THE EUROZONE "DEBT" CRISIS

ANOTHER 'CENTRE'-'PERIPHERY' CRISIS UNDER FINANCIAL GLOBALISATION?

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"If a blind man leads a blind man, both will fall into a pit" Mathew 15:13-14
from 'La Parabola dei ciecchi' by Pieter Bruegel il Vecchio

Pieter Bruegel il Vecchio, *La parabola dei ciechi*, Olio su tela (1568). Conservato alla Galleria Nazionale di Capodimonte a Napoli
"If a blind man leads a blind man, both will fall into a pit."

— *Matthew 15:13-14*

Introduction

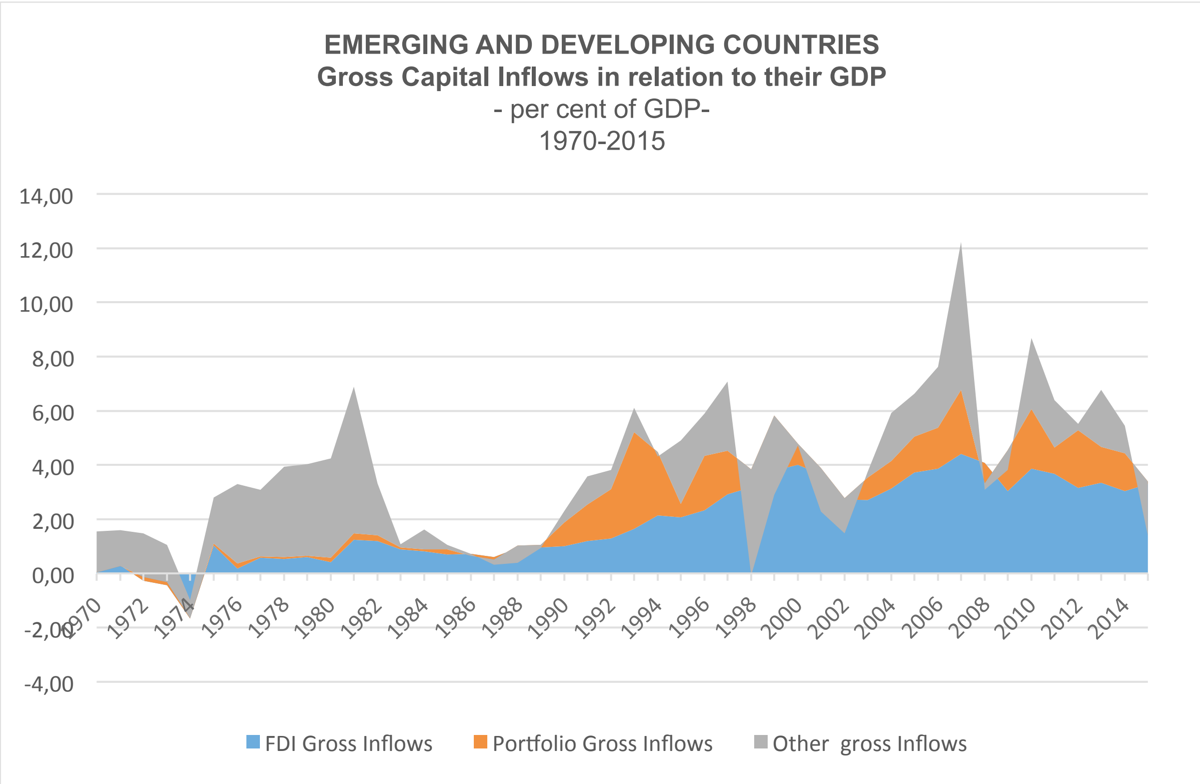
In this note I would like to explore a different viewpoint on the sources of the Eurozone "debt" crisis, curiously enough almost absent in the European debate in spite of the resuscitation of the 'centre' or 'core'-'periphery' terminology. This viewpoint, I rush to say, that wouldn't exclude other considerations, derives from precisely the global experience of the 'centre'–'periphery' pair of the last decades under de-regulated financial globalisation.

1. The behaviour of cross-border finance and the specifics of the European "centre"-"periphery" system

<u>The behaviour of cross-border finance</u>

Cross-border capital flows – gross - reaching the 'periphery' are well-known for their volatility and for being massive in relation to the size of these economies as measured in the following graph in terms of the recipient countries' GDP. At their peak, right before the still present crisis, they had reached in the aggregate of all EMs 12 per cent of their GDP but they could suddenly – from one year to the next one - drop to about 3 points, the less volatile component being Foreign Direct Investment.[1]

Figure 1 Gross Capital Flows Reaching the global 'Periphery'



Source: Database elaborated by E.Torija Zane from IMF International Financial Statistics and kindly provided to this author.

Additionally, such behaviour is mainly determined by system-wide factors at the financial 'centres' (Calvo, Leiderman and Reinhart 1993). And if those global factors

[1] In the early 1980's there was drop of almost 6 points between 1981 and 1983 and in the late 1990's in just 1 year – from 1997 to 1998 – of more than 7 points.
For one viewpoint on the importance of a distinction between gross and net inflows see Forbes and Warnock "…the size and volatility of gross flows have increased while net capital flows have been more stable, the differentiation between gross inflows and gross outflows has become more important. Foreign and domestic investors can be motivated by different factors and respond differently to various policies and shocks (Forbes and Warnock 2012).

have always been important, they have become more even so in the last decade (Eichengreen and Gupta 2016).

It is the leverage cycle of banks resident in the ‘centre’ – a “global banking glut” in the upside phase (Shin 2012) - 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 (Miranda-Agrippino and Rey 2015) that generate flows towards the rest of the world 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). [2]

As financial flows start moving towards the ‘periphery’, an economic expansion follows, as demand both private and public is fed by the additional purchasing power provided from abroad. In addition, foreign exchange needed to pay for the induced expansion of imports is easily available.

However, their abundance depresses its value, on the one hand, moderating inflationary pressures but, on the other, generating an overvalued domestic currency. Overvaluation viewed from another angle, non-tradables, including labour, tend to increase in relative prices making it for the economy to progressively become internationally less-competitive. Asset prices, both real estate and securities also tend to shoot up.

The problem is by now installed much before the “sudden stop”. The ‘periphery’ economy is already in serious trouble behind, so to speak, the façade of the boom created by the avalanche of foreign finance. Financial fragility, balance of payments disequilibria and distorted sectoral structures all point to a crisis in the waiting.[3] Recognition after several decades of such circumstances repeatedly underwent by EM countries led the IMF back in 2011 to grudgingly accept that controls on capital inflows – envisaged in its Articles of Agreement but always criticized and discouraged – could be acceptable and important (IMF 2010,2011a and 2011b).[4]

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[2] 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, besides, have little to do with current account imbalances.

[3] That’s why A.G. Haldane has rightly criticised the notion of “sudden stop” to suggest a different metaphor. In his view “…the underlying problem may be as much the start as the stop. In his opinion the seeds of emerging market crises are sown in the build-up phase, as inflows dwarf the absorptive capacity of recipient countries’ capital markets. Capturing that dynamic requires a different metaphor – the ‘Big Fish Small Pond’ (BFSP) problem. The Big Fish here are the large capital-exporting, advanced countries. The Small Ponds are the relatively modest financial markets of capital-importing emerging countries. Past experience suggests that as big fish enter the small pond, this can cause ripples right across the international monetary system, never more so than in today’s financially interconnected world” (Haldane, A.G. 2011).

[4] See in the IMF’s Articles of Agreement Art. VI Capital Transfers, Section 3. “Controls of capital transfers “

“Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2” (Article VII, Section 3(b) refers to additional limitations that a member could impose on transfers denominated in a currency that had been declared “scarce currency” and Article XIV, Section 2 refers to additional limitations under transitional arrangements at the moment when the IMF started operating). (IMF 2016a).

But, under EU rules such controls have been prohibited to Members since the late 1980's.[5]

As long as renewed lending keeps going, refinancing service on accumulated exposure plus further domestic and external deficits, the process, however, feeds into itself; this time it looks different.[6] But, at some point, however, continuation of "carry trade" becomes riskier or less profitable as financial instability in the "centre" generates increased risk perceptions or a turnaround in monetary policies both forces attracting finance to stay in 'centre' countries, like back at the end of 1928, in late 1979 or early in 1994 in the U.S. Sometimes, "awareness" about the build-up of disequilibria and financial fragilities in the recipient country also dawns on cross-border financial traders, with the same consequences. All of a sudden, inflows of finance stop or even reverse, i.e., a "sudden-stop" has materialised. [7] It is the phase that follows the previous "boom" that anyway was less than favourable for the recipient country as we have examined just above.

Confronted with less availability of re-financing, debt accumulation becomes a problem worsened by the slowing down if not directly a reduction of GDP. The crucial debt/GDP and debt service/GDP ratios become much higher inducing further reductions in availability of foreign finance. The "host" country is forced to introduce severe restrictions in public and private demand; a "debt crisis" has set in.

On the other side of the coin (debt=credit), financial institutions that had handled the flow of cross-border lending also find themselves over extended and in some cases close to sheer bankruptcy faced with the possibility of repayment difficulties arising. Bearing in mind the size and connectedness of those institutions, the "Too-Big-To-Fail" ones, the danger involved transforms what was supposed – from the creditors side - to be an exclusively private question into a serious public issue that challenges governments in the 'centre' countries.[8]

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[5] See the European Council Directive 88/361 (European Council Directive 88/361/EEC 24 June 1988) later consecrated in art. 63 of the "Consolidated version of the Treaty on the Functioning of the European Union" (EU 2008) on cross-border financial liberalization: "1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited".(EU 2008).

[6] Of course, the phrase is borrowed from the monumental work by Reinhart and Rogoff (Reinhart and Rogoff 2011).

[7] The massive cyclicality of cross-border financial flows is not the sole problem about these flows. Besides their cyclicality– and the instability induced on both sides of the process – it has been challenged that it could be a positive force for development of the recipient countries as argued for quite a long time by many authors and again by, for instance, Prof. Hélène Rey: "To sum up, gains to international capital flows have proved elusive whether in calibrated models or in the data, though perhaps this is just because those gains are hard to measure. For example, they might occur through improvements in TFP, which we have not been able to measure precisely (but then why don't we see them in growth rates?) or they might manifest themselves mainly when large shocks hit. One thing is clear at this stage: we cannot take them for granted". (Rey, H. 2013 Section VI). Even more recently, renewed doubts about the positive effect of resorting to foreign finance for growth have been expressed, for instance, in Cavallo, E., B. Eichengreen, and U. Panizza (2016) "Can Countries Rely on Foreign Saving for Investment and Economic Development? [3]," IHEID Working Papers 072016.

[8] That the position of the cross-border creditor institutions was a private matter that had to be sorted out through "normal" market mechanisms was the view of Mr. Donald Regan, the US Secretary of the Treasury when the 1980's crisis started; early in 1985 Mr. James Baker III replaced him. On the opposite side of the table, so to speak, Gral. Pinochet put forward the symmetric argument on the

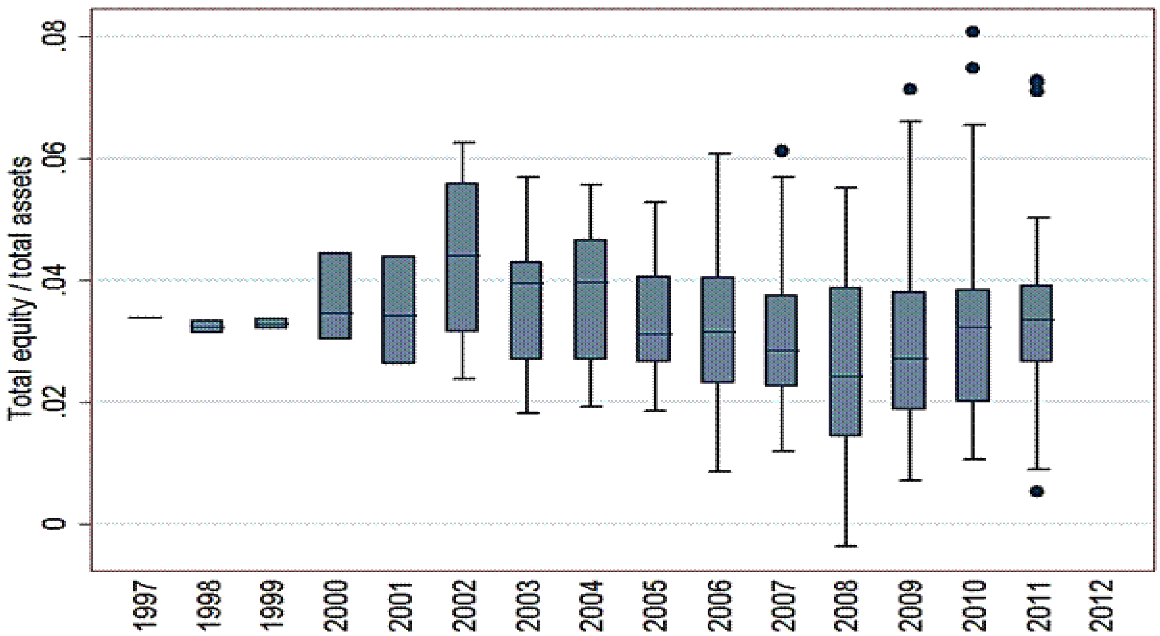
Consequently, governments become involved on both sides of the problem although, particularly from the creditor's side, at the beginning of this stage there might be little if any public lending outstanding.

A habitually called "debt workout" has been entered into. Curiously enough, however, as it was to a great extent the case in the early 1980s, the dangers – and their urgency - of collapse to the creditor side if compared seem much larger than those of the debtor's side; the whole process could better be labelled as a "credit workout" one. Debtors are confronted with a typical long-drawn process of adjustment but creditor institutions – and therefore the whole financial system - are dominated by the speed of financial processes that demand immediate and massive solutions.

The performance of cross-border flows in the European Union

In the case of banks with their main office based in the euro area 'centre' countries the performance of the inverse of leverage – the equity/asset ratio – may be gathered from the following Figure 2. Still in 2003-2004 assets were 2.5 times – the inverse of 0.4 – of capital; but in 2008 leverage - median – had reached more than 4 times and for quite a few institutions it was higher than 5 times. Associated with the beginning of the crisis, after 2009, leverage starts decreasing. If anything, their "leverage cycle" was much more intense.

Figure 2 The leverage cycle of 'centre' EZ banks (1997-2012)



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.

debtor's side – 80 per cent of Chile's external debt was owed by private firms – but pretty soon his government had to assume responsibility for the negotiation of the entire external debt of the country.

In fact, as shown in the following Figure 3, the cross-border cycle of ‘boom’ – 2000 to 2007 - and ‘bust’ -2007 to 2011 – in the euro area and Great Britain was the most acute among all world regions.

Figure 3 The ‘boom’ and ‘bust’ cycle in cross-border capital flows

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)

		% of total increase, 2000–07					% of total decline, 2007–11				
		Loans[1]	Bonds	Equity	FDI	%	Loans[1]	Bonds	Equity	FDI	%
Western Europe	Eurozone	19	5	3	3	31	-19	-14	-4	-2	-40
	United Kingdom	11	4	-3	1	13	-13	-5	-1	-3	-21
	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	9	5	0	1	15	-4	1	-2	-1	-6
Emerging	China	1	0	0	2	4	1	0	0	1	2
	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

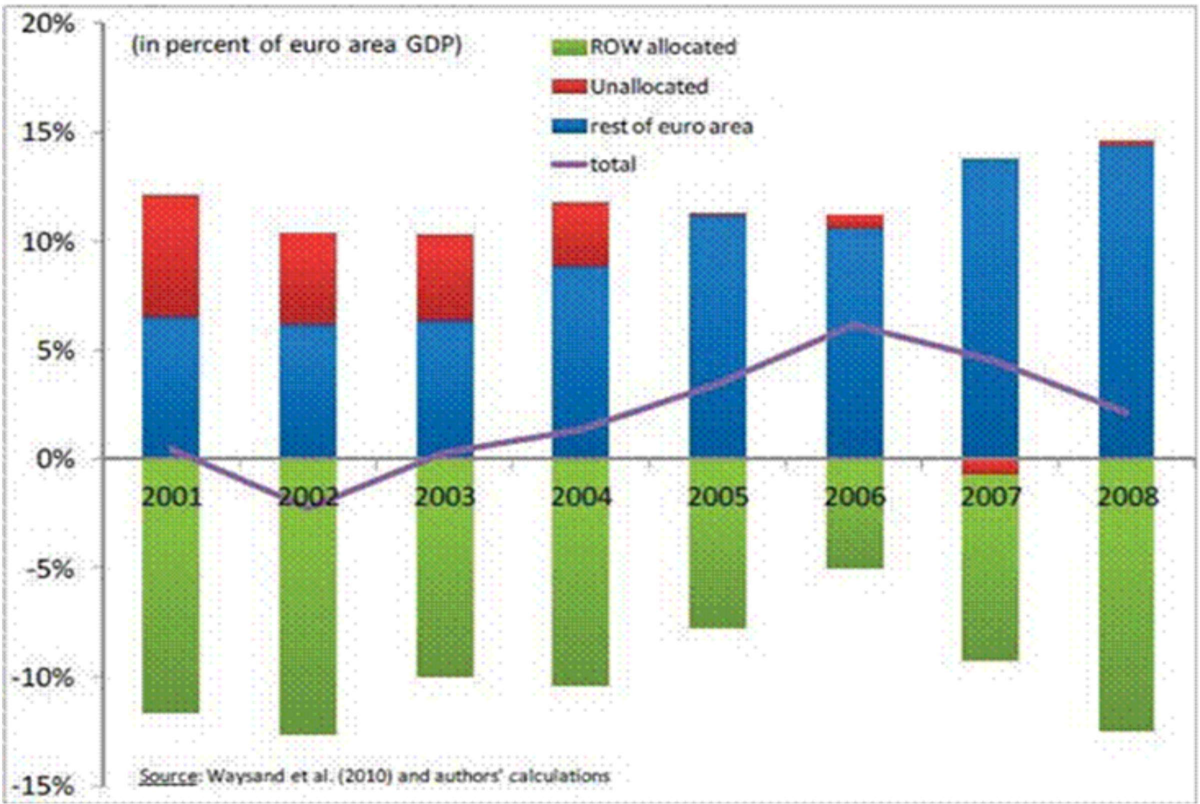
Most interestingly, the ‘Rebooting Eurozone Consensus’ - a large and significant group of distinguished European colleagues – holding different views have at the end of 2015 come to partially share this viewpoint (Baldwin et al. 2015). In fact it is their opinion that: “The real culprits were the large intra-EZ capital flows that emerged in the decade before the crisis” (Ibid.). Additionally, as in Haldane’s “Big Fish Small Pond Metaphor”, they state that: “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). Unfortunately, however, their attention keeps being concentrated on the “sudden stop” and the debtor’s side – the doom-loop between ‘periphery’ country banks and their governments - and that the lack of “competitiveness” of the ‘periphery’ had in fact originated in those large intra-EZ capital flows is not fully taken into account.

In the same vein as our previous analysis and with a very revealing title - “The Greatest Carry Trade Ever? Understanding Eurozone Bank Risks” - Acharya and Steffen have found evidence of high risk associated with moral hazard and regulatory capital arbitrage due to the fact that sovereign debt was considered risk-free not requiring additional regulatory capital. Furthermore, as a consequence of their zero risk-weight, government paper would be accepted by the ECB as collateral with no haircut at all.

These authors, consequently, found that large banks – the Too-Big-to-Fail (TBTF) relying on their being rescued in case of running into problems – and the undercapitalised ones – betting for survival - would be those most probably lending to the 'periphery' (Acharya and Steffen 2015).

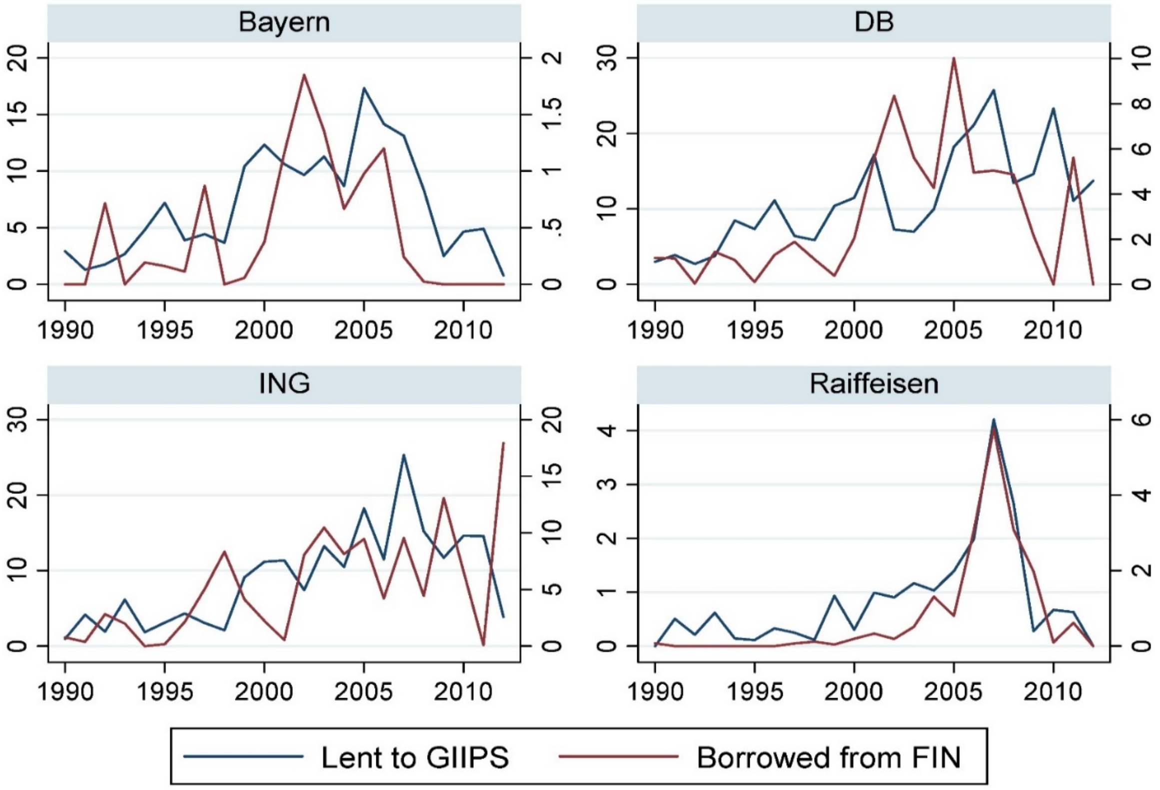
But, even more interesting is discovering that the acute cycle in cross-border lending within the euro area by financial institutions based in its 'centre' countries was funded in the rest of the world, most significantly in the U.S. Money Market Funds. Thus euro area 'centre' banks played a pivotal role in global finance recycling funds across continents part of it provided to their 'periphery', besides huge amounts that returned to the U.S. in lending to the subprime mortgage market.

Figure 4. Net foreign asset position of euro area 'centre' countries



As an illustration of the above let's see in the following figure 5 the case of some individual EZ banks borrowing from financial centres (FIN) to lend to the 'periphery' (GIIPS in the more polite rendering).

Figure 5 Funding and Lending to the 'periphery' of some euro area 'centre' banks



Therefore, what the euro area '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 pronouncements back in 2003 - but just providing finance; a major point that should be kept in mind.

By the way, contrary to official statements and academic comment, the counterparties to the "credit shock" were not governments. In fact, the Euro area indebtedness was almost fully driven by the private sector. As shown by Storm and Naastepad with Eurostat data, in the period right before the crisis (2000-2007) government debt – as a percentage of GDP – actually declined. The only country experiencing a significant increase in government debt was Portugal but with a 2007 public debt level comparable to those of France and Germany (Storm and Naastepad 2015). Over that same period and for the Euro area in the aggregate, out of a total increase of 159 per cent in indebtedness – as a percentage of GDP – that of the financial sector reached 132 per cent (Ibid.).

2. Three major points about cross-border finance [9]

First; finance provides purchasing power and not savings.

As we have just remarked, and more fully argued by Borio and Disyatat, "…financing, a cash-flow concept, is access to purchasing power in the form of an accepted settlement medium…". While "Saving, a national-accounts concept" - linked to a territory – "is simply income (output) not consumed". (Borio and Disyatat, 2011 and 2015). Moreover, "Investment, and expenditures more generally, require financing, not saving. And financing is a gross, not a net, concept" (Ibid.)

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 the case of the 'centre' countries' banks when lending to the 'periphery' in the euro area.

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 incurred 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. It is not country "A" in the 'centre' that is transferring "national savings" – or even finance – to country "B" in the periphery.

By 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. [10]

Net balances – particularly when visualised from a current account optic and their equivalent savings-investment gap – do not provide useful information about the

[9] On this matter I was originally inspired by Hale and Obstfeld (Hale and Obstfeld 2014) and Hyun Song Shin (Shin 2012) to focus on the way banks in the 'centre' European countries recycled funding obtained in the U.S. and other financial centres to the euro area 'periphery' (O'Connell 2015). But more recently I cannot but feel obliged– and the profession at large should - to work by BIS officials – including now also Hyun Song Shin himself - and consultants - that I quote time and again on the more general question of a more accurate identification of forces behind cross-border capital flows.

[10] This is part of what has been labelled by BIS colleagues as the "triple coincidence" between GDP area, decision-making unit and currency area (Avdjiev, McCauley and Shin 2015). The GDP area could be one Euro area 'centre' country (country A), but the decision making unit in providing cross-border finance to borrowers in a country in the 'periphery' of that area (country B) could be the head office of a subsidiary in the territory of country A, say, of a British bank – but funding the operation in the U.S. financial market - and the currency of denomination of the provision of finance could be the United States dollar (or the Japanese Yen although 80 per cent of the international financial market operations uses the US$ as currency of denomination).
Standard analysis, instead, would speak about a net capital flow from country A to country B matching their reciprocal positive and negative current accounts denominated in euros, i.e., making a transfer of savings from country A to country B and the resulting stock would be considered as a debt of country B towards country A.

volume and character of the activities and objectives of actual lenders and borrowers and the resulting balance-sheet reciprocal structures.

Countries might run current account deficits and still their banks could be large providers of finance – like in the case of Great Britain - and the contrary is also true.

Third; it is gross capital flows that should be examined and not net ones matching current accounts

Attention should be focused on gross cross-border financial flows that are registered in the capital accounts - away from the current accounts - that in a world of financial globalisation dominate balance of payments and, in fact, end-up determining the whole performance, of the countries involved.

The impulse for gross financial flows is more related to a “banking glut”, rather than driven by “imbalances” in current account associated with a “savings glut”, what Shin thinks is the right characterisation of the behaviour of international financial flows at large (Shin 2011).

For instance, “round-tripping” by European banks financing themselves in U.S. Money Market Funds – a gross flow from the U.S. to the EU - to reinvest those funds to a large extent in securities associated with subprime mortgages in the funding market – a gross flow in the opposite direction - are gross flows that net out so as not to turn up in current account statistics. That is why – besides the Forbes argument we took up earlier - to understand the functioning of the system one should focus on gross flows and not on net flows that end-up registered as the counterpart of current accounts. It boils down to focusing on the crucial actors – large financial institutions - that are those that take the decisions.

In fact, neither financing of trade nor transfer of savings – as visualised in current account balances - explain the “credit shock” let alone the subsequent “sudden stop”[11]. As seen above it was the leverage cycle of the ‘centre’ euro area and UK banks that explains the “credit shock” in the upswing and the “sudden stop” in the downswing.

[11] See Waysand et al. (Waysand,C., J. C. De Guzman and K. Ross 2010) for an examination of mismatches between trade balances, on the one hand, and gross debt, on the other, with current accounts by pair of countries in the EU.

3. The need for a "credit workout"

But the most critical side to the problems left behind by the "sudden stop" in lending to the 'periphery' – to a great extent determining the strategies applied to sort them out - is the extraordinary vulnerability of the 'centre' creditor banks to difficulties in being paid back the huge amount of accumulated credit. This is the true "doom-loop"; not the one on which attention keeps being concentrated between banks and governments in the 'periphery'. No; the true "doom-loop" is that between creditor banks and governments in the 'centre' countries.

In the following tables and figures the volume and degree of exposure of the European 'centre' banks vis à vis the 'periphery' may be seen as extremely high both for their balance sheets and that of their countries.

Figure 6 Individual banks proportion of their Total Net Asset Values exposed to the 'periphery'

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

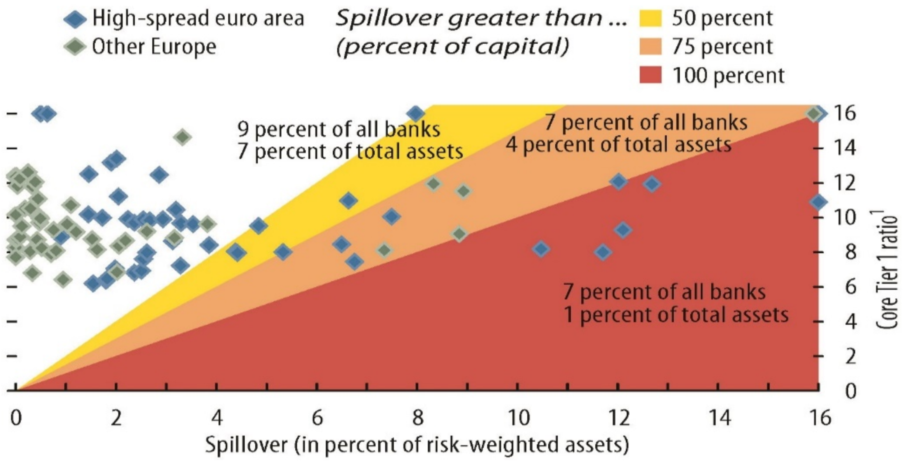
Out of 21 large euro area banks the 10 with largest exposure – in terms of their own Total Net Asset Value (TNAV) - has credit outstanding almost and above one-fifth of their TNAV a much higher proportion than that of regulatory and actual capital; a truly dangerous situation.

Globally, the exposure to the ‘periphery’ of banks with their main office located in the ‘centre’ countries territory reached almost the equivalent of a quarter of their GDP at the end of 2009. But, already by September 2012 with the increase of lending from official sources that exposure had been reduced almost by 40 per cent.

Figure 7. 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 lending	275	859
SMP	0	209
EFSF/EFSM	0	301
Lending by private banks	1391	852
Centre of Euroarea GDP (at current prices)	5,795.05	6,378.74
Lending by private banks/GDP	24.00%	13.40%
Source: for periphery borrowing from centre IMF-GFSR, September 2012		
Chap.1, Graph 1.7 and for GDP figures IMF-WEO, Database, Sept.2013		

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 2011c, 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.

4. A creditor's crisis – the "triangular bailout" - vs. the conventional "narrative"

Bearing in mind the volume of their exposure to 'periphery' debtors – not only governments as we have seen - in relation to the size of their head office economy, the direct fiscal costs of extricating 'centre' banks from their vulnerable position were of a colossal magnitude.

Governments of the 'centre' countries were confronted with the prospect of a potential serious financial crisis, on the one hand, but, on the other, the difficulty of making budget room for a "bailout" additionally challenged, as they were, with the justified animosity of public opinion against banks and finance . On top of it, a justification for the laxity of their supervisory obligations was not easy to provide. Thus a "narrative", i.e. that of the "irresponsibility" of the 'periphery' had to be concocted to conceal the facts; just a fig-leaf attempt to cover up that of their banks and supervisory agencies.

Consequently, well-known elements from other experiences of big creditor banks dangerously exposed to large stocks of lending provided to the 'periphery' were borrowed.

First, the "revolving door strategy". 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. Thus creditor banks were allowed to gradually get rid of their high exposure (as may be gathered from the significant drop we have seen already achieved by September 2012).

'Centre' countries official resources, instead of directly "bailing-out" their banks would be "generously" lent to the 'periphery' 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 amount of lending from official sources of €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 Private Sector Involvement; an agreed reduction of part of private lender's lending).

The "revolving door strategy"- or "triangular bail-out" - was complemented in an amplified form by two other servings from conventional thinking, again throwing the burden of the adjustment on the "irresponsible" debtors rather than on the creditor's side.

On the one hand, to make room for the full repayment of debt service above the resources provided by official bodies of the euro area 'centre' – and the IMF that was reluctantly brought into the exercise - public expenditure had to be cut down drastically.[12] Of course, it was argued that no negative consequences would follow

[12] See , for instance, in the case of Greece, the debate at the Board of Directors on the first IMF programme. The Brazilian director declared that it "may be seen not as a rescue of Greece, which will have to undergo a wrenching adjustment, but as a bailout of Greece's private debt holders, mainly

as 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 (the “Expansionary Fiscal Austerity”). On the other hand, “structural reforms” was what really mattered and would counteract whatever negative the effects of the “austerity” policies and unleash a dynamic growth process.

Eventually the IMF – in a somewhat significant break with past thinking and policy advocacy - would provide us with rather full criticisms of that notion, i.e. it was acknowledged that multipliers could be large so that austerity policies could have significant negative effects on GDP and employment; other authors had previously and afterwards contributed to a new consensus on this matter. [13]

Additionally, recent work has shown that fiscal consolidations have long-term effects on GDP in much longer horizons than in habitual analysis of fiscal multipliers (Fatás and Summers 2015).

Confronted with less than a full success of the above package, however, rather than reviewing it, the “muddling-through” or “kicking the can down the road” attitude was adopted.

Programmes were put together laboriously and with great cost for the countries involved that clearly had serious limitations. Accordingly, the ‘periphery’ was thrown into a species of continuous instability threatened with default every few months on top of the results of the austerity programmes; the negative consequences of “uncertainty” “…(a) highly reflexive relationship between rising uncertainty and rising debt” as pinned down by Pettis (Pettis 2015). Once again, eventually, the IMF has come 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 2015).

European financial institutions” (Blustein 2015). In fact, the Fund had to introduce a qualification to a rule on “exceptional access” that had been passed back in 2003 after the Argentine default. That rule prescribed that such access could be granted only if there was a high probability of a country recovering access to private financial markets in the coming years.

[13] In the World Economic Outlook of October 2012 (IMF 2012) there is a Box 1.1- whose authors were Olivier Blanchard and David Leigh - where it is acknowledged that fiscal multipliers widely in use were around 0.5 while in the conditions of the “Great Recession” a better estimate would have been in the 0.9 to 1.7 range. This argument is repeated a few months later in a NBER paper by the same authors (Blanchard and Leigh, 2013). Moreover, based on the experience of the 1930’s a multiplier of 1.6 was estimated (Eichengreen and O’Rourke 2012) in a paper responding to the IMF’s WEO, October 2012, Box 1.1. and based on a careful research of the 1930’s experience (Almunia,M., A.Benetrix, B.Eichengreen, K.O’Rourke, G.Rua, S.Tenreyro and F.Perri 2010). Previously, in a working paper of the IMF (Guajardo, Leigh and Pescatori 2011) based on a careful new dataset of fiscal actions motivated by a desire to reduce budget deficits not in response to economic conditions- what in (Romer and Romer 2010) are called “exogenous” fiscal actions - an estimate of the result of fiscal consolidations in OECD economies (the multi-country database identifies 173 adjustments) reaches the conclusion that they are contractionary (much to the point the paper’s title is “Expansionary Austerity: New International Evidence”). As to the distributional effects of fiscal consolidations, at least in OECD countries, the conclusion of other authors publishing again an IMF working paper is that they typically lead to “…a significant and persistent increase in inequality, declines in wage income and in the wage share of income, and increases in long-term unemployment” (Ball, Furceri, Leigh and Loungani 2013).

On the question of fiscal policies, however, the IMF keeps biased towards recommending fiscal consolidation to most countries in the Euro area in presence of a sizeable current account surplus; vide (Setser 2016).

But worse, governments in the ‘centre’ countries supported policies that transferred to borrowers in the ‘periphery’ the burden of adjustment. Additionally, these countries had to get further indebted now with official institutions of the European Union - and the IMF - in spite of the main culprits having been the ‘centre’ banks in their push for higher profits. Thus, the “triangular bailout” was made to become a conflict between members of the EU tinged with bitter memories of historical conflicts.

Analysis coming from most professional sources has not been particularly helpful ridden by confusion placing the roots of the crisis in supposedly transfers of savings from hard-working citizens of ‘centre’ countries to ‘siesta’ loving inhabitants of the ‘periphery’ rather than the recycling of funding by mammoth banks headquartered in the ‘centre’ countries. Additionally, against all evidence ‘periphery’ countries’ governments were blamed for the crises as fiscal crises of borrowing. And on top of it all, responsibility for lagging competitiveness – driven by the previous avalanche of profitable credits – was squarely placed on governments and workers unions. [14]

In fact, had ‘periphery’ countries been 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?

[14] On the matter of competitiveness see Storm and Naastepad (Storm and Naastepad 2015).

5. Conclusion

No doubt, there are weaknesses in the institutional structures of the Euro area. They were designed having in mind that the only potential source of problems would be the misbehaviour of governments. Consequently, limits on fiscal deficits and government debt were instituted. Following the acquired consensus of the decades previous to the ongoing crisis, however, no provisions were introduced to cope with a financial crisis originating in the misbehaviour of big private financial institutions and their supervisors.

But having seen that crises are just the end result of an upside phase of capital flows, even more importantly than being prepared to fight a “sudden stop”, new structures and policies should be designed to manage the “boom” phase and not only the “bust” as most of the proposals that have been put up try to deal with.

Changes are needed both in the architecture of the area and also about the vision that inform their authorities. The best full employment and growth oriented macroeconomic policies can do little to handle the massive waves of finance and, most specifically cross-border finance. Unless strong regulations to manage those financial flows, if not cancel them out, are introduced the best inspired and carefully crafted policies will be powerless. [15]

Of course, adoption of such policies for the future does not cope with the ‘legacy’ problem of the accumulated stock of credits/debts. ‘Periphery’ countries in the Rest of the World have resorted in such situations to nominal devaluations – that with dampened pass-throughs became also real - and economic expansion. A few have obtained significant ‘haircuts’ in the principal of their debts and/or ‘reprofiling’ of maturities at moderate rates of interest.

To the contrary, in the Eurozone, policies have concentrated almost exclusively on achieving real devaluations through domestic deflation and imposing drastic reductions in ‘absorption’ – both public and private – to make room for debt repayments that have not resulted in renewed growth nor in a significant – present-day or near future - reduction of Debt/GDP ratios.

And besides the “revolving door”, one gets the impression that the other component of the strategy applied to the EMEs, the “muddling-through” strategy – or step by step going from crisis to a renewed one –has also been employed in the Euro area ‘periphery’. While the opposite, an upfront wholesale all-around reduction in the debt/credit overhang looks like the only way-out to ensure growth and employment.

How is that all-around reduction of the debt/credit overhang to be achieved without bringing down some financial institutions or massively bailing-out them from their own countries’ government budgets? Proposals have started coming forward implying a much faster strategy than through the “revolving-door” cum “muddling-through” one with all its costs in terms of recession, unemployment and poverty in the recipient countries and its consequences for the ’centre’ ones. But, to my knowledge, they all start from the wrong point, i.e., responsibility for the crisis is

[15] Besides what comes out in an already mentioned paper by Hélène Rey (Rey 2013) about the introduction of capital controls of some kind to regain a degree of autonomy for monetary and economic policy in general, there are other contributions like, for instance, that of Ghosh et al. in which using a vast database a positive conclusion is reached about the power of instituting capital controls at both ends (Ghosh, Qureshi and Sugawara 2014).

squarely placed on the countries receiving the financial flows rather than on the institutions in the 'çore' countries originating them and their supervisors as well as the still predominant de-regulated scheme under which those institutions are performing their role.

Additionally, and in a language that should be avoided because of the danger of feeding old feuds and xenophobias there has been too much talk about overcoming "German" opposition. It is framed as if creditors would be the German people and not a narrow – but perhaps powerful - section of the population of Germany and a tendency by its government to follow the "triangular bail-out" strategy. And, consequently, the issue is being transformed in a conflict between different euro area nations, not precisely the right way to strengthen the integration process.

What is in crisis, as it was the case back in the 1980s and 1990s for Emerging Market economies like those in Latin America, is the strategy of "triangular bailing-out" large creditor 'centre' banks through the wrong means, i.e. via further compression in economic activity in the 'periphery' countries and transferring a sizable portion of those credits to official institutions just to try to make room for their keeping up-to-date service of the "toxic" loans in the balance sheets of 'core' countries' "Too-Big-To-Fail" banks.

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 "debt relief" by the 'centre' countries' governments was shown to be a global positive force for growth which would push up their own economies. That was the conclusion of simulations done by the Research Department of the IMF with their world economy model of those days. It was presented to a meeting of the Interim Committee as an Appendix to the WEO of March 1988 (a mimeo, being pre-digitalisation era) that unexplainably 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 besides victimizing 'periphery' countries were making other sectors of their own society – the poor carpenters and plumbers as well as middle class taxpayers - pay for the adventurous behaviour of those institutions.

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