Capitolo 5

European finance in the new international monetary and financial system

Paul Tucker, Harvard Kennedy School

I have been asked to say something about the future of European finance. Since I cannot remotely predict how things will turn out, I shall instead sketch some of the forces that will shape the environment for the European financial system over the next couple of decades. Rather than attempting to be exhaustive, I will concentrate on four areas in which politics is intertwined with policy: the legacy and longevity of the crisis; the geopolitics of the evolving world system; the fragilities in the European monetary and credit system; and the problems inherent in a rules-based regulatory regime. That leaves out technological change, but will be more than enough to ground my central points.

They are that the fortunes of European finance will be precarious unless there reform goes broader and deeper. Internally, reform is imperative in order for the monetary union to be sustainable. Externally, reform is needed to ensure a place for European policymakers at the new world's Top Table. Those in the financial industry and elsewhere who resist reform because of the distribution of its short-term costs and benefits need also to weigh the medium-to-long term prospect.

1. A long haul

Let me begin by saying that, on my reckoning, we are about a third of the way through the long period that it will take for finance to adapt to the post-crisis world, and for those outside finance to get comfortable with it again.

At a technical level, not all the planned regulatory reforms are quite in place yet. Notable gaps include policies to ensure that distressed clearing houses can be resolved without taxpayer solvency support, and a general policy framework for shadow banking. Both matter to Europe in order to ensure that the migration towards a somewhat more market-based system of finance does not merely replicate the vulnerabilities inherent in the existing bank-based system.

At a political level, it remains to be seen whether the US Presidential election race affects the terms of trade for finance around the world. More problems, and in particular more scandals, would reignite the anger and distress felt by the public.

At a more fundamental economic level, everything is still in transition. It will take some years for monetary policy to normalize. Obviously, we are not even close to that process beginning in the euro area, but even in the US it is going to take time before we know where the policy rate settles. On the real side, we have little idea whether productivity growth will return to anything like its previous trajectory. Putting those points together, we remain in the dark about the steady-state risk-free rate of interest, risk premia and relative asset prices.

Given all of that, at a micro level, unavoidable uncertainty hangs over the business models and strategies of financial intermediaries of all kinds. For example, we do not yet know whether the shape and size of banks and banking will be materially affected by the market discipline that higher equity requirements and new resolution regimes are designed to harness. If not, we will be in trouble. Nor can bankers and asset managers themselves know which markets offer profitable opportunities and which are plagued by unpriceable risk.

Against that not entirely reassuring backdrop, I will broaden out to look at the international monetary system before returning to Europe.

Such is the uncertainty that there is a premium on gripping problems, on putting the long term before the short term. Within the financial services industry itself, it is essential that the authorities grasp the nettle of dealing with fragile or unviable banks. To delay invites decline, or just puts off crisis until what could prove to be even more unfavourable circumstances. That, I would say, is the mainstream view in the rest of the world, which matters more than usual since the world is being reshaped.

2. Fitting in to a changing international monetary and financial system

The international monetary and financial system (IMFS) is being transformed in the wake of the 2007-09 crisis and, separately, by the emergence of a new geopolitics. Even if Europe were not itself changing, its place in the wider international order could not help but alter.

We might have seen the last global financial crisis where the subsequent reform agenda is framed largely via deep transatlantic relationships. By the time of the next truly global crisis, the major banks and other intermediaries might be domiciled across the whole world rather than, as now, largely in the US, London, Switzerland, France and Germany. It might, in short, be a multipolar world. Europeans and European governments should want to remain at the top table in that possible new world.

That is not guaranteed, as I hope will become apparent by broadening the canvass somewhat.

2.1 The geopolitics of the international monetary system

A striking thing about the operation of government is that most of the time foreign policy and economic policy inhabit separate spheres, not just day to day but strategically. Moreover, they are spheres occupied by distinct tribes or castes, who have been trained differently, think about the world differently, and draw on separate networks of power and influence.

But that is most of the time. Occasionally, at big moments when the world is reshaped, they come together, either colliding or in strategic concord. The periodic revolutions in the international monetary system are such moments.

If, for example, we think back to the 1944 Breton Woods conference that introduced the gold-exchange dollar monetary standard, it is natural to focus only on Keynes' grand designs and Harry Dexter White's strategic and managerial brilliance. It is, in consequence, all too easy to overlook the great foreign policy *dictat* that preceded and was a precondition for the gathering in New Hampshire's White Mountains: US Secretary of State Hull's insistence that Britain's system of imperial preference should be taken apart.

Indeed, in the grand sweep of history, we could see the post-war international monetary order as predicated upon two grand bargains. First, the dollar succeeded sterling as the world's preeminent reserve currency and the European powers abandoned their colonial projects; and 'in exchange', Europe outsourced its defence to the US, via NATO. Second, the marginal supply of Middle Eastern oil gradually moved to being invoiced and traded in dollars, and 'in exchange' the new world hegemon acquiesced in the accommodation reached between the region's rulers and religious authorities.

Of course the equilibrium international monetary and military order has been hugely more complicated than that. But it is striking that even when the direct and indirect costs of the Vietnam war drove the US off gold, and even in the face of strategic oil shocks in the 1970s/early 80s, which combined to throw most of the western world into stagflation, the core elements of the system --- dollar, NATO, and oil --- remained completely intact. So I would suggest that I don't need to get into the richer subtleties of post-WW2 history to convey that, at a high level, power and the international economic architecture are joined up.

For this part of the world, what matters is that the countries of Europe and the EU have been able to pursue their affairs taking that wider global backdrop as a given.

It has, further, been and remains a world order where, to put it boldly, the baton of leadership passed between allies who, despite family differences, drew and still draw on shared histories and cultures. A world in which, in the economic sphere, Europeans have been leaders at the International Monetary Fund and, perhaps especially, in designing and reforming the system of international financial regulation that emerged following the shift to floating exchange rates and freely following capital during the 1970s.

It has, in short, been a world order that suited Europe rather well.

2.2 Prospective change

That settled world might now be changing. Even while their per capita income levels remain well below those of the West, already China and India are big parts of global output and trade, and officials from countries as widely dispersed as Mexico, Brazil, Korea and Malaysia are serious players in central banking and finance ministry councils.

This might prove to be a world in which new reserve currencies emerge alongside the dollar. We see that in the infrastructure established in many jurisdictions to support renminbi transactions and trading outside the People's Republic, in the currency's addition to the SDR basket, and in central bank Governor Zhou's public thoughts about the international monetary system[1].

[1] Zhou Xiaochuan "Reform The International Monetary System", People's Bank of China, March 2009.

It would be surprising if China did not entertain such thoughts or plans. While the value of the 'exorbitant privilege' of being the world's reserve-currency issuer is contested, the reduced funding costs are plainly worth something. But they might be seen either as a subsidy to American consumers and businesses or, alternatively, as part of the broader geopolitical settlement I described, in which symmetry was maintained through European countries and Japan financing the US's external deficits in return for its support in post-War reconstruction and ongoing defence.

Beyond any running saving in financing costs during normal times, issuing the world's leading currency provides an important insurance policy in the event of big economic shocks. Even in the face of the national and international crisis sparked by US sub-prime mortgage improvidence, US Treasury bonds rallied, reducing the cost of government debt just as fiscal support was provided to the economy and the American people --- and this despite the fact that the US had been running a sizable external deficit for years and has continued to do so. Having such a shock absorber to help them get through their biggest domestic economic and financial crisis for nearly 80 years, must have struck US officials and legislators as providence indeed. And it can hardly have failed to be noticed in the capitals of the new rising economic powers.

Of course, there is a question as to whether any 'privilege' is balanced by a 'curse', as posited in the dilemma made famous amongst economists by the Belgian-American Robert Triffin. Cheap external financing can lead to potentially destabilizing cumulative current account deficits, and thus the international monetary system can risk undermining its own fulcrum. But, since nation states emerged, no global leader has voluntarily foregone the opportunity to attach monetary dominance to economic and political hegemony.

When, in the last part of the 19th century, European currencies competed for dominance, the world became a very dangerous place. The capitals of the new world are no more destined to revisit the missteps of our past than we are destined to be caught frozen in the difficulties of the present. But the very prospect of such a world, whether or not it is realized, does present Europe --- its governments, businesses, and peoples --- with challenges that add to those that are home grown.

2.3 Being at the Top Table in the new world

Politically, perhaps the biggest question is whether Europe and Europeans will carry weight in that new world. That will matter to whether distinctive European interests and perspectives are reflected in the regimes that govern finance in a generation or two's time.

In 2011 I attended the ceremony in Frankfurt to mark the passing of power at the European Central Bank from Jean Claude Trichet to Mario Draghi. Amongst the many remarkable speeches, Chancellor Merkel made some comments that struck many of those present. As I remember them, and I should say that I have not checked the text, there were four key points, which I would put as follows:

- It is wonderful to be part of a world in which so many emerging market economies are lifting hundreds of millions of people out of poverty.

- This will be a world in which the global Top Table covers the planet. It will include the US and, likely, China, India and perhaps others. Europeans should want to be at that Table, as we have valuable things to bring to it
- Germany has had another period of economic success, drawing on the human capital of its people and helped by some successful structural reforms.
- But in the new world we are headed towards, Germany is unlikely to be big enough on its own, however successful, to be at the Table. That will take Europe as a whole to be a success.

Put like that, it is hard to avoid the question of whether Europe can make it. As a prelude to discussing some of the reforms that are vitally necessary to do so, I shall first look at the fault lines in and challenges for European finance revealed by the current international monetary order.

3. Challenges in the current IMFS

Those fault lines and challenges occur in each of the three main spheres of the international monetary and financial system (IMFS): the drivers and consequences of the pattern of *net* capital flows, which can be thought of as the territory of macroeconomic policy; second, the composition of the underlying *gross* capital flows, which can be thought of as macro-financial; and, third, rendering safety to the interconnections amongst internationally active financial intermediaries, which is a regulatory problem.

3.1 Current account imbalances

In the years running up to the financial crisis of 2007/08, the world economy was plagued by persistent imbalances in the pattern of trade. Big picture, the US along with some others ran external deficits, while China and others ran massive external surpluses. The counterparts were, by definition, in savings/investment imbalances. While the expansion of domestic investment in China during this period was quite extraordinary, it could not keep up with the growth in savings. On a current orthodox view, this led to a compression of global real interest rates, and an accompanying rise asset values. That in turn provided the collateral that helped fuel the credit boom which paid for the West's consumption splurge and created the overhang of debt. When it was realized that not all the debt could be repaid, asset prices collapsed, some borrowers defaulted and a feeble banking sector collapsed. In other words, macroeconomic, macro-financial and financial –regulatory imbalances and fault lines combined to create the worst crisis for nearly a century.

In terms of the macroeconomic component, the standard analysis points out that rather than letting its currency appreciate, which might have kept its external position closer to balance, the Chinese state intervened to hold down the renminbi's value against the dollar and other currencies, accumulating a vast portfolio of foreign exchange reserves in the process. The post-Bretton Woods system of floating exchange rates hadn't catered for a rapidly expanding economy that, for domestic reasons, preferred to more or less peg its currency in order to underpin export-led growth in an economic system where, at the time, it was easier to expand production than consumption.

Following the 2008 crisis, one of the reform programmes established by the G20 was to examine the workings of the International Monetary System (IMS) with a view to seeing whether it could operate without such persistent macroeconomic imbalances. Those efforts got nowhere, slowly, basically because officials got stuck on the inevitable issue of how to get to a world of more symmetric adjustment by surplus and deficit countries. Guess what, the surplus countries didn't want to play ball.

But to be clear, the problem of imbalances was not just about China. Any summary of international gatherings in the years before the crisis would have to include the strictures on Germany to consume more, the pleas for the US to save more (that's to say, spend less), and the urgings for continental Europe to liberalise its services sector and labour market.

This also provides part of the background to irritation around the world with IMF assistance to euro-area crisis countries. Taken as a whole, the euro area is broadly in external balance. Its problems are, therefore, distributional. Why, therefore, they ask, should non-European countries bear any of the risk or cost of IMF programmes? We cannot know yet whether a long-term political price will be paid for that.

3.2 Hot money and whole-economy macro-prudential policy

From a macro-financial perspective, time and again policymakers have had to be reminded that *gross* capital flows matter as well as net flows. In the 1990s Asian crisis, the sectors under pressure varied according to who had borrowed short term in foreign currencies in external markets. In Thailand, it was the government; in Korea, the banks; but in Indonesia, the non-financial corporate sector. The rapid withdrawal of hot money triggered liquidity and exchange-rate-regime crises. In addition to the virtues of floating exchange rates, lessons included the importance of monitoring and managing *national balance sheets*.

It is easy to think of this as relevant only to EMEs with thin domestic capital markets and a consequential over reliance on foreign currency-denominated financing in external markets. But that is very far from the truth.

A number of euro-area countries financed their external deficits in the inter-bank market for some years. Indeed, in some cases there were signs of that over a decade ago, ie before the crisis. Within the financial system itself, too many European banks and vehicles became dependent on flighty US money market funds to finance holdings of dollar-denominated asset-backed securities. Hot money financing imprudent money is a recipe for trouble, as it proved. Thus, even with a broadly flat net external position, the euro area's *gross* external balance sheet was not a pretty sight, leaving the continent vulnerable and exposed.

One lesson is the imperative of careful monitoring of the external balance sheet of nations and of the euro area as a whole. That might fall to the European Systemic Risk Board or the Commission or the ECB, but someone should do it. The IMF should ensure that it is done, as well as doing some of the work itself in its Article IV surveillance of Europe[2].

3.3 Internationally active financial intermediaries

When we come to the third element of the IMFS --- the financial system in the more familiar sense of financial institutions: banks, dealers, insurance companies, funds, etc --- some important things change.

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[2] The IMF's role in this field is discussed in "Risks and Spillovers", an external study for the IMF's 2014 Triennial Surveillance Review (TSR), prepared by David Daokui Li and Paul Tucker (http://www.imf.org/external/pp/longres.aspx?id=4902)

So long as we are talking about macroeconomic policy, each country can (more or less) collect the information they need to make what are, in a world of floating exchange rates, essentially domestic policy decisions. But when it comes to supervising internationally active financial firms, with outlets, exposures and dependencies around the world, national authorities are hugely dependent upon each other.

This means that it is vital that regulators and supervisors elsewhere in the world trust the capabilities of European regulators. That took more than a blow during the crisis, and it will take some years to rebuild. But a quite new kind of challenge beckons as well.

If, as part of the newly fashionable world of macro-prudential policy, regulators dynamically adjust regulatory requirements to maintain the resilience of their financial system, they are going to have to reach views about the threats posed to 'their' firms' by exposures to and in other economies. As well as intensifying the existing informational dependency, this means that their published policy decisions will give signals about the state of other countries' financial systems and economies.

Concretely, if in the mid-2000s European regulators had raised capital requirements against US sub-prime mortgages, they would have been signaling that something was awry there. That might sound good. But symmetrically, if the US and/or others had raised capital requirements against euro-area sovereign or banking exposures, that might have brought forward Europe's own crisis.

At one level, this means we are heading towards a world in which active cooperation and possibly even policy coordination may be needed, and in which a retreat into autarky will threaten unless that can be achieved[3]. More immediately, what matters locally for Europe is that foreign regulators might not sit back if euro area fragilities persist. But their acting to protect the resilience of their financial systems from euro-area risks would increase the costs of adjustment in the euro area and thus, for governments, raise the hurdles in the way of reform. But this should not be thought of as a problem for governments alone. Such actions might restrict the international options available to European financial intermediaries, which might find themselves expected to ring-fence foreign operations in order to insulate host countries from vulnerabilities in Europe.

That brief outline of how Europe might be affected by just some of the forces reshaping the international monetary and financial system sets the stage for a closer examination of some of the things required in order for Europe to adapt to this possible new world.

4. Completing Monetary Union will condition Europe's place in the new world

The survival and long-term success of the monetary union requires banking union, a form of fiscal union that can avoid moral hazard, and reforms that incentivize and unblock much greater dynamism. The financial system will be affected by all three. Banking Union (BU) will directly affect the terms under which banks trade; a healthy fiscal union would reduce risk; and a revitalized real economy would increase opportunities.

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[3] For a more systematic discussion of this issue, see Cecchetti, Stephen G. and Paul M.W. Tucker, "Is there macro-prudential policy without international cooperation?" CEPR Working Paper 11042, January 2016. http://people.brandeis.edu/~cecchett/WPpdf/2015_Cecchetti_Tucker.pdf

4.1 Banking Union: essential to monetary union

A monetary union is defined by its member countries having one money. That is true of Europe's base money, of course. It is issued by the European Central Bank, and so is homogenous. But Europe's broad money – the private money of bank deposits – is not homogenous. That means that the vast bulk of the money people and businesses actually use across the monetary union is not homogenous.

There are two possible responses to this. One would be for such money, retail and business deposit money, to be risky, with the riskiness varying according to the balance-sheet structure, asset composition and business franchise of each bank. This would be a world where, big picture, banking risk would be highly idiosyncratic, each bank standing alone regardless of its nationality, domicile or business. It would be a world with much higher holdings and use of ECB bank notes, and in which there would probably be calls for the ECB to make its own e-money available to everyone. It is most definitely *not* the world we live in.

The second possible approach is for the state to stand behind the value of transactions deposits, so that they are regarded as safe. This is the world we live in. It is, broadly, the route adopted by all advanced economies around the world. In the language of economics, the aim is to make transactions deposits 'information insensitive', meaning that there are not returns to ferreting out information on this or that bit of deposit money issued by different banks.

As put, I have made transactions-deposit money sound homogenous. Indeed, it is homogenous in most advanced economies. But transactions-deposit money is still not homogenous across the euro area. It is homogenous at the level of each member state but heterogeneous across member states.

Up until recently, this dispersion in the nature and riskiness of transactions-deposit money across the euro area was sourced in responsibility for prudential supervision of banks, the bankruptcy/resolution of distressed banks and deposit-insurance each being a local matter under the control of individual member states. With some inevitability, that undermined the monetary union's foundations and helped make the continent vulnerable during the global financial crisis.

The Banking Union (BU) is intended to remedy this, but to date does not do so decisively.

4.2 The centralization of bank supervision

The key headline reform has been the move of prudential supervision of significant banks to the centre, at the ECB. This has two merits. First, it will give the central bank a much better picture of the resilience of the credit system, a key part of the transmission mechanism for monetary policy. Banking stability is part of broader monetary stability; it is a mistake to think of prudential supervision as a branch of consumer protection, which became the norm during the 1990s.

Second, it is a sensible and necessary in order to overcome problems --- real or perceived --- of supervisory capture in a number of capitals. As I touched on above, rightly or wrongly, fairly or unfairly, there is a widespread perception around the world that in too many member states, prudential supervision worked in the interests of the banks rather than of the economy and society as a whole. This might be rooted in flaws of regulatory design at global level rather than locally. It might be the result of well-intentioned forbearance going awry. It might be a product of cohesive elites at the top of banking and government in some capitals. It might even be utterly baseless. But it *is* the perception, and the centralization of prudential supervision under the ECB provides an opportunity for a new start, breaking from perceptions of the past.

This is likely to entail tough action by ECB supervisors. For what it's worth, in the wake of the crisis I saw the Bank of England as operating a Hayekian banking policy and a Keynesian macroeconomic policy in the UK. In other words, the objective and practice of banking policy was to take tough measures to recognize losses, provide against impaired assets and capitalize against an uncertain and threatening outlook. Our driving principle was that weak banks do not lend; that a necessary condition for credit supply to recover was a repaired and resilient banking system. The US led the way on that, and now the euro area has an opportunity to adopt a similarly robust strategy.

If the opportunity is not seized, the costs will be paid in continued economic torpor. A risk premium will be charged on investment capital in the euro area economy, which will erode productive capacity and progress. Governments need somehow to get this grave risk across to the public, commentators, and the financial services industry. It will not be easy. That more reform is essential after the hard slog of the past few years will be unwelcome. Amongst many other short-term costs, it might easily entail the demise of parts of the banking sector.

4.3 A single resolution regime

That underlines the importance of the second component of the BU: the adoption of a standard resolution regime across the EU and the establishment of a central resolution authority for the euro area.

Although I would say this having chaired the G20 Financial Stability Board's initiative on solving the problem of Too Big To Fail, the resolution regime is definitely a big improvement. It can do something quite profound. By making the bonds that banks issue information sensitive – *by making them risky* --- this policy regime can separate the monetary liabilities of banks from the other liabilities of banks. Investors need to understand that.

Without a sound and credible regime that distributes losses to bondholders --- in reality as well as on paper --- the monetary union would be in very deep trouble indeed, as few of its member countries can afford --- politically or economically --- to stand behind all the liabilities of their banking systems. This set of reforms amounts to nothing less than an attempt to make banking part of a capitalist market economy again, rather than continuing as a peculiar and illegitimate hybrid of privatized returns and socialized risks.

Most people are becoming familiar with resolution jargon: single point of entry (SPE) when a group is resolved top down, as one; multiple point of entry (MPE) when it is resolved in distinct pieces, each of which themselves may be subject to SPE resolution.

In either case, a key step is to ensure that the capital structure has bondholders taking losses before liabilities associated with the provision of operational services, such as deposits or debts to trade creditors or debts to derivatives counterparties. If that is not done, authorities will find themselves in an agonizing quandary: fearful economically of haircutting senior creditors as well as bondholders, but fearful legally of not doing so.

This means that many banks need financial restructuring in order to become resolvable in a tolerably orderly way. Banking groups (or, for MPE banks, subgroups) need either to be headed by pure holding companies or, alternatively, the subordination of the claims of bondholders to all other creditors of operating companies needs to be 100% beyond doubt. Second, it must be possible for losses in lower parts of a group to be transmitted up to the holding company or intermediate holdco that would go into resolution (the 'resolution entity). That is best effected by operating subsidiaries issuing deeply subordinated debt to the resolution entity, with the requisite triggers to write down or convert the debt into equity being under the control of the local authorities. And the resolution entity needs to issue a minimum value of bonds to the market (so-called gone-concern loss-absorbing capacity), providing the means for recapitalizing a bankrupt group (or subgroup).

The EU has a good resolution law with a good set of powers. But it is behind the US on getting its banks to restructure so that those powers can be used effectively. Supervisors need to press on with this. Otherwise, banking risk will be priced into government securities, entailing higher taxes or lower public expenditure.

Assuming that the necessary changes to banks' capital structures are made, there is a further essential step. It matters who holds the bailinable bonds that take losses immediately after equity. It shouldn't be other banks, as that would simply transmit losses imposed on bondholders from the failing bank to other banks (and lead to complex equity cross-holdings). For similar reasons, shadow banks with short-term or runnable liabilities should not hold bailinable bonds. And retail investors must know that such bonds are highly risky. There are issues of both investor protection and systemic stability here, all of which have been flagged by international policy makers for some time but which await decisive steps in some jurisdictions here in Europe.

The euro area authorities, via the new Brussels-based resolution authority, have an opportunity to show leadership here. Doing so would be another step towards rebuilding the reputation of European banking in the Americas and Asia. But local, member state authorities need to act too.

Nothing I have said here should be news. It was all set out some years ago, and has been firmed up by the international authorities. I worry that it has not been explained to the public.

4.4 Deposit insurance

If the first two components of the new euro-area dispensation stack up well, I am afraid that, as we meet at this conference, the same cannot be said of its deposit-insurance arrangements. They are fundamentally inadequate for a sustainable monetary union.

The insurance in one country is not the same as in another, which means that broad money is not homogenous across the monetary union. Only some kind of collective deposit-insurance scheme can deliver that. It should be funded by the banks themselves, in order to ensure that defaulters contribute something. A funded scheme can also shield the taxpayer somewhat, but I recognize that this would be a step towards some kind of a fiscal union and so raises profound constitutional and political questions. For that reason, steps in that direction will rely on firm banking supervision that ensures that banks are well capitalized, liquid and properly diversified.

Arguably, there are other solutions. For example, equity requirements for euro-area banks could be increased materially relative to the international standard incorporated into EU law. Doubling them would I think underpin confidence, but I suspect that that would be unattractive to pretty well every member of EMU.

If that is so, then I hold to the view that without clear steps towards one deposit-insurance system, the monetary union will remain fragile: an incipient fracture in the credit system will persist, even when the current crisis has finally passed. In a nutshell, banks domiciled in euro area countries need to be euro-area banks.

For that to happen, they need to behave more like euro-area banks, not giving preference to local governments and not being subject to local laws or rules requiring them to do so. In this sense, Banking Union must be seen as a monetary union project, a vital one.

5. A risk-transfer Union

In the US, the deposit-insurance regime is part and parcel of the fiscal union. The euro area needs to debate what *kind* of fiscal union it should have, and through what staged-process it could move there. The issues are profound, requiring thorough technical exploration and proper public debate before political decisions could be taken.

5.1 The inevitability of transfers

I want to underline that a risk-transfer union exists already, but it is highly opaque. This is as important politically as it is economically.

Some parts of the euro area run 'current account' deficits with other parts of the currency union, just as in any single-currency area. Those deficits must be financed: and that is to state an accounting identity not to advance a normative or moral proposition. The financing can take many forms: the net sale of securities or other assets in the capital markets, borrowing at term maturities from banks, transfers from surplus-country governments or, if none of those occurs, borrowing within the central bank system.

Before the crisis, MU-member deficits were financed via the markets and the banking system. Since the crisis, they have been financed, at the margin, via the central banking system.

That might be overt, via the ECB purchasing securities in open market operations; or it might be less overt, via the TARGET payments system. In either case, were borrowers to default, any losses would be shared amongst EMU central banks according to the ECB's capital key. Since losses to the national central banks would mean lower seigniorage transfers to governments, the greatest share of the ECB's losses would go to the biggest economies' governments. Other things being equal, those governments would over the medium-to-long run have to raise taxes or cut expenditures.

It is in that sense that there already exists a risk-transfer union. It is absolutely unavoidable as a matter of accounting, but there are ways of making it more open and comprehensible to the people and ways of incentivizing the governments of recipient countries to reform. At some point, the people need a say in the form of transfer union the Union should adopt.

5.2 Catastrophe unemployment insurance

A decent first step would be an expert commission, which should be seen as completing the work of the 1980s' Delors group on EMU.

Fiscal unions come in lots of varieties. On possible route would be a union of rules, where control over fiscal policy in a euro-area member country was transferred to 'the centre' if certain debt or deficit thresholds were breached. That seems to me likely to create political resentment and tension in the event of a country suffering a crisis that was not of its own making.

Another possible route would involve some kind of collective catastrophe insurance against the costs of big increases in *cyclical* unemployment. This has the key feature of the *people* of the euro area helping each other out, but with discipline on member-country governments. That discipline comes in two forms. First, there should be no subsidy for structural unemployment, which is a curse imposed by bad policies on the people. Surplus countries should not relieve other governments from the incentives to pursue necessary supply-side reforms.

Second, there should be no bailout for insolvent states. The US established in the mid-19th century that the people of America would not bail out bankrupt State governments; the Federal government would not stand behind the government of, say, California. The euro area needs to establish the same. But a 'no bail-out' rule means nothing unless it is clear how a member state government could go bankrupt in a reasonably orderly way. As with bank resolution, that too needs some technical ground clearing. It was absurd that the prospect of government insolvency in some small member states threatened the very existence of the euro area.

5.3 A Capital Markets Union: massively desirable for the monetary union

This could be misunderstood as arguing that fiscal transfers should or must be the core of risk transfer within a monetary union. That is not so. Most risks do not need to be transferred via the fiscal system.

Only recently have European policymakers and commentators focused on the remarkable extent to which risk transfer within the US economic and monetary union occurs via the equity markets. Imagine that you set up a business in Massachusetts. Your customers are in Massachusetts, your suppliers are in Massachusetts, and all of your employees are there. But your equity holders are in California. Now MA suffers a horrible local shock, throwing its economy into deep recession. Your business goes bust. This has nasty local knock-on effects, exacerbating the downturn. But part of the costs are borne in CA.

It is estimated that some 80% of US risk transfer occurs this way in normal circumstances. It is why the EU's Capital Markets Union (CMU) project is not a luxury; it is not a techy thing that matters only to financial firms or to the City of London. On the contrary, it is vital for the sustainability of the monetary union, it is therefore urgent, and it needs to be ambitious.

Without measures such as this, the fault lines in the architecture of the monetary union threaten to become ruptures, which I repeat raise the risk premium on investing in Europe. For these and other reasons, the world looks on worried, and sceptically. But a Europe with active cross-regional investment and risk transfer could be a different matter.

That is why the apparently technical CMU initiative is, in fact, truly strategic --- both substantively and in what it signals.

5.4 The price of risk under CMU: structural reform

One advantage of risk transfer via capital markets is that the price of risk is observable, for the private sector as well as the public sector. It plainly risks being prohibitively high, as has been apparent occasionally over recent years. The ECB holding down the price of risk is best thought of as providing a window for governments to reform their economies, making them more flexible so that adjustment comes via prices and wages rather than via jobs and output.

Of course, this is just another way into the familiar refrain that, under monetary union, when countries do not have the luxury of a locally tailored monetary policy to help smooth adjustment to local shocks, mistakes and misfortunes, the premium on real-economy flexibility rises.

Were those reforms to be pursued and were economic activity to be rejuvenated as a result, opportunities for financial intermediation would increase. That is hardly the purpose of such reforms, but it points to the question, I won't say mystery, of why finance has not been a strong advocate for structural reform since the monetary union was established.

6. Challenges independent of the incomplete monetary union

Let's assume a successful CMU occurs. My final set of observations concerns, therefore, the new world that will be ushered in as capital markets gradually take a greater share of total financial intermediation in Europe. Net, this should be a good thing, but it will bring its own challenges to stability and to international cooperation and co-ordination. In particular, securities regulators are going to have to do more, and rules are going to have to do less. I discuss those two issues in turn.

6.1 Markets and stability: an essential role for securities regulators

The five headline elements of the global programme to reform finance all focus on banking. They are: more capital for banks; more liquidity in banks; less opacity from banks; less inter-connectedness amongst banks; and making failed banks resolvable in an orderly way without taxpayer solvency support. But while this might be the popular core of the programme, it by no means exhausts it. Decades have passed since we lived in a world in which banking and capital markets were neatly segmented. Everything has been transformed by the trading of loans, over-the-counter markets, derivatives, securitization of portfolios of illiquid assets, and short-term money (or repo) markets employing a vast range of securities as collateral.

Just how inter-twined everything now is was put beyond doubt during 2007, when liquidity dried up in the money markets for borrowing against asset-backed securities (ABS-repo) and when the reliability of credit-rating agency (CRA) ratings were called into question. Problems were transmitted from the underlying asset markets to intermediaries, with the money markets as the conveyer belt.

The crisis demonstrated that an asset market is on shaky foundations if demand is concentrated amongst levered investors. In buoyant states of the world, such markets are prone to exuberance, with elevated valuations rendering the asset class uneconomic for unlevered investors. But the levered investors rush for the exits when the tide turns, raising the cost of capital for issuers until and unless longer-term money re-enters.

As Europe's capital markets grow in importance, the authorities are going to need a framework for determining which markets matter most to the real economy or to the workings of the financial system itself, and how to keep such markets on a broadly even keel. Important tests will be, respectively, whether there are ready substitutes if a market closes, and whether the market's liquidity is resilient to shocks. Those are questions that policy makers should have asked about ABS markets in the past.

Markets that matter a lot to welfare but which could not easily be replaced might reasonably be termed *systemically relevant markets*. Where such markets exist, they are --- or should be --- a matter for stability policy as well as for markets policy as it has come to be thought of in recent decades.

This means that the policy instruments delegated by legislators to securities regulators should sometimes be used to help preserve stability. Some of that is already happening: for example, in the new approach to the regulation of credit rating agencies, and in the plans to set minimum haircuts or margin requirements for secured money markets and derivatives markets. But, as yet, I don't see signs of stability policy reflected in the work of listing authorities.

Transparency is so important that we need to think about adopting a new macro-prudential approach to the functions of listing authorities. I have already discussed the importance of investors being put in no doubt about the riskiness of banks' bailinable bonds. But there might also be instances where aggregate issuance of a particular type of security is so great that investors should take into account the associated accumulation of debt in the economy as well as knowing the specific details of any particular security. That surely goes for ABS and CDO issuance in the mid-2000s.

Further, where the underlying collateral is fundamentally unsuitable for a *money* market, the authorities might need to go beyond warnings and alerts. This might mean throwing grit into a money market, offsetting the inducements of over-generous CRA ratings or of delusions about the liquidity of the underlying collateral under stressed conditions. That might warrant, for example, raising minimum haircut requirements, as a Pigouvian tax.

For the world as a whole, what I am describing implies momentous changes for securities regulators and in the often strained relations between market regulators, prudential regulators and central banks. The statutory objectives, historical mission and culture of securities regulators have typically been centered on the vital importance of honesty and efficiency, in the interests of investor protection, rather than on avoiding runs and, more broadly, preserving systemic stability. I am saying that that needs to change.

In this area, Europe's reforms offer grounds for hope. The Securities and Markets Authority was conceived and born in the wake of the financial crisis, and seems better tuned-in to stability issues than many of its peers. Also, the Systemic Risk Board, meeting in Frankfurt, provides a valuable forum for regulators of all sectors and from across the European continent to meet on more or less equal terms. I am guessing but I would think that there is work to do in embedding a stability-oriented approach into the work of the various national securities regulators around the EU, and that's something that ESMA and the ESRB might usefully foster.

In particular, the Commission and ESMA should check whether the statutory mandates, objectives and powers of national securities regulators explicitly cover stability. The European Parliament can create play an important role, creating incentives for market regulators to take stability risks seriously through the questions asked when ESMA, ESRB and others testify.

6.2 The problem of rules-based regulation

The second challenge that would not be cured simply by deepening the monetary union is the problem of rules arbitrage.

As the re-regulation of banks starts to bite, with constraints on leverage and asset composition, some of the business will almost certainly migrate elsewhere. If this is into pure capital markets intermediation, with increased use of equity, which can absorb losses smoothly, it might be a good thing. But if it replicates the inherent fragilities of banking, with portfolios of opaque credit assets funded by short-term debt or other runnable liabilities, it might make things even worse. This is, of course, the problem of shadow banking.

At bottom, what makes this complicated is that shadow banking is but one manifestation of a deeper issue: endemic regulatory arbitrage. The financial services industry is a shape-shifter. As a result, a fundamental design problem confronts regulatory regimes: how to find a workable balance between rules and discretion.

Legislators in many countries favour rules-based regulation in order to guard against the exercise of arbitrary power by unelected regulators. But a static rulebook is the meat and drink of regulatory arbitrage. What's worse, the more detailed the rules, the more rules-arbitrage is implicitly legitimized, because the rule-makers must have said precisely what they meant and no more, leaving attorneys and lobbyists arguing that any holes can be exploited legitimately. This shape-shifting dynamic can leave policymakers in a game of catch-up, responding only as each incarnation becomes systemically significant—a game that sooner or later the authorities are doomed to lose.

Some of this is well understood, but it remains a formidable policy problem. Policymakers need, somehow, to come up with a *general policy framework* for financial intermediaries heavily reliant on short-term or runnable funding. Broadly, if an important institution is substantively a bank, regulate it as a bank. That is easier said than done, but the general thrust of policy ought to be clear enough.

I don't have much sense that that debate is occurring. It desperately needs to if stability is to be restored and preserved. Europe should focus carefully on this issue as it acts to enable the expansion of its capital markets.

7. Conclusion

To conclude, European finance is going to be reshaped by potential tectonic shifts in the structure of the international order and, one way or another, an unavoidable transformation at home. In the process vested interests will resist change. They will do so with eloquence and, it should be said, that not all their points will be invalid simply by virtue of their source and motives.

Substantively, I can't see any attractive choice other than to get on with the changes necessary to make the euro area sustainable. Politically, it will be hard, as is abundantly clear. The standard of living enjoyed by most Europeans, particularly those who vote, is high. Why should they vote for structural change, an economist's euphemism for adapting the social model? The reason, of course, is to make that standard of living sustainable.

European financial intermediaries will find themselves marginalized if the euro area remains stuck in a trough. This would occur through two channels: reduced opportunities at home, and the reduced influence of European authorities in global councils. None of that is inevitable, however. The alternative scenario is that Europe reforms, grows, influences the evolution of the new world through a seat at the top table; its peoples prosper, and its businesses thrive. The tough choices would be worth it, but they need explaining in a balanced and open way.