FOREWORD

Christian Noyer

It is both a pleasure and a great honour to contribute a few opening words to this book, which celebrates the 50th anniversary of la Société Universitaire Européenne de Recherches Financières, also known as SUERF – the European Money and Finance Forum. The past 50 years have indeed been very rich on all fronts regarding monetary and financial affairs and the current circumstances require, more than ever, insights on structural change in monetary institutions and the interplay of financial innovation and financial regulation.

Our economic, political, technological landscapes today have very little to do with what they were in 1963, or even, for that matter, twenty years ago:

Exchange rates were fixed within the Bretton Woods system; capital controls were the rule and European monetary integration would first appear as a remote possibility in the 1969 Werner Report.

Throughout half a century of major evolutions of monetary institutions and transformation of the financial system, the SUERF, which has over 300 active members, has managed to spur an indispensable dialogue between economists, financial practitioners, central bankers and academics for the analysis and mutual understanding of monetary and financial issues. I am proud to stress that Banque de France has participated intensively in all the activities of SUERF and, actually, SUERF repeatedly helped us as many other institutions, to decipher economic and financial developments in order to best serve our fellow citizens.

This book analyses the main trends in the economic history in money and finance of the past five decades. It provides a rare combination of scope and depth with analyses of prominent economists, many of which have been or are still in charge of conducting monetary or regulatory policies in central banks or international organisations. The book is an occasion for them to take a step back and share with the reader a unique blend of analyses that are grounded in the constraints of real world policy making. In this sense, the book very much reflects the essence of SUERF.

The book covers an impressive scope, including global and European monetary institutions, macroeconomic imbalances, central banking, unconventional monetary measures, financial activity of industrial countries, the financial and economic integration, European and global financial regulation, the evolution of

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1 Governor, Banque de France.
financial supervision, the developments of the bank business model, the performance of European banking, shadow banking and new lending channels, the origins and handling of financial crises, and the development of derivatives markets. The book is policy-oriented, practitioner-friendly and provides new insights, with a European focus, although the analysis is embedded into the global dynamics of economic developments and thinking. It will become a landmark that many of us keep on a shelf close to their desk and go back to regularly to learn again and again from its invaluable insights.
Financial practitioners and academics with an interest in money and finance have often different perspectives on the world, but a lot to learn from each other. This vision, in May 1963, inspired two pioneers, Professor Pierre Tabatoni, University of Paris and Jacques Branger, Director General of the Caisse Nationale des Marchés de l’État, to invite a group of European financial practitioners and academics to discuss the possible formation of a European Group for Financial Research. At a small conference in November 25, 1963 Société Universitaire Européenne de Recherches Financières, SUERF was formally established. Alexandre Lamfalussy, a Senior Official of Banque de Bruxelles in Belgium, participated in the conference and was later appointed the first Honorary Treasurer of SUERF. In 1969, central bankers joined to form a third – and strong – “pillar” of SUERF.

This 50th Anniversary Volume differs strongly from the approaches taken by two publications published to commemorate previous SUERF anniversaries. In 1993, Stuart Wilson, (SUERF President 1973-6) authored a pamphlet sent out to members, “intended as a personal mémoire, rather than a definitive history of SUERF as an association”, to coincide with SUERF’s 30th anniversary. He had originally been approached by Mario Monti (during his term as SUERF President) to commemorate SUERF’s 20th anniversary, but had declined to publish such a publication until after he had stood down from the Council of Management. The resulting publication catalogued places (venues for Colloquia and other SUERF events), people (prominent speakers, members of Council), and a potential vision to be pursued in the future (in particular Wilson suggested how the countries of Central and Eastern Europe could be incorporated into SUERF’s activities).

In 2003, to mark the Association’s 40th Anniversary, a special anniversary volume “Monetary and Financial Thinking in Europe: Evidence from Four Decades of SUERF”, was produced. Jean-Paul Abraham, (SUERF President 1994-97), collected and examined the choice of topics in the twenty-four SUERF Colloquia held between 1969 and 2003. The volume contains quotations from the Colloquium books and from speakers, authors, Commission chairmen and participants contributing to the discussions. At the 40th Anniversary Seminar held in Paris in Banque de France’s Galérie Dorée, Jean-Paul Abraham spoke and was praised for the Herculean task he had done to document the working of SUERF as an active network between financial economists, financial practitioners,

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2 Many thanks to Michael Bailey for help in preparing this preface.
central bankers and academics for the analysis and mutual understanding of monetary and financial issues.

This present volume deals considerably with the evolution of issues in money and finance in Europe over the last 50 years, and also looks to the future. The remit given to the authors of the individual chapters was to take the events and issues of the past 50 years (albeit with particular emphasis on the post-2007 period) in order to be able to draw conclusions for the future. The volume aims to identify the main trends in international financial markets, in global and European macroeconomic balances, in European financial integration, in central banking, in banking and securities markets, in financial innovation and the origins and handling of financial crises. The focus is both policy-oriented and practitioner friendly. Both individually, and as a whole, the contributions are intended to provide new insights to the readers. Similarly, while the focus of the volume largely reflects SUERF’s European nature, it tries to also examine the global evolution of economic thinking and economic developments since the early 1960s.

In the Spring of 2012, the SUERF Council of Management asked Morten Balling, SUERF Managing Editor, and Ernest Gnan, SUERF Secretary General, to be editors of the anniversary volume. The Council also decided on a list of distinguished researchers who should be asked to use their expertise to write chapters for the volume. During the summer of 2012, the invited authors accepted to contribute.

Pleasingly, many of the authors of this volume will also speak at the special conference to be held at the Banque de France in Paris on 22nd November 2013, which addresses the topic of “The Financial Reconstruction of Europe” – since the topics they cover in this volume continue to dominate the agendas of researchers, financial market practitioners and policy-makers alike.

On behalf of SUERF, I would like to thank all the authors for their excellent work. At the same time we would like to express our gratitude to all individuals and institutions who contributed to SUERF’s endeavours for their generous support.

Zurich, June 2013
INTRODUCTION

Morten Balling and Ernest Gnan

“There are those who cannot remember the past are condemned to repeat it.”
Baruch de Spinoza, 1632-1677

In November 2013, SUERF – The European Money and Finance Forum – celebrates its 50th Anniversary in Paris. In the Spring of 2012, the SUERF Council of Management decided to mark the coming anniversary by publication of a volume “50 years of Money and Finance: Lessons and Challenges”, in which a group of distinguished researchers were asked to look at the monetary and financial history of the past 50 years, to summarise the most important trends and experiences and to draw conclusions for the future. In the spirit of Spinoza, the Council wanted to select a group of highly qualified persons that could help us to remember and understand the past and on this basis recommend improved policies to meet the challenges of the future. Authors were asked to identify main trends in international financial markets, in global and European macroeconomic (im)balances, in European financial integration, in central banking, in banking and securities markets, in financial innovation and in the origins and handling of financial crises. The text should be policy-oriented and practitioner friendly. Authors should cover path-breaking events, political decisions, and relevant outstanding research contributions in the field since the early 1960s.

In Chapter 1, Niels Thygesen, Professor Emeritus of International Economics, University of Copenhagen analyses the very significant changes that have occurred in global and European monetary arrangements since SUERF was founded in 1963. At the beginning of the 50 year period, the attention of European policy makers was to a large extent focused on improving the functioning of the Bretton Woods fixed exchange rate system. Gradually the system eroded as doubts regarding the sustainability of an international monetary system based on one national currency – the dollar – became widespread. The growing Atlantic imbalances and the privilege of the United States through the country’s ability to borrow substantially abroad in its own currency to finance persistent current account deficits were criticised particularly by France. In August 1971, President Nixon broke the link of the dollar to gold. In March 1973, fixed exchange rates for the dollar were abandoned by most IMF member countries, and in October 1973 OPEC announced a decision to raise the posted price of oil by 70% with far-reaching implications for global imbalances. The creation of respectively the European “Currency snake” (1972), The European
Monetary System (EMS) (1979) and the EMU (1999) should all be evaluated in the light of the global trend towards floating and more volatile exchange rates. Besides, the internal European ambitions were growing with the perception that a single market for goods and services ultimately required a single currency. With the 1992 Maastricht Treaty, Europe went much further than any defensive response to global currency instability required. In EMU, monetary policy is centralized. Fiscal policy is not. The Stability and Growth pact failed to provide fiscal discipline. In addition to imbalances between the European countries, sovereign debt problems grew. Recently, major repair work on the policy rules and on the effectiveness of surveillance has been performed by the Commission and the Council of Ministers, often under the prodding of the European Parliament and the ECB. The author gives an overview of the repair work in the form of tightening of SGP procedures, the fiscal compact, the European Stability Mechanism and improved procedures for crisis management. He concludes that in the period considered, the primary inspiration for Europe’s monetary arrangements has been internal rather than global.

In Chapter 2, Robert N. McCauley and Guonan Ma, BIS look at global and European macroeconomic imbalances. Global imbalances conceived in net terms often lead to discussions of the biggest pair of current accounts with opposite signs: US-Japan in the 1980s and US-China in recent years. In the chapter, the authors instead focus on the first and second largest surplus economies, which are also the second and third largest creditor countries, China and Germany. Both countries produced in the 2000s a current account surplus that the world (China) or Europe (Germany) found difficult. The sources of the surpluses were more similar than usually considered. Their recycling started out very differently but, with the euro crisis, has converged to some extent. The role of policy in the two surpluses is more complex than often thought. The authors find also important differences. German banks not only lent euros to banks and sovereigns in the periphery of Europe, running deficits against Germany. They also on a large scale bought risky US mortgage-backed securities, financing the US deficits and debt against the rest of the world. The risk appetite of the Chinese authorities and bankers has been much smaller. China has systematically allowed foreign investors to take equity risk in the Chinese economy, while mostly confining its dominant official investment to safe assets denominated in major reserve currencies. In a global recession, this portfolio produces steady income and even capital gains on the safe assets. In recent discussions about the need for surplus countries to take action to reduce their surpluses, it has been argued that China’s surplus is the result of Government policy and therefore unacceptable internationally, while that of Germany is the result of private decisions and therefore must be accepted. The strength of this argument must be evaluated with critical eyes.
In Chapter 3, William R. White, former Head of the Monetary and Economic department, Bank for International Settlements, poses the question: “Is Monetary Policy a Science? In the view of the author, the practice of monetary policy is far from science. Structural changes in the economy have changed the conduct of monetary policy. In addition, there have been significant changes in ‘accepted’ economic theory over the last fifty years. Central banks have gradually relied more on the operations of free markets and management of inflationary expectations. Choices of exchange rate regimes, monetary policy frameworks, and operational procedures have evolved since the 1960s. All monetary authorities must face Mundell’s “Impossible Trinity”: A country cannot simultaneously have free capital flows, a fixed exchange rate and an “autonomous” monetary policy. The Bretton Woods system gave priority to fixed (but adjustable) exchange rates and to the autonomous conduct of domestic monetary policy. So, some impediments to capital flows were accepted. Gradual liberalisation of capital movements contributed to the break-down of the Bretton Woods System in the early 1970s and implied that fixed exchange rates were abandoned. Later, highly volatile capital flows caused currency crises in Asia, Latin America and Russia. Taken together, these experiences indicated that both floating and fixing have their associated dangers. By creating the EMU, the member countries in fact gave up “national monetary policy” in the expectation that the single currency would give impetus to the establishment of a Single European Market. Some countries have tried to solve “The Impossible Trinity” by using a constrained version of all three elements. They have combined managed float, managed capital flows and a form of constrained monetary policy. Advanced market economies and emerging market economies follow very divergent exchange rate policies and that is why some observers have called the present situation in global currency markets a “non system”. Some central bankers have become increasingly uneasy about the analytical framework, they had previously relied upon. None of the macroeconomic models in wide spread use before the 2008-2010 crisis predicted it. Alternative lines of macroeconomic and monetary research are now being pursued. There are grounds to believe that the political framework constraining the conduct of monetary policy will change. Some blending of rules and discretion has evolved. It is possible that the crisis could swing the balance towards discretion. In the early 1990s, a number of central banks adopted explicit inflation targeting regimes. In the 1980s, macroeconomic problems building up under the “Great Moderation” were ignored. The author uses the expression “growing hubris”. It has been argued that a higher degree of transparency about the future use of monetary policy instruments might not contribute to financial stability.

In Chapter 4, Christiaan Pattipeilohy, Jan Willem van den End, Mostafa Tabbae, Jon Frost and Jakob de Haan, De Nederlandsche Bank analyse the use of
unconventional monetary policy by the ECB. They first provide an overview of conventional monetary policy. The period 1979-82 came to be known under the general title of “Practical Monetarism”. Policy makers focussed on the growth of M1 and M2 with a view to reduce inflation. From 1983 to 1992, many European countries made maintenance of their exchange rate peg to the Deutsche Mark (DEM) the centre-piece of their monetary policy. After 1992, there were serious crises, which boosted the idea to introduce a common European currency. Since 1999, the Governing Council of the ECB is in charge of monetary policymaking in the Euro area. The Maastricht Treaty made price stability the ECB’s primary objective. The ECB uses a “two-pillar” strategy based on monetary analysis and economic analysis. A focus on money growth (M3) has been motivated by the view that inflation in the long run is considered to be a mostly monetary phenomenon. In contrast to ECB, several central banks opted for inflation targeting. ECB’s conventional instruments are standing lending and deposit facilities and open market operations.

ECB and other central banks in industrialised countries have broadened their assortment of monetary policy instruments over the past few years. Conventional instruments have been supplemented by unconventional measures where central banks use their balance sheets to affect market prices and conditions beyond short-term interest rates. As a consequence of the use of unconventional measures, central bank balance sheets have expanded substantially. In order to document the impact on balance sheet composition, the authors compare changes in balance sheet indicators from 2006 to 2011 for a sample of central banks. One important observation is that most central banks converge towards a more balanced ratio between the public and private sector debt they hold. Another observation is that the ratio between domestic and foreign assets shifted in opposite directions depending on whether the central bank was focused on stabilising the exchange rate or primarily had the domestic financial or fiscal development in mind. After 2008, the ECB adopted respectively the Enhanced Credit Support programme, the Securities Market Programme (SMP) and Outright Monetary Transactions (OMTs). The authors provide an overview of studies of the effects of ECB’s unconventional monetary policy. Finally, they present new evidence on the effectiveness of this policy.

In chapter 5, Morten Balling, Aarhus University and Ernest Gnan, OeNB provide a survey of trends in financial markets, European regulation of organised financial markets and the development of financial theory. Since the 1960s, there has been a remarkable interaction between financial theory and financial practice. Academic research has stimulated financial innovation and led to the development of new financial instruments and markets. Important research areas are portfolio theory, capital asset pricing theory, interest rate structure theory, capital structure theory, agency theory, efficient markets theory and option...
proning theory. Milestones within these fields are identified and their contribution
to the complexity of instruments and risk measurement and possible relevance in
relation to the financial crisis after 2008 are discussed. In charts, the authors
describe the growth and the most important structural changes in financial
markets. The roles of different financial instruments have changed considerably
in the last decades. After 1999, the development of European regulation of
financial markets has taken place within the framework of the Financial Services
Action Plan (FSAP) and followed the so-called “Lamfalussy Approach”.

In Chapter 6, Paul Atkinson, Adrian Blundell-Wignall and Caroline Roulet,
OECD discuss integration versus interdependence and complexity in global trade
and finance in the post-war period. Since the early 1960s, there has been a trend
of both increasing integration and increasing interdependence. Within the OECD
countries, Europe was the early mover in the trend towards greater integration.
By 1968, a full customs union was established in the EEC. Trade liberalisation
proceeded more slowly at the global level. However, successive GATT rounds
contributed to expansion of trade globally. Capital account deregulation was less
rapid as documented by the experience with the OECD codes of liberalisation of
capital movements. Interest rate parity data can be used as measures of
integration of financial markets. So can correlations between national saving and
investment. The changing degree of openness is studied by regression analysis.
The overall trend in the saving-investment correlation is downwards but with
interruptions in crisis periods. Western Europe appears to have led the world also
in the opening up foreign direct investment. China and some other Asian
countries have followed policies to manage exchange rates at undervalued levels.
These policies impact on external imbalances. Financial market deregulation
proceeded in parallel with the opening of trade and capital markets. This led to a
greater integration of banking activities across countries. In the 1960s and 1970s
banking integration was centred on the development of the Eurodollar market.
Since the early 1990s, a considerable cross-border banking activity was focused
on Central and Eastern Europe. After the 2008-2010 crisis many banks have been
pulling back from foreign subsidiaries and branches. The authors use a global
bank beta based on bank stock prices as a measure of interdependence. The beta
tends to increase in crisis periods. OECD has carried out an empirical study of the
determinants of distance to default covering 94 global banks. The study
concludes that leverage, exposure to derivatives and dependence on wholesale
funding are crucial factors. The authors recommend that the current Basel
framework should be scrapped in favour of something vastly simpler, that capital
requirements to banks should be strengthened, that implicit guarantees to too-
big-to-fail banks should be limited and that corporate governance of banks
should be strengthened.
In Chapter 7, Charles A.E. Goodhart, London School of Economics, gives an overview of the trend since the early 1960s from national towards European and global financial regulation. At the beginning of the period under study, banking in Europe was almost totally national in character. There was little exposure of European banks to the outside world. In this fragmented, nationally-based context, regulation and supervision could, and did, develop separately in each country. There were few bank failures and no bank crises between 1945 and the 1970s. During the cold war, institutions from the Communist countries began depositing dollars with European banks, especially in London, and the euro-dollar market grew up in the 1960s and the 1970s. The internationalisation of banking and the growth of the Euro-currency market were stimulated by national controls and regulations. Under Regulation Q with ceilings on interest rates in the USA, banks in the Euro-currency market had an interest-rate advantage in attracting dollar deposits. So the late 1960s and early 1970s saw an influx of branches and subsidiaries of US banks into most West European countries. The internationalisation of banking became a matter of increasing concern for the European supervisors. After the quadrupling of oil prices in October 1973, the oil producing countries received huge inflows of dollars which were mostly placed as deposits in the euro-dollar market. This development led directly on to the question of what the relative responsibilities of the home, and host, supervisory authorities respectively for the solvency and liquidity of foreign banks should be. Against this background, the author gives an account of the formation in 1974 of the Basel Committee on Banking Regulation and Supervisory Practices, later shortened to Basel Committee on Banking Supervision (BCBS). The first job of the BCBS was to sort out the relative responsibilities of home and host supervisory authorities for the subsidiaries and branches of foreign banks. In the BCBS there was no consensus on the best definition of capital, or on its appropriate ratio to assets. After difficult negotiations, a compromise – the Basel I Accord – was reached in 1987 and introduced in 1988. By the middle of the 1990s, BCBS had become the quasi-official financial rule-making (regulatory) body for banks throughout the world. It became practice that EC Directives transcribed positions agreed within the BCBS. The Achilles heel of the Basel Accords has lain in the conceit that the authorities could ascribe (constant) relative risk weights to various bank assets. It was decided that the sovereign bonds of all OECD countries should be treated as riskless. In the mid to late 1990s, the analysis of risk was becoming more quantitative and supposedly more “scientific”. Value at risk measures (VaR) were accepted by regulatory authorities who overlooked that these measures were designed to tell the top management of banks how risky its own portfolio was currently. The greater reliance on VaRs and bank-based measures of risk, in Basel II than in Basel I, and the increasing use of mark-to-market valuation made the whole system more procyclical. The regulators failed to realise that a procedure developed for private sector
commercial purposes was inappropriate for public and social regulatory needs. In
the view of the author, the recent crisis was due to a bet that housing prices would
continue to rise, or at least not fall sharply. Most members of the economic
community were complicit in that. Regulation has become, to some extent, global
under the aegis of the BCBS. Enforcement of regulation and supervision, however,
remained national. The global system is under increasing threat. The financial
crisis has caused a fragmentation of banking back towards a strong national
focus, especially in Europe. The eurozone crisis is ongoing. The future of Europe,
and of its banking system, remains uncertain and at risk.

In Chapter 8, Marc Quintyn, IMF Institute, and Donato Masciandaro, Bocconi
University provide an overview of the evolution of financial supervision. They
describe the development of supervisory structures in the last decades by means
of milestones. Reforms of the architecture of financial supervision have
historically been driven by liberalisation, international financial integration and
by experiences from crises. Gradual blurring of boundaries between countries
and markets has made changes in the architecture and strategy of financial
supervisors necessary. Growing international financial integration and the
formation of large financial conglomerates created a need for reforms of the
supervisory architecture. The authors classify models of the architectures into
1) “silo models” with separate agencies for supervision of banking, securities and
insurance, 2) “unified models”, where one single authority covers all market
segments, 3) “(twin) peaks models”, which groups supervision aimed at
preserving systemic stability in one peak, and the conduct of business supervision
in another, and 4) “hybrid models” with some supervisors monitoring more than
one market segment and others only one segment. In a sample of 102 countries,
each of the three first models have been chosen by approximately a third, while
very few countries have chosen hybrid models. Countries also differ regarding the
role of the central bank in supervision. According to the “integration view”, a
high central bank involvement is desirable, while the “separation view” based on
moral hazard, distorted incentives, capture risk etc. provides arguments for
keeping central bank involvement in supervision at a low level. The diversity of
supervisory arrangements in the world reflects the fact that no consensus has been
reached. After observing the unsatisfactory role of supervision during the global
crisis, the authors also arrive at the sad conclusion that all the reforms and the
hoped-for improvements in the effectiveness and the incentive structure for
supervision did not work. In their conclusion, the authors compare the search for
effective supervision with the search for the Holy Grail. In their view, it is
probable that it will never be found.

In Chapter 9, David T. Llewellyn, Loughborough University, gives an overview of
the development of bank business models over fifty years. The components of
business models are the range of business undertaken, the banks’ ultimate business
objectives, balance sheet management strategies, type of intermediation business and the banks’ response to regulation. The period preceding the crisis was characterised by intensive financial innovation, substantial rise in the volume of trading in complex derivatives, growth in the value of financial assets and liabilities relative to GDP, a more market-centric structure of financial systems, increased inter-connectedness, emergence of a shadow banking system, globalisation, a rise in gearing, more reliance on wholesale markets for liquidity and funding and diversification of banks into different business areas. The author compares the traditional model of a bank with a securitisation variant and a model with use of credit default swaps (CDSs). Countries in which banks stuck to the traditional model came through the crisis largely unscathed. New business models changed the nature of risks. The use of credit-risk-shifting instruments exposed banks to low-probability-high-impact risks. Reward structures produced a bias to excessive risk taking. Growth of securitisation and structured investment vehicles induced an over expansion of banking business and unrealistic perceptions of risk. The degree of “financialisation” became excessive and unsustainable. Partly as response to regulatory requirements, capital (equity) ratios in European banks rose in 2011 and 2012. This was brought about by some capital injections but mainly by a reduction in risk-weighted assets. Recent bank strategies include lower degrees of maturity transformation, retreat from cross-border business, increased dependence on ECB funding and reduction of the number of employees. There might in the future be a reversion to the more traditional bank model with less reliance on volatile wholesale funding sources and with implementation of reward structures without incentives to take high risks. The range of business undertaken by banks may be restricted in accordance with the recommendations about “ring-fencing” in the Vickers and Liikanen reports.

In Chapter 10, Philip Molyneux, Bangor University analyses performance in European banking as measured by productivity, profitability and employment. The number of banks has fallen over time with a general increase in concentration. In the 1960s, banking systems were still mainly national and segmented, and commercial banks focused on business customers. Mutual banks, of one form or another, were the main providers of personal financial services. An important financial sector liberalisation driver was the EU’s First Banking Directive of December 1977 that started a programme of EU legislation aimed at reducing barriers to cross-border banking activity. From the mid 1980s, deregulation at the national level eliminated many of the lines of demarcation between banks and other financial service providers, and helped facilitate cross-border competition. In order to realize scale and scope economies and spread risk through product or geographic diversification, many European banks took advantage of the new opportunities often through mergers and acquisitions. By the end of the century, significant progress had been made towards creating a
fully integrated single market in banking and financial services in Europe – in particular in wholesale banking. The implementation of the EU’s Financial Services Action Plan between 1999 and 2004 provided greater EU wide integration in the banking system, and increased the inter-connections between cross-border financial institutions. Technology revolutionized delivery systems and led to use of different business models. The author presents for the period 1985 to 2011 structural indicators for the banking sectors of the EU-15 countries. Banking sector concentration ratios have increased in the majority of EU countries. Competition intensified and drew down margins. This encouraged banks to supplement their income by diversifying into non-interest income areas such as insurance and securities underwriting. The literature investigating the development of the productivity of European banks has provided mixed results. There has been substantial variation in the average profitability of banks located in different EU countries. The financial crisis first affected European banking in the summer of 2007. From 2007 to 2010, the largest European banks reported huge credit losses, and received massive capital injections. We have seen a wave of government-backed bank bailouts, recapitalization plans, liquidity injections and credit guarantee schemes. Governments and their respective regulators have moved rapidly to close the gaps and weaknesses in the system for bank regulation and supervision. It is unclear as to what the ultimate impact of the ongoing regulatory reforms will be on the performance of European banks – although it seems likely that the reforms will lead to a more conservative and less competitive system.

In Chapter 11, Patricia Jackson, EY, United Kingdom analyses shadow banking and new lending channels. Shadow banking has caused or been at the heart of various financial crises in different periods and one important factor behind its growth has been the style and extent of bank regulation. In the 1970s and 1980s the growth in shadow banking tended to be related to property lending and, even though it was not complex, the crises were sufficiently severe to require central bank or government intervention. The 1990s steadily saw more and more complex structures being used in shadow banking peaking in 2007/2008 and being central to the financial crisis. The development of UK fringe banks and US savings and loans institutions was stimulated because their activities were outside any banking supervision or more lightly regulated than banks. In the USA, the role of money market funds grew fuelled by the attraction of what were perceived as riskless demand accounts paying yields above risk free rates. During the 2008 crisis, money market funds fell into difficulty. A run only stopped when the Government stepped in with a guarantee. A variety of different types of finance companies grew up over the 1980s and 1990s. They provided loans to consumers and companies and funded themselves to a large degree from wholesale money markets. Some shadow banking issues are related to reverse repurchase
agreements (REPOS). Basel I provided clear incentives for regulatory arbitrage. It encouraged the use of securitization to alter the risk profile of banks’ portfolios relative to the capital being carried. Special purpose vehicles (SPVs) were treated as legally separate from the sponsoring bank and therefore not consolidated into the bank’s financial statements and regulatory reports. The author explains by means of diagrams the use of different securitization structures, originate to distribute models for mortgages, issues of asset backed securities (ABSs), collateralized debt obligations (CDOs), rated mortgage backed securities (RMBSs), credit default swaps (CDSs) and structured investment vehicles (SIVs). Banks held large blocks of these opaque instruments in the form of off-balance sheet vehicles, and it was this extremely complicated nexus of exposures which fuelled the solvency problems at the heart of the crisis once the value of the securities started to be marked down. European securitization activity has been severely constrained post crisis. Regulatory uncertainty contributes to the current pressures on the European banking industry. Deleveraging provides new opportunities for shadow banks. There are several ways in which institutional investors can expand their lending activities. The author explains the structure of investment fund vehicles and uni-tranching. Other forms of shadow banking are receivables exchanges and peer to peer lending. All types of credit intermediation have to deal with information asymmetries between the borrowers and lenders. Mechanisms for management of credit risk are essential. There is a risk that problems of opacity and interconnectedness will again ensue. The future balance between shadow banking and banking is uncertain.

In Chapter 12, Juan Ayuso and Roberto Blanco, Banco de España analyse financial crises. The economics profession seems to have an unfortunate tendency to time myopia. If observers look only at the latest data, they lose the experience and the lessons from financial crisis that have taken place many years ago. Most crises have common features, which the passage of time tends to blur. In the chapter, the authors argue that the crisis in the Euro zone after 2007 is special in the sense that the countries involved are parts of a monetary union that was not designed to deal with any kind of crisis. The institutional set-up of EMU was not well-equipped to prevent the accumulation of vulnerabilities. The elimination of exchange risk and the integration of financial markets contributed to the underpricing of risk. When the crisis hit, policymakers reacted quickly and decisively. In addition to fiscal stimulus programmes, their partially coordinated actions also included measures in the financial arena. The coverage of deposit guarantee schemes was extended, interest rates were cut, non-standard monetary policy instruments were introduced, bond purchase and securities market programmes were implemented and government guarantees and public capital injections were applied. The crisis has underscored the need for a deep overhaul of the governance of the euro area. Promising steps have already been taken.
In Chapter 13, William Arrata, Alejandro Bernales and Virginie Coudert, Banque de France, give an overview of the development of derivatives markets. They focus on three main categories of derivatives: equity options, commodity derivatives, and credit default swaps (CDS). The option markets have been growing since 1973, after Black and Scholes found a straightforward formula to price them. Commodity futures have also happened to soar since 1973, as the oil crisis introduced instability in energy markets. Credit derivatives have been developing fast since the beginning of the 2000s in line with the securitization of banks’ loans. Derivatives were initially designed for hedging purposes, but they are also widely used by speculators. They therefore raise issues for financial stability. Derivatives markets may have taken the lead over their underlying markets in the price discovery process. The authors study the relationship between option listings and their impact on asymmetric information. Equity options can improve market efficiency by decreasing transaction costs and market risks. The oil crisis in 1973 raised the volatility in oil prices and boosted the market for oil derivatives. The volume of commodity derivatives market transactions on OTC and organized markets largely exceeds that of physical market transactions. The authors give an overview of the long discussion of the role of financialisation of commodity derivatives markets in market volatility. They end up by recommending efforts to reduce financialisation through increased market regulation. CDSs are over-the-counter instruments designed to protect bondholders against the risk of borrowers’ default. They can, however, also be used to speculate. The CDS market soared from the beginning of the 2000s up to 2008, its notional amount reaching USD 58 trillion. The market expansion included sovereign CDS markets, and the differentials in sovereign CDS indices were used as measures of the tensions in the Euro area. Bond and credit default swap spreads have been particularly high and volatile since the onset of the 2008 crisis. The notional amount of outstanding CDSs has declined substantially since 2008. At the end of 2012, the notional amount was about USD 25 trillion.

The ambition of the present 50 year anniversary volume was to bring together the contributions by a group of outstanding observers and analysts of monetary and financial trends in order to summarize the most important trends and experiences from the last five decades. By participating in the process of creating the book on behalf of SUERF during 2012 and 2013, the editors have benefited very much from discussions of the collected insights of the researchers. We hope that the readers will experience similar benefits. If some future decision makers are among the readers of the volume, we may even hope – in the spirit of Spinoza – that knowledge of the past experience may inspire improved policies regarding money and finance and a better macro-economic and micro-economic performance.

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