

FINANCIAL CRISIS MANAGEMENT IN EUROPE AND BEYOND

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Financial and capital market integration in Europe is now well-advanced, but it confronts a serious challenge in the design of workable arrangements for crisis prevention, management and resolution. The expansion of large, complex financial intermediaries exposes the limits of a supervisory regime based strictly on the traditional principle of home-country control. Contemporary European debates on last-resort lending, home-host supervisory responsibilities, and fiscal transfers clarify the fundamental challenge globalizing finance poses more generally for world order. Ultimately, they suggest the necessity of reliable, legitimate and effective instruments for financial burden sharing among integrating polities.

JEL Classification: F36; F59; N24.

I. INTRODUCTION

As the Single Market Programme advanced in the European Union, difficult questions arose in the financial services sector. With capital already flowing more freely and many members of the Union sharing a single currency, truly European capital markets, increasingly free and increasingly open, seemed on the horizon. To observers anticipating the emergence of global markets in the twenty-first century, the rapidly evolving European case was a harbinger for the world. It also posed a profound political challenge. The institutional failures that spawned and deepened the Great Depression had taught the hard lesson that efficient and resilient financial markets depended both upon crisis prevention through effective supervision and upon occasional emergency interventions when supervision proved ineffective (Ravenhill, 2008, pp. 241–72). Legitimate national authorities—central banks, supervisors and ultimately finance ministries—were left with reasonably clear responsibilities.

An integrated pan-European market pushes such responsibilities past their limits. In fact, the emergence of certain large, complex financial institutions in Europe already blurs the identity and the obligations of the relevant national authorities in certain situations. It also opens the policy space for new cooperative supervisory arrangements and for mutual agreement on burden sharing in emergencies. In principle, such an agreement implies the ultimate commitment of fiscal resources. For various reasons and for the foreseeable future, the actual extent of any such commitment may have

to remain implicit. Nevertheless, we can already see that the difficulty in putting reliable crisis prevention, management and resolution arrangements in place for contemporary European finance exposes the political dilemma at the heart of a broader, global experiment in financial integration. This article briefly outlines the conceptual and historical context for understanding that dilemma in Europe, and in that light examines the current evolution of policy responses.

II. CRISES IN INTEGRATING FINANCIAL MARKETS

In 1922, prodded by states unwilling to take direct action themselves, officials of the League of Nations achieved surprising success in stabilizing a financially troubled Austria (Pauly, 1997, pp. 52–6). Jean Monnet and Arthur Salter, early proponents of a European common market, were directly involved in that signal effort. A decade later, however, Austria once more came to grief. This time the League and an emergency committee of central bankers convened at Basel by the Bank for International Settlements were helpless witnesses as European financial markets fell apart (Salter, 1932, pp. 42–4). The following catastrophic decade witnessed the coincidence and global propagation of banking and currency crises (Bordo and Eichengreen, 2002; Eichengreen, 2003; James, 2002; Temin, 1991). Although currency crises continued to plague the world economy that eventually emerged from the ashes of the Second World War, efforts by the United States and its victorious allies to ensure their own internal financial stability did succeed in reducing the incidence of banking crises. After 1973, when the Bretton Woods pegged-exchange-rate system broke down and the scale and speed of international capital movements began increasing dramatically, banking crises once again became a fact of international economic life.

In 1974, the first great systemic crisis of the new era occurred when a small German bank, Bankhaus I. D. Herstatt, failed to honour its foreign exchange contracts and a subsequent cascade of defaults brought down the Franklin National Bank of New York (Spero, 1980). With the assistance of the staff of the Bank for International Settlements, but actually led by central bankers from the UK and the United States, bank supervisors soon initiated regular consultations on the appropriate division of responsibilities between the home and host states of internationally engaged financial institutions. Finance ministers and legislators became seriously interested in the new dialogue on banking supervision after the 1982 developing-country debt crisis threatened large banks at the core of national payments systems (Wood, 2005). The IMF played a key coordinating role in that crisis, the worst since 1931, but it was not the lender or investor of last-resort. Certainly with regard to Mexican debt, the largest and most prominent debtor country, everyone knew that the central bank and ultimately the Treasury of the United States would have to play exactly those roles for its key money-centre banks if an actual run began. In the summer of 2007, an old-fashioned run on a relatively small bank occurred in the UK. Although the failure of Northern Rock was handled inelegantly, there was no ambiguity as to the identity

of the responsible central bank and government. When it happened in a turbulent systemic environment, however, buried memories of 1931 stirred once more. During the following troubled period of tightening credit and collapsing confidence, the evident fragility of much larger and much more globally expansive financial intermediaries exposed once again the political dilemma glimpsed during the Herstatt crisis.

At the extremes of analytical and policy debates since 1974, it was commonplace to depict international financial markets either as poised on the brink of integration so intense that a global financial regulator backed by last-resort lending capability was now required, or as so delicate that they required careful dis-integration if the stability of national economies was to be preserved (Goodhart and Illing, 2002; Fischer, 2000). In the world of actual policy, finance ministers, central bankers and legislators encouraged the development of an intergovernmental supervisory regime to cope with the awkward reality of powerful interests desiring both the benefits of globalization and the autonomy of separate statehood. Future-oriented analysts were quick to see the regime as unstable, and to venture the notion that it presaged the inevitable development of a World Financial Authority (Eatwell, 1999).

The explosion of international financial intermediation after the 1980s and the rising incidence of financial crises with cross-border effects were obviously related. For policy makers, the principal question was what it has long been: when real economic growth rates were sought in excess of those capable of being generated by domestic savings, how were the benefits and costs of financial openness to be distributed? In principle, inward flows of privately owned capital make it possible for real economies to grow more rapidly than if they rely solely on domestic resources. In practice, the extra costs associated with crisis-induced capital outflows, bailouts and the lost confidence of investors occasionally threatens to undermine real economies, set back the process of industrialization, and disrupt underlying political and social orders. The immediate costs of financial crises can be huge, their social and political effects insidious and lingering.

Nevertheless, by the 1980s it had become clear that states constructing the international economy had collectively moved away from one set of policy trade-offs and towards another. Immediately after the Second World War, they had sought to reconcile their newfound desire for exchange-rate stability with their interest in maintaining independent monetary policies; they therefore had to tolerate limits on inward and outward capital flows. Now, capital mobility and monetary autonomy were privileged, and they were willing to tolerate floating exchange rates as well as a degree of volatility in their expanding financial markets (Clark and Wójcik, 2007; Obstfeld and Taylor, 2004; Underhill and Zhang, 2003; Cohen, 2002; Tirole, 2002; Tran Van Hoa, 2002; Lamfalussy, 2000; Helleiner, 1994). Despite a clear trend toward capital market liberalization, however, no binding or broadly based international treaty analogous to that governing trade flows emerged to codify an underlying political understanding on the trade-offs implied by financial openness (Abdelal, 2007). Although some promoters of liberalization saw the necessity of new and enforceable rules, most apparently hoped that global markets would remain resilient over a full economic

cycle. That hope rested on the idea that the main role of governments was simply to reinforce confidence by pursuing sound macroeconomic policies, an idea that would soon be sorely tested (Alexander, Dhumale and Eatwell, 2006).

Before the Asian financial crises of the late 1990s hit, prominent voices advocated an explicit amendment to the 1944 Bretton Woods Agreement that would have had the effect of extending the IMF's formal jurisdiction over restrictions on current account transactions to a full range of imaginable restrictions on capital account transactions. When calm returned after financial emergencies spread rapidly from Asia to Russia to Wall Street, the broad movement toward capital market openness continued, even as governments refused unambiguously to embrace the principle that capital had an inviolable legal right to cross borders or the idea that an ultimate global authority was required to manage shared risks. National authorities instead opted to allow the financial institutions they themselves continued to license reciprocally to expand their international operations on the understanding that emergencies could be prevented or managed by national regulators collaborating more efficiently but only to the extent necessary (Andrews, 2008; Honohan and Laeven, 2005; Roubini and Setser, 2004; Hoelscher and Quintyn, 2003; Bryant, 2003).

Such an outcome would surprise no one familiar with the way most policies are actually constructed in democracies, the form of government shared in the states that first began rebuilding the world economy after 1945 (Fligstein, 2001; Seabrooke, 2006). The definitive articulation of policies in a broader than national context remained difficult, the coordination of those policies episodic at best (Wray, 1998; Greenfield, 2003; Pickel and Helleiner, 2005; Friedman, 2005). The prospect of future systemic gains was not often a successful motivator. As an empirical proposition demonstrated time and again since 1974, the credible prospect of imminent losses was a much more reliable motivator of the periodic collaborative action necessary to save the system (Aggarwal, 1996).

The main multilateral consultations on systemic risk focused until recently on banks at the core of vital payments systems. As Kapstein (1998, 2006) clearly demonstrated in his study of the Basel Committee on Banking Supervision in the post-Herstatt era, risk mitigation was from the beginning mixed together with a mandate to level the competitive playing field in international banking. This led it first to an agreement on the division of responsibilities between home and host country supervisors, prompted it later to make clarify the responsibilities of "consolidating" supervisors, and still later to accommodate legislative changes in the United States and the European Union by strengthening the role of host supervisors of banks from countries deemed weak in their capacity for consolidated supervision. The Committee also initiated protocols for minimum standards for back-up capital reserves to be held by banks.

In 2006, the "Basel II agreement" allowed internationally active banks to bring sophisticated risk-management techniques into the calculation of capital requirements. In contrast to the straightforward calculations of Basel I, capital requirements were more carefully calibrated with the risk profiles of different kinds of banking assets and with diverse portfolio choices. For the largest banks, heavy reliance was now

placed on internal value-at-risk models maintained by the banks themselves. Under the terms of Basel II, smaller banks and banks not based in advanced industrial states typically faced the less flexible capital requirements of Basel I. The fact that this seemed to provide a new source of competitive advantage for the largest money-centre banks was not the only controversy engendered by the new accord, but it immediately stimulated calls for a “Basel III” agreement. Along with the stabilizing “pillar” of minimum capital requirements, the Basel II agreement stressed the importance of two additional pillars: adequate supervisory review and “market discipline”. To improve the latter and to provide signals that might prompt early intervention by official overseers, the agreement recommended various mechanisms for increasing the disclosure of information by banks, information that would allow credit rating agencies and market counterparties to render judgments on their ability to meet their obligations (Kaufman, 2002).

It would be hard to sustain the argument that the main architects of today’s international capital markets did not make progress in the years before the summer of 2007. The Herstatt crisis, the Latin American debt crises of the 1980s, the American savings and loan disaster of that same decade, the later BCCI and Barings Bank failures, the Asian and Russian crises of the next decade—none caused a systemic meltdown. To be sure, the consequences of those crises, especially for developing countries, could be disastrous (Mishkin, 2006; Woods, 2006; Stiglitz, 2006). And as of early 2008, the extent and implications of the staggering damage caused by the sub-prime mortgage crisis in the United States remained uncertain. Nevertheless, even as that crisis was unfolding, leading states and their most powerful constituents would continue pressing the cause of globalizing private finance, industrializing states, most obviously in East Asia, would seek to limit associated risks by building up regional arrangements and costly levels of national monetary reserves, the poorest states would mainly be ignored, and only a few faint academic voices would be heard calling for definitive global regulation. Within Europe, however, dramatic market developments stimulated the quest for durable instruments for crisis prevention, management and resolution at the regional level.

III. MARKET OPENING IN THE EUROPEAN UNION

The Commission of the European Community began working on the coordination of member-state banking regulations in the early 1960s (Pauly, 1988, pp. 170–77), but the most significant stimulus to integration in both money and capital markets came after ratification of the Maastricht Treaty in 1993 and finally in 1998 with the creation of the euro and the abolition of national currencies among a subset of EU member-states. While one might have expected the European Central Bank (ECB) officially to oversee the subsequent deepening of European markets, the reality was more complicated (Commission of the European Communities 1985 and 2005).

In practice, the ECB is a collaborative instrument and agent for national central banks now formally linked through the European System of Central Banks (ESCB).

At the end of every year, profits earned by ECB operations are distributed to the members of the ESCB, each one of which maintained whatever historical role it already had in the management and supervision of local financial systems. The effect of irrevocably linking wholesale markets in the new currency, however, was profound, and pricing rapidly converged in intra-European interbank markets. The ECB has some capacity to provide immediate liquidity support for them, and it can muster more through its member banks. In the summer of 2007, it used that capacity effectively to calm markets and stabilize the interbank payments system. Accordingly, the ECB has an interest in extending its implicitly associated regulatory authority outwards from that base. Neither its member banks nor their counterpart governments, clearly anxious to preserve their own room for maneuver and limit the monetary power of the ECB, have demonstrated much enthusiasm. For their part, although ECB officials are most concerned to maintain their independence on monetary policy matters, they do have a watching brief on financial stability issues on behalf of the ESCB (Issing, 2003). On the critical question of access to the fiscal resources necessary to prevent or cope with more than short to medium-term liquidity problems in the capital markets of members of the Economic and Monetary Union, however, the “Eurogroup” of finance ministers remains dominant.

In recent years, banks from certain member-states, notably Germany, Austria, Sweden and Italy have taken very prominent roles in rapidly transforming central and eastern European markets. By 2004 the top 30 European banks overall had an average of 25% of their European assets outside of their home markets. Of these, nearly a dozen reported 50% or more of their total banking assets outside of their home markets. Nearly 50 institutions had cross-border and cross-sectoral features capable of complicating emergency management (Goodhart and Schoenmaker, 2006, p. 42; Rajan and Zingales, 2003). On the other hand, the number of regulators with potential interests in these intermediaries changed with each new chapter in the EU enlargement saga. Moreover, in the now 27 political jurisdictions within the single market project, some of which are in and some of which remain out of the monetary union, there is no common internal structure for regulating progressively integrating financial sectors.

In the late 1990s, within the policy space demarcated by the overlap between the continuing work-programs of the Basel Committee and the European Commission, European central bankers, bank supervisors, insurance supervisors and securities commissioners began a complex process of information sharing aimed at convergence on best practices. A series of experiments in stress testing various markets eventually ensued. One particularly enlightening exercise took place in April 2006, when the European Commission organized a “war game” involving a large-scale commercial insolvency threatening the stability of two banks with cross-border operations. Around the same time, the European Central Bank organized a similar exercise around the imagined failure of a large clearing bank, and the Financial Supervisory Authority in Britain did the same using the imagined collapse of a foreign bank subsidiary in London as the trigger (*The Economist*, 2007, p. 81; also see European

Central Bank, 2007a, pp. 73-84; Gieve, 2006; and Boss *et al.*, 2006). Technical issues and not the more problematic issue of financial burden-sharing appear to have been central to most such simulation exercises thus far, and the sponsors have mainly publicized comforting results on the readiness and robustness of communications networks. Common sense and reflection on the international crisis episodes discussed earlier, however, would lead one quite reasonably to imagine that such exercises also hinted at deeper problems and constraints (European Central Bank, 2007b; Bank of England, April and October 2007; IMF, April and September 2007).

What we do know from the kinds of low-probability/high-cost international financial crises discussed above is straightforward. A timely resolution and a workable division of the burden of adjustment can be facilitated by a legitimate and ostensibly neutral mediator and by limiting the number of parties around the negotiating table. The possibility of expansive cross-border contagion is limited when it is clear that the taxpayers of a single country will bear the costs of bailouts. Even when an institutional failure is resolved through a timely takeover by a stronger institution, authoritative political mediation behind the scenes is often crucial. Finally, the operational independence of many central banks and financial supervisory agencies today does not translate into their depoliticized access to national fiscal accounts when emergencies occur.

In the European Union today, even among members of the monetary union, there does not exist one fiscal account. Among members of the monetary union only, national fiscal policies are subject to an agreement that exerts some (weak) discipline. The operational mandate of the ECB is limited and does not encompass liquidity provision beyond the core trans-European payments system. The identities and responsibilities of the lead or coordinating supervisors of European entities incorporated as full subsidiaries outside of the home markets of their parents are not always clear. The basic approach to regulation and supervision in general still differs in subtle and not-so-subtle ways between members, notably between France, which prefers clarity on agreed principles and rules, and the UK, which prefers to leave room for pragmatic accommodation as markets evolve. Again, the number and diversity of players needing to be around the table in the case of the failure of a large, complex financial institution (LCFI) is expanding.

Although the political dilemma remains evident, the likely outcome is not entirely clear. According to some scholarly experts on the subject, the very existence of lenders-of-last resort has exacerbated systemically significant crises since 1973. In line with this kind of analysis, a flock of moral hazards have come home to roost. The system seems organized around the rubric: privatize the gains of finance capitalism and, at least in emergencies, socialize the losses. Under conditions of crisis, make the tax-paying middle classes or the immobile poor bear the burden of excessive risk taking by LCFIs. Even analysts and supervisors not entirely convinced of such a view sometimes take the related position that a high degree of “constructive ambiguity” is necessary to counter the temptations now confronting LCFI managers to chase ever higher returns or risk falling behind their competitors.

It is always easy to play such an analysis out to its logical conclusion in-principle—no bailouts. Since 1931, however, it has been politically unthinkable to put that principle into actual practice. Moreover, like it or not, every LCFI CEO worth his or her pay has understood since then the impeccable institutional if not individual logic of becoming too-big-to-fail, and lately even too-big-to-monitor. Stabilizing financial markets and striving to avoid crises is now hard-wired into governance systems. At the national level and now at the global level, this means managing systemic risk in more open and competitive markets and, despite evident constraints, seeking through political collaboration a sustainable degree of symmetry, or fairness, in adjustment burdens.

It would, however, also be too easy to take this to its logical functionalist conclusion—that the prudential dilemma must lead to the construction of a clear, transparent and robust burden-sharing mechanism in Europe, and perhaps beyond. What this would translate into in practice is an agreement on fiscal coordination, or an agreement to open national treasuries under certain circumstances and up to required limits. The problem with this logic is its conflict with historical experience. Even in the post-war collaborative project now called the European Union, the big leaps forward have not typically come from functional necessity. More often they have followed crisis moments or, like monetary union, reflected acts of political imagination in unique circumstances. The question currently confronting European financial policy-makers at the highest levels is whether the spectre of catastrophic crisis occasioned by potential troubles in one of Europe's own LCFIs is sufficient to stimulate policy innovation (Beck, 1999). Can the threat of crisis alone motivate a creative and coherent institutional response (Sunstein, 2005)?

IV. THE POLITICS OF EUROPEAN MARKET DEEPENING

The political authority to stabilize globalizing financial markets has an ultimate quality to it, a quality difficult to sense when those markets are functioning reasonably well. There is no reason why it cannot be delegated for a time to operationally independent central banks, financial supervisors or even private standard-setting organizations, and there are very good reasons having to do with the chemistry of financial innovation why such delegation is becoming more common. When such efforts accomplish their goals, markets deepen, catastrophes are avoided, few notice and public officials stay in the background. With the aim of maintaining just such an environment, technical debate in Europe now focuses on specific modalities for constructing burden-sharing mechanisms *before* a financial crisis requires them (Goodhart and Schoenmaker, 2006; Schoenmaker and Oosterloo, 2005, pp. 1–27; Goodhart, 2000).

The idea of a reliable *ex ante* agreement on burden sharing directly confronts the questions of what Europe actually is, whether its constituent members are fundamentally obliged to assist one another in an emergency, whether they trust one another to minimize financial losses, whether they share the same risk culture and whether they are guided by similar regulatory approaches. At the very least, it would assume continuing efforts to render national-level supervisory systems and practices more

compatible and to share both the fruits and the responsibilities of economic integration in a sustainably equitable fashion (Goodhart *et al.*, 1998; Padoa-Schioppa, 2002; Coleman, 1996; Rosenbluth and Schaap, 2003; Busch, 2004; Luetz, 2004; and Bovens *et al.*, 2001). Even the sympathetic observer of recent developments in Europe might be tempted to call such an assumption heroic, and certainly prominent officials, including the head of the ECB, have repeatedly and publicly repudiated the idea of an *ex ante* financial burden-sharing agreement. On the other hand, an *ex post* agreement in this arena would seem beside the point; once catastrophic financial losses are realized, the damage is done. Yet perhaps it is not so difficult to imagine an *ex ante* understanding aimed at prevention continually being negotiated and renegotiated at the core of the European Union and left implicit. Although it could never be acknowledged by the member-states, the notion of a Europe of “variable geometry” would be relevant here. In the face of a severe and generalized financial crisis, one can imagine leading states hanging together come what may and another group being left to fend for themselves. In less than catastrophic circumstances, and given both a basic sense of trust at the core and the presence of effective instruments for market intervention and political bargaining, one can even imagine *ad hoc* agreements on burden sharing being negotiated at the moment of the crisis itself. Even if this verges on the idea of *ex post* crisis management, not entirely dissimilar processes have been evident in modern European history.

Comparative political economists working on contemporary Germany, for example, have long emphasized that country’s characteristic and generalized *ex post* style of policy coordination. Given apparently strong rules and the pragmatic need for exceptions, this policy style has resembled “management by exception” (Derlien, 2001; and Green and Patterson, 2005). It is certainly hard to argue that this approach did not work within a highly decentralized Germany after 1945. Also hard to dismiss is the argument that just such an approach opened room for manoeuvre (and for complex bargaining) across various issues between post-war West Germany and its partners in the European Union. Still, to move today toward open-ended *ex ante* agreements on burden sharing even within a now-reunified Germany, or again between Germany and its now more numerous and variegated European partners, would presume faster transformation in deep political and ideological structures than seems realistic or plausible. Nevertheless, Germany did certainly play a leading role in building the European Union since the beginning, and it has obvious interests in promoting more integrated and more resilient European capital markets. This would suggest looking more at what it does than what it says on the complexities of preventing and managing future financial crises. The same goes for its key partners.

The financial vulnerabilities created by the current tensions within Europe between home and host country responsibilities and capabilities, are perhaps most visible in Eastern Europe, in the Baltics and in the Balkans. Governments now reliant on foreign-based banks to provide the lion’s share of domestic financial services are not entirely confident of the durability of this situation. Widespread requirements for

those banks to incorporate locally as fully capitalized subsidiaries might be taken to indicate as much, notwithstanding the original EU idea that a license in one member country should easily translate into a “passport” to do business elsewhere in the Union. For their part, contingency planning within bank headquarters to insure against losses in the portfolios of such subsidiaries would seem prudent. In an immediate sense, the regulators of those banks are surely right to focus on such things as the value of collateral held by such subsidiaries, but surely they must also consider what head offices will do if a local crisis engulfs their foreign operations. In short, they can cut and run at the risk of their global reputations, they can provide liquidity and even equity support at the risk of their consolidated balance sheets, they can work collectively with other similarly situated competitors or they can rely on their home and host states to work out mutually agreeable arrangements.

Large systemic risks point in the latter direction. In such circumstances, the twentieth-century experience recounted above suggests the necessity, but not sufficiency, of a neutral intermediary combining technical capability, delegated political authority and credibility not only with finance ministries and central banks but with private-sector institutions as well. A single point of coordination has obvious benefits when extreme crisis moments arise, but its very existence and presumed legitimacy likely have a preventive effect. The idea that a credible agency will promote collaborative solutions cannot help but reduce the temptation to panic. Any moral hazard issues thereby also raised, which are all too easy to exaggerate in contemporary capital markets, must be weighed against the alternative of self-help, either by private intermediaries or by their national overseers. The belief that without prior planning financial institutions and national authorities can be counted upon voluntarily and automatically to collaborate to an adequate extent in the face of catastrophe seems a classic example of wishful thinking. Where is the historical evidence that could justify it?

In the enduring Keynesian tradition, Kindleberger (Kindleberger, 1978, 1986; Kindleberger and Laffargue, 1982) repeatedly reminded us that leadership is vital either to head off financial crises or to manage them when they nevertheless occur (also see Minsky, 1986). If there existed a centralized fiscal authority in contemporary Europe, it would play the key role in any future regional crisis. Like the US Treasury in 1982, however, prudence suggests that it would need political buffers and a reliable surveillance and burden-sharing mechanism, such as the Federal Reserve and the IMF provided. Again, however, such a fiscal authority does not exist, and the mandate of the ECB is specifically limited. If unambiguous lines of supervisory responsibility could still be negotiated for the LCFIs now evolving in Europe—and if it could be guaranteed that even ineptly managed problems in more local or more specialized financial markets would not threaten systemic resilience—questions of ultimate fiscal authority and *ex ante* burden sharing might not arise in practice. Yet to the extent such lines ever existed, they are eroding rapidly as Europe’s key financial institutions expand in scope and depth (ECOFIN, 2001; Véron, 2007; Nieto and Schinasi, 2007).

Because they do not want to confront the potential implications of this fact directly, some proponents of deeper financial integration in Europe assert their belief in the inherent resilience of innovative markets that dice and slice risks finely and redistribute them widely. Somewhat less optimistic observers, especially after the credit squeeze of the summer of 2007, still profess abiding faith in the insurance provided by voluntary memoranda of understanding among national authorities, supported by the technical work (as in the so-called “Lamfalussy process”) of the Committee of European Banking Supervisors, the Committee of European Securities Regulators, and the Committee of European Insurance and Occupational Pensions Supervisors, supplemented by the work of more broadly based groups like the Basel Committee and the Financial Stability Forum. In the deep background, even after they repeatedly witnessed turbulence not stability emanating from US markets, perhaps some really think that the United States would ride to the rescue if European financial markets began crumbling (de Cecco, n.d.). Perhaps they will all be right, but are they wise?

Financial markets are indeed now more complex, geopolitical shifts are underway, and it is prudent to begin imagining serious regional equivalents to the role played by the IMF in 1982. In today’s Europe, such an exercise leads some observers to conclude that a European System of Financial Supervisors, analogous to the ESCB at the heart of the monetary union, is required (European League for Economic Cooperation, 2006). However, this just begs the same question. In a pinch and in the absence of a pan-European arbiter, who coordinates the coordinators at the moment of crisis, especially when those coordinators are not all similarly structured, similarly mandated by national governments, and, most importantly, similarly trusted by finance ministries? For the moment, the key link in the chain is yet to be forged. Ultimately, the link must be between the finance ministers represented on the Economic and Financial Affairs Council of the European Union (ECOFIN), the governors of Europe’s national central banks, and the diversely structured agencies charged with responsibilities for financial supervision at the national level. Adjustments in monetary policy, the reliable provision of liquidity at the core of payments systems, adequate prudential supervision, and, finally, the certain supply of fiscal resources either to solvent LCFIs that are indeed too-big-to-fail or to smaller institutions whose failure under certain circumstances could plausibly threaten the system—the coherence and effectiveness of all of these necessary responses depend upon such a link. When and if it is forged, it will very likely remain necessary to obscure it—because of the complex and decentralized nature of the European Union, because the strongest member-states are wary of assuming the full costs of bailing out weaker members, and because of shared perceptions of the related need to limit moral hazards confronting both market actors and member-states.

ECOFIN took an important step toward such a link in October 2007, when it agreed in principle to develop arrangements for cross-border financial stability within the EU. In this regard, it called for the negotiation of a new EU-wide memorandum of understanding on the management of systemic financial crises among supervisors, central bankers and finance ministers, and more significantly reached a

consensus on nine common principles to guide future cooperation. While seeking to “level playing fields”, encourage private-sector solutions and limit any commitments of public money to resolve crises, the noteworthy fourth principle states that “where a bank group has significant cross-border activities in different Member States, authorities in these countries will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden” (Council of the European Union, 2007, p. 4). The ninth principle further specifies that “the global dimension will be taken into account in financial stability arrangements whenever necessary [and] authorities from third countries will be involved where appropriate”.

Moving ahead in a complicated coordination exercise based upon these principles, ECOFIN ratified a new work program aimed first at stimulating “voluntary cooperation agreements” between national authorities, an EU-wide memorandum of understanding by the spring of 2008 and a “common analytical framework for assessing a cross-border crisis” by the end of that year. In the meantime, it left it to the Commission to propose ways to “clarify cooperation obligations, including possible amendments to EU-banking legislation”. (In this regard, Chapter 4 of Directive 2006/48/EC of 14 June 2006 for the first time in Community law already set out in considerable detail the mutual consultative obligations of key supervisory authorities.) New EU-level rules, for example, might specify when exceptions could be made to competition laws to allow rapid market interventions by public authorities, how the liquidation of failing cross-border institutions could be accomplished without prompting destructive rivalries over the seizure of assets, and what standards should guide national deposit insurance and other crisis-prevention schemes (Eisenbeis and Kaufman, 2007; Singer, 2007).

What ECOFIN did not yet promise, however, was a neutral arbiter legally mandated to coordinate necessarily complicated processes of emergency response. Certainly the separate directorates of the European Commission responsible for the internal market, for competition and for economic and financial affairs still lack the cohesiveness to manage financial crises, but the alternatives to an executive-level instrument within the EU would be an expanded ECB or a similarly “independent” institution given wide powers in the arena of cross-border prudential supervision. Neither yet seems palatable to ultimate national authorities who, to be sure, hope that occasional liquidity operations by the ECB will be effective but who also continue carefully to circumscribe the legal mandates of central banks and financial supervisors.

V. CONCLUSION

The fragility of integrating financial markets in a system of dispersed political power was exposed during the interwar period and occasionally glimpsed after 1974. Officials charged with ultimate oversight of those markets appear to have learned an historical lesson. When crises occur, confidence in the high probability of political collaboration remains necessary if the market-opening policy stances behind globalizing finance are to persist. If such collaboration fails, self-sustaining markets of global or even regional

scale are highly unlikely. Today, European authorities in particular seem unwilling to assume either that such collaboration will automatically arise or that it will develop inevitably out of the technical work of central banks. What they are actually thinking and doing in this vital policy arena hardly seems exhausted by the strict intergovernmental frameworks commonly employed by political analysts. Already in train is collaboration of an intensity not seen before outside of declared federations. Of course national authorities must speak the public language of state sovereignty even as they remind listeners of the dangers of nationalism, for they are speaking in practice mainly about the resources of national taxpayers who must be convinced and constantly reassured of the practical wisdom of economic integration. Of course they must depict themselves as struggling to cut deals exposing their own constituents to the fewest possible contingent financial liabilities. Of course they look to market participants themselves to help them limit systemic risks. Yet under the surface of transient events and in a densely technical language, they are moving beyond familiar structures of political obligation and accountability.

Unless one is seriously willing to contemplate capital market dis-integration along traditional national lines in the event of a major financial crisis, one must hope that what is really going in Europe today—and perhaps globally tomorrow—is analogous to the opaque debates, the constant haggling and the politically necessary denial that often characterizes regulatory innovation and reform within established federal states. Even in the tightening union of the United States after the start of the industrial era, the conflicts and contradictions posed by inter-state commerce and gradually integrating capital markets were eventually rendered more manageable by a complicated transformation and recalibration of political authority. In Europe, something similar appears to be underway in the arena of financial regulation and supervision (Sapir, 2007; Jabko, 2006; Menon and Schain, 2006; Grande and Pauly, 2005/7; Nicolaidis and Howse, 2001). Although there is nothing inevitable about the outcome, after all federations and confederations have fallen apart throughout history, the unavoidable question of fiscal burden sharing is now central to the idea of completing the European market in financial services. The question it begs is “internal to what?” In the long run, the answer must be a European polity with sovereignty and ultimate fiscal responsibility deeply shared.

Although much has obviously changed since the interwar period, the failure of key financial intermediaries under imaginable conditions could still call into question the creditworthiness, fiscal capacity, and confidence-generating political commitments of the states at the core of the post-1973 experiment in financial and capital market integration. The emergence of a global polity with effective and undoubted instruments for emergency financing, the orderly disposition of failing enterprises, and systemic resource redistribution would change things profoundly. Integrating markets might then be more certainly efficient and more durably resilient. Until then, realists count on the logic of market deepening being matched by the progressive development of what Europeans recognize as the complex politics of “co-responsibility”.

ACKNOWLEDGEMENTS

In preparing this article, on a confidential basis early in 2007 I interviewed many current and former officials in London, Brussels, Vienna, Frankfurt, Berlin and Paris. An earlier version was released as “Political Authority and Global Finance”, Working Paper Series-WP 2007/34, Global Economic Governance Programme, Centre for International Studies, University of Oxford, May 15, 2007, pp. 1–21. I benefited greatly from invitations to attend two timely conferences: the first in Brussels on “Challenges for EU Supervisory Arrangements” organized by the European Commission in June 2007; and the second on “Globalization and Systemic Risk” at the Federal Reserve Bank of Chicago in September 2007, for which I thank Douglas Evanoff and George Kaufman. For constructively critical comments on this article, I thank Ngaire Woods and her colleagues at University College, Oxford, Edgar Grande and his team of post-doctoral fellows at Ludwig-Maximilians University, Gordon Clark and his graduate students in the Oxford University Centre for the Environment, John Weaver and his colleagues in the History Workshop at McMaster University, Charles Goodhart, Geoffrey Underhill, Graham Hache, Vijay Singh, Andreas Busch, Walter Mattli, James Faulconbridge, Marc Ventresca, Eric Helleiner, Nicolas Véron, and the editors and anonymous referees of this journal.

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doi:10.1093/cpe/bzn006