two crucial, early-day roadmaps for financial regulation.

Recognition of the vitality of approach focused on financial stability was thus far from universal. As we have seen above, staff at central banks and other institutions were invested in developing a conceptual framework for financial stability, but most of this work stayed at the level of internal working papers and as Davies and Green put it:

In the years leading up to the crisis, central banks talked extensively about financial stability, published financial stability reviews, renamed sections of their organizations to emphasize the importance of financial stability and yet the financial system came close to collapse in 2008.⁵³

⁵¹ Implementing The Framework For Financial Markets: Action Plan, COM(1999)/232, Commission Communication of 11.5. 1999, online: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:51999DC0232&from=EN> (accessed on 13.2.2018).

⁵² Final Report Of The Committee Of Wise Men On The Regulation Of European Securities Markets, Brussels, 15.2.2001, online: <https://www.esma.europa.eu/document/lamfalussy-report> (accessed on 13.2.2018). Lack of the phrase in this document is ironic given that one of BIS documents contends that Lamfalussy's work at the institution “played a crucial role in shaping the Bank’s approach to financial stability”. See: I. Maes, *On the Origins of the BIS Macro-Prudential Approach to Financial Stability: Alexandre Lamfalussy and Financial Fragility*, “National Bank of Belgium Working Paper” 2009, no. 176, online at: <https://ssrn.com/abstract=1683333> (accessed on 13.2.2018).

⁵³ H. Davies, D. Green, op cit., at p. 52. See also their discussion of the poor quality of most of early financial stability reviews, *ibidem*, at pp. 61–69.

As we will argue, talk of financial stability was aplenty before the crisis, but the understanding of this term was not yet quite that which is attributed to it today it seems.

The Basel II measures reflect a different concept of how the financial markets behave, which in turn determined the measures adopted to ensure financial stability and supervisors’ attitudes to enforcing these measures.

One author concludes that:

[t]he financial crisis demonstrated that Basel II was built on many optimistic assumptions and incorrect trade-offs, namely that regulators do not understand the complexity of banking activities and that tight supervision should be replaced by market discipline. It looked at isolated areas of risk and focused on partially recognized threats to financial stability.⁵⁴

Other commentators agree:

The limitations of the Basel II approach, which was being rolled out and implemented at the national level in the years immediately prior to the financial crisis, have been clearly exposed. (...) Basel II had focused narrowly on the soundness of individual institutions, overlaid by a regulatory philosophy that largely assumed efficient markets, rational bankers, and the benefits of market competition. All that was required in this view was market transparency and effective risk management in individual institutions.⁵⁵

The GFC then verified the image of the markets held by lawmakers on both sides of the Atlantic and fundamentally challenged the regulatory paradigm where the financial soundness of individual institutions is the first and foremost concern and, what is more, these institutions are most often entrusted to self-regulate or to have their books rated by credit rating agencies.

This realization was not limited to doctrinal or academic circles only. It had its direct representation in the official documents that formed the basis of the policymakers’ understanding of the crisis and response thereto. As one report ordered by European Parliament highlights:

⁵⁴ E. Miklaszewska, *Small Banks in Post-crisis Regulatory Architecture: The Case of Cooperative Banks in Poland*, [in:] T. Lindblom, S. Sjögren, M. Willeson (ed.), ‘Governance, Regulation and Bank Stability’, Palgrave 2014, at p. 131.

⁵⁵ S.Bell, A. Hindmoor, *Masters of the Universe, Slaves of the Market*, London 2015, at p. 293.

A persistent theme of this Report is the intellectual failure of the philosophy of financial regulation that has dominated official thinking over the past two decades, and is embodied in Basel 2 and the CRD. (...)The approach has concentrated to an excessive extent on microeconomic risk, it has used market based, risk sensitive techniques that, in the face of extreme events, can exacerbate systemic risks, and there has been a persistent failure to incorporate systemic risks into the design of regulatory institutions and of risk management.⁵⁶

The influential Turner Review, the UK's Financial Services Authority investigation into the causes and remedies to the crisis expresses a similar concern:

The challenge to efficient market theory has consequences for the extent to which we can rely on market discipline rather than regulatory action to constrain risks. (...) But a strong case can be made that the events of the last five years have illustrated the inadequacy of market discipline: indeed, they suggest that in some ways market prices and market pressures may have played positively harmful roles.⁵⁷

The GFC marked a fundamental break with the mantras of transparency, disclosure and risk management which were “at the heart of financial regulation”⁵⁸ before the crisis. As Alan Greenspan bitterly admitted testifying in front of the US House of Representatives in October 2008: “This modern risk management paradigm held sway for decades. This whole intellectual edifice however collapsed in the summer of last year”.⁵⁹

⁵⁶ K. Alexander, J. Eatwell, A. Persaud, R. Reoch, *Financial Supervision and Crisis Management in the EU*, Policy Department. Economic and Scientific Policy of the European Parliament, Brussels 2007, at p. 57.

⁵⁷ Financial Services Authority, *The Turner Review A regulatory response to the global banking crisis*, March 2009, at p. 45, online at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf (accessed on 13.2.2018).

⁵⁸ J. Eatwell, *Practical Proposals for Regulatory Reform* [in:] ‘New Ideas for the London Summit. Recommendations to the G20 Leaders’, Royal Institute of International Affairs 2009, online: https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/International%20Economics/r0409_g20.pdf (accessed on 13.2.2018).

⁵⁹ E. L. Andrews, *Greenspan Concedes Error on Regulation*, “New York Times”, 23.10.2008, online: <http://www.nytimes.com/2008/10/24/business/economy/24panel.html> (accessed on 13.2.2018).

While one edifice collapsed, it uncovers a different one, waiting in the shadow of the former, ready to be taken on by regulators as their new heuristic device for making sense of the crisis: the macroprudential approach.

The change from the old Basel II-approach, to the new one was so swift and holistic that it led Claudio Borio, one of the analysts developing the concept since early 2000s to claim that “We are all macroprudentialist now”⁶⁰ and prompting another similarly-minded economist, Andrew Haldane to call macroprudential policy a “big idea” and a “new ideology”.⁶¹

As Andrew Baker recounts:

From being relatively unpopular and very much on the sidelines the idea of macroprudential regulation moved to the center of the policy agenda and became the principal interpretative frame for financial technocrats and regulators seeking to navigate the crisis and respond to it.⁶²

Another scholar notices that “the Basel III capital accord took only two years to negotiate – markedly less time than the six years it took to hammer out Basel II” and that despite forceful lobbying from the financial sector “the final Basel III regulations approved by the G20 remained largely unchanged from the draft proposals of a year earlier”.⁶³

How was it possible for such a radical change to occur, and what were the conditions that enabled the macroprudential approach to take hold of the imagination of lawmakers around the world, establish the primacy of financial stability as a goal of regulation and give it a particular meaning as well as set out the means to achieve it?

There needs to be a large enough disruptive event to open the financial Overton window and allow this kind of change of mind happen. This

⁶⁰ C. Borio, The macroprudential approach to regulation and supervision, VoxEU, 14.4.2009, <https://voxeu.org/article/we-are-all-macroprudentialists-now> (accessed on 13.2.2018).

⁶¹ A. Haldane, Small Lessons from a Big Crisis. A speech at the Federal Reserve Bank of Chicago 45th Annual Conference, 8.5.2009, online: <https://www.bankofengland.co.uk/-/media/boe/files/speech/2009/small-lessons-from-a-big-crisis> (accessed on 13.2.2018).

⁶² A. Baker, *The New Political Economy of the Macroprudential Ideational Shift*, “New Political Economy”, 2013, vol. 18, no 1, at pp. 112-139.

⁶³ D. Drezner, *The System Worked. How the World Stopped Another Great Depression*, Oxford 2014, at p. 92.

event was naturally the Great Financial Crisis. To cite Borio once more: “this swell of support could not have been anticipated even as recently as a couple of years ago. The current financial crisis has been instrumental in underpinning it”⁶⁴. But the crisis was only the starting point, from which things could go any other way.

Baker identifies four core prerequisites (the four Ps) for an ideational change – or in the words of Julia Black a “cognitive shift”⁶⁵ – to macroprudential policy. These are: P1 = presence: the prior intellectual and institutional presence of ideas; P2 = professional position: advocates of ideas becoming better positioned in professional policy networks; P3 = promotion and persuasion: individual insiders (norm entrepreneurs) willingly engaging in networking and persuasion strategies and P4 = plausibility: seeming increase in the explanatory capacity of those ideas⁶⁶.

As the survey of definitions above show the ideas on financial stability that ran contrary to the dominant paradigm of efficient markets have been in the making in BIS research departments for quite some time when the crisis hit (P1). For Baker “a key macroprudential concept is the Keynesian notion of fallacy of composition, or the idea that it is aggregate or collective system outcomes that matter”⁶⁷ which incorporates procyclicality, herding, externalities and systemic risk. It should not be seen as a surprise that these kind of ideas gained a sudden surge in explanatory power (P4).

The authors of the concepts engaged in the promotion of these ideas even more forcefully than before the crisis which had to do with the fact that with the rising popularity of the macroprudential approach the demand for their expertise rose. From being derided as the Cassandras of central banking and “Merry Sunshines”⁶⁸ they rose to global prominence in policy circles (P2, P3).

⁶⁴ C. Borio, *Implementing the macroprudential approach to financial regulation and supervision* [in:] ‘The future of financial regulation’, Banque de France 2009, at p. 39, online: https://publications.banque-france.fr/sites/default/files/medias/documents/financial-stability-review-13_2009-09.pdf (accessed on 13.2.2018).

⁶⁵ J. Black, op. cit., at p. 5.

⁶⁶ A. Baker, op. cit., at p. 114.

⁶⁷ A. Baker, op. cit., at p. 115.

⁶⁸ B. Balzli, M. Schiessl, *The Man Nobody Wanted to Hear. Global Banking Economist Warned of Coming Crisis*, “Der Spiegel”, 08.7.2009, online: <http://www.spiegel.de/international/business/the-man-nobody-wanted-to-hear-global-banking-economist-warned-of-coming-crisis-a-635051.html> (accessed on 13.2.2018).

This set of circumstances allowed the macroprudential approach to take center stage in post crisis financial regulation together with the overarching goal of financial stability; the De Larosiere Report⁶⁹ which set out the basic tenets for a new regulatory architecture in the EU is peppered with references to both concepts (invoking the former 38 and the latter 50 times) seemingly sealed their fate as inseparable partners for the time to come.

For Baker the macroprudential shift is an ideational one, a third-order change i.e. a “radical change in the terms of policy discourse, in the hierarchy of goals behind policy or accounts of how the world facing policy-makers actually work” which, surprisingly, preceded, and laid the groundwork for a second-order change in instruments and institutional settings designed to achieve the broad goals of the policy agenda and first order change, a change in day-to-day policy decision-making.⁷⁰

This confirms therefore Keynes’ musings about the influences of ideas on policymaking, with which the paper opens: the fundamental change in theoretic presumptions can, in favorable circumstances, be effectuated by sets of ideas formed in a spatio-temporarily independent context; these ideas inform later, more concrete measures undertaken by Keynes’ “practical men”.

It is now worth considering how this ideational change in understanding the optimal setting for achieving financial stability was legislated into EU texts.

5. Implementing idea into law – what is the role of the central bank?

The De Larosiere report, while expressing similar sentiments to most of the official papers investigating the causes of crisis, was also first and foremost a roadmap for future regulation and a plan for the new architecture of financial supervision in EU. “What is proposed here is basically a new structure to make European supervision more

⁶⁹ Report of The High-Level Group on Financial Supervision in the EU, Brussels 2009, online: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (accessed on 13.2.2018).

⁷⁰ A. Baker, op.cit., at p. 128

effective and so improve financial stability in all the member countries of the EU”, it states in point 166, while referring to the newly established agencies, the European Supervisory Authorities (ESAs): European Banking Authority⁷¹, European Securities and Markets Authority⁷² and European Insurance and Occupational Pensions Authority.⁷³ According to Article 1 par. 5 of the Regulations establishing ESAs, the objective of each Authority shall be to protect public interest by contributing to the short-, medium- and long-term stability and effectiveness of the financial system, for the EU economy, its citizens and businesses. Therefore, the principle of stability is enshrined even in case of a strictly macroprudential regulation.

The European Systemic Risk Board, according to Article 3 par. 1 of the Regulation shall be responsible for macroprudential oversight exercised in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU that arise from developments within the financial system taking into account macroeconomic developments, so as to avoid periods of widespread financial distress.

On the grounds of Article 2 par. 2 of the Regulation(s) (Article 1 par. 3 of the ESRB Regulation), ESAs, together with competent supervisory authorities in member states and the European Systemic Risk Board constitute the European System of Financial Supervision, which as a whole has an objective to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and to ensure confidence in the financial system as a whole and sufficient protection for the customers of financial services.

The goal of stability is therefore highlighted twice, both at the individual level of ESAs and ESRB and at the level of ESFS as a whole, which seems to respond to the claim in the De Larosiere report that

⁷¹ Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/78/EC, O.J. 15.12.2010 L 331, p. 12-47.

⁷² Regulation (EU) No. 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC, O.J. 15.12.2010 L 331, p. 241.

⁷³ Regulation (EU) No. 1094/2010 of the European Parliament And Of The Council Of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/79/EC, O.J. 15.12.2010 L 331/48.

“micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments”.

These new agencies have of course been instrumental in the regulation of financial markets in the EU since their establishment, but this fundamental makeover of supervisory architecture triggered by the ideational change discussed above begs the question of the role of the European Central Bank in this new reality. This is a particularly crucial issue because of the fact that the ECB is the sole entity which cannot only supervise and intervene legally in the financial market but also economically i.e. provide liquidity; and the exercise of this provision of liquidity affects EU financial markets as a whole. Setting the question of acting as a lender of last resort for states and engaging in monetization of public debt aside, the central banks standing vis-à-vis private financial markets remains a point of contention.⁷⁴

The proponents of the macroprudential approach have also mounted attacks on the narrowly understood price-stability objective of the ECB.⁷⁵ For many, such a return to the conception of a central bank as a provider of financial stability is simply a return to the golden principles of central banking as laid down by Bagehot and Thornton, which were abandoned in the West.⁷⁶ However, not for everyone is the marrying of financial stability and price stability a “simple story” in which “financial stability and monetary policy are so closely linked that it is not possible to separate them”.⁷⁷ Notably many Germans politicians, or one could even say Germany as a country, is especially averse to any conceptual enlargement of ECB functions and a possible subsequent redefinition of its mandate⁷⁸. This is not a case of a merely conceptual or policy issue, since there have been legal challenges mounted against non-orthodox ECB activities before, as

⁷⁴ For a comprehensive analysis of issues related to public debt and potential breaches of ECB’s mandate in this regard see: P. Yowell, *Why the ECB Cannot Save the Euro* [in:] W-G. Ringe, P. Huber (ed.), ‘Legal Challenges in the Global Financial Crisis. Bail-outs, the Euro and Regulation’, Oxford-Portland 2014.

⁷⁵ See W. White, *Is Price Stability Enough?*, “BIS Working Papers” no. 205, online: <https://www.bis.org/publ/work205.pdf> (accessed on 13.2.2018).

⁷⁶ R. Lastra, *Central Bank Independence And Financial Stability*, “Revista de Estabilidad Financiera” 2010, vol. 18, at p. 62.

⁷⁷ R. Billi, A. Vredin, *Monetary policy and financial stability – a simple story*, “Sveriges Riksbank Economic Review” 2014, no 2, at pp. 7-22.

⁷⁸ As highlighted above this stems from the ordoliberal heritage in its policymaking circles, see: S. Dullien, U. Guérot, op. cit.

illustrated in the *Pringle*⁷⁹ and *Gauweiler*⁸⁰ cases and, given the blurred boundaries between many functions conferred on the ECB nowadays, more of such challenges should be expected.

What then are these functions and why are the boundaries blurred? Generally speaking the EU legislator confers (via secondary law) ever new functions on the ECB while insisting on not redefining its mandate at the Treaty level.

To begin with, according to the Article 127 par. 5 of the Treaty on the Functioning of the European Union, the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system. What follows from this is that, given ESA and ESFS objectives on financial stability, the ESCB and therefore the ECB should contribute to the achievement of this goal. This in itself does not give the ECB a mandate for financial stability, neither does it place responsibility for ensuring it on the ECB.

However, upon further inspection of the design of the ESRB it becomes clear that it is an institution virtually formed under the aegis of the ECB. The President of the ECB is the Chair of ESRB and the vice-president of the Board is elected by and from members of the General Council of the ECB, and both are simultaneously members of the ESRB Steering Committee, its executive body. Although, according to the ESRB Recommendation 2011/3 and recital 24 of the ESRB Regulation “the national central banks should have a leading role in macro-prudential oversight because of their expertise and their existing responsibilities in the area of financial stability”, it is clear that on an EU level, the ESRB has a leading role when it comes to ensuring macroprudential oversight of financial stability. It thus follows, that “because the ESRB is responsible for macroprudential oversight with the objective of ensuring financial stability and ECB provides ESRB with substantial support to this extent, the ECB can be thought to be responsible for the financial stability of EU as well”.⁸¹

⁷⁹ Thomas Pringle v. Government of Ireland, Case C-370/12, Judgment of 27.11.2012, ECLI:EU:C:2012:756.

⁸⁰ Peter Gauweiler and Others v Deutscher Bundestag, Case C-62/14, Judgment of 16.6.2015, ECLI:EU:C:2015:400.

⁸¹ T. Knepek, *Zmiana roli Europejskiego Banku Centralnego na rynku finansowym Unii Europejskiej* [The change of role of the European Central Bank at the financial market

What is more, taking into account the changes introduced by the Single Supervisory Mechanism (SSM) within the European Banking Union, and the role of ECB therein, the stabilizing functions become even more visible.⁸² Under the SSM Regulation, the ECB becomes the microprudential regulator for the largest financial firms operating within the Eurozone and receives a range of supervisory duties, reserved up until then for ESAs such as authorization (Article 14), supervision *sensu stricto* (Article 16), the right to impose administrative sanctions (Article 18), power to conduct on-site inspections and investigatory powers (Article 9).⁸³ Apart from that, the SSM Regulation constructs a subsidiary role for ECB as a macroprudential supervisor, which the Bank can take up “if deemed necessary” by imposing stricter requirements than national regulators primarily responsible for that matter (Article 5).

It is worth noting here, that the macroprudential measures referred to in Article 5 are mostly capital buffers provided for in Capital Requirement Regulation⁸⁴ (CRR) and the Capital Requirement Directive⁸⁵ (CDR IV) which constitute the EU’s single rulebook, and implement the measures agreed on by the G20 states in the Basel III accord. These acts consists of measures that apply to individual financial firms and credit institutions but some of them (e.g. countercyclical buffers) do take into account the bigger, macroeconomic environment in which the individual entity operates. As such, they have been aptly named in scholarly literature as

of the European Union], [in:] Z. Ofiarski (ed.), ‘XXV lat przeobrażeń w prawie finansowym i podatkowym’ [XXV years of changes in financial and tax law], Szczecin 2014, at p. 728.

⁸² Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions OJ L 287, 29.10.2013 p. 63.

⁸³ M. Fedorowicz, *Stabilnościowe elementy Europejskiej Unii Bankowej jako podstawa reformy zadań i funkcji Europejskiego Banku Centralnego oraz Europejskiego Organu Nadzoru Bankowego* [Stability elements of the European Banking Union as the basis for a reform of tasks and functions of the European Central Bank], [in:] ‘XXV lat...’, op. cit., at p. 697.

⁸⁴ Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012, O.J. L 176, 27.6.2013, p. 1-337.

⁸⁵ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, O.J. 27.06.2013, p. 338–436.

“microprudential plus” measures (even though the SSM Regulation seem to qualify them as outright macroprudential tools).⁸⁶

These supervisory functions are to be performed by the Supervisory Board, which is an internal body of ECB. This is supposed to guarantee a degree of separation between its monetary policy functions and the new supervisory functions, but it should be noted that the EBC (together with the Parliament which has to approve the candidature) elects the Chair and Vice-Chair of the Board and designates four other members of the Board (Article 26 of the SSM Regulation). This is a substantial level of power over the composition of the Board.

In light of this multi-layered complicity of the ECB in matters related to financial stability, there have been numerous calls to recognize the changes to its mandate at the Treaty level.⁸⁷ The lack of such recognition creates a normative confusion by entangling the ECB in a dense web of stabilizing functions regulated by acts of a lower range as well as enabling the EBC to carry out activities that are *de facto* aimed at providing financial stability without recognizing this vital function explicitly. This is not a desired state in light of either the accountability principle of central banking, or the independence principle, since if the ECB pursues an activity having a financial stability objective in mind it cannot be sure that the discretion exercised will be protected to the same extent as the discretion exercised within the realm of monetary policy.⁸⁸

The conclusion of this part is, that the role of the ECB has been fundamentally redefined both at the ideational level (third order change) as well as its institutional setting (second order) and instruments (first order), without, however an explicit recognition of this fact at treaty level. This creates an ever so common phenomena of the normativity of law and the factuality of economic and policy action to drift apart.

⁸⁶ *The Macroprudential Approach*, [in:] J. Armour, D. Awrey, P. Davies et. al. (ed.), ‘The principles of Financial Regulation’, Oxford 2016.

⁸⁷ T. Knepek, *Zmiana...*, at p. 735, M. Fedorowicz, *Nowe zadania...*, at p. 172.

⁸⁸ For a comparison of the Article 130 of TFEU and Article 19 of SSM Regulation with regards to the independence principle see: M. Fedorowicz, *Nowe zadania...*, at pp. 82-88.

6. Concluding remarks

The term financial stability rose to ever increasing prominence in the aftermath of the Global Financial Crisis. As we have seen above, while having a rudimentary, intuitive meaning, the term functions differently in different images of how the financial market operates. What happened in the last decade was an abandoning of the Basel II, neo-Keynesian framework in which risk management and disclosure was enough to ensure the smooth functioning of financial markets whose only vice was thought to be information asymmetry and where the only task for the central bank was maintaining stable prices. Instead, a macroprudential framework was adopted by policymakers around the world, including the EU, according to which a greater supervisory involvement is required and where the central bank – the European Central Bank as examined in part 4 of this paper – is given increasingly more additional functions oriented on maintaining financial stability.

As we have shown drawing on ideas from political economy scholarship, the sequencing of this change was from broad ideas about the markets to concrete legal solutions. We believe that this fundamental change in axiology testifies to the political power of economic ideas tracing the current shape of regulatory architecture back to its ideological roots which deepens our understanding of the regulatory process. This ideational influence should be recognized in EU at Treaty level, as we argued, with respect to the *de facto* redefined mandate of the European Central Bank.

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