What are the constitutional limits on economic policies within the European Union? How has the situation of federal, centralised operation of monetary policy, on one hand, and the almost entirely national control over fiscal policy, on the other hand, been achieved? The structure of the financial system in larger and smaller EU member states. These and other topics are discussed by Charles Goodhart, Deputy Director of the Financial Markets Group, London School of Economics.

FINANCIAL MANAGEMENT IN THE EURO ZONE

Charles Goodhart[1]

Constitutional Limits on Economic Policies within the European Union

Estonia has a currency board system. What you gain is price stability, a nominal anchor for internal/external prices. What you lose is discretionary flexibility to adjust your own exchange rate/interest rate. Moreover, under a strict interpretation of currency board rules, a central bank cannot lend to domestic banks. A margin of flexibility both to support the local economy and local banks, at times of need can be achieved by fiscal measures if the fiscal position is initially strong. If the fiscal position is weak, as in Argentina, then under a currency board both a government default and a banking crisis is possible.

> **The EU has not, for the time being, perhaps for the foreseeable future, become a federal system.**

In some ways membership of the euro zone is, for the participating nation states, quite akin to belonging to a wider currency board system. But the EU has not, for the time being, perhaps for the foreseeable future, become a federal system. There are several possible criteria for assessing the extent of federalism in a system. The one that I want to emphasise relates to the ratio of fiscal competences, government expenditures and taxation that is determined by and passes through the hands of the federal centre, as compared with the subordinate (nation) states. In most federal systems, the USA, Australia, Canada, Germany, the ratio is about two or three times as large for the

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federal budget as for state budgets. In the EU by contrast the federal budget is well below 2% of EU GDP whereas national budgets are generally around 40% of national GDP.

This makes the EU federal centre fiscally weak and enfeebled, the more so since it cannot constitutionally run a deficit and borrow in its own name. **That fiscal weakness has several consequentials. One is that there is no inbuilt quasi-automatic mechanisms for helping to stabilise asymmetric shocks affecting some of the Member States**. In a proper federal system, a state which hits a particularly rough spot will get support by inward transfers from other states as its federal taxes fall and its federal benefits rise. In the early days of the Maastricht process, I and some other economists did a study for, and with, the European Commission to consider what minimal fiscal supplementation to the EU budgetary arrangements could be designed to allow federal fiscal policy support the federal monetary policy of the ECB, notably by enabling the federal centre to help stabilise asymmetric shocks in the constituent nations and regions. I think that we did a good job in our paper on 'Stable Money – Sound Finances: Community Public Finance in the Perspective of EMU', *European Economy* (1993)[2]. But in the event our proposals were turned down flat by the majority of nation states, mostly the richer ones including the UK, who were unhappy to allow any further significant transfer of fiscal competences to the EU.

The problem, however, that I want to highlight today is that the resolution of financial crises can be fiscally extremely expensive, for example in the recapitalisation of failing banks. Examples abound in Scandinavia, Japan, Latin America, etc., as has been enumerated and documented in several official and academic studies. For example Bordo et al. (2001)[3], Caprio and Klingebiel (1996[4], 1999[5]), Frydl (1999)[6], Hoggarth et al. (2001)[7], Lindgren (1996)[8]. Indeed, it is often necessary to be able to rely ultimately on a deep fiscal purse to be able credibly to control and surmount a financial crisis or panic.

The burden of any financial rescue will continue to fall on the Member States.

The key point of all this from an EU perspective is that there is, not only currently but for the foreseeable future, no capacity for the federal authorities to provide any fiscal support, for example to support failing banks, in order to stem a financial crisis within the EU. They just do not have the

[2] Commission of the European Communities; report of an independent group of economists, 1993. Stable Money – Sound Finances: Community Public Finance in the Perspective of EMU. *European Economy*, 53; also see, by the same authors, 1993. The Economics of Community Public Finance: Reports and Studies. *European Economy*, 5.
[3] Bordo, M., Eichengreen, B., Klingebiel, D., Martinez-Peria, S., 2001. Is the Crisis Problem Growing More Severe? *Economic Policy*, 32, April, 53–92.
[4] Caprio, G., Klingebiel, D., 1996. Bank Insolvencies: Cross-Country Experience. *World Bank Policy and Research WP* 1,574.
[5] Caprio, G., Klingebiel, D., 1999. Episodes of Systemic and Borderline Financial Crises. *Mimeo*. World Bank.
[6] Frydl, E.J., 1999. The Length and Cost of Banking Crises. *IMF Working Paper* 99/30.
[7] Hoggarth, G., Reis, R., Saporta, V., 2001. Costs of Banking System Instability: Some Empirical Evidence. *Bank of England Working Paper*, 144, November.
[8] Lindgren, C.-J., Garcia, G., Saal, M., 1996. Bank Soundness and Macroeconomic Policy. IMF, Washington DC.

fiscal competence to do so; nor could the federal authorities borrow from markets to obtain funds to finance a rescue. That effectively means that the burden of any financial rescue will continue to fall on the Member States. Any question of burden sharing between nation states cannot be internalised within the EU but would, presumably, be the subject of political negotiation and discussion between nation states. I will return to this key point later.

Interactions between Fiscal and Monetary Policies

The norm in sovereign states is for the key levers of monetary and fiscal policies to be centralised at the centre of the state, whether federal or unitary in constitutional form. **The EU is, to the best of my knowledge, almost unique in maintaining a disjunction between the federal, centralised operation of monetary policy and the almost entirely national control over fiscal policy**. This disjunction is, perhaps, the main source of strain within the EU.

How did it come about? One somewhat cynical view is that the strains had been anticipated at the outset, but that such pressures were even partly welcomed as being necessary to push otherwise unwilling nation states towards greater fiscal federalism. Such a view is sometimes attributed to French economists who have argued, usually against German economists, that monetary union will be the key to deliver economic and political union more widely.

A second explanation is that the divorce between monetary and fiscal policy arrangements occurred because mainstream economists systematically under-estimated and failed to recognise the importance and strength of the links between the two arms of policy. Thus the mainstream of economists, from Menger (1892)[9] over 100 years ago to Kiyotaki and Wright (e.g. 1989[10], 1993[11]) nowadays, sees the main function of money as its medium of exchange function, with its development arising from private sector attempts to minimise transactions costs in markets. In this story social relationships and government do not play any essential role. In the EU context the main analytical tool used to assess the desirability of the single currency, the euro zone was optimal currency analysis, or OCA, in which again social relationships and governments play little role.

In contrast to the mainstream theorists, there is another school of thought, stronger in the other social sciences, such as numismatists, sociologists, archaeologists, anthropologists, and historians of ancient societies, than in economics, who regard the main function of money as being its unit of account role for settling inter-personal debts and credits, usually initially arising out of the need for payment to settle legal, tax, or other social/

[9] Menger, K., 1892. On the Origin of Money (translated from German by Foley, C. A.). *Economic Journal*, 2, 238–55.
[10] Kiyotaki, N., Wright, R., 1989. On Money as a Medium of Exchange. *Journal of Political Economy*, 97, 927–54.
[11] Kiyotaki, N., Wright, R., 1993. A Search-Theoretic Approach to Monetary Economics. *American Economic Review*, 83, 63–77.

power relationships within the social system. On this view, money developed first as a social mechanism, and only subsequently became co-opted into the market system as a common medium of exchange.

This latter viewpoint is usually termed Chartalist or Cartalist, and is currently experiencing a renaissance, including one book to which I contributed, 'The State, the Market and the Euro' (2003, eds. S.A. Bell and E.J. Nell)[12]. On this view fiscal and monetary policies are intimately tied together. Thus intrinsically worthless pieces of paper in the form of fiat money are given value because this medium is what the government will accept as a means of payment for its currency. Equivalently a government with the capacity to print money can never be put in a position where it has to default on its domestically denominated nominal debt. It can always print money to meet such obligations.

Fiscal and monetary policies are intimately tied together.

The former linkage remains in the EU, that is to say that all the national governments accept euro in payment for taxes, so the inherent value of the euro fiat currency is fully maintained. But the latter link has now gone. The participating nation states in the euro zone no longer have the sovereign ability to print their own money. This means that they no longer have the unquestioned means of paying off their domestic debt obligations. They can now be forced into bankruptcy, into default.

Under some circumstances default is not necessarily too disastrous. **But in the context of the euro zone, the financial intermediaries, banks, and life insurance companies in particular, hold so much of their own government's debt that the default of a national government would most likely entail the collapse of the domestic banking and financial system**. For that, and other reasons, the prospect of default for a participating national government was held to be unacceptable, in the Report of the Delors Committee, in the fiscal conditions of the Maastricht Treaty, and then finally incorporated in the Weigel Stability and Growth Pact, enshrined now in the Amsterdam Treaty.

What the Stability and Growth Pact does is to seek to enforce sufficient fiscal discipline in order to minimise the risk of national default, by placing a limit on the size of the governments' acceptable fiscal deficit; there was also initially to be a constraint on the scale of the stock of debt, but this has for some, unexplained, reason become a dead-letter, not enforced. A resulting problem, however, is that when a nation state reaches the limit of its allowable deficit under the Pact, it has no macro-economic instruments left at all to counter a local recession. All the standard policy tools, fiscal, monetary, and exchange rate will have become constrained. The nation will find that it has little policy flexibility, or degrees of freedom.

[12] Goodhart, C.A.E., 2003. The Two Concepts of Money: Implications for the Analysis of Optimal Currency Areas, I peatükk raamatus *The State, the Market and the Euro*, Bell, S. A., Nell, E. J., toim. Cheltenham, UK: Edward Elgar, 1–15.

One standard response is that the nation only has itself to blame because, had it been more fiscally conservative and responsible beforehand, it would have had more freedom of manoeuvres in the downturn. While this is true enough, it is in fact little solace for those who have the present responsibilities for managing the economy. Another response is that the fiscal constraints on the nation states in the euro zone are less than those imposed on the constituent states in many other federal countries, notably in the USA, where most of the states have a balanced budget requirement. While that is true enough, the states in most other federal countries have two advantages for dealing with localised recessions, which the nation states in the euro zone lack. The first is that the mobility of the population, moving from areas of high unemployment to areas of low unemployment, is far greater in most other federal states than in the euro zone; in the latter differences in language, culture, social security systems, and so on reduce mobility. Second, as already noted, **the federal budget in these other countries but not in the euro zone acts as a quasi-automatic stabiliser. This suggests to me that within the euro zone nation states should have more fiscal lee-way for cyclical stabilisation than the current Stability and Growth Pact allows**. If that should raise the possibility of default above the present miniscule level, perhaps a better approach would be to limit the consequential implications of such a default by imposing strict regulatory limits on the proportionate holdings of any one government's debt, including that of its own government, on the banks and other financial intermediaries of each country.

But that is another story. The point that I want to make here is that the resolution of a financial crisis can be very expensive, and the only real source of such funding is going to be the taxpayer. It is not really possible, feasible, or desirable either to make the commercial bank system pay out deposit insurance premia, *ex ante*, against the possibility of an extreme event crisis, nor to expect them to contribute much to a massive *ex post* bail-out, especially when there is a significant number of foreign-owned banks amongst them, who are more immune to pressure from the authorities.

The resolution of a financial crisis can be very expensive, and the only real source of such funding is going to be the taxpayer.

But the scale of the fiscal burden arising from the crisis, usually for the recapitalisation of insolvent banks, can be massive, as instanced by numerous examples in Latin America, in Japan, and elsewhere in Asia. If such a crisis should occur and was met by the taxpayer, it could blow apart the Stability and Growth Pact fiscal limits. I cannot imagine that in such an example the Pact's fiscal limits would be enforced. I would assume that, under those circumstances, the Pact would simply be put on one side and discontinued for the time being.

The Structure of the Financial System

With the EU federal centre unable to provide fiscal support to meet such burdens as might result from handling a financial crisis, the national treasuries would have to do so. The usual assumption is that any such financial crisis will be concentrated in a single country, so that the responsibility of crisis management will fall upon one single country, rather than needing to be shared, somehow, between countries.

So far, despite the desire to achieve a single integrated European financial system, reaffirmed as part of the Lisbon process, the assumption that financial problems will remain concentrated in single countries has remained largely correct. Problems in France, e.g. Credit Lyonnais[13], have been handled and focused within that country, and the same goes for the other main nation states in Western Europe, e.g. Germany, Italy, Spain, and the UK.

That is a consequence of the fact that whereas wholesale financial markets within the EU are fully integrated and international, retail markets, notably including commercial banking, are not. Thus Baele et al. (2004)[14] show that the wholesale money markets, and Eurobond markets for government and corporate debt are fully integrated over the whole EU. In contrast the market for bank credit remains quite segmented between countries, and equity markets are only partially integrated.

Again the wholesale market in investment banking, e.g. M & A activity, new issues, corporate restructuring, etc., is largely dominated by the big international houses; several of these are not EU headquartered (e.g. US: Goldman Sachs, Citigroup; or Swiss: CSFB, UBS), though a few are from the euro zone, e.g. Deutsche Bank, BNP Paribas, ABN Amro, HSBC. In contrast retail commercial banking is almost entirely national in character, at least in the big nations in the EU. This is so for Germany, Italy, France, Spain, the UK, Ireland, Portugal, and Greece.

This latter is partly driven by the attempts of the authorities to keep their main domestic banking groups national in character. They have encouraged defensive mergers nationally and even the promotion of 'national champions'. They have in some cases put up barriers against the entry of a foreign bank, especially the entry by a merger with a domestic bank.

Moreover, there is evidence that the existence of borders between countries with their different languages, legal systems, tax systems, and cultures makes it more difficult for a foreign bank to enter these countries. Degryse and Ongena (2004)[15] outline the effect of borders on the geographical spread of banking in the EU. Moreover, where foreign banks do establish a presence in another country, this is more often done via establishing a subsidiary, often through a merger with a domestic bank, rather than by *de novo*

[13] In the 1980s, the state-owned Credit Lyonnais offered many loans which later turned out bad ones, and then falsified its accounting data to cover up the losses. (Editor's note.)
[14] Baele, L., Ferrando, A., Hördahl, P., Krylova, E., Monnet, C., 2004. Measuring European Financial Integration. *Oxford Review of Economic Policy*, 20(4), (Winter issue on European Financial Integration), forthcoming.
[15] Degryse, H., Ongena, S., 2004. The Impact of Technology and Regulation on the Geographical Scope of Banking. *Oxford Review of Economic Policy*, 20(4), (Winter issue on European Financial Integration), forthcoming.

branching, see Dermine (2002)[16]. This common tendency has remained, despite the fact that the 'common passport' established by the EU Banking Directives was meant to facilitate cross-border branching. Like most decisions on corporate structure, this was no doubt largely driven by tax considerations. Even so, it probably also reflected a desire to harness local (asymmetric) information and to benefit from local loyalties and habits. Whatever the cause **the fact that such cross-border banking penetration in the EU has occurred via subsidiaries rather than via branches has reinforced the continuing separation between the national banking systems**.

The focus of (banking) regulation and supervision naturally falls on commercial banks. Given the two key facts that the national banking systems have remained segmented, and that any burden from financial crisis resolution has to remain with national treasuries, absent any fiscal competence for this purpose at the EU level, the inevitable corollary is that the key powers of supervision and crisis management will remain, for the foreseeable future at the national level.

This is, in some respects, untidy, because the implication is that the domain of monetary policy is not coterminous with the domain of regulatory/supervisory policies, as remarked on several occasions by Padoa-Schioppa, e.g. in 'Regulating Finance' (2004)[17]. Indeed so, but this is just a reflection of a deeper disjunction which is that the effective domains of monetary and fiscal policies are not coterminous, with the former being centralised while the latter remains at the national level.

Nevertheless, it would become much more difficult, as we shall see, to maintain bank supervision, and crisis management at the national level were the commercial banking system to become much more fully integrated amongst countries throughout the EU. This latter integrationist outcome is what has been, in principle, the objective of the Lisbon process and of other EC initiatives. Be that as it may, the (major) nation states within the EU continue to drag their heels in allowing for international competition in their partly protected domestic retail markets, including equity markets as well as retail banking.

There is a contrast in this respect between the bigger nations in the EU and the smaller countries. **In the smaller countries there has been less disposition, perhaps because of less power, to maintain the purely national characteristics of domestic banking**. In the Scandinavian countries the largest banking conglomerate, Nordea, now covers all the four countries, despite these countries' differing positions within the EU and euro zone. This interpenetration was in some part accelerated by their financial crisis in the early 1990s. Again the Benelux countries have seen increasing bank interpenetration with Fortis and ING Bank becoming international, rather than national. And recently there has been a take-over of a locally large Austrian domestic bank by a German bank.

[16] Dermine, J., 2002. European Banking: Past, Present, and Future. *Conference Paper*. Frankfurt, Second ECB Central Banking Conference.
[17] Padoa-Schioppa, T., 2004, Regulating Finance: Balancing Freedom and Risk. Oxford, UK: Oxford University Press.

The penetration and involvement of foreign banks is most marked in East European countries, both those now in the EU and some prospective candidate countries. In some ways your histories have had some common threads. Following the dissolution of Comecon, and the collapse of communism, the liberalisation of the banking system led to the establishment of a large number of indigenous, local private banks. But many of these were under-capitalised, and, even more important, after so many years of socialist centralised planning there was insufficient knowledge of the requisite key skills of banking, e.g. project assessment and monitoring, and risk management. The inevitable result was that a large proportion of such local banks failed, as you in Estonia had to face, and something of a vacuum developed which became filled by an assortment of foreign banks.

So, in most East European countries, a large proportion, often a majority, of bank deposits and bank assets are placed with foreign-owned banks, in almost all cases, as already noted, in subsidiaries of such banks, not in branches. **So, there is a major division within the EU between the large countries with a primarily nationally-owned retail banking system and the smaller countries with a large proportion of foreign-owned banks in their banking system**.

Crisis Management when the Banks are Foreign-Owned

It is to be expected that the large countries will establish the structures and procedures within the EU that best suit themselves. With their banking systems remaining mostly domestically headquartered, (and political pressures for supporting national champions), and with any fiscal burdens from crisis management falling on national treasuries, the big countries will persist in insisting on the maintenance of nationally-controlled bank supervision, and on control over lender of last resort lending and crisis management. This was the gist of the letter on this subject issued by Chancellor Brown of the UK and the Finance Minister Eichel of Germany on the occasion of the Oviedo ECOFIN meeting in April 2002. Such national control over supervision and crisis management suits the big countries in the EU. Despite the desire of some at the ECB for greater centralisation, absent banking interpenetration in the big countries and any federal fiscal competence, the wishes of the large nation states will prevail here.

The big countries will persist in insisting on the maintenance of nationally-controlled bank supervision.

Now, where exactly does that leave you, especially you here in East Europe, with your banking systems largely consisting of subsidiaries of foreign banks. The mainstream line of argument in the West, especially in the USA, is that it actually leaves you in a much better, strong position. The foreign banks that have entered your country are, initially at any rate, likely to be better resourced and more professional than the local banks; indeed, that was one of the reasons why there was an opening for them to enter in the first place. Next, even though a subsidiary is technically separate from the main bank, the reputational effect of allowing a subsidiary to fail – except in the kind of political *force majeure* situation seen recently in Argentina[18] – could be disastrous. So, a subsidiary may well have the full strength of the consolidated bank standing behind it. Thus, it can be argued that **a country, like yourselves in Estonia, has a currency board which ties your price stability to the euro zone, and foreign banks which allow your financial stability to be guaranteed by the oversight of foreign supervisors and the full consolidated strength of those foreign banks**.

There is some considerable validity in the claim that you can comfortably piggy-back in these respects on the greater strength of such more-developed neighbours. But that comfort is not without its limits and in need of some qualification. The banking systems in many developed countries, including Austria and Germany, collapsed in the 1930s. There was a serious danger of a major international systemic banking collapse in 1982, when Mexico, Argentina, and Brazil simultaneously defaulted on their banking debts, leaving many major international banks technically insolvent. The problems of the Japanese banks in the 1990s are well-known.

It is just not the case that a foreign-owned bank is by definition an absolutely safe bank. So, what would happen in the case of a crisis affecting such a bank with a subsidiary in your own country? One answer is that we do not really know since no such crisis with international ramifications has yet arisen. In the absence of any such crisis, some countries with cross-border interpenetration of retail banking have been running simulated ‘war games’, playing out scenarios in which such a bank is assumed to run into serious difficulties. I understand that the results of such ‘war games’ have been instructive, but not always comforting. I wonder whether any such exercises have been undertaken whereby both home country supervisors and host country supervisors in East Europe have come together to explore how they might handle a joint problem. Although simulations, scenarios and ‘war games’ are worth doing, and much better than trusting to luck, hoping that everything will be ‘all right on the night’, simulation provides only partial preparation for the real event. **This is one reason why supervisors in Europe would quite like to experience a ‘small crisis’, big enough to provide lessons about how to handle such occasions, but small enough that any mistakes in crisis management do not have catastrophic results**.

Another partial answer is that crisis situations would be handled by enhanced co-operation between supervisors. A network of mostly bilateral memoranda of understanding, or MOUs, have been negotiated between supervisors, especially to handle home/host relationships. I would hope that these exist in Estonia with those countries where the banks with subsidiaries here are headquartered. But these MOUs relate mainly to the sharing of information, rather than the sharing of any fiscal burdens that a financial crisis might entail.

[18] Reference to the situation in Argentina where bank subsidiaries went bankrupt since the government set different exchange rates on assets and liabilities, did not pay back its own loans, and did other decisions harmful to banks. (Editor’s note.)

Even with information flows, the direction of such flows is, perhaps, rather more likely to be from host to home country than vice versa; on such information flows, see Holthausen and Ronde (2004)[19]. If a host country subsidiary gets into difficulty, it is bound to look to the home headquarters for assistance. With the failure of a subsidiary having a potentially devastating, reputational effect on the main bank, – and with the home regulator supposed to have an overall, consolidated view of the position of the commercial bank as a whole – the host country has to inform the home country supervisor of any problems in the subsidiary. It is less clear what the value would be of a home country supervisor telling host countries, where the subsidiary/branches are healthy on their own, of problems back at headquarters. Secrecy can often be vital in preventing runs and panics before remedial measures can be put in place, so the tighter such charged information can be kept the better. Moreover, if the host country subsidiary has remained healthy, what action is the host country supervisor supposed to take? Indeed, the host country supervisor may be placed in a nasty dilemma if she is informed of problems in the home country. One obvious response is to forbid the local subsidiary from transferring assets back to headquarters, but that may further weaken the home bank both directly and indirectly via reputational effects. On the other hand, to fail to act to keep the subsidiary's assets safely within the country could raise the fiscal burden falling on local taxpayers.

The question of how far the host supervisor may feel impelled to enter into an asset grabbing race at the very first whiff of bankruptcy will in turn depend on the bankruptcy laws of the home country. **Indeed, almost the first requirement for a host country supervisor is to make themselves fully conversant with the laws relating to the procedures for handling bank failures in the home country**. Several countries, notably the US and Australia have so-called 'ring-fencing' arrangements whereby assets available to the domestic liquidator have to be used first to pay-off locally resident depositors in full, before other creditors including foreign depositors get paid anything. Many other countries, like the UK, maintain a *pari passu* regime whereby all creditors of a particular seniority get paid equally out of a common pot of assets, irrespective of nationality or residence.

Clearly when a country is hosting a subsidiary from a ring-fencing home country, it will want and need to be much more careful about that subsidiary maintaining a sufficient local assets ratio; especially in a crisis it will be concerned that headquarters should not strip the subsidiary's assets for repatriation.

Assume that a crisis arises in a bank with subsidiaries in two countries, and headquartered in a third, because loans made in one of the two subsidiaries go bad. Let me take a numerical example, with headquarters in country A and subsidiaries in B and C. Loans made by C become non-performing, so that the supposed local assets and deposits are as indicated in the following Table:

	A	B	C	Sum
Assets	120	110	40	270
Deposit Liabilities	100	100	100	300

[19] Holthausen, C., Ronde, T., 2004. Cooperation in International Banking Supervision. European Central Bank. *ECB Working Paper, WP*, 316, March.

Although in the bank as a whole liabilities exceed assets, the deficiency is, in this example, concentrated in subsidiary C. So, the first question is whether the parent bank can just walk away from this subsidiary and leave the host country, and its deposit insurance fund (if any), to pick up the bits. The ability of the parent to distance itself from problems in the subsidiary may depend on circumstances. For example, were losses in the subsidiary caused by local factors, e.g. government interference (as in Argentina), over which the parent bank could have had no control, or was the loss caused by managerial failures which the parent bank should have prevented, e.g. Barings in Singapore, Allied Irish Bank in the USA? Again, it is easier for a parent to walk away from a subsidiary in dire straits if the name of the subsidiary is distinct from that of the parent. Particularly if the name is the same, and if the key operational decisions have been taken at parental head-quarters, reputational effects make it hard for a parent bank just to cast a subsidiary adrift.

Assuming that the supervisors in A choose to liquidate the headquarter bank, can the B supervisors keep the subsidiary going in business as a separate stand-alone bank? The experience of BCCI[20] (Hong Kong) suggests that the indirect reputational effect would be too great. Assume that country A has a *pari passu* bankruptcy law, so that if all assets and liabilities were put into a single pot and spread out equally, then each depositor would get paid 90 pennies in the kroon, would not there be an enormous temptation on the politicians and supervisors in B to undertake some *de facto* ring-fencing of their own, by repaying local depositors in full from local assets, and then returning just ten assets to the head office liquidator, so that depositors in A and C would get 85 pennies in the kroon, not 90. Assume next that A has a ring-fencing bankruptcy procedure. A and B depositors get paid in full, whereas C depositors would get just 70 pennies in the kroon. The lesson for host countries is to be especially careful and conservative whenever the home country ring-fences.

The problems are likely to be even more difficult when there is a wish by A country supervisors to recapitalise the bank and keep it as a going concern. There is no difficulty if A is prepared to face the fiscal burden all on its own, but A country politicians and tax-payers will surely demur. After all the failings arose in country C. Should not those who allowed that to happen, i.e. the authorities in C, share in the costs of recapitalisation? Moreover, the benefits of banking intermediation are shared amongst the depositors and local borrowers, in this case roughly equally, in A, B and C. Why should not the cost of recapitalisation also be shared out equally amongst the three countries? I rather doubt, however, whether the politicians and taxpayers of B would see the argument quite that way.

So, recapitalisation of a failing international bank with multiple subsidiaries would likely involve a politicised negotiating game with the whole panoply of potential threats, outside options and so on, as employed in game theory. There would, in the case pictured here, probably be multiple possible equilibria.

[20] The trustees in bankruptcy of the BCCI accused the Bank of England in overlooking the fraudulent operations at BCCI (money laundering, bribery, etc) which went bankrupt in 1991, with 6,500 British depositors losing their money. According to the trustees in bankruptcy, it was knowingly that the Bank of England employees did such a poor job of overseeing. (Editor’s note.)

Even when the various issues involved in recapitalisation are confined within a single country, as in Japan in the last decade, the question of resolving the distribution of burden between various potential classes, for example bank shareholders, bank creditors and debtors, and tax-payers, was so difficult and politically charged that decisive measures to contain the crisis and to return the banking system to health were unduly delayed. The complications of resolving an international distribution of burdens would be even worse.

I have wondered, for example in my Per Jacobsson lecture earlier this summer, whether there might be a role for an impartial international arbiter, to expedite the negotiations. That arbiter could be the ECB in the European case, or the IMF, World Bank, or BIS more widely. My more practically experienced friends, however, have been sceptical. A country which does not like the arbiter's ruling may reject it, and would put forward plenty of reasons for so doing. Moreover, all the countries involved would have to agree, *ex ante*, to accept the arbiter's ruling. Would such agreement be forthcoming? Nevertheless, the possibility of some possible court of arbitration in such cases has some merit.

But negotiations, especially international negotiations, and arbitration take time, often a very long time. If a bank, or worse a banking system, has been seriously weakened by bad debts, time if of the essence. Can we afford to run a banking system which is so interpenetrated that the resolution of any banking crisis involves international negotiations?

Conclusion

From the viewpoint of the big countries in the EU, we have not yet reached this stage, but the intended progress of structural change points in this direction. Moreover, certain groups of smaller countries in the EU, in Eastern Europe, Scandinavia, and perhaps, Benelux, have already got to this juncture. Within the EU the problem could, in principle, be resolved by centralising supervision and crisis management. But that runs up against the constitutional problem with which I began my lecture.

Crisis management is often extremely expensive, and there is no central, federal fiscal competence to handle it.

Crisis management is often extremely expensive, and there is no central, federal fiscal competence to handle it. If the burden has to be met by national treasuries, then supervision and crisis management will remain at the national level with all the problems that this entails. This is but another facet of the more general problem arising from the disjunction of having a federal monetary system but a national fiscal system. **There would be many fewer economic problems if the EU either moved on to a full federal system, or was to revert to just being a common market of national systems, including national monetary systems**. For the time being, however, we remain in a half-way house, and like most half-way houses is not likely to be satisfactory.