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When the financial crisis broke in early 2007, few envisaged the dimensions it would ultimately assume. At that time, the talk was mainly of a "correction" in over-inflated asset markets, mainly real estate and stock markets. The general expectation was that following this correction, markets could resume on their "merry way" and we could all return to our habitual profit-making activities.

Almost two years further on, the picture is quite different. The talk now is of "financial meltdown" and a new "Great Depression", as typified by an article by Joel Geier*). The former may have been averted, for now, by extensive state guarantees and recapitalisation of the banks; the latter is the reason for record deficit-spending programmes by the Obama government in the USA, in the EU, and elsewhere. After months of seeking to deny the advent of recession, we are now confronted with the prospect of a deep depression.

The optimism industry still talks of recovery in late 2009 or early 2010, and we sincerely hope that this buoyancy does not turn out to be unwarranted. However, we do notice that this hoped-for recovery is predicted in a time frame for which our projections tend to be rather imprecise, all the more so at present because current circumstances are atypical – in the language of forecasters, we are predicting out of sample range. Even more worrying is the thought that should the current global recession follow the pattern of the Japanese crash in the 1980s, and there are certain disturbing parallels, we may be in for bad times in the long haul.

One of the few growth industries at present is that of commenting on, and analysing, economic developments. Much of the comment focuses on the reasons for the financial crisis and a hunt for the guilty perpetrators of our misery. While an analysis of the causes is definitely of interest, much of this comment misses a fundamental point about our financial system, i.e. that the system, by its very nature, is permanently on the brink of crisis. A crisis could descend upon us at any time, triggered by factors which may not be readily predictable.

For this reason, it is more appropriate to focus on the institutional organisation, or architecture, which might offer some promise of avoiding a future recurrence of our present woes.

The Perpetual Problem of the Financial System

The emergence of human society from a primitive economic organisation of self-sufficiency combined with a measure of barter, to the specialised and diversified form we know today, would be completely unthinkable without a financial system. Health and education services would be virtually non-existent; communications, travel and transportation almost unknown; and investment, mechanised production, mass employment as well as saving for holidays or retirement all but impossible. Indeed, many regard it as the greatest socio-economic invention of mankind, and a benefit for everyone.

The benefits of the financial system are so beyond dispute that it is matter of public concern that it should perform well. Normally it does, but sometimes, like the present, things can go wrong. When they do go wrong, everyone suffers, with few exceptions. For this reason it is of the utmost importance that the stability and proper functioning of the system be protected and safeguarded.

And what does this wonderful invention do? Well, it has several functions, but its main one is accumulating the surplus, or savings, of potential lenders, and transferring them to borrowers who would like to carry out investments, and thus enlarge the economic pie. Sounds simple, but it's not.

The bulk of net saving is carried out by households, which have very specific goals and wishes concerning their savings. Most of the net borrowing, and investment activity, is carried out by corporations and organisations, which have quite different needs. There is an irreconcilable gap between the expectations of the two groups. The most important point for this discussion is that savers wish to lend on a short-term basis, i.e. have immediate access to their savings at all times, whereas investors need to borrow on a long-term basis.

It is the financial system which reconciles the wishes and needs of the two groups and it does this through a subtle subterfuge. It takes in the savings of households in exchange for short-term secondary securities, essentially promising them they can have their savings back at any time. It then lends them to investors in return for primary securities, basically permitting them to use the funds long term.

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I am indebted to Ciarán Cassidy for his assistance and support in the preparation of this article.

**) Joel Geier, The Coming Economic Meltdown, International Socialist Review (online edition), Jan.–Feb. 2008*

This subterfuge, which goes under the obfuscating title of "asset transformation", can only be sustained for as long as savers believe the promises they were given or, if they are aware they are being deceived, are still prepared to behave as though they believed them. To help this belief along, banks hold reserves, i.e. they do not lend out the full amount of savings they take in. In addition, banks hold capital to absorb losses which arise when a borrower/investor goes bankrupt and defaults on his repayments. Both reserves and capital help to reassure savers that their savings are safe, but they also constitute a cost for the financial intermediary required to hold them.

If all, or even a significant proportion, of savers were to turn up at their savings institutions on a particular day and demand to withdraw their funds, in line with their contractual entitlements, the entire financial system would collapse in a domino-effect. It could happen on any day, or on any hour of any day. That it does not happen is due to the confidence of savers that their savings are safe and available to them. However, this is a confidence trick, reinforced by confidence-building illusions and smoke-screens of deposit insurance, government guarantees, or whatever. But confidence is a fragile entity and has to be nurtured very carefully. Any threat to this collective confidence has to be treated very seriously indeed, which is one reason why financial fraud is treated as such a serious crime.

However, the financial system is not a static entity. There is a constant search for new methods and techniques for transferring savings between lenders and borrowers as efficiently and cheaply as possible. Activity of this kind constitutes financial innovation, and normally involves the introduction of some new type of financial instrument, or the emergence of an innovative financial institution engaged in a new form of specialisation, or previously unthought-of activity. Financial innovation is supposed to increase efficiency by reducing the cost of saving-investment activity to society, and thereby works to the benefit of all.

But not all innovations which reduce costs need to be efficient. Sometimes, innovations may be merely tax-efficient, or economise on costs associated with prudential, or safety, requirements. These we describe as rent-capturing because, while they increase the profits to the innovator, they do so at the cost of government tax revenue or the risk borne by society, with no increase in social welfare. Sometimes it may be difficult to tell whether a particular innovation is socially efficient or merely rent-capturing, because their novelty may make them difficult to understand for some time.

In the past few decades there has been a burst of innovative activity on financial markets leading to the introduction of many new financial instruments as well as markets on which they can be traded. This has led some commentators to warn about a debt explosion on a fixed narrow base of real assets*), with the implication that the current crisis is some sort of meltdown. This fear is exaggerated as most of the financial instruments concerned are not debt instruments at all. Instead, they are either insurance products, such as Credit Default Swaps (CDS), or risk-hedging instruments, such as options, futures and other derivative instruments. These are new services.

The Financial Crisis 2007 – ?

International comment was largely confined to the business press when the sub-prime mortgage crisis broke in the United States in April 2007. When the stock-market tumbled in the summer of that year the repercussions were felt worldwide. Many countries had experienced significant asset-price inflation over the previous decade, at least, and there had been warning voices that a correction was inevitable.

Few investors took advantage of the early warnings. For years there had been talk of a "new economy", driven by technological advancements and computerisation, so that old relationships were no longer a reliable guide to economic values. For every prophet warning of a bubble, there were ten arguing that observed asset price increases were a realignment in relative prices. Most of all, perhaps, the purveyors of imminent doom had been crying "wolf" for so long that no one was listening anymore.

However, the prophets of doom were to be proven right – unfortunately. Only now is the picture becoming clearer so that we can detail the sequence of errors which produced a global crisis of confidence. Because, the real problem has been a crisis of confidence, a loss of faith in the integrity of the financial system ***occurred.*** Such a loss of confidence cannot be easily restored as we have witnessed from the ineffectiveness of monetary policy to halt the spiral to date. In the near future, we will see if fiscal policy will fare any better.

The US sub-prime crisis, by virtue of its relatively modest magnitude, was little more than a catalyst which set the downward spiral in motion. Other countries had subprime crises of their own, if on a lesser scale. What really shook public confidence was the manner in which credit-market "toxic waste" had been repackaged through a process of securitisation, given a high-gloss shine in the form of fraudulent AAA ratings, and sold to a more or less unsuspecting market. Thus, it found its way into the balance sheets of financial institutions around the globe. It turned out to be the aids virus of modern finance, creating a scare whose extent may yet turn out to have been unwarranted, if nonetheless understandable.

But the greatest loser in the long run will be the United States, its moral standing and its financial system in particular. For long the US has been the beacon of free-market enterprise. America set the standards for everyone else to follow. Now, it has been exposed as having the moral scruples of a foot-in-the-door salesman. America may have provided the ultimate proof that free-market rules are not appropriate for the financial system; the external effects or, if one prefers, the collateral damage of wrongdoing is too great. We do not know what is to come, but it is clear that a much larger measure of public control, and not just supervision, is in the offing.

**) Charles Morris, The Trillion Dollar Meltdown: Easy Money, High Rollers and the Great Credit Crash, Public Affairs (2008). Dicussed in Robert Skidelsky, Can You Spare a Dime? The New York Review, January 15th 2009*

The Demand for Higher Yielding Securities

Sometime around the mid-1960s, the United States changed from being a conservatively-run country, extolling the virtues of thrift and fiscal propriety, and slowly succumbed to what can only be described as consumer mania. It may have been triggered by notions of the supremacy of the American system, begun with the Vietnam War and reinforced by the demise of communism, but it quickly spread to the notion that America could have its cake and eat it.

By the 1990s, public social policy began to play an active part in the process. A policy of universal home ownership, promoted by the Affordable Housing programme, created an unrealistic illusion that each American could expect to own his own home, part of the proverbial "American Dream". In order to promote this goal, public policy began to exert significant pressure on financial institutions to eliminate discrimination in lending in poorer areas and, gradually, to loosen creditworthiness criteria in transactions involving lower-income and minority groups*). As a direct consequence of official intervention in mortgage loan policy, both Fannie Mae and Freddie Mac ended up in conservatorship.

Whereas the elimination of discrimination cannot be criticised, it seemed to escape notice that forcing a policy of this sort was bound to have undesirable side effects, given the very low short-run supply elasticity in the housing market. This had several consequences. First, house prices began to rise rapidly. Second, to enable the poor, and minority groups, to continue to afford the increasingly expensive housing, lending criteria had to be continuously diluted. This led to the absurd situation in 2006 where it was possible to get "a 100 % mortgage with no income, no job or assets"**). Finally, a mortgage-financed house is a highly leveraged investment, and with advancing house prices and home equity loans, the spending power of home-owners simply exploded. In 2005, Americans withdrew some US$ 750 bn in home equity loans and much of this was spent on personal consumption. It is no surprise that Robert Mundell should describe Americans as the global consumer of last resort.

This wealth effect, augmented by the dizzying climb of the stock market, led to a consumer boom and an alarming level of household indebtedness in the United States, in addition to a deteriorating balance of payments deficit. Under normal circumstances the exchange rate would correct such payments imbalances but two factors inhibited the necessary correction.

First, the reserve currency role of the dollar meant that foreign governments, especially in Asia, were prepared to accumulate dollar reserves in spite of the risk to their real value. Secondly, the Republic of China sought to exploit the US consumer boom to drive forward a policy of export-led growth. The renminbi kept in step with a depreciating dollar, as China struggled to maintain its competitive advantage on the US market. This had the mutually beneficial advantage of sustaining employment in China while keeping inflation in check in the US ***).

*) *Hannes Androsch, Exchange Rate Regimes and Economic Crisis, (2008)*

**) *Niall Ferguson, The Ascent of Money: A Financial History of the World, (2008) Penguin. Reviewed by Robert Skidelsky. (op. cit.)*

***) *Niall Ferguson and Moritz Schularick, Chimerica and Global Asset Markets, (2008) mimeograph.*

Thus, the counterpart of US indebtedness was that Asia was awash with dollars, which accumulated in the foreign exchange reserves of central banks. Central bank reserves are usually kept in the form of treasury securities, and this overseas demand kept yields on these securities very low in the USA. Other investors, including fund managers, banks etc were consequently on the lookout for suitable financial investments offering better yields than those available on treasury, and similar, securities.

Miraculously, such improved yields combined with suitable ratings were becoming available in the form of mortgage-backed securities, or MBS, which were then repackaged as collateralised debt obligations, or CDOs. The latter are non-marketable securities which are collateralised by fixed-income assets such as mortgage bonds. As such, they can be regarded as third-generation securities as they are debt securities which have been repackaged twice. As a result, the purchaser of a CDO is far removed from the ultimate borrower. The stock market provided another suitable outlet with persistent demand driving stock indexes steadily upwards globally.

The Supply of Higher Yielding Securities

The factors which contributed indirectly to the demand for higher-yield securities were also important in generating the supply. In particular, the priority of public policy placed on increasing home ownership led to the securitisation of mortgages, which had the effect of increasing the funding available. This quickly extended to other forms of household debt, ranging from car loans, credit-card loans, student loans etc. Households seemed to have almost limitless access to credit irrespective of the household's credit standing. Indeed, the borrower's creditworthiness became increasing irrelevant to the lender, as loans could be repackaged and sold-on as CDOs. And, the demand for CDOs seemed to be insatiable.

Thus, the criteria for lending switched from the credit rating of the borrower to the marketability of the subsequent CDOs. In the first half of the present decade, sub-prime mortgages became increasingly included in the composition of the MBSs incorporated into CDOs ****). Credit quality declined and riskiness increased. As CDOs had to be marked-to-market, as soon as the sub-prime crisis broke, the marking down of CDO-values put large holes in the balance sheets of many institutions.

****)*In 1999 some 5 % of MBS were backed by sub-prime loans. By early 2007, the figure was approaching 30 %. Twenty five people at the Heart of the Meltdown ..., The Guardian 26 January 2009.*

The losses turned out to be widespread and extensive, amplified by the interlinking of national financial markets as exemplified by the cross-lending between banks.

What had gone wrong?

First of all monetary policy had been extremely lax as reflected by the lengthy period of low interest rates. The Greenspan years can be summarised as a period of throwing liquidity at the market at the first sign of trouble. This had kept the US economy on a sustained recovery path throughout the 1990s, and was used to overcome the Dot-com recession of 2001/2. Repeated success may have induced a feeling of infallibility; who knows? Or, perhaps there was a feeling that a boom induced by capital inflows was tantamount to prosperity at someone else's expense, and too good to refuse? In addition, cheap imports and corporate relocation to low-wage economies kept inflation in check, so that the classical warning symptom of monetary excess was not apparent?

Failure to mop up the excess liquidity after the 2001 recession had passed, and to keep interest rates low, produced a haven for borrowers. And there was a subtle change in incentives. Mortgages were awarded, to a large extent, by mortgage brokers who operated on commission from the lending bank. This remuneration was based on the number of deals concluded, hardly an incentive for thorough credit analysis. Much the same was true of other securities – for example, CDS writers were also paid on commission which was to lead the insurance giant, American International Group, to within a hair's breadth of collapse.

But, at a higher level, the bonuses of the CEOs of many corporations, including banking corporations, are also related to performance – and annual performance at that. The incentive is to make a lot of profit quickly rather than moderate profits over a longer period – the latter would probably lead to being fired! On a rising market such as that of the 1990s and much of the first half of the 2000s, this meant one thing – leveraging.

There is scarcely a better way to boost profits on a rising market, especially when credit conditions are lax. But the reverse applies in a falling market. Across the board, virtually all financial institutions engaged in this – it effectively constituted 'best professional practice' – often using innovative techniques for moving unwanted, or lower-yielding assets off balance sheet.

In addition, there was extensive fraud. This was committed by lending depositors' money, held in trust, knowingly, to borrowers who could never repay. It was also committed by selling those loans to security investors who were unaware that they were really buying fraudulent loans. And, it was also committed by failure to report in corporate balance sheets that there might be any doubt about the value of those assets.
That no one blew the whistle is a shocking condemnation of the regulatory authorities and a confirmation that this structure is not suitable for a sensitive institution such as the financial sector.

The European Dimension

During the French presidency of the EU Council in the second half of 2008, we were told several times that the monetary union, along with its single currency the euro, had "saved Europe" from the global financial crisis. What was implied was that the Eurozone had been spared the fate of countries such as Iceland and Hungary, and the threat confronting the likes of Romania, Bulgaria or the Ukraine – a clear benefit of membership. The message is unmistakable; climb aboard the lifeboat as quickly as possible, or if you're already aboard, count your blessings!

How and why this should be the case is not specified. Nor is it obviously true. On closer inspection we see that Iceland's problems stemmed from its banks attempting to outgrow the restrictions imposed by the tiny domestic economic base. Deposits were sought internationally by internet which, in turn, found their outlet in the US securities markets. The low cost of this operation was reflected in attractive yields, which enticed many international banks and institutional investors. But, as soon as the liquidity and the solvency of the Icelandic banking system came under suspicion, there was no possibility of unwinding asset positions quickly to meet the foreign-currency deposit outflows.

In a sense, Iceland became a classic victim of the systemic risk in banking. It is unlikely in the extreme that Eurozone membership would have made much difference, as not even the ECB will lend to insolvent banks. Similar losses, and for similar reasons, have been sustained by banks in countries ranging from Germany, to France, to the United Kingdom (although the last of these is not a member of the Eurozone). But these have been propped up, or nationalised, by national governments and not the European Union. What made such a dramatic difference in the case of Iceland was that Iceland lacks the broad economic base which is necessary to absorb a shock of this magnitude to a single key sector of the economy. With bank assets at 900% of GDP, government assistance was never in prospect. Rather than being "too big to fail", Iceland's banks had the misfortune of being "too big to save".

The case of Hungary was quite different. Here, the main problem was the fragility of the currency and exchange-rate uncertainty. As is frequently the case in such emerging, or transition economies, a large proportion of the debt of companies, households and the government tends to be denominated in foreign currency. With the possible exception of export-oriented industries, most of the earnings from which debts have to be serviced are in domestic currency. At the first hint of trouble, capital flight occurs, producing a sharp decline in the external value of the currency. This can have serious consequences for the debt servicing burden and lead to widespread default and bankruptcy. In this case, membership of the Eurozone would have been a significant advantage as it would have virtually assured exchange-rate stability.

By what mechanism, then, could the Eurozone be expected to help individual countries avert the financial crisis, or avoid its consequences? A simple answer might be that the size of a currency area is important, in the sense that bigger is more stable. However, the United States is also one of the largest single-currency monetary unions in the world and no one would suggest that the USA has managed to avoid the crisis. Nor, by the way, have the Eurozone countries either.

A second possible answer might be that the European Central Bank (ECB) took decisive action in providing financial markets with liquidity and in cutting interest rates to ease funding requirements. To this we could respond that, first of all, central banks worldwide have responded in this manner, often to little or no avail. Moreover, the lead in this regard in Europe was given by the Bank of England rather than the ECB, whose response, rightly or wrongly, can best be described as having been "sluggish".

In any case, the provision of liquidity did not unblock inter-bank markets because this measure did nothing to address the problem of adverse selection, which was the main reason banks were unwilling to lend to each other. When banks lose faith in each other they will not lend to each other. The fear of losing the entire loan dominates any improvement in the lending margin, no matter how it is brought about.

Some commentators have suggested that European banks were no less leveraged than their American counterparts, and were perhaps even more so. If so, the scramble to deleverage would be a top priority, which means reducing debt-to asset ratios. In such an environment, offering the banks more debt in the form of short-term liquidity injections is unlikely to produce many takers.

So then, what did help the banks to survive the crisis, or at least the first phase of the crisis we have experienced to date? Some commentators suggest that the motive in cutting inter-bank rates was to steepen the yield curve and boost bank profitability. This would have a beneficial effect on reserves, and would certainly help – given sufficient time.

But, the most important measure, by far, was the effective extension of government guarantees to virtually all bank depositors and other creditors. Just as the creation of the Federal Reserve System in 1913, along with its "lender of last resort" function, and the introduction of deposit insurance in the USA in 1934 helped to stem a pandemic of bank runs and insolvencies, so did measures taken by individual governments in 2008 narrowly avert the collapse of their domestic banking systems. Rescue packages in various forms and/or blanket government deposit guarantees were issued in many countries, including the USA, Ireland and Austria.

And, what was the response of Europe? In one case, Ireland, the Prime Minister was "carpeted" for having acted unilaterally and without collective agreement, although the last-minute actions of his government averted the imminent collapse of the Irish banking system. In another case, Austria, the announced rescue package, in the form of a recapitalisation programme, was held up for some months awaiting official approval.

The key point is that unilateral measures in individual countries, rather than decisive centralised Euro-action, have been the key to averting the worst aspects of financial crisis in the Eurozone. And perhaps it is better so, because in this way we can address problems on a regional basis, which may differ in their severity, character and urgency across regions.

International Cooperation

The clearest advantage of the monetary union in the current crisis is the leading role it took in seeking to establish a new global monetary order. This leadership role has much to do with the size of the monetary union, which makes it a leading player, if not the leading player, on the global stage. However, much of this had also to do with the personality of President Sarkozy of France, who drove forward the project with determination and relish. Whether this preeminence can be sustained is another matter.

Much of this international cooperative effort focuses on repairing aspects of the international financial system which have not kept up with market developments, i.e. strengthening the roles of the IMF and World Bank; revising international accounting standards; improving international banking supervision; and coordinating global fiscal and monetary policies.

We have to await the coming months to see if any serious effort will be made to tackle one of the basic sources of international financial instability, i.e. the persistence of balance-of-payments surpluses and deficits, no matter whether they can be financed, or not. In 1944 at the Bretton Woods conference, John Maynard Keynes recognised that persistent surpluses carried as much a threat to global financial stability as persistent deficits. But for a variety of geopolitical reasons, this insight has been transformed into an attitude that persistent surpluses are, in some sense, virtuous while persistent deficits are deviant. The reality is that both are equally undesirable.

Monetary Union, the Gold Standard and Exchange-Rate Stability

One of the principal advantages of a monetary union is that it provides a stable exchange-rate environment which encourages trade and investment. An additional advantage of a single-currency monetary union, such as the EMU, is that it also provides a much greater degree of price transparency, which facilitates competition. But whether a monetary union can protect member states from financial crisis, or economic instability, is a different matter. Some views on this matter have already been expressed in a consideration of the history of the gold standard (1880 – 1914) and its lesson for today's world .*)

The gold standard can be regarded as a form of monetary union, albeit of a multiple-currency type and one with multiple monetary authorities. Although the gold standard, to this day, is looked back upon with a certain fascination, dare one say reverence, one thing it did not do was to eliminate financial crisis and

*) *Hannes Androsch, Exchange Rate Regimes and Economic Crisis, (2008)*

volatility of the real economy *). The story of the gold standard is, indeed, one of exchange-rate stability. But this stability was bought at a high price. The downside was widespread recession, even prolonged depression, in certain countries and at certain times. This could be tolerated in the 19 century because no one made the link between deflationary monetary policy, required to maintain external stability following domestic inflation, and heavy unemployment and social hardship. The rulers of the individual countries were not considered in any way responsible for social deprivation, many of whom still basked in the "divine right of Kings".

It was not until the beginning of the 20 century that national governments were forced to assume greater social responsibility for the welfare of their subjects, or electorates. Employment, in particular, became a high priority of economic policy, displacing the earlier priority on external stability. This shift, from external to internal stability, would have destroyed the gold standard in time, if World War I had not done the job first. It was later to scuttle the Bretton Woods System.

The implication for the Eurozone should be obvious. Even assuming that a reasonable measure of price equalisation was achieved in 1999 when the conversion rates of national currencies to the euro were established, this purchasing parity of the euro in different countries has not been sustained, not even for tradeable goods. A single monetary policy has not produced a uniform rate of inflation across member countries, which is also confirmed by anecdotal evidence from tourists. This has serious consequences for competitiveness, especially in small open economies. The implication is clear; countries with above average inflation rates over a number of years face the prospect of policy-induced recession, similar to the gold-standard experience, should they wish to continue as members of the Eurozone.

The Moral of the Story

The conclusion we should take from this is that a monetary union is a fragile eco-socio-political organism. To survive, it must focus on the welfare of the individual components, a form of welfare subsidiarity, rather than hold that the welfare of the constituent components is subservient to the greater good of the whole.

To put it bluntly, what is best for Germany need not to be best for Malta. In the EMU at present, economic policy decision-making and political influence are heavily concentrated in a small number of large countries, on the assumption that what is best for the majority is also best for everyone. This outdated attitude, currently represented by an intensified transition towards majority rule, may yet turn out to represent the greatest risk to the longer-run success of the union. Greater efficiency in decision-making is only better for those who expect their decisions, and interests, to prevail.

And, a general message we should keep in mind is that making extravagant claims about the utility of the union does little to further its credibility or survival prospects. In politics, as in finance, so much depends on trust, on confidence and in a belief that those in charge are well-intentioned and know what they are doing. The pricking of the financial confidence bubble, triggered by the subprime crisis in the USA, has led to a global financial, and real-economy crisis. Pricking the political-credibility bubble could lead to political disintegration.

As concerns the banking system, and the larger financial system, it looks increasingly likely that some extent, or form, of nationalisation will have to be confronted. The stability of the financial system is a public good, just like national defence. In private hands, and driven by the profit motive, clever minds will always find novel techniques, or innovations, for circumventing regulation; by definition, public regulation is a perpetual catching-up game.

Public welfare, which is dependent on financial-market stability, is too important to be left to the mercy of the free market and the profit motive. Attempts to date to implement a free-market organisation, propped up with institutional supports, have so far failed to overcome structural problems and provide the necessary stability. First, we had emergency refinancing of solvent banks, the „lender of last resort" measure, but this was insufficient. Then we installed a further support – a limited degree of deposit insurance. This could stem a particular crisis but was no longer adequate when the bulk of deposits ceased to be small.

In the past year, many Governments have been forced to guarantee most, if not all, deposits, but this provides short-term respite, at best, where the solvency of the system is in question. Thus, governments have been obliged to recapitalise the banks and this has generally taken the form of injections of preference capital. There is very little justification for taking preference, as opposed to ordinary, shares, but one possible, if weak, argument might be that the taxpayer is still not liable for possible rotten assets buried in the balance sheet of the financial institution. But now with the talk of the creation of "bad banks", which will purchase "rotten" or "toxic" assets of the banking system, there is no justification anymore for private ownership. The only logical "next step" is the nationalisation of the banking system, along with other sensitive parts of the financial system such as pension funds.

Otherwise, we may be witnessing the greatest example of moral hazard that has ever occurred.

While this is not an argument for abandoning the financial system to the mercy of political patronage and lobbying, the financial system, with its inherent risks, is not a suitable playground for competing, or colluding, capitalists. The argument that the financial system is too complex, or unsuitable for public-sector control, and that the private sector can do it better, applies equally to the defence sector. In any case, that argument rings rather hollow just at the moment.

**) Although a monetary union presupposes, by definition, a single monetary authority, the same effect is achieved by a multiple monetary authority where each component unambiguously submits its monetary policy to the requirement of external stability. This was the case under the gold standard. In this sense, the gold standard can be regarded as a quasi monetary union.*