

2nd Revision: 24 November 2009

The Aftermath of the de Larosière report on EU Financial Supervision: A Critical Appraisal

by

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1. Introduction
2. Regulatory repair
3. Supervisory repair
 1. European System Risk Board (ESRB)
 2. The Commission proposals
 3. The proposals of the ESRB appraised
4. Last Resort of managing Risk and the NCBs
 1. Internalisation of Money Externalities by the ECB
5. European System of Financial Supervision (ESFS)
 1. European Authorities: EBA, EPIA, ESA
 2. Issues in need of clarification
6. Role of National Central Banks (NCBs)
 1. The Steering Committee (SteCom)
 2. College of Supervisors
 3. National Supervisors
 - 4 NCBs and the Credit Rating Agencies (CRAs)
7. A European Fiscal Authority (EFA)
 1. European Fund for Financial Stability (EFFS)
 2. Mission of an EFFS
 3. Resources of the EFFS
 4. A Transaction tax
 5. Transaction tax and competition
8. Overall conclusion

Bibliography cited

Appendix 1: Taxonomy of money externalities

Appendix 2: Definitions of money externalities

Annex 1: A new European Framework for Safeguarding Financial Stability

Annex 2: A Single European System of Prudential Supervision (SESPPS)

1. Introduction

The High-Level Group on Financial Supervision in the EU submitted its report (hereafter, de Larosière report (DLR)) to the EU institutions, in February 2009, as mandated in October 2008.

The DLR examined the causes of the financial crisis and made 31 Recommendations to repair the EU Regulatory regime, to enhance the EU Supervisory structure, and to promote financial stability at the global level.

The European Commission endorsed the DLR recommendations, with some modifications relating to the sectors and stages of implementation. It also made suggestions concerning the composition, voting rights and addressee warnings, under the macro-prudential supervision.

The Economic and Financial Affairs (ECOFIN) Council of 8 June 2009 accepted the DLR's view for 'a' European Systemic Risk Board (ESRB) but changed its composition. It agreed to the establishment of a European System of Financial Supervisors (ESFS), but added a Steering Committee. And it emphasised that the new mechanisms 'should not impinge on the fiscal responsibilities of the Member States'.

The Brussels European Council of 18/19 June 2009 agreed to the new supervisory framework; it stressed the importance of 'the cross-border framework for the prevention and management of financial crises' and the need 'to take up the issue of global regulation and supervision'.

We concentrate on the EU supervisory structure proposed by the DLR and transposed into a package of *five* 'draft legislative acts' for EU action, submitted by the Commission in late September 2009. Two would establish a European Systemic Risk Board (ESRB) to undertake macro-prudential issues. Three would establish the system of European Supervisory Authorities (ESAs).

We examine the logic underlying the DLR recommendations and Commission proposals - briefly in section 2 on regulatory repair and extensively in section 3 on supervisory repair - under the 'methodology' described in our 1st WP. It is found to be *deficient*, in need of repair. In section 4, we restate the case for the Central Banks to assume responsibility for the 'last resort of managing risk'. In section 5, we appraise the three ESA draft legal acts and arrive at a 'preliminary' conclusion that they need major adjustments.

In this complex setting, we attempt to propose two institutional innovations. The first has to do with the role of the national central banks (NCBs) in 'micro-supervision', in section 6. The second innovation concerns the structure for the budgetary burden; that is to say the establishment of the 'European Fund for Financial Stability', in section 7.

2. The regulatory repair

The DLR regulatory repair consists of two elements:

First, to recognise the *complexity* of “dealing with financial bubbles, strengthening regulatory oversight on institutions that have proven to be poorly regulated, adapting regulatory and accounting practices that have aggravated pro-cyclicality, promoting correct incentives to good governance and transparency, ensuring international consistency in standards and rules as well as much stronger coordination between regulators and supervisors” (p.13).

Second, to propose 15 recommendations intended to undo the complexity and then remedy it.

On the major regulatory matters referred to in the DLR, the EU institutions have adopted or proposed legislation. Table 1 shows the state of affairs.

Table 1: Pending and recently adopted EU legislation

Proposal	Public consultation	Proposal submission	Final adoption
Regulation 2008/0217 on Credit Rating Agencies	31 July 2008	12 November 2008	23 April 2009
Amendments to Directive 2006/48/EC and 2006/49/EC, the Capital Requirements Directive	Initial consultation 15 April 2008 second consultation 30 June 2008	1 October 2008	6 May 2009
Amendments to Directive 1994/19/EC on Deposit Guarantee Schemes	none	7 October 2008	11 March 2009
Directive on Alternative Investment Funds	Green Paper 14 July 2005	COM(2009)207 30 April 2009	Pending
Derivatives 1. Communication outlining ways to strengthen the safety of derivatives markets; 2. Communication proposing policy actions to enhance the safety of derivatives market	Communication COM (2009)332 3 July 2009 Communication COM (2009)563 20 October 2009	Expected in 2010	

There four unresolved issues that pre-occupy the EU, USA and other important financial areas. These are: The Too Big to Fail Problem; Separation of Banking from Investment; Future of Shadow Banking; The Budgetary Burden. The LDR has not addressed them, hence no recommendations have been made. And at this stage of unfolding matters, we have not received concrete proposals from the Commission.

We attempt to fill the gap in section 7.

3. The Supervisory structure

The core argument of the DLR about the need to of a *new* European supervisory structure rests with a simple premise: To learn from “real and important supervisory failures, from both a macro and micro-prudential standpoint” (p.39), then to devise a new Architecture of Supervision

The DLR examined the ‘weak link in the chain’ and found at least 8 weaknesses of the current EU financial structure:

- a) Lack of adequate macro-prudential supervision,
- b) Ineffective early warning mechanisms,
- c) Problems of competences,
- d) Failures to challenge supervisory practices on a cross-border basis,
- e) Lack of frankness and cooperation between supervisors,
- f) Lack of consistent supervisory powers across Member States,
- g) Lack of resources in the level 3 committees,
- h) No means for supervisors to take common decisions.

Theoretically, these weaknesses make the case for another approach to supervision, seeking to solve the ‘supervisory trilemma’. The ‘financial stability trilemma’ - according to Schoemaker (2008: 44) - arises from a situation when one wishes to attain three objectives:

“[1] stable financial system, [2] an integrated financial system, and [3] national financial stability policy, [which] are incompatible. Any two of the three objectives can be combined but not all three; one has to give.” (my[])

Integration of financial markets in the EU has progressed satisfactorily. If we concentrate on cross-border penetration of European banking, we find that: “average cross-border penetration has gradually increased from 11% in 1995 to 21% in 2007” (Schoemaker, 2008: 46).

The UK House of Lords report (2009: 32) citing witnesses evidence, stated that “the establishment of a single EU supervisory authority for cross-border banks, since the largest 43 cross-border banking groups in the EU account for 77% of total EU bank assets. This would take powers of supervision from national supervisors in regard to the cross-border banks and would represent a major reform of the EU financial supervisory structure.”

If one examines the ECB’s mapping of banking groups, one finds that for the period of 2001 to 2005, “the consolidated assets of the sample as a whole increased from around 54% to 68% of overall consolidated EU banking assets. This indicates that cross-border banks hold a sizable – and rising – share of total EU banking assets.” (Schoemaker, 2008: 46-47)

Hence attaining the objective of financial stability means the national policy has to give.¹

¹ The same approach to the trilemma is followed by a member of the executive board of the ECB, Bini Smagli (2009), who argues that “while in principle there is a single European financial market, in practice, national institutions and financial centres compete.... This in turn encourages a ‘lighter’ supervisory touch ... In this context, the stability of Europe’s financial market is likely to depend on the weakest link in the chain.”

Suppose the theoretical case of the ‘supervisory trilemma’ was the underlying thesis of the DRL’s repair. What would its constituent elements be?

1. To separate the Micro from the Macro prudential Supervision.
2. To create a new structure called: *European Systemic Risk Council (ESRC)* endowed with Macro-prudential supervision based on an enhanced responsibility of the European Central Bank (ECB).
3. To modify the existing structure of Micro-prudential supervision by creating a *European System of Financial Supervision (ESFS)*.

Each of these elements merits exhaustive consideration. [Annex 1](#) may help.

As to the *Micro-prudential supervision*, the DLR states its *main objective*: “to supervise and limit the distress of individual financial institutions, thus protecting the customers of the institution in question. The fact that the financial system as a whole may be exposed to common risks is not always fully taken into account.” (p.38)²

Thus ‘protection of the consumer via mitigation of risks’ is a common objective which if attained, financial stability becomes a ‘public good’. This is so because of another reason related to the Money Externalities discussed in the 1st WP, and is recognised by the DRL:

“by preventing the failure of individual financial institutions, micro-prudential supervision attempts to prevent (or at least mitigate) the risk of contagion and the subsequent negative externalities in terms of confidence in the overall financial system” (p.38).

For *Macro-prudential supervision*, the literature is recent. The UK House of Lords report (2009: 12) describes the task: “Macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy. The focus of macro-prudential supervision is the safety of the financial and economic system as a whole, the prevention of systemic risk.”

Borio (2009: 1) stresses two features of macro-prudential supervision: “It focuses on the financial system as a whole, with the objective of limiting the macroeconomic costs of episodes of financial distress. And it treats aggregate risk as dependent on the collective behaviour of financial institutions ...”.

One should note the *contrast* between the micro- and macro-prudential. The former examines ‘how individual agents treat supervision’ on the assumption that asset prices, market/credit conditions and economic activity are independent of their decisions. This assumption is based on the premise that the decisions are taken individually or that they are typically too small to have any significant impact. Hence they possess no dominant position.

² The UK House of Lords report (2009: 12) went further in its elaboration: “Micro-prudential supervision is the day-to-day supervision of individual financial institutions. The focus of micro-prudential supervision is the safety and soundness of individual institutions as well as consumer protection.”

For Borio (2009), the macro-prudential consists of two dimensions:

- A. How risk is distributed in the financial system at a given point in time - the “cross-sectional dimension”.
- B. How aggregate risk evolves over time - the “time dimension”.

These two questions bring us back to the *transmission mechanism* of money externalities under the Monetary Triangle (Diagram 2 of 1st WP). That is to say: How does it affect the other sectors?; and How does it impact on the components of the monetary triangle? It is a generic follow up of the remit of a supervisory body endowed with four separate roles: Licensing, Oversight, Enforcement and Crisis management.

The macro-prudential supervision for the *cross-sectional dimension* is necessary because the induced ‘systemic risk’ may lead to a failure of the transmission mechanism or may generate a sequence of bankruptcies. Borio (2009: 2) tells us ‘why’:

“how to deal with *common (correlated) exposures* across financial institutions. These arise either because institutions are directly exposed to the same or similar asset classes or because of indirect exposures associated with linkages among them (e.g. counterparty relationships). Common exposures are critical because they explain why institutions can fail together”.³

This aspect of the transmission mechanism is also recognized by the DLR:

“While risks to the financial system can in principle arise from the failure of one financial institution alone if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the much more important global systemic risk arises from a common exposure of many financial institutions to the same risk factors. (p. 38).

It presupposes interdependence of systems and inter-connectedness of sectors. The ‘network externality’ is generated by the payments system and with it a number of other money externalities of the ‘transactions externalities’ are induced. Both are well advanced in the EU due to the shadow banking.

The *time dimension* also plays an important role in transmitting the risk externality to the real economy via ‘feed back effects’. According to Borio (2009: 2),

“the key issue in the time dimension is how system-wide risk can be amplified by interactions within the financial system as well as between the financial system and the real economy. This is what pro-cyclicality is all about ... Feedback effects - the endogenous nature of aggregate risk - are of the essence”.

³ In this context the question of the proper design is important. Borio (2009: 2) calls for attention: “*Just as an asset manager, who cares about the loss on her portfolio as a whole, focuses on the co-movement of the portfolio’s securities, so a macroprudential regulator would focus on the joint failure of institutions, which determines the loss for the financial system as a whole. The main policy question is how to design the prudential framework to limit the risk of losses on a significant portion of the overall financial system and hence its “tail risk”.*”

The mitigation of the ‘pro-cyclicality’ in the view of the DLR may be attained by two means. First, change the Basel 2, as suggested in the preceding section. Second, focus on ‘correlated shocks’. That is to say that “to pay particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects” (DLR: 38).

For this kind of monitoring, the body responsible for macro-prudential analysis should possess ‘specialised knowledge’ and ‘experience’.

The challenge, therefore, for the new architecture is dual:

- A. to *contain the cumulative impact* during the expansion period;
- B. to *manage the factors determining the speed of instability* in a recession.

In the absence of these two mechanisms, the seeds of ‘financial instability’ will be sowing at an unknown speed. The recommendation of the DLR has been to create a *new body*. The recently submitted legal proposals by the Commission called: *The European Systemic Risk Board (ESRB)*.⁴ In both the DLR and the Commission proposals, one cannot feel sure that the core problem of ‘How to mitigate the forces associated with challenges: A. and B. are fully taken in account.

This pre-occupation is present in our appraisal of the DLR and draft legislation. Yet the creation of a new institution usually raises two inseparable issues. The first has to do with its organisational structure, the second with its mandate and means.

3.1 European Systemic Risk Board (ESRB)

As to the ‘organization’, the LDR has proposed that the ESRB be chaired by the ECB President, with the logistical support of the ECB. In addition, it has considered ‘logical’ to compose the ESRB with the central banks of the ESCB general Council and other bodies.

The Council of 9 June 2009, with the support of the Commission, suggested a different composition, by adding a *Steering Committee* of members plus observers (representatives of the national supervisors and President of the Economic and Financial Committee). The end result is shown in Annex 1.

This organisational setting is taken up by the two draft legal acts.

⁴ See COM(2009) 500 final - 2009/0141 (AVC) - Proposal for a COUNCIL DECISION entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board, and COM(2009) 499 final - 2009/0140 (COD) - Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Community macro prudential oversight of the financial.

3.2 The Commission proposals

As mandated, the Commission has submitted two legislative proposals:

The *first* is a Council decision, based on Article 127 (ex-105) of the Treaty,⁵ which authorises the President and the Vice-President of the ECB become members of the ESRB (art.1); entrusts to the ECB the task of the secretariat of the ESRB (art.2); and lays down the guidelines for the ‘collection of information’ necessary for the tasks of the ESRB.⁶

The *second* proposal is an EP and Council Regulation based on Article 114 (ex-95), the single market legal base.⁷ The proposal is important in many respects:

1. It establishes a European Systemic Risk Board (ESRB).
2. It defines the Mission, Objectives and tasks of the ESRB.
3. It lays down the organisational structure: A General Board, a Steering Committee (see Annex 1) and a secretariat (referred to in the 1st proposal).
4. The General Board will have 33 members with voting rights and 2 Observers without voting rights.
5. It states the composition of the *Steering Committee* that will have 12 members (2 from the ECB, 5 from the General Board of the ESRB; 3 from the Authorities; one from each the Commission and Economic and Financial Committee (see Annex 1, middle-part).
6. It also creates an Advisory Technical Committee that will have 61 members (27 representatives of NCBs; one from the ECB; 27 supervisors from the National authorities; 3 representatives from the European authorities; 2 from the Commission and 1 from the EFC).

As to the 2nd issue of our ‘concern’: Tasks and Powers of the ESRB, they are laid down in four articles (15 to 18) of the second proposal. The Commission in its memorandum states:

“The ESRB will not have any binding powers to impose measures on Member States or national authorities. It has been conceived as a "reputational" body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority. To this end, it will not only provide high quality assessment of the macro-prudential situation but it may also issue risk warnings and recommendations which identify the potential unbalances in the financial system which are likely to increase systemic risks and the appropriate remedial actions.” (p.5)

⁵ The Lisbon Treaty has amended ex-article 105 (6); the amended Art. 127 reads: “6. The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”

⁶ See COM (2009) 500 final, 23.9.2009.

⁷ See COM(2009) 499 final, 23.9.2009.

This is a very restrictive mandate for the ESRB, based on the ‘**moral authority**’ of the ECB, because it “will not have any binding powers to impose measures”. And it is endowed with ‘toothless tools of power’ because it simply ‘**issue risk warnings and recommendations**’.

Without *real* Powers and Tools, the ESRB will rely on the good will of the National and European supervisory authorities to be supplied with ‘the necessary information’. Article 15(2) of the second proposal is revealing:

“The European Supervisory Authorities, the national central banks and Member States shall cooperate closely with the ESRB and provide all the information necessary for the fulfillment of its tasks in accordance with Community legislation.”

And there is an *erroneous* statement concerning the ‘budgetary implications of this proposal’. The Commission states:

“The budgetary cost related to the ESRB will be borne by the ECB and will not have any direct implication for the Community budget. The cost of such support will depend on the extent to which the existing staff and resources of the ECB can be used to fulfill the tasks of the Secretariat of the ESRB.”(p.4)

Who is to bear the cost of an enlarged Secretariat for the ESRB? Who will pay for the tasks conferred upon the ECB to organize the meetings and the selection of market information? Certainly, the EC budget will do so.

3.3 The proposals on the ESRB appraised

The theoretical justification for the involvement of the ECB is based on two shaky grounds:

First, let us put the matter in theoretical perspective. We have no agreed definition of ‘financial stability’.⁸ We have ‘a working’ definition of the concept of ‘systemic risk’ if it is considered as a ‘money externality’. The ECB has one instrument, the interest rate, to attain one objective, price stability. But the Commission’s two proposals endow the ECB with an additional task of managing ‘systemic risk’ across frontiers. A result largely induced by the ‘network externalities’ - themselves generated by the payments system and by a number of ‘seigniorage externalities’. Hence two goals: price stability and financial stability, to be attained by one instrument, the interest rate.

Hence, for de Vries (2009: 3), we are back to the days of the European Monetary System:

“So what should be the role of a Systemic Risk Board if it has no clear goal, no instruments and may only give advice? This is like an ECB that cannot set the interest rate, but has to advise national central banks on the interest rate that they should set. Pretty much a return to the days of the EMS it looks like. At the time local central banks were well advised to follow the lead of the Buba, but often acted otherwise. As national interests prevail in a crisis, the advice is likely not heeded when it is most needed.”

⁸ See Davies and Green (2008: 24-26) on the current surveys which are unable to define precisely ‘what is financial stability’. The ECB’s Financial Report (2009) describes it; it does not define it precisely.

Second, the ECB has *no* right to ‘bail out’ failed banking or financial institutions (Treaty, Article 125, ex-103). In the EU we have a centralized monetary policy (Treaty, Article 105) but decentralized national economic policies (Treaty, Articles 120 to 122, ex-98 to 100). And the EC budget provides for *no* burden sharing fund conceived to cope with either economic or financial crisis. We return to the last point in section 7.

Third, the second proposal recognises the important role of National Central Banks (NCBs) in providing ‘*specialised information*’ to the ESRB, and states:

“the objective of the reform is to ensure a smoother interaction of supervision at the macro-prudential and micro-prudential levels. In fulfilling its role as macro-prudential supervisor, the ESRB will need a timely flow of harmonised micro-level data, while micro-prudential supervision by national authorities will benefit from the ESRB’s insights into the macro-prudential environment.” (p.6)⁹

This is a commanding challenge and pre-supposes ‘expertise knowledge’ in both micro and macro, and of policies pursued. But the NCBs have acquired both. ‘Expertise knowledge’ in a sound macro-prudential system has not yet been acquired by the ECB.¹⁰ And the NCBs are in better legal position to acquire the ‘specialised knowledge’ from the National supervisors engaged daily in micro-supervision.

The above solution is dependent on two important elements: *transparency* and *regulatory tools*. The ESRB may organise its mandate to impose ‘transparency’. But it will possess no ‘regulatory tool’, as we said earlier. Hence we are faced with the question of a ‘voluntary delegation of national power to a European institution’, in order to save the proposals on the ERSB.¹¹

Fourth, the recent experience with the financial crisis of 2008 does not support the Commission’s thesis that ‘all can be arranged by tailor-made regulation’. The regulatory weaknesses identified by the LDR have been taken care of by new or amending EU

⁹ The UK House of Lords report (2009: 27) echoes the same sentiment: “one of the failures that led to the crisis was the lack of link up between the macro-prudential side and the micro-prudential side of supervision ... This highlights the two areas that reform of EU supervisory structures aims to address. First, there was a failure to identify macro-prudential and systemic risks to the financial services industry at any level. Second, there was a failure of micro-prudential supervisors satisfactorily to identify and mitigate risks through the supervision of individual institutions.”

¹⁰ For the ‘expertise knowledge’ of the Systemic regulator, the Chief Executive of Goldman Sachs states the following: “Regulators need to be able to identify risk concentrations early and prevent them from growing so large as to threaten the system. If systemic problems arise, regulators need to take prompt action to limit their impact and protect the safety of the system. To do this, the systemic regulator must be able to see all the risks to which an institution is exposed and require that all exposures be clearly recognised.” (Blankfein, 2009: 11 “To avoid crises, we need more transparency”, Financial Times, 13 October 2009).

¹¹ The 2nd proposal from the Commission (COM(2009) 499, 23.9.2009) suggests Article 95 of the Treaty as legal base for the setting up of the ESRB. This will mean that it will have no legal personality and no legal binding powers. Everything will depend on the ‘good will’ of the Member States and their supervisory authorities.

legislation. Tackling ‘systemic-risk’ is a Herculean task, and cannot not be dealt with by a Body stripped of ‘binding regulatory and supervisory means’.

Sixth, the single most important error of the proposals about the ESRB is the adoption of the DLR’s view that by upgrading the Level 3 committees to European Authorities, it will solve the problem of communication between the Micro-supervisors and the macro-supervisor (ESRB). This cannot be defended on theoretical reasons; powers still reside in the national domain.

Seventh, for practical but important matters, a ‘toothless ESRB’ will have less power than any European Supervisory Authority (ESA). Under the proposed Regulations, an ESA may *indirectly* impinge on the fiscal responsibility of a Member State by instructing National authorities ‘to ensure a timely follow up’ by the national competent authorities (see Article 21(5)). But compliance with the ESA’s decision implies a ‘fiscal cost’.

We propose a *different* theoretical approach based on the methodology of the 1st WP for making the case for the ECB to assume the *complete* role of the macro-prudential supervisor, in the next section.

4. The Last Resort of Managing Risk and the NCBs

This matter was first treated in my EMU monograph in 1994.¹² I repeat the argument here in order to slightly change the institutional architecture of the two proposals on the ESRB and thus make it more *resilient* and more *efficient* in eliminating sources of vulnerability.

Under the Treaty, the European Central Bank (ECB) defines the monetary policy of the euro area. During the 2008 financial crisis, the ECB provided ‘emergency liquidity assistance’ within the euro area. The US Federal Reserve followed in essence the same policy of monetary laxity as did the UK Bank of England and many other central banks in the globe. At present, the ECB has no direct supervisory functions. The two proposals under consideration, as we said in the preceding section, do *not* repair this deficiency.¹³

4.1 Internalisation of Money Externalities by the ECB

Let us borrow from the 1st WP, the underlying approach.¹⁴ A central bank theoretically should internalise and induce the *five* categories of money externalities. But the central bank that *fully* captures the *seigniorage externalities*, in particular, the four-type of *reserve externalities*, may be endowed with the responsibility of supervision of the banking and financial systems. The ECB captures the ‘reserve externalities’ and the current experience of its ‘liquidity assistance’ supports this theoretical premise.¹⁵

The question of interest is to know whether the traditional function of *lender of last resort* is appropriate when a NCB is faced with global markets and money externalities in its banking and financial markets. Even back to 1992, it was recognised by the Promisel report commissioned by the Basle Committee that: "banks increasingly have dealings with non-banks such as trust and insurance companies, so traditional measures of inter-bank dealings are potentially misleading. Banks and non-banks alike need proper contingency plans for disasters".¹⁶

Davies and Green (2008: 3-6) have examined the global role of banks - traditional and ‘shadow banks’ - as well as the scale of financial markets and said:

“McKensey and Company estimate that global financial assets have more than doubled in the last ten years, and are set to increase by a further 50 percent by the end of this decade ... It is therefore not surprising that a regulatory system designed some time ago is beginning to creak. Furthermore, the growth of the cross-border financial activity is even more rapid:

¹² This section relies heavily on Caravelis (1994: section 7.7).

¹³ Member States operate different formats of national supervision. In 1997, the UK split the roles of supervision and monetary policy between the FSA and the BoE; the discussion today is about going back to the before 1997 situation (the Bank of England being responsible for both). Some other Members States split these roles, notably Germany, but she has announced draft legislation to merge the two, under the auspices of the Bundesbank.

Several National Central Banks (NCBs) still hold a supervisory role: Spain, Italy, Portugal, Greece, the Netherlands and the Czech Republic.

¹⁴ See Taxonomy of money externalities in Appendix 1 for a reminder of this complicated terminology.

¹⁵ See Definitions of money externalities in Appendix 2

¹⁶ Quoted in Freeman (1993: 41) who summarised and commented on the findings of the Promissel report.

international capital flows have been expanding at over 10 per cent a year over the last fifteen years...”.

Given the scale of capital flows of cross-border, the interdependence of banking and financial intermediaries has increased to an extent that casts doubt on the ability of monetary authorities to devise contingency plans for financial crises. But under these circumstances, then the traditional function of lender of last resort is **redundant**. This becomes clearer if we examine the source of financial instability in global markets.

As we said in the 1st WP, *liability management* and *risk externalities* have increased **systemic risk** disproportionately. Given the global activities of banks (traditional and shadow) in managing their portfolios, payment systems and netting schemes have become global. Yet there is a fact here to recognise. Both the ‘liability management’ and the ‘risk externalities’ are internalised by the private sector: banks and financial companies, **not** by Central Banks. Consequently, this fact renders the traditional function of ‘lender of last resort’ **inoperative**.

Suppose financial instability is caused by ‘unmanaged’ systemic risk. Then its remedy cannot be based on the provision of the necessary liquidity because the Central bank does not manage ‘liability’, nor can it contain risks outside of its jurisdiction. The ECB’s ‘liquidity support’ in August 2008 simply prevented the collapse of the system.

There is another aspect to consider. To the extent that global markets are not regulated at a global level, three institutional prerequisites are **not effective**. These are: a) netting schemes, b) uniform accounting methods and c) disclosure rules. They have been rendered ineffective at national level because – as the 2008 financial crisis attests - the a), b) and c) systems could **not** on its own minimise *systemic risk*. Central Banks, therefore, will have to treat ‘*systemic risk*’ as their **principle function**.

Theoretically, *systemic risk* has increased exponentially because of the increased inter-connectedness of the global system and the cross-border capital flows. The institutional setting of 1944 was designed to deal with a different scale of finance, capital and investment movements. But by today, it has been rendered **ineffective** by a different structure depicted in our Monetary Triangle of the 1st WP. Globalisation has caused a change in the traditional function of central banks; it calls for a new institutional arrangement to deal with **liability** and **risk externalities**.

In other words, the theoretical case for the ECB to assume responsibility for **managing systemic risk** can only be made under the premise that Money is an Externality. Effectively, it is the *management of systemic risk*, which necessitates the supervisory role of the ECB in the scheme of the European System Risk Board (ESRB), **not** the function of lender of last resort. And this is the **first** pre-requisite to meet for the creation of the ESRB.

There is a **second pre-requisite**. For the ESRB to be able to manage ‘systemic risk’, a legally binding relation between the Macro-supervisor and the **Micro-supervisors** is needed for ‘the proper flow of information between the ESRB and the micro-prudential supervisors. The proposals seem to rely on ‘moral suasion’ and ‘the tool of embarrassment’ for this key relationship.

As we said in section 3.1, we have reservations over it:

1. Suppose the ESRB issues a macro-prudential *risk warning*, under Article 16 of the 2nd proposal, who would enforce it? The ESRB on its own can not do it, given its remit; it will send it to the ECOFIN or International bodies for a Decision.

However, setting priorities right is important to macro-prudential policy. The more important is *Monitoring*. “A macro-prudential approach has implications for the monitoring of threats to financial stability and for the calibration of prudential tools... it should pay special attention to the sources of non-diversifiable, or “systematic”, risk in the financial system.” (Borio (2009:3).

When we come to consider ‘the calibration of prudential tools’ (i.e. capital requirements, insurance premium, etc.), the macro-prudential supervisor will have to tailor its ‘guidance’ to the individual institutions responsible for their contribution to system-wide risk, irrespective of their size or legal form. But the ESRB would have **no** powers to impose it. For this to be effective, one needs the knowledge of the risk-related market in which the bank or financial company is active. The appropriate structure would be to have ‘*micro-prudential supervision integrated into the system of the ESRB*’. And the ‘micro-supervisor’ should be accountable to a single body, the ESRB.

2. How could one integrate the two? The DLR and the Commission proposals on ESAs propose an institutional change by *upgrading* of the Level 3 committees because “the structure and the role bestowed on the existing committees are not sufficient to ensure financial stability in the EU and all its Member States.” (DLR: 46) ¹⁷

They are to become, if the draft Regulations are adopted as proposed, Regulatory Authorities of the EU, endowed with a delegated power that *may* be considered ‘excessive’, under the Treaty.

In essence, the delegated powers of the ESAs constitute a transfer of power from the national supervisors to them on *unfounded grounds*. We explore this point further in sections 5 and 6.

The core problem is to identify the ‘risk concentrations’. One needs to have built a market-tailored system continuously feeding information to the ESRB. For this to happen, the Micro-supervisors should be obliged to provide the ESCB with ‘expertise information. Thus have the genesis of the ESFS (see Annex 1- 2nd part on micro-supervision).

Will the European System of Financial Supervision (ESFS) solve the problem?

¹⁷ What are these level 3 committees? They were created by the so-called Lamfalussy framework, in 2001.; Level 1 involves the adoption of legislative acts - under the co-decision procedure – which transpose global rules devised by international standard setting bodies into EU legislation. For example, the Capital Requirements Directive transposes the Basel II rules into EU legislation. Level 2 Committees provide the technical implementation of the legislation, creating a set of rules, “a second tier of more detailed regulation” that can be changed quickly and refined where necessary. This system is known as comitology. Level 3 consists of three Committees: European Banking Supervisors (CEBS), situated in London; European Securities Regulators (CESR), having its location in Paris; and European Insurance and Occupational Pensions Supervisors (CEIOPS) situated in Frankfurt. Level 4 refers to enforcement of regulations by the national authorities.

5. European System of Financial Supervision (ESFS)

Three Commission proposals for Regulation have followed faithfully the DLR recommendations for setting up the ESFS, consisting of two tiers:

- i. The **European supervisors** (in middle of Annex 1), consisting of three authorities:
 1. European Banking Authority(EBA)¹⁸
 2. European Pensions Authority (EPA)¹⁹
 3. European Securities Authority (ESA)²⁰

- ii. The **National supervisors** (at the bottom of Annex 1), consisting of:
 1. National Banking Supervisors
 2. National Insurance and Pensions Supervisors
 3. National Securities Supervisors.

5.1 European Authorities

The three new European Authorities are not new because they will replace the Level 3 Committees but will have a “New organizational structure’ and mainly a “New mandate”.²¹ The three will be Community bodies with Legal Personality.

For this WP, let us concentrate on the EBA proposal, since the proposals define the same ‘organizational structure’ and the same ‘mandate’.

The Composition of the EBA Authority shall comprise:

- (1) a Board of Supervisors, which shall have 32 members;²²
- (2) a Management Board,²³

¹⁸ See COM(2009) 501 final, 23.9.2009 - 2009/0142 (COD) - Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a European Banking Authority.

¹⁹ See COM(2009) 502 final, 23.9.2009 -2009/0143 (COD) - Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a European Insurance and Occupational Pensions Authority.

²⁰ See COM(2009) 503 final 23.9.2009 - 2009/0144 (COD) - Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a European Securities and Markets Authority.

²¹ Today, Level 3 Committees are not in charge of day-to-day micro-prudential supervision, which is a national competence. They simply bring together supervisors and act as a link between the Commission and national supervisory authorities. They also act as fora for information exchange between supervisors, foster supervisory convergence and formulate best practice. Level 3 Committees can issue *non-binding* guidance.

²² They will be: a) the Chairperson, who shall be non-voting; (b) the Head of the national public authority competent for the supervision of credit institutions in each Member State; (c) one representative of the Commission who shall be non-voting; (d) one representative of the European Central Bank who shall be non-voting; (e) one representative of the ESRB who shall be non-voting; (f) one representative of each of the other two European Supervisory Authorities who shall be non-voting.

²³ The Management Board shall be composed of the Chairperson, a representative of the Commission, and four members elected by the Board of Supervisors from among its members. Each member other than the Chairperson shall have an alternate, who may replace the member of the Management Board if that person is prevented from attending.

- (3) a Chairperson,
- (4) an Executive Director, and
- (5) a Board of Appeal.²⁴

The Tasks and Powers of each of the above are laid down in their relevant Draft regulation. And the caviar of EU institutional structure is applied to the new Authorities:

- a. To be independent from political and industry influences, at EU and national level;
- b. To have clear mandates and tasks coupled with sufficient resources;
- c. To be accountable to the political authorities at the EU and national levels.

The legal provisions of these ‘draft legislative acts’ merit careful consideration. But this is not the object of this WP. It is left to more competent minds. There are, though, some *unclear* points in need of clarification. And there grounds to believe that the ESAs may *not* attain the main objective of the exercise, namely, ‘*the integration of micro-prudential supervision into the system of the ESRB*’.

5.2 Issues in need of clarification

There are two principles upon which all EU legislation needs to respect:

1. The principle of Subsidiarity,
2. The principle of Proportionality.

Protocol no 2 of the Treaty of Lisbon lays down the procedure of Application of both principles on the day of entry of the Treaty of Lisbon (ToL), i.e. 1 December 2009.

1. For the three ESAs, we have the case of delegated powers based on a legal basis of the single market, i.e. Article 114 (ex-95). There is ‘shared competence’ between the Union and the Member States in the area of the *internal market* (see art. 4 of ToL). Could article 114 of ToL be the proper legal basis for the ESAs to assume ‘shared competence’ in the area of micro-supervision in the financial markets?

The UK House of Commons (2009) has cited evidence, oral and written, and concluded:

“they [draft regulations] push at the limits of what is permitted under European Union legislation without a treaty amendment, and there must be a real danger that, if challenged, the regulations as a whole will be quashed.” (p.27) (my [])

To arrive at such a conclusion, one should carefully examine the Tasks and Powers of, say, the Banking ESA. The Tasks would be:

- (a) contribute to the establishment of high quality common regulatory and supervisory standards and practices ...;

²⁴ Article 44 defines its Composition: 1. The Board of Appeal shall be a joint body of the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority. 2. The Board of Appeal shall be composed of six members and six alternates, who shall be individuals with relevant knowledge and experience, excluding current staff of the competent authorities or other national or Community institutions involved in the activities of the Authority.

- (b) contribute to a consistent application of Community legislation, in particular by contributing to a common supervisory culture, ensuring consistent, efficient and effective application of the legislation ...;
- (c) facilitate the delegation of tasks and responsibilities between competent authorities;
- (d) cooperate closely with the ESRB, in particular by providing the ESRB with the necessary information for the achievement of its tasks and by ensuring a proper follow up to the warnings and recommendations of the ESRB;
- (e) conduct peer review analysis of competent authorities, to strengthen consistency in supervisory outcomes;
- (f) monitor and assess market developments in the area of its competence;
- (g) fulfil any other specific tasks set out in this Regulation or in the Community legislation ...” (Article 6 (1)).

One may have legitimate doubts about the precise legal drafting, but this is a secondary issue. The most important is whether the Powers delegated to the ESAs respect the principle of Subsidiarity. Article 6 (2) and (3) of the draft legislative act state:

“2. [The] Authority shall have the powers set out in this Regulation, in particular the power to:

- (a) develop draft technical standards in the specific cases...;
- (b) issue guidelines and recommendations, as laid down in Article 8;
- (c) issue recommendations in specific cases, as referred to Article 9(3);
- (d) take individual decisions addressed to competent authorities in the specific cases referred to in Article 10 and 11;
- (e) take individual decisions addressed to financial institutions, in the specific cases referred to in Article 9(6), Article 10(3), and Article 11(4);
- (f) issue opinions to the European Parliament, the Council, or the Commission

3. The Authority shall execute any exclusive supervisory powers over entities with Community-wide reach or economic activities with Community

For that purpose, the Authority shall have appropriate powers of investigation and enforcement as specified in the relevant legislation, as well as the possibility of charging fees.”

The above mentioned Tasks boil down to one fundamental issue: Will the ESAs have the power to make binding decisions and these to be addressed to the Member States, as Article 6 (2) may be interpreted to mean?

The UK House of Commons (2009:24-25) cited the following legal position:

“The ESAs will not have power to take decisions or to make rules - European law requires that these powers are reserved to the Commission, and we believe that this could not be changed without an amendment to the EU treaty. The attempt to give the committees the power to review the issue of whether individual national regulators have correctly implemented EU legislation appears to be an attempt to stretch this point.”

‘Stretching the point’, though, is about whether the principle of subsidiarity is properly respected. If the ESA has the power, under Article 6 (2) (b), to issue “guidelines” and imposing on competent authorities an obligation “to make every effort to comply with those

Guidelines” (under Article 8), then this delegated power may be deemed excessive. The Courts may be involved in solving this problem.

Equally, conferring on the ESAs a power to take action against a particular national Regulator, under Article 6(2) (d), where it has not “correctly” applied “the relevant EU legislation”, under Article 10, is also troublesome. The same argument could be made for all Tasks referred to above. The subject needs clarification and appropriate amendments may be needed.²⁵

2. The principle of Proportionality under Article 5 of ToL requests that “the content and the form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties”. In economic theory we have the term of ‘cost efficiency’ to depict matters of this kind. When the European Council stressed that “decisions taken by the European Supervisory Authorities should not impinge in any way on the fiscal responsibilities of Member States”,²⁶ it did not have the ‘cost-efficiency criterion’ in mind but followed faithfully the conclusions of the ECOFIN of 8 June 2009.

Article 23 (1) of the EBA draft legislative act incorporates this Safeguard clause:

“1. The Authority shall ensure that no decision adopted under Articles 10 [action in emergency situations] or 11 [settlements of disagreements] impinges in any way on the fiscal responsibilities of Member States.” (my [])

This fiscal safeguard clause proposed by the ECOFIN, endorsed by the European Council and transposed into an article by the Commission is economically *erroneous*. We cannot devise a new EU policy on prudential supervision with *peanuts*. There are other articles, such as Article 21(4) on a warning or recommendation from the ESRB, which may involve fiscal action to remedy in time an emergency situation.²⁷

Who is to bear the cost? We have explained *why* this situation may arise in sections 4 and 6, which have led to proposing the European Fund for Financial Stability, with a new source of revenue in section 7.

3. There is another issue that needs clarification: ***Will the European ESAs be able to attain the main objective of the EFFS?***

²⁵ The House of Commons (2009: 25-26) quotes the following evidence that is of interest: “It is clear as a matter of European law that the European Court of Justice will not permit the Commission, or, for that matter, the Council, to grant to any subsidiary body the power to exercise discretion. Consequently, what this draft does is attempt to draft around that to create a regulator without the power to make rules or the power to exercise discretion.

²⁶ See Brussels European Council, 18/19 June 2009, 11225/2/09, para 20.

²⁷ The House of Commons (2009: 33) quotes the Commission stating: “According to long-standing case law, Member States cannot invoke financial grounds for not complying with Community law, as this would undermine the equal application of the law across the Community. Incorrect application of Community law cannot be justified by financial grounds.”

It effectively means that National Supervisors are required to become *subordinate entities* to the ESAs. It would thus end the long standing competence of national supervisors and the hierarchical structure they have worked with until the financial crisis of 2008.

The key to this change in structure is Article 25 on the composition of the ESA's Board of Supervisors, where 27 national supervisors would participate. Will it work?

The logic of the draft regulation is 'voluntary cooperation amongst national authorities and EU Institutions'. But this option has *not* worked under the Level 3 committees, and that is why the Commission and the LDR have strived to beef the new Authorities with new responsibilities. As we said in the preceding sections, it is unlikely to be functional under the Authorities because the 'specialised knowledge' and the 'local market expertise' reside with the national markets. Thus the need to have top-rated national supervisors.

In other words, something else is needed in order to make it obligatory for the national authorities prepare and submit to the ESRB the "*proper, primary, timely information exchange among all supervisors to enable complete assessment – from the national to European to global levels.*" (LDR: 48)

This can only happen if the National Central Banks (NCBs) retain competence in financial supervision, under a new architecture of supervision. Only then would the 'complete information' be legally obligatory. And only then would the step '*from the national to European to global levels*' be realised.

4. There is an additional issue about the LDR's view that "*the ESFS should be neutral with respect to national supervisory structures*" (p.48). This 'neutrality' is *not* feasible, given the current political integration of the EU, because of two reasons.

The first reason is recognised by the LDR:

"national supervisory structures have been chosen for a variety of reasons and it would be impractical to try to harmonise them – even though it may well be that the current trend could continue towards the emergence of a dual "twin peaks" system (banks, insurance companies and other financial institutions being covered by the same authority and markets/conduct of business by another one)." (p.48)

The second reason is 'national sovereignty'. If it is given up or delegated to an ESA, then the entire debate about the pros and cons of the Maastricht Treaty setting up Economic and Monetary Union is to restart. This is **impossible** today.

What is possible and feasible, today, is to recognise reality. And reality resides in the fact that the National Central Banks (NCBs), under the current Treaty, have lost their 'monetary sovereignty' to the benefit of the European Central Bank (ECB). Today, NCBs are Agencies of the ECB in implementing the centralised decisions taken by the ECB/ESCB system.

And there is another aspect of reality. In a decentralised system of monetary policy, **financial stability** in certain markets and countries is crucial for a timely and proper implementation of

monetary decision. The NCBs are better apt to assume the responsibility for the Last Resort of Managing Risk, something we examine in the next sections.

The important thing to recognize is the EFFS as proposed by the DLR and endorsed by the three 'draft legal acts' is a *very costly* institutional structure. We already have a structure that needs a different upgrading that would be cost-effective, as the principle of proportionality calls for.

6. Role of National Central Banks (NCBs)

The principle source of financial instability is the *risk externality* generated by the failure of one institution interlinked with a chain of financial markets and systems. Hence it is institutional in nature. The risk externality is the more important source because the settlement systems are part and parcel of the money process (M-C-M*). The latter is interwoven with advanced information systems and interdependent payment systems linked via the intermediation of money externalities. Failure to manage *liability* and *risk externalities* will expose EMU to *financial instability*.

In the alternative scheme we propose (see Annex 2), institutional financial instability could be remedied by conferring on national central banks the task of 'last resort of *liability* and *risk externalities*'. In this way, the moral hazard (induced by the same institution that authorises the establishment of a bank and also rescues it from failure) partly disappears because the two roles are divorced. The ECB is responsible for authorization. NCBs will be responsible for supervision and closures of insolvent institutions. The proposed ESAs cannot have this responsibility

Given that the ECB should assume power in prudential supervision, under our scheme, the responsibility of implementation should rest with the NCBs. This is analogous to the scheme of the ECB's centralisation of monetary policy and decentralisation of its implementation; under this scheme we respect the principle of subsidiarity and the principle of proportionality.

Under the principle of subsidiarity, the NCBs will be responsible for the closure of insolvent banks, as the second Banking Directive under the 'home-rule' requires. And under the principle of proportionality, cost efficiency will be increased substantially.

Separation of authority between two bodies dealing with *Decision* and *Execution* respectively is a means of checks and balances. And this is shown in Annex 2. The European Authorities have *no reason to exist*. The current committees of Level 3 will be under the authority of the *European Steering Committee* of Vice-Governors of NCBs.

6.1 The Steering Committee

It will assume the power attributed by the DLR to the Authorities, referred to in section 5.1. The Steering Committee, amongst other things, will:

1. become the implementing body of all decisions taken by the ESRB;
2. become the 'standards setter' for regulatory matters;
3. review, supervise and have powers over the National Supervisors;
4. supervise individual banks, insurers or investment firms;
5. re-define the Home versus Host supervision over the blurred definition of Branches and Subsidiaries;
6. have the power to impose Fines and Sanctions;
7. be the body to which the Level 3 committees are accountable;
8. be responsible for providing the ESRB with timely and reliable information about risks, potential and manifested, and possible exposures in all national markets.

In short, the Steering Committee will be responsible for the ‘correct implementation’ of the ERSB and have binding, discretionary, regulatory and supervisory powers, under the auspices of the General Council of the ESCB/ECB. It will become a powerful body, with a difference, on the following grounds:

First, the Steering Committee will have ‘legal personality’ derived from the Statutes of the National Central Banks – as 16 of them were reformed in accordance with the ECB/ESCB statute.

Second, the major weakness of the current structure of prudential supervision has been the inducement of Money externalities residing in the sphere of ‘failure of co-ordination’ between macro-prudential supervision and micro-supervision, and ‘failure to act’ at the level of Member States, despite the early warnings. The repair, therefore, should concentrate on the proper and balanced powers of the institutions concerned.

Third, the integration of the Macro-prudential with the micro- supervision will be the core responsibility of the Steering Committee. All other layers of power will be subordinate to it.

Fourth, the revised organisational structure - as depicted in Annex 2 - will capture all ‘Transactions Costs Externalities’ because it will be far more cost-effective if compared to the ESAs structure.

Fifth, the majority of ‘money externalities’ associated with “Confidence Externalities” will be captured by the Steering Committee. This is more important for public institutions, today. As we said in the 1st WP, one of the causes of the 2008 financial crisis has been the loss of Trust, Regulation and Guarantees Externalities.

6.2 College of supervisors

There would also be the *colleges of supervisors*, in our scheme (Annex 2). In fact their creation is foreseen in two Directives: revised Capital Requirements Directive (CRD) and the Solvency 2. Their task would be to monitor ‘all cross-border banking institutions established in the EU’. “As an order of magnitude, this could encompass at least 50 financial institutions having a significant market share in another Member State.”(DLR: 51) Yet the suggestion of the DLR is that: “these colleges of supervisors should be strengthened by the participation of representatives of the secretariat of the level 3 committees as well as of ECB/ESCB observers.” (p.47)

In our scheme, they would assume a more important role, under the guidance of the European Steering Committee, given their functional role to inform directly the latter of the potential or emerging risks in cross-border activities.

Each college would consist of the national supervisor of each country in which the bank has a branch, as well as the representatives of the bank. And colleges will play an important role in providing a consistent interpretation of rules applied to one bank across different Member States, and will become a forum for exchanging information amongst supervisors.

There is a ‘mandatory obligation’ - arising from the obligation of college of supervisors to act upon risks identified by the ESRB. It may be considered ‘toothless’ unless sanctions are foreseen. Who will impose them? Under the draft legal acts, we do not know. Under our scheme, it will be the European Steering Committee that would request national authorities to implement sanctions.

6.3 National supervisors

The DLR recognises that “the existing national supervisors, who are closest to the markets and institutions they supervise, would continue to carry-out day-to-day supervision and preserve the majority of their present competence” (p.47). However, under his recommendations and the draft legal acts, they would be subordinate to the European Supervisors. The new Authorities would have binding powers over national supervisors on supervisory standards, etc...

Furthermore, under the proposed legal acts, the supervisor of the home Member State will continue to function as the first point of contact for the firm concerned. On the other hand, the Authorities would co-ordinate the application of common high level supervisory standards, guarantee strong co-operation with the other supervisors, and guarantee that the interests of host supervisors are properly safeguarded.

But these matters, today, fall in the remit of responsibility of the national supervisors. The experience of the 2008 financial crisis is telling. National supervisors ‘ignored risk warnings’ Why? They were not fully involved, and because of ‘fractured relationship’ between the Level 3 supervisors and the national supervisors. The national supervisors possess an important advantage: ‘Expertise knowledge arising from their proximity to taking action at the national level’. The proposed ESAs would depend on this comparative advantage that is not their own but somebody else’s.

This thorny relationship is easily solved under our scheme. National supervisors are accountable to the Vice-Governors of the national central banks, and they have an interest to contain to provide them with ‘complete up to date information’. And the sanctions are easier to impose in a national context, without risking ‘misjudgment over ‘who’ is really responsible for failure to act’.

Resolution of the ‘thorny relationship’ does necessary solve a related problem; the necessary retraining of national supervisors, coupled with a new scheme of incentives. But both matters fall in the competence of national authorities.

In this new structure of Annex 2, there is a problem to solve. What to do with the recently adopted Regulation on Credit Rating Agencies?

6.4 NCBs and Credit Rating Agencies (CRAs)

An EC Regulation is now put in place. It has followed the DLR recommendation.²⁸ However, under our Money Externalities approach, it is not fully consistent with the principles of “good legislation” protecting both taxpayers and users of financial services. Furthermore, the question of legal and financial independence is not resolved. Nor is the question of sanctions clearly set.

This brings us back to the *linkages* we identified in the Monetary Triangle of the 1st WP and the role of oligopoly of three Credit Rating Agencies in the USA, appraising and setting the AAA rate for the mortgage-backed securities. It also raises the question of whether the real risk was spread via the *links* that packages of securities were supposed to do, but failed. The financial crisis of 2008 has shown that ‘the risk may have been spread but at the expense of a sky-high leverage’.

Under the proposed supervisory structure of Annex 2, the NCBs will license and supervise the CRAs. But as long as the CRAs are private institutions, they play an important role in the assessment of Risk. First, by legislation, the private sector is called upon to assess itself in order to safeguard a public good – i.e. financial stability. Second, the questions of Objectivity, Conflict of Interest and Accountability, although taken into account in the adopted Regulation, are difficult to enforce.

There is another fear. By regulating private rating agencies, the EU institutions “would actually become party to the blame when things go wrong in future”.²⁹ In essence, it is a recognition of an ‘inability’ by the public sector to have its own rating system serving the public good of financial stability.³⁰

This fear of public failure induces *external diseconomies* because, at present, ‘the rating of a financial institution determines the level of capital that the institution is required to hold under the Basel rules’. Even if the Basel rules are revised as proposed by the LDR, the new rules will have to rely on ‘some’ rating estimated by ‘some’ body. Hence this problem has to be

²⁸ The key elements of the initial proposal were: CRAs must disclose key models; methodologies and assumptions on which their ratings are based. The removal of conflicts of interest from the ratings system through disclosure requirements. Introduction of a registration regime for CRAs. EU financial institutions may only trade in instruments rated by an EU registered rating agency - were retained in the adopted Regulation.

²⁹ Prof Goodhart giving evidence before the UK House of Lords (2009: 17).

³⁰ The witnesses before the UK House of Lords (2009: 17-19) are revealing: “The French Representation felt that there was a need to avoid clearing the rating agencies of responsibility for the quality of their ratings and giving them a “public endorsement. Moody’s accepted that there was a danger that “legislators could create the mistaken impression that because ratings are a closely regulated product they are fully endorsed by a national or EU authority” ... The FSA told us that it was important for the Commission to monitor the use of ratings to ensure that regulation does not have this effect ... DG Markt, in response to these criticisms, highlighted the due diligence requirements on the part of financial institutions that form part of the amendments to the CR D... The Regulation itself states “The user of credit ratings should take utmost care to perform their own analysis and conduct appropriate due diligence”, although the proposal includes no enforcement process.”

resolved by the new structure of Annex 2, together with the question of ‘whether the new regulation in its article 4, will have ‘adverse effects on the competitiveness of the EU businesses in the global economy’.³¹ Or, whether in a globalised market, there should be a ‘new text requiring that the rating be issued in a country should be equivalent to the EU regulations on rating agencies’.

³¹ The view of the UK House of Lords, based on the evidence it received is that “The new text will therefore continue to inhibit the participation of EU financial institutions in the global market until there is an international consensus on the regulation of CRAs” (p.19).

7. A European Fiscal Authority (EFA)

Whereas the ECB under the Treaty (article 127, ex-105)³² can provide ‘liquidity’, it cannot provide ‘capital’. Furthermore, there is no automatic mechanism in the Treaty providing for ‘capital’ by an EU body in cases of stress, crises or natural disasters, save some budget lines in the EC budget for ‘emergency support’.

I argued in my monograph (1994: section 7.8) that the Maastricht Treaty erred in its institutional structure of Economic and Monetary Union because the EMU was essentially a ‘common monetary union’, neglecting the economic aspects of it. A repair of this neglect was needed by instituting “*A European Fiscal Authority (EFA)*.”³³ The optimism of the early 1990s did not allow proper discussion of the EFA, although the so-called ‘economic governance’ started drawing attention. Later on the Stability Pact stopped all discussion about an EFA. Nor was the question of ‘what could the ECB do if faced with the case of financial instability’ properly addressed.

The argument is essentially centred on ‘what’ categories of ‘money externalities’ are captured by the ECB for which a compensatory mechanism be devised to counter its effects, or to mitigate certain sources of vulnerability to the system.

The main concern was the capturing of *seigniorage externalities* and the generating of *price level externalities* by the ECB. It is in the nature of its monetary unit that will spur and internalise *learning* and *technological externalities*. The internalisation of these three categories of externalities effectively calls for the creation of a Fiscal Authority in the EU. In addition, given the fact that there can be no effective monetary policy without the support of a fiscal policy and given that money is considered as super-non-neutral, shared responsibility establishes a new regime. A European Fiscal Authority (EFA) for enhanced cooperation between the monetary and fiscal policy becomes imperative.

Our argument for an EFA has nothing to do with the Federal-camp proposal. The Federal-camp argument is about a Community mechanism of redistribution of income in order to correct regional disparities. Our argument is twofold. First, it is about the categories of money externalities captured by the ECB which are at the expense of national central banks and of national banking systems. Second, it is about *why* EMU is defective in its present institutional setting.

We have identified *seigniorage* as the internalisation of externalities generated in the banking system. This means a surplus that is generated by the banking system. It is mainly derived from two components of demand for money; the first is a direct demand for currency, the second is an indirect demand for bank reserves (i.e. demand for deposits and reserve requirements). In our scheme of a money process (M-C-M*), the exchange of money (M) for real resources - i.e. the commodities (C) - will be a loan carrying with it interest which is free and permanent but captured by M*.

³² All Treaty references here are made to the consolidated versions of the Treaties (OJ C115, 9 May 2008).

³³ It is to be understood that an EFA should be endowed with an EU Fund and with the management of Economic Policy at the EU level. An EFA will *not* have taxing powers. Hence ‘fiscal’ is *not* ‘synonymous’ to the power of Tax, in this WP.

In other words, in our oligopolistic money market (recall the monetary triangle of the 1st WP), the following is happening. The generation or internalisation of money externalities will be captured by the producer of a currency (in our case the ECB); in this way, the ECB will capture real seigniorage. A second mechanism is induced by the decision of the ECB to place its reserves on money markets; it mainly confers appreciable benefit to the banking system that manages the reserves, generating additional income via the *reserve liability externality*.

Theoretically, an EFA will be functioning as a body whose primary objective will be to 'redistribute' the *seigniorage externalities* captured by the ECB. However, there is no way to estimate what is the amount of seigniorage accrued or generated because 'money externalities' as we said in the 1st WP, are not measurable, nor quantifiable. And some others exist on account of the interdependent nature of the monetary system. Hence, the EFA is born out of the necessity to complete the institutional structure that would extract the optimum level of seigniorage and distribute it equitably. For this to occur, one needs to know the sources of seigniorage.

An important source of seigniorage externalities is the *reserve-type*. Suppose a central bank of a third country decides to hold Euro as their reserve. Any creation of reserve assets entails a *reserve-type externality* in the sense that low-powered money for the central bank in question becomes the reserve component of the national money supplies, generating either an external economy or diseconomy. And it will also induce a *distributional externality* since they share the same monetary unit. Then any reserve creation will create benefits and costs similar to the ones experienced under the dollar standard.

The Euro by now has become fully fledged credit money. Then the *resource saving* seigniorage generated, and is substantial. It is analogous to the major monetary transformations we have experienced, when moving from hard metallic money to refined with intrinsic value to paper money and possible to electronic in the near future. Any resource-saving seigniorage will lead to a greater producer's surplus on the borrower's side because the cost involved in fulfilling the function of a reserve centre or of a technological innovation in settlement of debts will be less. This results from the size of the European market and from the depth of unified financial markets. Consequently two sources of *gains-externality* will be born.

The first derives from the superior productivity induced by a superior technocratic frontier. The second is the *technological externality* internalised by the banking system because it will use advanced technology for the transmission of payments and of settlement of debts.

The term *forced saving externality* denotes the power of the banking system to extend credit in excess of saving either because banking liabilities are accepted as means of payment or because of a not-fully regulated banking system. In our Monetary Triangle of the 1st WP, these acts entail sources of financial vulnerability if 'confidence externalities' are destroyed in the process.

Similarly, the *revolving fund externality* is used to denote the power of commercial banks to use the flow of income, consumption, investment, profits and wages in order to create private debt or inside money. Both notions are integrated into the power of the banking system to distribute savings via their *liability* and *risk management externalities* but the two differ in their effects.

Whereas the *forced saving externality* will be operational when credit overdraft is extended to finance investment and thus, investment precedes saving without causing inflationary finance, the *revolving fund externality* will be effective only if it leads to redistribution of income via a

price increase. For this to occur, private debt should be considered as a net worth. When discussing the dynamics of the Monetary Triangle in the 1st WP, we depicted the mechanism via which the Shadow banking generated and captured these types of ‘money externalities’.

With the creation of the ECB, national banking systems have been obliged give up their activities in the financial area because their monetary unit no longer existed; in a sense they have transferred such seigniorage to the ECB.

The most important aspect of the ECB is the effective transfer of national monetary sovereignty to an EU institution whose capacity of creating the *price level externalities* is associated with the producer of a single currency. Yet a producer of money, even when inflation is anticipated, could impose an ‘excise tax’ on the holders of real balances whenever he decides to increase its money supply. This effectively means a *redistribution externality* capturing real national resources and transferring them to the European budget.

However, capturing the *redistribution externality* implies that a National tax authority or EU with its budget would put in place a system that would favour indirect transfers. Should this redistribution externality be captured by the ECB, because of the absence of an EFA endowed with a budget, it would lead to a second externality, identified as *fiscal set externality*. It is caused by the divergence between the *marginal value* attached by Member States and the *marginal cost* of an extra monetary unit issued by the ECB.

Still in the category of ‘price level externalities’, the *money-illusion externality* will be operative if the ECB uses its monetary policy to generate price level changes to modify the burden of debt proportionately. It is similar to the Keynes's method of the *General Theory*. Keynes proposed to use the money supply, instead of changes in wages, to induce changes in the burden of debt through the operation of the *money illusion externality*. If this power was exercised by the ECB, it would be an external economy to the Member States, though a number of social groups might not be consenting parties.

This brings us to another pressing problem. If the ECB assumed responsibility for monetary policy, its objectives might be in conflict with the economic policies of Member States. This separation of responsibilities reflects the economic logic of EMU but may lead to monetary instability. Meade (1990) had expressed concerns about this possibility. His explanation rests on the interdependence of monetary and fiscal policies *and* the elasticity of demand and supply coupled by multiplier effects, which would cause the following situation. Monetary policy might reduce the price level by less than it might affect the budget deficit while fiscal policy might affect the price level by more than the budget deficit.

Hence the interdependence assured by our money externalities, cannot be managed by two entities having divergent objectives. Assume the ECB raises the interest rate by $y\%$ in order to cause an $x\%$ fall in inflation. This would only occur if the *expectational demand* for money and *expectational rate of interest* react according to traditional theory. In our model, the situation is ‘ambiguous’ and would depend on the *expectations externality* and on *price level externalities*, causing fiscal set, redistribution and money illusion externalities. The end result might be lower or higher inflation rate depending on the new level of income that corresponds to the new *expectational rate of interest*.

An EFA would have to assume the above 'coordinating role'. A well functioning monetary system needs an '*automatic mechanism*' that allows monetary or systemic disturbances to be corrected without producing inequitable effects and without aggravating existing structural weaknesses. The solution to this automatic mechanism lies in the technical characteristics of the monetary system and in the institutional setting-up to support it.

In other words, if the proposed establishment of the ERSB were accepted *without* an EFA, there would be a *half-built house*. Under the current pressure due to the financial crisis of 2008, the Commission complied with the decision of the European Council of 18-19 June 2009 and submitted the package of legislative proposals referred to in the preceding sections

There is not a single clear (indirect, there is) hint to an EU capital recourse in the DLR or the five proposals. The latter respected the ECOFIN's conclusion of '*not* impinging the fiscal responsibilities of the Member States'. This is theoretically *incorrect* and in reality *inconsistent* with the mission of the proposals seeking to repair the EU supervisory structure. The urgent question to address is:

Who should bear the fiscal burden for mitigating and tackling Financial Instability?

This is the *missing element* in both the DLR and Commission proposals, but it could be easily repaired. We seek to make the case for a *European Fund for Financial Stability (EFFS)* in the next section.³⁴

7.1 European Fund for Financial Stability (EFFS)

Institutional balance in the financial field, under the Treaty of Lisbon, is rather difficult but not impossible, today. Ideally our EFA should be created to assume responsibility for 'economic governance of EMU', with its own budget, independence and mission. But this is almost impossible, today. A *reduced* mission in the right direction is a small step, but may help preserve 'financial stability'.

We start from the conclusion of our 1st WP that *regulation alone* - as conceived by the LDR and the ECOFIN conclusions of 8 June 2009 proposals - *can not repair 'financial instability', nor can it 'preserve financial stability'*.

Furthermore, the Commission's recent proposals for supervisory repair, as we argued in sections 5 and 6, without the necessary modifications, will lead to a high cost, which may be translated into a deadlock.

The second conclusion of the 1stWP has been that the Supervisory repair needs a *global response* because the Actors are global, the Markets are globalised and the Forces of change reside with the Monetary Triangle. But I do not see the global response forthcoming in the short period, but an EU response in time could be welcomed.

³⁴ The title is optional and open to suggestions to improve it. But it should not be confused with the Structural Funds of the EU

By default, therefore, we are left with the EU searching a regional answer. The *European Fund for Financial Stability (EFFS)* is conceived in this endeavour:

- It will have a Mission, whose content will tell us whether the legal base should be Article 114 (ex- 95) or Article 352 (ex-308) of the Treaty.³⁵
- It will have its own budgetary resources.

7.2 Mission of a European Fund for Financial Stability (EFFS)

The EFFS will take action for all cross-border cases considered by the ESRB ‘eligible’ for ‘*emergency capital support*’ (see Annex 2).

There should be no confusion between the ECB’s facility to provide ‘liquidity assistance’, as it has done since August 2008, and the EFFS’s power to grant ‘capital aid’ for a specific objective to preserve financial stability or to repair a fractured financial system.

The EFFS’s action should respect the *same principles* under which the recent ‘state aid’ in the form of ‘guarantees on deposits’ granted by Member States to their financial sector in 2008. It effectively invoked Article 87 (3) (b) of the Treaty by respecting the principle that such ‘support’ should not distort competition or affect trade, both being incompatible with the single market.³⁶

There is a problem with ‘responsibility’ for bailing out a failed institution. If the ESRB assumes the ‘moral suasion’ powers proposed by the Commission proposal, then ‘cross-border crisis management’ means that *it is exercised at the EU level*. In such a juncture, it would need to be at an EU level, with “EU money”, rather than at the national level.³⁷

In reality, the EFFS would be endowed with the ability to provide ‘capital of last resort’, something that only the Member States have had so far.

This case of ‘bailing out’ should **not** be confused with the cases covered by Article 125 (ex-103) of the Treaty. The latter prevents the EU or other Member States from providing financial assistance to a Member State facing rising ‘public debt’.

³⁵ The first refers to the single market, entailing some approximation of laws; the second refers to this flexibility article use in the past for the creation of the Galileo Supervisory Authority (Reg. (EC) no 1321/2004, OJ L246, 20.7.2004).

³⁶ See European Commission press release, *State aid: commission approves UK rescue aid package for Northern Rock*, 5 December 2007. On 17 March 2008, the UK authorities submitted to the Commission a restructuring plan. In fact the Commission separated ‘the emergency liquidity assistance’ provided by the Bank of England on 14th September 2007, from ‘the guarantee on deposits granted by the Treasury on 17th September and ‘measures granted’ on 9th October, to Northern Rock. The Treasury assistance was considered by the Commission as ‘constituting state aid’. See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/489>.

³⁷ We are proposing a ‘rescue’ for the DLR: “In view of the absence of an EU-level mechanisms for financing cross-border crisis resolution efforts, Member States should agree on more detailed criteria for burden sharing than those contained in the existing Memorandum of Understanding (MoU) and amend the MoU accordingly.” (p.37)

Under our scheme of micro-prudential supervision (see Annex 2, lower part), it will remain a national responsibility, with the exception of cross-border cases. If a national financial firm ‘gets into trouble’ then ultimate responsibility for bailing out a failed institution remains a national concern.

Or if Member States would be ‘unwilling to cede national micro-prudential supervisory powers to an EU body’ (opting out clause, under our Annex 2), they would hold on to their responsibility for bailing out their financial companies.

In our alternative scheme, the European Fund for Financial Stability (EFFS) would be endowed with its own capital resources under the EC budget (see section 7.3). This would permit it to have the budgetary resources needed to rescue ‘distressed banks’. In this instance, the legal proposal for the creation of the EFFS would need to lay down a system of *mandatory burden sharing* between Member States for ‘capital support’ if it would exceed a certain amount.

Furthermore, the financial crisis of 2008 has shown that the private sector did not restructure by itself.³⁸ It left it to the public sector. Hence ‘how’ could one finance a ‘rescue plan’? The ‘burden sharing’ becomes an urgent issue in search of a solution.³⁹

Given the mandate of the European Fund for Financial Stability (EFFS), how could it be created? Given the fact there would be no Treaty modification for the foreseeable time and that our EFFS does not touch ‘taxation’, which remains a ‘fiscal’ competence of the Member States, we have two options, as we said in section 7.1. Article 114 (ex-95) is used for all matters concerning the single market. Article 352 (ex-308) is a ‘flexible provision’.

Irrespective of the proper legal base, two main features should be retained:

- a. Legal personality for the European Fund for Financial stability (EFFS);
- b. Regulatory in nature, with binding powers.

7.3 Resources of the European Fund for Financial Stability

In order to maintain the independence of the entire system, and, in particular, the ECB’s, the European Fund for Financial Stability (EFFS) should be endowed with its own capital resources.

We are not short of proposals, today. First, the DLR (2008: 36) proposed a *theoretical* scheme of *burden sharing* arrangements. The sources of capital would come from the financial institutions. They entail one or a combination of the following: a. the deposits of the institution; b. the assets

³⁸ For the ‘distressed banks’, the DLR sets the priorities: “priority should always be given to private-sector solutions (e.g. restructuring). When these solutions appear insufficient, then public authorities have to play a more prominent role and the injection of public money becomes often inevitable” (p.33).

³⁹ Our scheme opts for Buiter’s 2nd and 3rd potential solutions; he states “1. a supranational euro zone-wide tax and borrowing authority; 2. a euro zone wide fund, specifically dedicated to fiscal backing for the ECB/euro system; and 3. an ad-hoc, fiscal burden-sharing rule options” (Willem Buiter, “*The fiscal hole at the heart of the euro system*”, Financial Times, 21 March 2009. And it is pleasing to note that, after 15 years since my proposal for a European Fiscal Authority was first made, Prof Buiter proposed as his preferred option the creation of ‘euro zone-wide tax and borrowing authority’. It is the same as my EFA.

the institution; c. the revenue flows of the institution; d. the share of payment system flows of the institution. And the public purse of Member States would have to contribute to the private resources. Yet they are voluntary agreements.

Gros and Micossi (2008) proposed a Delors-type scheme. It has three elements. First, there would be EU-backed bonds, offered to the public with the intention of creating a new market. Second, these EU- bonds will be the capital of a newly set up, called ‘European Financial Stability Fund’; its size is expected to be about ‘€500-700 billion’. Third, this Fund would be set up at ‘the European Investment Bank’. Its main mission would be to use the Fund ‘for bank recapitalisation’, especially for banks which are situated in the EU periphery.

Although the idea is good, it is not in competition with our proposal, but its structure (i.e. budget resources, objectives and management) is totally at variance with our EFFS.⁴⁰

We are tempted to propose three potential sources:

- a. Transaction tax,⁴¹
- b. Fines imposed by the EU,
- c. Various EC budget lines on recovery.

We concentrate on the transaction tax (TT) in the next section. Fines and various EC budget lines is not the object of this WP.

7.4 A Transaction Tax (TT)

The objective of imposing a ‘transaction tax’ is six-fold.

1. To ***eliminate holes in the market*** of the ‘monetary triangle’ referred to in 1st WP, where a two tier financial system - one ‘regulated and taxed’, the other ‘slightly regulated and largely untaxed’ – exists. This situation has given rise to two important categories of money externalities: ‘Transaction Cost Externalities’, and ‘Seigniorage Externalities’. The ‘slightly regulated and largely untaxed’ sector in the main has captured both categories and has established via this act the so-called ‘too-big-to-fail’ institutions.

This first objective does not necessarily mean that on its own it can solve all aspects of competition. On this aspect, we say more in section 7.5.

2. To ***apply a uniform transaction tax*** to all institutions and all types of liability managed, without exemptions and without differential rates, it will generate an immediate impact. It will change the ‘incentives of the actors’. It will favour incentives towards long term investments and away from short term speculation; in this way, a transaction tax (TT) may induce another

⁴⁰ In a scheme like ours, the EU is a ‘guarantor’ by definition. Then it is only logical that ‘a’ crisis in the financial sector would mean that the crisis management is based on public funding. If used, it would induce a number of *money externalities* whose net impact is disproportionate to those who bear the cost vis-à-vis to those who benefit from the crisis management.

⁴¹ Other sources may be or Insurance fee, or Resolution fund, or Contingent capital. But they are complicated and have not been debated.

‘external economy’ by stabilizing financial markets via a combination of other acts to which we refer below.

A single TT will mean that the current costs arising from 1) brokerage fee, 2) exchange fee, 3) short term volatility of prices, 4) market movement in response to transactions etc, will disappear. And with them their potential to ‘distort’ and to ‘control liquidity’ will disappear. This is a major capture of the ‘*efficiency externality*’, whose quantitative dimension cannot be known *ex ante*.

Yet the major attraction to governments is that a TT is a secure source of revenue for dealing with so many effects the 2008 crisis has generated. Kapoor (2009:1) assembled the evidence of the Norwegian study and said: “Various estimates show that such taxes could rise predictable, stable, and easy to collect revenues in the range of hundreds of billions of dollars annually. Figures of the range of 0.5%-2% GDP annually have been reported by several studies”.

3. To ***install fair treatment***. We argued in the 1st WP that the Monetary Triangle - coupled with its exceedingly high turnover⁴² - had caused serious disturbances to the market. It had captured and used for its own benefit the ‘*forced saving externalities*’ particularly in the subprime sector and the ‘*revolving fund externality*’ in financing of Mergers and Acquisitions.

The Monetary Triangle also generated two other M_E , the *distribution* and *fiscal set* externalities because the former was used for the act of securitisation of financial products, thus increasing leverage. But increased leverage is an act of conferring upon those managing ‘securitised products’ an external economy, and impose on the end-user an ‘external diseconomy. The first may not be taxed, depending on the location, whilst the end-user will be taxed. Hence the origin of the *fiscal set externality*. Setting a ‘transaction tax ‘on each stage of securitisation, it will impose a fairer share of the burden.

4. To ***minimise waste***. There is an *efficiency externality* largely geared into the minimisation of waste and resources, due to the simplicity of a TT. Kapoor (2009: 3) states:

“Consider a stock transaction tax of 0.1% for instance. A trader with a daily investment horizon would on average trade once a day and end up paying a $250 \times 0.1 = 25\%$ effective tax rate. A pension fund with a five year horizon, on the other hand, will end up paying only 0.02% or 1/1250th the rate of the daily trader.”

⁴² Hillman, D, S. Kapoor and S. Spratt (2006: 7) studied the evolution of currency markets from the 1970s to 2005 and found who are the biggest beneficiaries of globalisation: “Annual turnover in the global market for currencies, has, for instance, expanded from about \$4 trillion in the 70s to \$40 trillion in the mid- 80s to more than \$450 trillion now - a more than 100 fold increase. Profits at financial services firms are also at a record high with the top two most profitable banks, Citibank and HSBC, posting more than \$40 billion of profits between them in 2005 alone”

Kapoor (2009:1) also looked at the ‘equity markets’: “Turnover in equity markets registered a seven fold increase between 1993 and 2005 to about \$51 trillion and the notional value of OTC credit default swaps alone rose to more than \$60 trillion from almost nothing a decade ago”. His statistics confirm those of Table 2 of the 1st WP.

Furthermore, according to the Norwegian study: “Applying small transaction levies, of the order of a few hundredths of one per cent, can raise vast sums of money, and because these transfers are carried out electronically, it makes implementation simple and each transaction traceable. Many such transaction taxes already operate successfully and raise billions of dollars of revenue for countries as varied as the UK and Brazil.” (Hillman, D, S. Kapoor and S. Spratt (2006: 12)

5. To ***create a fair tax incidence***. The TT will touch all markets, and its impact will be felt by the Shadow banking. In this way the principle of fair incidence is met. But more importantly, its system risk will be minimised and its leverage reduced. Transaction taxes, by its form, entail a highly progressive incidence as opposed, for example, to sales taxes or value added taxes which are regressive.⁴³ If applied to the hedge funds, which in 2007 accounted for as much as 50% of trading volume in certain markets, price volatility and speed of movement will be reduced, and disclosure enhanced. Thus, two main sources of financial vulnerability will be contained.

Who are these large co-operations which benefit from the ‘absence of a transaction tax’? Hillman, D, S. Kapoor and S. Spratt, (2006: 26) compiled a table showing the ***profits*** for the 10 major banks in 2005⁴⁴: And who are the citizens involved? (Kapoor, 2009: 2) summarized the finds of the Norwegian study: “financial transactions are still disproportionately conducted by the richer segments of society either directly (through in house asset management) or through vehicles such as hedge funds. More than 25% of financial assets in the United States, for example, are owned by the top 1% richest population.” The same trend of concentration of economic benefits is found in Europe.

6. To ***create a difficult to evade and avoid system***. Historically, transaction taxes are not new in the globe. Hillman, D, S. Kapoor and S. Spratt (2006) in their study - commissioned by the Norwegian Ministry of Foreign Affairs - compiled a list of the countries that have some form of transaction tax levied on financial services. About 40 countries (both developing and advanced) have taxed these services. At least 10 EU Member States have exercised this tool.

The UK has been in the first one, and its tax earnings are substantial. “Financial Transaction taxes have been around for hundreds of years with the Stamp Duty on the trading of shares in the London Stock Exchange being one of the oldest still around. This tax, which is now, levied electronically at 0.5% (50 basis points) of the face value of share purchases collects more than \$7 billion every year.” (Kappor, 2009: 3).

The US has its regime by using the Section 31 fee on financial transactions. “Security transaction taxes apply to transactions in publicly traded shares and exchange traded futures and options and the revenue raised is used to cover the cost of the operations of financial regulators such as the Securities and Exchange Commission (SEC)” (Hillman, D, S. Kapoor and S. Spratt, 2006:15)

⁴³ The Norwegian Study (2006) devotes its chapter 3 to responding to the objections, one of which is the tax incidence (i.e. the burden impact), the economic incidence (i.e. who pays the TT), the efficiency gains arising from our learning and technological externalities, and net benefits for the banks involved arising from a Rent (when banks’ transactions are settled in ‘gross’ form but they are funded on a ‘net’ basis.

⁴⁴ In 2005, these were: Citigroup (\$25bn), HSBC(\$16bn), UBS (\$11bn), JP Morgan Chase (\$8bn), Barclays (\$7bn), Goldman Sachs (\$6bn), ABN Amro (\$5bn), Merrill Lynch (\$5bn), Morgan Sanley (\$5bn), Deutsch Bank (5bn).

All past and recent official reports on ‘offshore financial centres’ and those who have been against the Tobin tax (initially intended for the stabilisation of exchange rate) stress the point that such taxes should be applied at world level. They all propose an International Agreement to be struck for its effective implementation. And they usually accuse the US for laxity, but the truth is different.⁴⁵

The above mentioned and other objections to the TT on grounds that they are costly to transact and difficult to collect were examined by the Norwegian study (commissioned to Hillman, D, S. Kapoor and S. Spratt, (2006), which found exactly the opposite.

First, one can *not* easily evade and avoid it. “Such levies are collected electronically at minimal cost, on average about 50 times less than the corresponding costs for the collection of income taxes. Once the collection has been plumbed into the electronic system it is automatic and very difficult to avoid.” (Hillman, D, S. Kapoor and S. Spratt, 2006:12)

This is so because financial transactions leave an electronic trail and/or are settled at a central clearing centre. And “they are difficult to avoid [because] that they are collected automatically either at the point of the initiation of the transaction or at the point of their settlement. While there have been some fears of transactions moving offshore to avoid unilaterally implemented taxes, these are exaggerated.” (Kappor, 2009: 3) (my [])

Hillman, D, S. Kapoor and S. Spratt, (2006: 16) summarised their findings as follow:

- “It is not unusual for financial transactions to be taxed in some form or other – this ranges from the duty on share trades in the UK, the tax on corporate bond trading in Germany and the generalised levy on financial transactions in Peru
- Where FTTs [Financial Transaction Taxes] have been levied, financial markets have generally adopted them with no major repercussions
 - FTTs raise substantial amounts of revenue
 - In most cases, this income is collected electronically at the point of settlement with minimum cost to the governments
 - Evasion has not proved a serious problem.’

There is another finding relevant to our TT. It has generated interest in the developing countries, which are affected. Hillman, D, S. Kapoor and S. Spratt, (2006: 16-17) state:

“One of the key points that emerge from this discussion is that the foreign exchange market is unusual for not yet being taxed. Given that it is the largest financial market in the world, a levy on foreign exchange trading would be expected to raise substantial amounts of revenue provided a suitable collection mechanism could be designed at the point of trade settlement. With the tax designed at an appropriate low rate it would not have an adverse impact on the day to day operation of the market. The income could then be mobilised to such ends as the implementing government(s) should wish, such as international development.”

⁴⁵ Kappor (2009: 3), however, finds the US case interesting: “This is an interesting model where the financial markets pay for their own regulation and can be expanded also to include not only paying for all financial market regulation and supervision but also for rainy day financial bailout funds and past bailouts.”

7.5 Transaction tax and Competition

We argued in the 1st WP that the most important impact of the ‘money triangle’ has been on increasing the fluency of the financial markets and its capacity to extend liquidity via the spread of all sort of risk. At the same time, it had assumed the power to extend or deny the financing of ‘real investment’. And this has been due to a number of inherent features of shadow banking that favours ‘short term financing at the expense of longer term investment. Could a TT reverse the direction? Our answer is “Yes with qualifications” because of four inter-related reasons.

First, a TT will internalise almost all Confidence externalities, the major victims of the financial crisis of 2008. The basic act that would enhance ‘confidence externalities’ is to imposition of a TT on ‘a disorderly market captured and managed by the ‘too-big to fail’ companies. They possess the power to set indiscriminately ‘high fees’ to retain profits.⁴⁶ But the most important element of building ‘confidence externalities’ would be that a TT would remedy in part the ‘taxed’ versus ‘untaxed’ system. This is important to installing fair competition; and to begin considering the ‘monopolistic features’ of the too-big to fail companies that have maintained ‘high net profits’ (without counting bonuses and other fringes) for a long time, something that fair competition would not have permitted.⁴⁷

Second, whereas a TT may enhance ‘confidence externalities’, by itself will not enhance the competitiveness of the financial sector of the EU. As long as the sector allows cross-subsidisation of diverse activities - such as Banking and Investment – its size has *no limits*. And with it a number of uncompetitive practices will be accepted by the competition authorities in the EU.

Three uncompetitive practices come to mind:

- a. Practices of collusion are not easily spotted by authorities because cross-subsidisation and numerous subsidiaries and branches.
- b. The power of extending credit to financial innovation at the expense of ‘industrial innovation’ resides in the complex nature of incentives of capturing Rents that may be lawful or unlawful.
- c. The role of ‘intermediation’ has destroyed its *trust* and *credibility externalities*; the discretionary power of these mega institutions to direct savings to ‘portfolio investments’ at the expense of the real sector has broken the link between the savers and the intermediary.

Third, there is another interesting question. Why is a ‘mega’ with respect to a ‘small’ financial company more apt to internalise three categories of ‘money externalities’:

⁴⁶ The Leader of the Financial Times, 18.11.2009, stated: “Fund managers’ charges, for example, are usually large and are often not linked to the quality or the real costs of their services”.

⁴⁷ Again the Leader of the Financial Times, 18.11.2009, stated: “The profit-generating power of financial companies across the developed world has been stubbornly remained higher than that of other companies”.

- Transaction cost externalities;
- Technological externalities;
- Seigniorage externalities?

One possible answer is that the internalisation of these M_E is easier by a 'mega' financial company if its activities are centred on both sectors (regulated and unregulated) of the Monetary Triangle. If this hypothesis is true then capturing the above mentioned M_E effectively establishes a *Natural Monopoly*.

If this is a plausible theoretical case, the regulatory, fiscal and supervisory policies need major revision. For example, if the market power possessed by a Natural Monopolist is exercised at will and discrimination, then it will become a permanent source of vulnerability, and thus confer a serious '*diseconomy*' on the rest of the economy. The regulatory and supervisory repair that we have so far proposed may not be appropriate. Our transaction tax cannot do much in this instance.

8. Overall conclusion

No lo so

INCOMPLETE

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Appendix 1: Taxonomy of Money Externalities

I Transaction Costs Externalities

- a) Shared-Variable: Network Externality
- b) Information:
 - i) Efficiency Externality (E_f)
 - ii) Organizational Externality (E_o)
 - iii) Expectations Externality (E_e)

ii Price Level Externalities

- a) User Externality:
 - i) Distributional Externality
 - ii) Hoarding Externality
- b) Producer Externality:
 - i) Fiscal Set Externalities
 - ii) Redistribution Externality
 - iii) Money Illusion Externality

iii Confidence Externalities

- a) Commodity Clause or Constant PPP Guarantee
- b) Brand-Name Cost
- c) Government's Functions and Economic Background
- d) Symbol of Sovereignty
- e) Trust Externality
- f) Guarantees:
 - i) Constitutional Rules and Objectives
 - ii) Credibility and Reputation
 - iii) Endowments

iv Learning and Technological Externalities

- a) Technical Learning
- b) Social Economies
- c) Informational Content
- d) Public Good
- e) Technological Knowledge and Invention
- f) Capital Accumulation and Innovation
- g) Gains Externality

v Seigniorage Externalities

- a) Liability Management
- b) Risk Externalities
- c) Forced Saving
- d) Revolving Fund
- e) Reserve-Type:
 - i) Reserve management
 - ii) High-powered money
 - iii) Interest rate
 - iv) Exchange rate

Source: G. Caravelis, *EMU: An application of the fundamental principles of monetary theory*, Aldershot: Avebury, 1994: Table 6.1.

Appendix 2: Definitions of Money Externalities

Money externalities

In a money process defined as Money-Commodity-Money (M-C-M*), a money economy (or diseconomy) - M_E - is an event realised in the market that confers an appreciable benefit (or inflicts an appreciable damage) on some person(s), transactor(s) or institution who were not fully consenting parties or active participants in reaching the decision(s) which led directly or indirectly to the event in question.

Money externalities

They are *non-quantitative, qualitative and not -measurable*. Money externalities are *not priced*.

Interwoven M-C-M* process

It should be understood that the banking system, securities and futures markets, stock and money exchanges, payment and net settlement systems and everything else necessary to organise a money process, are integral parts of the institution of money. Otherwise monetary policy cannot be assumed to work, let alone have effects on key monetary variables such as the rate of interest.

Transaction costs externalities

They are generated in the trading system by either incomplete markets or by market failures. An ideally efficient trading should function without cost. If not, we have 'market organisation cost set of conditions' leading to real-income externalities. In a money economy in which the money process (M-C-M*) is interwoven, income effects are generated by the intermediation of money. The trading system is inseparable and interwoven; an externality generated in one system will enter into the utility or cost function of more than one independent decision-maker.

A shared variable externality

It is due to the existence of the monetary stock in a M-C-M* and has to do with the fact that the possession of a real balance carried with by individual A affects not only the welfare of the holder but the welfare of everyone else in the system who gains from the fact that individual A is a participant in the exchange system.

Efficiency externality, (E_f)

It is generated by the transformation of monetary systems reflected in evolution of their monetary unit - i.e. Nature of money (the stuff made of) - from the Primitive stage to the Advanced stage. Adam Smith (1776: ch. iv) made the case for the *efficiency externality*, by examining the monetary transformations as the development stages unfolded.

Organisational externality, (E_o)

It is Meade's (1973: 40) postulate that "in every concern, both public and private, the operation of the pricing system will involve a cost.... Everywhere there is some element of externality due to the 'market organisation-cost' ". We may think of the cost-effectiveness due to the organisation of a money economy, an *organisational externality*. Thus, E_o is the result of organised markets that follow a M-C-M* process. Goods do not buy goods, but only via money in any organised market.

Expectations externality (E_e)

It is Keynes's (1936) link between his 'liquidity preference' and 'user cost'. Where expectations rule, they attribute to money a special status as a 'liquid asset': "expectations as to the future of the rate of interest as fixed by mass psychology have their reactions on liquidity preference (GT: 170). The induced role of money as a liquid asset assumes the role of a 'store of value' and helps to bridge the lack of knowledge about the ruling prices in the present with the uncertain future prices. Thus, through the reduction of the cost relating to imperfect information about ruling commodity prices and about the expected rate of interest, the *expectations externality* reduces uncertainty and costs associated with uncertainty.

Price level externalities (P_E)

They are generated by any act of a *user* of money or of a *producer* of money, which affects, either directly or indirectly, the general level of prices. The case of *price level externalities* due to the *user* of money has been made by Wicksell (1906, Lec. II: 11). The case of *price level externalities* due to the *producer* of money was made by Keynes in his *A Tract on Monetary Reform* (1923).

Distributional externality

It is induced by an individual's decision to withdraw from or inject into the money process his real balances held in the form of money with a view to the future. In doing so, he confers an effect on all other individuals who are not necessarily fully consenting parties to this decision. Any change in the price level would change the marginal valuation of their tangible goods and thus may cause an *equi-proportional income distribution*. It would also cause a divergence between private and social valuations.

Hoarding externality

It is better illustrated with an example taken from the resource allocation case. The use of money affects the intertemporal allocation of resources and, in this sense, bypasses the problem of synchronisation of receipts and payments. It thus contributes to superior productivity since synchronisation depends on the costs of acquiring information and of exchange. If the hoarding of today leads to superior techniques tomorrow then we confer an appreciable benefit on the next generation.

Fiscal set externality

"The power of taxation by currency depreciation is one which has been inherent in the state since Rome discovered it" (Keynes, *Tract*: 8). This is a pure case of a *fiscal set externality* since the event is not fully consenting and the divergence between marginal value and marginal cost widens as the power of taxation increases, causing marginal value to remain above marginal cost.

Redistribution externality

It is induced by the power of a producer of money to tax via its act having an impact on the price level, resulting in *unequal incidence*. It gives rise to redistribution of *wealth*. An act by a financial company that causes a 'stock appreciation' is a windfall *profit*. In a zero sum game, it is a 'redistribution externality'. A windfall profit is also induced if the 'money' rate of interest is not equal to the 'real'; "that is, the real rate of interest falls to a negative value, and the borrower reaps corresponding benefit" (*Tract*: 20).

Money -illusion externality

In Keynes's world of Uncertainty, Unemployment and Inflexible money wages, his preferred policy was to *change the burden of debt* via unexpected changes in the total stock of money. This act would confer appreciable external economies or diseconomies on a number of social groups who are not necessarily fully consenting parties. It is perceived as a means to overcome the inefficiency of labour markets, lack of knowledge and confidence crises.

Confidence externalities (C_E)

They are generated by the institutional structure necessary to support a monetary system and its money. They are mainly associated with the producer of money but are internalised and reflected in the choice of the users. Mundell (1980: 379) gives an example of this type of externalities in his discussion of the EMF and of the ECU: 'Any new institution that is created is an attempt to internalize what used to be an externality in the system.' The idea is about mechanisms or means that would *mould the preferences* of citizens in favour of 'a' money

Commodity clause externality

It is a derived 'external economy' linked to induce confidence in the use of money. It was once thought that a national currency's convertibility into a specific amount (weight) of gold or another precious metal was a necessary condition for it to have value.

Constant PPP guarantee externality

It is also derived from a 'legal' clause guaranteeing the *constant value of money*'. Hayek's (1978) *Denationalisation of Money* is about entrusting private institutions with money-issuing powers to issue non-interest bearing Swiss ducats, under three guarantees: price index, legal clause, convertibility.

Brand name externality

It is geared into a 'special feature' of a money associate with a cost for the producer to engineer it; in its absence, consumers will not be able to distinguish between the output of different firms, and the quality of money sold will be destroyed. Hence brand-name differentiated output is necessary for the competitive production and sale of money.

Government's economic resources externality

It resides with the 'economic size' of the producer of money, usually measured by its GNP. It is also linked to the *complementary activities* of government - such as defence, stability, social cohesion, etc. - which are generators of 'confidence'.

Symbol of sovereignty

It assembles a number of 'relationships' linked to the nature of the State and of the Society. For example, the relationship between money and freedom; between the keeping of promises and the certainty of contracts; between social function and the rule of law". Simmel's (1990) symbolic expression of money is thus stated: "One of the basic facts of our subjective world was that we express social relations through symbolic images. Money was one of these. From being a functional it had become a symbolic expression of economic relationships."

Trust externality

The essence of it is best stated by Frankel (1977: 14): "money contributed to the extension of individual personality and facilitates the development of an ever widening circle of economic interdependence based on trust. Under conditions of direct barter trust is confined to the parties immediately involved. The use of money extends it to the people of the village, of the tribe, of the nation, and finally, to vast areas of the world"

Constitutional guarantees externalities

They are related, for example to two *constitutional features* of the ECB intended to induce confidence externalities; they are its *independence* and its *price stability objective*. On paper, the ECB entails the only legally guaranteed clauses in the world.

Credibility externality

Credibility arising from the consistency of monetary policy is not marketed and has no price. It is an essential element won the hard way. Moreover, it is a shared-variable type. It enters into the utility function of every transactor that uses, say, the Euro which had internalised this *credibility externality*. It also enters into the cost function of every producer who uses this money to conclude a contract.

Reputation externality

Credibility feeds 'reputation' in monetary stability and this is important for creating and maintaining confidence in the strength of the new institutional arrangement. Bundesbank's reputation had been established because its D-mark had served as an anchor currency for the EMS and the ERM, relying on Germany's monetary restraint.

Endowments externality

It is induced at a micro level in the banking sector by the ability of a bank or other financial company to face 'set-up costs'; its capacity of raising 'emergency capital' is another added advantage. In a competitive setting, substantial set up costs would give rise to losses or to a non-convex production possibility set.

Learning (L_E) and technological (T_E) externalities

They are generated in all economic activities on the assumption are capable of learning and communicating. Both learning and communicating contribute to the growth of knowledge and to the induced externalities. In forming his decisions, economic man applies reason in the context of accumulated experience. The greater the market and volume of transaction, the greater the social economies of scale, the greater the internalised external economies. *If this growth of knowledge is applied to a process, it is transformed into human capital.*

Technical learning externality

It is associated with the capacity of man to learn from the past technical progress and with his ability to transpose it into 'technical invention'. Pasinetti (1981: 22) equates growth in knowledge with technical progress and maintains: "as long as the intellectual abilities of mankind do not deteriorate, technical progress is an inherent characteristic of human history."

Social economies externality

It is due to the fact that the use of 'one' money is not only a function of the width and the depth of the market. It also stems from the external economies due to 'new information' which only money carries with. Given that the production of information is costly and that it is cumulative, the introduction of money would capture all the

external economies of the sectors of research and technology; these are interwoven with the growth of knowledge.

Informational content externality

It is an in-built feature that money carries. Brunner and Meltzer (1971: 792) believe that money reduces costs in two ways. The first reduction in information costs concerns the quality of goods. The second has to do with the increased knowledge: “as the use of an asset in exchange increases, the transactor learns more about the asset's properties.” In this sense, money is said to internalise all externalities induced by the 'use of the same currency unit'.

Public good externality

The public properties of money stem from its being a standard and those gains are generated in comparability and inter-changeability. Given that money introduces standardisation, it leads to reduced transaction costs and to economies of scale. Both are external economies to the firm and to the user. Weldon (1968, 1971, 1973) argued that money is essentially a public good, because it entails *public attributes* by reference to its provision and its availability and because the distribution of real balances among individuals generates money externalities.

Technological knowledge externality

A body of knowledge is accumulated in the M-C-M* process via learning and communicating. Given that knowledge arises from the deliberate seeking and observing of markets or other activities, such knowledge could be considered as a source of human capital. If human capital via the use of a monetary unit is preserved, then it is capable of being transformed into *technological knowledge*.

Invention externality

It arises from the internalisation of existing knowledge available in the money process (M – C – M*) and transposed into a ‘monetary invention’ or financial product. In principle, if the ‘characteristics’ of an input or of a product are known and made public, then the individual consumption of this knowledge does not diminish the availability or usefulness of that knowledge to any other. The indivisible information can be transmitted easily from one person to another. This is Arrow’s (1962:172) invention becoming a production of information; this means that the optimal conditions require that the transmission should take place at a marginal cost close to zero.

Capital accumulation externality

Technological knowledge if correctly used will promote capital accumulation. Yet the mechanism through which capital accumulation is promoted has not been clearly stated. Wicksell (Lec. II: 6) recognises that, though the technological knowledge we have inherited from the past and captured by money is a source of growth, it does not necessarily mean a higher production possibility frontier. It mainly depends on monetary policy.

Innovation externality

If the internalisation of any of the above-mentioned learning and technological externalities is transposed into a new product or new application constitutes an ‘innovation externality’. All monetary transformations have been associated with a new family of such externalities. And the credit creation power of the banking system induces the financing of innovation externality.

Gains externality

It is induced in the sphere of our M-C-M* and associated with the *idea of unequal exchange* in a money economy where money captures the additional value (M*). Thus, money as an intermediary would confer *new and additional gains* over and above the values, which existed before.

Seigniorage externalities (S_E)

At one time 'seigniorage' originated with the right of the State to charge a 'fee' for minting money on private account. This charge was higher than the actual cost of minting; thus it was a source of income to the State. Today, *seigniorage has to do with the internalisation of externalities generated in the banking system* and with its incidence on and consequences for those who are participants in our M-C-M* process.

Liability management externality

There are, at least, two sources of *liability externalities*. The first arises when a bank or financial company provides this facility and acts as a clearing house for payments. The banks or companies reduce transaction costs. The second source arises when a financial company is capable of ‘transforming liabilities into assets’. The latter

will possess entirely different risk, return maturity and liquidity characteristics. These two *liability externalities* procure to the banks or financial companies' profits.

Risk externalities

In principle, all contracts concluded in money-terms involve risk. A *risk externality* is present in our money process (M-C-M*) whenever a time element is involved. Paying out in money for wages and other expenses of production, separating purchase from sale, production from consumption or investment from saving induce a risk externality. All these acts involve a period; a contract is concluded in period t in the expectation of recouping the incurred expenses plus profit by disposing of the product or service for money at period $t+1$. *Managing risk generates a risk externality*. There are at least if *four* risk externalities arising from differences in bank regulation.

Regulatory risk externality

It stems from the regulatory systems existing in different countries while the same bank is located in different countries, managing savings of depositors residing in different countries. A failure of this bank will confer an appreciable damage on residents in more than one country.

Inter-banking risk externality

It is present when the failure of one bank causes loss of confidence in its 'subsidiary' or its 'branch' located in different countries. This kind of risk externality is prominent in global markets where market exposure increases as the banking activity in different countries or locations. This source of risk externality is due to the inter-bank market handling foreign assets in portfolios that are global.

Network risk externality

A third source of *risk externality* arises in the payment systems. This is a cross-border externality that mainly depends on technology and regulation. The payment systems externality could be defined as the volatility of potential outcomes when the failure of one system inflicts an appreciable damage upon other systems connected with it.

Systemic risk externality

It is defined by the Committee of Governors (1992: 488): "the risk that the failure of one participant in an inter-bank funds transfer system or securities settlement system, as in financial markets generally, to meet his required obligations will cause other participants or financial firms to be unable to meet their obligations when due". Two overlapping aspects of *systemic risk* exist: a) payment systems and b) netting arrangements; both have a common origin: a counterpart may default on its side of a contract causing a series of failures. This is an event inflicting appreciable damage on third parties while the latter are not fully consenting parties in reaching the decision of default.

Forced saving externality

It arises from the fact that 'bank liabilities are not necessarily regarded as liabilities'. Bank liabilities are seen as means of payment. Any bank lending in excess of saving shall result in unintended forced saving. Chick (1983: 237) stated the case: "No one asked the holders of the new deposits whether they wanted a larger aggregate money supply, nor does that question occur to the receiver. No one refuses payment for a sale just because the source of payment is an overdraft - otherwise granting overdrafts would be pretty futile. But in aggregate there is now a larger quantity of money than before which 'no one intended' to accumulate. In that sense it could be said to be 'forced'".

Revolving fund externality

Whereas money constitutes a constraint on effective demand, the ability of banks to offer their liabilities as credit constitutes the case for a *revolving fund*. "The 'revolving fund' reflects the fact that the circular flow of income, consumption as well as investment, profits as well as wages, runs, almost in its entirety, through the banking system. That is even truer today, with the great diminution of payment of wages in cash" (Chick, 1983: 240). And 'inside money' (debt created by the private sector) is associated with the 'revolving fund externality'

Producer's surplus externality

It arises from the internalisation of 'gains in efficiency' or from capturing 'Rents' that are not legalised. The real source of it is the when competition is imperfect, either through collusion or the result of legal or constitutional arrangements.

Reserve management externality

Suppose the ECB pays interest on its reserve liabilities. Then the ECB could use the differential between the rate paid on reserve liabilities and open market rates on similar securities to influence demand for substitutable assets. This act amounts to saying that if the bank pays higher interest on reserves, the demand for reserves rises; thus, there is deflationary pressure.

And there is another source. Suppose non-residents hold Euro-cash. Any change, say, in the exchange rate of Euro/Dollar or Euro/Yen would mean an induced *exchange rate externality* since the non-residents are not consenting parties.

High-powered money externality

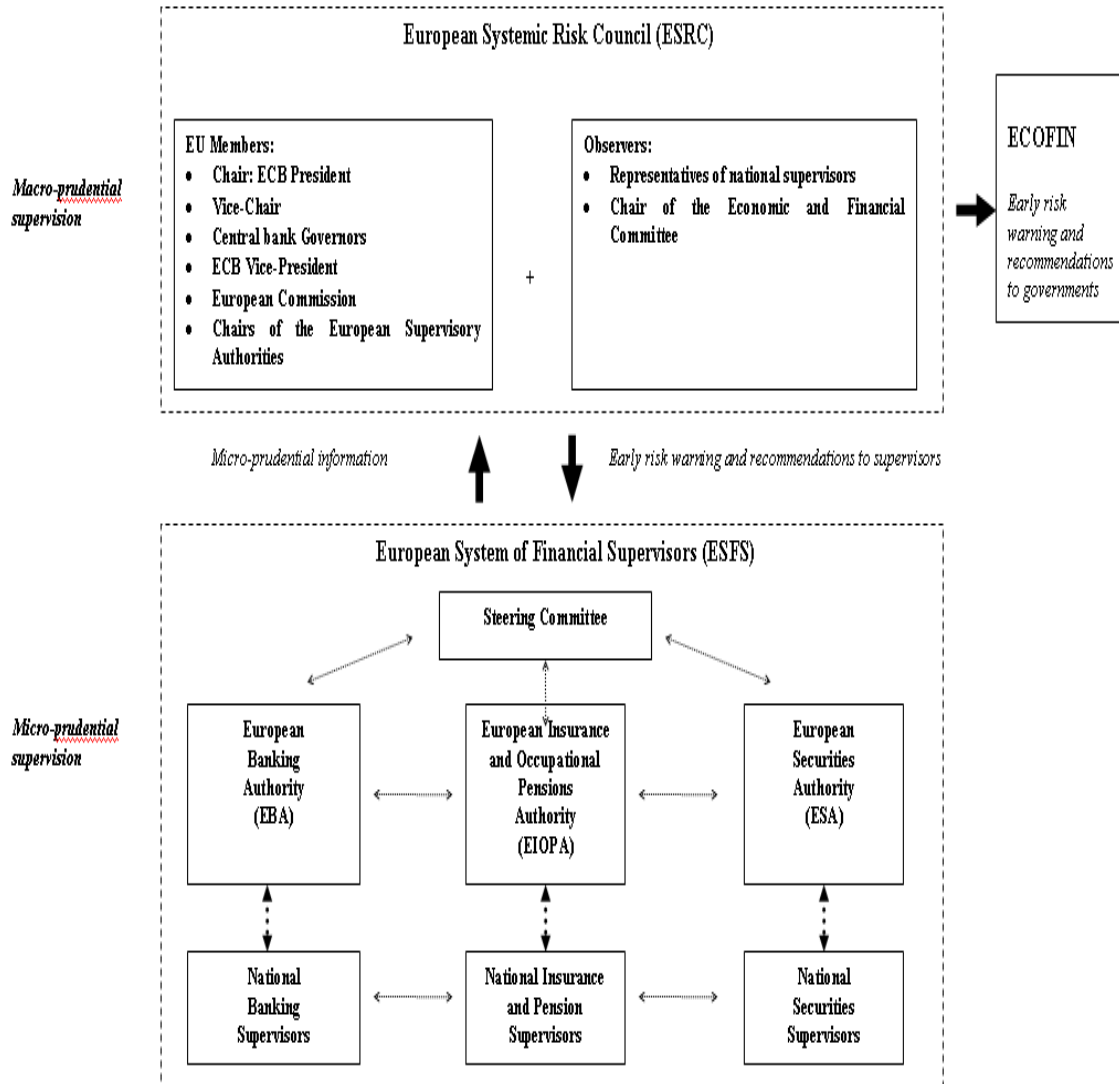
It arises from the fact that 'a low - powered in the home country (Euro) *becomes reserves* to other countries; this would constitute an external act generating an economy or diseconomy, stemming from sharing the same monetary unit. Take the case of the US dollar. "International banking means the private creation of international or multinational money. Low-powered money in the United States becomes high-powered money in Europe. The European central banks have increasingly lost control over domestic money supply" (Mundell, 1973b: 152).

Debt reduction externality

Suppose a third country holds its official reserves in the form of interest bearing assets denominated in Euro. The holding of these assets would mean a corresponding increase in demand for Euro denominated assets in the Host country. This would indirectly cause a fall in the interest rate of the Euro issuing country. This *interest rate externality* will induce all the incidence externalities and the most important effect would be to *change its debt* with respect to third countries holding Euro-denominated assets.

Source: G. Caravelis, *EMU: An application of the fundamental principles of monetary theory*, Avebury, 1994: Chapter 6.

Annex: A new European Framework for Safeguarding Financial Stability



Source: Commission on 'European financial supervision', COM(2009), 252, 27.05.2009, based on the de Larosière report (2009), and adapted in accordance with the ECOFIN's conclusions of 9 June 2009

Annex 2: A EU System of Financial Supervision (EUSFS)

