10. REGAINING FINANCIAL STABILITY: TAMING FINANCIAL MARKETS IS A MUST[1] - A FOCUS ON NMSS[2]

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Introduction

The need for a radical overhaul of the regulation and supervision of financial markets has been acknowledged in all advanced economies. And yet, there still is a line of reasoning which argues that the main source of the current financial crisis is the cheap money of the past, which would have caused large global imbalances as well. But another, that I share, is that something wrong has been occurring with overall financial intermediation in recent decades. This is like saying that *structure* has been no less important in derailing economies than misconceived policies and unavoidable cyclical dynamics. By *structure* we mean the configuration of rules and practices in the realm of regulation and supervision, on one hand; and the evolution and practices of financial institutions, including securitization and the growth of the so-called shadow banking sector (which has escaped regulations), on the other hand. *Structure* has, arguably, influenced policies in view of the relative neglect of systemic risks and the almost blind belief, by some, in the self-regulatory virtues and clairvoyance of financial markets. For a long time financial stability was relegated, de facto, to a second tier policy priority – especially in advanced economies. The current crisis has brought this concern back, with vengeance, and relates it to *structure*. The “great moderation” reveals itself as a “great misperception” period, which compels a rethinking of regulations and practices, of monetary policy itself (of inflation targeting, too), of the linkages between various domains of economic policy. Nothing seems to be certain any longer, in an increasingly stochastic world. Just think about the huge difference between how Spain and Ireland were judged before and after the eruption of this crisis – with a sharp deterioration of public finances and drastic economic downturn.

The economies of EU new member states (NMSs) in Central and Eastern Europe have been most hardly hit by this financial crisis, a fact that has intrigued observers. Because these economies’ exposure to toxic products was quite minimal and their budget behaviors, with some exceptions, were not profligate. And yet, apart from

[1] *Paper based on a presentation made at a symposium organized by the National Bank of Romania, Bucharest, 4th September, 2010.*

[2] *NMSs refers to EU new member states from Central and Eastern Europe.*

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Poland, their economic downturn was, on average, the most significant among emerging economies. What this paper argues is that this dynamics can be explained by considering implications of deep financial integration. The latter can bring benefits and rapid growth, which did take place in the Region until 2008, but it can also harm unless proper institutions and policies operate. Moreover, the impact of the current crisis on NMSs illustrates the role of *Structure*, of the rules of the game in the EU (complete capital account liberalization), the nature of regulation and supervision, and, not least, massive cross border operations. The case of NMSs is all the more significant since these economies imported capital on a big scale as a means to foster growth – while in Asia and Latin America, the episodes of crisis of the past two decades induced countries to attach a high premium on the accumulation of foreign exchange reserves and the reduction of current account deficits. NMSs look like they have tried to defy the lessons of previous crises by betting on the virtues of deep financial integration. This paper looks at their case and probes into future possible developments. This discussion is couched in a broader context, of the need to reform *structure* (rules and arrangements), in the EU, too. A key argument is made: in order to regain financial stability, at the international level, a return to the initial logic of the Bretton Woods arrangements is needed. The financial policy trilemma (*the impossible trinity*)[3] would ask for releasing monetary policy and trade flows from the vicissitudes posed by unconstrained financial flows. The currency war underway and rising protectionism are additional indications that new international arrangements are badly needed if an open global system is to be preserved. Finally, the paper puts forward a range of issues which need further scrutiny in order to make policy more effective

1. Financial Stability: rediscovering *Structure*

The Great Depression prompted a radical reform of the regulation and supervision of financial markets, especially in the US. The Glass Steagall Act, which split investment from retail banking epitomizes that reform. Since then the western world has not witnessed a crisis of the magnitude and implications that the current one has entailed. Arguably, this situation explains why financial stability has staged a formidable comeback on the policy-making agenda in advanced economies. Episodes of financial crises did occur in emerging economies during the past century recurrently. But they were thought about as a specific phenomenon of poorly developed financial systems and fragile institutions. In addition, a paradigm extolling the virtues of deregulation of financial markets dominated increasingly policy-making in advanced economies (in the US and the EU) and influenced, considerably, the policy recommendations made by the IFIs to emerging economies. Once the crisis engulfed almost the whole industrialized world[4] a watershed chain of events has taken place. A cosmology that extolled the virtues of financial markets and neglected systemic risks is fading away.

[3] *Conceptualised on the basis of the Mundell-Fleming model.*

[4] *Financial crises did happen in western economies in recent decades: in Scandinavian economies in the early '90s, in the US (the Savings&Loan Associations crisis in the '80s), etc. Canada has been less hit by the current crisis owing to its much better regulated and supervised banking system.*

Eugene Fama (and his “efficient markets hypothesis”) has given way to Hyman Minsky’s insights into how financial markets function. This crisis gripped the markets of the western world, where deep financial integration was seen as a complete blessing. Late in 2008 European leaders continued to be mired in the illusion of a relative robustness of EU economies. They thought that the subprime crisis across the Ocean would stay there; they seemed not to realize the extent of EU headquartered big banks’ involvement in the origination and distribution of fancy financial products, the interconnectedness of the financial markets, the presence of a shadow banking sector in Europe as well. As a matter of fact, many people in central banks and finance ministries seemed not to realize the implications of the new structure of the financial intermediation system, of the shadow banking sector – with their immense risks.

The current crisis shows that something is structurally wrong with financial markets. For a long time not a few economists and policy makers decried the fact that policies are geared toward complying with markets’ excessive pressure, with the power of a structure – which, seemingly, is beyond any control. What Perroux, though in a different context, called *l’emprise de la structure* (the power of structure) was a cause of major concern before this crisis. Imagine what the thinking is now in this regard. *Structure* is key in understanding the current crisis. For, on one hand, it can derail even brilliantly conceived policies; on the other hand, for it can shape policies wrongly. For instance, complacency vis-à-vis the overexpansion of financial entities overexposes economy to major risks (like it happened to Iceland, Ireland, etc.). Or consider a premature opening of the capital account, as it happened in numerous Asian economies during the past decade, not least under the prodding of the IFIs, and the policy approach what propounded the deregulations of financial markets as a means to foster economic growth.

The paradigm shift which is, currently, underway is rediscovering systemic risks: the complexity and inter-connectedness of financial markets, contagion effects, “Minsky moments”. But there is need to make here a distinction between two opposed cognitive approaches: one that believes that nothing can be done about the evolution of markets, whatever way financial innovation goes; and another approach, which does not take the complexion of markets as God given and has misgivings about a range of financial innovations. Networks do not mushroom accidentally only; they are also shaped by policies. As Haldane, the director of research from the Bank of England, aptly remarked: “Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness. That is one reason why Glass Steagall is now back on the international policy agenda”(p.31). The inference is that waves of deregulation of financial markets (see also Johnson and Kwak)[5] have amplified systemic risks and have endangered the functioning of economies.

Financial intermediation, as it has evolved during the past decades proves, peremptorily, that not all financial innovation is good, that inadequate risk and business models have been used by banks and other financial institutions. Quite a

[5] *The repeal of Glass-Steagall in 1999, the Commodity Futures Modernization Act (2000), etc. have favoured high leverage, speculation, excessive risk taking, etc.*

while ago clear warnings were sent regarding the growing opaqueness of markets due to securitization and off-balance sheet activity. Lamfalussy observed that financial integration made “crisis prevention and handling it more difficult” (p.73). Moreover, the financial industry has become oversized in not a few economies. Just think of the damage caused to Ireland, Iceland, the UK, by bank overexpansion and over-risky operations. As a matter fact, the Icelandic and Irish economies were brought on their knees by the reckless expansion of some of their banks. Some make reference to Diamond and Mirlees(1971) and judge financial transactions as "intermediate production", which, presumably, makes economy function better. Therefore, the argument would be that no interference should take place with this intermediation. And that, consequently, it should not be taxed in order to avoid resource misallocation. But this view is more than questionable when financial intermediation develops its *raison d'etre*. This has occurred in the last couple of decades, with much of transactions undertaken for their own sake – because of inadequate incentives and other reasons. Financial entities created their own demand by enticing clients with various types of securities. They did it because of big fees. Clients accepted this game because they thought they could invest safely; others because they thought they can borrow very cheaply. Add to it the mountain of CDSs and CDOs, which have caused, directly and indirectly, an immense systemic risk.[6] Contrary to what Diamond and Mirlees say, this financial intermediation led to a large scale misallocation of resources and over-indebtedness[7]. Thence resulted the budget crisis in Europe and the US and intense deleveraging by banks. And the distortions will persist if nothing is done about it. Arguably, Diamond and Mirlees might have judged differently a state of affairs as the one we experienced, increasingly, in the financial system until the crisis irrupted. For a lot of fixed income transactions is pure speculation, which reinforces the idea that much of financial intermediation is undertaken for pure financial gains. Some say that a transaction tax would be deleterious overall, since it would increase volatility and transaction costs, but this is a one-sided argument. A liquidity crisis, as the current crisis has amply shown, is more likely when there is a rise in systemic risks. And an increasing volume of "fancy" financial transactions, instead of enhancing liquidity in markets, can bring about their standstill. What matters essentially is the nature of financial transactions, whether they create value, or are simply either a rent-seeking exercise on the part of the financial industry, or pure gambling. This is why a transaction tax, as a means of reducing volatility in currency markets, does make sense. And technology can help implement it.

Banking (financial intermediation, in general) performs an essential public utility function; it can do much good, but it can also do much harm unless it is properly regulated. This is why it is essential to understand the functioning of its structure and regulate and supervise it adequately. Nowhere is more glaring the significance of structure than in the European Union, in the EMU in particular. Because, in this area massive cross border operations take place while national prerogatives in regulation

[6] *Not incidentally Warren Buffett called them financial weapons of mass destruction. And George Soros suggested that some of them be prohibited.*

[7] *As the head of the FDIC in the US Sheila Bair put it: “the bust was clear evidence that capital was misallocated and could have been put to more productive use”, Financial Times, 24 August, 2010.*

and supervision, in tax policies stay, basically, in national hands. Moreover, as some stressed from its very inception, the EMU is not an optimal currency area[8].The current crisis gas has revealed the inadequacy of existing arrangements. The latter have favored the accumulation of internal imbalances against the background of one-sided policy tools. The "one size fits all" monetary policy of the ECB could not prevent excessive capital, frequently of a speculative nature, flowing into less developed areas of the EMU, in the EU as a whole; a misallocation of resources was stimulated in this way. Likewise, an increasing entanglement of mutual exposure among financial entities has happened while burden-sharing (fiscal) arrangements were missing. Unless major changes take place in EU economic governance, in the regulation and supervision of financial markets, the very functioning of the Union is put at risk. It is not an exaggeration to say that this crisis is also one of deep financial integration. Thence the need for deep reforms, for appropriate policy and institutional underpinnings. The situation of NMSs is to bee seen in this context; the accession treaties ask them to comply with the rules of a Union (structure), which entail benefits but, also, pose risks. As mentioned above, misallocation of resources took place in several NMSs[9] following a premature opening of the capital account. And inadequate regulatory and supervisory arrangements operate in their case, too, in view of the size of cross-border financial flows and the domination of local markets by foreign banks.

Outside Europe, and learning from previous crises, emerging economies tried to forestall shocks by the accumulation of foreign exchange reserves as a buffer (a high premium was put on them). This trend was reinforced by "industrial policies'' aims;

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[8] *The optimum currency area (OCA) theory shows that the adoption of a single currency pays off when the monetary area is highly integrated economically and has the capacity to adjust quickly to asymmetrical shocks. Traditionally there are five core OCA properties namely: wage and price flexibility, trade integration, cyclical convergence, factor mobility, and fiscal federalism, which are used to assess a success of an OCA area. On these accounts, the euro area still seems to have way to go in order to achieve an efficient functioning. In the EU wage setting continues to be done, predominantly, at the national level, and quite often at the sectorial level. This mechanism reinforces the relative inflexibility of the individual countries' labour markets. Within the euro-area real wages have tended to be downwardly rigid with a relatively high level of indexation. Moreover, although nominal interest rates have largely converged, there is a wide discrepancy among real interest rates of the Eurozone members. Although business cycles synchronization appear to have increased within the Eurozone countries, much of it has to do with the recent fall in the amplitude of global business fluctuations, which benefited from low interest rates, high economic growth and low inflation. However, considerable structural differences remain at the Eurozone country member level. European labour mobility remains fairly limited, despite persistent differences in regional unemployment. Given the existence of an independent EU monetary authority, the ECB, the argument for an EU Fiscal Authority appears to be compelling. This would create more room for manoeuvre for the fiscal mechanisms of purchasing power transfers in the face of idiosyncratic shocks. It would also place less pressure on the ECB when dealing with regional divergences. The EU budget is little more than 1% of the EU GDP, providing limited scope for stabilising cross-state transfers. Moreover, a large part of that budget is allocated towards spending on the Common Agricultural Policy and Structural Funds, which are weakly related to cyclical fluctuations in the individual member states.*

[9] *A Bruegel publication highlights this type of capital flow into the Baltic economies, Hungary, Romania, Bulgaria (Becker et al., especially chapter 2, 2010).*

uphill financial flows were seen as a cost for the build up of a wherewithal capacity in the advent of anticipated external shocks. In Europe, integration, with its financial component, was seen as a principal way to achieve catching up. And partially, this philosophy brought about expected benefits. But it has also entailed weaknesses, which are not to be linked, exclusively, with weak policies. The power of structure (including the free flow of capital) has an explanatory role in what has happened.

The reform of regulations and supervision has to target the whole structure. In my opinion, banking should get back to its roots. The Volcker's rules, what Lord Turner and Vince Cable advocate in the UK, and some EU reforms are pushing in the right direction; arguably, more is needed – not least for preventing regulatory arbitrage. Regulations need to be comprehensive, which means that the shadow banking sector (including the hedge funds, private equity funds, all kind of derivatives) be covered with no exception. Regaining financial stability, therefore, implies reforming *structure* and repairing policies. Monetary policy would have to be redefined; price stability plus financial stability, as objectives of central banks, would, quite likely, make simple rules a thing of the past. Economic policy, in general, would be harder to define and implement in a more uncertain world. For, as Pisani Ferry remarked, deterministic governance does not work in a stochastic world (2010, p.2). A consequence is that policy-makers have to develop policy space in better times, which implies, among others, that they need to conduct anti-cyclical policies.

2. A focus on NMSs: the role of *Structure*

Integration in the EU has been a strategic aim of most post-communist countries. In simplistic terms, it meant the ticket to economic prosperity and being part of an exclusive club, which would operate as a shelter as well. In many respects integration has speeded up institutional and economic progress, not least by forcing EU candidates to undertake major reforms and comply with EU rules of the game. But this crisis indicates also less rosy parts of deep financial integration – some of them linked with the total opening of the capital account and contamination effects.

Financial integration has been a major channel for the transmission of shocks. In some countries the credit crunch has been very severe, liquidity shortages were acute at the height of the crisis and even the spectre of solvency problems emerged, especially where external imbalances had grown quite rapidly in the past decade. The NMSs region experienced a much sharper capital flows reversal than Latin America or Asia during 2008-2009: capital inflows decreased by about 10 percent of GDP on average between 2007 and 2009. The fact that most of these countries are small and open, and hence typically have less domestic resources to avert crises and could be more sensitive to changes in investors' sentiment, cannot be the main reason, as there are many small countries all around the world where the crisis had less of an impact.

A more plausible reason for the special worries about NMSs lies in the deep financial integration that these countries have achieved and in the related reliance on net capital inflows. Financial integration and, in the case of EU members, the logic of the single market, predisposed NMSs and EU candidate countries to external imbalances.

The reliance on net external funding created a systemic risk in non-Eurozone member countries because of potentially devastating chains of corporate defaults and the related currency risk for the economy as a whole. But no meltdown of financial systems has taken place; this is a fact that deserves scrutiny. However, there are worries about future economic growth.

2.1 Deep financial integration and NMSs

Huge externalities were produced by the financial crisis in terms of magnitude and the geographic area they cover. These externalities, which are rooted in big countries' policies, are not something new. One could make an analogy with the Fed's policy turnaround decades ago, when double digit inflation was brought down by a very severe tightening of US monetary policy. That move threw in disarray countries which had borrowed heavily externally by having been encouraged to do so by negative real interest rates (which followed the recycling of petrodollars). But the current crisis is much more profound, and its roots are embedded in the pattern of financial markets that have evolved in advanced economies during the past two decades.

EU specifics matter a lot in the way the financial crisis hit NMSs. Thus, there is a single market while national prerogatives remain important. Whereas monetary policy is unique in the Euro Area, the regulation and supervision of financial markets stay in national hands. Massive cross-border operations bring to the fore the issue of crisis management, burden sharing and resolution schemes. A convergence in the regulation and supervision does make sense (hence the need for common rulebooks), but this is not enough for an orderly functioning of the single market. In addition, the very functioning of the single financial market has to come to grips with its imperfections – which implies that macroeconomic policies have to be adjusted accordingly.

NMSs' varied circumstances matter too: size, in or outside the Euro Area, domination of local financial markets by foreign groups (Figure 1); high euroization (except the Czech Republic). From the euphoria of accession (for NMSs) and pretty high economic growth rates there is now gloom because of deep recession and much worsened prospects for future economic growth. While Poland has not fallen into recession, that is an exception, its budget deficit, too, rose sharply. The massive presence of foreign banks on local financial markets has brought benefits, but it shows its less favorable side too; the credit crunch has added to the pains of an excessive reliance on capital imports. During the crisis, parent banks in the EU-15 had to face serious liquidity and capital pressures and at the time of acute market turbulences it was not at all clear how these parent banks would manage their subsidiaries and branches in NMSs[10]; this contributed to uncertainties regarding foreign subsidiaries.[11]

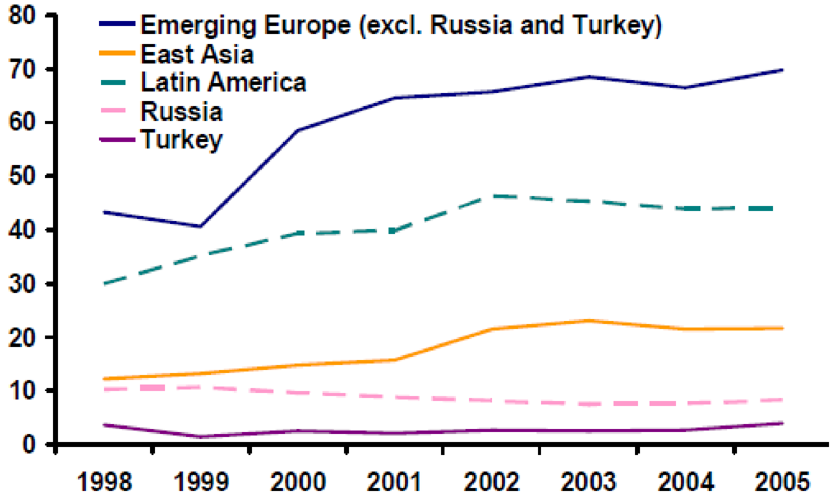
[10] *In the heat of the crisis the subsidiaries had difficulties accessing to liquidity and the first bank rescue attempts by EU-15 governments were especially targeted at the home-country operations of the banking groups, thereby weakening the subsidiaries further.*

[11] *Later, however, the ECOFIN issued a declaration that packages must support subsidiaries as well.*

Figure 1

Foreign bank ownership, 1998-2005

(Assets owned by foreign banks as a per cent of banking system assets)



Source: Chart 6b from Berglöf et al. (2009).

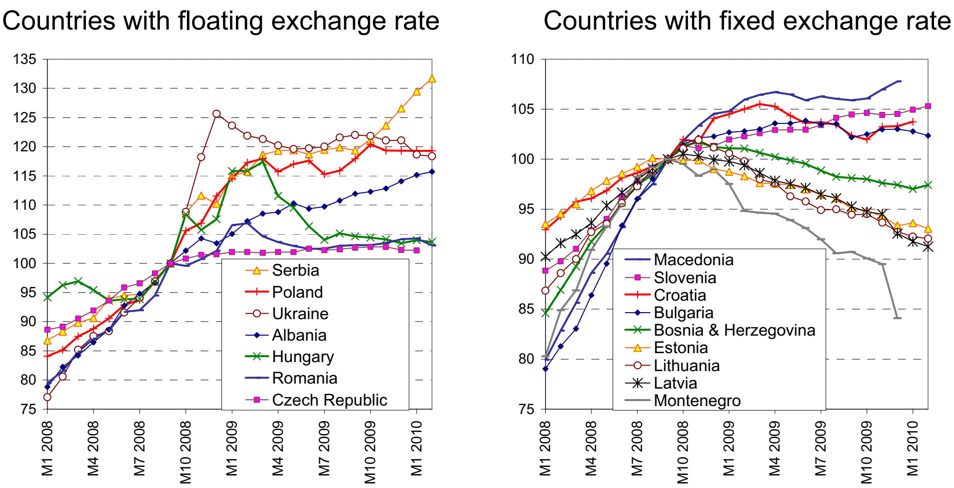
Until the crisis hit a rapid expansion of credit (fuelled by foreign lenders) took place in most NMSs. In the currency board using countries, in Hungary, Romania, etc., rates of over 30-40% yearly were the norm while much of this credit was foreign currency denominated and taken by the private sector . Though public debts are low in most NMSs private debts had been growing quite rapidly in the years preceding this crisis and a large portion of them was short term. A credit crunch was unavoidable[12]. Like in Asia a decade ago the private debt and the sudden stop of funding created a systemic risk in non-Eurozone member countries because of potentially devastating chains of corporate defaults and the related currency risk for the economy as a whole. Therefore, government intervention became inevitable and, in several cases, external official assistance was asked for. Figure 2 shows the level of credit (measured in domestic currency unit) normalized as September 2008 = 100 (i.e. it starts from the date of the collapse of Lehman Brothers); [13] net lending collapsed and quickly turned to negative soon after September 2008.

[12] *Ghosh (2009) studied this question for Hungary, Latvia and Poland for the 2008Q3-2009Q2 period. He finds evidence of a credit crunch in all these countries, though at different times: the crunch affected Poland in 2008Q4 only, Latvia in 2008Q4 and 2009Q1, and Hungary from 2008Q4 to 2009Q2. Ghosh concludes that 'the initial credit crunch and credit supply problems is likely to have contributed to the decline in GDP and hence to the decline in credit demand subsequently' (p. 43). This suggests that the credit crunch was an important factor of recession during the current crisis. Other NMSs have quite likely faced similar developments.*

[13] *The fast increase of the market value of credit outstanding to the private sector immediately after the collapse of Lehman Brothers in some countries is largely due to valuation effects as*

Figure 2

Credit to the private sector (measured in domestic currency unit, September 2008 = 100), January 2008 to February 2010



Note. The scale of the two panels is different.
Source: IMF International Financial Statistics; Becker et al. (p.93).

The current financial crisis underlines pitfalls of seeing financial integration as the main driver of real convergence. Financial markets are more volatile than others and are more likely to bring about a boom-bust dynamic. One can establish here an analogy between what happened in several NMSs and in Ireland and Spain, which are members of the EMU. Financial integration and the logic of the single market (in the EU) has predisposed NMSs to growing external imbalances – due primarily to their inferior economic development and, thence, perceived substantial positive yield differentials of investment opportunities. In the Baltic countries, in Bulgaria and Romania, much of this investment was of a speculative nature, or, was focused on non-tradeables[14]. The rising indebtedness of households and firms, increasingly on short-term and foreign currency-denominated, should be seen in conjunction with weakened monetary policy and budget policy ineffectiveness as a means of restricting growing imbalances, and the opening of the capital account.

The reliance on massive capital imports is illustrated in Figure 3, which presents data on the 2008 public and private debts in the NMSs and several other EU and non-EU countries. Except Hungary, public debt in NMSs was not high by international standards. Total private debt was comparatively low in Poland, the Czech Republic

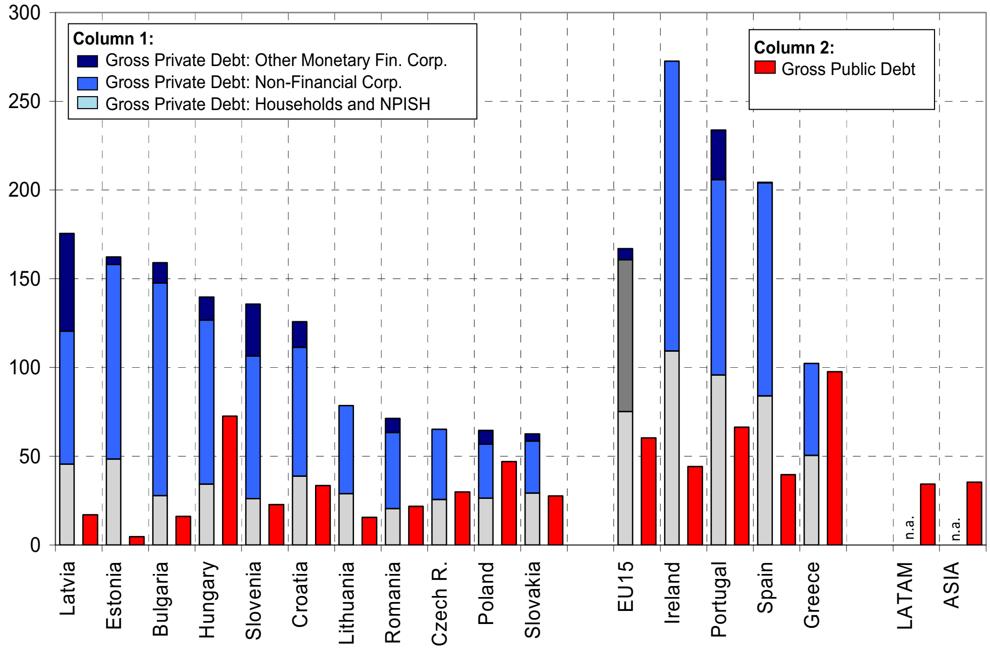
the domestic currency value of foreign currency loans rose sharply as exchange rates depreciated.

[14] *See especially chapters 1 and 2 in "Whither economic growth in central and eastern Europe?"(Becker et al.).*

and Slovakia, but high – taking into account relative development levels – in Latvia, Hungary, Bulgaria and Estonia.

Figure 3

Gross private and public debt (% of GDP), 2008

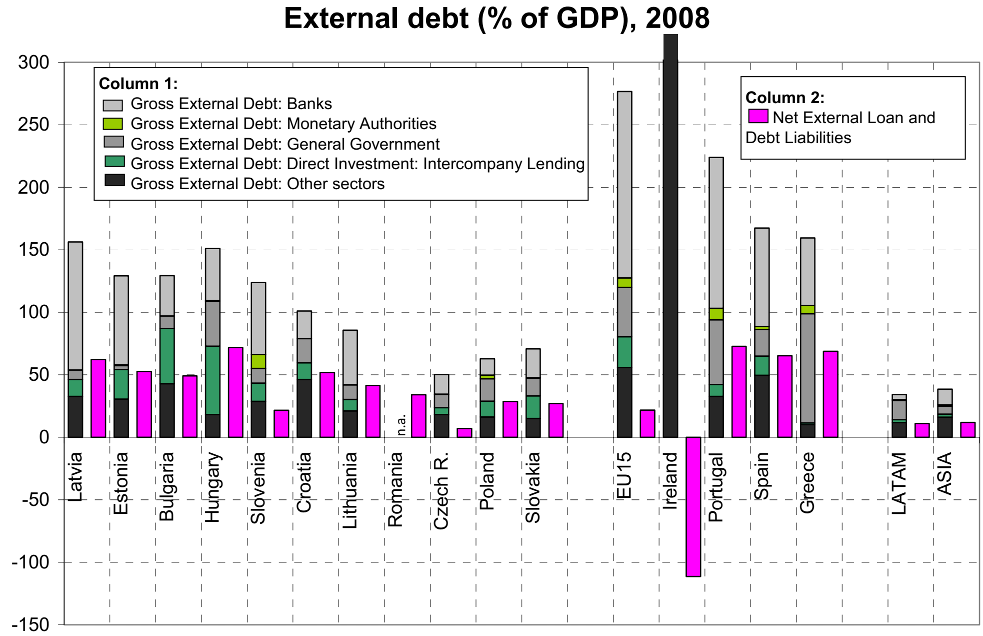


Source: Eurostat, IMF and Becket et al. (p.80).

This relatively high level of indebtedness proved to be a weakness in the crisis, especially when loans had been denominated in foreign currency. Figure 4 presents indicators of gross and net external liabilities for 2008. Differences within the region are evident: Central European countries had reasonably low liabilities, again with the exception of Hungary, while the Baltics and Croatia were heavily indebted externally, especially when compared to Asia and Latin America. So by common standards they could be considered vulnerable ex ante. Only three Central European countries – the Czech Republic, Poland, and Slovakia – avoided falling victim to rapidly rising domestic debt and only four (the same three plus Slovenia) avoided the external debt trap. All other countries experienced foreign-financed credit booms and the resulting accumulation of private (or, in the case of Hungary, private and public) debt. In these countries neither monetary and fiscal policies nor financial regulation were able to avoid the build-up of imbalances in a financially integrated environment.

Contagion, i.e. intra-regional spillovers, was also among the major features regarding NMSs during this crisis. As past financial crises show a crisis can spread through contagion even to less vulnerable economies.

Figure 4



Note: Ireland's total gross external debt is 915% of GDP, but for better readability of the figure, the vertical axis has a 300 cut-off. Apart from Croatia, data for Western Balkan countries are generally not available.
Source: Eurostat, IMF, and Becker et al. (p.82).

2.2. STRUCTURE and a magnified monetary policy dilemma

Rapid growth of credit created bubbles in several NMSs and accentuated a monetary policy dilemma. This policy concern is not unusual in emerging economies, where there is relative capital scarcity, which would create good investment opportunities. Provided these countries enjoy political, social and economic stability capital inflows would be commonsensical. Essentially, this dilemma refers to the inability of monetary policy to prevent a rise in the current account to possibly unsustainable levels irrespective of the stance of monetary policy; it was highlighted regarding the NMSs owing to their clustering in the vicinity of older member of the EU and their presumed increasing institutional and economic stability following market based reforms – which would have fuelled capital inflows. Even before joining the EU this policy dilemma was pretty obvious and debated[15] since these economies were considered to have very good prospects for durable high economic growth rates under the safety umbrella of the Union. This dilemma is organically linked with the functioning of liberalizing financial markets – when governments no longer have the capacity to restrict, potentially, overwhelming capital inflows. High interest rates would attract capital flows (short-term, in particular) which would appreciate the local currency ever more (for pegged currencies this would occur via real appreciation entailed by inflation

[15] *Lipschitz, Lane and Mourmouras.*

differentials), which enlarge the current account deficit; the latter would also increase when low interest rates (aimed at discouraging capital inflows) would fuel domestic demand too much. Thence the acrobatics the policy makers in NMSs had to undertake. One should underline, in this regard, specific circumstances of NMS before and after accession: lower endowment of capital as against labor (capital/labor ratios are lower than in the rest of the EU), financial markets which are much thinner than in EU advanced economies and a gradual, but steady, process of capital account liberalization (which was a must for joining the EU). The latter process has led to intense euroization in most of these economies (except the Czech Republic), which has further crippled the potency of domestic monetary policy. It should be said that euroization was also stimulated by the commitment to adopt the euro after accession.

The capital account liberalization has undermined the monetary policy attempts at cooling down overheating economies. When central banks tried to tighten policy local banks lent in foreign currency at apparently much more convenient rates than for local currencies; the seemingly much more attractive borrowing in foreign currency was reinforced by declining interest rates on world credit markets during the decade of the Great Moderation and the real appreciation of local currencies. Central banks were left with the option of raising reserve requirements as a very crude way of tightening liquidity.

Until the irruption of the financial crisis a substantial real appreciation did occur in all NMSs, which is not surprising in view of the heavy capital inflows which they received during this decade. In both currency board and managed floating arrangements domestic currencies went up substantially until 2008 [16]. But fundamentals of this appreciation were precarious, particularly where current account deficits went into the double digit territory and their funding included much speculative capital. Analysts cautioned European transition economies as to the pitfalls of heavy capital inflows and underlined the virtues of prudent fiscal policies when monetary policy is deprived of efficacy. Nonetheless, like in the Asian experience of the last decade, the largest part of the current account deficits was caused, in not a few NMSs, by substantial private sector borrowing. Actually, the logic of the single market, with its ensuing liberalization of the capital account, is arguably, responsible for their rising current account deficits[17]. It should also be noted that most of the credit drive in the NMSs was the result, primarily, of foreign banks' expansion policies. This is why Baltic economies, Romania and Bulgaria, etc. should not be totally blamed for “home-made” vulnerabilities. Moreover, this expansion is the product of EU rules of the game. That fiscal policies in these economies were too pro-cyclical, in some countries (including Romania) at a time of high economic growth is a different matter for discussion.

The credit crunch, the loss of appetite for assuming risks and, especially, the capital flight seem to have modified the context drastically. Will policy makers revisit this monetary policy dilemma in the not too distant future? Several remarks deserve to be made in this respect:

- pressure toward depreciation is undermining financial stability where euroization is pretty high;

[16] *See also Brender and Pisani .*

[17] *This is blatantly indicated by Bulgaria’s experience; for years this country registered budget surpluses while its current account deficits went above 15% in recent years.*

- the financial stability concern is strengthened by foreign currency lending practiced by local banks;
- currency boards arrangements are under pressure in the Baltic economies, where devaluation has been avoided through very painful measures cuts of wages and pension in nominal terms);
- the financial crisis will have lingering effects, which would reduce the appetite for risk taking;
- big economies exert a crowding-out effect on global credit markets, that would keep the cost of credit high in the years to come (in spite of massive liquidity injections by central banks);
- local banks will be more cautious in their lending.

2.3 Cross-border bank ownership and financial stability

The substantial exposure to NMSs of banking groups headquartered in older members of the EU has become a source of both home- and host-country concern. One reason is related to potential losses resulting from sharp economic downturns.[18] Another concern, from the host country perspective, is the fear of a possible disorderly disinvestment of these banking groups from NMSs countries. The increased exposure of a bank to a particular geographic area also raises micro-prudential regulation and supervision issues.

The distribution of responsibilities between home and host country and the inexistence of detailed burden-sharing arrangements in the event of a crisis is a major handicap for the single market under conditions of deep financial integration.[19] Under current arrangements, responsibility for the stability of financial institutions belongs to the supervisor of the country where they are headquartered whereas responsibility for the stability of financial systems belongs to the supervisor of the host country. So for a country whose financial system is dominated by foreign banks institutional supervision belongs to various foreign supervisors whereas the local supervisor has responsibility for the local financial system. To correct this far from ideal allocation of responsibilities, ex ante cooperation among supervisors takes place in committees and memoranda of understanding have been agreed upon to guide action in crisis situation, but incentives to share information are weak and provisions for cooperation in crisis management are little more than declarations of good intention. As to crisis resolution, there are no ex ante burden-sharing arrangements and the management of the near-bankruptcies of Fortis and Dexia in 2008 illustrated how much solutions are dependent on the ability of governments to quickly agree on ad hoc arrangements[20].

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[18] *This especially applies to countries like Austria, Belgium and Sweden whose banking sector exposure to the NMSs region is significant macroeconomically.*

[19] *As the de Larosiere report (2009) says, 'The absence of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers' protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place' (p. 76).*

[20] *Pisani-Ferry and Sapir (2010) provide an informative account of the management of the banking crisis in the EU.*

This crisis brings ammunition to the idea that a common rulebook, more integrated supervision, and a common framework for crisis resolution are all needed to match the degree of market integration in financial services. On the other hand, the burden-sharing issue prompts national governments and supervisors to think more along national lines, in view of their accountability toward national tax-payers. How this contradiction will be addressed and whether or not it will be resolved is crucial for the future of European integration.

Before this crisis, the lead supervisor concept (which was promoted by leading financial groups) was resisted by small countries on both political and financial stability grounds. These countries feared that a loss of final say in the deliberations of the supervisory colleges, because of their host-country status, would cripple their capacity to intervene during a crisis. Because foreign groups, that operate multi-jurisdictionally, could be tempted to reallocate capital in a way that might create havoc locally, what would seem optimal for a financial group might be quite suboptimal for a host country. If problems emerge there may be a divergence of interest with 'the home supervisor wishing to see maximum transferability of liquidity to offset the emergence of group wide liquidity problems, while host supervisors wish to ring fence liquidity at national level precisely because they have growing concerns about the whole group position' (*The Turner Review*, 2009, p. 99). And, as the Turner Review stresses, even well capitalized local bank subsidiaries are likely to face liquidity crises if the whole group is seen to be in trouble. And in view of the powerful contagion effects which are likely to operate in the event of a crisis the trouble would extend to whole banking systems.

The De Larosière group report, followed by the decisions by the Ecofin meeting of 9th June (2009) to strengthen micro-prudential supervision via turning the Lamfalussy Level 3 Committees into 'European Authorities' and the creation of the ESRB (European Systemic Risk Board) in charge of macroprudential supervision are important steps which have given an impetus to the creation of a European system of regulation and supervision.

2.4 Why no meltdown occurred

There are four main explanations behind the avoidance of a financial meltdown in the NMSs. Thus, prior to the crisis, the region's financial sectors were relatively sound, in comparison to, e.g., the Asian countries in the 1990s (see EBRD, 2009). Multilateral responses were undertaken. Medium-term financial assistance conditional on fiscal consolidation and on the implementation of comprehensive economic reform programmes has played a crucial role.[21] Other multilateral support includes the frontloading of disbursement from EU structural and cohesion funds as well as the expansion of European Investment Bank and European Bank for Reconstruction and Development activities. Next, a European Bank for Reconstruction and Development Co-ordination Initiative aiming at ensuring a rollover of the Western European bank's

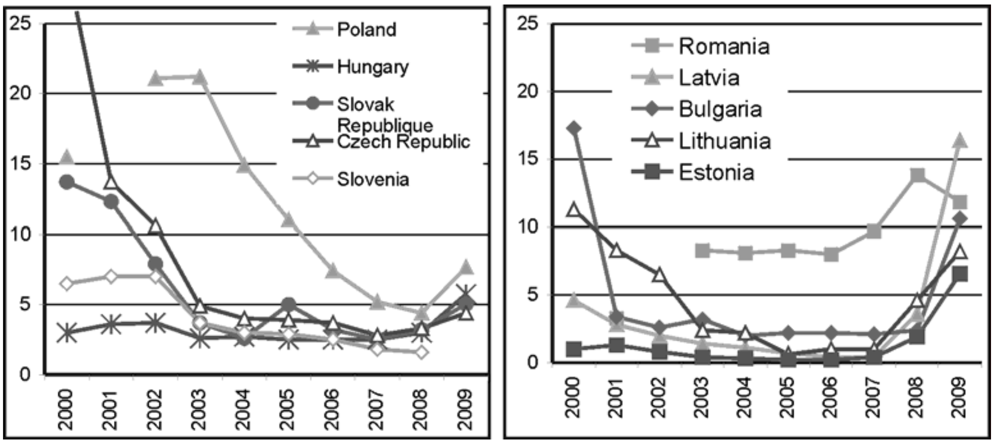
[21] *Programmes were led by the IMF, but for three EU countries (Hungary, Latvia and Romania) with EU participation both financially and substantively (as well as World Bank and EBRD assistance, and, for Latvia, bilateral assistance by seven European countries).*

claims on the region ('The Vienna Initiative')[22], the ECB's support for parent banks, and the EU's political commitment that bank rescue packages would have to support subsidiaries, have all played important roles. And, not least, the swift rescue of parent banks by EU-15 governments has greatly contributed to stability. Without it, crisis management measures specifically targeted at the region would have not been effective. In the case of a failure of a parent bank that has an important market share in a NMS country, that country – even if it was a least vulnerable one – would have suffered much more.

Stress tests for banks were conducted. Yet the overall assessment of the ECB at the end of 2009 was cautious: 'Looking ahead, the macroeconomic outlook in the non-Euro Area EU countries has improved somewhat …, although there is still an unusually high degree of uncertainty. Rising unemployment, lower incomes and corporate defaults are likely to lead to a further increase in loan delinquencies and a further deterioration of bank loan portfolios.' (ECB, 2009, p. 29.) The share of non-performing loans (Figure 5) has indeed been rising in many countries, though end-2009 levels were still well below, even in the worst hit countries, the levels reached in several Asian countries in the late 1990s (30-40 per cent in some of these countries). Yet the share of non-performing loans is a lagging indicator. Also, as it does not include all rescheduled debt, it may not give a full picture of bad loans.

Figure 5

Share of non-performing loans, 2000-2009



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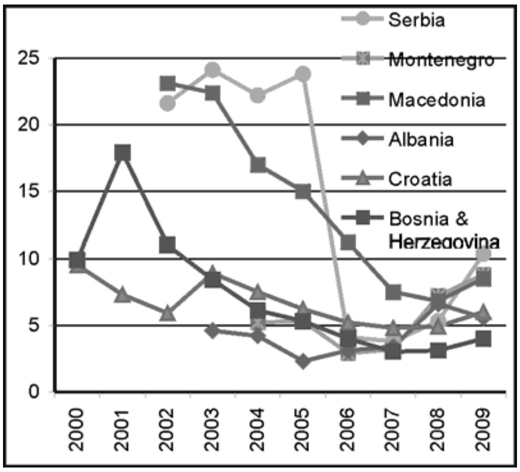
[22] *The 'Vienna Initiative' is a multilateral effort to secure financial sector stability in those CESEE countries with substantial foreign bank ownership. It stipulates coordination between all relevant stakeholders, including international banking groups, home- and host-country authorities, international financial institutions and the EU, with the aim of developing a common understanding on key issues. It aims to secure the commitments by both international banking groups and home- and host-country authorities, and to coordinate a fair burden sharing (see Box 1.4 in EBRD, 2009).*



Note: Data refer to end of the year.
Source: IMF GFSR October 2009, EBRD, Berglöf et al. (2009), and Becker et al. (p .87).

3. Regaining Financial Stability

Regaining financial stability must target both *structure* and policies. *Structure* refers to its configuration, in the EU and globally. The reform of the governance in the EU and the reform of the regulation and supervision of financial markets are essential for improving the functioning of EU structure. In the EU national policies depend on EU institutional and policy arrangements. Likewise, national policies would have to consider the effects of the current crisis, the external environment and the rising sovereign debt problem.

3.1 EU arrangements and national policy options

This paper puts emphasis on ***structure*** in understanding the roots of this crisis and the tension in the EU (EMU). Such a perspective reinforces the rationale for a reform of EU economic governance; since without it a breakdown of the EMU is to envisage, with effects on the existence of the EU itself. As the current crisis indicates it is not only fiscal rules and their compliance with that a proper functioning of the EMU hinges on. Growing imbalances stemming from the dynamics of private sector saving and investment flows have also played a major role in triggering the sovereign debt crisis in the EMU. In this context the overexpansion of financial institutions and their investment behaviour is to be highlighted. Therefore, a reform of governance has to address, apart from fiscal rules and compliance with them, issues such as imbalances in current accounts, wage dynamics and, not least, how to strengthen surveillance of member countries in the working out and reporting of economic data. How to foster real economic convergence is another major policy challenge since the EMU does not enjoy sufficient optimality as a currency area. It appears that the policy proposals which are put forward in Brussels (either by the special task force led by President Herman van Rompuy, or by the Economic Commission) address less the issue of dealing with insufficient real convergence and ensuing disequilibria which, sooner or later, strain the Union. A threat for the EMU is a growing cleavage between its northern and its southern tiers, with the latter one being held in vicious circles, incapable of overcoming the impact of austerity measures (which are asked for by fiscal consolidation). In this context resolution schemes, including orderly restructuring of sovereign debts is to be highlighted.[23] But would these schemes help achieve convergence? I doubt it. Moreover, the involvement of the private sector in these schemes is quite tricky under the current circumstances, though it does make a lot of sense in order to restore the logic of properly functioning markets – which implies that those who rake risks bear both rewards and losses. For it would, quite likely, raise budget deficit funding premia for some EMU states, which are already under the threat of sovereign debt crisis. Not least, in the structure of EU governance reform, the reform of the regulation and supervision of financial markets – with its European (EU) bodies – and the construction of burden-sharing arrangements are to be underlined.

NMSs have a stake in EU governance reform since they cannot escape the impact of EU wide externalities, contagion effects. For even countries which were quite prudent budget policy-wise and limited their external disequilibria (ex: Czech Republic, Poland, etc.) were caught into the crisis maelstrom. In addition, NMSs are bound to join the EMU according to accession treaties. This crisis has taught them lessons regarding linkages between overall economic policy and financial stability. In this context a rethinking of monetary policy is in the cards, too. For most NMSs in which the private sector has become highly indebted a process of deleveraging is underway . A crucial issue for these countries is how to avoid that deleveraging weigh too much on growth in the years to come. In a few Central European countries with reasonably low private sector indebtedness controlling the expansion of credit may come to the fore earlier than elsewhere. But in all countries, liquidity and perhaps solvency risks may show up again should market sentiment worsen again. Last but not least, crisis resolution remains an issue in countries with significant foreign bank ownership.

Rethinking monetary policy

How would this crisis change the practice of monetary policy ("inflation targeting", where it is practiced) owing to the new focus on financial stability? One problem regards the control of monetary aggregates when credit expansion is very intense and financial innovation loosens the relationship between the monetary base, M0, and broad money, M2. Over the last three decades, the relationship between M0, over which a central bank has control, and M2, over which a central bank does not have control, has weakened considerably. This has made the task of implementing monetary policy by a central bank more difficult. In hindsight, the increase in M2 in a global low inflation environment was made possible with increased leverage by financial institutions – helped by the development of complex financial product and the creation of a parallel architecture to the banking system (the so-called shadow banking system). The size of the latter, which was basically non-regulated, has been constantly increasing over the last 10-15 years. This evolution brings to memory the Gurley-Shaw report of decades ago, which highlighted the imprecision in

[23] *What Jean Pisani-Ferry calls a "statutory European Debt Resolution Mechanism" (2010). The task force under Herman van Rompuy, the president of the European Council, does address this issue as well.*

distinguishing between credit and money; and, consequently, major hurdles for effective monetary policy. Financial stability, by being added quite explicitly to the objective of price stability, will complicates the conduct of monetary policy.

Credit resumption

Government policies can impact on credit creation in several ways:

- Credible macroeconomic policies (including the consolidation of public finances and the reduction in the level and volatility of inflation, where these are needed) so that markets do not ask for excessive risk premia in lending to local businesses.
- Macroeconomic adjustment in countries with overvalued exchange rate and high private debt. Both internal adjustment and currency devaluation would increase the debt/income ratio further, but in the actually adopted first scenario the adjustment is slower, economic recovery is also slower, and banks do not need to rely on government support. An adjustment in macroeconomic policy that may include devaluation would lead to immediate heavy losses to the banking sector and government intervention would be needed. This would ask for debt resolution schemes, and the government may assume part of the bad loans (i.e. provide subsidy to banks and/or the non-financial private sector). But, any subsidy will likely raise serious moral hazard and distributional issues and NMSs governments have very limited resources for such an undertaking.
- Fostering credit through public banks or through domestic development banks. Governments or central banks may promote lending this way. The use of this channel would find a boundary in the scarce resources NMS governments can muster to this end.
- Creating a public institution ('bad bank') to deal with dubious credits and fostering banks to sell their dubious credits to this institution. But cleaning up banks would not automatically raise banks' propensity to lend, and there are questions marks about whether such an institution could be set up at a host country level.

The EU can support these actions by a high use of EU structural and cohesion funds to bolster economic growth and enhance the crowding in of commercial lending.

Access to liquidity and solvency problems

There are several means to enhance access to liquidity and mitigate solvency threats at a supra-national level, and indeed many of possible remedies have been implemented during the crisis: rules on convergence of deposit guarantees, which should prevent beggar your neighbour policies; medium-term financial facilities[24]; other IFIs credit lines and investments. Two avenues to improve the EU's support to NMSs deserve discussion: swap lines between the ECB and central banks of non-Euro Area countries; a broadening of ECB range of accepted collaterals to national currency denominated bonds issues by non-euro NMSs countries. These two measures, which would have helped to ward off euro liquidity shortages, were considered but not implemented at the height of the crisis. They should apply, if conditions require them again, at least to EU members, but the ECB may also consider EU candidate and potential candidate countries, with appropriate provisions

[24] *IMF resources were tripled from USD 250 billion to USD 750 billion, and the EU's medium-term financial facility was also upgraded from EUR 12 billion to EUR 50 billion.*

to risk considerations, of course)[25]. Finally, although a rise in capital requirements is necessary, an immediate implementation of Basel III would be counterproductive at a time when economies are still fighting to get out of recession and credit markets are functioning very precariously. The phasing-in should rather be gradual.

Crisis resolution

Since NMSs' financial markets are dominated by foreign groups, the home-country authorities have to work very closely with host-country authorities should a case of bank distress appear. It would be important for governors of the central banks (representing the main regulatory/supervisory bodies) in the region to stay in close contact and coordinate their measures. To this end, it would be useful to set up a Financial Stability Initiative (FSI), which should focus on the systemic problems of the non-Eurozone countries and report back to the ESRB and the EFC of the Council. Such a body would demand close cooperation among supervisors and central banks in the region and it would broaden the concerns which have motivated the establishment of the Vienna Initiative. As a matter of fact, the de Larosiere report (2009) recommends that special issues and events should prompt the 'Authorities' to create and lead groups of national supervisors, which should tackle those issues. When arguing in favour of creating such groups the de Larosiere report refers, in particular, to 'bankruptcy of a third country systemic group' (p. 54).

Preventing future credit booms

The most frequently considered instruments are: counter-cyclical capital and reserve requirements; dynamic provisioning against expected losses; limits on leverage and maturity mismatches; discretionary macro-prudential measures under the guidance of newly created marcro-prudential supervision bodies such as the European ESRB. The difficulty for the NMSs is that this toolbox mostly applies to countries where credit is in the hands of national banks or autonomous local subsidiaries of foreign banks. It is not likely to be effective in countries where credit is mostly in the hands of foreign bank branches or lending can be outsourced to foreign entities of the banking group (i.e. the parent bank or a subsidiary in another country). Coordination among supervisors can be a response and should continue being developed but calling for coordination is no solution when institutions participating in it have different, possibly conflicting mandates and incentives. Structural measures to improve the monitoring of financial stability in host countries include: turning foreign bank branches into fully-fledged subsidiaries; making foreign-owned subsidiaries 'subject to the same capital requirement calculations, and hold that in domestic assets, as the domestic banks'[26]; imposing restrictions on the setting up of new bank subsidiaries in certain areas[27].

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[25] The indication by the ECB in March 2010 that it wishes to review its collateral policy (which was arguably prompted by the escalation of the Greek crisis, because under the previously announced return to pre-crisis collateral rules Greek government bonds would have not been eligible for ECB refinancing) provides an excellent opportunity to consider extending the ECB's regional responsibility to the CESEE region.

[26] *Brunnermeier et al., p. 65.*

[27] *'The EU home country authorities should limit the acquisition of subsidiaries in other countries, where appropriate' EFC (2009) p. 14.*

The outsourcing of lending to foreign entities of the banking group does obscure the scope of regulatory measures. Therefore, a range of additional means have to be considered both at the national and EU level. At the national level:

- Tax policy should be actively used (e.g. abolishment of deductibility of interest payments in tax declaration and other tax incentives to the housing sector where they exist; introduction or increase in property taxes).
- Measures to encourage domestic saving, such as creating schemes, perhaps with tax incentives, to promote long-horizon saving would also improve the loan/deposit ratio and thereby limit the potential to unhealthy credit booms and the vulnerability of a country in the wake of a crisis.

At the EU level:

- Use the college of supervisors for coming to a common understanding with the home country supervisors regarding a proper conduct of foreign banks' external lending operations.
- The home- and host-country supervisors should compare the exposure of various banking groups towards a host country as it is illustrated by their consolidated balance sheets as against those of the subsidiaries in the host country; they should also assess the attempts to optimize the use of liquidity on a regional basis, which may harm local currencies.
- The ESRB and the EFC should address this issue and ask the home country supervisor to 'internalize' in its policy requirements the host country's risk judgment and worries regarding the expansion of credit and the 'optimization' of the use of excess liquidity.

Capital controls have resurfaced after the Asian crisis and are increasingly talked about nowadays. There are also studies (by the IMF too[28]), which show that capital controls, if used smartly, can help macroeconomic policy in small open economies, as financial markets can be inherently unstable. Thus, contrary to the common perception that capital controls can be easily evaded, they do affect the cross-market premium in a sustainable way.[29,30] NMSs cannot rely on capital controls as the single market prohibits such measures. But in candidate countries outside the EU capital controls could be considered. It may be that renewed capital inflows in and the relative ineffectiveness of regulatory measures would force governments to implement measures as being applied in other emerging economies, where there is an attempt to restrict speculative capital inflows by taxing currency, equity, debt and real estate transactions[31]. Capital controls that are now being proposed are more in the spirit of

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[28] *Ostry et al.*

[29] *Controls on capital inflows put downward pressure on domestic markets relative to international ones, generating a negative premium. The opposite happens with controls on capital outflows. This signals the inability of market participants to engage in perfect arbitrage (see Yeyati et al.).*

[30] *Rodrik 's opinion: 'Prudential controls on capital flows make a lot of sense. Short-term flows not only wreak havoc with domestic macroeconomic management, but they also aggravate adverse exchange-rate movements. In particular, 'hot' capital inflows make it difficult for financially open economies to maintain a competitive currency, depriving them of what is in effect the most potent form of industrial policy imaginable'.*

[31] *In Brazil a 2% surcharge was imposed on purchases by foreigners of equity and debt. Russia, India, Thailand, have also resorted to such restrictions.*

'macro-prudential regulation, to be taken in response to capital flows surges that have the potential to create bubbles in asset prices, including exchange rates' (Subramanian)[32]. For current EU members the risk of destabilizing capital inflows leading to credit bubbles has to be addressed through other means, which may include action on the demand for credit. Regulatory and tax instruments can, for example, be used to tame mortgage credit when deemed excessive from a macro-prudential point of view. Finally, the issue of the denomination of lending, i.e. whether in domestic or foreign currency, also deserves important considerations.

3.2 STRUCTURE: Taming financial markets is a must

A return to the initial logic of Bretton Woods is needed in order to preserve an open global system. The current crisis has reinforced one of Keynes' intellectual legacies, which was enshrined in the Bretton Woods arrangements – namely, that highly volatile capital flows are inimical to trade and growth and that financial markets are inherently unstable. As a matter of fact restraining financial flows is a way to solve the 'financial policy trilemma" (*the impossible trinity*); if free trade and relative stability of exchange rates are to support durable economic growth capital flows need to be managed.

For decades now a mantra has been heard worldwide: that not much can be done, in this regard, because markets would punish a government. But aren't they, aside from technological drivers, also the product of human beings' decisions to set rules for finance, trade and investment? To claim that nothing can be done about financial flows, when they bring about misery, is unconvincing. Whereas cycles in the motion of markets are to be expected deep crises can be averted. The bottom line is that well functioning markets, which serve most citizens, are not synonymous with deregulated and un-supervised markets!

The financial crisis cannot be explained only by years of cheap money and growing imbalances in the world economy. Mistakes in macro-economic policy were accompanied by gross abuses of securitisation, abnormally skewed incentives and a loss of moral compass, inadequate risk-assessment models and failures to check for systemic risks, a breakdown of due diligence and an almost blind belief in the self-regulating virtues of markets. Harmonization of rules is not a sufficient response to the crisis, since the very content of regulations and supervision needs change. This is what comes out prominently from the de Larosiere[33] report and the Turner report (in the UK), from documents of the European Parliament[34] and directives of the EC. A reformed regulatory and supervisory framework would observe certain basic principles:

- all financial entities (including hedge funds and private equity funds35 should be regulated and leverage be constrained;

[32] Subramanian (2009) also notices that, in contrast, the initial Tobin tax and the Turner variant would be structural, in the sense that would tax all financial transactions irrespective of the state of the macroeconomic cycle.

[33] "Report" by The High Level Group on Financial Supervision in the EU, chaired by Jacques de Larosiere, Brussels, 25 February, 2009.

[34] See also Ieke van den Burg and Daniel Daianu (2008).

[35] Hedge funds and private equity funds contribute to higher systemic risks. The claim that it is the money of investors which is at stake is very little of the whole story. High leverage and

- derivative markets should be regulated (products be standardized/simplified and clearing houses be used);
- remuneration be tied to long-term performance and be constrained;
- banks be better capitalized (both the amount and quality of capital, primarily of tier 1) and capital adequacy ratios set in light of systemic risks;
- pro-cyclicality be avoided in macro-economic policymaking and the way banks modify their capital adequacy ratios;
- banks asked to hold equity shares of securitized loans;
- accounting rules should not fuel pro-cyclicality and be standardized globally36;
- dealing with the "too big to fail" and "systemically important" entities: the splitting of big groups37 and a return to a sort of Glass-Steagall38 legislation are sensible options;
- regulatory arbitrage (including tax havens) be avoided;
- use of capital controls for macro-prudential reasons (these are not permitted in the EU)
- limiting volatility in exchange rates and commodity markets (buffer stocks, curbing naked short-selling);
- the protection of consumers of financial services;
- transaction taxes as a means to downsize an over-expanded financial sector, diminish negative externalities, and create fiscal revenues39;
- and, not least, a rethinking of systemic risks40.

Vested interests have a long arm and try to influence regulations and supervision. Already the financial industry is fighting back, by arguing against "regulation overkill". But vested interests must be strongly resisted. In the real world, we need regulators

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focus on short term gains increase overshooting and the speculative nature of such operations enhances instability.

[36] *There are still major differences between the standards used by EU countries and those used by the US.*

[37] *Market power (concentration) leads to market abuse and, in banking, as this crisis has glaringly proved, to heightened systemic risks by the formation of conglomerates that have engaged in the manufacturing of synthetic products, used high leverage and very risky investment strategies. Ironically, "the oligopolistic banking system that has emerged from this crisis is riskier than the one that went into it" (Wolf, "The Challenges of Managing our Post-crisis World",* Financial Times*, 30 December, 2009, p. 9). Those who claim that size does not matter use a self-serving argument. The British authorities have already taken steps in this field by asking several banks to divest from some of their business components.*

[38] However complicated such an undertaking would be it does make sense. 'Casino-type" banking has to be curtailed as much as possible and "proprietary trading" operations of banks be severely restrained.

[39] *There are two basic issues here: a) systemic risk, which cannot be divorced from size; and b) allocation of resources and distribution of profits. The intake from such a tax would help the IFIs cope with effects of crises in emerging economies, poor economies in general. Proceeds from such a tax could also help the EU set up a stabilization funds for dealing with crises.*

[40] *For an overview of the current thinking on systemic risks see 'The Concept of Systemic Risk", in* Financial Stability Review*, European Central Bank, December 2009, pp. 134-142. See also "Global Financial Stability Report. Responding to the Financial Crisis and Measuring Systemic Risks", IMF, April 2009, particularly chapter 3*

and supervisors who have a good understanding of how financial markets function[41]. They should never underestimate systemic risks; they should always be alert to financial stability. Strains and crises cannot be entirely avoided – but we can limit the damage they cause. Next two issues are looked upon: whether there is danger of regulation overkill; and the “too big too fail” problem.

3.1 The danger of overregulation is overblown

Over time, as the financial crisis has deepened, it has demolished long-held tenets, forcing even zealous advocates of light-touch regulation and self-regulation to admit fundamental flaws in such regimes.[42] But despite this seismic change and despite the evidence of a financial system in need of thorough reform, a line of reasoning has persisted, whose intent appears to be to resist reform and regulation of the financial industry. Consider the debate on both sides of the Atlantic about whether and how much derivatives – over-the-counter (OTC) products – should be regulated.

The financial industry is fighting back, arguing that such regulations would stifle innovation and prompt companies to re-locate where regulation is lighter. But not all financial innovation is benign. Likewise, many financial products which were created by using mathematical models have proved to be highly unreliable. Nor is the risk of re-location convincing. Financial institutions' reputations are tarnished; avoiding regulation limits the chances of restoring some of that reputation. And, secondly, regulation will follow financial institutions, because most countries increasingly realize that reform needs to be coordinated internationally. Principally, though, the industry is arguing that more regulation would cut its profits, which might sound a good argument at a time of the pressure for recapitalisation. But that argument is short-sighted, self-serving. It is short-sighted, because what is at stake is the prevention of similarly acute crises in the future. It is self-serving, because one industry's profits should not be protected at the expense of the rest of the economy. And it is unjustified, because over the past two decades the financial industry's profit share of the world's gross domestic product (GDP) has increased four or five fold. The argument also avoids the moral dimension of the debate on regulation and reform of the industry. How can governments sell painful policies that clobber public budgets to citizens while allowing those that caused the mess to preserve their old ways of doing business and get big bonuses again while their operations are massively subsidized by governments? How can they do so when big financial institutions, deemed ‘too big to fail', have been kept afloat with public money?

The current crisis is no ordinary recession, and its effects will be long-lasting. In the years to come, a phrase frequently used in the poor world – ‘distributional struggle' –

[41] *Beatrice Weder says that reforms should address the flawed incentives in the regulatory and supervision systems, including low pay (“The dog that did not bark”,* The Economist*, 3 October, 2009, p.88). By emphasizing the neglect of systemic risks Gillian Tett talks about a “silo curse” (*Financial Times*, 6 October, 2009). The experience of Spain and Canada, where regulators and supervision have done a much better job than in other advanced economies, is quite indicative in this regard.*

[42] *Alan Greenspan, the long-time head of the US Federal Reserve told the US Congress in October 2008, a “risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year [2007]”.*

will probably begin to gain greater traction in advanced economies as well. The past couple of decades has revealed a growing income inequality in the US and Europe. This income discrepancy will strain public policy and welfare states and cause political tensions. At this point, “over-reforming” is, arguably, not the big threat. What would be fatal would be failure by policymakers to learn from this huge debacle.

3.2 If banks are too big to fail, then split them up

The demise of investment bank Lehman Brothers is seen by many analysts as the event that brought the confidence crisis in world financial markets to a head. Although the financial crisis erupted almost a year earlier, the demise of Lehman Brothers seems to have been the tipping point into a worldwide recession. Lehman Brothers did not receive government help but many other large financial institutions have. One of the key issues in the debate on government bail-outs is whether (and why) the entities that are given public money pose any significant systemic risk. When the insurance group AIG was bailed out with a staggering amount of US taxpayer's money, the argument was clear: the scope and depth of its operations and its links to financial clients around the world made rescue a must; non-intervention was judged potentially fatal to the financial system as a whole. In a way, the action to rescue AIG replicated, on a much grander scale, what the Federal Reserve did in 1998 when it helped, indirectly, LTCM, by summoning five investment banks to participate in a joint aid initiative.

The phrase ‘too big to fail' has frequently been used in terms of bail-outs. If the size, or influence/reach, of financial groups can become an overwhelming problem and policy issue, then it has to be dealt with. Anti-trust legislation used to be enacted by governments, in the US and in Europe, in order to combat monopolistic behavior that undermined competition and extracted undue rents[43].

In finance, waves of deregulation over recent decades increased the scope for the formation of very large groups, with operations covering the entire gamut of financial services. Globalisation of markets and new information and communication technologies (which enhanced global trading in real time) stimulated the emergence of genuinely global players – one of which was AIG. Some of these groups have cornered the market – as demonstrated by the manifold rise in the share of world gross domestic product accounted for by the financial industry's profits in the past couple of decades.

But a fundamental challenge is that reckless behaviour by financial giants, accompanied by the intense degree of interconnection among them, has epitomised systemic risk. Such groups are an obvious flaw in the financial system, to the extent that governments are forced to step in when there is need to avoid financial meltdown. The current efforts to overhaul the regulatory and supervisory systems of financial industries in industrial economies should firmly address the size of financial groups. If they are too big to be left to die, one has to find an effective response to two problems: the moral hazard (not to encourage bad practices by eliminating failure);

[43] Both Standard Oil and AT&T were split up in this way. There were also waves of divestments in certain industries when it became clear that conglomerates and oversized groups did not necessarily bring about better performance.

and reducing, as much as possible, the burden on the public purse in cases of government action. When the size of some players holds the system hostage, it is arguably not enough simply to increase transparency, cap leverage, improve capital adequacy ratios, avoid pro-cyclical behaviour, impose new remuneration schemes, try to regulate conflicts of interest and improve quantitative methods. Splitting large financial groups, however, does, arguably, make sense under such circumstances. When CEOs of large banking groups argue that not size is the problem – but interconnectedness – it sounds very much like a self-serving argument. It would be interesting to see one major, global financial institution, which has engaged in merchandizing only simple, not toxic, financial products. The big groups have been very much behind the financial innovation which has gone astray during the past decade. The irony is that the current crisis has induced a spate of takeovers which run counter to this policy. In addition, in Europe the burden-sharing of rescue is more than murky while the supervision and regulation of banking sectors is fragmented along national lines. This state of affairs may discourage the drive by many banks to continue to expand internationally; they may even retreat and become more parochial. But overall, this crisis is likely to lead to a consolidation in finance, the perpetuation of ‘too big to fail' syndrome (be it on a local or national scale), which might recreate the systemic risks we are trying to diminish via regulatory and supervision reforms. This situation is a further reason to resort to anti-trust law, or very strict regulation of finance if banking should be deemed a special industry of a ‘public utility' nature.

Some might ask if the US and Europe can afford to split up large financial groups at a time when Asian financial entities appear to be gaining a competitive edge in the wake of the current crisis. This motivation has to be seen in relation to the regulatory arbitrage argument. Both these issues need to be taken into account. But it would be wrong to jeopardize the functioning of whole economies for corporate benefits which are, in the end, uncertain. In addition, why would Asian banks themselves ignore the lessons of the current financial crisis, which has worldwide implications? And why should the G20 and the Financial Stability Board not help major countries see eye-to-eye in this regard?

4. Issues to ponder on

Disentangling private from public debt has become a huge, overwhelming issue in the EU in view of its deep financial integration. As a matter of fact, the rescue program for Greece, which was worked out by EU leaders in the Spring of 2010, was motivated, not least, by the big exposure French and German banks have to Greek sovereign debt. Private sector debts are making up enormous contingent liabilities on public sector debts when bankruptcies are not tolerated. This is one of the big revelations entailed by the current crisis. And the inability to disentangle the myriad of intertwined debts will impact, negatively, on fiscal policies for years to come. Even now this feature of deep financial integration seems to be under-estimated. What is even worse is that bank consolidation would increase moral hazard in this industry and would preserve the hostage relationship governments budgets are held into.

The current crisis has refocused attention on public budgets owing to big jumps in their size registered in countries where large financial entities were threatened by collapse and state intervention (rescues) did take place. But the fiscal deficits are no less important in economies where the economic downturn has been significant and a permanent fall of potential output has been entailed –where the crisis blew up bubbles and underlined years of resource misallocation. A country may have, relatively, a low public debt, but if a newly revealed structural deficit is pretty high its dent service can skyrocket. Unless fiscal consolidation is put into motion a solvency crisis looms at the horizon. Related to this issue is the relevance of economic indicators. Fiscal deficit my be low for a while, until they explode when “hidden” imbalances come into the open. In the EMU current account imbalances among member states were not paid enough attention until this crisis hit. Not a few loved to use an analogy with US member states –which is quite irrelevant in view of the totally different fiscal arrangements in the EU as against the US. And to what extent the intended reform of economic governance in the EU would change things dramatically is to be seen. Fiscal rules, surveillance and peer pressure may not be enough for strengthening the cohesion of the EMU, of the EU in general. An additional handicap in the EU is linked with the political reality that tax-payers are, ultimately, national. Can “common goods” (including the euro) be protected unless “common resources” are more substantial? Can resolution schemes and orderly restructuring schemes of sovereign debts be devised so that they compensate the smallness of the EU budget and complexity of the EU decision making process?

Would a deflationary bias in the conduct of monetary policy appear in view of the willingness to prick bubbles in their infancy? On the other hand, would’ n’ it, by fostering less instability, support long-term growth? This is also an issue which demands more thorough answers. In a way, answering this question is analogous to deciding on a proper speed of implementing Basel III: for a too fast implementation could stifle recovery; on the other hand, a too slow implementation would create prerequisites for a new crisis.

Debt deflation is a policy risk. If this would occur in several major economies a relapse into a financial crisis could ensue, with staggering effects. A “japanization” of these economies , namely a long period of stagnation induced by liquidity trap and low consumption, would take place. Financial stability would be once more at the top of public agenda in view of the steadily worsening bank balance-sheets. Public debts may be burdened again provided an exit via deliberate creation of inflation is considered not an option.

Does size matter for judging fiscal risk? It appears that it does. Large economies are, seemingly, considered to have a bigger capacity to resists shocks; they are, potentially, more resilient. Resilience (ability to withstand external and internal shocks) will increasingly be a principal policy aim.

When it comes to judging structure globally the emergence of new economic powers and the dynamic of competition, via non-zero sum games, get to the forefront. Because unwinding global imbalances, when zero-sum games are frequent, is quite painful. This has to be seen in conjunction with a shifting geopolitical reality. The latter is visibile also in the functioning of the G 20, in the functioning of the IFIs. Bank competition should be seen through geopolitical lenses too. And if this is so prospects for a reform of regulation and supervision would be influenced.

What would be the impact of new technology for circumventing rules (ex: high-frequency trading)? Regulators and supervisors need to take it into account as well, when thinking about financial stability. The latter can be linked also with the capacity of economy to withstand effects of natural disasters, with social strain. Demographics, too, plays in a role when it perturbs inter-generational balance and, consequently, fiscal equilibrium.

Overall, the years to come will quite likely be accompanied by an increasingly uncertain environment; complexity will also be on the rise. These circumstances would advocate for a more simple financial intermediation system, for banking getting back to its roots. If this will not happen, more fragmentation is to be expected, with societies turning, probably, more inward-looking. This will have profound implications for the global system. It may be that, by taking into account the lessons of financial crises and the need to lend to economies more resilience, that there is an optimal size of openness (trade and finance-wise). This implies that firms need to think globally and operate selectively (be close to home) as a means for mitigating risks. It may also be the case that, over the longer run, we will end up with a three blocs-based world financial system as a means to maintain a relatively open global system.

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