Perspectives of Financial Stability as an Implicit Economic Policy Goal

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Abstract

The main aim of this article is to answer a question whether financial stability belongs to the domain of the public good and in what way it should be provided by the state, especially in the face of a financial crisis. A financial crisis has once again become a stimulus to starting a discussion concerning the challenges that financial stability has to face as a goal of the economic policy. Above all, a question appears whether the significance of this aim should go up in the hierarchy of the economic policy, especially by specifying it more explicitly. The above-presented aim determines the layout of the article, which consists of two fundamental parts. Part one (section 2) presents the conception of financial stability and verifies the thesis that financial stability serves as a public good. Furthermore, the authors point out to the consequences of that thesis, especially with reference to the economic policy goals. Part two (section 3) offers a discussion on the methods, instruments and mechanisms of providing financial stability by public institutions.

Keywords: financial stability, economic policy, public goods

1. Introduction

In the face of the recent financial crisis more and more space is devoted in economy-related literature and the media to the issue of financial stability. It is not surprising, since a crisis is an extreme example of a lack of stability. A frequently asked question is whether financial stability should be provided, and if so, in what way and by which institutions? Is the current state of affairs in this matter adequate in Poland and around the world? This issue is also considered from a wider perspective, i.e. with reference to the scale of state intervention in the economy. A thesis may be put forward here that the occurrence of a crisis situation results from an overly liberal approach to conducting the economic policy and serves as an argument for increasing the degree of state intervention in the market. Much as the crisis situation is a strong stimulant to increase state intervention in order to combat a crisis, its long-term trend (i.e. after the end of the crisis) is a rather disputable issue.

Another stimulus for writing this article were the opinions voiced by economic decision-makers who tend to use in their speeches and publications the term of a public good with reference to financial stability (Skrzypek, 2007). The validity of such a statement may serve as a strong argument in the discussion over the degree and form of state intervention in the economy in the face of a financial crisis, and in a wider approach, with reference to financial stability. It results from the fact that the subject literature as well as practical experiments indicate that if the public good should be provided to the society, it must be "produced" by the state. Failure to provide a consumer with a public good shall be considered as one of the drawbacks of the market and constitutes an efficiency argument in favour of state intervention. State intervention due to efficiency results from a failure to fulfil the so-called "standard assumptions" which condition proper functioning of the "invisible arm of the market". They include the following: perfect information, perfect competition and a lack of market drawbacks. One of the market drawbacks is, however, a failure to ensure a public good to the society (Barr, 1993, pp. 99-103). On the other hand, it is indicated that state production, among all, is a proper form of intervention. Other forms include: regulation, finance monetary transfers (Barr, 1993, pp. 97-99). The main aim of this article is to answer a question whether financial stability belongs to the domain of the public good and in what way it should be provided by the state, especially in the face of a financial crisis.

A financial crisis has once again become a stimulus to starting a discussion concerning the challenges that financial stability has to face as a goal of the economic policy. Above all, a question appears whether the significance of this aim should go up in the hierarchy of the economic policy, especially by specifying it more explicitly. The above-presented aim determines the layout of the article, which consists of two fundamental parts. Part one (section 2) presents the conception of financial stability and verifies the thesis that financial stability serves as a public good. Furthermore, the authors point out to the consequences of that thesis, especially with reference to the economic policy goals. Part two (section 3) offers a discussion on the methods, instruments and mechanisms of providing financial stability by public institutions.

2. Financial Stability in the Hierarchy of Economic Policy Goals

2.1. The Conception of Financial Stability

Financial stability is a conception which is frequently used both in the economic policy practice and economy-related literature. It may thus seem that defining this conception should not cause any problems. However, over viewing the subject literature with reference to financial stability, it may be concluded that there is no uniform, widely accepted definition of this conception. Depending on the aims of their publications, various authors adopt different definitions of the conception of financial stability. This article does not make any attempts at resolving which definition is the best and should be commonly accepted. It does, however, offer a review of a few selected definitions. The approaches described in this article present various aspects of this conception. The approaches have been put in order according to the level of their accuracy. According to the most general approach, financial stability is a state without any major disturbances or crisis situations in the economy (Fidrmuc, Schardax, 2000, p. 92). Such a description is, however, not very precise and corresponds rather with the definition of economic stability. It shall be highlighted that it refers to a crisis as the main symptom of a lack of financial stability. The author refers here in particular to a financial crisis, and not an economic crisis. We should bear in mind, however, the process of transformation of crisis phenomena, which is frequently observed in practice. A crisis strikes the banking system in the first place, subsequently turning into a financial crisis, finally touching the real sphere of the economy and becoming an economic crisis or a social crisis. In such circumstances, financial stability is usually identified with the stability of the banking system. Such a thesis is additionally justified in the case of a German-Japanese model of the financial sector and is applied in this work.

The second approach, which is slightly more detailed, indicates a state in which the financial system is capable of fulfilling its fundamental functions in a permanent manner, i.e. effectively allocate funds from the savers to the most productive investors (Issing, 2003, p. 1). Characteristic features of such a definition are, first of all, identifying financial stability with the stability of the financial system, and second of all, defining financial stability by the functions it serves. To clarify, it shall be highlighted that apart from the above-mentioned general function, there are more detailed functions such as: monetary, capital and redistribution as well as controlling (Szczepańska, 2008, pp. 13-18) According to the third approach, financial stability is a state in which economic activities are not disturbed by considerable changes in asset prices or by major disturbances of the liquidity of financial institutions (Crockett, 1997, p. 2). A specific feature of this definition is emphasising the two sources and symptoms of financial instability: changes in asset prices and disturbances of financial liquidity of institutions. At the same time, they also serve as two fundamental conditions for financial stability. Last but not least, the following approach constitutes a completion to the previous one. It also highlights the criteria for financial stability. They are, however, more detailed in this case. According to this approach, financial stability is a situation in which the economy fulfils a wide range of macro- and microeconomic criteria (Kiedrowska, Marszałek 2003, p. 5). The former concern among all such values and indices as: inflation, budget deficit/GDP, public debt/GDP, current account deficit, short-term flows, capital inflow/GDP, the relationship between short-term debt and currency reserves. On the other hand, the latter refer among all to: private sector debt/GDP, a real increase in the private sector debt, investment profitability, covering bad debts with their reserves, capital adequacy ratio of banks, rate of return on the assets of financial institutions, capitalisation of the stock exchange.

2.2. Financial Stability as a Public Good

One premise for further considerations is obtaining an answer to a question whether financial stability is a public good. This answer will influence the need for and manners of state intervention aiming at ensuring the stability. In this context, it seems necessary to – first of all, determine the characteristics of a public good and – secondly, refer them to financial stability.

A pure public good is characterised by three main features (Barr, 1993, p. 102): no competitiveness in consumption, no exclusion and no renewal. The first feature means that when the good is consumed by one entity, its availability is not limited for other entities, the final cost of an additional user amounts to zero, which is not equivalent to a zero final production cost. The second feature means a lack of possibility of excluding an entity from using a public good, and as a result there occurs a problem of the so-called "fare-dodger", which consists in an inability to charge an entity for a good. Last but not least, the third feature derives from the previous one and indicates that a user cannot resign from using the good by him- or herself. Referring the above features to the financial stability characterised in the previous section does not require sophisticated analyses. There is a clear indication that financial stability is a public good. First of all, taking advantage of the state of stability of the financial system by an additional user (consumer, enterprise, etc.) does not generate costs. Secondly, the privilege of financial stability may be claimed by every entity and no entity shall be excluded. For example, an enterprise running in a country with a stable financial system takes great benefits for which it is not charged. Thirdly, a "user" of financial stability cannot resign from functioning in a stable environment.

The above assumption entails major consequences regarding the economic policy. The subject literature and practical experiences indicate that if the public good should be provided to the society, it has to be "produced" by the state. The market is not interested in providing a good having the above-mentioned features. In order to eliminate this microeconomic drawback of the market, it is necessary to have state intervention. Bearing in mind various possible forms of state intervention due to the effectiveness, it shall be clearly highlighted that it is state production that is pointed out to be adequate in such circumstances. Simultaneously, it is an instrument which assumes the greatest degree of state intervention in the market among the types of interventions relating to the effectiveness. In connection with determining the proper form of intervention, one should bear in mind the specific character of the good of financial stability. It may be said that it is a peculiar service which shall be provided by the state to the society and the economy. Thus, providing financial stability does not entail the necessity of setting up a factory or another state enterprise. It is realised by certain institutions which apply various forms of intervention relating to the effectiveness, including above all regulation and finance.

2.3. Financial Stability as an Implicit Aim of the Economic Policy

In the light of the above remarks and a significant role of financial stability in efficient functioning of the economic system, it may seem that it should be an important goal of the economic policy. In reality, this situation is extremely complex. Among all, it is difficult to answer a fundamental question of which entity and in what way is responsible (or shall be held responsible) for the goal of financial stability. Addressing the first part of the question, the most frequently indicated reply is a lack of a central bank. Among other institutions which are referred to as (financial) safety nets there are: governments, financial supervision authorities and deposit-guarantee schemes. At the same time, none of the central banks nor any other entity of the economic policy is responsible for "ensuring financial stability". In fact, financial stability plays the role of a mission, and not a goal of the explicit economic policy[1]. In practice, we speak mostly about the "actions for" or "support of" financial stability. Among the group of 35 analysed central banks around the world, 31 have declared their readiness to undertake such actions as a mission. On the other hand, only 18 of them have a proper statutory statement which corroborates the commitment to support financial stability (Szczepańska, 2008, pp. 67-72). Moreover, financial stability, being an official goal of a central bank, is not included in the structure of monetary policy goals. One example might be the Bank of England whose official webpage provides information concerning two core targets: the goal of monetary policy which is price stability and the goal of financial stability (www.bankofengland.co.uk). A similar situation takes place in the case of the National Bank of Poland.

The actual state concerning the character and placement of the goal of financial stability in the practice of the economic policy has both numerous positive and critical premises concerning the above statement. Generally speaking, the main premise of the first type is the significance of financial stability for the efficient functioning of the economy. Research shows that it has a positive influence on the economic growth and social well-being (Szczepańska, 2008, pp. 18-22).

[1] One example of an *explicit* goal may be price stability. It is currently the major (and the only) goal of monetary policy in most countries around the world. It is operationalised (i.e. its value aspect is specified in the form of a target rate of inflation together with the horizon of realisation), and central banks have been equipped with proper instruments on the one hand, yet on the other they have become responsible for the realisation of the goal.

Much as the intention of realising the goal concerning financial stability is fully justified, its practical implementation encounters numerous obstacles. First of all, the lack of a precise definition of financial stability makes it impossible to formulate the explicit goal. Most frequently, in order to operationalise, supervision of finance asset prices is recommended as a derivative of the goal of financial stability. Among the methods of supervision there are: including the price of assets in the index of prices or intervention in the case of the occurrence of speculative bubbles, as well as gradual softening of the ascending trend of asset prices by skilfully increasing the interest rates. It shall be highlighted that the subject literature enumerates both the arguments for and against giving prices the character of the monetary policy. It seems, however, that the disadvantages outweigh the advantages to a large extent (Bernanke, Gertler 2000; Cecchetti, Genberg, Lipsky, Wadhwani, 2000; Borio, Lowe, 2002). Secondly, a central bank (or any other entity of the economic policy) does not possess adequate instruments which would make it possible to influence effectively financial stability (especially the control of asset prices). Thirdly, the manner of influence of certain instruments on the goal under analysis (in the form of transmission channels) is also doubtful. Financial stability is a very wide conception, affected by a number of factors, and the decisions and actions taken under the monetary policy have limited possibilities of influence. The problem does not stem solely from the difficulty with specifying the measure, value and horizon of such a goal. Among the other factors, there are:

- A limited influence of short-term interest rates as the basic instrument of a central bank on asset prices; furthermore, it shall be highlighted that it is pointless to burden the central bank with new tasks without increasing the number of available instruments (cf. the model of Tinbergen, Acocella, 2002, pp. 223-228).
- The possibility of occurrence of the moral hazard; entities may take advantage of the fact that financial stability has to be ensured by the central bank, and especially the necessity of stabilising asset prices. As a result, they will be more inclined to take a greater risk on the one hand, and on the other to speculate on asset prices.
- The possibility of occurrence of a conflict between price stability and financial stability.

In the context of the last factor it shall be noted that a traditional view says that both types of stability are complementary to each other. On the one hand, stable prices are a necessary condition of financial stability. On the other hand, a stable financial system makes it possible to perform an efficient transmission of impulses of monetary policy, and consequently increases the effectiveness of controlling the inflation. In recent years a contrary opinion has appeared, claiming that there is a discrepancy between financial and price stability. On the one hand, low and stable inflation may create favourable conditions for a growth in asset prices due to excessive optimism of business entities and taking more risky investment decisions. Additionally, overly low inflation increases the risk of the occurrence of deflation and financial stability associated with it. What is meant here is the “bad” type of deflation, which is accompanied by a decline in production and employment. The rate of the fall in prices is high, and the durability of deflation is relatively high as well. It is caused by a negative demand shock, bringing about considerable costs. It is associated with the phenomena of the lower borderline of nominal interest rates, liquidity trap and speculative bubble. Its causes and transmission channels are complex and difficult to identify. Combating this kind of deflation requires applying special, non-standard measures (Bordo, Lane, Redish, 2004; Buiter, Sibert, 2004; Ito, Mishkin, 2004). On the other hand, the realisation of the goal of financial stability by a central bank may damage price stability. The main premise of this phenomenon shall be ascribed to a failure to adapt short-term interest rates, being an instrument of the monetary policy, to the incompatible dynamics of asset prices and the prices of consumer goods and services.

3. Mechanisms of Ensuring Financial Stability

3.1. Manners of Producing Financial Stability by the State

Financial stability has been classified as one of the public goods in this work. Thus, there is a question of how we can provide such a good or, in other words, which issues we should refer to in order to present financial stability produced by the state (public institutions).

It has been assumed that the manner of production of the stability under analysis may be depicted by making a reference to the following elements:

- The time in which financial stability is provided,
- The institutions which are responsible for providing this stability or the institutions which have adequate means (instruments) to produce the public good under discussion,
- The instruments which make it possible to provide financial stability,

- The market knowledge concerning the available instruments and directions for their application.

Table 1 presents particular institutions and the instruments available to them at different stages of producing financial stability.

Financial stability is most frequently referred to in situations when there occur disruptions on the financial market (smaller or larger deviations from the financial stability). These disruptions may result for example from a systemic lack of confidence on the interbank market or directly from an abrupt deterioration of the rate of return from financial assets in the sector of commercial banks[2]. However, when financial stability is regarded as a public good, the state is obliged to provide it both in the case of the disturbances on the financial market and in the face of a financial crisis. That is why, the first column of table 1 presents the stages of providing financial stability. The stages of crises prevention and crisis management have been indicated as well. Crises prevention has been defined as the time when there are no deviations from the financial stability. Crisis management has been specified as the time when a crisis situation has already occurred. Columns 3-6 of table 1 show the public institutions responsible for the production of financial stability. These institutions include: a central bank, the government (the representatives of public authorities), financial supervision authorities and the deposit guarantee scheme[3].

Column two of the table presents the instruments which are used by particular public institutions to provide financial stability – the X mark indicates that a given institution may apply a particular instrument. It shall be highlighted that the placement of the X mark may be a disputable question in a few cases. Nevertheless, according to the authors of this work, a clear system of public institutions and instruments in the context of maintaining and restoring financial stability in the contemporary market economy should be presented as the above table. Drawing on table 1, it may be concluded that, depending on the stage of provision of the public good in question, there is a different set of instruments. At the stage of crises prevention there are the following: regulations, control, sanctions, security of the payment system and macro-prudential analysis. These instruments may be divided into those which influence the stability of the financial system itself and those which have an impact on the environment in which the system operates. It shall be noted that the market knowledge of these instruments and the directions of their application is (or can be at any time) complete. However, if – for some reason – there occurs a financial crisis (banking sector crisis), public institutions must establish a different set of instruments as a method of crisis management. These include the following: lender of last resort, corrective programmes, guaranteed deposits payments and public support. The market knowledge concerning the available instruments at the stage of crisis management shall also be considered as complete, yet the directions and – above all – their scope of application cannot be fully predicted. The institutions of supervision and deposit guarantees have clearly specified tasks at the time of a crisis (especially in the case of a fall of one or more banks); in other words, they have a limited scope for taking the so-called unconventional actions. On the other hand, a central bank and the government have a wider range of unconventional options to influence the banking sector at the stage of a financial crisis. Such a possibility of arbitrariness of actions of the monetary authorities and public authorities is a major reason why the financial market is not able to fully predict both the directions and the scope of application of the instruments of crisis management. A question arises at this point concerning which activities of the central bank and the government may be deemed as unconventional actions during a financial crisis? In the case of the central bank, an unconventional action is regarded to be any transactions aiming at strengthening the commercial banking sector (within the option of an open market), which would not occur under normal circumstances (in the case of a lack of deviations from the financial stability). Two contrary trends in the discussion concerning the role of central banks in managing a crisis may be presented here. According to the first trend, monetary authorities should not perform any activities aiming at stabilisation either during a financial crisis or even at the time of the first premises of the occurrence of a crisis, e.g. a rapid growth in asset prices (shares or real estate). It shall be noted at this point that this work assumes that the main symptom of deviations from the financial stability is a financial (banking) crisis itself identified with a sudden deterioration of the index of return on the banking sector assets.

[2] It shall be reminded at this point that financial stability (financial crisis) has been narrowed down in this work to the stability of the commercial banking sector (the crisis of the commercial banking sector).

[3] To learn more about the subject of financial supervision institutions and the system of deposit guarantees go to: (Daniluk, 1996; Szczepańska, Sotomska-Krzysztofik, Pawliszyn, Pawlikowski, 2004; Pawlikowski, 2005).

However, the premises for the occurrence of such a crisis, e.g. a rapid growth in asset prices (mostly shares and real estate) are also considered to be a certain symptom of deviations from the stability of the financial system (Kiedrowska, Marszałek, 2002). The proponents of such an approach indicate that a growth in asset prices under the conditions of low inflation would pose a huge problem for the central bank (Pepper, Oliver, 2006, pp. 133-139). If the central bank was going to slow down the growth in asset prices, it would have to sharpen its monetary policy in order to make the market interest rates go up. In fact, higher interest rates do not only reduce the demand for loans to finance, for example, a purchase of shares, but also increase the attractiveness of debt instruments, especially the treasury bonds. A negative consequence of such actions would be a deflation pressure resulting from overlapping low inflation and high interest rates. One should also bear in mind that the society perceives favourably a high value of their assets or an increase in their value. Thus, all actions taken by monetary authorities in order to lower the prices of shares or real estate will probably be considered as "undermining common prosperity" and will be contrary to the guidelines of the economic policy, even when we take into consideration the fact that monetary authorities are not subject to the re-election processes (Jurek, Marszałek, 2007, pp. 14-15).

It has been pointed out, however, that the main symptom of deviations from the financial stability is the banking crisis itself. The opponents of stabilising activities of the central bank under the conditions of such a crisis emphasise the fact that one cannot destroy the accomplishments of the institutional "revolution" in terms of the functioning of central banking, which began in many countries (also in Poland) at the beginning of the 1990s. Two main elements of this "revolution" – the functional and political independence as well as the specification of a superior goal in the form of price stability (at least in most countries) – began to define a new manner of perceiving the role of a central bank in the contemporary market economy (Eijffinger, DeHaan, 1996). The opponents of conducting interventions by the monetary authorities at the time of financial crises claim that granting complete independence to the central bank and a clear definition of its superior goal is not a sufficient condition to build a reliable monetary policy. This credibility appears when a central bank really focuses on realising one goal (price stability), and not when it realises a few equally important goals. In other words, a fully reliable central bank should not give up on the inflation goal in order to reduce the effects of financial instability by supplying commercial banks with extra money. On the other hand, the opponents of the above-presented trend claim that in the event of a financial (banking) crisis, the monetary authorities shall be the main public institution which should aim at restoring stability in the financial system. According to them, it stems from a few reasons. First of all, the monetary policy, apart from the fiscal policy, belongs to the main economic policies. Within the monetary policy, one cannot only define the goals and instruments, but a central bank has also got measurable resources (money) which may be used for influencing the macro-system[4].

Secondly, imposing very stiff rules of procedure on the monetary authorities (due to statutory provisions), is in fact conducive to the realisation of the inflation goal, yet such rules may also result in the occurrence of considerable costs in the economy. Disregarding the significance of financial stability may considerably decrease the reputation of a central bank, even when it is successful in realising its inflation goal. On the other hand, lower credibility makes it more difficult to realise inflation goals in the following periods. Thirdly, a really credible monetary policy should take into account the possibility of the occurrence of disruptions in the financial system. That is why, a central bank must be ready to depart from its inflation goal in the short-run for maintaining both a low price level and financial stability in the long-run. It is pointed out that in order to do so, the monetary authorities should establish proper rules of communication with the financial market. It seems that the arguments of both the proponents and the opponents of the central bank intervention in the event of a financial crisis are understandable and rational (their further analysis goes beyond the scope of the subject matter of this work). Nonetheless, as has been pointed out above, contemporary institutional bases for the functioning of central banking depend in many countries on the realisation of the superior goal of the monetary policy, which is the price stability. That is why, supplying central banks with additional money under the conditions of a financial crisis is regarded as an unconventional action of a central bank. It shall be highlighted once again that even in the event of a crisis, the supporting transactions of a central bank take place with the use of the market instruments of the monetary authorities, and especially the open market operations.

[4] The authors of this work express a viewpoint that the concept of policy is frequently mistaken with influence in the contemporary economic literature. The activities of the institutions of the authorities may be regarded as policy only when given authorities possess measurable resources at their disposal. That is why, the policy defined by a central bank may be regarded as the monetary policy.

In the case of the government, an unconventional action at the time of a crisis may be considered to be any support directed at the commercial banking sector and coming from public resources. Such support may consist, for example, in granting a government loan, buyout of a part of shares of a given bank or its nationalisation. Compared to the support from the central bank to commercial banks, government support is not such a disputable question as far as the subject literature is concerned. It stems from a much larger interrelation (coupling) between the monetary authorities and the banking sector than between the sector and the government. Nonetheless, in reality, any form of support for the banking sector from the state budget causes controversies similar to those of the support from the monetary authorities.

3.2. Effects of Providing Financial Stability to the Real Sphere of the Economy

Unconventional actions of the central bank and the government at the time of a financial crisis cause significant repercussions for the economic policy. The market may assume that both the central bank and the government will act in a similar manner in the event of another crisis. In such a case, there occurs a peculiar paradox, namely the current actions taken by the two main centres of power (monetary and public) in order to restore financial stability create the conditions for a growing “moral hazard”, and thus the conditions for the occurrence of a larger number of deviations from the stability in the future. A question shall be posed here concerning the situation in which the above paradox may actually occur. It seems that the main issue here is the recognition of the reasons for the current financial crisis. If the main cause of this crisis was an inappropriate behaviour of the market participants (bankers in this case), reflected by irrational crediting of the real sphere of the economy, it may be assumed that they will be likely to show similar behaviour in the following periods. It may be further concluded that this inclination to irrational behaviour on the financial market will be higher in the future in a situation when a central bank and the government will conduct intervention activities in order to reduce the effects of the current financial crisis. The above observations delineate a crucial problem for the economic policy. If the financial market participants show the tendency to irrational behaviour, reducing the effects of the current banking crisis by supply transactions from the central bank and public support cannot be considered as fully effective. In fact, the actions of the monetary authorities and the government increase the likelihood of the occurrence of another financial crisis in the future.

It shall be highlighted at this point that the most frequent irrational behaviours of market participants result from the existence of certain sources which induce such behaviours. The last banking crisis which occurred in the American economy is a good example of the existence of such sources. It is indicated that this crisis was an effect of connecting faulty macroeconomic and institutional frameworks created by public and monetary authorities. It shall also be mentioned that the existence of such sources does not obviously justify the irrational actions. It seems, however, that the main cause of the American crisis was the inertia of institutional solutions. The first wrong solution concerned the attitude of the public authorities, which played the role of a peculiar guarantor for a considerable part of granted mortgage loans. Thus, the boards of commercial banks assumed that their investments (granted loans) were secured. The function of a guarantor on the mortgage loans market performed by the American government resulted among all from maintaining two public institutions: Fannie Mae oraz Freddie Mac. Both institutions participated actively on the mortgage loans market by buying out securities which constituted collateral for the loans. Another inertia of institutional solutions consisted in a lack of adequate regulations concerning the functioning of the financial sector. An important role, being a negative one – as it later turned out, was played here by Alan Greenspan, who served as Chairman of the Federal Reserve for many years. He was an ideological proponent of economic liberalism and he opposed imposing strict regulations on lending institutions. In fact, he believed that the more regulations there were, the worse it was for the economy. As it later turned out, his unbounded belief in the self-regulatory mechanism of the market was unreasonable. The third symptom of bad institutional solutions stemmed from an insufficient control of the activities of the boards of commercial banks by their owners. Until the owners noticed the premises of the crisis, they had been convinced that the boards they hired conducted proper lending policy. The boards, in turn, were not afraid of conducting the irrational lending policy due to this lack of regulations from the authorities, lack of control from the owners and an assumption that their investments were secured. It may be concluded that the above-described three institutional insufficiencies on the American financial market strengthened the “moral hazard” altogether, leading in effect to an outbreak of a banking crisis and its spread to the other regions of the world.

3.3. Methods of Preventing Financial Instability

A question shall be formulated here concerning the activities which may lower the risk of the occurrence of a financial crisis in a given economy. According to the data presented in table 1, such an activity is strengthening the role of regulations and control over financial institutions, especially from the banking sector. Obviously, it is not consistent with the trend of the liberal economy; however, one should realise that a fall of a few banks constitutes much more serious consequences for the economy that liquidation of a few enterprises due to economic reasons. In other words, the banking sector is vital for the entire system. Let us refer at this point to the views of Adam Smith, who claimed that it is every man's nature to be greedy and to care about one's own business. From an economic point of view, these are positive features, since they stimulate a man to start economic activities. Smith stressed the fact that a man's activity would be more efficient if there were not overly many regulations limiting this activity (a viewpoint shared also by Alan Greenspan). The last financial crisis which began in the United States proved, however, that regulations and control of financial institutions are indispensable in order to channel "economic greed" in a desired direction.

Furthermore, of considerable importance here is the macro-prudence analysis. The crisis in the United States showed explicitly that mong the elements of this analysis there should not be only the assessment of the shape of fundamental economic policies (monetary and fiscal) or the level of the main macroeconomic indices. An equally important issue (and maybe even more important) is preventing the situation in which the authorities, through their actions (both practical and at a verbal level) encourage market participants to make sub-optimal decisions. It has also been already highlighted that such decisions are shaped on the basis of an assumption that a given investment is protected by the authorities. Table 1 also depicts sanctions as one of the instruments of preventing crises. They play (for the financial supervision) the role of a disciplinary instrument. This function has a possibility of using clearly specified administrative measures with respect to both financial institutions and particular persons responsible for the irregularities which were created. It seems that the sanctions should be an effective instrument for preventing crises; thus, legal and technical bases for the implementation of these instruments should be created in particular countries. However, the authors of this work point out to two crucial problems connected with the actual application of sanctions. The first concerns the assessment of the actions taken by financial institutions. It shall be assumed that, especially on the bank loans market, the majority of transactions are burdened with a considerable risk, despite complying with the collateral requirements. Thus, in numerous cases it will be difficult to conclude explicitly whether the reason for the "missed" investment were irrational behaviours of the financial market participants or other unforeseeable circumstances.

The second problem is a consequence of applying the sanctions in the economy. A fear of bearing the professional and penal responsibility resulting from making an unsuccessful transaction may induce the financial market participants (and especially the participants of the bank loans market) to seek safer forms of allocating funds, e.g. widening the scale of loan channelling for the state. As a result, the real sphere of the economy will be cut off from a considerable amount of free funds, which will disturb not only the allocation of capital but also the course of transactions in the economy. What follows from the above deliberations is that the implementation and application of sanctions may cause numerous controversies. Nonetheless, it is obviously impossible to resign from this instrument of preventing crises. There should be, however, legal and technical frameworks worked out carefully in such a way so as to make it possible for the sanctions to really fulfil their disciplinary function on the one hand, and on the other to encompass the indicated problems. As has been presented above, there are actions which reduce the risk of the occurrence of a financial crisis. In other words, the authors have shown the manners of providing financial stability by public institutions at the stage crises prevention. It shall be clearly highlighted, however, that the effectiveness of providing a given public good depends not only on the provider of the good, i.e. the state, but also on the behaviours of broadly-understood receivers. In this area, great responsibility is put on the shoulders of the owners of commercial banks and the broadly understood ownership supervision performed by them. In fact, the economists have been aware for a long time that those who carry out orders (the boards) frequently realise their own particular interests, and not the interests of their clients and customers (the owners). The fact that the bank does not always secure the interests of its depositaries and shareholders cannot be a surprise to anybody. That is why, the owners of the banking sector should currently focus on a maximal reduction of the information asymmetry between them and the boards of their banks, and they should constantly monitor the activities of the boards. It is particularly justified in the situation of an inertia of institutional solutions created by public institutions on the financial market.

A thesis may be put forward at this point that the form of ownership in the banking sector, and the degree of organisation of the owners, is the main factor influencing the efficiency of controlling the boards. The more centralised the ownership is (the strategic investor dominates or has a complete power), the more chances there are for minimising the information asymmetry between the owners and those who carry out their instructions.

4. Summary

Public goods constitute one of the manifestations of the microeconomic disabilities of the market. The necessity of their provision by the state is conditioned by the fact that, for some reasons, there is a radical decrease in the motivation to produce such goods by the private sector. The currency and banking crises which have haunted the world's economy in recent years have forced the economists (and other observers of the socio-economic life) to take a closer look at the issue of financial stability – especially in the area of functioning of the commercial banking sector. Due to the fact that the stability under discussion has a considerable influence on the efficiency of the economic system, it shall also be included among the public goods. In other words, the state should provide financial stability, since the market would not probably create the institutional and legal frameworks which would be efficient enough in the event of a crisis. However, a number of problems appear in the background of the above. Any deviations from the financial stability require taking actions by the two main centres of power: the government and the central bank. Such actions are not, however, commonly accepted by the general public. On the other hand, a lack of any reaction from the authorities to a financial crisis may result in the breakdown of the entire economic system. That is why, a crucial issue is concentrating on improving the instruments which are used for providing financial stability at the stage of crises prevention. It shall be clearly highlighted, however, that public institutions (especially the government and the central bank) are not able to ensure this stability on their own, even if they strengthen the instruments at their disposal. Much depends on the scope of the supervision and control exercised by the bank owners in the sector of commercial banking and the activities taken by the boards of these banks.

Table 1: The Manners of Providing Financial Stability by Public Institutions

Stage	Instruments	Supervision	Central bank	Deposit guarantee scheme	Government
Crises prevention	regulations	X			X
	control	X			
	sanctions	X			
	security of the payment system		X		
	macro-prudential analysis		X		
Crisis management	lender of last resort		X		
	corrective programmes	X		X	
	guaranteed deposits payment			X	
	public support				X

Source: (Szczepańska, 2008).

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