

Confronting the financial crisis: surveillance and regulation

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The financial crisis continues to unfold, taking new turns. By now, it is clear that bank bailouts have a heavy cost for the public purse.¹ This adds to the usual increase in public deficits in periods of economic crisis. Countries with a history of economic mismanagement of the public sector, such as Greece and Portugal, or those more heavily affected by the economic crisis, such as Spain due to the size of its construction sector, or those more heavily exposed to an oversized and fragile banking sector, such as Ireland, find themselves in a difficult position. Financial markets price these difficulties in terms of wider spreads between bills and bonds of such countries compared to “safe” countries such as Germany or France. In turn, this increases the cost of public debt and risks igniting an unsustainable downward spiral, whereby increases in the spreads imply an increase in the expenditures for interest on public debt, and this in turn worsens the perceived risks inducing new increases in the spreads.

Within the euro-area at least, restructuring of the public debt, even of relatively minor countries, is a non-solution. It would provoke huge losses to the banking system, especially for German banks and in a lesser measure for French banks, which have been very active in underwriting treasury bills and bonds of the PIGS attracted by their higher interest rates; such losses would then require further banking bailouts that may turn out to be excessively costly even for Germany or France, not to name Great Britain or Italy. It would also induce unbearable tensions on the euro exchange rate and on the policy choices of the EBC, such as the risk of breaking the euro area into two parts, a pro-strong currency

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¹ On the costs of bank bailouts, see Fratianni and Marchionne (2010) in this review.

zone characterized by higher international competitiveness of its producers, and a lagging zone with lower international competitiveness, where the need to finance a growing public debt couples with the need to finance a persistently negative balance of payments. For Italy (as well as for Belgium), such a situation has an additional risk in terms of national unity, with Northern regions aiming at inclusion in the first group and Southern regions drawn into the second group.

Needless to say, recourse to heavy cuts in public expenditure (and to a lesser extent to tax increases) is called forth by some powerful European governments and by the remnants of the Washington consensus; however, under the pressure of financial markets even those who are not convinced by the validity of this policy strategy have to give in. Thus, the costs of banking bailouts are shifted onto social expenditure, while the general retrenchment of the public sector aggravates the economic crisis. Social inequalities increase; social tensions worsen. Ethical considerations are largely ignored, in the present political climate. However, we should keep in mind that social unrest is also priced by financial markets in terms of increases in interest rate spreads, aggravating the risk of an unsustainable spiral.

All this calls for an internationally agreed upon policy action, preferably not under the pressure of day-by-day events but with a conscious longer term strategy aiming for the recovery of income and employment and a reduction of social inequality: a strategy in which stronger countries must take the lead. This may imply increases in public expenditure financed by tax increases (with as large a part as possible of the cost attributed to the financial sector, with recourse for instance to an internationally agreed upon Tobin-tax on financial transactions and an internationally agreed defusion of tax heavens).

However, what is most important is that attention on current monetary and fiscal policies should not imply renouncing to wide-ranging structural reforms of the international monetary system and of the financial sector. Debate and action on current policies and on

structural issues should proceed in cohesion (Sarcinelli, 2009). A reform of the international monetary system is called for (Volcker, 2009), such as to ensure a lesser role for financial speculation on currency markets and a greater symmetry in adjustment policies for surplus and deficit countries. A re-regulation of financial markets is also widely considered an absolute necessity, in order to avoid the creation of new speculative bubbles (such as on gold, already under way), worsening financial fragility and further financial crises (Roncaglia, 2009).

Two of the articles published in this issue of *PSL Quarterly Review* (Masera, 2010; and Tonveronachi, 2010) are devoted to the themes of financial re-regulation. They both describe what is currently being done, and discuss what should be done in the near future. In doing this, they take on partly different attitudes, as will be apparent to the reader.

Masera (2010) provides an in-depth and wide-ranging illustration of the work in progress in this crucial area on the two sides of the Atlantic, with the attempts at reaching an international consensus on new rules and their phasing-in (a crucial issue in view of the strengthening of capital requirements foreseen by the Basel 3 accords). Stress is put on the interaction between rules and supervision, with an overall positive judgment for the balance struck in this respect by the policy authorities responsible for implementing the new rules.

Tonveronachi (2010) raises the issue of the large discretionary powers that a prudential approach to financial regulation leaves to supervisory authorities. The recent US reform and EU proposals further increase these powers. It is argued, both on theoretical grounds and on the grounds of past experience, that in a prudential framework supervisory discretion is no defense against the building-up of financial fragility and that a structural approach to financial regulation is required to increase systemic resilience.

The final paper in this issue, by Najafi, Aridi and Askari (2010), tackles a separate but connected issue: that of the international political relations between the dominant country, the

United States of America, and periphery countries, and of the impact of such relations on the economic growth of the periphery countries. Although they do not focus on financial and monetary relations, the paper raises relevant questions on the interaction between political and economic developments.

All these issues are of the greatest relevance. As usual, our journal welcomes new contributions and comments on the articles published, in light of the widest plurality of views and approaches and in the hope of contributing to the cultural debate underlying the process of policy-making.

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