Beyond Europe's financial bifurcation point:

Policy proposals for a more stable and more equitable financial system

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The European citizens need a financial system that provides for their credit and payments-system needs without imposing costs from excessive volatility, recurrent crises and financial discrimination. Such a financial system will use productive finance to reduce inequality by levelling "up."As things stand, the European financial system both reflects the effects of three decades of worsening inequality and operates in ways that deepen it. This policy brief proposes ten reforms aimed at breaking the inequality-finance cycle in Europe.

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1. Introduction

The people of Europe need a financial system that provides for their credit and payments-system needs without imposing costs from excessive volatility, recurrent crises and financial discrimination. Such a financial system will use productive finance to reduce inequality by levelling "up." As things stand, the European financial system both reflects the effects of three decades of worsening inequality and operates in ways that deepen it.

Super-leveraged speculation enriches the 1% in the financial system's inner core while fragilizing the financial institutions on which commerce, industry, and households depend. When these institutions' weaknesses are exposed, it is the too-big-to-fail megabanks most prone to excessive risk-taking that have absorbed the lion's share of bailout support: not as a reward for cushioning the economy from crisis, but because of fear that their failure could lead to system collapse. These bailouts, which must be funded through public-expenditure cuts or higher taxes, increase inequality and contribute to the forces pushing everyday Europeans into predatory lending schemes. These uses of scarce national public resources have only propped up a dysfunctional and crisis-generating financial system. Shadow banks, their growth nurtured by megabanks' business models, have stepped in to supply credit markets that banks no longer serve. These poorly regulated funds' increasing role introduces new systemic risks of unknown magnitude. At the same time, competitive pressures from inside and outside of Europe have eroded the local banking structures that traditionally supported the small and medium sized enterprises at the heart of a numerous European economies' growth engines.

The European Central Bank (ECB)'s inflation-focused operations and its reluctance to play either a lender-of-last-resort or a burden-reducing refinancing role, together with national banking authorities' failure to rein in excessive financial leveraging and risk-taking, have given rise to financial-market concern that Europe's megabanks are now too-big-to-save. The ECB will not save them; the nations that chartered them cannot save them.

So Europe's financial system is caught in a self-reinforcing cycle. Speculative finance heightens fragility and worsens inequality, leading to asymmetric rewards for those in the financial inner-core and generating crises whose costs are paid disproportionately by the rest of society, enabling a new round of speculative finance, and so on. The costs from the failures of super-leveraged finance spill over to society as a whole, but the gains from super-leveraged finance never do.

The European Commission's policy initiatives to centralize and rationalize financial regulation are welcome. But these initiatives, some undertaken in coordination with the G-20's financial-regulation initiative, have not fully addressed the scope of possible risks. The Commission's "bail-in" feature – the idea that the costs of a failing bank should be borne by the depositors of that bank's home nation – guarantees a future in which the European taxpayers, who have no access to tax shelters and who have already paid for a first round of bank bailouts, will pay again when the next round of bank bailouts erupts.

Restoring popular trust in finance requires ending the reliance on top-down directives in moments of crisis, and instead ensuring that the financial system is functional from the bottom-up. This policy brief proposes ten reforms aimed at breaking the inequality-finance cycle in Europe:

Reform of European banking and financial market regulation

1. Eliminate excess financial risk-taking.
2. Rein in the activities and size of too-big-to-fail megabanks.
3. Gain regulatory control of shadow banking and of offshore financial-centre tax-havens.
4. Limit those forms of interconnectedness across national borders that can lead to destabilizing financial flows, make liquid markets brittle under crisis conditions, and exploit borrower firms and households in lower-income European countries.

Structure and functioning of European banking and financial markets

5. Encourage pluralistic banking systems to better meet local needs.
6. Retool the European Investment Bank (EIB) so it can better facilitate European economic and social development; and create national development banks that function as strategic allies both of the EIB and of member countries' governments.
7. Reform the mandate of the European Central Bank (ECB) to include employment targets, and make the ECB democratically accountable.
8. Rethink the forms, extent and terms of Europe's financial integration with financial centres and firms in the rest of the world.

The financial rights and financial security of everyday Europeans

9. Set trans-European limits on predatory lending.
10. Establish the concept of financial citizenship for Europeans.

Section 2 briefly summarizes the recent history of European finance. Section 3 sets out its contemporary crisis and its possible futures. The key point is that there is no "normal" to re-establish. The European financial system faces a bifurcation point. It will either become more centralized and top-down, or more locally responsive and bottom-up. Nothing in between is sustainable. Section 4 provides some support for the idea that the policy measures advocated here can create a more locally-responsive and safer system.

2. The recent history of banking in Europe

The financial sectors of the nations of Europe have co-evolved in the last quarter-century, under the impetus of market innovation and opening, deregulation, European integration and intensifying global competition. A particularly important driver of financial-system change and transformation was the design of the Eurozone financial framework, wherein nation-states would remain responsible for maintaining safety and soundness and for defining their intermediaries' institutional mission. The Principle of the Single Market meant that each national market would be open to free entry by other

nations' financial-services and market practices. At the same time, nation-states' central banks would lose the lender-of-last-resort capacities they'd had prior to the introduction of the Euro. Central-banking powers were vested in a European Central Bank which was given an incomplete mandate: it was tasked with fighting price inflation, but not given a lender-of-last-resort directive.

This design created special challenges for European financial systems. Its failure to offset Euro-adopting nation-states' loss of their lender-of-last-resort capacity with a lender-of-last-resort mandate at the Eurozone level implied that the system could not have a financial crisis. This mechanism design was seen as eliminating the possibility of moral-hazard-motivated behaviour by member-nations. This implied, as well, that the Eurozone could not withstand a profound financial crisis without setting aside its own rules. This was, to say the least, a strong bet on the capacity of market forces to anticipate the build-up of excessive risk and to react in ways that defused possible crisis moments in advance.

A second set of challenges arose because Europe's financial systems had evolved in very heterogeneous ways, reflecting the diverse political and economic circumstances, as well as the regional variations, that underlay nation-state formation. The key difference arose between the arms-length-market approach to credit and financial-service provision in some countries (notably Great Britain) and the "relationship-based" approach in other nations (with Germany as a paradigm case). In some parts of Europe – such as Spain, Italy, and Germany – regional and city-based financial institutions provided core financial services; elsewhere – the Netherlands, Luxembourg, and Switzerland – regional differences were unimportant, and instead international linkages were fundamental.

To prepare for the Single Market, most of the nations entering the Eurozone encouraged banking consolidation in advance of the introduction of the Euro. This established national champion banks large enough to stand up to the force of the heightened competition. With expanded markets and – in most cases – national regulatory mandates to expand the scope of their activities, change was in the air, especially for new national champions. At the same time, many national components of European banking retained defining elements of their distinctive characters – gathering in local savings, providing mortgage credit or commercial and industrial loans, as per the business practices these institutions had established many years before.

Many apparent benefits flowed from Europe's embrace of a Single Market in finance and strong cross-border capital flows: until the crisis year of 2009, the Eurozone as a whole experienced a uniformly low interest rate as capital flew from surplus areas to deficit areas – the sort of resource reallocation that economic theory suggests should occur. However, these benefits were uneven, and they unfolded on a shifting financial playing field. Some institutions lost their function, and either came under stress or had excess investable funds; others saw seemingly irresistible opportunities for expansion. Smaller, "less competitive" banks – many of them in peripheral nations and aimed at catering to local needs – disappeared as intra-European competition increased. Others started to engage in alternative business practices and financial operations so as to survive in an

increasingly competitive environment.

Parallel to these important changes within the Euro-area, financial intermediation worldwide was undergoing several epochal transitions. Deregulation at a time of increasing communications speed and falling information-processing costs led to a shift toward standardized practices and arms-length financial instruments: institutions offering customized, relationship-based intermediation shifted to market niches, as some of their former customers were left behind. Rising global imbalances – especially the US's chronic capital-account surplus (a consequence of its chronic current-account deficit) – increased the pools of savings looking for offshore investment options.

The rise of stateless money accentuated the importance of regulatory gaps and led to hyper-leverage in money markets and to the multiplication of markets for both speculation (risk-taking) and for hedging (insuring against financial risks). Large financial firms operating comprehensive, integrated financial service platforms on a global scale – that is, megabanks – have been best able to exploit the profit-making opportunities thrown up by this new landscape of finance. The size and scale of the megabanks, driven by unrelenting global competition operating on a 24-hour-per-day, 3600-seconds-per-hour basis, has grown out of all proportion. This includes both geographic expansion and the creation of new financial products - the latter in many cases too complex to be understood even by their own creators. One consequence has been the disproportionate income and wealth gains experienced by the top 1% in virtually every country; another has been the growth of bank balance sheets to levels far exceeding their host nations' gross domestic products. The result of the first consequence is the tremendous influence of those at megabanks' inner-core on the trajectory of financial regulation; the result of the second consequence is that megabanks that are too-big-to-fail can generate financial black holes that are too large to fill even with all the income earned by all the businesses and workers in any nation. Another result of rising income inequality and on the competitive pressures acting on (and emanating from) megabanks was the emergence of a vast shadow banking system which caters to the "super-rich" and conducts banks' operations off-balance sheet. These institutions escape regulatory oversight but pose substantive systemic risks due to their interconnectedness with the core banking system.

3. The contemporary crisis of European finance and its two possible futures

The collapse of leveraged subprime securitization from 2007 onward compromised global liquidity and forced the use of scarce national public resources to prevent collapse. The banks were rescued, but credit remains unavailable for small/medium businesses. Predatory lenders have moved in to help income-constrained households make up their expenditure gaps. Meanwhile, housing markets have not normalized. Spanish and Greek markets, are sites of speculative purchases by hedge funds and megabank subsidiaries.

Approaching a bifurcation point in European finance. Since 2007, the scope of the instability and multiplicative losses to which a leveraged originate-to-distribute, largely-unregulated system of finance can lead has become clearer and clearer. Money markets

have melted down, frozen, and been subjected to rate manipulation by insiders. Non- or poorly-performing assets have either been exposed and caused losses or else remained hidden on the balance sheets of financial firms unable to declare the extent of their losses, in nations unable to bear the cost of marking these assets to market prices. In effect, the US subprime crisis broke open the tension between the older traditional character of the financial system and its newer, more speculative activities. The results have been uneven: some attempted mergers have fallen apart, some tranches of bad loans have been written off, and some speculative vehicles have failed. Huge damage was done. Since megabanks were in most cases supported by too-big-to-fail public interventions and subsidies, this damage to lending and savings channels has been concentrated among the smaller and more localized institutions. Local banking systems have become more concentrated and less diversified.
Households have lost homes, and businesses have lost access to credit just when it has most been needed. Shadow banking and predatory lending has further grown to fill the void previously filled by a diverse set of banking institutions.

European national governments that are members of the Euro zone have been caught in a particularly vicious whipsaw by these developments. The design of the Eurozone does not allow for central-bank liquidity provision for either the case of a meltdown in a national financial system or the case of budgetary deficits. Nation-states in either situation can use (and have used) their banks' lending capacity in crisis moments; but this ends up being a short-term fix that compromises market confidence, imposes borrowing-cost penalties, and creates destabilising negative sovereign-bank loops. The stock of unpayable bank and government obligations can multiply faster than resources can be freed even with extreme austerity policies.

The possibility of attacks by suspicious global investors on bankrupt governments and insolvent banks will cease only in one of two circumstances. One circumstance is that the possibility of unpayable obligations, linked to speculative excess, by banks so overleveraged and large that their liabilities exceed the capacity of their national states to meet them, is taken off the table. In this scenario, megabanks' balance sheets are shrunk, and their speculative activities and links to international financial markets reined in to the benefit of local banking needs. The other alternative is that the possibility of unpayable obligations due to unmanageable balance sheet size, speculative excess and overleveraging remains; but this possibility has to be (?) accompanied by the certainty of lender-of-last-resort intervention when and if necessary by a willing and able central bank. The ECB will, in any case, be willing to use its full powers to bail out European banks in trouble, if and when they need it, only if the banks in question are indeed European in scope. This future scenario would thus be one in which a small set of large banks with truly European market presence – in lending and in payments and saving services – were operating.

This is then the bifurcation point. In one direction, a diverse eco-system of European banks, differing among countries and regions, all operating at scales and in activities that do not pose risks larger than their national governments can handle. In the other direction, a small set of homogeneous large European banks, offering similar products and services throughout Europe, operating adventurously in global markets – in head-

to-head competition with large Wall Street banks; systemic and even catastrophic failure would be a possibility, one that is viewed as more than offset by the gains accruing to international financial center status. In this latter scenario, the European Central Bank would have to accept its role as a backstop against meltdown, since meltdown would bring the entire European financial system with it. The first part of this latter option – the existence of megabanks whose scale dwarfs national income flows – has already happened. What has not yet happened is continent-wide expansion by a small set of European (or non-European) megabanks; it may yet come. Regardless of whether the European Central Bank agrees to backstop the banking system, though, this sequence of events is likely to end in catastrophe.

European banks themselves, caught between Wall Street and the City of London, are lobbying for maximum regulatory flexibility and no restraints (bonuses, bank size), while searching for new business models. Their view is that flexibility will permit them to overcome any challenges they might foresee. But the reality is that only extraordinary measures and luck permitted Europe's banks to survive the 2008 crisis. The capacity of European governments to support – and if necessary underwrite - new megabank recombinations and rescues under the current patchwork quilt of national bank/national-sovereign circumstances should not be exaggerated.

In any event, Europe's financial system has not returned to 'normal;' it will not, and it cannot. 'Normal' banking was replaced in the 1980s and 1990s by a system that hurtled into the originate-to-distribute, securitization-driven, risk-hedged future so fast and furiously that no stability – no 'new normal' – was ever achieved. Further, changes associated with the coming of the Single Market have cast traditional banking institutions into next contexts; their purposes must be re-examined, their client bases redefined, and their focus and social efficiency restored. So it is no use thinking of restoring the 'normal' functioning of the banking system. The financial system should be rebuilt, working from first principles regarding what purposes it serves in the broader economy and in full recognition of the capacity and willingness of nations across Europe to come to assist when any one nation's financial system is in jeopardy.

4. Policy proposals for more stable and equitable finance

This section takes the first step toward shaping a productive financial system for Europe by setting out ten policy proposals in three clusters: one focused on regulation, the next on market structure and purpose, and the last on consumers of financial services.

4.1. Regulation and oversight of European banking/financial markets

Problems posed: As argued above, pressures and forces at work across Europe have created national banking sectors that are increasingly large relative to national GDP, able to more freely take positions in speculative instruments and offshore markets, and more able to build increasingly complex interconnections both across their own balance sheets and with other firms.

Uneven and often permissive regulatory vigilance, combined with lax tax laws and with the increased capacity and willingness of market participants to securitize loans (and to bundle and sell loans originated by others), in the context of loosening controls on capital movement, have opened the doors to the creation of offshore activities in tax havens and to shadow banking activity. Shadow banking, of course, is the name given to activities that are historically associated with core banking – in particular, credit provision, underwriting, lines of credit, and so on – but which are undertaken by financial vehicles outside the normal channels of bank regulation that escape the vigilance of bank regulators. Since shadow banks are, in most cases, operationally integrated with megabanks chartered in nation-states, shifting financial activities from banks to shadow banks is no guarantee that the onerous costs of financial meltdowns can be avoided. To the contrary, such a shift virtually guarantees that a day of reckoning lies ahead.

In consequence, some of the weaknesses in European banking that have been exposed in the past five years have to be addressed by regulatory shifts aimed at ensuring that European banks function well, even in adverse circumstances.

Some solutions: Reform of European banking and financial market regulation

1. Eliminate excess financial risk-taking.
2. Rein in the activities and size of too-big-to-fail megabanks. Set size limits on banks' on-balance-sheet and off-balance sheet activities.
3. Gain regulatory control of shadow banking and of offshore financial-centre tax-havens.
4. Limit those forms of interconnectedness across national borders that can lead to destabilizing financial flows, make liquid markets brittle under crisis conditions, and exploit borrower firms and households in lower-income European countries.

Eliminate excess financial risk-taking. To avoid excessive risk-taking, bounding leverage is fundamental. For a key problem at present is not just megabanks' willingness and capacity to take large risks with their own resource, or even with their clients' money; it is rather that the current market architecture permits multiple institutions to take what may turn out to be excessive risks based on the multiplication of the same pledged collateral.1

One way to mitigate excessive risks is to establish a financial transactions tax on short-term position-taking. Proposals along these lines have been made and extensively debated in the European Parliament, as have proposals to tax financial profits. An alternative method of risk mitigation, which is not incompatible with the first, is to establish firmer regulatory control over financial markets and processes. Such regulation should be forward looking and comprehensive. It must address the problem of regulatory "gaps," as well as the possible complications arising from having multiple regulators. Special attention must be paid to controlling the interconnectedness among

[1] Rehypothecation is the name given to the practice wherein an institution accepts collateral (such as a Treasury bill) in exchange for providing a loan, but then re-hypothecates – sells – this collateral on, in exchange for another loan, which in turn leads to another loan and possibly others, within the time-frame and efficiency of functioning of the network of bank interconnections in question.

different financial functions and markets, especially across national borders.

A third approach is "ringfencing" – separating "core banking" activities – and any guarantees of back-stopping them with public resources – from "non core" activities, which would be conducted without any public safety net. Ringfencing does not obviate the need to rein in excess leveraging and interconnection; to the contrary, a ringfence will only work if one part of a financial conglomerate can fail without bringing the rest of the financial system with it. Requiring that non-core financial transactions be exchange-traded is helpful: this will normalize secondary markets and put in place a market maker obliged to look after the welfare of the market. This market maker has incentives to limits leverage and the offloading of risks, so that most markets will continue to operate even when dire circumstances jeopardize a subset. Market makers have an incentive to set limits that respond in real time to evolving patterns of position-taking.

Rein in the activities and size of too-big-to-fail megabanks. One way to eliminate the too-big-to-fail problem is to set size limits on banks' on-balance-sheet and off-balance sheet activities (based on a reference point such as member nation GDP). Note that this size limit must correspond to the capacity of the available rapid resolution mechanism for banks in danger of becoming insolvent. If resolution mechanisms are de facto national – something implicit in the "bail-in" provision of the newly-adopted European model of unified regulation – then size limits must be clearly linked to national GDPs. The efforts to rein in megabanks then must also pay attention to off-balance-sheet obligations, and indeed to the definitions used to differentiate between on- and off-balance-sheet activities.

If the resolution mechanism established against the possibility of systemic emergencies – for example, an ECB equipped with a market-calming mandate – is Europe-wide, it is important to insure that timely intervention will occur. The discussion above about system bifurcation has highlighted some scepticism about the willingness of Europe-wide governing bodies to play a crisis-resolution role effectively for banks whose scope of operation is less than Europe-wide. If such a Europe-wide mechanism were created, it could be funded with uniform Europe-wide deposit insurance and a percentage pay-in to a deposit insurance fund for European banks. Note that the current European legislation putting in place a unified bank regulator for systemically important banks represents a step in the right direction.

But there is a dilemma here that has to be faced. On the one hand, many of the design features of the Eurozone can be traced to participating nations' concerns about other members' backsliding on behaviors that could put the entire Eurozone under threat. But while such moral hazard concerns are real, it is also true that the lack of full-faith commitment to doing "whatever is necessary" to overcome systemic threats to European banking as they emerge, no matter the cost, is problematic. Speculators prey on weakness in moments of financial panic; and if speculators are up against an opponent (the ECB) that has limited capacity to respond in crises, they are more likely to push harder, rather than back off, in the midst of a crisis. The point here is that resolving this dilemma will require careful thought – not inattention or denial.

Gain regulatory control of banking and of offshore financial-centre tax-havens. Shadow banks – that is unregulated non-bank institutions such as hedge funds, institutional asset managers, and private equities – have experienced unprecedented growth in part by increasing leverage, and in part by taking on banking functions that megabanks are shedding. Shadow banks operate outside public scrutiny and exercise no public functions. Their aim is to cater to high-wealth individuals or banks to generate excess returns. They pose system risks because of their close links with the official banking system; and their operations can be read predatory. Thus, shadow banking should be strongly restricted and moved into regulatory control and "outside the shadows".

The regulations of hedge funds that have recently been established are a step in the right direction. These regulations should limit hedge-funds' penetration of European credit or asset markets. Such limits are crucial in assuring that regulators are able to de-complexify Europe's money and interbank markets; this will not only make them more transparent, but will also make them more robust when they come under pressure in periods of global financial-market pressure. And in any event, it is important to require more balance-sheet transparency and outlaw tax-haven activities within the European Union.

Limit destabilizing, illiquidity-inducing, and exploitative forms of interconnectedness across national borders within Europe. Permitting financial flows across borders is, in principle, a way to equalize opportunity and reduce wealth disparities among interconnected regions: capital-rich areas export money to capital-poor areas, and everyone gains as regional returns equalise. While this result follows under strict textbook conditions, in the world of experience many other possibilities can arise.

It is largely the case that money – in the form of debt commitments, equity flows, or greenfield investment – flows from Europe's Northern reaches (the 'core') to its Southern reaches (the 'periphery'). This is regarded as a natural accompaniment to Europe's optimal-currency-area design. It should – again according to textbook principles – permit more rapid industrial and employment development in areas with lower wages and other costs. In practice this is demonstrably not the case. Foreign capital has been channelled into unproductive investments, such as local housing markets, and has taken advantage of sustained yield differential between the core and the periphery. Lower-income areas' asset prices will be very susceptible to "sudden stops" in cross-border flows of capital to buy those assets. Asset-price rises in peripheral areas will quickly rise to unpayable levels vis-a-vis local income flows. In effect, financial market transfers cannot substitute for fiscal recycling mechanisms. Indeed, it has to be considered that in other integrated federations (such as the United States), capital flows across intra-national borders are only one dimension of equalizing flows. There are fiscal transfers – recycling mechanisms – as well, which channel money from higher-income to lower-income spaces. This does not happen in the Eurozone – the cross-border flows of Eurozone budget funding are negligible.

In the absence of such mechanisms, the risks of destabilizing market outcomes are

higher. So financial institutions that decide to take on the risks of providing mortgage loans for home purchase, for example, should take the loss when risks are realized at high levels. Further, financial firms in European markets should not be able to exploit the higher levels of financial distress in lower-income countries by making predatory loans to the inhabitants and firms of those nations. Europe need not be the site of the internationalization of the subprime market. This is especially the case because the gains from financing risky projects in peripheral countries are privatized, while the costs, when such schemes fail, are borne by the public. Destabilising cross-border financial flows should be replaced by implementing both far larger fiscal transfers and by implementing ex-ante debt restructuring mechanisms.

The current configuration of the money markets, as noted above, is one in which excessive leveraging is chronic. When that leveraging is obtained by money-market flows across borders, leading in turn to multiplicative asset purchases, the money market becomes very susceptible to shifts in funding flows from outside the Eurozone. Reducing excessive interconnectedness can insure that money markets will behave more normally – by shifting liquidity to where it is needed – in crises, rather than becoming themselves liquidity deserts due to refusals to refinance.

4.2. Structure and functioning of European banking and financial markets

Problems posed: There is currently a lack of funding available to support the operations and/or expansion of small and medium enterprises throughout Europe. This problem exists now, insofar as some deleveraging has already occurred in some nations; and further deleveraging will be needed to meet banks' required capital-asset levels. But further deleveraging may be necessary, as discussed above. Under such circumstances, it will be crucial to insure that firms and households have access to the credit and financial services they require so as to facilitate recovery and growth. Here active intervention by public banks to affect market dynamics, as well as recourse to the diverse eco-structure of European banking, will prove decisive in guiding overall banking-system responses to enterprise credit demand.

There is a further dimension to the problem of unmet credit demand. That is, in times of stagnant growth, existing businesses struggle to maintain operations; so the focus falls on the adequacy of working-capital and inventory-financing availability. What cannot be forgotten is the need for venture capital and start-up capital to provide a boost for next-generation businesses that may lead to the next wave of economic growth. Innovators need access to financial services as much as do established business leaders. Private-sector banks are unlikely to sort out worthy and unworthy business prospects in good times; in slow-growth periods, this likelihood decreases further.

This leads to the need for European development banking capacity. It is worth considering whether a broader view of the purposes of the European banking system should be taken on in this period of stagnant European growth. What would be required to position European banking as a venue for helping to create a European economic future by financing next-generation businesses as well as worthy existing businesses who need credit support. Some of this support already exists in the loan offices of

smaller, regional banks that understand their business customers and their real dynamics. Some of it, however, has to be re-envisioned. For this purpose, it is worth thinking about the circumstances surrounding the creation of the Euro itself, vis-à-vis the trajectory followed by developing nations such as Brazil and South Africa.

Some solutions: Support diversity and public purposes in the structure and functioning of European banking and financial markets.

5. Encourage pluralistic banking systems to better meet local needs.
6. Retool the European Investment Bank (EIB) so it can better facilitate European economic and social development; and create national development banks that function as strategic allies both of the EIB and of member countries' governments.
7. Reform the mandate of the European Central Bank (ECB) to include employment targets, and make the ECB democratically accountable.
8. Rethink the forms, extent and terms of Europe's financial integration with financial centres and firms in the rest of the world.

Establish more pluralistic banking systems responsive to local banking needs. What is especially lacking now is working-capital for small and medium enterprises. It is crucial to revitalize the financial institutions that serve modal non-financial businesses, drawing on traditional national forms. Cooperation between cooperatives and community-based initiatives (CDFIs) is to be encouraged. Further, criteria for more economically-functional banks should be developed and applied at the national regulatory level.

Retool the European Investment Bank (EIB) and create national development banks in Europe. One model for the EIB is provided by the Brazilian National Bank for Economic and Social Development (BNDES). The EIB should be able to nurture European infant industries in potential growth areas for the global economy; it should be able to support SMEs' as well as larger enterprises' growth; and it should be able to support social as well as economic activities. The EIB should be permitted to take equity positions in industries it supports. To facilitate this expanded agenda, the EIB should be provided with annual budgetary support from the European Commission's budget.

The interventions of a (largely) net set of public financial institutions into credit and venture-capital markets could build industrial capacity and equitable development across Europe. Embedding it at the national, and not just European level, means that it would turn from an unobtainable iconic ideal (in the view of most nations) into a set of national development plans.

The idea of development banking has advanced considerably over the past several years. Once, the idea was that development banks would undertake, primarily, big-ticket, high-publicity projects associated with grand national development agendas. This was the case, for example, with the Brazilian National Bank for Economic and Social Development, which was founded in the early 1950s with the aim of creating a Brazilian energy industry (and which responded by financing the founding of Petrobras, currently the 20th largest global business). This concept has subsequently been refined, however.

It is now understood in Brazil that development planning and intervention can be scaled locally as well as nationally. Europe's Horizon 2020 plan, in turn, envisions increasingly interconnected city-regions, industrial and intellectual hubs, and enhanced communications among knowledge-exchange networks. The capacity exists in Brazil – at the level of its development bank and of its publicly-owned commercial banks – to provide the support funding needed to bring the firms that might populate these networks to life.

Europe faces limitations here because its banks, large and small, are hampered by problem loans and capital deficiency, and thus are reluctant to take risks on new investment areas. In addition, the new Basel III rules penalize banks for undertaking commercial and industrial loans. This is precisely where government can step in.

Reform the mandate of the European Central Bank. The last of our proposals in this section is longer-term in focus and would require changes in the rules of the European Union. It involves the European Central Bank. First, the ECB's policy objectives should be broadened to include employment (unemployment rate) targets, alongside its price inflation mandate. Second, the ECB must also be made democratically accountable to the citizens of Europe; it should regularly report on and explain how it is meeting its inflation/employment targets. Third, make it clear that the ECB has lender-of-last-resort responsibilities that entail protecting the liquidity of the money markets of all European member nations. It is understood that these or other suggested reforms of the ECB represent longer-term objectives, as they would require profound changes in the rules under which the European Commission operates.

Rethink the forms, extent and terms of Europe's financial integration with financial centres and firms in the rest of the world. European policy-makers should consider splitting Europe's financial markets and institutions off from global-megabank competition with Wall Street by setting limits on over-the-counter derivatives, trading on 'own account', leveraging of risky activities, credit-default swaps, etc.

Europe's embrace of the Single Market has opened up the possibility of a Europe-wide financial market; the fact that the City of London falls within the Union opens Europe's market to the world. As noted above, nation-states within the Union have reacted in part by bolstering "national champion" banking firms that could survive these shifts; a number of European banking firms have climbed the global financial league tables.

This has not come without cost. The past 30 years of global experience have taught us that excessive financial openness exposes nations and regions to huge swings in financial flows, prices, and risks. It puts national banks under competitive pressure from globally operating financial institutions. And it has to be remembered that the roots of the European crisis lie in European financial institutions' interpenetration with instruments and contingent liabilities emitted on Wall Street and, to a lesser extent, in the City of London. The firms with which European banks have been competing have become excessively complex, unaccountable entities whose earnings derive from taking and selling risks. Herding and imitative behaviour lead to rapid shifts among markets. These firms objective is no longer serving sectors needing financial services, but beating

competitors to new market niches. The result is continual disruptions in financial markets, the manufacture and then reproduction of excessive complexity and leveraging, and the view among policy-makers that the only way to appease the financial markets is to cut back social Europe and its safety nets and public goods.

This cause-effect chain is rooted in the openness of Europe's financial system to global flows of capital controlled from tax havens. Positioning the markets as judges of the feasible cannot work. For one thing, it puts Europe's money markets – perceived by Schumpeter as the "engine room of capitalism" – under continual threat of breakdown. For another, the financial markets impose contradictory demands: their participants both want the flexibility to unwind without damage and financing structures that they perceive as sustainable. In a world of uncertainty and continual geo-surprises – the world in which we live - this contradiction will necessarily arise; it cannot be avoided. One end or the other must be unwound. The financial markets will either continue as masters of social and state relations, occasionally making fresh demands for forbearance or bad banks or bail-ins or subsidies, or they must be reshaped into the servants of these relations. And the point of departure for shifting from the former to the latter is to reconsider the forms, extent, and terms of European financial institutions' integration into the rest of the world. European financial institutions must be refocused to serve the financial needs of European firms and households, and weaned away from the idea that they will succeed when their scope of freedom of action equals that of Wall Street. As noted, Europe does not have a central bank willing and able to play the role for its financial centres that the Federal Reserve plays for Wall Street; nor are its nation states able to bear the cost of overleveraged megabanks' occasional failures. A global financial centre in any European Eurozone country is simply not sustainable. Whether or not a "China-type" financial structure is the right way forward can be debated. But any such change will begin by reworking the cross-border integration of European finance.

4.3. The financial rights and financial security of everyday Europeans

Problems posed: Household members and small/medium enterprises are most exposed to the ups and downs associate with the crisis: lower and less secure wages, and reduced working hours for workers; declining sales and eroding lines of credit for small businesses; and for both, heavier reliance on credit to fill in gaps between falling/stagnant incomes and rising costs.

While these pressures are at work, the financial institutions that serve households and businesses are experiencing cash-flow, loan non-performance, and illiquidity problems. They are under pressure to increase efficiency and capital, which means being cautious in loan commitments and closing branches. The result is likely to be reduced financial service provision in lower-income neighbourhoods, declining urban areas, and rural areas.

The combination of reduced financial-institution service capacity and increased household/small-business need makes it likely that alternatives will emerge; and those alternatives are likely to involve lenders in less-regulated portions of the credit market. These market conditions, indeed, make various forms of predatory lending more

attractive. And in a world that is increasing reliant on digital communications – especially mobile applications and internet linkages – the opportunities for such un-monitored lenders to invite the needy and the desperate to sample their products multiply weekly. While some non-bank lenders provide credit to risky borrowers at rates that are not abusive, many do not; those who borrow with such lenders are most likely entering debt traps from which escape is all but impossible. Migrant workers are especially vulnerable.

Some solutions: Secure the financial rights and financial security of everyday Europeans:

9. Set trans-European limits on predatory lending.
10. Establish the concept of financial citizenship for Europeans.

Set trans-European limits on predatory lending. Unregulated lenders who set payday and other lending rates at very high rates for economically vulnerable people should be reined in. The European Community can lead the way by establishing standards for non-bank lenders, including limits on the borrowing rates, penalties, and fees that they can impose. The European Commission, having already proposed frameworks for capital markets, for consumer protections on bank account fees, and for investment funds, should take up this portion of the credit markets as an urgent matter. In so doing, it will be important to insure that enforcement mechanisms are in place, thus inducing informal and lower-income lenders to comply with the limits established. South Africa's National Credit Act of 2005, and the US Home Ownership Equity Protection Act of 1994 provide examples of alternative legislative approaches.

Establish the concept of financial citizenship for Europe. The idea of financial citizenship, introduced in Dymski (2005) and refined in Kear (2013),2 builds on the idea that financial inclusion is more than a guarantee of access to a given set of markets; it involves instead the notion of voice and exit rights for European citizens in their transactions with financial institutions. Consequently, the financial citizenship concept should include: the right to a bank account no matter the level of income; the right not to be subjected to predatory lending; and the right to be protected from the threat of duplicitous, misleading lending offers and excessive fees.

[2] See Gary Dymski, "Financial Globalization, Social Exclusion, and Financial Crisis," *International Review of Applied Economics* 19(4), October 2005: 441-459; and Mark Kear, "Governing Homo Subprimicus: Beyond Financial Citizenship, Exclusion, and Rights," *Antipode* 45(4), 2013: 926-46.