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Political Authority and Global Finance: Crisis Prevention in Europe and Beyond

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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 seemed a harbinger for the world. In the wake of the turbulence that had rocked international capital markets ever since the Bretton Woods system of pegged exchange rates and limited capital movements ended in 1973, however, a deeper question could not be ignored. The failures that spawned and deepened the Great Depression had taught the lesson that efficient and resilient financial markets depended upon effective and legitimate oversight. National governments were left with a reasonably clear responsibility—that is, until they had to begin sharing it with one another as nationally-based financial intermediaries and investment vehicles began building large, complex border-spanning operations.

In the wake of several financial crises that also now spanned national boundaries, pragmatic financial supervisors gradually built a workable regime around the principle of "home-country control"—the government ultimately responsible for any particular coordinated response necessary to stabilize an interdependent system was the government of the state within which a troubled institution was licensed and clearly based. A truly integrated pan-European market, just as a truly global market, would push such a regime past its limit. In fact, the emergence of certain large, complex financial institutions in Europe already blurs the identity of the responsible government in certain situations. It opens the policy space for new supervisory approaches and, ultimately, common agreement on burden sharing. In principle and in extremis, that space can only be filled with an understanding involving the commitment of fiscal resources, and by the sharing of such a commitment by national authorities. For various reasons in contemporary Europe, the extent of that commitment may have to remain implicit, but it will only be plausible if neutral and credible overseers are in place to coordinate responses in the event of emergency. The difficulty in putting these crisis prevention and crisis management arrangements in place exposes the political dilemma at the heart of the financial integration project, both in Europe and more broadly. This paper sets out the conceptual and historical context for understanding that dilemma, and in this light examines the contemporary evolution of policy responses.

Background

In his seminal study of the Great Depression, Charles Kindleberger (1986) famously concluded, "For the world economy to be stabilized, there has to be a stabilizer--one stabilizer." In 2001, the second Brouwer Report (Economic and Financial Committee, 2001, p. 11), one of the highest-profile policy studies on the subject of European financial integration, came to a similar point:

. . . there may be cases where the traditional division of responsibilities between home and host country authorities may not provide sufficient guidance in the decision-making process. When, for example, disturbances are being channeled through money and capital markets, a potentially large number of intermediaries located in different jurisdictions could be affected. Under such circumstances, multilateral co-operation may be required in order to provide for a coordinated response.

At the international level, the most dangerous financial crisis since the Depression erupted in Mexico in 1982. Under the leadership of Jacques de Larosière, certainly one of the best managing directors it has ever had, the International Monetary Fund stepped into the role of crisis manager. But he was improvising as he went along, and the eventual success of the Fund in helping to resolve the developing-country debt crisis owed much to the fact that the U.S. Federal Reserve was understood to be standing behind it, and behind the Fed stood the full faith and credit of the U.S. Treasury. As de Larosière clearly understood, his institution served as a multilateral facilitator—and political buffer—between fragile financial markets and the ultimate financiers of any necessary bailouts, the taxpayers of the United States and of its partner countries with significant stakes in those markets (Pauly, 1997; Kraft, 1984). Restoring market confidence, limiting that potential liability and related moral hazards, and easing the burden in troubled debtor countries were the crucial aspects of the challenge. The specific task was to find an indirect, private-sector solution to the fullest extent possible. In such a context, a senior US official at the time explained that the Treasury had made a decision never to "ask the banks to put another nickel into these countries because the minute the Treasury does that, they're our loans." For similar reasons, the Fed turned to the IMF. As a senior Fed official recalled, "De Larosière was better placed to do some things. He could demand cooperation from the financial community. As an international civil servant, his role as the 'heavy' further depoliticized the process (Solomon, 1995, pp, 230-31)." Just as importantly, the Fund could encourage constructive policy reform in countries where the problems and limit the risk of a nationalist backlash.

Surely capital markets are far more sophisticated and inherently more resilient today than they were in the 1980s (Cohen, 1996 and 2002). Financial risks as well as opportunities now flow more freely. On the supply side, foreign capital can usefully supplement domestic savings and accelerate growth. On the demand side, vast new pools of liquidity seek new outlets through capital markets that are more open and increasingly difficult to keep segmented (commonly, across banking, bond, stock, and other types of investment activities). Especially in combination with floating exchange rates and relatively open markets for goods and services, financial globalization in principle diversifies investment portfolios and thereby reduces economic volatility in the aggregate (Mishkin, 2006). In practice, it can encourage herd-like behavior among investors, the taking on of excessive debt, and the rapid transmission of shocks. It also entails diverse social effects across diverse risk cultures and raises vexing distributive questions (Fligstein, 2001; Beck, 1999).

The task of maintaining the confidence necessary to keep financial markets open and resilient therefore remains at base a political one. For this reason, doubts remain, as do profound questions the IMF and its political masters confronted in the past. At the leading edge of a nascent global experiment with deep financial integration, the EU faces them today. What political structures can prevent panics in markets still in the process of transformation? What kinds of intermediaries require special attention if markets are to be resilient? Who will manage and ameliorate periodic crises of confidence spilling over political boundaries? How will occasional liquidity squeezes that tip into insolvency crises be resolved? Whose fiscal resources must be made available to serve as ultimate defenses against market instability? And, in the most complex cases, who will provide the necessary services of multilateral coordination and political buffering?

Such questions confront policymakers around the world. Core payments systems, and the communications technology upon which they depend, remain vulnerable. More broadly, responsible political authorities are struggling to find new policy balances between the exigencies of freer capital markets and the political necessity of protecting their citizens from a broadening array of systemic risks. Although risk cultures continue to differ markedly around the world, integrating financial markets expose the awkward political reality that mobilized and organized savers and investors want the best of both worlds. They want better returns but they also want an ultimate safety net. Economists can easily identify inconsistencies and contradictions. Political analysis starts with their persistence.

After they gave up on the post-war system of pegged exchange rates, leading states exhibited in their policy practice if not always in their policy pronouncements their view that more open capital markets were both desirable and fragile. Of course, capital markets are still not completely open anywhere. Despite tremendous growth in the scale of foreign asset holdings by direct as well as portfolio investor, and despite a vast expansion in the overseas operations of banks and other intermediaries, evidence remains of a home bias, especially but not only in contemporary equity markets. By most estimates, net international capital flows before the financial crises of the late 1990s did not yet exceed those characteristic of global markets in the pre-1914 period (Obstfeld and Taylor, 2005, chapters 2 and 3; Isard, 2005, Tirole, 2002). Nevertheless, after a remarkably brief pauses occasioned by crises, the broadening expansion of international capital flows has always resumed in the contemporary period and their home bias has slowly been eroding.

The overall direction of those flows is worth noting at this point. One might imagine that open markets would ideally facilitate the movement of capital from rich countries, where returns should be relatively low, to poor countries, where returns should be relatively high. Although this does happen to some extent, the most significant capital importer has long been the United States (64% of net global capital imports in 2006) and the top net capital exporters are China (13.5%), Japan (12.2%), Russia (8.8%), Saudi Arabia (8.8%), other petroleum producers (15.5%), and Germany (8.8%) (IMF, 2007, p. 141). It remains the case, moreover, that developing countries in general are less engaged in global markets than some of their forebears had been before World War I, even if capital imports by so-called emerging markets did rebound sharply after 2003, especially in East Asia. In short, even if returns are risk-weighted to help account for the distance between today's capital markets and an idealized globally integrated system, the contemporary policy experiment in deeper financial integration remains mainly a project of advanced industrial countries. In broader terms, a capital recycling mechanism constructed mainly by their policy choices makes it possible to sustain large trade and investment imbalances.

The structure of the markets through which enduring imbalances are financed deserves emphasis. Where commercial banks handled the lion's share of cross-border business in the period immediately after World War II, after the 1970s investment banks, the financial arms of industrial corporations, and eventually pension funds, other kinds of pooled investment funds accounted for rapidly rising capital flows (Clark and Wójcik, 2007). This entailed significant and still incompletely understood shifts in the various associated risks. Where banks making straightforward loans and holding the risks characterized the post-1945 system, certainly after the mid-1980s underwriters developed myriad techniques to segment and rebundle risks and sell them into more decentralized markets. Bonds, stocks, and an array of products derivative of underlying financial claims came to overshadow traditional banking products. Privatization programs helped drive the trend, so too did the vast expansion of savings in many countries and the attendant global expansion of portfolio and direct investment. Governments on both sides of burgeoning capital markets could hardly proclaim themselves to be unwilling participants. More open and integrating markets, still rested on evident foundations of vital interest embodied in legitimate political authorities.

Despite much debate concerning its sustainability, US consumption in late twentieth and early twenty-first centuries was the engine of the global economy, and it remained in the interests of states pursuing essentially export-led economic strategies to finance that consumption. In turn, it remained in the American interest to accommodate the efforts of many states to export far more than they imported. Not dissimilarly to the early post-1945 period, that calculation reflected a strategic conviction that the prosperity thereby generated would continue to underpin regional political stability (Katzenstein, 2005). Multinational firms became the principal vehicles and most immediate beneficiaries of that strategy, and their more obvious interests in turn reinforced the policy line, eventually far beyond the United States. In recent years, the strategic calculation became more complicated just as US capabilities appeared stretched to their limit. Intractable challenges emanating from the Middle East, the rise of China and India and associated policy reactions, and the environmental constraints facing a petroleum-based production system—all combined to heighten the political and economic risks of relying on the US consumption engine. While some talked of balancing American power, wiser policymakers simply emphasized the prudence of moving toward a less fragile but still globalizing economy. Contemporary policy work on European capital markets needs to be understood in just such an overarching political environment.

Nationalism, Financial Crises, and Political Authority

The emergence of global finance, or ever more open national and regional markets, is hardly the story of the inexorable progress of liberal principles or the compelling logic of individualism. It begins instead in the late eighteenth century as competitive and insecure states confronted the necessity of constituting nations. Nationalism gradually succeeded in replacing dynastic and religious foundations of claims to political legitimacy, first in Britain, then in the United States, and then in France. As it did so, a series of remarkable technological innovations disrupted traditional solutions to the classic economic problem of scarce resources and unlimited wants. Central to the legitimation contests that took apart old empires, reorganized dysfunctional polities, and gave us the modern national state is the struggle to control finance. (Hardly tracing a simple or uni-directional process, a diverse interdisciplinary literature with deep sociological and economic roots converges on this theme. See, for example, Minsky, 1986; Goodhart, 1988; Strange, 1988; Neal, 1990; Helleiner, 1994; Wray, 1998; Flandreau and Zumer, 2004; and Seabrooke, 2006.) This basic point, of course, encapsulates diverse, sometimes bloody, and always venal case histories. In the obviously successful cases, however, the growth-enhancing nationalism of competition in open markets prevails over the depressive nationalism of market closure.

Despite frequent cosmopolitan claims, the architects of modern financial markets typically focused on local interests. The markets that had a global dimension in the pre-1914 period were linked by the interests and ideological foundations of empires built around the English, French and Dutch nations. Their analogues in the late twentieth century mainly connected financial centers like New York, London, and Tokyo, but their heavy reliance on the US dollar and their support of multinational corporate investment mainly emanating from the United States suggested something similar. By then, however, parochial financial policies within both the United States and Europe were giving way to the logic of federalism, certainly in wholesale markets. In principle, this offered a model for future regulatory architecture at both regional and global levels, for federalist solutions accommodated diverse nationalisms and do not necessarily imply complete convergence. Even in federal contexts, however, the principal raison d'être for more open and competitive financial markets is to facilitate economic growth and prosperity sufficient to sustain the claim of authority inhering in polities that were certainly more complex but not entirely dissimilar from their predecessors (Greenfeld, 2003; Friedman, 2005; Pickel and Helleiner, 2005). The essential idea that such markets both rested on and reinforced the legitimacy of state power however constituted was decisively tested around the world between 1929 and 1933. Unfortunately, it passed the test. Going through a similar experience today is precisely what national and, in Europe, regional financial overseers are trying to avoid.

The truncation of international capital flows in the 1930s taught a hard lesson (Kindleberger, 1978; Kindleberger and Laffargue, 1982). The same lesson had been taught in the earlier histories of large federal states. Integrating financial markets necessitated deepening cooperation among regulators, and in the extreme, the scaling of regulatory authority to the size of the market. The passionate advocates of "free banking" notwithstanding, financial markets everywhere are regulated. In most leading industrial states, the development of national central banks reflected long political battles that ended with regulation moving to encompass the scale of dominant financial institutions. When the possible failure of such institutions poses larger threats, both economic and political, the state has an interest in intervening to stabilize and reorder markets. The experience of actual crises ensured that this interest congealed into expectation and even obligation. Mitigating systemic risk sometimes required recourse to the public purse, and in turn spawned 'moral hazard,' the temptation to take excessive risks financiers undeniably face when they believe they can count on implicit public guarantees (Goodhart, 1999, pp. 339-360). Moral hazard, in turn, spawns the necessity of official supervision, which itself depends upon the ultimate power to liquidate and place a market-protective ring around problematic institutions. Central bankers, financial supervisors, finance ministers, and legislatures are thus locked into a delicate but unavoidable relationship manifesting itself most clearly at crisis moments.

The disastrous decade commencing in 1929 was characterized by the coincidence and propagation of banking and currency crises (Pauly, 2007; Temin, 1991; James, 2002). After the Bretton Woods system of pegged exchange rates ended, banking crises once again became a fact of international economic life; so too did their coincidence with currency crises, but now mainly in newly industrializing countries. In 1974, a German bank, Bankhaus I. D. Herstatt, spawned a run that ultimately caused the Franklin National Bank of New York to fail (Spero, 1980). With the assistance of the staff of the Bank for International Settlements, but actually led by central bankers from the United Kingdom and the United States, bank supervisors subsequently 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 dialogue of the Basel Committee on Banking Supervision after the 1982 developing-country debt crisis exposed the virtual insolvency of banks at the core of national and international payments systems (Wood, 2005). At the extremes of serious analytical debates that followed the 1982 debt crisis, 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 so fragile that they required careful dis-integration if the stability of national economies was to be preserved.

It had become clear by then that the states central to the international economy had collectively moved away from one set of policy trade-offs and toward 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. Despite a clear trend toward capital market liberalization, and other spectacular bank failures (Gapper and Denton, 1996; Fay, 1996; O'Brien, 2003), no binding 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).

Before financial sparks in Thailand set off a systemic wildfire in 1997, some prominent voices were in fact advocating an explicit amendment to that agreement that would have the effect of extending the IMF's jurisdiction over exchange restrictions on current account transactions to restrictions on capital account transactions (and, by implication, expanding the agreed purposes of the Fund to include not simply the promotion of open current accounts but also open capital accounts). In the midst of a new systemic crisis, debate on the proposition ceased. For the system as a whole, however, obvious questions arose. As Stiglitz (2006, p. 246) put it, "While money should be flowing from the rich to the poor and risk from the poor to the rich, the global financial system is accomplishing neither." (Also see Woods, 2006.) Nevertheless, after direct and indirect official interventions restored confidence in the key intermediaries, the global movement toward capital market openness resumed, both without unambiguous rules and without the designation of an ultimate supervisory authority.

In short, the architects of the post-1973 order could not easily balance emergent market facts with continued political realities. They could not clearly align the domain of the regulator and the domain of the market (Alexander, Dhumale, and Eatwell, 2006). Of course, well-functioning financial markets are in some sense designed to push the boundaries of regulation. If regulators are not engaged in a constant game of catching up, productive innovation is not likely occurring. Nevertheless, if markets completely outrun the capacity of their overseers to intervene and stabilize in emergency situations, history suggests they will not be resilient or innovative for very long. So the issue remains the lodging of political authority at the level where it logically belonged in a world of freely flowing capital. (See Eatwell (1999) for an early proposal to establish a World Financial Authority.) Thus far, however, no international agency has been authorized to regulate or supervise integrating capital markets. None has been provided with the resources necessary to stem a global crisis (Fischer, 2000; Goodhart and Illing, 2002; Mussa, 2006). National authorities instead have opted to allow the financial institutions they themselves continued to license and supervise to expand their international operations on the understanding that sound macroeconomic policies would stabilize deepening cross-border markets and that emergencies could be prevented or managed by national regulators collaborating informally to the extent necessary (Honohan and Laeven, 2005; Hoelscher and Quintyn, 2003). Such an outcome would surprise no one familiar with the way most policies are actually constructed in democracies, the form of government shared by the states that built the world economy after 1973. The definitive coordination of national policies is difficult in the best of times. The prospect of future systemic gains is, in truth, not often as successful a motivator as the credible prospect of imminent and catastrophic losses (Aggarwal, 1996).

The frontier of markets integrating across political and legal boundaries nevertheless continues to be patrolled by intergovernmental bodies charged with negotiating more common understandings on appropriate standards and decentralized enforcement (Bryant, 2003). Organizations created by private sector actors have been enlisted in these efforts. For example, standard-setting bodies set up by accounting and other types of firms or private associations are increasingly common. In the United States, the United Kingdom, and elsewhere, governments have typically and not surprisingly been willing to let market participants attempt to reach agreement among themselves on best practices. When such attempts fail and markets are threatened with disruption, however, governments and central banks come out of the shadows.

Well into the 1980s, the main arenas within which financial regulators sought to coordinate their standard-setting and enforcement activities were easy to identify. Bilateral negotiations between national regulators and central banks were nothing new. Innovative multilateral consultations related to banks at the core of vital payments systems, however, continued under the auspices of the Basel Committee. As Kapstein (1998, 2006) demonstrated, however, such a mission was from the beginning mixed together with a mandate to "level" the competitive playing field of international banking. This led first to a 'Concordat' on supervisory responsibilities. In the wake of various scandals, that agreement later evolved to make clarify the role of 'consolidating' supervisors and to accommodate legislative changes in the United States and the European Union that strengthened the role of host supervisors of banks from countries deemed weak in their capacity to provide supervision. The Committee also initiated a protocol (Basel I) for minimum standards for bank capital reserves. In 2006, the "Basel II agreement" allowed internationally active banks to bring sophisticated risk-management techniques into the calculation of capital requirements. (Beyond the mutual recognition of other and disparate practices at the national level, the agreement also emphasized the importance of adequate supervision and 'market discipline,' which implied future consideration of ideas like forcing banks to issue subordinated debt, the fluctuating price of which could provide signals to supervisors that early intervention might be required (Kaufman, 2002).) In contrast to the straightforward calculations of Basel I, capital requirements were now 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. Partly for this reason, political pressure immediately began to build for work on 'Basel III'.

Basel II heightened the interest of financial supervisors in the activities of globally expansive insurance companies, investment banks, pension funds, hedge funds, and private equity funds. Even in the case of indirect intervention to deal with the insolvency of the LTCM hedge fund in 2001 (Lowenstein, 2002), it remains clear that preventing the failure of large banks at the core of the system is the vital public interest, for those intermediaries still manage most routine payments and settlements, consolidate and liquidate bad debts, and provide vital policy instruments for governments and central banks. That interest, nevertheless, now implies deeper scrutiny of new investment vehicles directly or indirectly linked to banks that in-principle should be allowed to fail if they mismanage their risks. In practice, this is not so easy. In addition to uncertainties concerning the location of final risks, say in the case of booming markets in credit derivatives, discerning precisely what events will undermine the confidence in the future that underpins core markets remains more art than science. In this context, notwithstanding the human tendency to temporize when conditions are calm, more ambitious aspirations to bring the scale of regulation into better alignment with the structure of integrating financial markets are in evidence, not least in Europe.

Inside 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 financial integration 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) to oversee the subsequent deepening of European capital markets, the reality is more complicated.

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 can muster more through its member banks. It manages a core interbank payments system, and has obvious interests in extending its implicit regulatory authority outwards from that base. But neither its member banks nor their counterpart governments 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). Since in this arena access to fiscal resources is ultimately, the "Eurogroup" of finance ministers remains dominant.

In recent years, banks from certain member-states, notably Austria and Sweden, have taken very prominent roles in rapidly transforming central and eastern European markets. By 2004 the top 30 European banks 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 (Goodhart and Schoenmaker, 2006, p. 42). On the other hand, the number of regulators with potential interests in these intermediaries changes 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 various and interlinking financial sectors.

In the policy space demarcated by the overlap between the continuing work-programs of the Basel Committee and the European Commission's 2005 White Paper in financial services, European central banks, bank supervisors, insurance supervisors, and securities commissions began a series of experiments in stress testing their markets. 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. Around the same time, the European Central Bank organized an 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; European Central Bank, 2007, pp. 73-84; Bank of England, 2007;

IMF, April 2007, chapter 3; and Gieve, 2006; Boss et al., 2006). Technical issues and not the more problematic financial burden-sharing issues appear to have been central to most simulation exercises thus far, and the sponsors have only publicized comforting results. Common sense and reflection on the international crisis episodes discussed earlier would lead one quite reasonably to imagine that they also hinted at deeper problems and constraints.

Beyond contentious issues concerning the distribution of the actual costs of crisis resolution, what we do know from previous low probability/high cost financial crises 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 cross-border contagion is limited when it is clear that the taxpayers of a single country will bear the costs of a bailout, and even when an institutional failure is resolved by merger into a stronger institution, authoritative political mediation is 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 the responsibilities of the lead supervisors of European entities incorporated as full subsidiaries outside of the home markets of their parents are not clear. The number of players needing to be around the table in the case of the failure of an LCFI will be large, and their interests will be quite diverse. There is no established crisis-management mechanism equivalent to an IMF with its own paid-in and callable, if still limited, financial resources.

Financial supervisors and members of the ESCB are now focusing attention on such issues, and signal EU legislation now provides an innovative framework of legal obligation to facilitate future collaboration. (Specifically and significantly, Chapter 4 of Directive 2006/48/EC of 14 June 2006 for the first time in Community law sets out in considerable detail the mutual consultative obligations of consolidating supervisory authorities.) More informally, so too are Europe's economic and finance ministers beginning to think through the issues under the auspices of the Eurogroup and the Economic and Financial Council of the EU. Moreover, the European Commission and national supervisors have established regular consultations on these topics with regulators in the United States and Japan. Contacts have also been initiated in China.

Although the political dilemma remains evident, the likely outcome of all of this activity is not entirely clear. It is hardly uncommon for scholarly experts on the subject to argue that the very reason for the many systemically significant crises since 1973 has been the experience of last-resort lending at both the national and international levels. According to 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 socialize the losses. In particular, 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 degree of "constructive ambiguity" is necessary to counter the temptations now confronting LCFI managers to chase higher returns.

It is always easy to play this out to its logical conclusion in-principle—no bailouts. Since 1931, however, it has been politically unthinkable to put such a conclusion into actual practice (Schubert, 1992). 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 to-big-too-fail, and lately even too-big-to-monitor. The impetus to stabilize financial markets and reduce the risk of crises is now hard-wired into governance systems. At the national level and now at the global level, this means managing systemic risk and ensuring a rough 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 great post-war experiment in political economy now called the European Union, the big leaps forward have not typically come from functionalist 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 policymakers at the highest national levels is whether the specter of catastrophic crisis occasioned by potential troubles in one of Europe's own LCFIs is sufficient to stimulate just as much imagination as contemporary political (and legal) constraints will allow (Sunstein, 2007). Can the threat of crisis alone motivate a creative institutional response?

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 (Porter, 2005). 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, 1-27; Goodhart, 2000). Since moral hazards are unavoidable in such a policy context, the debate is shrouded and contentious (Financial Times, 2007). But it is the politics underneath that renders it doubly difficult.

The idea of a reliable ex ante agreement on burden sharing directly confronts the questions of what Europe actual 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 appear to assume continuing efforts to render national-level supervisory systems and practices more compatible and to share both the fruits and the responsibilities of Union in an agreeably 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 casual and sympathetic observer of recent developments in Europe would surely have to call such an assumption heroic. On the other hand, an ex post agreement in this case would seem beside the point, for once catastrophic financial losses are realized, the damage is done. This may not be so clear-cut, however, if we can imagine something like just such an agreement being continually renegotiated 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 readily imagine core states hanging together come what may and another group being left to fend for themselves. Evenso, in less than catastrophic circumstances, and given a basic sense of trust and irrevocable commitment at the core, one can imagine an agreement on burden sharing 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 a 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.' It is certainly hard to argue that this approach did not work within a highly decentralized Germany after 1945 (Derlien, 200l; and Green and Patterson, 2005). Also hard to dismiss is the argument that just such an approach opened room for maneuver (and for complex bargaining) across various issues between Germany and its partners in the European Union. To move now toward an open-ended ex ante agreement on crisis management within a now-reunified Germany, and again between Germany and its now more numerous European partners, including a financially robust United Kingdom that remains outside of the monetary union, would presume a deeper structural and ideological convergence than currently exists. Nevertheless, the grounds for trust and implicit understandings exist, and there are good reasons for optimism on continuing and constructive evolution of policies that simultaneously promote deeper financial integration and stable, resilient capital markets in Europe.

The financial vulnerabilities created by the current tensions within Europe between home and host country responsibilities, and home and host country 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. Requiring those banks to incorporate locally as fully capitalized subsidiaries might be taken to indicate as much. For their part, contingency planning within bank headquarters to insure the portfolios of those subsidiaries internally or externally would seem prudent. In an immediate sense, the home-country 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 they will do if a banking and or currency crisis begins in one of those countries. If they are doing so, history would seem to hold some lessons.

One lesson suggested by even a brief review of twentieth-century experience with financial crises concerns the necessity, but not sufficiency, of a neutral intermediary combining technical capability, delegated political authority, and credibility with both finance ministries and central banks. A single point of coordination has obvious benefits when crisis moments arise, but its existence and legitimation likely have a preventive effect. The idea that a credible agency will promote collaborative solutions when emergencies arise 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. The belief that financial institutions and national regulators will voluntarily and automatically collaborate to an adequate extent in the face of a financial panic and in the absence of central coordination seems a classic example of wishful thinking. Where is the historical evidence that could justify it?

As Kindleberger reminded us, leadership is vital both to head off and to manage financial crises. In 1982, the IMF was in place and just adequately authorized by its leading member states to improvise a crisis management role. 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 a political buffer. But such a fiscal authority does not exist, nor is the ECB charged with clear responsibilities for more than limited liquidity-support operations. If unambiguous lines of supervisory responsibility could be still negotiated for the large, complex financial institutions 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 the resilience of those institutions, questions of ultimate fiscal authority might not arise. But to the extent such lines ever existed, they appear to be eroding rapidly as Europe's LCFIs expand in scope and depth.

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 but still hopeful observers have faith in the insurance provided by voluntary memoranda of understanding among national ministries, central banks, and financial supervisors, supported by the technical work of the Banking Supervisory Committee of the ESCB, the Committee of European Banking Supervisors and others involved in the Lamfalussy process, the Basel Committee, and the Financial Stability Forum. In the deep background, perhaps some really think that the United States will ride to the rescue if serious trouble arises (de Cecco, n.d.). Perhaps they will all be right. But are they wise?

I am personally not yet willing to concede that the IMF will never again be called upon to play the systemic role it played in 1982 (Bryant, 2004). Still, financial markets are indeed now more complex, geopolitical shifts may be underway, and it is prudent to begin imagining serious regional counterparts. In today's Europe, such an exercise leads close 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). But this just begs the same question. In a pinch and in the absence of a pan-European supervisor, 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 seems yet to be forged. The link is between ECOFIN and the ESCB. When and if it is forged, it will very likely remain necessary to obscure it, both because of the complex and decentralized nature of the European Union and because moral hazards need to be limited. If the Commission (in particular, DG ECFIN) and the ECB did not exist at that point, they would have to be invented.

Conclusion

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. Jean Monnet and Arthur Salter were involved in that effort. A decade later the League had become a helpless witness as European financial markets began to deteriorate, and Salter recorded the following (1932, pp. 42-44; also see Salter, 1961):

In the early summer of 1931 a director of the Credit-Anstalt of Vienna asked that its assets be revalued. . . . The financial institution most closely associated with the industrial life of Austria was revealed as insolvent. . . . The Austrian state was at once involved, because the government felt it must give its guarantee to prevent a run . . . This in turn had grave reactions on the budget and currency. . . . The consequences of the visible cracking of the structure in Austria extended rapidly over a much wider area. The world's balance of payments had for some years been maintained only by the constant renewal of large short-term advances which were liable to be called in at the first shock of confidence. . . . A run on Germany began. . . . A prime ministers' conference was called in London; and the bankers who had made the principal short-term advances to Germany made a stand-still arrangement [to February 1932]. . . . Germany's situation was relieved for the moment but obviously needed more radical action than could be immediately improvised and a strong Committee at Basel examined the general position of her foreign obligations.

The fragility of integrating financial markets was experienced in the interwar period, profoundly sensed in 1982, and occasionally glimpsed during the next quarter century. Comprehending that fragility begins with an understanding of the politics underneath those markets. Innovation, openness, and growth may make it easier to design institutional responses, but they do not obviate the need for them. A high degree of political collaboration remains necessary if the relatively progressive policy stances now observable around the world are to persist. If such collaboration fails, self-sustaining markets of global or even regional scale would be a highly unlikely outcome. European authorities in particular seem unwilling today to bet on it. What they are actually thinking and doing today in this vital policy arena hardly seems exhausted by the strict intergovernmentalist frameworks commonly employed by scholarly analysts. Already in train is collaboration of an intensity not seen before outside declared federations (Coleman and Pauly, forthcoming). 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. But under the surface of transient events and in a densely technical language, they are moving beyond familiar structures of 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 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 might plausibly be imagined and supported by careful analysis of what policymakers are actually doing in important policy arenas like financial regulation and supervision. (Grande and Pauly, 2005/2007; Menon and Schain, 2006; and 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 'internal 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 at its financial core, deeply shared. Not least, anyone with an interest in the financing of development in the rest of the world must hope for such an answer, unless they are willing to bet either that the American consumption engine will continue running smoothly or that China and India will somehow provide a reliable substitute.

Prudence, fairness, and long-term stability imply a move toward more balanced consumption, savings, and investment patterns across the world's major regions. Even in such an environment, and especially if ambiguity remains in the area of crisis response, contemporary history suggests caution. The emergence of a global polity with effective and undoubted instruments for resource redistribution and emergency lending would change things profoundly. Integrating capital 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 stabilizing wisdom of what Europeans call 'co-responsibility' among polities sovereign only in the most abstract legal sense.

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