



EUROPEAN POLICY BRIEF



FINANCIALISATION ECONOMY SOCIETY AND SUSTAINABLE DEVELOPMENT

Making the European Union a viable construction

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INTRODUCTION

The recent result of the UK referendum on exiting the European Union (EU) is the more visible sign of the shortcomings and fragmentation of the Union's political, institutional and policy framework. The present policy brief, which was written months before the UK referendum and draws from earlier works (Tonveronachi 2014, 2015, 2016), proposes to revise the monetary operations of the European central bank, the euro area's fiscal rules and the financial regulatory approach in order to overcome some of the main inconsistencies and fragilities of the current design. Thought of as requiring no treaty changes and a minimum of political convergence with respect to alternative proposals, if successfully implemented the new design would contribute to give a viable perspective to the Economic and Monetary Union, capable of attracting the EU non-euro area countries that consider the mismanagement of the recent crisis as reason enough for resisting further losses of sovereignty.

The EU institutional and political perspective

Any regional agreement wanting to be more than the design of a free trade area needs relevant shift of sovereignty from member countries to *ad hoc* designed central institutions. The shift should be proportional to the degree and type of economic, social and political integration sought. The higher and wider the chosen integration, the longer the time to attain it. In the meanwhile, the gradual building of centralised institutions and rules should follow from a clear final design and should ensure a sufficient degree of consistency in each step of the integration process. In addition, the unavoidable inconsistencies brought about by a dynamic structural process require the institutional framework to contain some political and economic cushions of safety against unforeseen shocks. The current EU design is far away from following these viability conditions.

The transformation of the entire European Community into a close union, with its single currency appendix, has been relegated to the category of the improbable. Adding the disastrous management of the recent crisis to the unsolved inconsistencies of the design of the euro, a serious political fragmentation, not an ever closer union, has been produced. Despite what clearly stated in the European treaties, demands for opting out from maximum harmonisation, such as adopting the euro and entering into the banking union, are increasing and becoming of a permanent nature. The political union of the euro area, at least in the degree necessary to make it viable, is not in the agenda.

The recent Five Presidents Report (EC, 2015) clearly recognizes the political impossibility of forcing member countries to comply with the European treaties and to adopt the common currency, which now brings with it increased losses of national sovereignty, as those due to the banking union. Thus the Report counts on its proposed reforms of the euro area to produce enough incentives for convincing EU non-euro area countries to apply. Apart from the usual dose of rhetoric, enlarging the set of rules and maintaining that convergence relates to rules and not to economic and social matters, the Report's proposals do not contain anything really new just because of real-political constraints. It should then not be a surprise that the Report has failed to revive the convergence process. On the contrary, and with some inconsistency, the more recent official attempt to reinterpret the European treaties' ever closer union just in terms of close cooperation to appease nationalistic fervours and to avoid exits from the European Union, renders the *de facto* two tiers union a permanent feature. The result is institutional inconsistency because the overall institutional framework built up to now following the

treaties' agreement to converge towards the common Economic and Monetary Union (EMU) is not functional to a permanent two tiers system. That entering into the European Union would have guaranteed the convergence towards, and enforcement of the democratic values and fundamental rights purported by its Charter is revealing an illusion; the political fragmentation touching also these substantial matters necessarily increases internal inconsistencies.

Major political and institutional problems then face the EU: whether the euro construction devoid of political union is a viable design or if it needs significant reforms; whether, with the euro area surviving, a permanent two tier system creates relevant internal conflicts, negatively affecting the entire decision process and design consistency, thus requiring a general institutional redesign.

If the lack of political union were seen as condemning the euro construction to fail in delivering acceptable results, a general repatriation of powers, higher than the one asked for by the UK before its referendum, could come to be considered as the best solution. The EU would then become an association of countries competing among themselves under a set of minimum common rules, thus under minimum harmonisation. This solution would not produce, or maintain the goal of, a single internal market, whose attainment requires maximum harmonisation, that is a close union. It would produce a preferential area weakly shielded from international liberalisation, but protected from eventual de-globalisation processes. It would be left to the asymmetric forces of member countries and markets to decide on the extent and type of economic integration. The disciplining power now weakly carried out by central institutions would be entirely left to markets. However, as the pre-Maastricht experience shows, international liberalisation, asymmetric powers and outlier and beggar-thy-neighbour behaviours could easily put an end to a regional union. This alternative design does not seem to be in any way more viable than the current one.

However, a permanent two tiers system, in reality a three tiers one considering the looser agreements with Norway and Switzerland, has nothing to commend it without introducing significant treaty changes. As things now stand, sub-group agreements, such as those governing the euro area (EA), cannot contain preferential clauses discriminating against EU non-EA countries because, it is argued, they would disrupt the internal single market. This constraint is built on a false notion because only centralised or federal states can produce a single market, and the EU is a coalition of fiscally sovereign states, not a federal construction. If the EA progressed towards significant forms of political union, it would produce its own single market inside a looser preferential area. Not being fair for EU non-EA countries to reap the benefits of a single area without paying the related costs, the EA progress towards a true single market soon encounters a

limit. Hence two options, both requiring revisions of treaties. Either to amend the clause of equal treatment, or establish a definite term-period to choose between adopting the common currency and external association.

The second option should however be accompanied by a reform of the EA that, differently from the proposals of the Five Presidents, would make it a viable construction and capable of offering enough incentives to join in. This is the perspective explored in this policy brief. Focusing on the EA and taking the relevant constraints coming from the existing treaties as given, monetary, fiscal and financial regulatory reforms are proposed that would increase the degree of institutional and policy consistency, would transform the current deflationary stance into a reflationary one, and would render financial regulatory harmonisation consistent with local specificities.

Reforming the monetary operations of the ECB

The EA member countries share a single currency, a single central bank, a single monetary policy, but not a single financial market.

For a single financial market to exist, all EA financial operators should have access to a single set of risk-free assets for pricing risks and managing liquidity. In short, they should confront a single risk-free yield curve. Retaining their fiscal sovereignty, the 19 euro countries produce 19 (almost) risk-free yield curves. As a consequence, the EA national financial markets are far away from forming a single regional market. The result is that we may have monetary convergence, as it happened before the recent crisis, but not monetary integration. As the recent experience shows, also at the international level, convergence is a fragile attainment.

The European Central Bank (ECB) was born and has been managed as if it were the central bank of a federal state. Its monetary policy operations are technically indistinguishable from those of a central bank serving a federal state. But the ECB is serving a coalition of states, each retaining full fiscal sovereignty. The result is that the effectiveness of its single monetary policy depends on the fragile convergence of sovereign ratings as expressed by private financial markets. Since the inception of the crisis, the ECB has enlarged its weapons to include the selective acquisition of national debt, justifying their adoption with the need to contain the fragmentation in the transmission mechanism of monetary policy across member countries. The fragmentation has been contained, but financial markets have learned from the management of the crisis that they cannot count on a common fiscal backstop to avoid private costly sovereign debt restructuring. On the contrary, some German authorities are proposing to extend to sovereign debt the bail-in clause applied to the resolution of failing banks. The result is that significant spreads across national sovereign debt are bound to remain, maintaining structurally fragmented EA financial markets and creating heterogeneous and fragile funding conditions for local financial and real operators, thus

impinging also on the economic aspect of the so-called single market. This while the creation of the euro area, defined as Economic and Monetary Union, was explicitly directed at deepening the single market by creating a single financial market. A clear inconsistency exists between the goal and the institutional framework.

The main fault of the Maastricht treaty was to seek to impose national fiscal rules as if they were good proxies of shared fiscal sovereignty. Apart from recurrent enforcement problems, the point is that no set of fiscal rules, even if adding macroeconomic constraints and liberalisation policies, will ever be capable of homogenising the credit rating of the member countries. The states forming the federal republic of the USA are a good example, even if they are aided by federal redistributive policies and, more in general, by conditions that approximate an optimal currency area better than the ones existing inside the EA.

As a significant political union is not feasible, the solution to the single financial market quandary is to render the ECB operations consistent with serving a coalition of sovereign states.

In its general outline, the proposals are quite simple. Financial intermediaries holding euro area national sovereign debt in their portfolios would be given the opportunity to swap it for ECB liabilities, or 'debt certificates' (DCs), which would cover the entire maturity spectrum of the yield curve. The issuance of DCs is already included among the tools that the ECB can use as part of its toolkit for open market operations. They are listed among the liabilities in the ECB's financial statement, and were up to now utilised on a small scale, particularly in the early years and very briefly in 2007 and 2009 to absorb liquidity. The monetary policy guidelines of the ECB classify DCs as structural open market operations, which would have a 12-month maturity and be sold at a discount in standard tenders managed by the national central banks. Despite the maturity specified in the policy guidelines, the EU treaties and the charter of the ECB do not pose limits on the quantity and maturity of DCs.

The issuance of DCs would be backed by the acquisition, in the secondary market, of a portfolio of sovereign securities of the euro area countries in proportion to the contribution of each country to the paid-up capital of the ECB (capital key). On completion, the ECB and EA national central banks would suspend their acceptance of sovereign national bonds as collateral for their refinancing operations and emergency liquidity assistance and restrict their operations to DCs, while financial operators would face a single risk-free yield curve.

As far as the ECB reputation for containing inflation remains credible, its DC liabilities would be effectively risk-free. A new seigniorage, call it S2, would then accrue to the ECB due to the difference between the average

return coming from the portfolio of sovereign securities and the cost of serving DCs. S2 would be paid back to national treasuries according to their capital key, and a part of it could eventually be used to feed a specific reserve fund against default risks, analogous to the one in use for private assets.

The DC scheme is not intended to deal with the sovereign debt problem, but to create the necessary conditions for the single EA financial market, thus posing all EA private operators on the same structural footing. Fully including DCs among the ECB monetary tools, their issuance would only respond to the demand for liquidity of the financial market and to the monetary policies decided by the ECB following its statutory objectives.

Debt dynamics and a revision of the fiscal rules

Although the DC proposal complies with the legal constraints posed by the existing EU treaties, and thus do not necessitate their revision, the scheme has relevant implications on the dynamic of sovereign debt that must be fully analysed.

Once the ECB operations on DCs have started, the total sovereign debt of each member countries is divided between the share held by the central bank and the share held by the market, which becomes the reference for debt sustainability (see Tonveronachi, 2016). If a positive functional link exists between the demand of liquidity and the rate of growth of nominal income (g) of the entire area is assumed, the emission of DCs and the corresponding acquisition of national sovereign debt follows the path of g . In these conditions, the rate of decrease of debt held by the market depends, for each country, on the overall initial amount of DCs issued, on the parameter linking the overall demand of liquidity to g , on the rate of growth of nominal income, capital key, outstanding debt and fiscal deficit of the specific country. In descriptive terms, for each country the increase of income decreases the numerator and increases the denominator of the debt/income ratio, being the reduction of the degree of indebtedness sensitive to the above specified parameters.

If the fiscal rule requiring a balanced budget when the debt held by the market oversteps the 60% ceiling is adopted, and adopt the sensible hypothesis that the parameter linking the demand of liquidity of the area to g is equal to one, the countries' debt negative dynamic with reference to their indebtedness and capital key and to hypotheses on the amount of the initial DC emission (i.e. debt acquisition) and the trend of individual g can be simulated.

With reference to debt data of end 2014, Table 1 shows the countries that would immediately go under the 60% ceiling under two alternative hypotheses of initial ECB debt acquisition: H1 = 2.5 trillion, which represents 1/3 of total securities and 27% of total debt; H2 = 3.7 trillion, which represents 1/2 of total securities and 40% of total debt. Under H2 only six countries would remain above the

60% ceiling at time zero.

Table 1 – Countries going immediately under the 60% ceiling		
	H1	H2
Austria	-	x
Estonia	x	x
Finland	x	x
France	-	x
Germany	x	x
Latvia	x	x
Lithuania	x	x
Luxemburg	x	x
Malta	x	x
Netherlands	x	x
Slovakia	x	x
Slovenia	x	x
Spain	-	x

A further implication is that under the 60% ceiling a negative debt dynamic would result from the positive trend of income. In order to show that below the 60% ceiling debt sustainability would be coherent with fiscal deficits, two alternative strategies can be examined. The first is to maintain constant the amount of debt held by the market, which means that the effect of increasing nominal income both on ECB debt acquisitions and the denominator of the debt ratio permits to couple diminishing indebtedness to a fiscal deficit; the second is to maintain constant the degree of indebtedness, which permits an even higher deficit. This follows from debt sustainability depending not on specific fiscal rules, but on fiscal rules that permit to comply with the chosen maximum level of indebtedness.

Given the favourable debt conditions created by the DC reform, we could prefer to create a further cushion of safety for debt sustainability, and transform the above two strategies into rules, binding the adoption of the first strategy for debt/income ratio below 60% but, let us say, higher than 30%; and the second strategy for the debt ratio below 30%. Table 2 shows for Germany the resulting debt dynamic under the H1 and H2 hypotheses.

Under H1, in the first 13 years the deficit would be roughly equal to what required by the current rule, but a fiscal space would anyhow come from the lower cost of debt. Under H2 the adjustment period is shorter and the equilibrium deficits and the overall fiscal space are significantly higher.

With the common political will to follow the above rules, the current structural deflationary stance of the EA could be transformed into a reflationary one. If, under H2, all the thirteen countries falling under the 60% ceiling at time zero adopted the first strategy, or rule, they would impress to the EA the aggregate demand push that it is now badly needed, with positive effects both on real growth and inflation. This would increase nominal growth for the remaining six countries, thus shortening their adjustment period and strengthening in the medium term the reflationary stance of the entire area. Under H2, $F = 0$ and enhanced growth, Belgium, Ireland and Portugal could adjust in four years, Italy in eight. Greece would anyway require some debt restructuring to shorten its adjustment period to a sensible level.

Table 2 – Debt dynamic for Germany

Years	H1 ; g=4.5				H2 g=4.5			
	D _T /Y	D _M /Y	D _B /Y	F/Y	D _T /Y	D _M /Y	D _B /Y	F/Y
0	74	53	22		74	42	33	
1	72	50	22	0.94	73	40	33	1.42
2	70	48	22	0.94	71	38	33	1.42
3	68	46	22	0.94	69	36	33	1.42
4	66	44	22	0.94	68	35	33	1.42
5	64	42	22	0.94	66	33	33	1.42
6	62	40	22	0.94	65	32	33	1.42
7	61	39	22	0.94	63	31	33	1.42
8	59	37	22	0.94	62	29	33	1.42
9	57	35	22	0.94	62	29	33	2.67
10	56	34	22	0.94	62	29	33	2.67
11	54	32	22	0.94				
12	53	31	22	0.94				
13	52	30	22	0.94				
14	52	30	22	2.22				
15	52	30	22	2.22				

Legend: D stands for debt, T for total, M for market, B for central bank, F for deficit and Y for nominal income. All variables are expressed as percentages.

The present proposal also offers the possibility to introduce enforcement rules on debt sustainability more effective than the existing ones, whose compliance has been up to now more the exception than the rule. As an example, a country would be expelled from the scheme if not complying with the new rules for two years or more in a five years' period, thus going back to the costlier current fiscal and monetary arrangement. Losing the benefits coming from the present proposal would represent a strong incentive to comply with the new rules.

Not being an instant panacea, the proposal would, however, entail a significant fiscal easing with respect to the existing rules. In addition to satisfying the chosen debt

threshold, the EA countries would gain flexibility to respond to special or unforeseen needs as well as to asynchronous cycles across the area. For countries that are in dire need of increasing and improving their infrastructures, the preferred solution might be to require the fiscal space acquired when debt is below the 60 percent ceiling to be used to finance public investments. Also considering the beneficial financial and real effects coming from the creation of the single financial market, the EA would resume a positive and credible design for its future and attract EU non-EA countries that are currently strongly resisting entering into it.

Financial regulatory reforms

If proof were required that public involvement in the financial system is critical for the entire economy and that a systemic view embracing the consistency of the whole spectrum of public policies is necessary, the recent crisis has abundantly provided for it.

The current regulatory framework, designed at the international level with the critical contribution of the EU and directed at producing national and international financial stability, fails in several main aspects.

Its focus on promoting or maintaining financial globalisation, hence on the regulatory level playing field, does not take into account the absence of a coherent and stable international monetary and financial arrangement. In these conditions, the regulatory level playing field abstracts both from the systemic fragilities affecting the world scene and from structural physiological differences across countries. Like the overall European approach, it is based on the convergence of rules and not of results.

The post Bretton Woods experience abundantly shows that leaving international imbalances to persist and prosper, and entrusting their management to private markets and institutions, only produces recurrent systemic crises. Global financial markets favour global actors that are too large and interconnected to be managed, supervised and resolved. Global markets make national anti-trust policies ineffective, especially because they abstract from market structures and go after specific abuses of dominant position. With financial regulation based on the freedom to innovate, financial morphology is moulded by private rent-seeking strategies, quite often directed at eluding regulation. Shadow banking is just an example. Independently of their relative size with respect to the overall financial activity, in the current institutional setup banks remain crucial actors due to their role in the payment system and credit creation. With regulation looking at their micro stability following international standards, banks' dynamic quantitative and qualitative response may well exceed, or fall short of the financial needs of the economy, especially when engaging in profit games that are only internal to the financial system. The current intense debate over the correct degree of bank capitalisation show the inexistence of any sound reference to excessive or insufficient degree of

bankarisation (total bank assets/nominal GDP). The recent macro-prudential additions to a fundamentally micro-prudential scheme fail to produce a consistent framework of economic policies because they appear to be ad hoc interventions, not stemming from a concerted view of economic policies and tools. The newly created special regime on the resolution of failing banks requires the mission impossible of drafting living wills for systemic banks; in addition, with the bail-in placing all losses on private unsecured and uninsured liabilities, at regime constituting a large share of total liabilities due to resolvability requirements and to the many exceptions, the scheme will enhance market discipline but in the direction of investors' early runs. The scheme suffers from the micro-approach that since its inception has characterised the Basel regulation; bank crises are extremely dangerous because they have the bad habit of being or swiftly becoming systemic. Given the opacity of bank operations, also idiosyncratic crises are capable of producing general runs. Instead of trying to avoid incentives to run, as it was done in the past by introducing deposit guarantee schemes, the bail-in design creates incentives to a general run. As Persaud (2016) vividly observes, markets cannot be relied on when there are market failures. Europe adds further problems as when giving to the European Commission ample discretionary powers for invoking the state aid regime on competition grounds for the intervention of the resolution and deposit guarantee funds, and for approving their proposals. Taking into account that existing national disparities on banks' fiscal treatment and exemptions on public ownership and guarantees are already heavily distorting regional competition, it makes little sense to punish new distortions in one country while those already originating from other countries are left untouched. The increasingly baroque and discretionary post-crisis regulatory framework is thus far away from levelling the playing field and enhancing financial stability, not secondarily because of the relevant increased regulatory compliance costs charged to banks. Being profitability the crucial component of long-term stability, it is difficult to explain its neglect by prudential regulators, especially in the EU where bank profitability, when properly expressed by the return on assets, is structurally low.

The first line of reform should concern the international monetary system. Keynes' proposal for an international clearing union should be resumed for entrusting to public hands mechanisms for limiting and managing international imbalances (Kregel 2015). Behind Keynes' proposal lies his idea that in order to leave countries with the enough flexibility to deal with internal economic and social goals, the post nineteenth century world order should have been built on a regulated form of trade internationalisation, but keeping private finance national.

Keeping finance national would eliminate the need to produce international regulatory standards aimed at producing an international regulatory playing field.

Financial regulation could thus resume the role of being one of the policy tools directed at domestic goals, as it was, at least partially, before financial liberalisation. Managed together with fiscal and monetary policies, its objectives would be to help both to maintain stability and foster growth and employment.

Keeping finance national would also break global banks and other financial institutions into independent national units, making them less big and interconnected. It would also leave national authorities free to deal with the systemic nature of single institutions and the financial system following national conditions and preferences, without their decisions affecting other countries.

The national or regional design of financial regulation could then follow some principles and suggestions offered by Minsky (1977; 1986). Following Minsky's analysis, the first step is to adopt a functional perspective starting from debt, intended as any form of guarantee granted to a counterparty. If financial institutions are unable to serve their debt, they fail. If they are supposed to be unable to serve their debt, funding disappears and illiquidity causes bankruptcy. This applies to financial institutions in general, not just banks. Three principles should be followed. First, financial institutions should be allowed to use leverage only if required by the physiology of their business, not as a means to amplify profits (and losses). Second, uniform regulation should apply to all leveraged financial institution. Third, the physiology of debt should only apply to what Minsky calls the acceptance function, by which new credit is created. In the present institutional setup, only those labelled as banks or credit institutions perform this function. In any case, any financial institutions allowed to create credit through leverage, basically by direct or indirect access to central bank's discount window, would be considered and regulated as a bank.

The adoption of the previous principles would produce far-reaching consequences. First, it would not require authorities to adopt a taxonomy for differently regulating financial institutions, a taxonomy easily circumvented by financial innovations. Second, shadow banking would disappear and with it a large portion of fictitious liquidity. The term fictitious liquidity is due to Kregel, according to whom the deregulation of the last decades "validated a plethora of diverse structures that were introduced to provide additional liquidity into the system as a result of competition between commercial and investment banking. [...] Indeed, the recent crisis can be described as the collapse of "fictitious" liquidity created by these structures, the failure of the banking sector to provide sufficient liquidity to prevent the onset of a 'debt deflation' (what Minsky defined as the ultimate attempt to access liquidity by "selling position to make position" – that is, selling assets in order to redeem liabilities), and finally, the inability of the Federal Reserve to intervene sufficiently quickly to ensure the provision of liquidity for the non-bank

financial institutions which could not find support from the insured banks.” (Kregel, 2012, p. 12). Third, securitisation could regain the transparency that had, and still has, in some European systems. Fourth, because financial contracts would be forbidden using leveraged instruments such as margins and haircuts, fictitious liquidity would take another fatal blow. Fifth, with trading requiring full coverage by own capital, the issues of specialisation, separation and ring fencing would only concern putting bank’s capital at risk in financial non-leveraged operations, which would anyway be much less attractive. This would pose no problem once capital requirements for banking operations were separately satisfied.

The substantial residual issue would be how to regulate banks. Minsky’s approach concerning size, assets growth and composition, liquidity and capitalisation gives again the required perspective.

Being one of the intended effect of the Banking Union (BU) to increase cross-border banking inside the EA, by tearing down almost all infra-area differences in supervision and resolution, *ceteris paribus* the BU will exacerbate the systemic threat posed by large banks, a threat that cannot be effectively countered by the prudential and structural measures that are being implemented. Not secondarily, the dimensional problem exceeds the economic sphere due to the distortions that it produces in democratic decision processes. The more direct solution would be to dismember banks that trespass a given size, let us say 100-150 billion euro, which is a level where genuine economies of scale and diversification are already exhausted and up to which resolution of failing banks remains manageable.

In order to keep the dynamics of bankarisation within the physiology of credit creation as determined by the chosen macroeconomic objectives, the growth of bank assets (that in steady growth equals that of capital) should be constrained to roughly equate in the medium-term the sustainable average growth of NGDP. Taking a long-term perspective, banks’ growth is geared to internal growth which depends on profitability, leverage and retention ratio. Minsky proposed to impose a common ceiling to leverage and then use the retention ratio to discipline the asset growth of individual banks. With respect to the current bottom-up approach, we would shift to a top-down one. Because under the present proposal only banks can assume debt, the leverage of the entire financial system would thus be kept under control. The more resilient configuration of the mix of the above parameters comes from reaching the desired growth objective with higher profitability and lower leverage. Given that in the long period bank profitability is a crucial ingredient of a smooth growth of the economy, the coordination and not independence of fiscal, monetary and financial regulatory policies is called for. Under the present proposal for the monetary and fiscal policies of the euro area, the creation of a truly single financial market would decrease the

rigidity coming from applying a common monetary policy to a diversified area. Some of the residual policy rigidities would be dealt with by the acquired flexibility of national fiscal policies aided by the flexible Minskyan macro prudential regulation applied at national and case-by-case level. Besides, the reflationary stance coming from these reforms would help banks' profitability. The single supervisory mechanism (SSM) of the banking union would be called to enforce the above general principles, not the same specific rules to all member countries and to all banks. If, as I argue below, regulation should do away with risk-sensitive capital requirements, focussing instead on an un-weighted leverage, the SSM would predominantly become a macro prudential authority. Given that under our reform the more relevant coordination at the national level would be between fiscal and regulatory policies, a single systemic financial authority (SSFA) separate from the central bank could include, both at the national and centralised level, the three pillars of the BU, supervision, resolution and deposit guarantee, each with independent but cooperating operative powers. This solution would also help to bring institutional homogeneity and clarity to the current heterogeneities both across member countries and with respect to the centralised model. This institutional reform would, however, require introducing modifications in the Treaty of the Functioning of the European Union (TFEU). Because authorities not disciplined by the EU treaties must be created by means of regulations, art. 291 of TFEU requires that implementation powers rest with the Commission and the Council, as it was recently established for the banking union's Single Resolution Authority. This would create both an institutional monster and an unacceptable disparity with respect to EU non-EA member countries.

The issue of the composition of bank assets should be seen in the Minskyan perspective, according to which the fragility of banks also depends on the fragility of the positions that they finance. Because long-term investments are speculative and often Ponzi positions, the problem they pose is not just one of liquidity but of excessive credit risk. Because experience shows that mortgages are the type of long-term investments that in most cases cause financial crises, the previous rule on constraining the growth of bank assets could be partially ineffective if real estate bubbles cause NGDP booms, being the two politically difficult to contrast. Following a generate-to-distribute model, which has a long and not infamous tradition in Europe, the addition of simple macro prudential rules, as the ones currently discussed and sometimes applied on ceilings to debt/equity ratio and debt service/income ratio, would help to contain systemic leverage and keep credit risk within acceptable limits, thus generating more trustworthy securitised assets. This strengthens the case for changing the SSM into a macro prudential authority.

Although reduced to non-systemic dimensions and

backed by deposit guarantees, maturity mismatch requires that banks should be submitted to limitations on risks of concentration and maturity transformation. With credit and liquidity creation part of the same function, physiological hedging requires first of all to limit ex ante those risks, not to leave them wide open and partly hedge them with capital and short-term liquidity. Instead of the costly and useless Basel's liquidity coverage ratio, and of the complex Basel's net stable funding ratio, simple limits to maturity transformation could be adopted both for banks and non-bank firms.

Finally, the issue of regulating bank capitalisation. As noted above, the level of minimum capital requirement should follow from dynamic considerations and take into account the medium-term profitability of banks. Higher capitalisation should be required for systems with more profitable banks. Creating the conditions for profitable banks means, by maintaining their growth in check, higher resilience also because of higher capitalisation. Hence, the need not to burden banks with useless and costly regulation. This leaves the issue of how to define and compute minimum capitalisation. The experience gained by the introduction of Basel's risk-sensitive capital requirements militates against that approach and in favour of an un-weighted leverage ratio, possibly strictly based on own capital. Experience abundantly shows the ineffectiveness and distortions coming from the attempt of regulators and supervisors to meddle with industry-based concepts of risk measures and to follow risk-sensitive capitalisation. The elimination of the current enormous regulatory costs, rigidity and complexity, especially high for smaller banks, coming from a leaner approach would also help to fill EU banks' depleted coffers and leave bankers free to add qualitative to quantitative risk evaluation.

Such radical regulatory redesign would encounter the formidable opposition of the many and well-placed advocates of globalisation and of powerful vested private and public interests, not least by regulators and supervisors that have invested much efforts and credibility in the current design. However, the opinions of experts and authorities on the current design are far from being unanimous. Although maintaining the previous design as the final objective and remembering that finance is not substitute for sustainable demand, we could start from a configuration on which the convergence of opinions would be easier to obtain, limiting deviations from international standards and giving enough time for financial firms to adjust their business models. The following points provide a rough outline of the first measures to adopt.

1. The distinction between leveraged and non-leveraged institutions would be implemented, giving time to adjust to progressive diminutions of instrument leverage (margins and haircuts) for trading operations.
2. Conversion of foreign branches into foreign subsidiaries, fully subject to national or regional regulatory

requirements, starting from those with local systemic footprint.

3. Obligation to ring fence banks' commercial activity from trading operations on own or customers' account.

4. Decrease the size of banks with assets higher than 100-150 billion euro by imposing them a negative rate of growth for both the banking and trading book. Empower supervisors to intervene on the pay-out ratio not just to increase capitalisation, but mainly to discipline asset growth.

5. Abolition of Basel's internal models for risk evaluation (IRB) and adoption for large banks of a simplified version of the current standardised methods; smaller banks would be only subject to the constraint of a minimum unweighted leverage ratio. All banks would be subject to simple ceilings on risk concentration and liquidity mismatch.

6. Given a common floor, the Basel constraint on minimum leverage ratio would not be homogeneous across countries and banks, but flexibly adapted to local conditions and needs.

7. Establish minimum but significant stable requirements on debt/equity and debt service/income ratios for the origination of mortgages.

8. In the resolution of failing banks, limit losses to own capital and subordinate securities. State intervention should be considered as physiological and the eventual public debt created to resolve banks, also through guarantees, should be accounted for as net of the book value of the new/bridge bank. The sovereign debt space created by the ECB reform more easily allows for public intervention, national or through the ESM, in the resolution of troubled banks. Hence, the state aid regime, now interfering with resolution, should be limited to well-documented and significant distortions of competition produced by bank resolution. The European Commission's discretionary powers should be consequently restricted when approving decisions by resolution authorities.

POLICY IMPLICATIONS AND RECOMMENDATIONS

Conclusions

The three areas of reform dealt with in the previous pages do not obviously exhaust all structural problems affecting the euro area. However, the political convergence required for their adoption would mark a new start with respect to the increasing fragmentation experienced in the last years. Reverting the current deflationary trend, the reforms would bring new stimulus to deal with the remaining issues. The hope is that Keynes was right in singling out old ideas and not vested interests as the main obstacle for solving economic and social problems.

RESEARCH PARAMETERS

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

PROJECT IDENTITY

PROJECT NAME	Financialisation Economy Society and Sustainable Development (FESSUD)
COORDINATOR	Professor Malcolm Sawyer. University of Leeds, UK: email fessud@leeds.ac.uk
CONSORTIUM	University of Siena, Italy School of Oriental and African Studies, UK Fondation Nationale des Sciences Politiques, France Pour la Solidarité, Brussels, Belgium Poznan University of Economics, Poland Tallin University of Technology, Estonia Berlin School of Economics and Law, Germany Centre for Social Studies, University of Coimbra, Portugal University of Pannonia, Veszprem, Hungary National and Kapodistrian University of Athens, Greece Middle East Technical University, Ankara, Turkey Lund University, Sweden University of Witwatersrand, South Africa

University of the Basque Country, Bilbao, Spain

FUNDING SCHEME

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EU contribution: 7,923,728.02 euros

WEBSITE

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