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INSIGHT

Financial Stability and Economic Growth

February 12, 2026

The Financial Stability Oversight Council (FSOC), an interagency council headed by the Treasury Secretary and composed primarily of financial regulators, has been tasked with monitoring and mitigating systemic risks to financial stability. (For background, see CRS Report R48739, *Financial Stability Oversight Council: Policy Issues in the 119th Congress*, and CRS Report R47026, *Financial Regulation: Systemic Risk*.) Examples of financial instability include a widespread financial crisis or a more limited disruption to parts of the financial system. Until now, FSOC's approach has focused on identifying a wide variety of risks to financial stability. Under Treasury Secretary Scott Bessent, FSOC has taken actions consistent with a more "hands off" approach—it has not released any reports on financial stability topics to date, its annual report was narrower in scope than prior editions, and it has reduced its budget and the budget of its support agency, the Office of Financial Research. It has instead emphasized promoting economic growth through regulatory relief, in contrast with efforts to mitigate systemic risk through new regulatory requirements in the aftermath of the 2008 financial crisis.

The Relationship Between Growth and Financial Stability

Secretary Bessent has argued that "economic growth underpins financial stability" and "expanding economic growth must be among [FSOC's] top priorities." He notes that strong growth results in strong household income growth, which in turn promotes healthy household balance sheets. Healthy balance sheets reduce spikes in default rates that can cause financial instability, all else equal. Weak economies also arguably have fewer resources (for example, capacity to provide fiscal stimulus) to respond to financial instability.

Growth and stability do not always go hand-in-hand, however. When thinking about financial stability, it is useful to distinguish between short-term and long-term growth. Higher sustained growth in the long run has many economic benefits and may promote financial stability. But many historical examples of financial instability were preceded by an acceleration in short-term growth that proved after the fact to be unsustainable. One recurring cause of financial instability is boom and bust cycles, where credit grows rapidly or asset prices rise rapidly only to be followed by losses as borrowers or investors become overextended, ultimately resulting in a destabilizing market crash. Examples include the 1929 stock market crash that instigated the Great Depression and the housing bubble that resulted in the 2008

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IN12655

financial crisis. Bursting asset bubbles do not always lead to financial instability, however. The dotcom stock bubble of the 1990s was followed by a mild recession in 2001 that did not feature significant financial instability.

It is also not a given that higher average income growth will result in healthier household balance sheets. Households could respond to higher income by consuming more or saving more—only the latter causes their balance sheets to improve. Or if income growth were not evenly distributed, it would not improve the balance sheets of households whose income did not grow. In addition, asset bubbles make households and businesses appear wealthier, which can temporarily obscure weak balance sheets.

Policy Implications

The view favoring promoting financial stability by promoting growth leads to different policy prescriptions than the view that excessive credit or asset price growth increases systemic risk. Policymakers addressed vulnerabilities revealed by the Great Depression and financial crisis by adding regulators and regulatory requirements. Bessent wants regulators to focus instead on "where aspects of the U.S. financial regulatory framework impose undue burdens and where they harm economic growth, thereby undermining financial stability."

But absent regulation, financial market participants face incentives to maximize profits, not maintain financial stability. Generally, greater risk-taking leads to higher expected profits in financial markets. Financial firms or their employees may take excessive risks, because they profit from the upside but do not bear all of the downside when risky actions backfire. This asymmetry could occur because those downside risks are partly borne by the government via deposit insurance or ad hoc bailouts or by market mechanisms such as limited liability or private insurance. Prudential and systemic risk regulation is broadly aimed at curbing excessive risk-taking, so regulatory relief could increase systemic risk and, paradoxically, ultimately increase the government's footprint in financial markets if bailouts are used to restore stability.

On the other hand, financial activity inherently involves risk, and too much regulation could result in what Bessent calls the "stability of the graveyard." Or regulation can backfire and increase systemic risk if it is poorly designed. For example, regulation can potentially shift risk into less regulated parts of the financial system instead of reducing it. Or by discouraging certain activities or investments, regulation can reduce diversification of risk by encouraging all financial firms to have the same risk exposures, potentially resulting in synchronized losses. Ill-conceived government policies can also create vulnerabilities that weaken financial firms' solvency. For example, the combination of federal interest rate caps and high inflation in the 1970s eroded the deposit base and profitability of banks and thrifts. This set into motion what eventually became the savings and loan crisis in the 1980s. Deregulation then exacerbated the crisis by allowing distressed banks and thrifts to take excessive risks that increased losses.

Macroeconomic policies can also affect short-term growth and economic stability. Prudent fiscal and monetary policy can stabilize the business cycle, but imprudent policy can amplify it. During a credit boom, contractionary policy can be used to lean against the wind, whereas expansionary policy can potentially fuel a bubble.

Bubbles or unsustainable credit booms may be easy to identify after the fact but difficult for policymakers to accurately identify as they are happening. For example, there is currently a debate about whether there is an artificial intelligence (AI) bubble or whether high AI-related valuations can be justified by the technology's potentially transformative nature. It is also challenging to identify the turning point when boom turns to bust. In all three of the bubbles noted above, higher growth persisted for several years before the bubble burst. Furthermore, efforts to stop a bubble from growing can potentially cause the same economic damage as a bursting bubble.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

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