Threat to Multilateralism of Global Financial System

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Abstract*[2]*: *This research has been encouraged by two major developments of December 2017: the US National Security Strategy announced the end of the "global community" and coldly replaced it with the paradigm of great power competition; the European Commission transmitted to the European Council the Proposal for establishing a European Monetary Fund. Both documents raise the awareness of the crisis of the world order and the need for action. The paper combines the literature research with the field experience of the author in various international forums. The fragile equilibrium of present state of affairs in world finance is threatened by a combination of political mistrust in multilateralism with enhanced nationalism and hegemonic attitudes. Confronted with those, Europe needs a determined action to foster both unity and its political power, and findings of this paper are meant to provide arguments for action.*

Keywords: *international finance, world order, multilateralism*

The Challenge

A decade has already passed since the burst of the first crisis of globalization. It started in the area of finance because the humankind progress achieved after 1950s was due to the unprecedented development of worldwide finance. Investors, consumers and governments enjoyed the easy access to money which has made everyone to buy and get richer. When the financial crisis emerged in 2008-09 most people was taken by surprise and governments started to look around to find the guilty one. Nobody assumed responsibility for ignoring the run to indebtedness and only the accumulated wealth made possible a rapid recovery and the return to the habits which stood at the roots of the „run". Free movement of capital flows has become a matter for concern of major global financial institutions, with the purpose of protecting prosperity and avoiding another loss of welfare. This has been called search of financial stability and sustainable development.

But, all those efforts require multilateral cooperation and common discipline in the context of reshaping the poles of leadership of the World. Suddenly, politicians rediscovered that compliance with norms of international order may be detrimental to their ego and their old-fashioned promises will become liable for their failure. These

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policies turn detrimental to multilateralism, to coherence in the World, and their outcome is only a threat to liberal order and free market. Global warming is accompanied by temptation for protectionism, and hybrid war, that turn the sophisticated artificial intelligence instruments into dangers for the financial stability of small and big markets. Do we leave an era of adjustment to a higher stage of progress, or we near the darkness of selfishness and broken solidarity? Yes, technology moves ahead of the capacity of conservative institutions to adjust. Currently, the World moves forward with the engine of free flow of capital and spread of financial institutions and instruments, tailored to fit everyone. They are part of only one network, serving us all. Will it resist to the emerging nationalism, populism and extremism of the left and right?

The Turmoil

Along the decade after the fall of Lehman Brothers, which marked the beginning of a global crisis, we witnessed a persistent concern to prepare better for the future and protect the financial stability. However, better does not always make for a strong shield. The economic history of the world has revealed that the spark of a crisis is not always the same and, each time, it is more sophisticated, if not unexpected.

The IMF director general, Christine Lagarde, recalls the need for attention to complex links between the financial sector and the real economy (Lagarde, 2018), as most politicians have ignored it during the crisis, and their lack of reaction delivered an increased invoice. Every regulation of the financial system aims at a moving target, caused by the fact that technological progress moves financial relations into other spheres and that the society changes its valuation criteria.

There are many concerns and fears over the governance of the global financial system. The fear of globalization (blamed for welfare gaps) is opposed to arguments for support of international cooperation required to move forward and protect together. And the reshaping of the poles in the world economy is incriminated for the decline of the share of traditional leaders in favour of emerging powers. The usual "culprits" are the openness of markets for goods, services and capital. The impressive growth of global welfare, extended job offers, and the technological advance brought by the cooperation of the last seven decades are ignored.

It is a bitter truth that financial and banking companies set profit and short-term options ahead of long-term prudence or concern for sustainability: while Europe has limited since 2014 the value of annual bonuses paid to treasurers at the value of their fixed annual income, in the US the bonuses grew steadily to rich the highest level since 2006 (Chocron, 2018). The above is just one as proof of the Trump Administration's distance taken from the need to act in concert on the control of global capital market.

No research has delivered, yet, a model of the future architecture of the international financial system. It is not evident if leaders' priority is still a system based on joint interaction and responsibility, or they favour the internal market only, showing no interest for global responsibility. At least, the White House give a mixed signal of return to hegemony and despise for multilateralism. The "America First" policy mix of nationalism, unilateralism and xenophobia undermines the American leadership and is only making the world worse (Blinken and Kagan, 2019)! The widening of the number of participants to globalization and the complexity of their interaction has opened the degree

of permeability of the borders, so that no desire to slow down or recoil globalization will return the financial system at a time in the past, but will only push it towards other segments of the market, requiring always to draw rules for ensuring prudence and protection of stability.

While international bodies (IMF, EU) stress the need for collective control practices over the management of financial and banking markets, the number of populists, considering their doctrine to be more suitable than curtailment of sovereign prerogatives, is increasing. Economic populism claims that restrictions recommended to government, and regulations issued by independent authorities to restore macroeconomic balance (as central banks and market surveillance bodies) be submitted for review and adjustment to the politically appointed authorities.

The attractiveness of economic populism lies on two built-in shortcomings of economic policies. On one side, their implementation is affected by an asynchronous feature, since the economic policies generate short-term costs for politicians who implement them and bring long-term welfare gains for the population. On another side, since most of the political entities design their economic policy framed to the time span of the voting cycle, they fear that complimentary rules issued by autonomous authorities may deprive them from witnessing the benefits of their policies enjoyed by their supporters, leaving them vulnerable to the next poll. Hence, populists feel the need for stopping the delegation of rules drafting and policies to independent authorities, urging a return of decisions making and implementation of policies to politically elected bodies only. Their approach is mixing pure conservatism to a far-right attitude.

The world is facing a difficult choice for the existing order, its development and stability, including peace: it should weight the effects of stability measures undertaken by international bodies, the effects of politicians' doubts and the limits of anticipating technological advance in the financial-banking field. Projecting based on recent trends, China emerges as becoming the world's first economy, ceteris paribus. Will its manufacturing and commercial power pair with the new global financial-banking architecture? How will a centralized power act in an open market? We are heading towards un-Westernized leadership, a stage in which the future will be made either through negotiations between the economic areas, or through a tiresome bilateralism with few results. Other opinions give the digital revolution the ability to cancel shortly all attempts for isolationism.

Ethics is not the strongest point of financial affairs, but it does not characterize either political decisions when the issue is not about altruism, but of cooperation efforts. Politics is not prepared for trade-off solutions with the nations' ego. The world of finance has changed dramatically: new centres of economic power have emerged, new currencies search for market share, new multilateral financing institutions have been created, some economic areas strive for strengthening their own financing and stability arrangements, new tools and technologies have developed to meet the growing needs of those eager to invest, to consume, to save, and to hedge. The temptation for deregulation is vigorous and not without ground: while after 2008 Europe supported the divorce from "too big to fail", a decade later it encourages cross-border mergers with the hope of strengthening the Banking Union.

The logic of stability requires the world to cooperate and not act against it.

Cooperation in economic policies, at a global level, can succeed if 4 conditions are met: (i) focus on technical aspects, and conduct negotiations between experts who share the same knowledge, giving thus a greater chance to reach a consensus; (ii) be institutionalized by the existence of rules that guide the behaviour of negotiators and deliver expectations on results; (iii) accept the maintenance of the status quo on policies; (iv) to be carried out within a framework of cooperation between States (Gallarotii,2004; Eichengreen, 2011; Gaspar, Hagan and Obstfeld, 2018).

At the IMF and World Bank meeting in Fall 2018, the G-20 presented the report "Making the Global Financial System Work for All", highlighting three requirements: the need for a better system than the present, promoting stability, growth, and sustainable economic development; the need for global financial institutions to work together as a system and not as separate entities; the need for a new governance structure able to ensure the coherence of key institutions and that the system works well through all its components[3].

The perspective of the global financial system cannot be dissociated from other components of globalisation. Three decades after the fall of the Berlin Wall and many others opted for the market economy, a chilly wind of market and individual freedom dereliction is blowing. America is brutally retiring from its former role in protecting the liberal international order, the rivalry between the great powers grow stronger, with the promotion of neo-autocracy, which appear to be proper to political culture of more people than democracy is. Some leaders believe that the decoupling of economic progress from democracy is possible and lasting.

Companies, pushing for globalisation, have done it from the position of Western values of free market and rules applied to it via multilateral bodies. Now, many of EU's Eastern member states, confront a new stage of geopolitics, of inner creative destruction (Schumpeter, 1942), the bond that reflected the common aspirations is no longer able to maintain the unity. The economic model of growth based on the migration of capital and companies, the cross-border integration of production and sales markets, was not rooted in Eastern European economies and any advance in this direction following the awakening from the euphoria of freedom, appeared to many as opposite to "traditions". We are in the situation of a geopolitical risk emanating from the very transition itself. The decline, for over two decades, of macro-economic volatility, made possible by the interconnection of economies, is seriously jeopardised by the geopolitical developments and the inward-looking position, chosen by those leaders who use the primacy of national law against international agreements, to acquire the legitimacy of authoritarian attitudes. A similar process develops in trans-Atlantic relations.

After a period when the globalization levels of trade and financial relations were roughly equal (1983-1997), the trend of globalization was set by financial flows. Enough caution must be shown when increasing the share of non-banking intermediation in the financial markets, noting that the interaction with banks of those institutions make possible changes to the dynamics of the market response to shocks. The total assets of non-banking financial institutions (first-rate players of globalization) have reached about

3 We cannot return to the past. Our central challenge is to create a cooperative international order for a world that has changed irreversibly: one that is more multipolar and decentralized in decisions, yet more interconnected, and with challenges ahead that are much larger and more pressing than we have seen in decades.

USD 160 trillion, exceeding those of the banks (Financial Stability Board, 2018). Because the channels of market propagation of shocks are more diverse, the need to strengthen considerably the supervision of non-banking sector is increasing.

The Awakening

In September 2018 a group consisting of former representatives of Fed and U.S. Treasury, released a report containing recommendations for the management of a crisis, based on the experience of the years 2007-2009 (Liang, McConnell, Swagel, 2018). Out of the eight recommendations, whose logic points to the role of regulations and oversight, two are the basis for any action needed to meet the mentioned desiderata: a) prepare for what is foreseeable to happen; b) prepare to be surprised. The first requirement derives from recognizing the likelihood that both the causes and the forms of future crises will be different from those we met previously. The second recognizes the inherent ambiguity and lack of predictability associated with lack of predictability of navigating through crisis, which require rapid innovation in terms of damage control, assuming "trial and error" practices, together with rapid dispersion of solutions to responsible agencies.

Present time points to three menaces for the peace of the financial system: the political attitude of favouring the protectionism, not only in the sphere of flow of merchandise, but also of controlling capital and banking activity; the contagion effect of raising public debt of emerging and autocratic countries, (hiding the structural gaps), on intertwined currencies and financial institutions; the cyberattacks that can ruin the large financial institutions form inside. The technology is not immune to the pendulum rules and the upward trend installed after the 2007-2009 crisis can be stopped by externalities.

After the crisis, Europe started to look for a deeper "unity" in the areas of banking, money and, more timid, capital markets. As time went by, the enthusiasm curbed and appetite for ring-fencing grew stronger, made possible by local management of funds available for rescue systems and non-uniform rules. Risk-sharing is not attractive, since there is no trust that the cost of multilateral intervention is lower compared to one of national level. Multilateral oversight and bank resolution arrangements do not prevail yet, the lack of confidence acting being responsible for the delay in establishing EDIS (European Deposit Insurance Scheme). The consequence is that mergers and cross-border acquisitions are discouraged and the advance towards a real and stronger Union is fragile. The possibilities to move forward are small since pro-Union political attitudes turned fewer, but they are in need to get stronger to defeat euro-sceptics who oppose amendments to EU treaties, a necessity which is hard to achieve in the present political context (Thomsen, 2018).

The progress of credit and hedging technologies met banks and other financial corporations demand for performance, measured both by growth of their market share, and personal income. Company headquarter will always call subsidiaries in other jurisdictions to use the new techniques, because it is inappropriate for a group to act coherently using different procedures of processing business data. This requires oversight to act likewise and develop the software able to deal with errors and risk in the new environment. Unfortunately, the double standard is still alive through political will to designate national champions, coupled to overplaying the risk that multinational corporations bring in (see "injuries caused by credit outsourcing").

Can a coherent financial system be continued worldwide? The G-20 Financial Stability Board, the European Central Bank, the Single Supervisory Mechanism, the Single Resolution Board, the European Securities and Market Authority, supported by the International Monetary Fund and the Bank for International Settlement are working to strengthen the rules aimed at ensuring a better stability to financial and banking institutions. On the other hand, from the World's most powerful economy (but not only), the message sent to the World is one of mistrust of partners and despise of multilateral rules. No perfect technical mechanism can withstand the lack of political will or the attitudes of voluntary breach of the consensus. The global financial system is fractured politically and is confronted with the risk associated to differentiated regulations and their controversial hierarchy. To the question if we are better prepared to face a new crisis of global magnitude, the answer is positive, mainly if it bears similar characteristics. Otherwise, the magnitude of the unknown depends on the degree of convergence of national and multilateral regulations.

Innovation leads

The dynamics of technology cannot be stopped: already artificial intelligence and the settlement of payments via blockchain, including via cryptocurrencies, conflict not only with the conservatism of central banks, but also with all those who fear the future. Blockchain is the pioneer of a de-centralized global financial system, which, although more rigorous than humans, does not exclude definitively the systemic risk. Can we oppose the process? Can monetary and government authorities prevent it? Only to delay it, all the more so as the value that blockchain brings to protection of personal data and private information is greater than what the regulations offer and which, in fact, make them less secure[4]. Considering its future worldwide impact, the blockchain may prove to be a similar phenomenon to the occurrence of the internet a quarter of a century ago.

Although central banks show refrain from cryptocurrencies (compared to a bubble or Ponzi scheme – BIS, 2018), the shift of confidence from traditional institutions, such as commercial banks or central banks, towards the transparency of the distributed ledger technology (DLT) cannot be stopped by administrative measures or via return to traditions. Instead of rejecting them, central banks must act to internalize the phenomenon before it will set the competence left to the central authorities.

The other component of the expansion of financial services based on new technologies, *the fintech*, also knows rapid progress: the credit volume has risen from USD 11 bn in 2013 to USD 284 bn in 2016 (Claessens, Frost, Turner, Zhu, 2018). Fintech grows mostly in countries where income is high, the banking system is less competitive and banking regulations are less coercive. Those features made China the first fintech user for start-ups, small companies, students, and consumers, followed by USA and UK.

The future of the financial system depends on how smooth politics and technological innovation will accommodate to each other, until one of it will dominate. The present proves that politics continues to remain behind science, and politicians can no longer make use of others' ignorance, as access to information grew tremendously.

4 Hacking is not excluded and security measures are needed to be permanently developed, irrespective of AI or traditional banking.

People will learn that a virtual currency is less open to corruption and that the partnership of financial of giants with the power cannot be an expression of the market freedom, nor of democracy. Already more than 50 p.c. of the world's population meets the middle-class and rich standard of living, with the prospect that by 2030 their number will top 5.6 bn people (an increase by 1.8 bn people compared to the present). Those figures compare to 450 million registered as poor and 2.3 billion still exposed to vulnerabilities (Kharas and Hamel 2018). Even if some of us do not enjoy globalization, the above figures stand evidence for what it has generated and may continue to bring.

The analysis of the trend of financial market and banking indicators for the last 12 years, indicates a divergence of the integration ratio for the markets of US, China and Euro area. While the convergence of monetary markets and real exchange rates have improved, the indicators for the interest rate of 10-year T-bills and the stock market point to a divergent trend, which leaves open the possibility of asymmetric shocks, and increased fragility of global economic development and stability.

Between sustainable development and the financial system, it is a direct and close link: financing of investment must not jeopardize financial stability or sustainability factors. However, anti-globalization attitudes from various capital cities of the world, and the social sites managed by opponents of freedom, who seek a return to the Cold War, do not entitle us to an optimistic conclusion. On the contrary, the few ideas to fight the fragmentation of the World require efforts to withstand the consequences for its stability. In a generic sense, finance consists of trading expectations carried out in an interconnected system, where parties have asymmetrical information and follow pro-cyclical motivations. This trade bears leverage effects and a nonlinear dynamic. However, the financial system plays the key role in resource allocation over time and space in uncertainty conditions (Levine, 1997).

Before the First World War the global society has opened the way to find stability anchors, linking exchange rates to gold standard and freeing the movement of capital. Bretton Woods brought a first restructuring, by setting the "fixed but adjustable" exchange rates system and introduced the primacy of national interventionism over liberalism by imposing control to the freedom of capital movement. Life has rejected the hostility to capital movement: in fact, the contribution that Bretton Woods agreements had for the recovery of economies after the World War II, has encouraged the emergence and development of the Eurodollar market, the multinational companies bypassing the American surcharge on capital outflows through offshore loans in dollars, intermediated by international banks. The American dream of making the USD "as good as gold" has crumbled and since 1976 (Jamaica agreement) the world has entered the era of floating exchange rates and liberalization of capital movements, while internal policies become subject to harmonization with international developments.

Today, the nominal stability of exchange rates is increasingly dependent on price stability and purchasing power, and no longer pegged to a reference currency. In fact, World's major currencies - the US dollar, the Euro, the sterling pound and the yen - converged towards a monetary stability measured by the evolution of the prices around +/-2 p.c. per year, observed over a medium-term period (Trichet, 2018). This arithmetic convergence of the definition of monetary stability is one of the deepest transformations after the global crisis.

If currency volatility almost stabilized, the public debt continued to rise. After the crisis almost all economies allowed a worsening of budgetary position, forgetting the motives that generated it. Both public and private debt continued to grow globally, most countries taking no countercyclical measure, leaving open high degree of vulnerability for the global economic and financial system.

The solutions to limit vulnerabilities must be global, but this is not easy to achieve under different options of financing the economy: while the European economy is 75 p.c. financed through the banks, the American economy is just a quarter. In other words, the difficulty of implementing the Basel III capital requirements has a broader impact on European economies.

A decade after the crisis, the financial market tops USD 320 trillion, i.e. four times larger than the World's GDP, carrying an unpredictable evolution and being a generator of externalities. The economic and social cost of the past crisis is considerable in terms of lost opportunities: EU GDP would have been 1/5th higher if the conditions of prior 15 years wouldn't have changed. On the other hand, the political cost is huge: credibility of elites, trust of open economy, and of liberalism suffered most. The global financial environment has turned to be dominated by uncertainty more than by risk. This has become an aggravating factor, since the risk can be mastered, while the uncertainty does not.

Along money creation by the banks and with their tacit participation, a "shadow banking" system develops (non-bank financial intermediaries). Its assets exceed USD 160 trillion (2017), up from USD 27 trillion in 2002. It uses quasi-repo operations with short-term securities (U.S. T-Bills being preferred) to supply liquidity for financing third-party operations. A significant part of the contemporary financial system generates its own money, with more alert rotation, widening the market of financial securities, while public policies remain hesitant.

One aspect that cannot be left aside is the transformation of the attractiveness of stock exchange: the number of companies listed on American stock exchanges fell to 3627 in 2016, compared to 4943 four decades ago (Stulz, 2018). Contrary to the American entrepreneurship, the number of companies listed per 1 million inhabitants, fell from 23 to 11. What has vanished from the stock market? Mainly small and medium-sized firms and those looking to finance intangible assets (mainly R&D), less attractive to investors. It is axiomatic that the dramatic drop of listed companies with assets up to USD 100 million, from 61.5 p.c. in 1975 to only 22.6 p.c. in 2015, indicates their turn to alternative sources of funding.

First part (2007-2009) of the global crisis was a "run on the shadow banking" (Gorton and Metrick, 2009) which developed along two pillars: on one hand, non-renewal by investors of the financing facilities (or at a very high cost); on the other, the request of increased "haircut"[5]. As outcome, the availability of collaterals dropped, producing a liquidity crisis. A 20-pc haircut applied to USD 10,000 bn repo market (equivalent to the size of the American banking system) rose the additional net financing need by USD 2,000 bn, creating the combination of credit risk with the liquidity risks.

Although reforms for better oversight of the functioning of the global financial

5 Difference between the market value of an asset used as collateral to a loan and its issuance value.

system are substantial and bold, the race of sophisticated mechanisms between the financial industry and market regulators is a priori lost by the authorities, mainly on the sustainability part. A nationalist proudness turns domestic monetary order to prevail against the dialog on reshaping both local and international monetary system. Hence, the response of public policies to systemic crisis remains focused on three coordinates: 1) socialize losses; 2) increase public debt with the hope to avoid recession; 3) lower the policy interest rate in order to help clean of companies' balance sheet.

Securing financial stability is a key job of central banks, but QE (quantitative easing), coupled to drop reference rate turned to be inspired by incentives of stimulating demand and provide solvency to companies. They became a form of "assisted" stability, a medical ventilation (Cailleteau, 2018). It brought the overall debt of advanced economies to a size equal 4 times their GDP, like 2009.

The current state of indebtedness is not unprecedented, but it is extraordinary! IMF estimates the total debt of the world to USD 164 trillion (Fiscal Monitor, April 2018), respectively 225 p.c. of global GDP, i.e. twice as high as before the burst of 2007 debt crisis. Germany apart, the global debt has increased in most of G20 countries. The excess of indebtedness, supported by the excess of short-term financing, led to risk interaction between the volume of debt and its nature.

It looks absolutely mean the political attitude to set ceilings on banks but avoid any limits of public appetite of indebtedness. The inability of public policies to prevent financial cycles and curb the high propensity of financial sector to lend, mirror the limits of domestic policies to master the effect of amplified global finance. The weakness of public policies is not without consequences for pro-cyclical decisions of companies, based on the short-term stability of prices (Borio, 2014).

The financial system confronts a 3-time unholy trinity, (Boughton, 2012; Padoa-Schioppa, 1988; Obsfeld and Taylor, 2017):

- You cannot enjoy, at the same time, the stability of the exchange rate, the freedom of capital flows, and an autonomous monetary policy;
- You cannot benefit, at the same time, from financial stability, integration into international financial system, and a national financial stability policy;
- You cannot have, at the same time, democracy, national sovereignty and integration into the world economy.

The failure to give solutions to trilemma leads politicians to simplify things and find solution to a dilemma: a country cannot enjoy an independent monetary policy unless capital flow is regulated and accompanied by rigorous macro-prudential policies.

And yet, the dimension of finance continues to grow. According to FSB (2018) at the end of 2016, the financial assets of countries accounting for 80 p.c. of world GDP totalled USD 340 trillion (compared with 145 trillion in 2003), thus divided:

- Central banks: 26.2 trillion
- Banking sector: 137.8 trillion
- Public financial institutions: 16 trillion
- Insurance companies: 29.1 trillion

- Pension funds: 31 trillion
- Other financial institutions[6] (shadow banking): 99.2 trillion.

Explanations for the above are linked, among other, to: 1) increase of financial resources is conducive to economic growth (globalization led the emerging and under-developed economies to search for resources to reduce the gaps from developed ones); 2) people's prudential attitude pushed forward the offer of saving instruments (higher living standards encouraged saving, whose level already exceeds investment, resulting in saving glut); 3) increasing demand by money creation (central bank's balance sheet rose: Fed - from USD 870 bn in 2007 to 4.5 trillion in 2017/2018, equivalent of 25 p.c. of GDP, Bank of Japan - from Yen 111.3 to 533.6 trillion, respectively 100 p.c. of GDP and, the ECB - from Euro 1.5 to 4.5 trillion, i.e. 40 p.c. of Euro area GDP).

Pro memoria: Why does Brexit really hurt? In 1964 the size of the British banking system stood around 2/3 of GDP. In 2017 it rose at about 4 times the size of GDP. According to EY, at end 2018 UK financial services sector already shifted £ 800 bn in assets to Europe[7], an amount equal to about 10 p.c. of the banking assets.

Socially, demand does not automatically legitimate the offer. At least a part of the financial growth has proved to be a response to a demand for which the risk attached to its added value was difficult to be assessed. Even if there is no physical limit to the expansion of the financial offer, an ethical limit to its social motivation should concern market regulators (Cailleteau, 2018).

Financial expansion leads to accelerated dematerialization of payments, central banks being more challenged with the need to review their monetary status. Idea that banks are passive intermediaries, which do not create money but only allocate it, becomes difficult to defend examining the credit growth and the monetary base. Kumhof and Jakab (2016) claim a relative consensus of the Bank of England, Fed, ECB and the IMF according to whom "credits determine deposits" and not more the other way around! The idea that the banks would grant loans based on widening or reducing the monetary base by the central bank is no longer valid, more so since several countries have already waived the reserve requirements. The above speaks about the central banks fragility endowed with the reference rate only to deliver both price and financial stability. An ambitious reform of the financial system, whatever authority the central banks enjoy, will not be successful only with their available instruments.

The liberty of monetary policy tends to exhaust once the present and predictable level of reference rate remains low (Blanchard and Summers, 2017) and its intervention becomes meaningless. In addition, if the banking sector has developed mechanisms to protect depositors and privatisation of losses by bail-in procedures, taxpayers are still exposed to risk of loss occurred in the non-banking financial sector, budget deficit and growth of public debt. What for long seemed a taboo, is gaining ground, and the solution of reducing the public debt via "happy monetization" (QE and the Mario Draghi's formula of "whatever it takes" - London, July 26, 2012) while it leads to reduction of public indebtedness cost, encourages states to persevere on the road of indebtedness.

6 Investment funds, holdings, brokerage firms, structured investment vehicles, special purpose entities, hedge funds, real estate and clearing houses.

7 *Financial Times*, January 7, 2019

The need to act resolutely

Without banks and without finance, the economy would be condemned to stagnation and poverty and a significant part of prosperity would be impossible. However, the invasive feature of finance, through the growth of balance sheet via offer to real sector and consumers, is also kept vivid by the public sector recurrent funding demand. On the other hand, those who for political, populist and electoral reasons exert pressure on central and commercial banks to keep interest rates at a low level, must not forget the restlessness character of the market and that depositors will look more to the offer of investment funds. Hence, resources will shift towards a less regulated financial industry, which, in turn, will hedge the government's T-bills. The competitors to the banking system suddenly become more virulent with the help of public policies!

After the first financial crisis of globalization, opinions claim that banks' operations be streamlined, and regulations be more severe have dominated the market. A decade later, banks have continued as before the crisis: the large banks of 2008 became the gigantic banks of today (the J.P. Morgan balance sheet is now over USD 2.5 trillion, compared to 1.5 trillion in 2007), the largest 20 European banking groups are twice the market share of the 20 largest American banks. The aggregate balance sheet of European banks is Euro 30 trillion, more than twice high as the American banks (13 trillion). The consequence is the acceptance of "too big to fail" formula. Thousands of pages about regulations can hardly be trusted to deliver results over weekend and make feasible the scenario of protecting vital functions. The resolution mechanism has not been put at real test, except for total or partial nationalization of small banks, via capital pledge from the deposit insurance schemes.

The paradigm of current regulations requires banking activity to maximize profitability and keep risk within the limit of capital data constraint. In other words, the market regulator sets the minimum level for required own funds and the bank seeks to maximize profitability observing this restriction. A reversal of the paradigm, at least for the large systemic banks, could consist in assuming an explicit threshold of social tolerance in case of losses. This would ask the bank's board not to approve an exposure higher than a set amount[8] above a risk grade, for which losses could be covered by the public institutions, such as deposit insurance and resolution funds. Imposing a threshold of tolerance for public intervention could be more realistic in practice than the continued requirement to increase capital in direct ratio to exposure. What can be a pertinent choice for small or medium-sized banks, has no way to match giant banks, where not the ratio of own funds could be the feasible solution, but the size of monetary units that can set the tolerance threshold. The preoccupation for encouraging banks to separate commercial activities from investment may be a way to increase credibility of resolution through privatization of losses.

Another alternative could be the establishment of a minimum threshold for credit quality for all large banks, aimed to support their qualification for public support in the event of difficulties. Rating agencies are already making a distinction between the intrinsic quality of bank credit (how much is supported from their own resources) and the final quality of the credit, which considers the hypothetical support of the state in

8 Negotiated by the bank's board with the market supervisor.

case of need. Obviously, the final credit rate is influenced by the sovereign rating. This alternative bears the risk of public power, which could limit the operation within their national territory only to institutions which have a credit rating similar to that of the state, or higher[9]. A member of the Basel Committee and former member of Fed Council (Tarullo, 2012) proposed the limit of short-term debt ratio to deposits as leading indicator of resizing the banking entities, an idea based on the realities of the previous "run". While in real economy large industrial groups undergo such recalibrations, in the banking industry this practice has not been applied.

The function of the financial system is to allocate capital, diversify and dissipate the risk. But a system meant to achieve this, becomes itself a source of risk (Summers, 2010). This should not be avoided when designing the system's perspective. What solutions are likely to calm down the growth of financial capital?

First, rethinking the liquidity requirement. Banks are always in the complicated situation to hold assets difficult to cash (loans to business, especially for SMEs) and to liquidate on spot a convertible passive (deposits) at nominal value. By opening a refinancing agreement with the central bank, commercial banks would limit the size of the hard-convertible assets to the volume of sight-deposits and debt maturing within 12 months (King, 2016). In such a way, the bank would acquire a renewable liquidity guarantee year after year.

Second solution may be to alleviate the frenzy of financial markets induced by institutional investors. Essentially, they are encouraged by the public policies, the asset holders being the pension funds, sovereign funds, insurance companies, whose trading is always dealing à la hausse against T-bills. As shareholders of world's major enterprises, they enjoy stability and benefit of secure resource market, whenever they trade as trade asset owners or via asset managers. *BlackRock*, *State Street*, *PIMCO*, *Vanguard*, *Amundi*, a.o. dominate the financial markets that move hundreds of billions of Dollars every week. Their appetite for T-bills maintains the politician's faith that they can afford anything. A quarterly requirement for "disclosure" on the rotation speed of their portfolio would be a first step towards limiting the rush for immediate profit, achieved more from financial speculation than from a safe placement. Institutional investors manage thousands of billion dollars worldwide and, consequently, their impact on stability is overwhelming. Their association with a supervisory regime, guided by prudence, like one applied to banks, could be a way towards a better moderation of the financial markets.

The third way would be to make the passive of the states more elastic. Sovereign debt is at its highest levels, and this is also the result of low interest policies. What states deliberately ignore is the pro-cyclical nature of indebtedness, which makes it grow permanently. Those who underwent restructuring (Argentina, Greece, Ukraine) became acquainted with the bonds indexed to GDP and the extendible bonds: in the first case, the coupon is indexed with the variation of nominal GDP; in the second case their maturity may be extended in relation to a predefined indicator (differential of interest, variation of tax revenues or GDP, etc.). Finding buyers interested in such titles is more difficult, but the risk of over indebtedness is reduced (IMF, 2017). A good start would be IFIs issue of bonds indexed

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9 See Pierre Cailleteau and Jean-Calude Trichet in *La vulnérabilité du système financier mondial*, [*The vulnerability of the world financial system*], 2018

to GDP, at least for countries whose difficulties in repayment of external debt is a reality. Domestically, such instruments could be assumed by central banks which may apply a smaller haircut for those indexed to GDP, but also by governments that could admit a tax deduction for buyers of such securities. The world economy has shown, for most of the last decade, robust growth, which give to everyone the comfort of stability. On the other hand, the financial system appears, in its turn, stable and comfortable for the capital it makes available to all. However, several political leaders started to inquire recently about the brake that globally accepted rules for capital flows may exert on fulfilling targets of national egoism. To them, the discussions about regulation, prudence, risk and creditworthiness appear primarily as being the preoccupation of some others who wish to be the masters of the process, but whose enthusiasm about concerted new rules is suspected to act against national goals. Hence, the rush towards nationalism appears to encourage the withdrawal from a mechanism which someone seek to impose[10].

The dismantling of co-operation makes room for shadow banking to prosper, together with the risk they carry. Cryptocurrencies are not an orderly generation system of money supply, but they grow out of the fear that what is subject to power of public authorities, may become unstable. The attitude of those who reject cryptocurrencies is more retrograde than an evidence of being in command: the curtailment of the central banks role is already a fact, and they should observe that the very will of preserving a traditional monetary policy pushes the new technologies towards creating virtual currencies, functional means of payment in the financial markets. But precisely because cryptocurrencies do not have boundaries, dealing with them should be a global liability (Lagarde, 2018).

The post-crisis practice proved that central banks have issued opinions on micro and macroeconomic policies, more open or concealed in their reports. This mechanism may not always alleviate the risk of recession, since companies remain opened to alternative sources of funding (Cunningham and Friederich, 2016). Time has come to realize that market is ahead of its regulation and supervision is incomplete.

Central banks have always been characterized by prudent, conservative attitudes. However, the present challenges their adaptive capacity, somewhat like the coexistence of, on one side, of conservative saving skills of retired people, with, on the other, the appetite for novelty, innovation and risk of young people. As it becomes increasingly evident, the instruments of monetary policy cannot adequately respond to financial stability. Central banks must either develop cooperation relations with other market authorities, or seek a redefinition of their statutes, making them stronger in regulating and supervising the market segments that generate private money, assuming a greater role in the economy. The currently experienced macro-prudential surveillance formula appears to be inconclusive and dissipates the responsibility of the member institutions. Central banks should enhance their function of mediator of financial risks with that of initiator of financial stability protection policies (Praet, 2011). As leaders look to move away from multilateralism, the more required is the assumption of this role.

10 Since the IMF is lacking authority to impose corrective measures to countries that are not enrolled in a support program with the Fund (but whose market size can be influential for the entire system), this becomes an argument to challenge its legitimacy and efficacy (Gnath, Mildner and Schmucker, 2012).

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