

Europe's Two Priorities for the G20

CEPS Commentary/14 November 2008

Daniel Gros

Generals often fight the last war. Regulators try to prevent the last crisis. There is thus a tendency to concentrate attention right now on securitisation and rating agencies. However, since the securitisation market has broken down and all ratings are now regarded with a healthy dose of scepticism, these two areas should not figure high on the agenda for the reform of the global monetary system.

The current crisis had a number of causes, some of which cannot be addressed, maybe not even prevented, by even the best designed global monetary system. For example, the under-pricing of risk in almost all financial markets until 2007 was a global phenomenon which regulators could not have prevented. But something could have been done. It is now clear that monetary policy should have reacted earlier to the boom in house prices and regulators should have forced banks to accumulate larger reserves for the tougher times that had to come sooner or later.

The root causes for these two macroscopic failures need to be understood properly before trying to create a new Bretton Woods.

The unwillingness of central banks to react to bubbles on their way up was not due to the design of the global monetary system. It represented the dominant ideology over the last decade, which held that bubbles could be diagnosed only once the boom had turned into a bust and that all central banks could do at that point was to try to minimise the impact on the real economy by lowering interest rates. This approach is now totally discredited and, in any event, it is unlikely that we will see another bubble emerging soon. It is also clear, however, that some time into the future the global monetary system will need a strong 'whistleblower', i.e. an organisation that has the expertise to diagnose a bubble and the clout to make its voice heard.

The Bank for International Settlements – the bank for central banks based in Basel – repeatedly warned about the build-up of risk in financial markets, but its warnings went unheeded. The International Monetary Fund would be much better placed to look at the macroeconomic dangers resulting from an excessive accumulation of leverage, but this would require the IMF to be sufficiently independent from its political masters (its larger members, in primis the US) to perform this function. A first item on the agenda for reform of the G20 should thus be not only an extended remit for the IMF to look at financial market stability, but also a much higher degree of independence so that it can actually warn of dangers even if this is politically

Daniel Gros is Director of the Centre for European Policy Studies. This Commentary was previously published in *What the G20 should do on November 15th to fix the financial system*, Barry Eichengreen and Richard Baldwin (eds), a VoxEU.org Publication, November 2008.

CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the authors in a personal capacity and not to any institution with which they are associated.

inconvenient for its major shareholders. To choose the next Managing Director of the IMF on a competitive basis (as called for in the text of the French EU Presidency) would be a first step in the right direction. The creation of the unified IMF representation for the euro area might have been a further important step into this direction because it would have broken the veto of the US concerning any criticism of US policy-making.

The second macroscopic failure mentioned above (lax supervision of banks) stems mainly from the fact that supervision remained national while the larger banks operated increasingly on a transnational level. The problem is particularly severe in Europe where a dozen complex international banking groups have emerged, which are all too large to fail, but some of which are also too large to be saved by their home country alone. National supervisors allowed this to happen because they perceived their mission as mainly to help their own national champions. This perceived competition among national supervisors meant that they did not focus on their main mission, namely to control risk-taking and it also meant that there was no exchange of the crucial confidential information among national supervisors that would have allowed them to see the systemic risk that arises when all banks are following the same strategy. National supervisors were confident that the situation was under control because they administered many stress tests. But none of these tests could reveal the consequences of problems arising simultaneously in more than one market because no national regulator had access to information from other countries and there was no European-level institution to look at the stability of the European banking system as whole.

The conclusion is clear: an internationally integrated banking market is not compatible with exclusively national competence for banking supervision. Unfortunately, however, European policy-makers have refused to recognise this. The latest proposal by the French Presidency concerning the EU position for the G20 mentions only the creation of so-called 'colleges' of supervisors. This will not be enough. At a minimum, national supervisors will have to follow the same (European) rulebook (to avoid competition in laxity) and must regularly exchange all information concerning large systemically important institutions (so that systemic risk can be recognised early).

The same degree of cooperation among supervisors would of course be needed for the (smaller number) of banks that are systemically important at the global level. It is unlikely, however, that this can be organised at the global level if it does not happen first within Europe.

Europe could have been the major driving force for a reformed global monetary system. But as long as the EU is not able reform its own internal organisation, its contribution will remain minor. Given that the United States has no strong interest in changing the status quo, it is thus likely that little will change.

Additional comment & analysis from CEPS on the financial crisis

CEPS has been at the forefront of conducting policy research and analysis on the global financial turmoil since it first emerged over a year ago. In addition to the present commentary, you may visit our website to download all of our recent Commentaries on the crisis:

“Returning to narrow banking”, Paul De Grauwe, 14 November 2008

“A call for a European Financial Stability Fund”, Daniel Gros and Stefano Micossi, 28 October 2008

“Restoring Confidence”, Karel Lannoo, 21 October 2008

[“A Concerted Approach to Re-start the Interbank Market”](#), Daniel Gros, 10 October 2008

[“Nationalizing banks to jumpstart the banking system”](#), Paul De Grauwe, 10 October 2008

[“Credit Rating Agencies: Scapegoat or free-riders?”](#), Karel Lannoo, 10 October 2008

[“The cost of ‘non-Europe’?”](#), Daniel Gros and Stefano Micossi, 7 October 2008

[“Europe’s banking crisis: A call to action”](#), Open Letter by ten leading economists, 3 October 2008

[“Crisis Management Tools for the Euro Area”](#), Daniel Gros and Stefano Micossi, 30 September 2008

[“‘No recourse’ and ‘put options’: Estimating the ‘fair value’ of US mortgage assets”](#), Daniel Gros, 23 September 2008

[“The beginning of the endgame...”](#), Daniel Gros and Stefano Micossi, 18 September 2008

[“The twin shocks hitting the eurozone”](#), Paul De Grauwe, 16 September 2008

[“The crisis, one year on”](#), Karel Lannoo, 8 August 2008

[“Cherished myths have fallen victim to economic reality”](#), Paul De Grauwe; 24 July 2008

[“It’s high time to create a truly European System of Financial Supervisors”](#), Karel Lannoo, 27 June 2008

[“The US Housing Bust and Soaring Oil Prices: What next for the world economy?”](#), Daniel Gros and Cecilia Frale, 5 June 2008

As early as April 2006, with the publication of *A world out of balance?*, CEPS provided an analysis of the forthcoming problems by diagnosing a bubble in real estate markets. See [A world out of balance?, Special Report of the CEPS Macroeconomic Policy Group](#), Daniel Gros, Thomas Mayer and Angel Ubide, April 2006.