

Zielińska, Klaudia

**Article**

## Financial stability in the eurozone

Comparative Economic Research. Central and Eastern Europe

**Provided in Cooperation with:**

Institute of Economics, University of Łódź

*Suggested Citation:* Zielińska, Klaudia (2016) : Financial stability in the eurozone, Comparative Economic Research. Central and Eastern Europe, ISSN 2082-6737, De Gruyter, Warsaw, Vol. 19, Iss. 1, pp. 157-177,  
<https://doi.org/10.1515/cer-2016-0009>

This Version is available at:

<https://hdl.handle.net/10419/184386>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



<https://creativecommons.org/licenses/by-nc-nd/4.0>



---

KLAUDIA ZIELIŃSKA\*

---

## Financial Stability In The Eurozone

### Abstract

*Financial stability inside the European Monetary Union (EMU) is a trendy topic in most developed countries around the world. From the moment the EMU was brought to life, there was much speculation about its imperfections, inadequate management, and vulnerability. Some of them have turned out to be true, while others have been proved invalid. Nevertheless, the debt crisis has demonstrated inadequacies in the EMU's structure and proved that a higher degree of integration is necessary in order to guarantee the robustness of the common currency and fully utilize its potential.*

*This article summarizes the most serious doubts with respect to the functioning of the monetary union and evaluates their credibility over time. New financial stability-securing solutions are also described and analyzed as to whether they are sufficient to prevent Europe from stumbling from one crisis to another. The subject is analyzed over different periods of time – firstly describing the term “financial stability”, along with the major concerns about the process of introducing the euro at the time of its finalization and implementation. Secondly the article describes how these preceding doubts have been verified during the following fourteen years of the EMU's functioning. The revealed weaknesses of the EMU are also underlined in order to prove the need of further integration. The final section summarizes the solutions implemented in response to the crises that have hit Europe during the time of the Euro's functioning.*

**Keywords:** *financial stability, EMU, euro, financial institutions*

---

\* University of Łódź, International Economic Relations, e-mail: [klaudia.a.zielinska@gmail.com](mailto:klaudia.a.zielinska@gmail.com)

## **1. Introduction**

The history of financial markets is like a sinusoid of stability and instability, with a number of strong disruptions in the form of financial crises. Nowadays there is a large increase in the popularity of financial stability issues, which is due to the most recent financial crises. The complexity of the market mechanisms have not allowed for finding the precise roots of the destabilization. Moreover, vast numbers of interdependent financial institutions, which operate on an international scale with asset values exceeding the GDP of the richest nations of the world, pose a threat to the global economy and at the same time underline the importance of maintaining financial stability.

The strong connections between the countries using the EMU common currency should not come as a surprise, inasmuch as integration was one of the most important goals underlying the creation of a monetary union in the first place. Thus the contagion between Member states is also likely to be strong and the interconnected countries have to cooperate in order to be seen as a secure place to invest.

The aim of this article is to analyze the financial stability aspect of the Economic and Monetary Union since the moment of its creation and during the most recent financial crisis. The banking sector plays a vital role in this analysis due to its special role in the functioning of the financial market, strong influence on the European economic situation, and the high interdependence between banks around the world. The last part of this article focuses on the measures which have been implemented in order to handle financial crises in the future.

## **2. The term “financial stability”**

‘Financial stability’ is a quite new term, owing to the fact that in the last years of the 20<sup>th</sup> century financial institutions, especially central banks, were focused on domestic financial markets. The aim of central banks was only to keep prices at a certain level. Over time, the central banks launched the policy of establishing explicit inflation targets. However, the most recent years have shown a major change in the way the financial market works, in particular because it is becoming more global. Financial services play a vital role in this process, namely the customized financial instruments, which help investors diversify their risk and bring about new means for allocation of their financial capital.

These changes in the way financial markets operate have created new types of risks, which could have an adverse influence on financial stability. According to European Central Bank (ECB), we can define several causes of the

instability risk (ECB, 2015, online). For example it could manifest itself in a slowdown of production and economic growth – companies may have problems paying off their loans and society could have problems with repaying their mortgages. Secondly, abrupt changes on the stock market could cause a decrease in trust among investors. Last but not least, commercial banks could invest in financial instruments, which due to declining share prices on the stock exchange could suffer major declines in their worth.

These changes have forced financial institutions to change their policies. Nowadays the economic literature states that inflation targets should no longer be the only aim of a central bank, but so too should financial stabilization. In his works, A. Icard wrote that stabilization is a “twin aim” to price stabilization (Icard 2003, p. 228). Such an approach to the aims of a central bank manifests the significant correlation between inflation and financial stability and shows that one cannot be realized without the other.

Unfortunately, until now no single definition of financial stabilization has been elaborated. One definition says that financial stabilization concerns the situation in which the financial market is both operational and an effective market (Kałużyńska 2009, p.127). In the opinion of F.S. Mishkin, financial stabilization prevents the very rapid spread of financial crises. In other words, financial stabilization is a period of time without strong variations on the financial market (Mishkin 1997, pp. 55–96). Another opinion concerning the definition of financial stabilization, presented by the Central Bank of Poland, states that financial stability means the effective functioning of the system even in cases of unexpected, large-scale negative disruptions (Departament Systemu Finansowego 2015, p. 2). The robustness of the financial system seems to be the most intuitive definition of what financial stability consists of and why it is important.

Based on the general agreement that financial stability plays a crucial role in the financial system, governments implement a gamut of solutions, such as a discrete financial policy or prudential financial regulation, which are aimed at maintaining stability. Financial markets are also being monitored in order to predict and identify possible risks. Banks, key players on the financial markets, are subjected to special supervision by national authorities due to the fact that irresponsible actions on their part may pose great threat to the global economy. Such tools and interactions for monitoring and assessing potential risks are thus presented in the following parts of this article.

### **3. Integrating the financial systems inside the EMU**

Exchange rate fluctuations are one of the most difficult barriers on the path to liberalizing cross-border trade, as they strongly affect the profitability of exchanges and potentially discourage investors from expanding their businesses. Consequently, it would seem that the idea of introducing an international EU currency would be commonly applauded and supported. Yet once the project of currency union was introduced in 1999, it raised many concerns regarding the coordination of national monetary policies, cross-border transfers, and financial supervision in general. All of these aspects were analyzed in order to assess their potential impact on the financial stability of the EMU and whether the potential gains of a single currency were sufficient to consider these threats as a risk worth taking.

Bold as it was, the idea of creating a single currency apparently failed to address many issues regarding the stability of the integrated financial systems. Strong market integration between countries joining EMU was considered to have its side effects, namely less effective national supervision stemming from the high cross-border liquidity. The volume of transactions between countries of the Eurozone was expected to be high, yet the scope of the cooperation between the national supervisory authorities and their coordination remained unclear. One of the solutions to streamline surveillance over cross-border payments was the creation of TARGET – a real-time, cross-border payment system aimed at centralizing the money flow. The system, however, could not guarantee actual centralization as there were other, co-existing payment systems to compete with, and so rather being seen as a reasonable solution it became a separate concern.

The second concern was the way in which cross-border intraday markets would function; that is, which banks would be granted the right to access these markets and how the transactions would be collateralized. The organization of the interbank lending differed between the participants and a certain degree of harmonization was expected. Nonetheless this topic was not addressed properly, leaving room for speculations and causing anxiety over whether liquidity on these markets could be kept under control.

Once the single money market for the EMU would be established, it remained questionable whether the cross-border monetary policy would be effective and beneficial in common. Many experts were against passing one of the most important national tools for adjusting to an ongoing economic situation on to a pan-European institution. Since the developmental level of the member states differed, as well as their economic cycles, a common interest rate level satisfactory to all the parties involved was considered to be difficult to establish. This problem was underlined by the concerns towards interbank lending – should

the new monetary policy turn out to be ineffective, enhanced liquidity on interbank markets could end in hyperinflation in a short period of time.

Strengthened cooperation within the monetary union was seen as not only an opportunity, but a threat as well, due to the contagion effect. Among its definitions, the most appropriate for analyzing financial stability would be one incorporating the concerns towards the creation of a common currency – contagion is a shift in the pace in which an economic shock spreads across borders (Zielińska 2012). In other words, this term refers to every way which increases the process of infecting different economies. Contagion is a huge problem, especially for countries with expanded economic relations. For example, if a country declares insolvency, investors will automatically assume that its closest partners will do the same, even if their financial position is strong. There are many channels through which shocks transfer to other countries, and contagion was thought to affect all of them inside the EMU. It is hard to measure the strength of this phenomenon, but the assumption about its existence between countries with a common currency seems to be justified.

Having all the above-mentioned concerns in mind, one of the largest imperfections of the EMU project was the lack of potential crisis management schemes. This was, however, not a legislative mistake, but a consequence of the earlier agreement with respect to the direct inflation target of the ECB. The matters of bailouts and the institution of Lender of Last Resort (LOLR) were, in this case, very complex. Apart from disrupting the focus on restraining inflation, creating an international and powerful liquidity-securing institution for banks would also create great moral hazard. At the same time, leaving this task to national central banks could result in unconstrained bailouts due to high political pressure within the member states. These bailouts would, in turn, burden the national budgets, increase their public debt, and eventually increase the systemic risk within the whole European Union. However, regardless of how complex the matter was, crisis management tools should have been designed and clearly stated in the monetary union project back in 1999.

Apart from the macroeconomic approach presented above, integration within the EMU was expected to have its smaller scale consequences as well. While creating a single currency was seen as an obvious advantage for cross-border trade, for financial institutions this meant a substantial loss of income from currency exchange services. Moreover, integrating the financial systems of many developed countries led to an unprecedented increase in competition inside the banking sector. In such conditions, some banks were expected to suffer losses to such an extent that they could threaten their liquidity. This matter brings us back to the problem of bailouts by national financial institutions. In theory, eliminating uncompetitive institutions should be one of the core values

of a free market. In practice, the social consequences of a bank's bankruptcy are usually so high that the national authorities refuse to allow it to happen. In addition, it might turn out that transferring the responsibilities of a LOLR to the EBC would put it in a similar situation, in which political pressure would force it to bail out a failing institution. But on the other hand, the resulting financial burden could then be split among many nations.

To sum up this section, there were many objections in 1999 to the form of the EMU which was being brought to life. The most serious ones – regarding the lack of tools to tackle financial crises – proved nine years later to be right, yet it remains controversial whether the matter has now been properly resolved. Strengthened integration and growing competition between financial institutions provided an incentive towards further mergers and acquisitions, creating pan-European institutions which continue to grow far beyond the size in which they could be allowed to go bankrupt without causing a powerful, global shock. As a consequence, global financial stability came under the growing threat of insolvency of the banking sector, which required a corresponding, large-scale mechanism to keep it under control.

#### **4. Weaknesses of the EMU**

Once the final stage of the monetary union came to life, the process of economic adjustments began in all of the founding member states. While it was clear that the decision to create a common currency back in 1999 was more based on a political incentive than an economy-based motive, still voices could be heard stating that creating a monetary union would enhance the process of both political and economic integration (Becker, 2013). These arguments were reasonable enough to persuade governments that the implementation of euro was a powerful tool for strengthening cooperation between member states. But the intensity of integration inside the EMU turned out to be weaker than expected.

During the first eight years after completing the third stage of introducing the common currency, the new monetary policy proved to be able to control the inflation level as long as the economic situation was relatively favorable (see Figure 2). Financial market integration was also enhanced, although economic and political integration was not strengthened as expected and thus the developmental gap between member states was shrinking slowly. At the same time, new countries fulfilling the convergence criteria were entering the monetary union and loosening their financial discipline once they were able to issue the euro. The impact on systemic risk was clearly unfavorable, as the public debts of the member states

were growing and so were the largest European banks, and the economic cycles within the EMU remained unsynchronized and willingness for further integration remained low.

The TARGET payment system proved to be able to process a reasonable volume of transactions, enhancing money market integration inside EMU. In 2007, for the purposes of further European Union expansion it evolved into TARGET2 – a more transparent payment system also available to countries that had not yet joined the monetary union. In the following years, however, the transactions balance processed by TARGET2 became a separate concern, as some economists proved that the cross border money flows contribute to a drastic increase in the amount of refinancing credits granted by national central banks to secure liquidity on the local markets (Sinn, 2012). This problem became especially visible during the crisis, once interbank loaning practically ceased to exist and the central banks became the only source of liquidity. As a consequence, financial dependency became strengthened and this channel was accused of accounting for a large part of the growing systemic risk. Such imbalances, however, contributed to saving the financial markets from a breakdown caused by unavailability of credits for households and institutions.

These days, the consequences of the inadequacies described above would not be as hard to predict as they were back in 2008. The disproportion between the states managed by a common monetary policy remained high and the policy itself was focused on the inflation target. The problem of financial stability was not sufficiently monitored and the European Union failed to create any sort of tool for managing crises or sufficiently coordinating cross-border supervision. Public debts were growing and so were the powerful financial institutions of the core EMU countries. The incentives to maintain strict fiscal policies within the monetary union were insufficient, and the international interdependency of the banking sector was highly underestimated. When Lehman Brothers bank filed for bankruptcy, most European banks began experiencing troubles with maintaining liquidity.

Before the interim crisis management solutions are discussed, it must be noted that there is one more weakness of the EMU that was neither discussed or considered before the establishment of a common currency – public dissatisfaction with the introduction of euro (McGowan 2015). While the consequences of this phenomenon cannot be measured, it is clear that the public disapproval for further integration has its political consequences and acts to the detriment of integration inside the European Union. It should be noted though that this dissatisfaction is not only caused by the disappointment in what the EMU has brought about in comparison with what it was promised to bring. The situation also has its roots in politics, due to the fact that the politicians very often tend to blame European



Union for the recession taking place in their countries. As a consequence, the idea of an integrated Europe keeps fading away and the efforts to increase cooperation between the member states encounter more and more barriers.

Once the crisis reached Europe in 2008, member states were forced to bail out the financial institutions according to the mechanism described earlier. At the time no one any longer thought of maintaining the 3% GDP criterion, which resulted in a drastic increase of the public debt, exceeding even 15% in Greece (Bartovic 2014). As a consequence, many countries were forced to drastically increase the interest rates they offered for their bonds in order to find buyers and maintain liquidity, yet it became clear that they would not be able to pay back this debt without outside help. The threat of bankruptcy of not only a group of powerful and interdependent financial institutions, but also a whole country inside the euro area was so great that other member states decided to abandon one of the core rules inside the European Union – the no-bailout clause (Bartovic 2014).

Interim solutions were brought to life through the creation of special funds helping member states to manage their liabilities. Two funds were created under the joint jurisdiction of the IMF and the Commission to guarantee the security of bonds issued by member states and limit the growing debt crisis. The first fund, the European Financial Stability Facility (EFSF) was created in the form of an agreement, which allowed bypassing the EU law and creating an institution capable of lending up to 440 billion to a country threatened with insolvency. The second fund, European Financial Stability Mechanism – EFSM – was created in accordance with the EU legal framework, based on the solidarity clause. This fund, however was accessible to every EU member state regardless of whether it had adopted the common currency or not. Liquidity-securing facilities are naturally burdened with the risk of the potential insolvency of the member state which was granted a loan. Some authors claim that a similar insolvency risk is being transferred through cross border capital flows, since it forces the creation of additional refinancing credit by national central banks, as was described in the analysis of the functioning of TARGET 2. However, no direct correlation of this sort was confirmed.

The risk connected with loans provided by such international institutions is, however, divided between the member states and thus should not result in a chain reaction, even if the credit limit granted to the lending facilities would be completely utilized and threatened by a debtor's insolvency. This justification of creating the loaning facilities was the underlying argument for political pressures on the ECB to buy out the bad debt of euro-area member states most severely affected by the crisis. The ECB was reluctant to do so, as it was not within the scope its responsibilities, as well as because it might have a detrimental impact on the direct inflation target within the EMU. Such resistance was justified because

the central bank had no formal obligation to mitigate the systemic risk in a manner that could affect the inflation rate, although its support could reduce the burden of the constantly growing yields which countries had to offer for their bonds in order to maintain liquidity, e.g. especially Greece, Spain, Portugal and Ireland.

**Figure 1. Inflation inside the European Monetary Union since its launch**



Source: EBC, *Monetary Policy*, <https://www.ecb.europa.eu/mopo/html/index.en.html> (approach date: 02.03.2015).

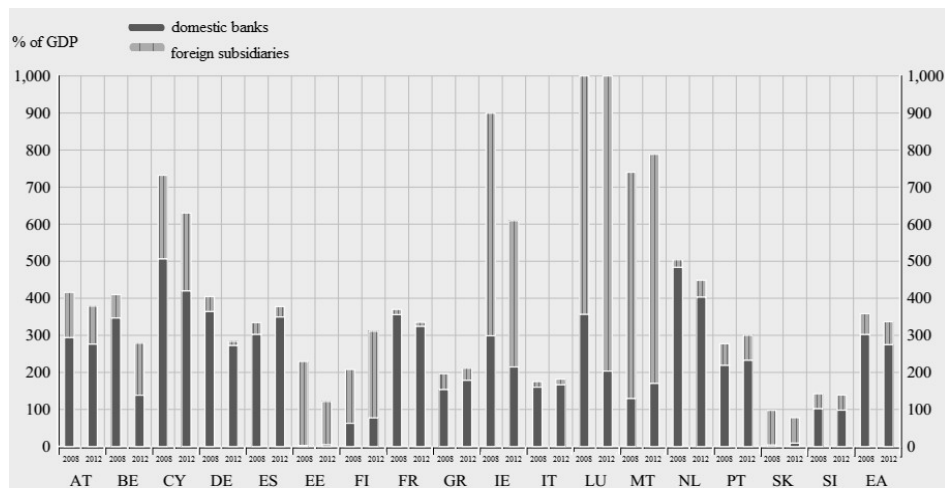
The risk connected with loans provided by such international institutions is, however, divided between the member states and thus should not result in a chain reaction, even if the credit limit granted to the lending facilities would be completely utilized and threatened by a debtor's insolvency. This justification of creating the loaning facilities was the underlying argument for political pressures on the ECB to buy out the bad debt of euro-area member states most severely affected by the crisis. The ECB was reluctant to do so, as it was not within the scope its responsibilities, as well as because it might have a detrimental impact on the direct inflation target within the EMU. Such resistance was justified because the central bank had no formal obligation to mitigate the systemic risk in a manner that could affect the inflation rate, although its support could reduce the burden of the constantly growing yields which countries had to offer for their bonds in order to maintain liquidity, e.g. especially Greece, Spain, Portugal and Ireland.

The massive amounts of money from performing the bailouts were a threat to the inflation level inside the countries with a common currency. Figure 1 represents the inflation level inside the EMU since its creation, proving

that over the midterm the inflation goal was maintained (the average inflation rate over the years is marked with a horizontal line). From this perspective, the ECB managed to fulfill its primary goal, despite being constantly attacked for its inactivity during the crises since 2008. At the same time, it should be noted that the central bank of the EMU did try to tackle the crisis, for example through supporting the liquidity of the banking sector by conducting unconventional long-term refinancing operations with a three-year maturity date for the purpose of granting credits to non-financial sectors. It also carried out several covered bond purchase programs and intervened on the secondary sovereign bond market to help the member states. While extended ECB presence can be appreciated in terms of helping to comfort investors, it should be noted that its resistance to national demands to bail out the Member states was higher than many people expected.

The discontent with euro has continued to grow since the 2008 crisis, yet ironically the crisis itself provided the necessary incentive to accelerate work on further integration. The size of the so-called “too big to fail” institutions is hard to decipher, so it is usually illustrated through dividing the bank’s assets by the GDP of its home country. For EU-15 this ratio is estimated at close to 4 – that is, on average, four times higher than the gross domestic product of many of the wealthiest nations of the world (Schoenmaker 2012). Both the size of the banking sector and its relative changes between 2008 and 2012 are depicted in Figure 2. The bankruptcy of institutions this size would most probably mean an economic breakdown and a global-scale crisis, so should the sector encounter liquidity problems governments rush to support it with public funds, disrupting the way in which a free market should operate, severely burdening national budgets, and strengthening moral hazard. All in all, this situation is a vicious circle and thus even though people were dissatisfied with the EU in general, most understood that the situation required firm decisions and cooperation.

While analyzing the data in Figure 2, it is worth noting that despite the apparent liquidity problems the banking sectors in some EU countries have not necessarily declined, especially in comparison with the national GDP. The total worth of the banking sector in Greece, Portugal and Spain has actually grown in comparison with their GDP. Nonetheless, in most cases the share of domestic banks in the total banking sector assets has declined. Simultaneously, the interdependency between the banking sectors remained strong, justifying the need to strengthen international cooperation in terms of supervision. The share of foreign financial institutions remains small, mostly inside the countries from which the largest European banks originate. At the same time, these banks account for a large part of the foreign subsidiaries operating in other parts of Europe.

**Figure 2. The problem of large financial institutions**

Source: Eurostat, ECB, Financial Stability Report.

The implementation of interim solutions was a necessary step to slow down the pace of the debt crisis, especially given that there were no predefined frameworks inside the EU for handling such situations. Nevertheless they were inherently insufficient to turn the economic situation around and put a stop to the contagion effect, thus making it clear that long-term, structural changes were needed to truly recover from the breakdown. Restoring the trust towards governmental debts as well as the banking system required serious decisions and firm actions that probably would not have been considered in a more favorable economic situation. The existence of contagion was, ironically, the lifeblood of works on further integration, the outcomes of which are further described further below.

## 5. Restoring financial stability after the financial crisis

The crisis of 2008 showed that turnovers on the financial market are not immune to shocks. What's more, the debt crisis in the Eurozone (in the years 2010–2011) showed that it is the taxpayers who have to pay for banks' mistakes and excessive risk taking. The vicious cycle between banks and national finances showed that there are gaps in the European financial system. Figure 3 shows how the vicious cycle functions. European Institutions need to be reformed in order to face new challenges and coordinate their supervision over the Eurozone as a whole, which would improve its financial stability. Most

importantly, member states have to find solutions which may prevent financial crises in the future and, perhaps more crucially, enable them to manage the crises once they occur.

**Figure 3. The vicious cycle between banks and public debts**



Source: European Commission, Banking union: restoring financial stability in the Eurozone, Memo Brussel, 2015.

The tools which European institutions have designed are unlikely to prevent crises from happening in the future, inasmuch as it is hard to say whether complete elimination of crises is even possible. Instead, the existing mechanisms should be focused on constructing the operational frameworks during crises and predicting their occurrences. An example of this kind of mechanisms is in the following part of this article.

## 6. Prudential requirements

The European Union implemented the Basel Agreement III through the CRD IV package. According to this package of reforms, a single rulebook is established for all the banks inside EU in order to simplify their supervision on an international level and avoid fraud. In the context of capital adequacy, prudential requirements are raised not only in a rated way, but also in qualitative categories. This guarantees that the banking system in Europe will hold disposable capital at an adequate level in case of shocks on the market. The previous liquidity-disturbing crises have proven that even though a bank may

appear to be properly secured on its financial statements, its assets may not be liquid enough to react to a critical situation on time. Along with CRD IV, liquidity becomes a separate concern, as the financial institutions will now be required to maintain sufficient liquid assets to cover their thirty-day liabilities, as well as hold assets that would secure their operations over the medium term.

Reinforced requirements towards banking liquidity are not new to the sector and have proven in the past to be insufficient to secure the financial condition of banks, as the asset quality was often overstated and the regulations themselves bypassed. The new directive aims to establish a separate cap on the maximum level of leverage for banks around Europe, so that even if the new requirements fail to prevent such bypassing, there will be another requirement reducing the systemic risk that a financial institution may create. Another new solution is comprised of the adjustment measures to the economic situation of a member state – countercyclical and systemic risk buffers. Both buffers aim to modify the necessary Tier1 capital requirement to fit the condition of the national economy by increasing or decreasing the amount of liquid assets securing the short-term position of the banking sector.

## **7. The European System of Financial Supervision**

At the beginning of the 2011, following conclusion of the de Larosiere Report from 2009, European System of Financial Supervision (ESFS) was created. This organ creates a system of micro- and macro- prudential supervision. The ESFS consist of European Supervisory Authorities (ESA) and the European Systemic Risk Board (ESRB). The new supervisory system was reorganized as a network of European and national supervisors in order to develop the necessary level of cooperation.

### **The European Supervisory Authorities**

The purpose of the European Supervisory Authorities (ESA) is to supervise in micro category on the European level. The ESA consists of three institutions – the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority. To be more precise, these institutions were created through transforming existing committees, known as the three committees of Lamfalussy. The aim of these three organs is daily control over the banking, market and insurance sectors, ensuring their stability. The European Banking Authority controls credit institutions, financial

conglomerates, investment companies, and payment institutions. It is also responsible for creating coherent rules in the banking sector. The headquarters of this institution has been organized in London. The European Securities and Markets Authority (ESMA) was founded in Paris. The ESMA controls the market and is responsible for supervision of the rating agencies. The European Insurance and Occupational Pensions Authority, with its headquarters in Frankfurt, is responsible for insurance institutions.

### **European Systemic Risk Board**

The purpose of the European Systemic Risk Board is to monitor and assess systemic risk in normal times, in order to mitigate the exposure to risk of the system. Following the Official Journal of the European Union about Regulation, the European Risk Board has to ensure financial stability and mitigate the negative impact on the internal markets and the real economy (Regulation (EU) No 1092/2010). The European Supervisory Authority is chaired by the President of European Central Bank. The European Central Bank's crucial role in macro-prudential supervision was the main reason why it was entrusted with this responsibility, as it is both politically independent and has access to all the necessary statistic information.

## **8. European Stability Mechanism**

Once member states acknowledged the need to create a separate fund in order to break the vicious circle of the increasing public debt, temporary solutions were implemented through the establishment of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). As mentioned earlier, both mechanisms were designed to provide financial support to EU countries encountering trouble with liquidity and with managing their debt. After these institutions were in place, works on a more permanent solution were undertaken and resulted in the establishment of the European Stability Mechanism (ESM) in October 2012.

The ESM is a permanent institution, replacing the EFSF, and is an important part of the new EU financial stability-securing network. Just like its forerunner, the ESM will be able to provide financial support to member states having trouble with managing their debt. However, such financial assistance will only be available after a country's government agrees to implement a specific adjustment plan which will allow it to rebuild and sustain its liquidity in the future.

In order to finance its operations, the ESM is entitled to issue financial instruments up to a total sum of 80 billion euro of its paid-in capital. This new, permanent tool for managing crises in the European Union is designed to closely cooperate with the International Monetary Fund (IMF) in the process of negotiating the terms on which financial support will be granted, as well as in sharing the burden of granting sufficient financial support to a member state (ESM 2015, online).

## **9. Banking Union**

The banking union was a proposal of the European Commission aimed at bracing up the Economic and Monetary Union. The outline of the banking union was submitted in 2012. The main purpose of this solution was to ensure harmonized rules and an operating environment for all credit institutions. Those common regulations should help simplify supervision over the banking system inside the EMU. Moreover, the project was the first to address the problem of “too big to fail” and offer a solution on an international level. The banking union consists of three pillars.

The first pillar, the Single Supervisory Mechanism (SSM), embodies the idea of coordinated, cross-border supervision. Since November 2014 it is responsible for supervising almost 6,000 banks in the Eurozone and in those countries which decided to join it via close cooperation. The SSM consists of the European Central Bank and domestic supervisors. The ECB took over direct supervision of 123 of the most important banks, which own as much as 82% of the sector’s total asset value. Smaller financial institutions remain under the scope of the national banks.

The second pillar, the Single Resolution Mechanism (SRM), was established by the European Parliament in April 2014. The SRM consists of a central decision making body – the Single Resolution Board and the Single Resolution Fund. The aim of the Single Resolution Mechanism is to cope with difficulties which banks may encounter despite the control of the Single Supervisory Mechanism. What’s more, the Single Resolution Mechanism aims at minimizing the cost connected with the resolution – both the cost for taxpayers and the cost for the economy. The purpose of Single Resolution Board is to prepare and manage the resolution of banks which are highly likely to fail. The resolution process would be managed in strong cooperation with national supervisors. Functioning of the SRM requires sufficient funds, thus a Single Resolution Fund is being created as well. The aimed-at size of the fund is 55 billion euro at the moment of being completely operational. Such an amount of money would seem to be quite large, yet many experts say that in case of a crisis the fund would be far from sufficient to save the most important banks (PWC 2014).

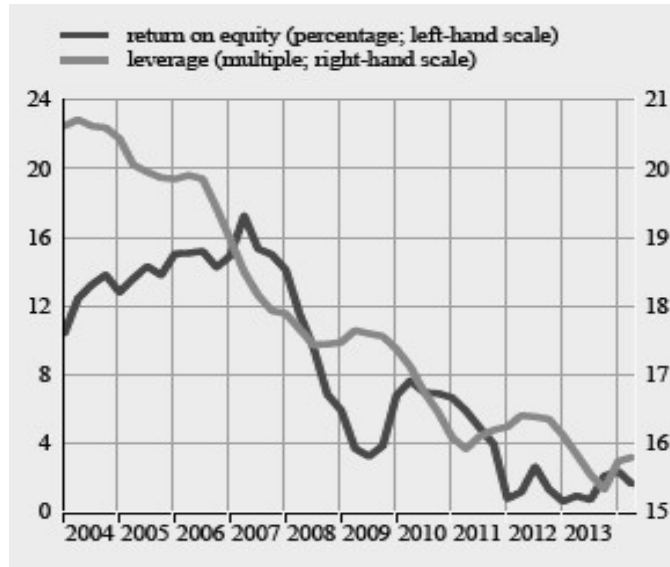


Last but not least, the third pillar proposed in the banking union project, is the Deposit Guarantee Schemes. The European Institutions decided that the third pillar will not be created in form of a single, pan-European institution, but instead will take the form of harmonization. The deposits will guarantee coverage up to 100,000 euros. The second decision, made by the member states, was to create national funds entirely supported from private bank's contributions – the fund will be based on 55 billion euro in 10 years, which is a huge turnover in comparison with the original proposal. In the opinion of the author we cannot talk about an actual pillar in this case, because the Deposit Guaranty Schemes exist only on paper, especially given that they will be fully operational no sooner than in ten years time, and this deadline can even be postponed in extraordinary situations. On the other hand it is arguable whether a pan-european institution would actually be needed for the purpose of safeguarding private deposits. Many countries already have their own guarantee funds, so the decision to harmonize the rules and rights for all EU citizens should, instead of expanding bureaucracy, not necessarily be seen as a failure on the way to European integration.

## **10. Financial stability as of 2014**

Every year, the European Central Bank publishes the Financial Stability Review. This report addresses the problem of maintaining financial stability, defined as a state of economy which allows it to absorb shocks without losing its operational capability. The report's importance is now underscored by the prudential responsibilities the ECB was given through the establishment of the Single Supervisory Mechanism, as it will provide it with the core data for potential risk recognition (ECB 2014).

The 2014 report announced that the systemic risk has dropped for the EU as a whole, yet it remains vulnerable and the post-crisis recovery is not complete. The money markets inside the Monetary Union noted increased activity, yet the turnover remains highest for the secured transactions segment, and only five financial institutions account for 90% of their turnover on the unsecured money market (ECB, 2014). It is also worth pointing out that the liquidity in this sector has rebounded after a continuous, seven-year decline and that the interest rates for unsecured transactions with a two-week maturity have dropped to a negative value. Turnover on the secured transactions segment has continued to grow since 2012, yet it was pointed out that last year's boost was due to repayment of the refinancing transactions performed by the ECB in previous years to increase the availability of credit to non-financial institutions.

**Figure 4. ROE default for large euro area banks**

Source: ECB, Financial Stability Report.

Strong emphasis has been put on the drastic changes in governmental bond prices. In response to low inflation levels, the ECB has announced the Expanded Asset Purchase Programme (APP) – a set of three schemes aimed to purchase, among others, government bonds of the EMU countries. The APP programme allows up to 60 billion euro worth of bonds to be purchased each month until at least September 2016, and thus since its announcement investors' demand for euro-area bonds has grown rapidly. For EU countries with the highest credit standing this has caused a situation in which their bonds were being purchased with a negative yield. Such a change in the way sovereign debt was perceived was an obvious relief to countries with high public debt, yet their yield drop was not so large as was the case in Germany. On the downside, large sums supplied by the EBC to the market have strongly weakened the euro with respect to other currencies.

The new requirements imposed on the banking sector have obviously affected the financial standing of many financial institutions. Banks incurred losses in many European countries, as recession rendered many companies unable to repay their loans, so the process of adjusting to the new threshold of the capital requirements became a heavy burden. The ECB has pointed out that the return on equity (ROE, see Figure 4) level remains below the actual cost of equity for a prolonged time, which could be an incentive for banks to take additional risks so as to rebuild their financial position (ECB, 2014). The impact

of the new banking provisions is also visible in the lower leverage, as a consequence of lower risk taking (Figure 4). Again, the profitability drop is a derivative of multiple factors, but the new prudential requirements have undoubtedly played a part in the process during recent years.

The same profitability problem may affect commodity trading firms as well, as according to the revision of the Markets in Financial Instruments Directive (MiFID II), all commodity derivatives (except gas and electricity) are to be considered as financial instruments, and thus every company involved in trading in these instruments will fall under the scope of the CRD IV directive. The previous directive distinguished this sort of instruments from the financial type as long as they were physically delivered upon maturity. Additionally, commodity firms were excluded from the CRD IV provisions if they were using commodity derivatives strictly for hedging purposes. The revised regulations eliminate such derogations. The underlying cause of this policy shift is the belief that commodity companies are no smaller than banks and therefore may pose a similar threat to global financial stability (Pirrongo 2015).

## 11. Conclusions

The fifteen+ years of the single currency has proved that in the long term the inflation level can be kept at the desired level inside the EMU. Even though the process of integration was not enhanced the way it was expected, the interconnections created between the core EU countries are forcing the member states to extend cooperation.

The lack of crisis management schemes inside the EMU was a hard lesson for all the member states. The imperfections of the monetary union caused the EU to move from one crisis to another, while at the same time USA was already recovering from the shock it suffered following the Lehman Brothers' bankruptcy. It should be noted that the lesson was most effective while the crisis was at full strength – at the time most governments were in favor of taking strong measures to revive the financial markets and put a stop to growing public debts. Once the economic situation began to improve, however, more nations began to neglect the need for further integration, disregarding the threat of contagion. The inconsistency of the EU policy may in fact be seen as one of the greatest barriers to the process of recovery from the crisis, causing uncertainty on the markets.

The reinforcement of prudential requirements according to the recommendation by the Basel Committee was a necessary step, aimed at increase the scope in which financial institutions are required to absorb the eventual shocks

that might affect their liquidity. The new solutions will now address the imperfections of the previous regulations, hindering the attempts to bypass the new requirements and providing room for adjustments in different economic conditions. The decision to include the bonds of the euro area into the most liquid and secure assets was a great relief to the countries which were having trouble managing their debt, but at the same time it greatly increased the risk of an economic breakdown should one of these countries declare insolvency. Over time, as the effects of the debt crisis began to fade, it turned out that this solution acted in favor of reassuring the actors on the capital markets. Solidarity in action and a reaffirmed belief in the stability of EMU member states has allowed for maintaining interest in purchasing euro-based securities by institutions specifically interested in low-risk money allocation.

During the times before the crisis, the Single Resolution Mechanism would probably be considered more as a fairytale than as a serious project that would have any chance of success before the European Parliament. The concept of transferring the right to decide about the future of the largest national financial institutions was long rejected in many countries. Eventually however EU nations were able to reach an agreement and even though the mechanism took a form in which it is primarily designed to support a failing institution, it is the first functioning scheme for a controlled bankruptcy i.e. the first institutional solution to the problem of moral hazard. Regardless of its actual effectiveness in the case of a bank's insolvency, the resolution mechanism has however one major drawback – long before the merits of this solutions were even discussed, Great Britain declared that it would not be joining the banking union. As a consequence, Europe's largest financial center does not fall under the jurisdiction of the newly established institutions.

Simultaneous with to the growing functionality of the second pillar, EU countries have created a stabilization mechanism in order to prevent member states from falling into a debt crisis when forced to restore the liquidity of their financial institutions. Thus it may be said that the former no-bailout clauses have evolved into a joint responsibility solution to manage the complex matter of stabilizing the market. Since it has become clear that no country will allow its core financial institutions to fail, the decision seems reasonable enough, as the new mechanism is a natural constraint to the constant bailouts and distributes the financial burden of such intervention between the EU countries.

The negation of the third pillar – the Deposit Guarantee Fund – should not be seen as a step back from the path to further integration. The underlying reasons why this solution was not implemented on an international scale were reasonable and did not express any specific national interests. Harmonization in

this field allows the establishment of the same goals without the unnecessary bureaucracy, and may in fact enhance the process of paying out the guarantees should a financial institution declare bankruptcy.

The post-crisis solutions are a good step towards proper financial stability supervision. The imperfections of the monetary union from the previous years are now being fixed through the establishment of permanent tools and harmonization of the law. A consistent strategy for preventing and managing financial crises was a necessary step on the way to further and safer integration inside the European Union.

## References

- Bartovic V. (2014), *Efficiency on the Economic and Monetary Union coordination*, Visegrad Fund Publishing House, Bratislava.
- Becker W., Lochel H., Gregosz D. (2013), *Crisis Management in the Euro Area: Why Europe's Policy is on the Right Track*, 'Konrad Adenauer Stiftung', Konrad Adenauer Publishing House, Berlin, no. 116.
- Departament Systemu Finansowego (2015), *Raport o stabilności systemu finansowego*, NBP Publishing House, Warsaw.
- Icard A. (2003), *Comment on Should financial stability be an explicit in central bank objective?* [in:] P.C. Ugolini, (ed.) *Challenges to Central Banking from Globalized Financial Systems*, Publishing House of IMF, Washington D.C.
- Kałużyńska V. (2009), *Bank centralny wobec kwestii stabilności systemu finansowego*, 'Ruch prawniczy, ekonomiczny i socjologiczny', Poznan University of Economy Publishing House, Poznan, no. 1.
- McGowan J., Dallago B. (2015) *A global perspective on the Crisis in Europe*, [in:] L. Casba (ed.) *On the Crisis of the EMU: Failed Construction, Failed Implementation or Failed crisis Management?*, Routledge Publishing House, London.
- Mishkin F.S. (1997), *The cause and propagation of financial instability lessons for policymakers*, 'Proceedings – Economic Policy Symposium – Jackson Hole', Federal Reserve Bank of Kansas City Publishing House, Wyoming.
- Pirrong C. (2015) *Not too big to fail. Systemic Risk, Regulation and the Economics of Commodity Trading Firms*, Trafigura Publishing House, Houston.
- PwC (2014), *Regulatory briefing: SRM – What to expect from Banking Union?*, PwC Publishing House, London.
- European Parliament and the Council (2010), *Regulation on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board*, EP Publishing House, Strasbourg No. 1092/2010.

Schoenmaker D., Werkhoven D. (2012), *What is the Appropriate Size on the Banking System?*, 'Duisenberg School of Finance Policy Paper', DSF Publishing House, Amsterdam, no. 28.

Sinn H.W. (2012), *The European Balance of Payments Crisis*, CESifo Publishing House, Munich.

Zielinska K., Lont P. (2012), *The Debt Crisis – Contagion*, 'Deal Magazine', Inwestor Students Scientific Association, Lodz, no. 1(13).

<https://www.ecb.europa.eu/mopo/html/index.en.html>

<https://www.ecb.europa.eu/ecb/tasks/stability/html/index.en.html>

<https://www.ecb.europa.eu/pub/fsr/html/index.en.html>

<http://www.esm.europa.eu/about/index.htm>

## Streszczenie

### STABILNOŚĆ FINANSOWA W STREFIE EURO

*Problem stabilności finansowej w strefie euro jest często poruszonym zagadnieniem zarówno w Europie jak i na świecie. Od chwili powstania unii walutowej, pojawiało się wiele spekulacji co do jej niedoskonałości, niemożności sprawnego zarządzania jak również wrażliwości na szoki ekonomiczne. Część z tych spekulacji okazała się prawdą, część zaś była nieuzasadniona, niemniej jednak kryzys zadłużeniowy w Europie uwidoczniał braki w strukturze unii monetarnej jak również udowodnił, że dalsza integracja wewnątrz Unii jest niezbędna zarówno dla zapewnienia bezpieczeństwa wspólnej waluty, jak również dla pełnego wykorzystania jej potencjału.*

*Artykuł podsumowuje najpoważniejsze zastrzeżenia wobec funkcjonowania strefy euro od chwili jej powstania. Analizie poddane zostały również nowe rozwiązania w zakresie nadzorowania stabilności finansowej pod względem ich zdolności do uchronienia Europy przed przyszłymi kryzysami gospodarczymi oraz błędnym kołem zadłużeniowym wywoływanym koniecznością ratowania instytucji finansowych. Problem przeanalizowany został w trzech okresach czasu – na początek przybliżono definicję stabilności finansowej oraz największe obawy wobec utworzenia strefy euro. Następnie opisano jak obawy te zostały zweryfikowane w ciągu 14 lat funkcjonowania strefy euro. W trzeciej części podsumowane zostały rozwiązania, jakie wprowadzone zostały na rzecz walki z kryzysami finansowymi oraz utrzymania stabilności finansowej państw Unii Europejskiej.*

**Słowa kluczowe:** stabilność finansowa, strefa euro, euro, instytucje finansowe