THE EUROZONE “DEBT” CRISIS

ANOTHER ‘CENTRE’-’PERIPHERY’ CRISIS UNDER FINANCIAL GLOBALISATION?

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Introduction

- In this presentation I would like to explore a different viewpoint on the sources of the Eurozone “debt” crisis, curiously enough almost absent in the European debate in spite of the resuscitation of the ‘centre’ or ‘core’-’periphery’ duality. This viewpoint, that I rush to say wouldn’t exclude other considerations, derives from precisely the global experience of the ‘centre’–‘periphery’ duo of the last decades under de-regulated financial globalization about which a vast literature already exists.

Four basic points

- There are four main points that I will further elaborate but would like to make clear right from the beginning;
- first, **cross-border capital flows are cyclical and dominated** both in the upswing – credit booms - and the downswing – busts - **by "push" factors**, i.e., by developments in the financial sector of the 'centre' countries most specifically by a "leverage" cycle of banks and not by borrowers that are sequentially flooded and then drained by foreign finance;
- second, **nations do not lend neither borrow**, cross-border lending is done by banks and other financial institutions mainly those based in the 'centre' countries and borrowers, based in another country, are banks, financial and non-financial firms, households and, yes, governments also;
- third, **cross-border lending is not a transfer of savings between nations but just provision of finance** by those institutions in the form of gross-flows that are unrelated to current account balances and;
- fourth, debt=credit so that cross-border "debtor crises" are generally also if not only **"creditor crises".**

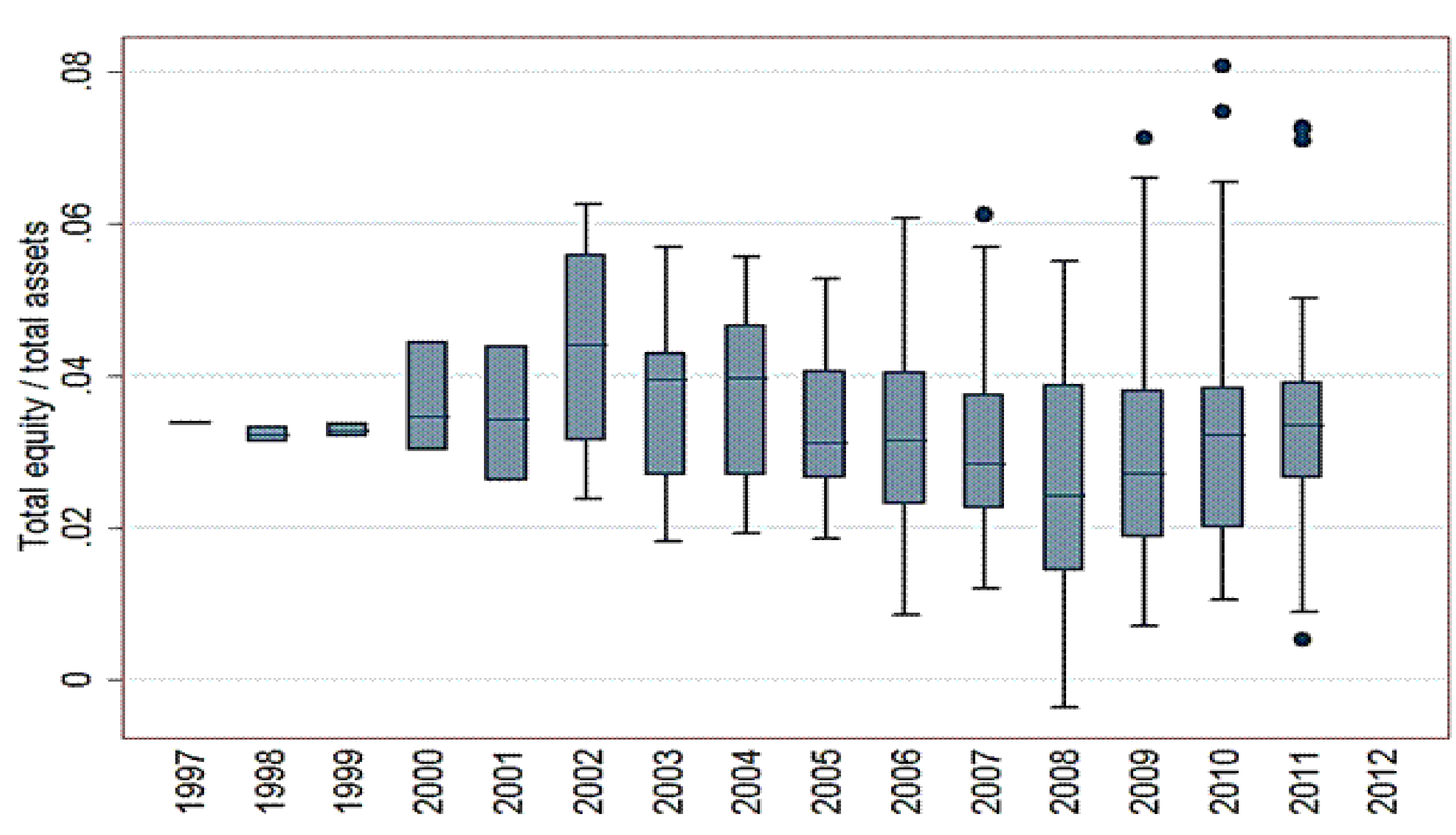
The Rebooting Eurozone Consensus

- Five years after the Eurozone crisis got started and countries were put on a diet of fiscal austerity policies, the ‘Rebooting Eurozone Consensus’ - a large and significant group of distinguished European colleagues - agreed that “Importantly, the EZ crisis should not be thought of as a government debt crisis in its origin…” (in Baldwin et al. November 2015).
- So what was it ? “The real culprits were the large intra-EZ capital flows that emerged in the decade before the crisis” (Ibid.). Additionally, “The period 2003-2007 was characterized by a credit supply shock with the global financial system bankrolling large net debt flows to advanced economies” (Ibid. – also to EMEs by the way). And, importantly, “A major slice of these were invested in non-traded sectors…It also tended to drive up wages and costs in a way that harmed the competitiveness of the receivers’ export earnings…” (Baldwin and Giavazzi (2015).

Cross-border financial flows are handled by large global financial institutions, they are cyclical and dominated by "push-factors" in 'centre' countries

- Cross-border capital flows – those credit supply shocks reaching the 'periphery'- are mainly determined by global factors at the financial 'centres' (Calvo, Leiderman and Reinhart 1993). It is the **leverage cycle of banks resident in the 'centre'** (see Gourinchas&Obstfeld 2011), in its turn associated with risk perceptions in their own financial markets (Bruno and Shin 2013) - perceptions that co-move with VIX (a financial volatility index) – and/or shifts in U.S. monetary policy (Rey and Miranda-Agrippino 2015) and that generate outflows that result in all the 'periphery' countries entering at the same time and independently of their own circumstances in a wave of borrowing (Rey 2013).
- Or in the words of colleagues from the BIS (Borio and Disyatat 2011) gross capital flows waves are grounded in an "excess elasticity" of the monetary and financial system to prevent **unsustainable booms in credit and asset prices and have little to do with current account imbalances**.

A leverage cycle of ‘centre’ EZ banks with a lowering of the equity/assets ratio in the years previous to the crisis



See Figure 1 in (Hale, G. and M. Obstfeld 2014).
Original source: Bankscope; Note: Boxes represent the 25th. to 75th. percentile range, with the horizontal lines indicating the median. Whiskers extend to adjacent values, dots are outside values. Very limited coverage of institutions prior to 2004.

Leverage cycles connected with 'Boom' – 2000-07 - and 'Bust' – 2007-2011 in Eurozone cross-border flows – the most acute of all the world regions

Exhibit 13

Western Europe accounted for most of the recent rise and collapse of cross-border capital flows

Change in global capital inflows
Composition by asset type and region

● Total global change in capital flows ($ trillion)

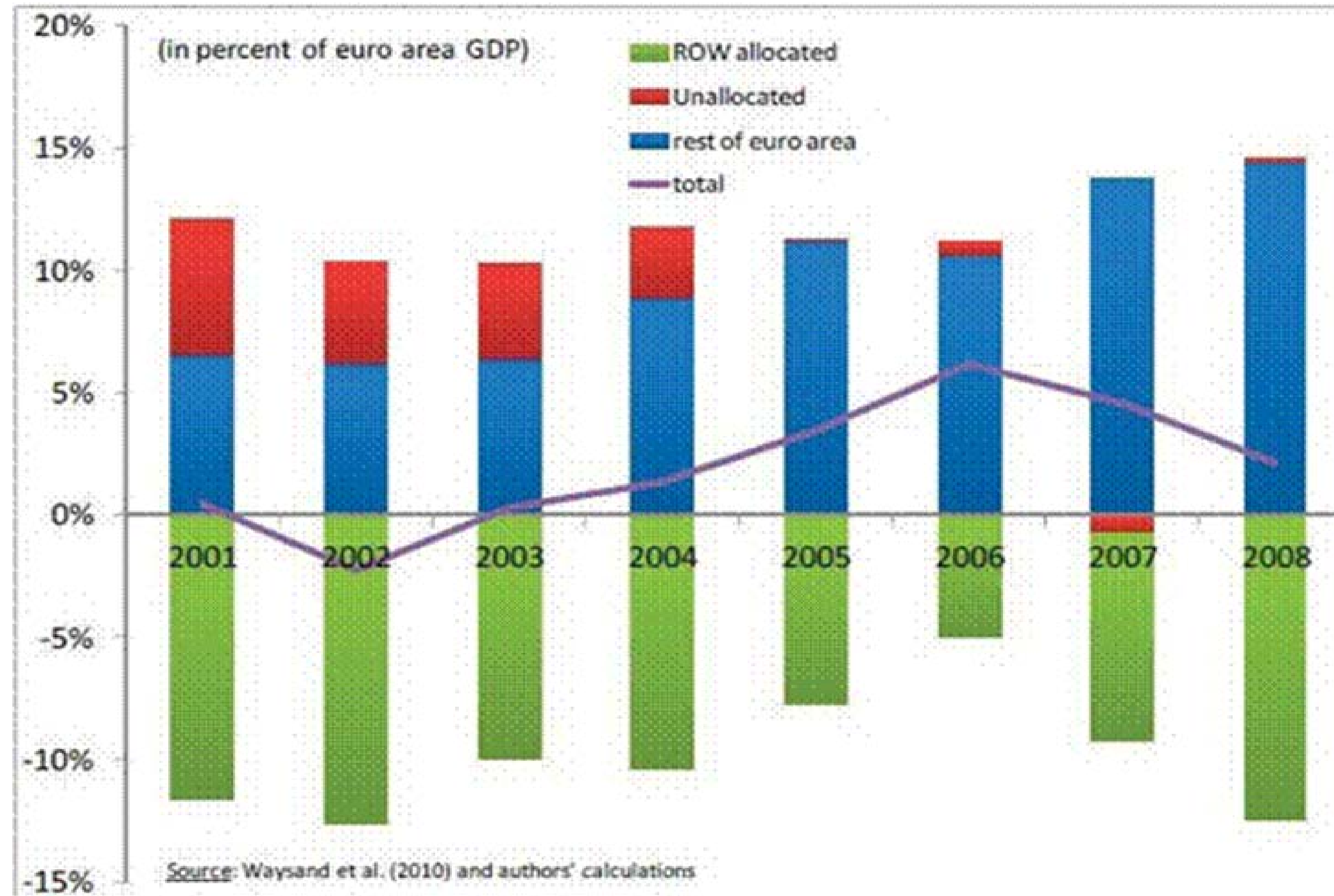
Region	Country	% of total increase, 2000–07: Loans[1]	Bonds	Equity	FDI	%	% of total decline, 2007–11: Loans[1]	Bonds	Equity	FDI	%
Western Europe	Eurozone	19	5	3	3	31	-19	-14	-4	-2	-40
Western Europe	United Kingdom	11	4	-3	1	13	-13	-5	-1	-3	-21
Western Europe	Other W. Europe	4	2	0	0	5	-7	-2	0	-2	-11
Other developed	United States	6	9	1	0	17	-4	-9	-4	-1	-18
Other developed	Other developed	9	5	0	1	15	-4	1	-2	-1	-6
Emerging	China	1	0	0	2	4	1	0	0	1	2
Emerging	Other emerging	8	1	1	6	16	-5	1	-2	0	-6
	%	58	26	3	13	+6.9	-50	-28	-13	-9	-6.6

1 Includes primarily loans, currency, and deposits, as well as a small share of trade credit. Excludes operations of foreign affiliates.

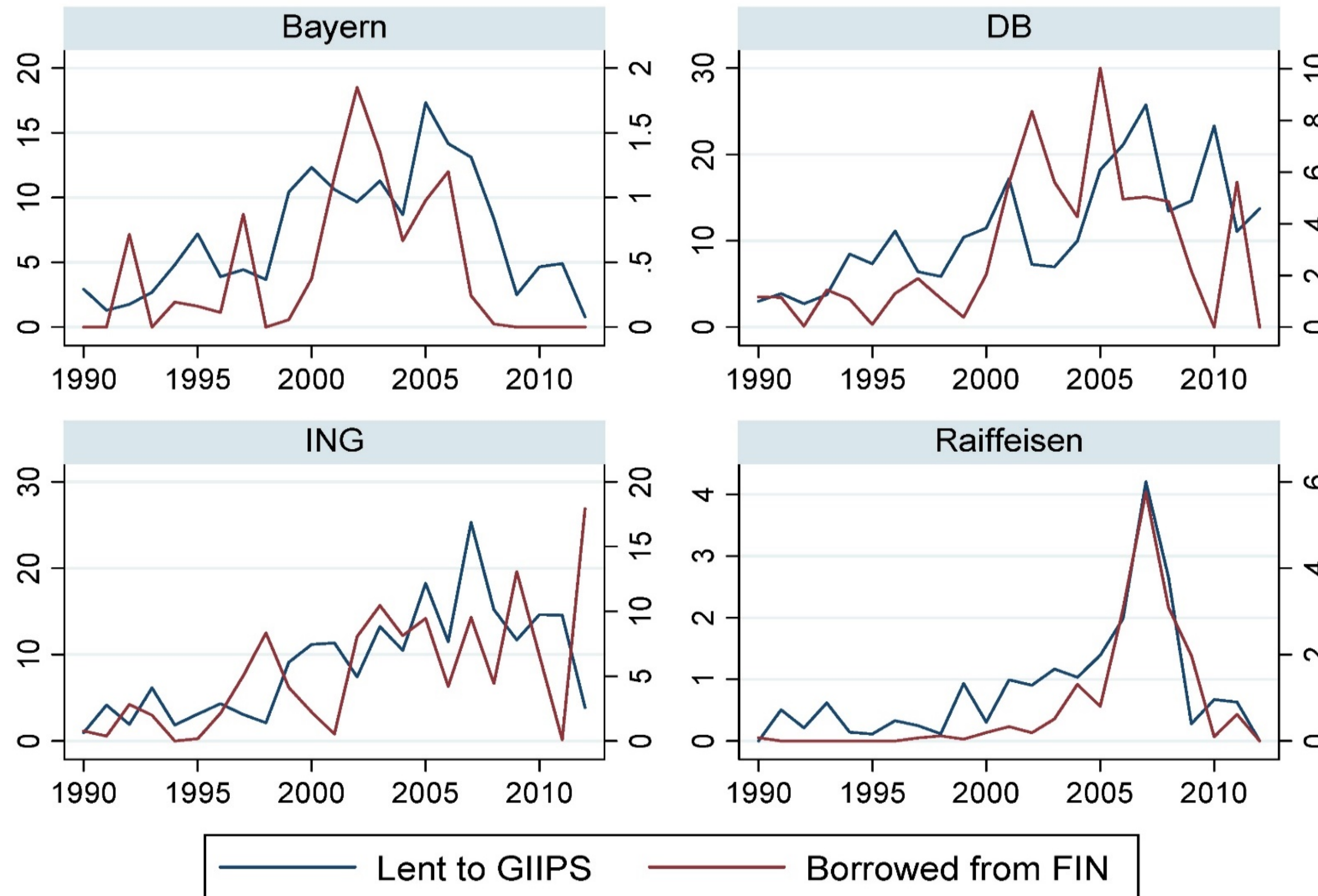
NOTE: Numbers may not sum due to rounding.

SOURCE: IMF Balance of Payments; McKinsey Global Institute analysis

Net foreign asset position of euro area ‘centre’ countries, countries of residence of the creditor institutions, assets accumulated in the rest of the EZ but simultaneously funding drawn from the rest of the world; ‘centre’ banks played a pivotal role in global finance recycling funds across continents part of it provided to their 'periphery’



As an illustration let’s see the case of some individual EZ banks borrowing from financial centres (FIN) to lend to the ‘periphery’ (GIIPS in the more polite rendering)



Creditor institutions in 'centre' recycling finance to the 'periphery'

- In fact from what may be gathered from the previous graphs (Figure 8 in Chen & Al 2012 and Figure 11 in Hale and Obstfeld 2014) creditor institutions in the 'centre' countries were financing their exposure to agents in the 'periphery' mainly by getting indebted in the RoW mostly in the financial 'centres' as we have just seen (part of that RoW financing was returned to the U.S. to participate in the sub-prime mortgage market boom).
  Therefore, **what the centre' countries banks were doing was not to transfer savings from their own countries – those of their carpenters and plumbers to recollect Mr. O'Neill the U.S. Secretary of Treasury back in 2003 - but just providing finance; a major point that one has to keep in mind.**

Two major points about cross-border finance

- First, finance provides purchasing power and not savings.
  Financing, a cash-flow concept, is just advancing purchasing power, in an accepted medium of exchange. Saving, a national-accounts concept linked to a territory, is income not consumed within some country or region borders. **Expenditure requires financing not savings**. Eventually, income generated by the expenditure will give rise to some amount of savings (Borio and Disyatat, 2015). **Cross-border finance, therefore, does not necessarily involve a transfer of "savings"** from the country of location of the lender to that were the borrower is located; it is **only a transfer of purchasing power** as we have just seen was what the 'centre' countries' banks were doing in the EZ.
- Second, nations do not lend or borrow; "Cross-border finance" is not "cross-national finance"
  Cross-border lending is an activity handled by banks and other financial institutions – exceptionally by official institutions – and **cross-border borrowing is done by a myriad of economic agents**, financial and non-financial firms, households and, yes, also governments or public institutions.
  It is that diversity of agents that take the decisions to lend or borrow – gross - not the "nations" – whatever that means - in which they are located neither their governments.
  Concentrating on nations – and their current accounts - all those different agents are collapsed into **some kind of national "representative agent" that is taking the decisions to lend or to borrow in the name of the whole country**. Net balances – particularly when visualised from a current account optic and their equivalent savings-investment gap – do not provide useful information about the activities and objectives of actual lenders and borrowers and the resulting balance-sheet reciprocal structures. Countries might run c/account deficits and still their banks could be large providers of finance (UK) and the contrary is also true.

Neither financing of trade nor transfer of savings explain the “credit shock” let alone the subsequent “sudden stop” that seriously hit the creditor’s side of the cross-border flow, resulting in a “ creditor’s crisis

- As seen above it was the **leverage cycle of the ‘centre’ EZ and UK banks that explains the “credit shock” in the upswing flooding the ‘periphery’ borrowers among other things resulting in their loss of competitiveness**. A process that noticing the experience of some EM countries led the IMF back in 2011 to grudgingly accept that controls on capital inflows – envisaged in Art. VI, Sec. 3 of its Articles of Agreement but always criticized – could be acceptable and important (see, for instance, IMF 2010 and IMF 2011a) although prohibited under art.63 of the “Consolidated Version of the Treaty on the Functioning of the EU”.
- But the most critical side to it – to a great extent determining the strategies applied to sort out the problems left behind by the “sudden stop” in lending to the ‘periphery’ - is the extraordinary **vulnerability of the ‘centre’ creditor banks** to difficulties in being paid back the huge amount of accumulated credit.

Rest of Euro Area Exposures to Greece, Ireland, Italy, Portugal, and Spain

(In billions of euros and percentages)

	Dec.2009	Sept.2012
	in euros	
TOTAL	1666	2221
ECB borrowing	275	859
SMP	0	209
EFSF/EFSM	0	301
Borrowing from private banks	1391	852
Centre of Euroarea GDP (at current prices)	5,795.05	6,378.74
Borrowing from private banks/GDP	24.00%	13.40%

Source: for periphery borrowing from centre IMF-GFSR, Sept. 2012, Chap.1, Graph 1.7 and for GDP figures IMF-WEO, Database, Sept.2013

Exhibit 15

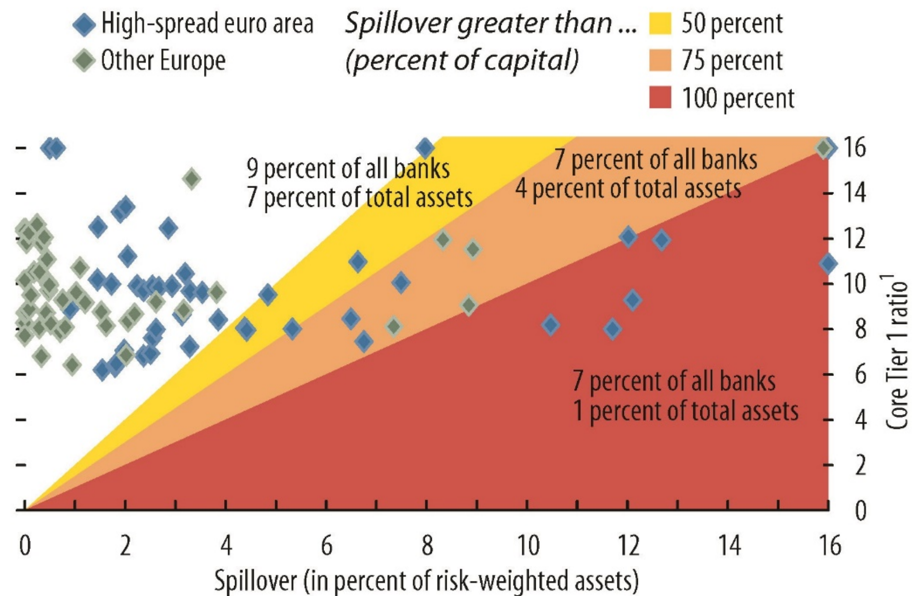
European Banks Exposure to the Periphery (€m)

Bank	Sovereign Periphery Exposure	Periphery Loan Exposure	Periphery TOTAL	TNAV 2011	Sovereign Periphery Exposure as % of TNAV 2011	Total Exposure as % of TNAV 2011
Credit Agricole	3,261	31,825	35,086	28,612	11%	123%
Dexia	6,713	3,894	10,607	8,905	75%	119%
RBS	3,533	73,857	77,390	68,752	5%	113%
Danske Bank	89	11,086	11,175	12,103	1%	92%
Santander	5,173	33,342	38,515	51,530	10%	75%
Lloyds BG	169	31,451	31,619	52,223	0%	61%
Barclays	1,838	20,728	22,566	53,781	3%	42%
Intesa SPI	794	9,362	10,156	29,866	3%	34%
SocGen	5,093	4,830	9,923	34,149	15%	29%
BNP Paribas	8,090	3,500	11,590	59,675	14%	19%
Natixis	716	576	1,292	12,776	6%	10%
HSBC	2,517	-	2,517	91,456	3%	3%
UniCredit	1,066	-	1,066	49,946	2%	2%
Banco Popolare	89	-	89	5,165	2%	2%
Deutsche Bank	700	-	700	40,701	2%	2%
Monte dei Paschi	131	-	131	9,705	1%	1%
Nordea	102	-	102	24,233	0%	0%
SEB	16	-	16	8,054	0%	0%
Credit Suisse	-	-	-	23,056	0%	0%
UBS	-	-	-	34,155	0%	0%
Handelsbanken	-	-	-	8,826	0%	0%
TOTAL	77,773	269,669	347,442			

Source: CEBS, company data, Morgan Stanley Research

Just for the “exposure” to sovereign risk, 23 per cent of the European Union banks, that had 12 per cent of all the banking assets of the area, would belong to that section for which “exposure” - direct and indirect – only to sovereign risk in the “periphery” countries plus Belgium – with a high debt/GDP ratio – was above half of its capital, i.e., they were under a serious threat of going bust (IMF-GFSR, Sept. 2011b, p.22).

Figure 1.19. Distribution of Spillovers from High-Spread Euro Area Sovereigns to European Banks



Source: IMF staff estimates.

Note: For presentational purposes, the cutoff points for capital ratios and spillovers are 16 percent. The high-spread euro area countries are Belgium, Greece, Ireland, Italy, Portugal, and Spain. Data are based on sample of 90 EU banks in EBA 2011 stress test.

[1]Includes core Tier 1 capital at end-2010, actual equity raising in Jan–Apr 2011, and commitments for equity raisings made by April 2011.

The conventional “narrative” – irresponsibility of the ‘ periphery’ - results in transforming the crisis in a conflict between nations

- The direct fiscal costs of extricating ‘centre’ banks from their vulnerable position were of a magnitude as to make it an “impossible” political task for the EZ ‘centre’ countries governments confronted with the justified animosity of public opinion against banks and finance. **A “narrative” had to be concocted to conceal the facts, basically that of the irresponsibility of the ‘periphery’.**
- Thus, in spite of the actors being banks and their borrowers the crisis was made to become a conflict between nations but then “...the view that the European crisis is a conflict between prudent Germany and irresponsible Spain (stands for the ‘periphery’, my annotation) could **easily tear apart the European experiment**…”(Pettis 2015a).
- “In fact, the current European crisis is boringly similar to nearly every currency and sovereign debt crisis in modern history, in that it pits the **interests of workers and small producers against the interest of bankers**. The former want higher wages and rapid economic growth. The latter want to protect the value of currency and the sanctity of debt” (Pettis 2015a).

A "counternarrative" – an attempt

- Now, if 'periphery' countries were packed with "irresponsible" agents, governments, banks, non-financial firms and households, how could one qualify the behaviour of the management of those 'centre' countries' banks that kept lending to them to reach those levels of exposure? And even more serious, how one would qualify the work of the 'centre' government's bank supervisory agents? Was it not that under Pillar II of Basel II rules they could have stopped their supervised banks in continuing to lend to the "irresponsible" periphery?

Strategy to deal with the credit accumulation in the 'periphery' by 'centre' banks - the "revolving door" strategy

- The "narrative", of course, prevailed so that the same strategy that was initially tested in Latin America in the 1980's was applied, the "revolving door" strategy, i.e., lending from official sources to the 'periphery' would be used coupled with a reduction in absorption by these countries – of a magnitude and consequences that also dwarf what resulted in the "lost decade" of the LAC countries in the 1980's – to keep as "performing" those accumulated credits allowing banks to gradually get rid of their high exposure (as may be gathered from the significant drop as we have seen already by September 2012).
- 'Centre' countries official resources, instead of directly "bailing-out" their banks would be "generously" lent to the 'periphery' to so as to set up a more veiled triangular "bail-out" via these countries. For instance (see Rocholl and Stahmer 2016), in the case of Greece out of a total €215.9 bn. - 1st. and 2nd. programme - €139.2 bn. ended up as debt service payments while only €9.7 bn. - less than 5% - contributed to the fiscal budget (the rest was used to recapitalize Greek banks – €37.3bn. – and €29.7bn. to provide incentives for investors participating in the March 2012 PSI).

“Austerity” and “structural reforms”

- The “narrative’ was complemented with two convenient servings from the most conventional economics textbooks.
- First, that if to make room for the full repayment of debt service above the resources provided by official bodies of the EZ ‘centre’ – and the IMF that was reluctantly brought into the exercise - public expenditure had to be cut down drastically it didn’t matter because Keynesian “multipliers” if at all existed were minimal; to the contrary, the vision of a government fulfilling its moral duty to honour its debts would unleash a flow of investment that would lift up the economy.
- Second, “structural reforms” was what really mattered and would counteract whatever negative the effects of the “austerity” policies and unleash a dynamic growth process.
- As it happened with our colleagues from “Rebooting Economics” eventually the IMF – in a somewhat significant break with past thinking and policy advocacy - would provide us with rather full criticisms of both ideas, i.e., it was acknowledged that multipliers could be large so that austerity policies could have significant negative effects on GDP and employment (see Blanchard and Leigh, 2013) and quite recently that structural reforms could make things worse at least in the short-run (IMF 2015b).

Neither the EZ nor the EU are in crisis; what is in crisis is a set of policies wrong and biased in favour of powerful interests

- No, neither the Eurozone nor the EU are in a fundamental crisis. At least not as a consequence of the lax behaviour of the “periphery” countries. What is in crisis, as it was the case back in the 1980s and 1990s for EM countries like in Latin America, is the strategy of “bailing-out” large creditor ‘centre’ banks through the wrong means via further compression in economic activity in the ‘periphery’ countries and transferring a sizable portion of those credits to official institutions to try to make room for their keeping up to date service of the “toxic” loans in the balance sheets of ‘core’ countries’ banks. And, consequently, **transforming the crisis in a conflict between EZ nations, not precisely the right way to strengthen the integration process.**
- **Oddly enough it could be proved that proceeding in the above way the countries of residence of the large creditor banks are also on the loosing side in terms of GDP and employment**; already back in the 1980’s that was the conclusion of a simulation done by the Research Department of the IMF with their world economy model of those days and presented to a meeting of the Interim Committee as an Appendix to the WEO of March 1988 (a mimeo, being pre- digitalisation era) that was struck out from the printed version made available to the general public.
- Therefore, **taking the narrow side of the banks, governments in the ‘centre’ countries were making other sectors of their society – the poor carpenters and plumbers as well as middle class taxpayers - pay for the adventurous behavior of those institutions.**

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“Muddling-through” or “kicking the can down the road”

- Taking another page from the 1980’s manual the “revolving door” strategy was complemented by what used to be called the “muddling-through” approach.
- Programmes were put together laboriously and with great cost for the countries involved that clearly had serious limitations; consequently the ‘periphery’ was thrown into a species of continuous instability threatened with default every few months on top of the consequences of the austerity programmes; the negative consequences of “uncertainty” “…(a) highly reflexive relationship between rising uncertainty and rising debt” as pinned down by Pettis (2015b).
- Once again the IMF has come eventually on the right side – not too firmly - when arguing that they will refuse to be part of those programmes without reducing the debt burden (IMF 2014 and 2015a).

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