Ten Years into the Global Financial Crisis

The Current State of Finance in the EU: Prospects and Alternatives

Nicos Poulantzas Institute | transform! europe
EuroMemorandum Group

Ten Years into the Global Financial Crisis - The Current State of Finance in the EU: Prospects and Alternatives

Contents

Contributors

Judith Dellheim is a Senior Fellow at Rosa Luxemburg Foundation, Berlin. She studied political economy from 1973–1978, obtaining her PhD in 1983. She has worked in the foreign trade sector of the GDR. Since 1990, she has been working on political economy, economies of solidarity, on political parties and movements, and on economic policies. She was a member of the Federal Board of the PDS in 1995–2003, a free-lance scientific consultant is 2004–2010, and senior researcher at the Rosa Luxemburg Foundation since 2011. She is also a member of SERI Germany (Sustainable Europe Research Institute) and of the EuroMemo Group.

Marica Frangakis is a member of the Executive Board of the Hellenic Financial Stability Fund. She is a member of the Nicos Poulantzas Institute and of the EuroMemorandum Group. She has published widely on finance, as well as on European economic policy. Her latest publication is a chapter in *The internal impact and external influence of the Greek financial crisis* (J. Marangos, Ed.), "The ECB's non-standard monetary policy measures and the Greek financial crisis".

John Grahl is Professor Emeritus in Economics at Middlesex University Business School. His main research interests are European economic policies, European employment relations and financial integration in Europe. He is active in the EuroMemorandum Group. His latest publication is a chapter in *Rethinking Britain: policy ideas for the many* (Konzelmann et al. Eds.), "How can we stop the social security system aggravating mental distress?"

Stefanos Ioannou is a Postdoctoral Research Associate in Finance and Geography, University of Oxford. He obtained his PhD in Economics from the University of Leeds in 2016. Prior to his doctoral studies he completed an MPhil in Economics at the University of Athens (2012) and an MSc in Finance at Newcastle University (2009). His research interests include fiscal and monetary policy, financial macroeconomics, economic geography and political economy. His most recent publication is: Ioannou S.and D. Wójcik (2018), 'On Financialization and its Future', *Environment and Planning A: Economy and Space*, 51 (1): 263- 271, https://doi.org/10.1177/0308518X18820912

Konstantinos Loizos is a Research Fellow at the Centre of Planning and Economic Research (KEPE) and post-doctoral researcher at the Department of Economics, University of Athens, Greece. He is also an adjunct lecturer at the Hellenic Open University and a member of the Board of Directors of the Hellenic Development Bank and the TANEO. His research interests include development finance, financial systems and financial regulation both from a theoretical and a policy perspective. His published papers include "The Financial Repression-

Liberalization Debate: Taking Stock, Looking for a Synthesis" (*Journal of Economic Surveys*), "Alternative Financial Regimes and Development Banks in Greece 1963-2002: What Have We Learned?" (*Economic Alternatives*) and others. He is now working on a model of the interbank market and the link between liquidity and solvency risk.

Vlasis Missos is currently a research fellow at the Center of Planning and Economic Research (KEPE) on the field of income inequality, poverty and the political economy of social welfare. He has been adjunct lecturer at the University of Athens and has undertaken consultancy work for government in less developed countries. He is the coauthor of "*The Real Economy: Experience of development, crisis and impoverishment in Greece*" (2018, Athens: Kritiki, in greek) with Costis Vaitsos.

Jan Toporowski is Professor of Economics and Finance at the School of Oriental and African Studies, University of London; a Visiting Professor of Economics at the University of Bergamo; and Professor of Economics and Finance at the International University College, Turin; he is also active in the EuroMemorandum Group. His research is concentrated on monetary theory and policy, and finance. He has published two volumes of biography of *Michał Kalecki* and nearly 300 books, articles and papers. He has worked in fund management, international banking, central banking, and economic consultancy. He studied economics at Birkbeck College, University of London, and the University of Birmingham, UK.

Acknowledgements

The work leading to this e-book was carried out in a thematic workshop, "Ten years into the global financial crisis – The state of finance in the EU", sponsored by the Nicos Poulantzas Institute and the Transform! Europe Network. We would like to thank all the people and the institutions that made both the workshop and the book possible.

The authors are further grateful to the following experts who contributed to the proceedings of the workshop. **Gary Dymski**, Professor of Applied Economics, Leeds University Business School, **Apostolos Fasianos**, Hellenic Ministry of Finance, Council of Economic Advisors and Cyprus International Institute of Management, **Haris Golemis,** Scientific and Strategic Advisor to the Board of Transform! Europe, **Danai Koltsida,** Director of the Nicos Poulantzas Institute and **Roland Kulke**, Transform! Group.

Special thanks go to **Aimilia Koukouma**, researcher at the Nicos Poulantzas Institute, for her diligence and valued support throughout the project.

Views expressed in this publication reflect the opinion of individual authors, who are responsible for any errors and omissions in their contributions.

Preface

The year 2008 is conventionally considered to mark the start of a financial crisis that shook the foundations of the advanced capitalist world, starting from the USA and spreading to Europe with the speed of a wildfire. Indeed, the collapse of 'Lehman Brothers', a US based investment bank, on 15 September 2008 made the leaders of both the USA and of the EU hold their breath.

Although the novelty of the situation and the fear of a new depression spearheaded many governments into action, ten years later, the ripples from the shock of the crisis are still there. This is not only due to the intensity of the crisis, but also to the ways and means adopted in dealing with it both in the US and in the EU. Thus, on the occasion of an 'unhappy anniversary', we thought it was time to visit certain issues and areas that are pertinent to the present state of the financial services sector. Our main focus is on Europe and in particular on the EU, although references are also made to the USA, which remains the precursor of things to come in the financial world.

This present volume includes papers presented and discussed during a workshop that took place on 28 and 29 March 2019 at the Nicos Poulatzas Institute, Athens. The objective of the workshop was to contribute to the debate over the state of the European financial system after the 2007/2008 global financial crisis, by bringing out the adjustment process that has taken place, its future prospects and the alternatives that may be proposed from a left perspective.

Areas under discussion included the US-EU financial nexus, new developments in the financial services sector and associated risks, the economic and social implications of non-performing loans, with special reference to the Greek case. Alternatives from a radical Left perspective, especially put forward by the European Economists for an Alternative Economic Policy (EuroMemo Group) were also extensively discussed.

It is hoped that the present publication will contribute to the deepening of the discussion of issues that may appear technical at first sight, but which are deeply political and that it will be the beginning of a much needed further debate in this area from a radical Left perspective.

Project Coordinators
Marica Frangakis
Aimilia Koukouma

Part I - The EU's financial and banking system – Global Considerations

The Coming Dollarisation of the Eurozone

John Grahl[1]

Abstract -

Although dollarization is typically a consequence of uncontrolled inflation, it can also be a result of a deflationary crisis and thus relevant to the Eurozone today. It would amount to a process of "indirect integration" through the common subordination of member states to US institutions, but this would be nothing new. Eurozone vulnerability is increased by the ECB's lack of an active external strategy. The fact that much of the world is already dollarized increases the threat to the EU. In the Eurozone two important monetary functions, transnational funding and collateral provision, are already performed by the dollar. The European failure to supply safe assets in the form of high-quality euro-denominated bonds is exacerbating these weaknesses. A key market in the relations between dollar and euro systems is that for FX swaps: here there is a persistent "basis spread" giving important advantages to dollar-based investors. The establishment of continuing dollar-swap facilities between the US Fed and other major central banks reflects the increasing dominance of dollar finance; these are not symmetric arrangements but rather involve the latter in the stabilisation of asset prices and financial markets in the US. There is no escape from creeping dollarization through a break-up of the monetary union which would only give rise to accelerated dollarization in the fragments. Only a unified approach, deepening both the economic and the political coherence of the monetary union, offers a possible assertion of autonomy.

Introduction

The project of European monetary integration was not based solely on the internal goal of reduced transactions costs but also on an ambition to build a currency, a financial system and an economy with a great measure of autonomy from policy and financial developments in the US. At present the increasing subordination of monetary and financial conditions in the Eurozone to those in the US is threatening to undermine the entire process of European construction. Thus the recently introduced structure of financial regulation in Europe can be circumvented if the Trump administration abandons the Dodd-Frank reforms. More generally it will be increasingly difficult to influence the governance of European corporations if they

[1] Professor Emeritus in Economics, Middlesex University and member of EuroMemo's Group Steering Committee.

are tied into dollar-based financial markets. Subordination can be tracked in the security markets, especially in the dominance of US bond markets, in the functioning of the ECB and now in the money markets and the supply of short-term credit. It is argued here that unless the Europeans can recover their original ambition for a currency union and financial system sufficiently liquid and robust to work in parallel to the dollar-based system rather than as an appendage to it, the social and environmental goals of the EU will be increasingly beyond its powers.

Can the notion of dollarization be applied to a case of illiquidity and deflationary pressure and not just to cases of hyper-inflation?

We can invoke Aglietta and Orléan (1984) on the breakdown of monetary systems. A rapid move to a new monetary object seems more likely following an inflationary crisis because that tends to be a centralising process, facilitating a general move from the discredited money, and a process dominated by debtors who will be advantaged by the elimination of their old currency liabilities. A deflationary crisis is decentralising, attenuating or destroying old economic relations, and one dominated by creditors who might stand to lose if old currency claims were wiped out. In the classic case of deflationary breakdown, the general departure from the gold standard in the 1930s, there was no common move to an alternative until Bretton Woods. Nevertheless, the salience of the dollar as an alternative and the unresolved deflationary pressures arising from the workings of the Eurozone may make dollarization plausible – in the form of a slow erosion of certain monetary functions. Nor would the process be unified – one might expect the turn to the dollar to be earlier and more complete in the weaker Eurozone economies than in Germany.

Indirect European integration – via Americanisation – would be nothing new

There is firstly the enormous role played by the US in the birth of the integration project (Lacroix-Riz, 2014). There are many subsequent examples. After the dissolution of the EPU (insisted on by Britain) in 1959, monetary integration was, until 1971, a consequence of the Bretton Woods exchange rate regime: the franc was tied to the D-mark because both were tied to the dollar. De Gaulle's bid for monetary independence collapsed with the *événements* of 1969. Similarly, the irony of the pursuit of the "European Company" was clear to many commentators. The corporations which moved most fluently across the EC's internal borders and were least tied to particular locations were in fact American multinationals.

"The villainy you teach me I will execute and it shall go hard but I will better the instruction." US financial practices, often imperfectly understood by their European imitators, had enormous impact on both private and public actors in the EU. Consider the breath-taking leverage ratios achieved by Eurozone banks in the subprime/securitisation bubble, which easily surpassed those of their US counterparts. Again, just when the shareholder value drive was meeting some determined judicial and legislative resistance in the US, the European

Commission went all out for a takeover directive which would have abolished any effective defense against hostile takeovers.

The Eurozone's rejection of external objectives weakens its internal policies

The external use of the euro is carefully monitored by the ECB which insists, however, that it has no external policy objectives. This is a damaging abdication, weakening Europe's potential influence on the evolution of global financial institutions and practices; it has also led to a weakening of internal monetary policy. The absence of an active policy reflects, as do so many of the dysfunctional aspects of the monetary union, the parochialism of the German authorities, now reinforced by the equal commitment to Biedermeier styles in the so-called Hanseatic League. The ECB's 2017 report on the international use of the euro puts a figure of 5% on the loss of efficacy of monetary policy instruments due to the growing interpenetration of US and Eurozone financial systems (ECB, 2017, pp. 7-8).

It is worrying that the ECB suggests that this loss is compensated by moves in the $-€ exchange rate induced by its interest rate moves. Countries which implement monetary policies essentially by targeting their $ exchange rates are already in a clearly subordinate position: there is no "trilemma" for them – their open capital accounts eliminate monetary independence because they can never treat their exchange rates as a matter of indifference. On the contrary, regardless of the formal nature of the policy – float, crawling peg, or whatever – they have to set interest rates in function of FX pressures; See Rey (2013). Turkey is a recent case in point.

Much of the world is already partially dollarized. The US will not be much constrained by capital outflows to countries which make substantial use of the dollar – there is no real threat to convert dollar balances to rival stores of value. This impunity is an effect of *scale*: the more countries there are in such a position the weaker the external constraint on US finance and US macro policies. We have been waiting a life-time for these chickens to come home to roost but, as with the sterling balances of the British Empire, the very possession of hegemony leads to its reinforcement. Ito and McCauley (2018): "This study divides the world into currency zones according to the co-movement of each currency with the key currencies. The dollar zone groups economies that produce well over half of global GDP. … Global imbalances differ from a currency perspective. In the 2000s, the dollar zone's current account disappeared by the onset of the Global Financial Crisis (GFC), even as the US current account plumbed all-time lows."

We observe ongoing dollarization in two key areas: collateral and funding

Both of these involve the market in FX swaps which has grown to staggering dimensions and which fulfils a key function in the global economy: that of permitting the transfer of monetary resources across currency zones. In the case of collateral, the FX swap market makes it possible to substitute dollar assets for assets in local currencies if these are scarce. In the case of funding the FX swap markets facilitate the use of funds raised in one currency zone to finance investments in another – but currently in a highly asymmetric way which privileges dollar funding.

The collateral problem relates to the German government's petty bourgeois views on credit. Borrowing is bad and so there should be a law against it – preferably one with constitutional force. Germany itself will cling to the *Schuldenbremse*; misbehaving governments in the Club Med will have to pay a risk premium on their bonds, even though this declared risk complicates their use as collateral and renders the pricing of other securities more difficult. (The ECB currently holds so much Eurozone debt that it strains credulity to suggest that bond yield differentials are simply a matter of market forces. The ECB has become the market). Every proposal for bond issuance at European level is blocked by the German and like-minded governments. (Recent indications that big EU banks have been rigging the bond market are hardly likely to inspire investor confidence[2], but the very ability to manipulate bond yields may suggest the illiquidity of the market). European policies contribute to the world-wide shortage of safe assets. The primary cause of this shortage has been the downgrading of subprime and similar debt after the crisis, but the disruption of Eurozone bond markets is also a significant factor.

Table 1: A List of Safe Assets – Pre- and Post-Crisis

A List of Safe Assets—Pre- and Post-Crisis

	Billions of US$		*% of world GDP*	
	2007	*2011*	*2007*	*2011*
US Federal government debt held by the public	5,136	10,692	9.2	15.8
Held by the Federal Reserve	736	1,700	1.3	2.5
Held by private investors	4,401	8,992	7.9	13.3
GSE obligations	2,910	~~2,023~~	5.2	~~3.0~~
Agency-and GSE-backed mortgage pools	4,464	~~6,283~~	8.0	~~9.3~~
Private-issue ABS	3,901	~~1,277~~	7.0	~~1.9~~
German and French government debt	2,492	3,270	4.5	4.8
Italian and Spanish government data	2,380	~~3,143~~	4.3	~~4.7~~
Safe assets	20,548	12,262	36.9	18.1

Source: Caballero et al., 2017

A recent IMF paper considers the exceptional demands for good collateral that might arise from a specific financial emergency – the breakdown of one or more of the central counterparties (CCPs) established since the global crisis in the hope of reducing the risks of derivative trading. The contrasting capacities of US and EU to respond to such an eventuality illustrate well the huge advantages of dollar-based finance over finance in the Eurozone:

[2] "EU accuses eight banks of rigging €7tn Eurozone bond market", *Financial Times*, 01/02/2019, p.1.

"While in Europe, HQLA[3] continues to be in short supply (Bund repos are in the negative 50 bps range), the opposite is true in the US where GCF (collateral rates) is close to 2 percent (200 bps) at present. U.S. dollar-denominated HQLA should be able to satisfy much of the worldwide HQLA demand". (Turing and Singh, 2018, cited by John Dizard, FT, 28/02/2019).

One, traditional response to the limitations of European bond markets is of course to refer to the salience of bank finance in most EU member states. It is doubtful whether this objection still holds the force it had in the past. The inanition of EU banks, after their misadventures in the subprime and similar markets, has become a frequent complaint of commentators. Federal Reserve economists Beschwitz and Howells (2016) suggest that, although bond market access was not important for EU enterprises in the past, it may be becoming so because of new constraints on the banks. If this is the case the undeveloped nature of EU bond markets may be becoming an obstacle to EU investment.

Use of dollar collateral within Europe

There appears to be a sharp asymmetry in the use of FX swaps in the US and in the EU. In the US, FX swaps are used essentially for international, cross-currency, transactions – they would not typically be used within the domestic money markets. The situation appears to be very different in Europe, where the ECB reports FX swap transactions alongside those relating to other internal money market instruments such as repos (for example, ECB, 2015). It appears to be the case that dollars are used as collateral in internal credit transactions, both because other forms of collateral are scarce and because of the relatively favourable regulatory treatment of FX swaps as against euro repos. Indeed, FX swaps may be the most important instrument within Eurozone credit markets: turnover is higher for repos but when transactions are weighted by maturity it is clear that much more capital is raised in the Eurozone by FX swaps than by repos.

Given the scale and liquidity of American capital markets, and the fragmentation of non-dollar markets into several currency zones, the enormous growth of FX swaps seems to have highly asymmetric effects, transmitting US money market conditions to other countries but much less the other way round. Abundant US liquidity spills over to all participants in the global financial system, mitigating inflationary pressures, while a US liquidity squeeze, forcing up the basis spread and cutting off non-US borrowers from dollar credit, exports much of the resulting tension to other players.[4] The hypertrophy of foreign exchange markets, at first misinterpreted as a matter of speculation, is in reality a powerful mechanism of US-led globalisation.

"The dollar reigns supreme in FX swaps and forwards. Its share is no less than 90%, and 96% among dealers. Both exceed its share in denominating global trade (about half) or in holdings of official FX reserves (two thirds). In fact, the dollar is the main currency in

[3] HQLA = High Quality Liquid Assets.
[4] This is hardly a new phenomenon: compare the drastic consequences for European dollar debtors of the US liquidity squeeze which followed the Wall Street crash.

swaps/forwards against every currency. For instance, it predominates in forwards in the Norwegian krone, the Swedish krona and the Polish zloty, currencies that trade in the spot market more against the euro." (Borio et al., 2017) Thus, the close trading relationships of these countries with the Eurozone are compatible with a predominance of the dollar in their financial relations.

Tensions in the Eurozone bond markets contrast with a much easier situation in the dollar markets (in spite of Trump's tax cuts)

The EU situation can be related to a general, global shortage of "safe assets", but is specific in that political pressures drastically curtail issuance of high quality debt and restrict and complicate official support for bond prices.[5] Negative yields now prevail for much German debt and these can even go below the ECB's deposit rates; non-bank actors are not permitted to hold ECB deposits and seem often to prefer direct claims on the German government to deposits with commercial banks.[6] Regulatory and other administered constraints on banks and institutional investors may account for some disturbances. Nevertheless the crash of the repo market to massively negative yields in December 2016 suggests that institutions having to hold and trade bonds have to cope with a very fragile and volatile environment. In that, admittedly extreme, episode some investors were prepared to lend money at -6% in order to get hold of high quality collateral.[7]

The actors most affected by lack of good collateral and thus illiquidity in the repo market are institutional investors using reverse repos to acquire government debt on a short- or long-term basis. To the extent that US mutual and pension funds are not similarly handicapped they seem well positioned to capture more of the EU savings market.

A basis spread consistently adverse for European investors gives dollar-based banks and fund managers an advantage not only in the dollar markets but also in the Eurozone.

The "law of one price" lost one of its few remaining empirical supports when forward exchange rates ceased to be priced on "risk-free" interest rate differentials. What began as a

---

[5] On the general shortage see Caballero et al. (2017). These authors argue that the downgrading of mortgage-backed $-securities and similar claims is the main factor reducing the availability of assets presumed to be "safe" since the crisis. However, downgrading of Eurozone sovereign debt – they give figures only for Italy and Spain – was also a significant factor. The first involved about $9tn of claims, the second $3tn. One example of political constraints is that the ECB is required to purchase the government debt of EMU member states in proportion to their GDPs – meaning that its QE exercises involved completely dysfunctional accumulations of bunds.

[6] *FT* 5/2/19 gives the following yields on German benchmark bonds: maturity October 2020, bid yield -0.61; February 2025, -0.25; July 2028 +0.06; August 2048+0.77.

[7] See Hill, A. (2017). Hegives a very interesting list of factors behind the repo market breakdown.

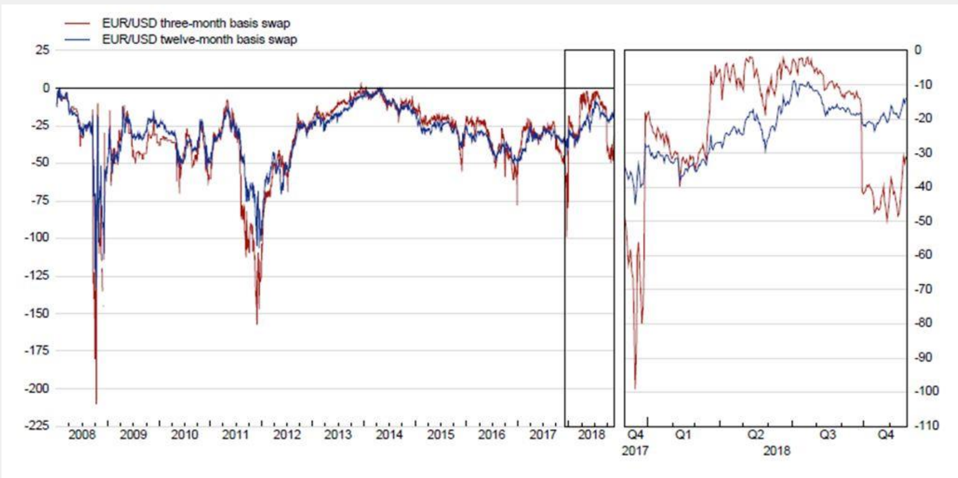
a) Shorting of bonds
b) US banks taking advantage of wider basis spread to invest in euro assets
c) QE, although the ECB did attempt to mitigate the shortage it was causing.
d) Tighter bank regulation impacting end-of-month portfolios

crisis phenomenon, reflecting suspicion of counterparties and perceived exchange rate risks, has now become an established and continuing feature of international financial relations.

The explanation of the basis spread, which makes it profitable to swap $ for € and costly to take the other side of the same swap, is extremely technical and beyond the capacities of the present writer. But some literature from the BIS suggests that the following simple account may be adequate for a broad overview. The basis spread can be regarded as arising from two forces. On the one hand, on the "demand" side, there is massive pressure from European investors for exposure to dollar-denominated assets. This pushes up the spot rate for the dollar, while the necessary hedging of euro advances pushes down the dollar's forward rate.

Why do US banks not take advantage of the resulting arbitrage opportunity to lend dollars and gain a risk-free profit on the return leg of the swap from the cheapness of forward dollars? The simplest view is that there is a "supply" constraint arising from the balance sheet implications of FX swaps for US banks.[8] Since the global crisis and the reawakened concern with leverage ratios which followed, any asset appearing on a bank's balance sheet can be regarded as having a shadow price to the extent that it tightens actual or potential regulatory constraints. (Some accounts suggest that US regulators go beyond Basel rules in their discouragement of FX positions, even the closed positions arising from FX swaps (Borio et al, 2017), in particular, argue that large FX positions represent a form of debt inflation). Recently, spreads have widened, reaching some 50 basis points on three month dollar-euro swaps.

Chart 1: EUR/USD cross-currency basis swap spreads (basis points; last observation: 22 Nov. 2018) and EUR/USD three-month basis swap EUR/USD twelve-month basis swap



Source: ECB, after Bloomberg

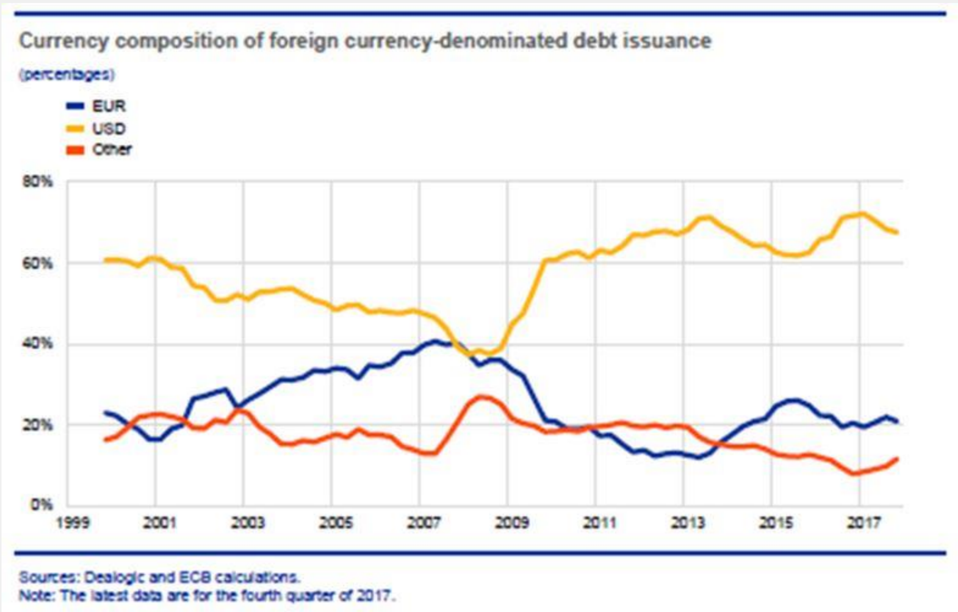
The *Financial Times* analyst John Dizard suggests that the increasing cost for European companies of hedging their dollar exposures is bad news for the Trump administration, since

[8] This constraint exists despite the relatively favourable treatment of FX swaps, compared to repos, in the Basel III regulatory framework.

it will curtail external finance of its adventurous tax cuts (FT 12/10/2018). The prominent financial analyst, Zoltan Pozsar, also suggests that certain limits to the cheap foreign finance of the US government deficit are being reached: dollar long rates are too low to attract foreign investors given that short rates are pushing up the cost of dollar swaps; some move away from the present inverted yield curve is going to be needed (Pozsar, 2019).

However that may be, the persistence of significant basis spreads against the euro works directly against euro funding of any positions inside or outside the monetary union. Investors from the US and third countries will tend to find it cheaper to borrow dollars and swap them for euros even when they are funding Eurozone positions. Here again the autonomy of the Eurozone seems to be narrowed.

Chart 2: Share of the euro in foreign currency-denominated debt issuance stable



Source: ECB (2018) "The volume of euro-denominated foreign currency debt issuance remains well below pre-global financial crisis peaks"

The ECB as a branch of the Fed

Relations between central banks in the $ and € economies seem to reinforce the notion of a gradual subordination of European finance. Official FX swaps between the Fed and other major central banks around the world emerged first as a crisis phenomenon but now appear to have been given a continuing institutional form, when standing facilities were introduced in October 2013. The crisis issue was, originally, an American problem. Foreign, especially European, banks went into the crisis loaded with dollar assets, including an unknown proportion of the most toxic varieties. Funding for these holdings became problematic as money markets seized up and US institutions became suspicious of foreign players. Since the Fed did not provide refinance for foreign banks in the same way as for domestic ones there was a risk that European, Japanese and other non-US banks would start to dump their dollar-denominated assets, making the crisis more acute.

The response was an official FX swap – the Fed lent dollars to the ECB with which the latter refunded the $ positions of the Eurozone banks.[9] Both central banks clearly had an interest in the success of this exercise – the Fed in avoiding further asset price collapses and the ECB in preserving the liquidity/solvency of major Eurozone banks – but it can be seen as primarily an extraterritorial extension of the US stabilisation policy: "In general, the issuing central bank contributes to defining the pricing terms at which liquidity is provided by the home central bank to its counterparties, in order to avoid interference with the issuing central bank's monetary policy implementation" (Borio et al. 2017, p. 71).

An interesting question arises as to the use or otherwise made of the counterpart currency, for which the Fed had no particular need: US banks had no problem funding their non-dollar assets. In the case of Japan, a special bill was issued in which the Fed could conveniently park its yen. It is not clear whether the ECB has followed an analogous procedure.

With other major central banks around the world carrying out this distribution of "synthetic" dollars in a synchronised way, the official swaps seem to constitute a move towards the integration of monetary policies under US auspices. There was some speculation that the Trump administration would annul the official swap but so far there is no sign of this – the arrangement in any case does not conflict with the priority of "America first".

Dollarisation of other monetary functions

The conjecture here of a gradual loss of monetary and financial autonomy in the Eurozone is admittedly precarious. The zone is immensely rich and the ECB, under the active presidency of Draghi, displayed an formidable capacity both for self-defense in the massive deployment of central bank resources and for institutional development in the strong moves to a more centralised supervisory and regulatory structure (De Rynck, 2015).There is, however, some anxiety about the readiness of a successor to depart so far from the Bundesbank's notions of orthodoxy. The argument here has involved dubious extrapolations and even the perception of future tempests from clouds no bigger than a man's hand. The interpretation of the Trump presidency is important. It is consonant with the argument above to stress the unique financial strength of the US which renders recent erratic and maladroit policy moves feasible. It would be counter to the main argument here, however, if dysfunctional policies in Washington DC should so weaken the US financial structure as to call dollar hegemony into question.

Meanwhile, it is hard to think of a financial function where the Europeans are not potentially exposed to a gradual imposition of US practices and standards. Trump's support for financial deregulation illustrates the point: if the post-crisis structure embodied in Dodd-

[9] The ECB did not use FX swaps but rather repos in this refunding. Big haircuts (20%) were imposed during the crisis; these were later reduced.

Frank is undermined in the US, then the elaborate regulatory structure introduced in the EU will come under strain. Even before the US presidential election of 2016, the House of Lords (2015) EU Committee was reporting that the US was not prepared to harmonise financial regulation with the EU.

Conclusion: the possible consequences of a Eurozone breakup

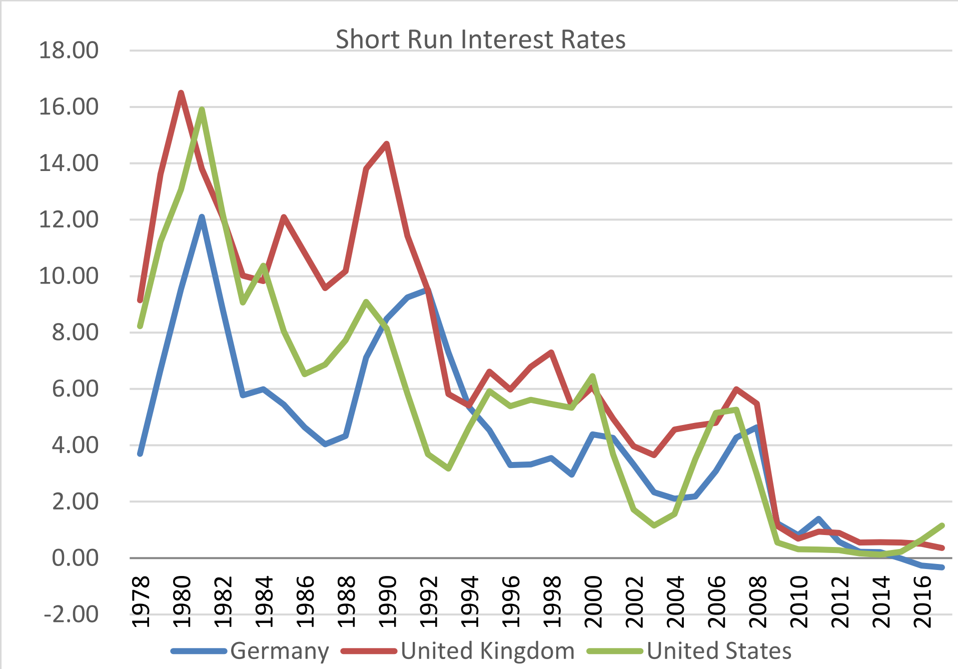
The argument above has been that the Eurozone is being slowly dollarized. No comfort can be drawn however from this conjecture for the various projects for member state departures from the monetary union. Should the Eurozone break up the most probable outcome is galloping dollarization in the fragments – immediate in the smallest and weakest of these, but still marked even in France and Italy.

The performance of British finance can stand as a warning to those in search of national monetary sovereignty. The status of the City of London, and its role in most large-scale international operations, fail to safeguard the British currency which is only propped up by consistent and substantial risk premium on sterling-denominated assets. A divergence of euro (formerly D-mark) and US interest rates very occasionally makes it possible for British rates to lie between the two. This was the case briefly during the Volcker shock and, in the early 1990s, during the post-unification frenzy of the Bundesbank which squeezed longer and harder against inflation below 5% than Volcker had against inflation around 20%. Britain could in the latter case use a premium over dollar rates to secure a soft landing after its departure from the EMS.

But these were very brief exceptions. The norm is that British rates have to be higher than those in both Germany and the US. Anything else would threaten a collapse on the FX markets.

This is the record for a large economy with unique financial strengths. What could be expected for Italy, Cyprus or Latvia if any of them abandoned the euro? The Eurozone is still large and powerful enough to represent a partial exception to Rey's (2013) finding that there is no trilemma in monetary policy: that the straight choice is between open capital accounts and monetary independence – a dilemma from which floating exchange rates fail to provide an escape. Turkey can stand as the most recent example. For those promoting the various "exits", *de te fabula narratur*. Hanging separately only offers a somewhat more prompt dénouement than hanging together, while only a unified approach, deepening both the economic and the political coherence of the monetary union offers a possible assertion of autonomy.

Chart 3: Data from OECD stats: short-run interest rates



References

Aglietta, M. and Orléan, A. (1984) "La violence de la monnaie (extrait): les crises monétaires" in Alary, P. et al. (eds.) *Théories françaises de la monnaie*, PUF, Paris, 206.

von Beschwitz, B. and Howells, C. T. (2016) "Are euro-area corporate bond markets irrelevant? The effect of bond market access on investment", *IMF International Finance Discussion Papers*, 1176.

Borio, C., McCauley, R. and McGuire, P. (2017) "FX swaps and forwards: missing global debt?", *BIS Quarterly Review*, September, pp. 37-54.

Caballero, R. J., Farhi, E. and Gourinchas, P.-O. (2017) "The Safe Assets Shortage Conundrum", *Journal of Economic Perspectives*, 31(3), pp. 29-46.

DeRynck, S. (2015) "Banking on a union: the politics of changing eurozone banking supervision", *Journal of European Public Policy*, 23(1), pp. 119-135.

ECB (2015) *Euro money market survey*.

ECB (2017) *The International Role of the Euro*, July.

ECB (2018)*The International Role of the Euro*, June.

Gordon, P. (2019) "Weidmann's Litmus Test for ECB Presidency Is 'Whatever It Takes'" on Bloomberg web-site: https://www.bloomberg.com/news/articles/2019-06-01/weidmann-s-litmus-test-for-ecb-presidency-is-whatever-it-takes.

Hill, A. (2017) "Closed for Business: A post-mortem of the European repo market break-down over the 2016 year-end", ICMA, February.

House of Lords (2015) “The post-crisis EU financial regulatory framework: do the pieces fit?”, House of Lords EU Committee, 5th Report of Session 2014-15.

Lacroix-Riz, A. (2014) *Aux origines du carcan européen: La France sous influence allemande et américain*, Éditions Delga, Paris.

McCauley, R. and Ito, H. (2018) “A key currency view of global imbalances”, *BIS working paper*, 762, December.

Pozsar, Z. (2019) “Lost in Transmission”, *Global Money Notes*, #20, Crédit Suisse.

Rey, H. (2013) “Dilemma not Trilemma: the Global Financial cycle and Monetary Policy Independence”, in *Economic Policy Symposium*, Jackson Hole: Proceedings, pp. 286-333.

Singh, M. and Turing, D. (2018) “Central Counterparties Resolution – an unresolved problem”, *IMF working paper* 18/65.

Post-Crisis European Banking and the Modern Financial Regulation Game

Stefanos Ioannou[10]

Abstract -

In this article we provide an overview of post-crisis developments in European banking, focusing particularly on the efforts to re-regulate the sector. Our discussion shows that despite the reforms on capital requirements and resolution planning, banks' business model remains highly similar to the pre-crisis one. While proposals for structural reform were not absent from the debate - most notably, Liikanen report's proposal on ring-fencing and European Commission's proposal on the prohibition of proprietary trading - these were continuously compromised, with their most toothy parts being ultimately abandoned. For conceptualising these trajectories, the dimension of power needs to be taken into consideration. The influence of banking lobby on European regulation, whether by day to day engagement or by means of revolving doors with EU regulators, is a key component for understanding how the modern financial regulation game has played out in the continent from the time of the crisis onwards.

Keywords: Europe, banking, too-big-to-fail, financial regulation, bank lobbying

Introduction

> *"The system has become too complex for flesh-and-blood people, who make the mistake of thinking that passing a new law means the end of the discussion, when it's really just the beginning of a war...* [...]
>
> *...You win the modern financial-regulation game by filing the most motions, attending the most hearings, giving the most money to the most politicians and, above all, by keeping at it, day after day, year after fiscal year, until stealing is legal again."*
>
> (Taibbi, 2012)

Ten years ago, one could have expected some sort of change in the pre-crisis business model of banks. If anything, securitisation, shadow banking, and the resulting fragility in banks' balance sheets were at the very epicentre of the causes of the global financial crisis of 2007/08, a crisis that started in the US and rapidly expanded in Europe.

Focusing on the case of the European continent, this article shows how little has actually changed in the regulatory framework that governs banks' operations. While some steps forward have been taken by the European Union in increasing capital requirements and designing resolution plans, particularly for banks deemed as "too-big-to-fail", the actions

[10] Post-Doctoral Research Associate in Finance and Geography, School of Geography and the Environment, South Parks Road, OX1 3QY, University of Oxford; email: stefanos.ioannou@ouce.ox.ac.uk.

towards more structural reforms have been much milder. The two major European projects in this direction, namely Liikanen's recommendation of separation of investment from retail banking, and European Commission's proposal to prohibit proprietary trading for big banks, were largely watered down by pre-emptive legislation at the national level, and ultimately abandoned at the European level. At the same time, the currently ongoing project of the Capital Markets Union opens up the prospect of a new wave of securitisation and financialisation in the continent.

Matt Taibbi's article, quoted above, was written with reference to the Dodd-Frank Act in the US. It nevertheless provides us with a useful starting point for understanding the limited scope of European reforms too. In his schematisation of the modern financial regulation game, the power of banks to lobby is crucial in shaping regulatory outcomes. Even more importantly, though, those outcomes are always fluid, constantly susceptible to new attacks from bankers and their representatives. One of the central points of our article is that this scheme holds in Europe inasmuch as it documented to hold in the US.

We proceed as follows. In the next section we provide an overview of European banking, as developed from the start of the 2007/08 crisis onwards, using evidence from both the macro- and the meso-scales of analysis. We then examine in detail the regulatory reforms pursued by the European Union throughout the past decade, and attempt to trace their implementation paths. Following, we bring the dimension of lobbying power into the fore. In the last section we conclude and discuss some relevant policy proposals.

It is important to note that our article omits an in-depth discussion of UK banking. Being heavily based in London - one of the world's largest financial centres - the ecosystem of British banking is to a very large extent worth a separate consideration. Given the limited size of this article, this task is left for another paper.

1. The background

It would be impossible to write about the current state of affairs in European banking without any mentioning of the European crisis of the past decade. While the key events of the crisis are by now quite well known, both academically and also as personal memories to many of us, it is important to remember the precise starting point of the crisis. In this regard, it is useful to recall that the crisis in the continent did not commence in 2010 when the Greek government found itself at the brink of default. It began in 2008 when European banks found themselves into trouble, particularly in countries like Ireland and Germany. This is when the first rescue packages were designed and implemented.[11]

Stolz and Wedow (2010, p. 20) nicely summarize the total amounts which were committed for rescuing banks in Europe, during the period 2008- 2010. As calculated by the authors, the total sum of capital injected in banks in the European Union (EU) was €236

[11] For some indicative news of the time, see Kate Connolly, "Banking crisis: Germany earmarks €500bn for rescue package", *The Guardian*, 13 October 2008; Spiegel, "The Banking Crisis in Germany: Can the Bailout Prevent an Economic Meltdown?", *Spiegel*, 20 October 2008; Spiegel, "Germany's Faltering Bank Bailout Program: The Bottomless Pit", *Spiegel*, 23 December 2008.

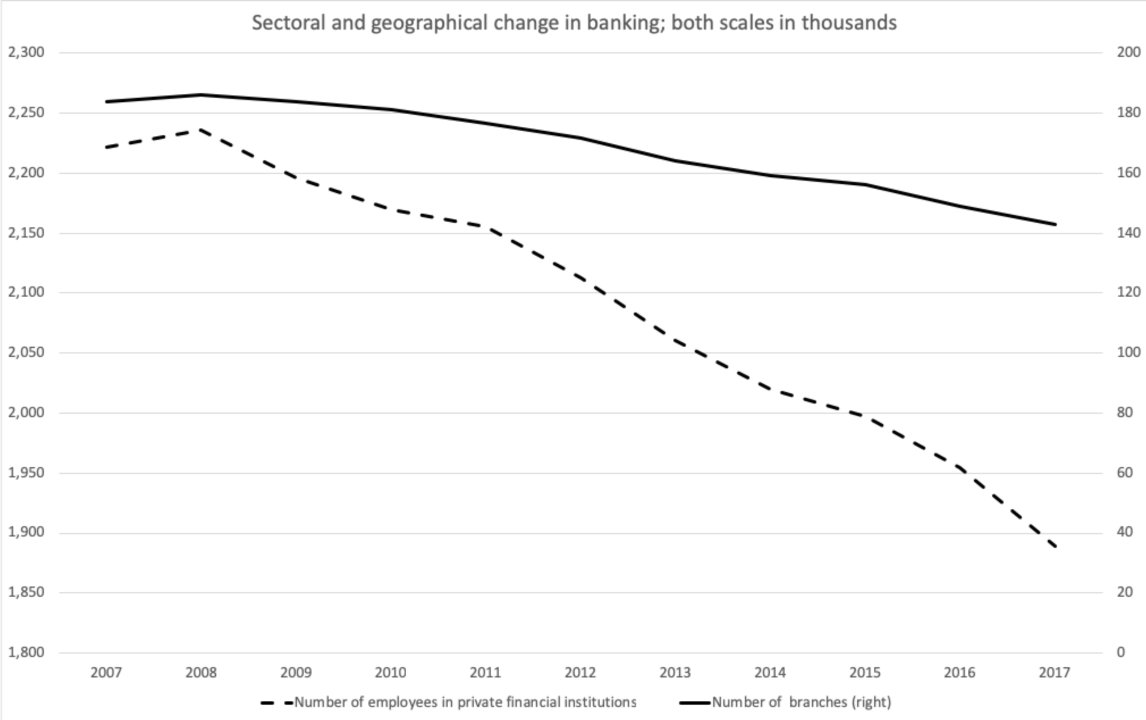
billion. Additionally, about €725 billion were spent for guaranteed purchasing of bonds and almost €350 billion for the removal of precarious assets from banks' balance sheets. Stolz and Wedow estimate the total commitment for bank support to amount to 26% of the GDP of the entire of the EU for 2008. In the most extreme case, that of Ireland, bank support reached 319% of the country's GDP.

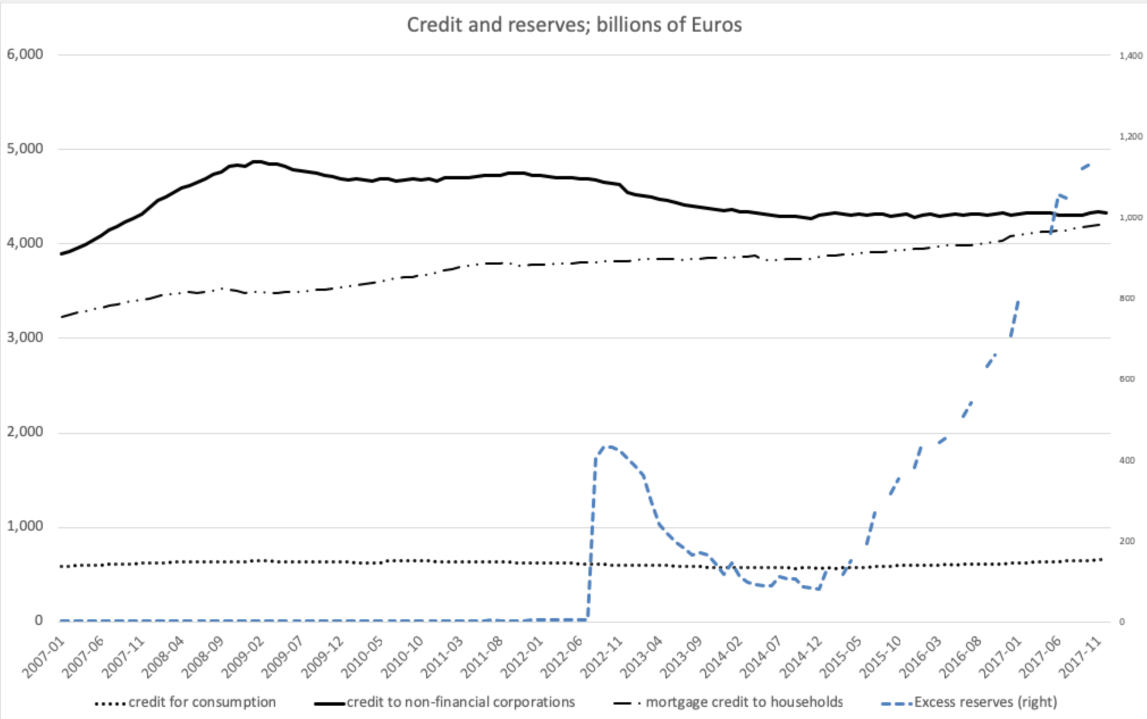
The subsequent deterioration of public finances is by now well-known too. Indicatively, Germany went for a balanced budget in 2008 to a 4% deficit two years later (Eurostat). In 2009, Spain, Portugal and Greece recorded budget deficits of about 11%, 10%, and 15% respectively.[12] Five years later these countries' public debts were standing at almost 100% for Spain, 130% for Portugal, and a bit less than 180% for Greece.

It is worth describing some additional stylized facts related with the post-crisis landscape of European banking. To start with, the upper-part of Figure 1 displays the geographical contraction of the sector since 2007. As one can observe, both the number of bank branches and the total number of banking employees have exhibited a steady decline. Out of the two, employment is where the steepest decline can be traced. To a great extent these developments can be connected with the process of "rationalisation", i.e. cost cutting, pursued by banks in face of declining revenues. Another part of the explanation could be ascribed to technology, e.g. rise in the usage of e-banking.

[12] One exception in the relationship between bank bailouts and deteriorating public finances is the revealing of Greece's cooked statistics in 2009.

Figure 1: Geographical and monetary developments in the banking sector of the European Monetary Union (changing composition)





Source: ECB

The lower part of Figure 1 depicts the evolution of different lines of credit in the Euro area for the same time span as above. It also displays the evolution of excess reserves (i.e. liquidity) in the Eurozone monetary system; in them one can read the development of the policy of quantitative easing (QE) as put forward by the ECB from 2012 onwards. What is particularly interesting to observe in this graph is that despite the large-scale QE operations, especially since 2015, credit towards non-financial corporations has remained stagnant. In conjunction with the moderate increases in mortgage and household credit, this finding is suggestive of how little QE has managed to foster investment, and thus employment and growth.

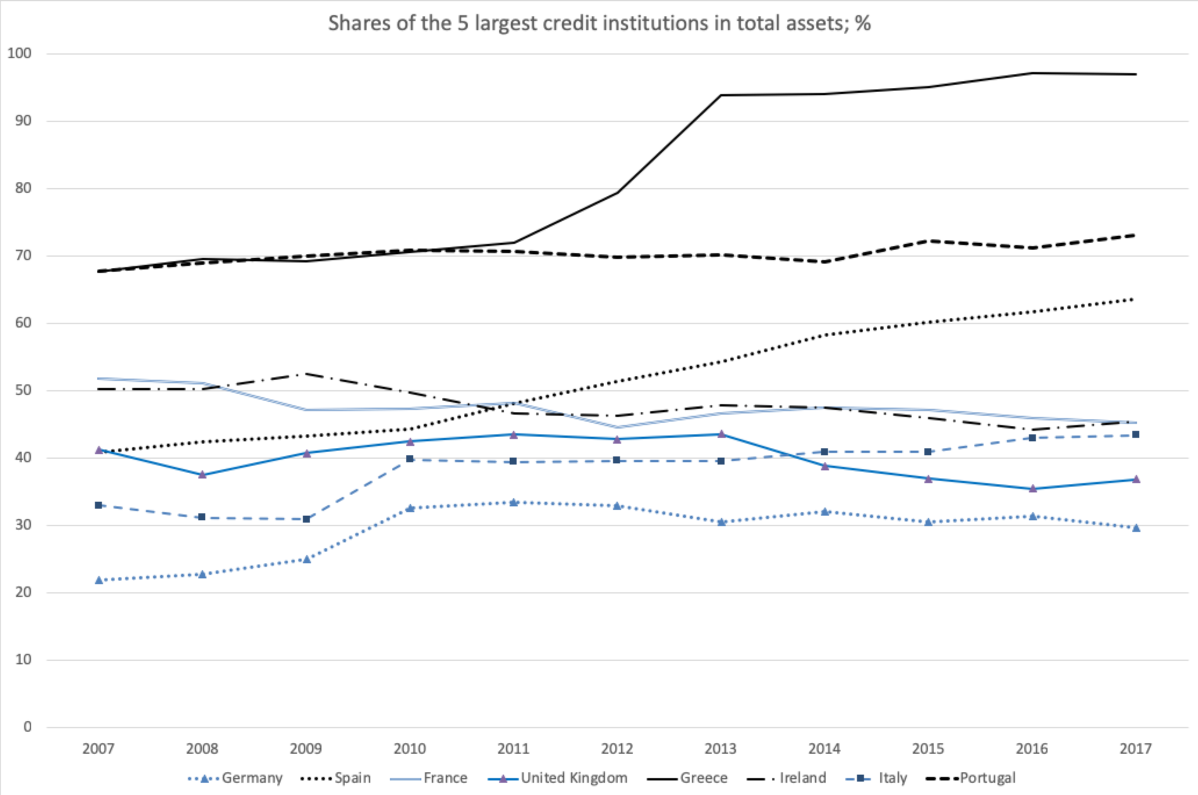
Furthermore, Figure 2 presents the concentration of the banking sector in a selection of countries, from 2007 to 2017 (upper part). As seen in the graph, Greece is ranked first, with the 5 largest credit institutions of the country accounting for 97% of the sector.[13] Although the Greek banking system has long been highly concentrated, in comparison to other EU countries, it is also the one that recorded the steepest increase throughout the crisis. Portuguese banking is also significantly concentrated, with the share of the 5 largest institutions accounting for 73% in 2017. Spain is slightly below that, but with a notably increasing trend. Germany, on the other hand, remains a country with a very decentralised banking system.

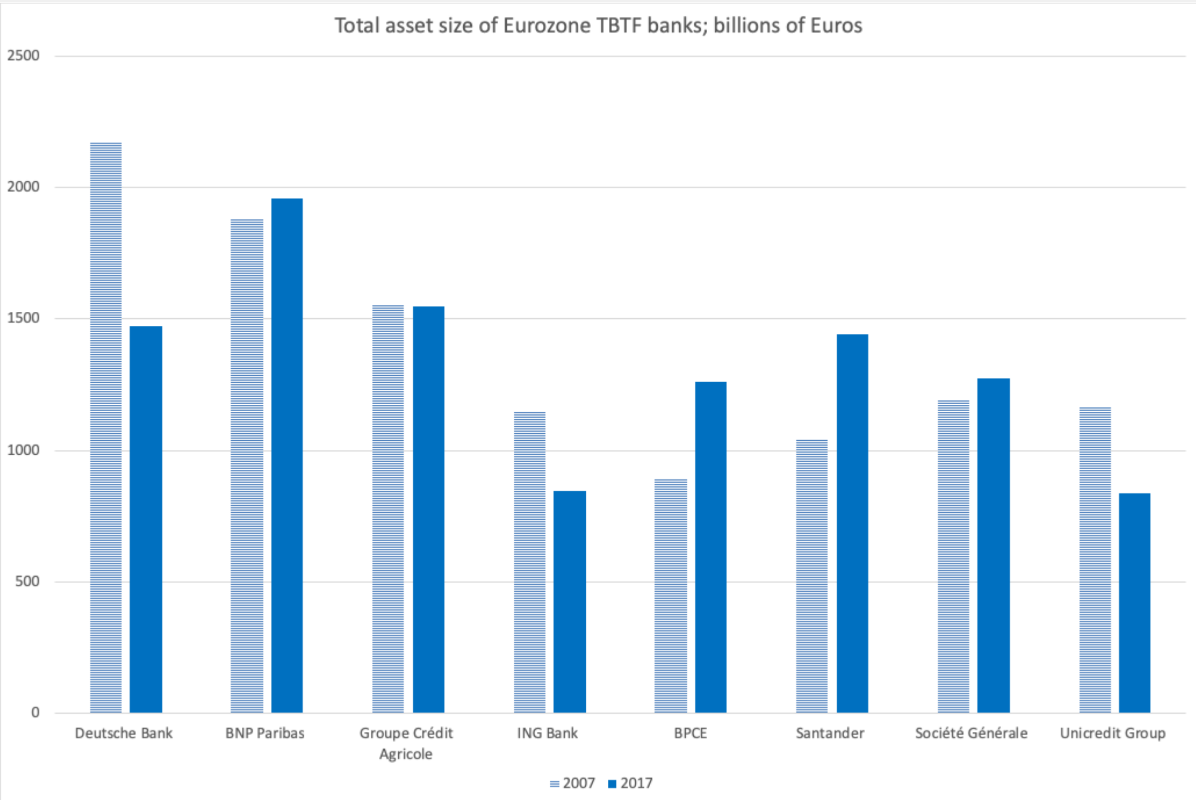
The lower part of Figure 2 delves a bit more deeply into the European banking sector, by examining the change in size of the banks described as too-big-to-fail (TBTF) by the Financial Stability Board (FSB) of the G20. This is based on an annual report published by the Board, in which global TBTF banks are listed, based on size, complexity, interconnectedness and global presence (FSB, 2018).[14] The primary aim of this listing is to identify additional capital requirements required for each of the included banks. In its most recent publication (November 2018) 29 global banks are listed. Out of these 8 come from the US, 8 from the Eurozone, 3 from the UK, and 4 from China. Other hosting countries include Japan, Switzerland and Canada.

Figure 2*: Sectoral concentration in banking for selected Eurozone countries, and change in size of Eurozone too-big-to-fail banks*

[13] Although the official statistics of the ECB account for the share of the 5 largest institutions, in Greece it is essentially 4 systemic banks that dominate the market.

[14] In the language of the FSB these institutions are labelled as global-systemically important banks (G-SIBs). In this article, the two terms are treated as synonyms.





Note: BPCE is the product of the merger between Groupe Banque Populaire and Groupe Caisse d'Épargne in 2009, and hence BPCE's asset size for 2007 is the combined asset size of the two at the time.

Source: ECB and S&P Global

What is interesting about the graph is the lack of a systemic decline in the size of Eurozone TBTF banks. In particular, although some banks have shrunk considerably since 2007 (e.g. Deutsche Bank), others have managed to remain in similar levels (e.g. Crédit Agricole), while some have even increased in size, as for example Santander. Taken at the aggregate level, and divided by the added-up GDP of the hosting countries of these banks (Germany, France, Spain, Italy, and the Netherlands), their size has moved from 126% in 2007, to 116% ten years later (source S&P Global and OECD). Those eight banks in other words are still bigger than the added up gross domestic product of their countries. At the same time, all banks are nowadays much better capitalized. In five out of the eight cases the declines in asset to equity ratios range between 32% and 56% (S&P Global).

These findings might come as a surprise to one that would expect the US and European crises, and their unfolding, to have an impact on the size of those banks. To a large extent, the lack of any notable change can be explained by the asset and equity support discussed earlier. Notice however that there is an additional element of support, not documented in above figures. This has to do with the indirect benefit these banks received out of the bailout packages imposed on crisis-hit Eurozone economies. In the case of Greece for example, Bortz (2019) calculates the support to the banks out of the first two bailouts to have amounted to 97.3% of the total money that was disbursed by the Troika.[15] To its biggest part, this support took the form of debt repayments and recapitalisation operations.

2. Post-crisis reforms in Europe

For assessing the strength of the implemented regulations since the crisis, one needs to consider the steps taken in the broader political and economic conjuncture of the time. Given the cost of rescuing the big banks, the public outrage against them, and the declared intentionsof even moderate policy makers for real change, the question is not whether something was done to regulate them, but whether what was done was enough.

2.1 Capital requirements and resolution directives

Two of the major steps taken were the increase in capital requirements and the establishment of a resolution mechanism for failed banks. The first in 2013 with the introduction of the Capital Requirements Directive IV (CRD IV), and the second in 2014 with the Bank Recovery and Resolution Directive (BRRD). Under the BRRD, a bail-in mechanism was put in place, in which shareholders and creditors would take priority in rescuing a failed bank. These would be followed by support from a resolution fund, built on ex-ante contributions of banks. Applicability of the Directive was for the

[15] European Central Bank, European Commission, and International Monetary Fund.

national level. For the countries of the Eurozone, implementation went a step further with the transferring of power and competency at the supranational level and the creation of the Single Resolution Mechanism (SRM), one of the key pillars of the European Banking Union (the Single Resolution Board and Single Resolution Fund - SRB and SRF respectively - are the two main institutions falling under the SRM umbrella).

Both the enhanced capital requirements and the introduction of resolution plans were in line with the reforms that were taking place internationally and in the US throughout the same time (Basel III; Dodd-Frank Act). These were reforms which by their nature did not aim in challenging the pre-crisis model of banks, but in containing its adverse impact towards the rest of the economy.

It is also worth noting that the resolution legislation is still a roadmap, largely untested in practice. Only one case of implemented resolution is mentioned in the official website of the European Commission, that of Banco Popular Español in 2017, which was subsequently bought by Santander (European Commission, 2019a). Add to this that the BRRD still leaves open space for bail-out with public money, now called "precautionary recapitalisation". The support of the Italian bank Monte dei Paschi di Siena (MPS) in 2017 is already an example of government rescuing compatible with the BRRD (European Commission, 2017a). Quaglia and Spendzharova (2017) also describe how the case of MPS brought into light some of the practical difficulties and complexities in applying the bail-in scheme of the Directive. Moreover, the build-up of the Single Resolution Fund is still halfway from its completion, currently targeted for 2023 (SRB, 2019). At the time of writing (June 2019) the Fund holds a total stock of €24.9 billion in contributions, a figureless than 0.3% of the combined asset size of the 8 European TBTF banks alone(€10,647.7 billion in 2017).

2.2 The Liikanen report and Commission's proposal on prohibiting proprietary trading

While the consultation of the above reforms was under way, back in 2012, the proposal on the structural reform of the EU banking sector, the so called Liikaken report, came out, ordered by the European Commission. The main call of the proposal was for the legal separation of proprietary trading and other high-risk activities (e.g. derivative positions taken in market-making) from retail banking. In comparison with all other reforms, this was enough to make it the biggest threat of the time to the pre-crisis European banking model.

To begin with, although the Liikanen report might give the impression of a red manifesto, it was actually a mild proposal, seen in the broader historical context. Contrary to the Glass-Steagall Act of 1933 in the US for example, which imposed a complete separation between investment and retail banking (an equivalent of which never existed in Europe), the Liikanen report was much friendlier towards the banks in allowing separation to take place within the same banking group. Second, rather than imposing a mandatory separation, it recommended separation only if risky activities were to amount to a significant share of a bank's business, estimated at the time at 15-25% of total bank's assets, or €100 billion in absolute terms (see Liikanen et al., 2012, p. v). Third, its recommendations were left open to interpretation at places, for example with regards to the time required for implementation (ibid).

Part of the explanation of this mildness can be traced at the mind frame of the authors. In their narrative as to why the separation between high-risk activities and retail banking should be allowed within the same banking group, Liikanen and his co-authors point out the efficiencies that are supposed to be achieved by big banks, and the consequent benefits for the consumers and the broader economy. The associated "universal banking model" as it is called would thus be maintained, despite the separation (ibid, p. iii). This line of logic is problematic for two reasons. One, the calculation of efficiency is highly questionable in the case of banking, due to the immaterial nature of the primary good produced (credit), and the central role of expectations, uncertainty, and economic sentiment in the determination of its supply and demand. Two, while empirically one could estimate such "efficiencies" by measuring the difference in costs between banks of different size, a recent empirical exercise by the Bank of England shows how this difference evaporates once one adjusts for the inflated credit ratings and the low borrowing costs associated with the TBTF protection status of big banks (Davies and Tracey, 2014).

Having said this, it is important to follow the journey of the Liikanen report from the day of its publication onwards. As discussed in Hardie and Macartney (2016), and Quaglia and Spendzharova (2017), although the European Commission was at the time receptive to the recommendations of the report and even warm to the idea of more radical steps (see below), a number of EU countries chose to legislate pre-emptively, establishing weaker reforms at the national level. France and Germany were the two most important countries that acted in such direction. Both passed banking reform bills in 2013, aiming to show that they were doing what was necessary to ensure safe banking. In both occasions, however, the voted reforms were lighter versions of Liikanen. In France, for example, only those proprietary trading activities that were deemed as "speculative" were forced to separation from retail banking.

There were two lines of logic that were employed by French and German authorities for justifying pre-emptive legislation. One was the idea that the prohibition of trading activities should not compromise banks' capacity to serve the economy. This is far from a new argument. What is interesting in the current context is that despite the rhetoric neither the French nor the German authorities ever tried to make the argument more explicit as to which of those activities were supposed to have those positive effects on lending (Hardie and Macartney, 2016, pp. 513- 515). Another interesting point is that this rhetoric so happened to mimic precisely the claims made by the banks of the two countries themselves (ibid). As more clearly expressed in

Quaglia and Spendzharova (2017, p. 1118) the preferences of the French and German governments ‘strongly resembled those of their domestic banking industry and did not change over time’.

The second line of logic employed in France and Germany was the need to protect their national banking “champions”, primarily against Wall Street. As documented in Hardie and Macartney (2016), people like Christian Noyer and Pierre Moscovici were open in admitting their fear that a tougher ring-fencing would have given an advantage to US investment banks in satisfying demand for investment banking services in their countries, and in that respect would have been a “gift” to them.[16] It takes little imagination to consider the replication of the exact same argument from the other side of the Atlantic, and the consequent overall win-lose outcome for banks and governments respectively.

Following these national reforms, the European Commission published its official legislative proposal in January 2014. This was not just in line with the spirit of the Liikanen proposal in calling for the mandatory separation between high-risk trading activities and retail banking. It was even recommending the prohibition of proprietary trading for big banks (European Commission, 2014, p. 26). Despite its delay, it was meant to be Europe’s response to the Dodd-Frank Act of the US. The proposalwas met with opposition from the Council of the EU, which in summer 2015 presented its own draft for structural reform (Council, 2015). The draft had no mentioning of prohibition of proprietary trading. It was instead suggesting a light version of ring-fencing, which member states could implement at the national level, as had already happened in countries like France and Germany. The chasm in legislative proposals between the Commission, the Council and the European Parliament was not bridged in the years that followed, so that none of these ever found their way into becoming European law. Ultimately, in autumn 2017 the Commission announced its intention to withdraw its 2014 proposal (European Commission, 2017b). It officially buried it in summer 2018. To justify its decision, it pointed out the lack progress and the absence of any foreseeable agreement (ibid). It also asserted, in a rather laconic manner, that the purpose of the proposal had largely been achieved already by the rest of the European reforms on banking supervision and resolution (ibid). Despite this statement, no elaboration of how these reforms hadsatisfied the need for structural reform was anywhere offered.

Perhaps to no one’s surprise, the burying of the proposal was met with enthusiasm from the banking industry. A research note from BBVA for example describes the withdrawal as ‘reasonable’ and ‘timely’ (Soler, 2017).[17] It also agrees with the Commission in identifying a ‘panoply’ of measures already in place. Furthermore, BBVA argues that the 2014 proposal of the Commission would have

[16]Christian Noyer: former governor of the Bank of France, 2003- 2015; Pierre Moscovici: former minister of finance in France, 2012- 2014.
[17] Notice, for the record, that BBVA was classified as a G-SIB by the FSB for the years 2012 and 2013.

posed negative consequences on other projects of financial integration in the EU, as the one discussed right below.

2.3 The Capital Markets Union

One of the most prominent projects of financial integration in the EU at the moment is the development of the Capital Markets Union (CMU). This is not meant to be just another financial reform, but Europe's new plan for growth. As officially declared in the relevant webpage of the European Commission, the CMU aims at facilitating the channelling of funds to start-ups and small & medium enterprises (SMEs), while also creating new opportunities for savers and investors (European Commission, 2019b). The target list of the project acknowledges the current inertia of banks to provide lending to SMEs, which CMU aims to solve by facilitating cross-border investment. At the same time, the project also aspires to strengthen banks' capacity to finance the economy. To this end, it re-introduces securitisation, which this time will be 'simple, transparent and standardised', or STS (European Commission, 2019c), in other words "different".

Engelen and Glasmacher (2018) make a number of critical points against the CMU and its accompanying rhetoric. First, the consideration of the CMU as a growth plan for Europe, and the claim that the main obstacle for the financing of investment lies in the over-reliance of European economies on bank lending, hides the disastrous role of the austerity policies put forward by the EU, both before and after the crisis. Second, the promotion of securitisation - on which most of the efforts of the Commission have been directed so far - will further advance financialisation, especially in countries in which it had remained relatively marginal until now, e.g. Germany. The emphasis on securitisation also contradicts the Commission's declared intention to "correct" over-reliance on bank lending. Securitisation is not about an alternative to bank lending, but about the further deepening of economies' dependence on it.

Engelen and Glasmacher provide evidence showing that pre-crisis securitisation in Europe was to its largest part related with mortgages (ibid, p. 169). They claim a functional reason for this, since the riskiness of mortgages is easier to assess compared to the risk of loans to SMEs (a logic which also appears to match the post-crisis evidence presented in Figure 1 of the current). Against this background, the authors point out the lack of any analytical explanation from the side of the Commission as to how is securitisation meant to play out differently this time. It is therefore likely that instead of fostering investment and employment, the so-called STS securitisation will lead to a new round of asset price inflation and bubbles. Engelen and Glasmacher also argue that it is hard for securitisation to be genuinely simple and transparent, since it is by nature a complex process. Moreover, they observe that while the legal documents of the Commission address the quality of the securitisation process (structuring, tranching, rating and distribution), they have nothing to say about the quality of the underlying raw material that is expected to feed into it. For example, no thresholds are placed for loan-to-value or loan-to-income ratios for determining the eligibility of mortgages for securitisation.

3. The dimension of power

In the realm of financial reforms, as elsewhere, the battle of ideas is paramount for moving towards a well-functioning financial system. It would nevertheless be naïve to assume that the designing and maintenance of financial reforms is solely a product of rational discourse. Power matters. This is even more so when power becomes asymmetric in its distribution between the different sides involved (businesses, consumers, employees, policy makers). And finance is one of the fields in which - perhaps against all odds in what could have been expected ten years back - the interests of private banks and other financial institutions have managed to remain as forceful as before the crisis, if not more. The dimension of power is therefore crucial for understanding how the modern financial regulation game is played. This takes us to the consideration of banks' continuous attempts to compromise new regulation while it is drafted, and their persistent effort to dismantle it thereafter.

Think of the case of European banking. As it is routine in the process of EU pre-legislative consultation, the views of stakeholders are invited, both at the stage of initial consultation, and also at the level of working out the "technical" details of agreed proposals. In the beginning of the Liikanen report for example it is openly stated that hearings were organised throughout its drafting with representatives of banks, consumers, investors in banks (who are often banks themselves), policy makers, and academics (Liikanen et al., 2012, p.i). Engelen and Glasmacher (2018) also write that Commission's draft proposal on the legal framework of STS securitisation was forwarded to the European Parliament and the European Council with much of its fine-tuning left open for figuring out later at a technical level. Here again the views of market participants were openly requested (ibid, p. 174).

The language used by the European Commission is deceptively unbiased in giving the impression of an invitation to all sides to sit around a table. Actual evidence however tells us a different story. As demonstrated in a number of studies conducted by the Corporate European Observatory (CEO), people with ties to the private banking sector have systematically been in close partnership with the different bodies of governance of the EU, in a variety of ways.

First, representatives of private banks have been documented to form the vast majority of participants in committees and advisory boards of EU institutions. As reported in CEO (2018) for example, 92% of the meetings of the Directorate-General responsible for banking and financial regulation at the European Commission (DG-FISMA) are with representatives of corporate interests, most of who represent financial institutions. Only the remaining 8% consists of meetings with people from civil society, academics, etc. In another study, the Observatory records that out of the 517 seats of the advisory boards of the ECB, 508 have been assigned to representatives of private financial institutions (CEO, 2017).[18] Just the representatives of 16 large financial institutions, such as Deutsche Bank and Citigroup, occupy 208 seats. Out of the remaining 9 seats, 7 represent other corporate interests. Only 2 come from consumer groups.

Then, there is the long-standing phenomenon of revolving doors, wherein policy makers and regulators either come from the private sector, or take up jobs in it after the end of their terms. CEO (2018) for example documents that 6 out of 27 heads of units, and 7 out of 22 deputy-heads of units, who worked in DG-FISMA between 2008 and 2017, had previously worked in the financial sector. According to the same study, out of the 5 former directors of DG-FISMA between the same years, 4 took up jobs in firms they oversaw or lobby firms that represent them after the end of their mandate. Similarly, 2 out of the 3 commissioners responsible for finance throughout that period went to work for financial interests. Add here the more conspicuous case of the former Commission President, José Manuel Barroso, who took up a senior position in Goldman Sachs soon after the end of his presidency in 2014.

Overall, the banking sector has been recorded to spend more than 120 million Euros a year for lobbying in Brussels, employing more than 1.700 people to this end (CEO, 2014). The amount of money spent is estimated to be at least 30 times the money spent by trade unions, NGOs, and consumer groups combined.

Concluding remarks and ideas for policy

In this article, we delve into the post-crisis landscape of European banking. We provide an overview of the sectoral developments of the last decade, focusing at the macro- and at the meso- levels. Two of the stylized facts that emerge from our analysis are the stagnation of investment credit in the Eurozone and the maintenance of the overall size of European too-big-to-fail banks.

We also discuss the efforts to re-regulate the financial sector that have taken place in recent years in the EU. We show that despite the steps forward in increasing capital requirements and in designing resolution plans, particularly for big banks, regulation has achieved very little in altering the pre-crisis business model of banking. The recommendation of the Liikanen report to ring-fence retail and investment banking, and the 2014 proposal of the European Commission to prohibit proprietary trading were weakened by pre-emptive legislation at the national level of EU member states, and were ultimately abandoned at the transnational level. At the same time, the ongoing project of the Capital Markets Union, and the praise of securitisation -

[18] The ECB has 22 advisory boards in total. The 517 seats exclude observers and ECB representatives. For a detailed breakdown of the advisory boards and their composition, see CEO (2017, p. 6).

which this time will be "different"- is not only in line with the interests and the pre-crisis model of banks, but it is even advocated as the new plan for growth in the continent.

We claim that it is impossible to understand the above outcomes without considering the dimension of power. Even after the crisis, the banking lobby maintained a strong foothold in the EU, by populating the advisory boards and committees of European institutions, and by preserving revolving doors with regulators. Bankers and their representatives have systematically been in a position to influence new reforms in all stages of their creation.

A number of policy ideas stems from the preceding discussion. First, the banks deemed as too-big-to-fail need to be broken down, with a complete separation between investment and retail banking, similar to the US Glass-Steagall Act of 1933. Complete separation is crucial, not just for curtailing the volume and impact of opaque trade activities, and thus for facilitating financial stability. It is also important as a step in the fight to contain the political power of these banks. Furthermore, it is a more solid reform, and thus one which has a greater chance of remaining in place in the medium run, once the lessons from the global financial crisis start fading away.

Second, the institutional structure of the EU needs to be re-shaped. Debates on financial and economic reforms ought to be more transparent and political. They need to be taken out of the shadows of technocracy and brought into the light of democratic scrutiny, e.g. by augmenting the legislative powers of the European parliament. The isolation of regulation drafting and legislation decision making from the influence of the banking lobby is also paramount.

Acknowledgments

The author is grateful to the participants of the 'Workshop on the Current State of Finance in the EU: Prospects and alternatives' held at the Poulantzas institute in Athens (March, 2019), and those of the 'Annual Meeting of the American Association of Geographers' held in Washington DC (April, 2019) for all discussions and feedback. The paper has benefited from funding from the European Research Council (European Union's Horizon 2020 research and innovation programme; grant agreement no. 681337). The article reflects only the authors' views and the European Research Council is not responsible for any use that may be made of the information it contains.

References

Bortz, P. (2019) "The Destiny of the First Two Greek "Rescue" Packages: A Survey", *International Journal of Political Economy*, 48(1), pp. 76-99.

Corporate European Observatory (2014) "The Fire Power of the Financial Lobby. A Survey of the Size of the Financial Lobby at the EU level", Published by the

Corporate Europe Observatory (CEO), The Austrian Federal Chamber of Labour and The Austrian Trade Union Federation, available at: https://corporateeurope.org/sites/default/files/attachments/financial_lobby_report.pdf (accessed 6 June 2019).

Corporate European Observatory (2017) “Open Door for Forces of Finance at the ECB: 500 financial lobbyists at large at the ECB - by invitation”, Corporate European Observatory, available at: https://corporateeurope.org/sites/default/files/attachments/open_door_for_forces_of_finance_report.pdf (accessed 6 June 2019).

Corporate European Observatory (2018) “Financial Regulators and the Private Sector: Permanent Revolving Door at DG FISMA”, Corporate Europe Observatory, available at: https://corporateeurope.org/en/power-lobbies-revolving-doors/2018/04/financial-regulators-and-private-sector-permanent-revolving (accessed 6 June 2019).

Council of the European Union (2015) “Council Position on Proposal for a Regulation of the European Parliament and Of the Council on Structural Measures Improving the Resilience of EU Credit Institutions”, 10150/15, 19 June, available at: https://www.consilium.europa.eu/media/24486/st10150-en15.pdf (accessed 6 June 2019).

Davies, R. and Tracey, B. (2014) “Too Big to Be Efficient? The Impact of Implicit Subsidies on Estimates of Scale Economies for Banks”, *Journal of Money, Credit and Banking*, 46(1), pp. 219-253.

Engelen, E. and Glasmacher, A. (2018) “The Waiting Game: How Securitization Became the Solution for the Growth Problem of the Eurozone”, *Competition & Change*, 22(2), pp. 165-183.

European Commission (2014) “Proposal for a Regulation of the European Parliament and of The Council on Structural Measures Improving the Resilience of EU Credit Institutions”, 29 January, 2014/0020, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0043&from=EN (accessed 6 June 2019).

European Commission (2017a) “State aid: Commission authorises precautionary recapitalisation of Italian bank Monte deiPaschi di Siena”, 4 July, Press Release, available at: http://europa.eu/rapid/press-release_IP-17-1905_en.htm (accessed 6 June 2019).

European Commission (2017b) “2018 Commission Work Programme. An Agenda for a More United, Stronger And More Democratic Europe – Annex IV: Withdrawals”, 24 October, available at: https://ec.europa.eu/info/sites/info/files/cwp_2018_annex_iv_en.pdf (accessed 6 June 2019).

European Commission (2019a) "Bank Recovery and Resolution", available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/bank-recovery-and-resolution_en (accessed 6 June 2019).

European Commission (2019b) "What is the Capital Markets Union?", available at: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/what-capital-markets-union_en (accessed 6 June 2019).

European Commission (2019c) "Securitisation", available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/securitisation_en (accessed 6 June 2019).

Financial Stability Board (2018) "2018 List of Global Systemically Important Banks (G-SIBs)", Financial Stability Board, 16 November, available at: http://www.fsb.org/wp-content/uploads/P161118-1.pdf (accessed 6 June 2019).

Hardie, I. and Macartney, H. (2016) "EU Ring-Fencing and the Defence of Too-Big-To-Fail Banks", *West European Politics*, 39(3), pp. 503-525.

Liikanen, E., Bazinger, H., Campa, J.M., et al. (2012). High-level Expert Group on Reforming the Structure on the EU Banking Sector. European Commission Report, 2 October, Brussels.

Quaglia, L. and Spendzharova, A. (2017) "The Conundrum of Solving 'Too Big to Fail' in the European Union: Supranationalization at Different Speeds", *Journal of Common Market Studies*, 55(5), pp. 1110-1126.

Single Resolution Board (2019) "What is the Single Resolution Fund?", available at: https://srb.europa.eu/en/content/single-resolution-fund (accessed 6 June 2019).

Soler, P. (2017) "European Commission withdraws Banking Structural Reform proposal", BBVA Research, Regulation Watch, 27 October 2017, available at: https://www.bbvaresearch.com/wp-content/uploads/2017/10/Regulation-Watch-EC-withdraws-Banking-Structural-Reform.pdf (accessed 6 June 2019).

Stolz, S.M. and Wedow, M. (2010) "Extraordinary Measures in Extraordinary Times – Public Measures in Support of the Financial Sector in the EU and The United States", Discussion Paper Series 1: Economic Studies No 13/2010, Frankfurt-em-Main: Deutche Bundesbank, available at: https://www.econstor.eu/bitstream/10419/37071/1/631858768.pdf (accessed 6 June 2019).

Taibbi, M. (2012) "How Wall Street Killed Financial Reform". *Rolling Stone,* 10 May 2012, available at: https://www.rollingstone.com/politics/politics-news/how-wall-street-killed-financial-reform-190802/ (accessed 6 June 2019).

The European leveraged loans market - Developments, Risks and Policy Implications

Marica Frangakis

Abstract

In the aftermath of the crisis, the financial regulatory framework was tightened. However, this led to new developments while a new generation of distortions appeared. In particular, the combination of the legacy of the crisis, the revised regulatory framework and technological developments, especially digitilisation, have reinforced the appeal of leveraged finance - both bonds and loans – giving rise to excesses and posing new problems for the stability of the financial system. The combination of a complex leveraged finance structure, the lack of adequate macroeconomic firepower to deal with the lingering effects of the more than ten-year old financial crisis and a loose financial regulatory framework create a toxic mix, which will easily unravel at the next economic crisis.

Our focus is mainly on leveraged loans, the most intransparent element of the sector.

Introduction

Leveraged loans are not a new financial tool. They reached a peak on the eve of the global financial crisis, took a plunge soon after only to recover by 2012. They have since reached new peaks, returning to pre-crisis levels and indeed exceeding them in certain instances Furthermore, the new 'generation' of leveraged loans is associated with a deteriorating credit quality, made even more systemically menacing due to the lack of transparency that is inherent in this type of financial intermediation.

It is against this background that the present paper seeks to provide an overview of trends and developments in the area of leveraged loans with a special emphasis on the European market for such loans (Section 1). The policy response of the Federal Reserve and the ECB is also discussed (Section 2). The factors leading to the growing popularity of leveraged loans are then analyzed as well as the risks associated with it (Section 3). The question of what could go wrong is delved into. Is a Minskian type of financial stability hypothesis at work? If so, what are the policy implications? (Section 4).

1. Trends and developments in the leveraged loan market

1.1 Defining leveraged finance

'Leveraged finance' consists of leveraged loans, high-yield bonds for non-investment firms and private debt. High-yield bonds are issued and traded in the corporate bond market, while private debt is extremely opaque, since it is a bilateral transaction not necessarily recorded in a publicly accessible record. Leveraged loans on the other hand are the most important segment of the leveraged finance sector.

There is no universally accepted definition of what constitutes a leveraged loan. As the ECB has pointed out “while there is a general understanding that a leveraged loan is a secured loan granted to a highly indebted (levered) company, there is no generally agreed definition. The industry defines leveraged loans as secured loans where the borrower is sub-investment-grade or the spread at issuance is higher than a certain threshold” (ECB,2018, p. 74).

In other words, some market participants define a leveraged loan in relation to its spread, typically based on LIBOR plus a stated interest margin. If the interest margin is above a certain level, it is considered a leveraged loan. Others define a leveraged loan based on its rating, i.e. if it is rated below investment grade, such as Ba3, BB- or lower. Further, FitchRatings provides a more descriptive definition of a leveraged loan. Namely, a leveraged loan is defined as a “commercial loan to a high-yield company provided by a group of lenders; they are typically senior secured debt (secured by company, or borrower assets) and are at the top of a company’s capital structure. Leveraged bank loans are often floating rate and priced at a spread over a referenced rate” (FitchRatings, 2018, 2018, as quoted in NAIC Capital Markets Bureau Primer, p. 1). It is worth noting that credit spreads on leveraged loans are usually larger than investment grade bonds and smaller than high-yield bonds, as the greater yield vs investment grade reflects greater perceived credit risk of bank loans, while the slightly lower yield relative to high-yield is the result of bank loans’ higher position in the capital structure.

The qualitative differences between leveraged loans and high-yield bonds are presented in Table 1 below.

Table 1 – Comparison of Leveraged loans and High yield bonds

	Leveraged Loans	**High Yield Bonds**
Interest rate/coupon	Floating rate	Fixed rate
Rating	Below investment grade	Below investment grade
Security	Typically senior secured	Generally unsecured
Priority	Senior	Subordinate
Callability	Generally no, pre-payable at part without penalty	Usually call protected
Term	5-9 years	7-10 years
Amortization	Required quarterly principal payments	Bullet payment at maturity

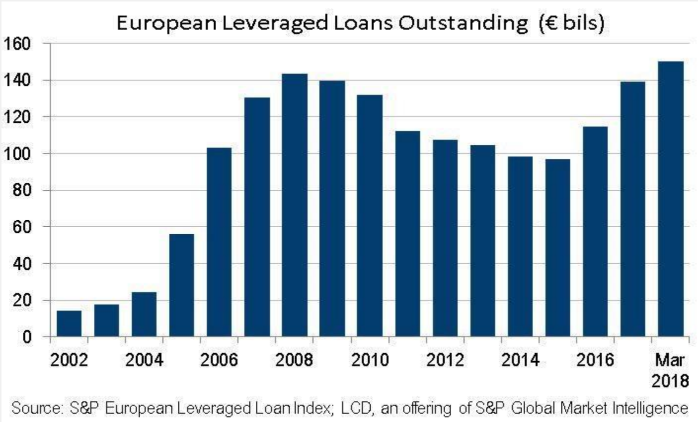
Source: Wells Capital Management, as quoted in Jennifer Johnson, 2018, Leveraged Bank Loans Primer, National Association of Insurance Commissioners, Capital Markets Bureau

1.2 Developments in the leveraged loan market

The issuance of leveraged finance by EU non-financial corporations declined after the outbreak of the global financial crisis in 2007/2008 although it picked up soon after, reaching and exceeding the pre-crisis levels by 2017.

As shown in Figure 1 below, in the European leveraged loan market the volume of outstanding institutional loans in March 2018 (Euro 150 bn) outstripped that in October 2008 (Euro 148 bn), while the number of issuers was also the highest on record (269), pointing to the growing popularity of this market[19].

Figure 1[20]



[1] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/european-leveraged-loan-market-reaches-record-size; accessed 14/8/2019

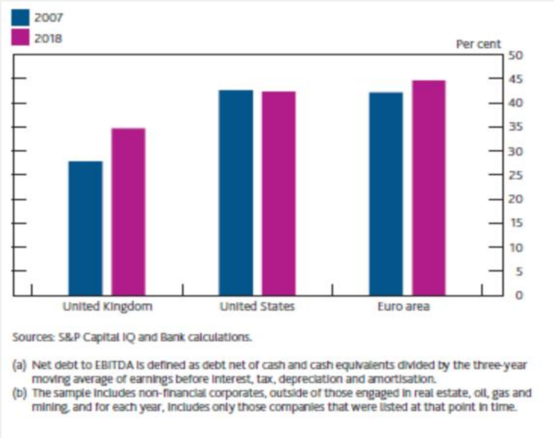
Furthermore, as leveraged loans issuance has increased, so too has the debt-to-EBITDA (Earnings before Interest, Tax, Depreciation and Amortization) of corporate borrowers to levels higher than that before the crisis. Indeed, as the ECB has pointed out, “in many cases, actual leverage is likely to be significantly higher than reported leverage, given the increasingly common practice among borrowers of making optimistic adjustments to pro-forma EBITDA levels” (ECB, 2018, p.76).

The growing popularity of leveraged loans and the increasing competition among lenders have led to the emergence of ‘covenant-lite’ loans, i.e. loans not protected by financial maintenance covenants, i.e. contractual agreements once routinely embedded in loan documents. Thus borrowers are not required to maintain certain financial performance measures throughout the life of the loan, which would otherwise provide an ‘early-warning’ system to lenders of a potentially deteriorating credit situation. ‘Cov-lite’ loans, as they are best known, took off in late 2012 and they now comprise the majority of newly issued leveraged loans. This is an indication of deteriorating credit quality, as well as of the weakening of regulatory standards.

[19] Institutional loans are those bought by institutional investors.

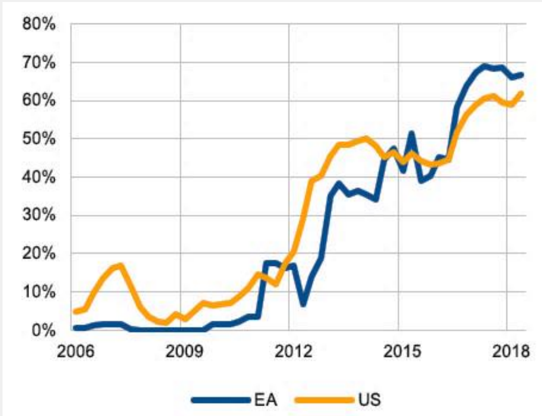
Figure 2 below shows (a) the share of corporate debt owed by highly leveraged companies across major advanced economies, and (b) the share of cov-lite loans in the primary leveraged loan market in the US and in the Euro Area.

Fig. 2a- Proportion of debt by listed UK, US and Euro Area companies with a ratio of net debt/EBITDA greater than 4 (2007-2018; %)



Source: Bank of England, 2018

Fig. 2b – Share of covenant-lite leveraged loans in the primary leveraged loan market (2016-2018%)



Source: Dirk Schoenmaker, 2019

As we can see, ten years after the start of the global financial crisis, the share of leveraged loans – i.e. debt owed by highly indebted companies – not only reached, but also exceeded the pre-crisis level. This is especially true of the Euro Area. Further, leveraged loans on light financial covenants were sharply on the rise as of 2012.

Leveraged loans are used mostly to fund Merger and Acquisition activities (M&A), recapitalize the balance sheet via the buyback of shares or the refinancing of debt, the payment of dividends or for general corporate purposes. M&A could take the form of a Leveraged Buy-out (LBOs). Overall, leveraged loans are not used for productive investment.

1.3 Investor base

According to the Bank of England, the investor base of the leveraged loan market consists of banks, which hold one-third of the loans globally, insurers and pension funds, which hold another third and hedge funds and open-ended investment funds, which account for the last third. In this section, we shall look into the banks, the Collateralised Loan Obligations (CLOs) and the other non-bank investors that are active in the European leveraged loan market.

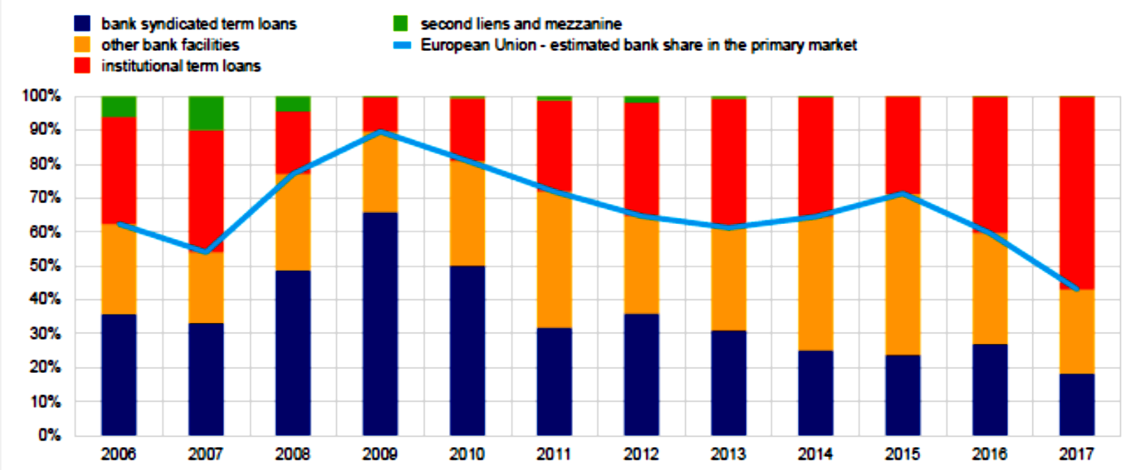
1.3.1 European banks

A leveraged loan is structured, arranged and administered by at least one commercial or investment bank, which subsequently may sell the loan in a process known as ‘syndication’, to other banks or investors to lower the risk to lending institutions.

As Figure 3 shows, non-bank investors have increasingly replaced banks in the financing of highly indebted companies, although the European banks remain a key player in the leveraged loans market.

Figure 3 – Breakdown of leveraged loan facilities in the EU market by type and estimated share of primary market loans extended by EU banks

(2006-2017; percentages)



Sources: Thomson Reuters and ECB calculations.
Notes: Institutional term loans cover term loans B, C, D and E, while bank syndicated term loans cover term loans A (TLAs). Other bank facilities cover bridge loans, revolving credit facilities, and capital expenditure (capex) and acquisition loans. Banks' share in the primary market is estimated as the share of term loans retained by the banks and of other bank facilities in the total volume of leveraged loans syndicated in the primary market.

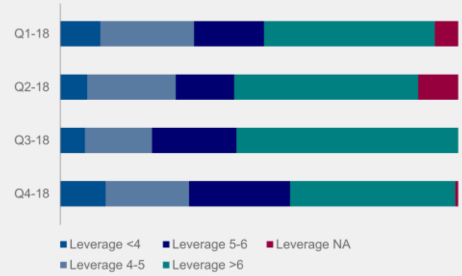
Source: ECB, 2018 (p. 77)

As mentioned earlier, statistics on the direct holdings of leveraged loans by euro area banks are not available. However, according to the ECB, syndicated leveraged loans are estimated to account for about a third of the total syndicated loans extended by euro area banks in major jurisdictions to euro area non-financial corporations.

In particular, UK, Irish, French and German banks are driving overall euro area bank exposure higher, while Spanish and Italian banks have decreased their holdings since the beginning of 2012. Against this background, underwriting standards have been loosening further as cov-lite transactions have become the market standard across the European market, which is converging to the US paradigm.

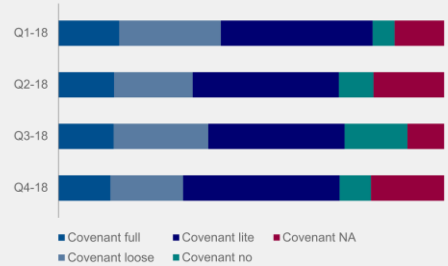
Figure 4 below displays the percentage breakdown of the leveraged transactions originated by the eighteen most active supervised by the ECB banks in each quarter of 2018 (a) by leverage and (b) by covenant protection.

Fig. 4a – Percentage breakdown of leveraged transactions originated by 18 supervised banks by ECB in each quarter by leverage



Source: ECB, 2019

Fig. 4b – Percentage breakdown of leveraged transactions originated by 18 supervised banks by ECB in each quarter by covenant protection

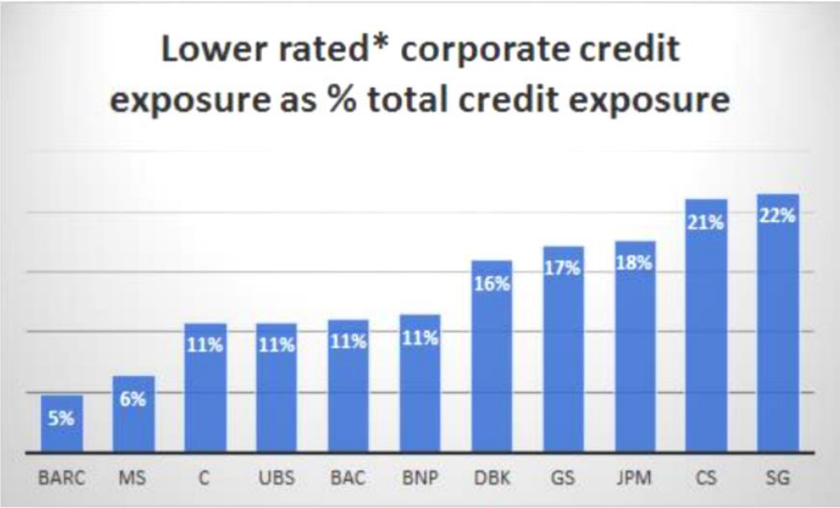


In view of the non-availability of statistics, estimates of individual bank exposures have been made by based on 'Pillar 3' filings, which all banks have to make in a standardized format, so that data between banks can be compared even when their accounting methods are different (Seeking Alfa, 2019).

The Pillar 3 filings contain data on the composition of banks' credit portfolios, including an analysis by 'probability of default' which is reconciled to external credit ratings. Thus a probability of default which is greater than 0.5% is typically equivalent to a credit rating of BB or below. Thus estimates of individual bank exposures to leveraged corporate borrowers (usually with a rating below BB-) are made possible.

Figure 5 below shows the estimates for the major European and US banks. As it can be seen, of the top four most exposed banks, two are European, with Societe Generale and Credit Suisse being the most exposed ones.

Figure 5 – Individual bank exposure to leveraged loans



Source: https://seekingalpha.com/article/4275021-banks-leveraged-loans-exposed
Notes – SG: Societe Generale; CS: Credit Suisse; JPM: JP Morgan; GS: Goldman Sachs; DBK: Deutsche Bank; BNP: Bnp Paribas; BAC: Bank of America; UBS: UBS Investment Bank; C: Citigroup; MS: Morgan Stanley; BARC: Barclays

1.3.2 Non-bank investors

Non-bank investors include institutional investors, such as pension funds and insurance companies, which usually invest in 'term loans', i.e. loans that amortize via a repayment schedule. These often include cov-lite loans as well as second lien loans, which are second in priority to first lien loans in terms of claims to assets in the event of a company's bankruptcy.

Non-bank investors further include hedge funds, business development companies, mutual funds and Exchange Traded Funds (ETFs) as well as private debt funds, which lend to smaller companies in bespoke deals, known as 'direct loans'.

Private Equity firms have also increased their role in the leveraged loan market since the financial crisis. For example, some PE firms have affiliates that create Collateralised Loan Obligations (section 1.3.3 below), to purchase and distribute leveraged loans. Further, they borrow to finance M&A activities. Indeed, sponsor leveraged buyouts (LBOs) – whereby a private equity firm buys a company and levers it up with debt to pay for an acquisition – are considered to be the 'most aggressive part of the market' (Ford, 2019).

1.3.3 Collateralised Loan Obligations (CLOs)

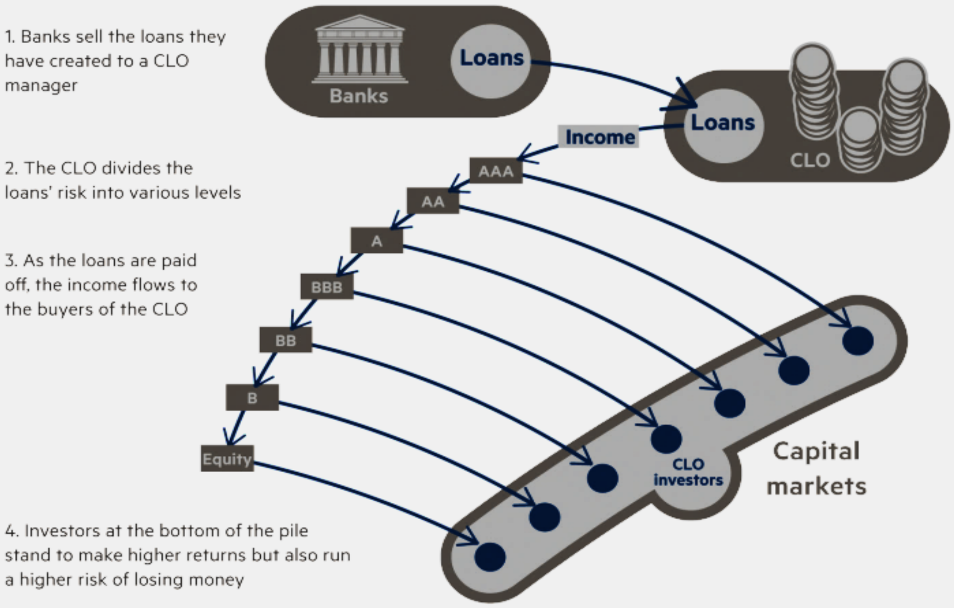
A Collateralised Loan Obligation is a single security backed by a pool of debt; often this consists of corporate loans that have a low credit rating, i.e. leveraged loans.

The investor receives scheduled debt payments from the underlying loans assuming most of the risk in the event of borrowers' default. Furthermore, the investors in the lowest 'tranches' (riskiest loans) receive higher returns but they are hit first if the underlying loans begin to default.

CLOs are an essential component of the leveraged loan investor base, rivalling the high yield bond market. Figure 6 below schematically shows how CLOs work.

Figure 6

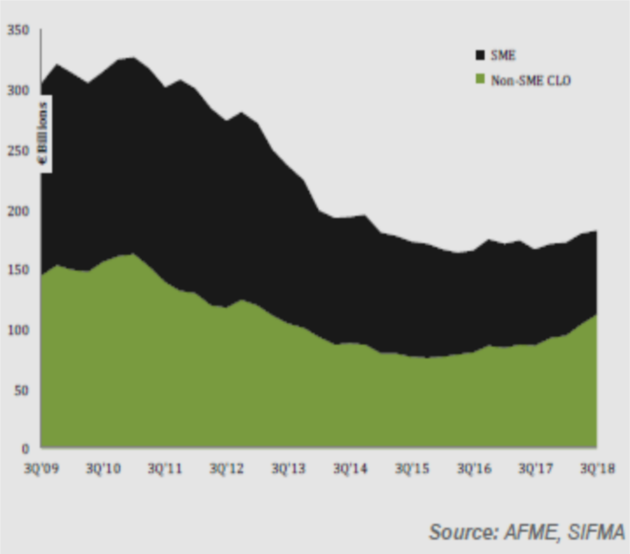
How collateralised loan obligations work



Source: Rennison, 2019

According to the Financial Stability Board, CLOs are supporting high leveraged loan market growth. In fact, it is estimated that CLOs hold around 30% of the leveraged loans outstanding in the EU. As shown in Figure 7 below, the European CLO outstanding declined after the peak of the pre-crisis years, only to pick up again in 2016.

Figure 7 – European CLO Outstanding



Source: AFME Finance for Europe (p. 5)

In the US, further to a February 2018 court ruling, 'retention requirements' (i.e. the requirement to keep a certain part of a securitization on originator's own balance sheet) no longer apply. Thus it is estimated that the CLO issuance has risen over 60% in the US since 2016.

The FSB estimates that around two-thirds of global CLOs are held by non-bank investors, including pension funds, insurers and investment funds. International banks hold the remaining third, which is usually the less risky tranches (FSB, 2018).

Overall, CLOs serve as packaging vehicles for the underlying leveraged loans, so that no specific loan information is available to the end investor base. This lack of transparency heightens the risk of a sell-off, should a state of uncertainty arise and market sentiment turn.

2. Regulatory framework

The first regulatory approach to the issue of leveraged loans was made in the US. In particular, in March 2013, the US federal banking agencies issued Leveraged Lending Guidance (LLG) setting limits on parameters such as debt-to-income ratios and maturity.

However, in October 2017, the US Government Accountability Office determined that the LLG is subject to the requirements of the Congressional Review Act, meaning that the Congress can overturn it. Furthermore, in September 2018, a joint statement by US banking agencies clarified the non-binding role of supervisory guidance, which is distinct from laws and regulations. Thus the US regulatory framework may be said to be quite accommodative.

In the EU, the ECB published its 'Guidance on leveraged transactions' in May 2017 to enter into force at the end of 2017. In November 2018 the banks themselves were required to provide an internal assessment of their implementation of the guidance expectations. Thereafter three-yearly compliance reports are to be submitted by the European banks to the ECB. Also, in 2018 the ECB started collecting data from the 18 most active supervised banks while a multi-year programme of on-site inspections was launched in January 2019.

The ECB Guidance applies to all 'significant credit institutions' supervised by it and it has two main objectives: to facilitate the identification and monitoring of leveraged loans and to foster sound origination and risk management practices for these transactions. It also provides a single definition of leveraged transactions to be applied by supervised banks across all business units and geographical areas and it establishes a set of quantitative and qualitative supervisory expectations.

According to the ECB Guidance, a 'leveraged transaction' is defined as one where the ratio of total debt/EBITDA of the borrower is greater than a multiple of 4. Where total debt/EBITDA is greater than 6, this is considered to be a 'High level of leverage' which 'raises concerns'.

By comparison to the US Leveraged Lending Guidance, the ECB one has a narrower scope, certain aspects of which are highlighted below (Shearman & Sterling LLP, 2017).

- It has a narrower application. In particular, it applies to 'significant' credit institutions based in member-states participating in the Single Supervisory Mechanism, whereby the categorization depends on certain criteria, including size and cross-border activities. By comparison, the US Guidance applies to all federally regulated financial institutions, including non-banking subsidiaries of bank-holding companies and US branches of non-US banks.
- A 'leveraged transaction' according to the ECB meets one of two criteria: either the borrower's post-financing leverage exceeds a total debt/EBITDA ratio of 4.0 (leverage test) or one or more 'financial sponsors' control or own more than 50% of a borrower's equity (sponsor test), where a 'financial sponsor' is an investment firm that undertakes private equity investments with the intention of exiting on a medium term basis. By

contrast, the US Guidance definition is broader, as it allows for a variety of characteristics.

- Certain transactions are explicitly exempted from the definition of total debt; namely, loans to natural persons, credit institutions investment firms, public sector entities and financial sector entities; loans below Euro 5 million; loans to SMEs, except where the borrower is owned by a financial sponsor, loans classified as 'specialised' lending (project finance, real estate and commodities financing); trade finance and loans to investment-grade borrowers. By contrast, the US Guidance contains no such exemptions.

On the other hand, the effect of non-compliance is to say the least not clear both in relation to the ECB and to the Fed Guidance, as neither is binding law. Thus at a minimum con-compliant institutions face the risk of public censure by regulators and reputational damage.

Overall, in view of the fact that leverage multiples have long exceeded 4.0 times and more recently even 6.0 due to the continuing competition with US banks, it is generally thought that the expected impact of the ECB Guidance in the short run will be limited, if any. Such impact will be felt mainly in relation to bank governance structures and procedures.

3. Factors and risks associated with the rise in the leveraged loan market

There is a multiplicity of factors accounting for the rise in the volume of leveraged loans following the global financial crisis, so that ten years after its outbreak they have reached and in certain cases exceeded their pre-crisis levels. These factors include the general macroeconomic environment, the accommodative monetary policy pursued during this period, as well as the equity market.

In particular, the pursuit of austerity and internal devaluation resulted in the accumulation of private debt, making it difficult for many corporations to borrow in the traditional, bank-intermediated way. By the same token, the accumulation of bad debt in bank balance sheets reduced the banks' risk appetite and by extension their lending to the economy.

Equally importantly, the prolonged period of very low interest rates led to a search for yield strategies by investors, who are prepared to buy more debt at a higher debt/EBITDA ratio than in the past, i.e. of especially highly indebted companies. So much so, that they are willing to extend loans with fewer credit protections or financial covenants than in the recent past. Such a loosening of underwriting standards have further made it easier for banks to arrange these loans, since there is less need to monitor whether the loan taking firm complies with the requirements.

The accommodative monetary policy on both sides of the Atlantic has included generous quantitative easing programmes to stimulate the economy. As government and corporate bonds were bought up by central banks, demand in credit markets boomed. In combination with the low interest rates and the hunt for yield, equity markets were strengthened, further intensifying the interest in the leveraged loan market.

Interestingly, the same factor that accounts for the increase in leveraged loans may also signal its demise; namely, an economic downturn, a rise in interest rates, a weak equity market. Generally, the risks associated with the leveraged loan market generally include the following (Johnson, 2018).

- *Credit risk* – Risk of loss due to borrower's failure to make payments on their debt.
- *Default risk* – This is the portion of credit risk that measures the severity of the loss if the borrower were to default;
- *Liquidity risk* – Pressure on secondary market resulting in reduced liquidity as investors react to industry &/or market events and forced ales lead to price declines;
- *Market risk* – Risk of a market decline that in turn reduces their value
- *Prepayment risk* – As interest rates decrease, bank loan issuers refinance higher-yielding coupons for lower yields. Conversely, as interest rates rise, borrowers may experience challenges making payments on the bank loans resulting in defaults.

While the above types of risk refer to credit risk, there is broad agreement that leveraged loans 'may create *financial stability risks'* according to the ECB, while they 'may become a source of *systemic risk'* according to the FSB, 2019.

More specifically, as pointed out in the 2018 Financial Stability Review of the ECB:

> "Developments in leveraged loan markets may create financial stability risks. In particular, the rollover of maturing loans into exposures with a significantly worse risk-return profile may create vulnerabilities. In addition, the distribution of risks beyond the banking sector is unknown, given the lack of statistical data. Finally higher than expected potential losses in this sector may spill over to the wider economy" (ECB, 2018. P. 78).

The same concerns are voiced by the FSB, 2019, where it is stressed that:

> "… non-bank financing may become a source of systemic risk, both directly and through its interconnectedness with the banking system, if it involves activities that are typically performed by banks, such as maturity/liquidity transformation and the creation of leverage" (FSB, 2018, p.4).

4. What could go wrong? - Policy Implications

Our diagnosis of the factors that led to the rise of the leveraged loan market begs the question; namely, what could go wrong should the low-interest rate environment go into reverse of indeed should the economic cycle turn? In answering this question, Hyman Minsky's Financial Instability Hypotheses provides some useful insights.

More specifically, this posits five stages from boom to bust (Schoenmaker, 2019):

i. credit expansion, rising asset prices;
ii. euphoria, overtrading;
iii. distress, unexpected failures;
iv. liquidations;
v. panic, desire for cash

On the basis of the trends and developments reviewed above, it would appear that the leveraged loan market is in the second stage, where investor complacency, if not euphoria, has taken over. This is evidenced by the fact that financial institutions have increased their leverage and shifted their portfolios towards projects that were previously considered as too risky. Overtrading is in fact encouraged by analysts who claim that:

> "It is easy to write headlines, but as ever, the devil is in the detail. The loan market has seen strong demand, with investors being drawn to the attractive yields, low duration and downside protection offered by their senior secured position in the capital structure" (Johnson, E., 2019).

In the same vein, the FT's Andrew Davies notes that:

> "Fretting about the growth of collateralized loan obligations, the popularity of covenant-lite loans and the potential impact of an economic slowdown all distort a fuller understanding of how CLOs work and their possible impact on the global financial markets today" (Davies, 2019).

While such admonitions may indeed influence developments in leveraged finance, distress and default is inevitably harsher when the cycle turns bringing bad news. The bad news is the feared downturn due to the brewing trade war between the USA and China and the outlook for the trade-dependent economies of Italy and Germany, two of the biggest economies in the EU.

At the same time, monetary policy finds itself in a bind, as measures designed to counter a potential downturn tend to fuel the leveraged finance sector. Thus, the Federal Reserve cut is benchmark rate to just below 2.25 pc on 31/7/2019. The last time the Fed cut its rate was in December 2008. Although the July cut is presented by the Governor of the Fed as a 'mid-cycle adjustment', there is a broad market consensus that further cuts will follow within the year.

The ECB on the other hand is already in interest rate territory, as its deposit rate is currently equal to minus 0.4 pc having been set below zero since June 2014. However the outgoing ECB President, Mario Draghi, whose term of office expires in October 2019, is said to be preparing a new economic stimulus package before leaving his post.

In total, current monetary policy by both the ECB and the Fed encourages further risk-taking and thus greater financial fragility. The move from the second to the third stage of the FI Hypothesis thus both more likely and more painful. The trigger may be any event, ranging from a rumor (e.g. of monetary tightening) to an actual fact (e.g. the German economy sliding into recession). To meet such an eventuality policy needs to adjust accordingly both on the level of overall economic policy and on the level of financial regulation.

With regard to economic policy generally, fiscal policy needs to become activated in order to revive the failing EU economies. Indeed the current historically low interest rates present governments with an opportunity to fund spending in infrastructure, which was badly hit by the crisis.

In addition, EU financial regulation needs to adjust to the developments in the European leveraged loan market. In particular, a system-wide approach to macroprudential regulation is necessary. For example, a maximum leverage ratio (Debt/Equity) should be applied to non-bank investors, as well as to all the ECB supervised European banks, rather than just the 'significant' ones. Admittedly the lack of a comprehensive macroprudential framework for non-banks is a constraining factor. However these are precisely the challenges that need to be overcome.

With regard to cov-lite loans, the erosion of standards needs to be stopped and reversed as far as possible. Borrower-based requirements need to be introduced while non-bank regulators across the EU member-states need to adopt a common stand in order to avoid regulatory leakages.

Overall, the recovery and continuing rise of the leveraged loan markets both in the US and the EU is the result of both the legacy of the global financial crisis and of the policies pursued to deal with it. It is a complex situation which has only recently come into the orbit of international regulatory and monetary institutions. The policy implications of making the leveraged finance sector safer are quite demanding.

The global financial system is complex and adaptable; it is driven by 'highly motivated people', who are resourceful, closely linked to politicians and strong believers in the market as an arbiter of productive and social relations. By comparison regulators are in a weak position, especially to the extent that they regard leveraged finance as a market failure. Although international organisations rightly worry about leveraged finance, they seem to remain entrenched in their pre-crisis mindset. This time around it is necessary to better understand asset price bubbles, deficiencies in the financial architecture, panics and their consequences and to act accordingly.

References

AFME Finance for Europe, 2018, European High Yield and Leveraged Loan Report, Q32018; Available at: https://www.afme.eu/en/reports/Statistics/high-yield-data-report-q3-2018/

Bank of England, 2019, Financial Stability Report, Issue No. 45, July

Davies, A., 2019, Investors should relax about the big build-up in corporate debt, Financial Times, 20 June

ECB, 2017, Guidance on leveraged transactions, May. Available at: https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170516.en.htm

ECB, 2018, Financial Stability Review, May. Available at: https://www.ecb.europa.eu/pub/financial-stability/fsr/html/index.en.html

ECB, 2019, Keeping an eye on banks' leveraged lending; Available at: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl190515_2.en.html

European Parliament, 2019, Leveraged finance: a supervisory concern in the Banking Union? Available at: https://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_BRI(2019)634369

Financial Stability Board, 2019, Global Monitoring Report on Non-bank financial Intermediation 2018, May; Available at: https://www.fsb.org/2019/02/global-monitoring-report-on-non-bank-financial-intermediation-2018/

FitchRatings, 2018, The 2018 Annual Manual US Leveraged Finance Primer, May; Available at *https://www.naic.org › capital_markets_archive › primer_181101*

Ford, J., 2019, Elizabeth Warren is right to worry about private equity looting, Financial Times, July 29

Johnson, E., 2019, Leveraged loans – a look behind the headlines, 30 April; Available at: https://www.janushenderson.com/nlpa/post/19583/leveraged-loans-a-look-behind-the-headlines

Johnson, J., 2018, Leveraged Bank Loans Primer, National Association of Insurance Commissioners, Capital Markets Bureau

Plender, J., 2018, Complacent investors face prospect of a Minsky moment, Financial Times, November 13

Rennison, J., 2019, CLOs: the specialist loan vehicles luring yield-hungry investors, FT Services, The Debt Machine, Leveraged Loans, January 28

Seeking Alfa, 2019, Banks and leveraged loans: Which are most exposed, July 15; Available at: https://seekingalpha.com/article/4275021-banks-leveraged-loans-exposed

Shearman & Sterling LLP, 2017, Leveraged Lending: Summary of ECB Guidance compared to US Guidance, 21 June; Available at: https://www.shearman.com/~/media/Files/NewsInsights/Publications/2017/06/Leveraged-Lending-Summary-of-the-ECB-Guidance-compared-to-the-US-Guidance-FN-062117.pdf

Schoenmaker, D., 2019, Reining in shadow banking, VOX CEPR Policy Portal, 8 Feb

Part II - Addressing the Non-Performing Loans (NPLs) problem

Non-Performing Loans over the Business Cycle

Jan Toporowski[21]

Abstract

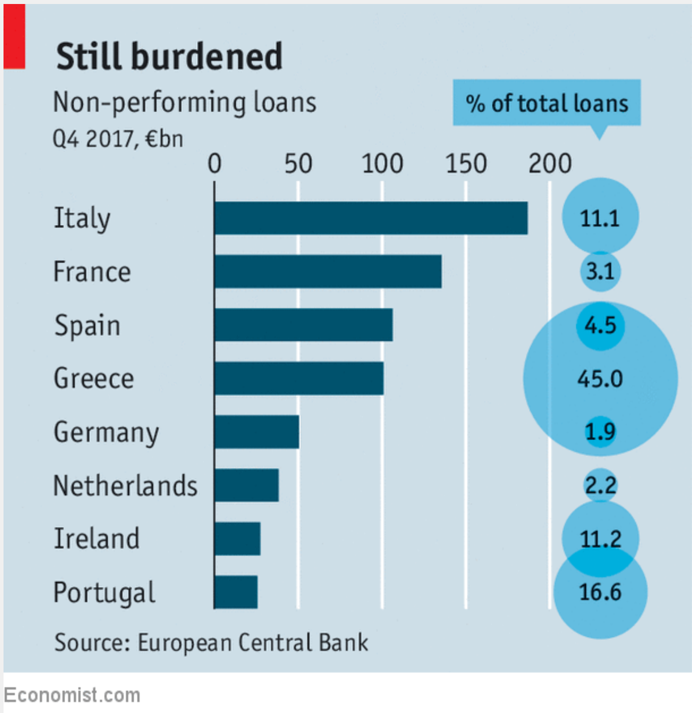
This chapter examines non-performing loans in Greece and their consequences for banking and the regulation of debt and liquidity in the Greek financial system. After a brief survey of non-performing loans in Europe, the chapter examines how non-performing loans are viewed in current theory and practice. This leads on to an analysis that makes the case that NPLs are endogenous to the business cycle. The policy implication of this is that banking regulation and monetary policy may be helpful at the margin in controlling non-performing loans. However, banking regulation and liquidity management need to be supplemented by fiscal policy in an overall macroeconomic policy framework to regulate cash flows in the economy.

1. Non-performing loans in Greece

As reported in the Economist on the 2 June 2018, European banks are burdened with non-performing loans. These are defined by the European Banking Authority, in line with other banking regulators, as loans on which payments are 90 days or more behind schedule, or unlikely to be made. In absolute value terms these are highest in Italy, followed by France and Spain. Greek banks are only the fourth-largest holders of non-performing loans among European banks, holding €95.7bn of bad loans. However, as a percentage of total loans, these non-performing loans constitute an alarming 45% of all loans: by far the highest such share of loans in Europe, with the country where bad loans constitute the next highest share of bank loans, Portugal, having only 16.6% of its bank loans deemed to be non-performing. Ireland and Italy then have just over 11% of loans reported to be bad. At the centre of 'sound' finance in Europe, only 1.9% of loans in Germany are deemed to be bad (The Economist, 2 June 2018).

[21] SOAS School of Oriental and African Studies, University of London.

Figure 1: Non-Performing Loans in Europe



In Greece, some 60% of these bad loans are to small businesses. Individually, they are also mostly small loans. Loans to small businesses are clearly casualties of the bad state of the Greek economy, discussed further below. In some respects, however, the situation of around a quarter of bad loans is more interesting. Greek bankers suggest that these are owed to 'strategic defaulters', or borrowers who default in the expectation that the debts may be written off and will therefore, largely or wholly, not have to be repaid. On May the 29th 2018, Piraeus Bank, one of the 'big four' lenders in Greece announced that it had agreed to sell to Bain Capital Credit, a finance house that specialises in buying up portfolios of bad debts, a bundle of non-performing loans totalling €1.45bn, and representing loans to some 180 borrowers. The security for this was supposed to be provided by 1,700 buildings in the main cities of Greece. The average size of these loans was therefore some €8mn. (The Economist 2 June 2018).

'Strategic defaulters' represent a feature of the interface between banking and business, what the Austro-Marxist Rudolf Hilferding called 'finance capital', that is wholly missing from the academic, or even journalistic, discussion of banking. What is sometimes referred to among bankers as a ‘debt run’ arises if a borrower suspects that the bank, to which the borrower owes money, may be in difficulty. A rational response in this situation is to withhold debt payments, in much the same way that, on the other side of the balance sheet, rational depositors hasten to withdraw their deposits. At the very least, ‘strategic default’ gives some temporary relief to cash outflow. It should be pointed out that this is a consequence of the application of market forces, of a ‘survival of the fittest’ kind, to banking business: the slightest sign of balance sheet weakness evokes behaviour by borrowers that further impairs bank balance sheets. It is common in many developing countries where economic and banking institutions are already weak, and where businesses can use their borrowing power to refuse payment.

‘Strategic default’ is the practical application of the dictum, often attributed to Keynes, that if I owe my bank a thousand pounds, the bank wants it back, and I cannot pay it, then I am in trouble; but if I owe my bank a million pounds, which the bank wants returned and I cannot, then it is the bank that is in trouble. One can therefore infer from this that strategic defaulters in Greece are among larger businesses.

2. Non-performing loans in current practice

Non-performing loans (NPLs) are treated in the banking literature as the result of 'risky' asset portfolio choices, in the form of ‘risky’ lending, or the purchase of ‘risky’ securities. This is the standard explanation for the 2008 crisis in the United States, and the difficulties that have affected banks in Europe, in particular Greek banks, with adverse consequences for their solvency and credit policy. The standard treatment for such ‘risky’ management of bank assets is a microeconomic one that requires individual banks to manage their capital in such a way as to ensure that banks have adequate capital to maintain their solvency, i.e. enough assets to cover their liabilities. If their capital is insufficient then banks must take 'prompt corrective action' to put more capital into the bank affected. If the existing managers and shareholders cannot do this, a ‘resolution’ has to be sought in which new owners and managers take over the affected bank, to assure payments on liabilities.

The principal ‘alternative’ view of NPLs is that they are the result of ‘asymmetric information’. Put forward by authorities such as Joseph Stiglitz and Frederic S. Mishkin, this is the view that lenders cannot know the true purposes to which borrowers will apply their loans, or they cannot know the true returns on those loans (Greenwald and Stiglitz 1990; Mishkin 1990). In this view, there will always be a group of loans that will turn bad and default is inherent in certain loan agreements, but lenders cannot identify those loans that will turn bad or the scale of the default. The flaw in this reasoning is that it gives a generic explanation for non-performing loans, but it does not explain why these loans may increase or decrease over time, either in absolute terms, or as a share of loans. This leaves proponents of this view dependent on exogenous factors, or 'shocks', such as the 1929 Crash, as explanations of changes in the value or share of NPLs. Moreover, reducing the explanation for NPLs to factors which cannot be observed and can only be known retrospectively, such as asymmetric information, or 'shocks', is not particularly helpful in avoiding a build-up of non-performing loans.

This indeterminacy of what may be non-performing loans has important implications for banking regulation. On the one hand, in a fractional reserve system, there is uncertainty as to whether any amount of capital set aside by banks is sufficient to protect banks from the consequences of 'shocks' or 'asymmetric information'. The only knowledge that bank regulators may have are the bad debts that banks may report, and that may retrospectively be attributed to shocks or information asymmetries. On the other hand, there is the 'moral hazard' that, were banks to have sufficient capital, they would lose the incentive to exercise 'due diligence' to inform themselves of the credit-worthiness of their borrowers.

In practice, bank regulators resolve this uncertainty by agreeing 'conventional' ratios of capital to risk-weighted assets, while holding over banks the possibility that those capital ratios may be raised if regulators consider that the risks to which banks are subject warrant such additional 'macro-prudential' capital. But these decisions are judgements made subject to considerations for which there is often little objective evidence. Banks then adapt their balance sheets to these regulations by either raising capital or, as in Greece, by selling off bad loans to non-bank financial institutions.

Prompt corrective action and resolution works in a routine way in the United States, where there is a fragmented banking system and liquid capital markets, in which banks can raise capital for the merger and acquisition procedure that underpins this kind of resolution. However, this is not the case in Europe, where capital markets are less liquid and a tradition of general banking keeps much of that capital market activity on the balance sheets of commercial banks with more rigid reserve requirements. Even before recent financial difficulties created a pretext for banking consolidation, financial integration in the 1990s, under the banner of creating a Single Market in Europe, led to a festival of mergers and acquisitions in banking in order to create 'national champions' or even international banks to rival American banks in cross-border lending (Chick 2000).

Following the 2008 financial crisis, many of the new large banks, such as Deutsche Bank, Santander, or Unicredit, were deemed 'systemically important financial institutions' and therefore 'too big to fail'. Where previously such banks had heroic status as 'successful' (i.e. large, or transnational) banks, measured by their size and subsidiaries outside their home countries, the financial crisis also showed that diversification also brings exposure to payments difficulties in more than one country. The size of these banks, and their links through inter-bank arrangements with other, smaller banks means that such 'national champions' are also capable of bringing down other banks. In Europe, in the absence of a sufficiently large and liquid capital market in which banks can refinance themselves, the failure of such systemically important financial institutions requires government support. European banks with troublesome amounts of non-performing loans have therefore had to resort to government support, for example during the financial crises in Spain and Ireland, or more recently in Italy. In this situation, governments wishing to rescue banks have had to offer guarantees for capital issues by banks. The whole process has been highly politicised by the Stability and Growth Pact because of the prospect that it raises of the so-called 'doom loop', in which recapitalising banks in difficulty pushed government borrowing in Spain and Ireland from modest proportions through the ceiling imposed by the Pact.

The European case also reinforces the case again using market re-capitalisation as a means of 'resolution' in cases where banks have insufficient capital to deal with their non-performing loans. As argued in the next section, non-performing loans rise with the decline in cash flows in an economic recession. In this situation, the response of non-financial corporations is to strengthen their balance sheets by issuing new equity to 'fund' (refinance into long-term capital) the short-term bank borrowing that they may have difficulty in rolling over. Their demand for new capital enters a capital market in which banks and other financial institutions are already queuing up to issue capital, the former to satisfy the demands from bank regulators to improve bank ratios, the latter to fund their purchases of bad debts that banks have difficulty in funding (e.g., in the case of Greece the finance houses Bain Capital, or Intrum, that are buying up the bad debts of Greek banks) (Toporowski 2009; Toporowski 2016). In recent years, quantitative easing by central banks, including the European Central Bank, have effectively increased the demand for new capital issues: central banks' buying up of government and commercial bonds provides financial investors and banks with bank deposits and reserves with near-zero or even negative returns, making the purchase of bonds with higher returns more attractive. Although Greece has been excluded from ECB bond-buying, such buying of bonds has left financial investors (principally pension funds and insurance companies) with a much greater need for long-term assets that will generate higher returns to cover liabilities that are being swelled by the recession in Europe. It is this need to cover liabilities that is providing the finance for the finance houses that are buying up distressed debt from Greek banks.

3. Non-performing loans and the business cycle

Contrary to the prevailing notion that some level of risk is objectively inherent in particular loans, in fact the ability of borrowers to service their debts is, in fact, endogenous to the business cycle. There are two ways in which this happens. First of all the business cycle manifests itself in variations in gross incomes and expenditures, or cash flows, in the economy. Fluctuations in these cash flows then affect the ability of indebted individuals and businesses to make payments on their outstanding debts. This is now recognised by requirements for 'macro-prudential' capital, which may be required by banking regulators to enhance the capital base of banks in the face of 'macroeconomic risks' such as lower economic growth. Despite the name 'macro-prudential', such capital requirements are essentially a microeconomic solution to a macroeconomic problem, in that they seek to modify banks' behaviour (asset choice and liability management) rather than eliminating the source of the macroeconomic disturbances.[22]

The business cycle affects the liquidity of the financial system in another way as well. This is by increasing the amount of credit in financial circulation that may be used for debt servicing. During an economic boom, banks not only are more willing to increase their advances for trade and investment in the real economy. Banks also increase their secured lending against financial assets. If anything, lending secured against financial assets rises more significantly in a boom than lending for trade and investment, and declines more sharply in a recession. The rise in financial advances is enhanced by the increase in the value of financial assets during the boom. That increase improves the quality of that security. By contrast, in a recession, the value of financial assets falls, which reduces the amount of credit that may be advanced on the security of assets.

[22] A systematic analysis of the origins of macroeconomic fluctuations is beyond the scope of this chapter. Suffice it to say that the most widely used current approach is based on Dynamic Stochastic General Equilibrium, in which 'shocks' to the system are unpredictable. This gives changes in bank capital, *in advance* of those shocks, the potential to exacerbate macroeconomic disturbances, should an anticipated positive shock turn out to be a negative one and *vice versa*.

The fluctuations in liquidity in the financial system are then reflected in corresponding increases and decreases in the velocity of circulation of money in financial circulation. Advances on the security of financial assets are typically sought in order to purchase more of the same, or some other, financial securities. The higher turnover in financial assets means that any security of a given maturity is more likely to be converted into cash (in practice bank deposits) within a shorter period of time. This effectively shifts the yield curve towards vertical axis as, say, bonds maturing in *x* years can be sold for their nominal value, or even above, in *x* – *n* years (where *n* is proportionate to the velocity of circulation of money in the financial system).

These effects on the structure and liquidity of the financial system reinforce the importance of central bank open market operations and commercial banks' credit policy in dealing with NPLs. Central bank buying or selling of bonds increases or decreases the amount of reserves held by banks, and can therefore make it easier or more difficult for banks to settle their obligations to each other on behalf of their customers. Commercial bank advances or loans 'create' credit that can then also circulate within the financial system, easing payments on loan contracts. One of the reasons why loans become 'non-performing' in a recession is precisely because there is not enough credit or liquidity in the system to allow payments to be made on loan contracts.

The key factor determining the business cycle is the level of investment in the economy. Given government expenditure and the relatively more stable rates of consumption by households, investment not only determines the level of output and employment. It also has an important influence on cash flow in the economy. Low levels of investment are usually associated with high rates of 'liquidity preference', as the large businesses that undertake the vast bulk of private sector investment prefer to hold on to liquid assets, investing bank deposits in financial instruments in preference to buying plant and equipment. Such financial preference concentrates monetary resources in the financial system, rather than spreading them through the economy at large, enhancing cash flow and easing loan payments in small and medium-sized enterprises. High levels of investment take monetary resources out of the financial system to be increase the turnover of such resources in the real economy. In this way loan contracts 'perform' better in a boom (Kalecki 1933/1990).

According to official statistics, gross fixed capital formation in the Greek economy reached a peak of €17,204 millions in 2007. On the eve of Greece's financial crisis in 2010, it still exceeded annually €12,000 millions. Within two years, by 2012, capital formation halved to 12% of GDP, and has remained even below such low levels through to the time of writing. By comparison, in

Europe as a whole, fixed capital formation peaked at 32% of GDP in 2008, before falling to just below 20% of GDP since 2016. Clearly the decline in investment has been much more extreme in Greece. The link with non-performing loans arises because fixed capital investment has a much clearer influence on *changes* in cash flow through business balance sheets, or transfers of money from the financial system to the real economy. The other component of business cash flow, from household consumption, has been remarkably stable in Greece at around 70% of GDP, with falls in real wages being off-set by reduced household saving, as households try to maintain standards of consumption. The reduced business cash flow is then concentrated among larger firms and multinational companies, whose control of markets affords them a wider profit margin than small and middle-sized companies. These changes in total expenditure in the economy, through a structure of business enterprise with varying profit margins, rather than some nebulous 'risk', accounts for the dynamics of non-performing loans in Greece: the rise of bad debts among smaller businesses, and the rise of strategic default among larger businesses.

4. Government Policy and Non-Performing Loans

The standard Keynesian solution to this problem of non-performing loans is through a rise in government expenditure. This provides cash flow in the economy in addition to that provided by private expenditure on consumption and investment. Such cash flow then allows firms to settle their obligations under debt contracts between each other (trade debts) or with banks, thereby reducing the amount of non-performing loans (Minsky 1986, chapter 13). The literature is, in this author's view, confused about whether the additional expenditure should be financed by borrowing, or by taxation, that is whether the fiscal stimulus is delivered by additional government expenditure, or by a fiscal deficit regardless of the level of total expenditure. The economic decline in Greece has undoubtedly been exacerbated by the emphasis in the fiscal targets set for the Greek government of fiscal surplus, achieved to a significant extent by a reduction in expenditure that has squeezed cash flow in the real economy. An important consideration here is the maintenance of financial stability by ensuring that accumulations of liquidity do not build up in the economy, where they can destabilise asset markets. These accumulations are effectively the bank credit of larger businesses, banks and financial institutions that are most likely to benefit from any increase in government expenditure. In bank balance sheet terms, they are the liability counterpart in the banking system of the non-performing loans and other credit instruments in the financial system. This liquidity would tend to rise with an increase in government expenditure. The stabilisation of this liquidity could be effected by financing the government expenditure with taxes on profits or wealth, or by long-term borrowing. Either method involves draining the accumulations of liquidity in the financial system and putting these financial resources into circulation in the real economy (Toporowski, 2018).

An appropriate fiscal stance, consisting of additional government expenditure financed by taxes on profits or wealth, or by long-term borrowing, could be reinforced by open market operations of the central bank. Buying bonds effectively adds reserves to the assets of banks, facilitating the settlement of inter-bank obligations and providing the liquidity to finance the purchase of securities and debt instruments, including the purchase by distressed debt funds of packages of non-performing loans, at a suitable discount. In the European Monetary Union and elsewhere, these open market operations have been in the guise of 'quantitative easing'. Quantitative easing (QE) is not quite the same as regular open market operations to regulate financial liquidity. QE is inspired by considerations of regulating the quantity of money (including bank deposit money) in general circulation, and consists of buying pre-determined amounts of bonds, rather than regulating the liquidity of the financial system (Toporowski 2019). In the case of Greece, Greek bonds have been largely excluded from the European Central Bank's asset purchases. But the buying of packages of non-performing loans from Greek banks by Swedish, Norwegian and American funds indicates that, in an international capital market, liquidity provided by central banks outside Greece, can ease the removal of non-performing loans from Greek banks. The commercial rationale for such transfers is clearly that Greek banks are under pressure from their regulators and shareholders to reduce their holdings of non-performing loans, while the funds buying up the loans are paying less than the value that they expect from the loans. In general, they hope to benefit from any economic recovery that will improve the quality of those loans. In this way, it is the business cycle that has created the bad debt problem in Greece, and that will resolve it in the future. But the European Central Bank can do more by a policy of systematic open market operations to maintain a stable yield curve for government bonds.

Conclusion

According to the report in the Economist magazine, non-performing loans in Greek banks are being reduced, having fallen by €13bn from their peak in March 2016. Proposals for the Greek government's departure from the European Union's assistance with the government's debts, included a forecast that non-performing loans in Greece would be reduced to 35% of loans, or €65bn by the end of 2019 (The Economist 2 June 2018). However, these reductions in the non-performing loans on books of Greek banks are not diminishing the amount of bad debt in the economy. For the most part, the bad debts are simply being taken off bank balance sheets through sales of such bank assets to non-bank financial institutions, such as Bain Capital Credit, mentioned above, or Intrum, a Swedish financial institution specialising in the recovery of bad debts. In terms of the system as a whole, such debt sales merely reclassify loans from non-performing bank loans to non-performing loans owned by non-bank financial institutions. In effect, such sales take bad debts off bank balance sheets and into the shadow banking system. There may be a modest reduction in banking risk, insofar as the non-bank buyers of the non-performing loans are not themselves financed by loans from banks. But the bad debts stay in the economy until the circulation of money re-starts with the economic revival. That recovery can be assisted by increasing government expenditure, thereby enhancing the cash flows in the economy to facilitate payments on loans.

References

Chick, V. (2000) "Big banks, small business and the regions in bankers' Europe", in J. Toporowski (eds.) *Political Economy and the New Capitalism essays in Honour of Sam Aaronovitch* London: Routledge.

The Economist (2018) "Rebuilding the ruins. A critical task for the Greek economy enters a new phase. Greek banks have begun to reduce their enormous pile of bad loans", 2 June 2018.

Greenwald, B.C. and Stiglitz, J.E. (1990) "Asymmetric Information and the New Theory of the Firm: Financial Constraints and Risk Behavior", *American Economic Review*, 80(2), May, pp. 160-165.

Kalecki, M. (1933/1990) "Essay on the Business Cycle Theory", in J. Osiatyński (eds.) *Collected Works of Michał Kalecki Volume I Capitalism: Business Cycles and Full Employment* Oxford: The Clarendon Press 1990, pp. 65-108.

Minsky, H.P. (1986) *Stabilizing an Unstable Economy* New Haven and London: Yale University Press.

Mishkin, F.S. (1990) "Asymmetric Information and Financial Crises: A Historical Perspective", *NBER Working Paper*, No. 3400, July, pp. 1-38.

Toporowski, J. (2009) Evidence in House of Commons Treasury Committee, "Banking Crisis: International Dimension of the Banking Crisis" *Eleventh Report of Session 2008-09*, HC 615, London: The Stationery Office 24 July 2009, pp. 59-63.

Toporowski, J. (2016) "The Crisis of Finance and the Crisis of Accumulation: It was not a Lehman Brothers Moment", in T. Subasat (eds.) *The Great Financial Meltdown Systemic, Conjunctural or Policy Created?* Cheltenham: Edward Elgar, pp. 236-247.

Toporowski, J. (2018) "Financing a Labour Government", *Open Democracy*, 28 September.

Toporowski, J. (2019) "Open Market Operations", in D.G. Mayes, P.L. Siklos and J-E Sturm *The Oxford Handbook of Central Banking* New York: Oxford University Press.

Solving the NPLs' Problem in Greece: Where do we stand?

Konstantinos Loizos[23]

Abstract

This paper aims at shedding light to the issue of NPLs in Greece, both from a theoretical and a policy perspective. Our main argument is that a heterodox approach to solving the NPLs' problem should focus both on the specificities that characterize the Greek case and on boosting credit growth. In this respect, development banking might be a useful long-term policy tool to supplement any short-term NPLs' management solutions.

Introduction: The NPLs' problem between a rock and a hard place

Non-Performing Loans has been one of the major problems that European economies faced after the financial crisis of 2008 (Magnus et al., 2018). This problem has become even more pressing in some countries such as Greece with an average annual NPLs' ratio of 29.6% compared to 6.5% Euro Area average for the period 2009-2015. The Greek situation got worse during the next two and a half years as the average NPLs' ratio rose steeply to 47.8% (2016-2018Q3) (World Bank, 2019a; Bank of Greece, 2019).

The Greek case reflects, in an extreme manner, the precarious conditions that prevail in the world economy. The *Financial Times* of September 11th 2018 published an article with the title "Is the next financial crisis already brewing?" (Roubini & Rosa, 2018). Furthermore, *The Economist* of October 13th 2018 featured a cover story entitled "The next recession. How bad will it be?" not to mention the interest of the latter in "The rise of millennial socialism" (see the issue of February 16th 2019).

Hence, solutions to NPLs should take into account the murky and uncertain conditions prevailing in world capitalism today. In fact, government policies should steer their economies between the fragility of markets' expectations and the pressing need for economic recovery in the wake of the deepest recession after the 1930s.

[23] Research Fellow, Centre of Planning and Economic Research (KEPE), Greece, kloizos@kepe.gr.

2. Sorting out the theoretical landscape

The above indicate the importance of the theoretical tools whereby one approaches the NPLs' problem within such a wobbly economic environment. Yet, formulating an avant-garde proposal to solve the NPLs' issue is not straightforward. Obviously, pinning down the determinants of bad loans is necessary for deriving possible solutions which are provided to banks, borrowers and the government. However, a selection of recently published papers mainly in mainstream outlets suffices for a researcher to conclude that the literature on NPLs is strikingly an empirical one. In most cases, reference to theory concerning the factors affecting NPLs gives the impression of an undisputable underlying line of thought. This perspective eventually marks indelibly the discussion on possible solutions to handle the NPLs' problem. In such an instance, the question becomes overwhelmingly technical, and in that form contradicts the social and economic nature of this issue.

On the top of this frustrating intellectual environment, heterodox approaches on the subject are rare. This paper attempts an alternative approach to the NPLs' problem. The NPLs' question is being considered as the offspring of an economy plagued with fundamental uncertainty instead of being guided by probabilistic certainty equivalence (Keynes, 1936). This is important for a theoretical perspective that aims at providing practical solutions to economic and social problems. A theoretical point of view which claims that banks first collect deposits and then extend loans would have in mind a quite different approach to NPLs than a heterodox argument which asserts that the causality runs the other way around. Besides, if banks' wobbly expectations drive credit expansion and contraction, then financial instability as an endogenous phenomenon in the midst of financial markets' tranquility provides the proper context for NPLs generation (Minsky, 1982). One might say that the financialisation phenomenon is the obvious outcome of the above processes. In this sense, policy choices for the real world are unconceivable beyond the relevant institutional and historical context (Niggle, 2006). Hence, it is not enough to embrace a theory which acknowledges the need for realistic assumptions. For a policy to be workable and social-minded at the same time, the particularities of each country should be taken into account. Such a point of view contradicts with monolithic perceptions of policy recipes in the orthodox tradition of "one size fits all". The rest of this paper will use the above framework when addressing the NPLs' problem in Greece both from a theoretical and economic policy perspective. After reviewing the recent literature on the Greek NPLs' issue, I will extend the discussion to the policy proposals for solving it.

3. The literature on the Greek case

In current economic conjuncture, a growing literature is preoccupied with credit risk management and especially the thorny issue of handling NPLs. A natural way to start discussing this problem is by identifying the factors that generated NPLs in the first place. The literature presented below usually distinguishes four major groups of factors: 1) Macroeconomic, which relate to those variables that are affected by the business cycle; 2) Bank-specific, are associated with measures of financial institutions' efficiency and solvency; 3) Borrower-specific, which depend on descriptors of borrowers' total wealth and outstanding debt; Finally, 4) institutional such as the legal and political environment.

Monokroussos et al. (2017) study the evolution of provisioning practices in the Greek banking system for the period 2005-2015 by posing two questions: Which are the determinants of aggregate (across the banking industry) ratio of loan loss reserves to total loans ratio? Do Greek banks take higher provisions when macroeconomic conditions deteriorate, i.e. does the procyclicality hypothesis hold? Using both macroeconomic and bank-specific variables to explain NPLs in Greece during the relevant period, the authors reach quite interesting conclusions: The rise in NPLs and hence, LLRs (loan loss reserves) has been the reason for the three major recapitalizations of Greek banks. Hence, Greek banks provisioning is procyclical whilst the rise in NPLs of Greek banks is due mainly to the domestic recession. Greek banks seem to respond quickly to macroeconomic shocks (within 2 quarters) by changing their loan loss reserves ratio and at the same time the effects of these shocks on the provisioning behaviour of banks is persistent since it dies out in 10 quarters. The results show that after the Greek sovereign debt crisis the impact of macroeconomic shocks on loan loss reserves ratio has increased. This should indicate the importance of a stable macroeconomic environment.

Kapopoulos et al. (2017) focus on how the "inability to pay" and the "unwillingness to pay" affected the formation of NPLs in Greece. The first pertains to recession-induced effects whilst the latter refers to moral hazard aspects. They use quarterly data for the period 2004Q1 through 2015Q4 to find that the main determinants of NPLs are unemployment, recessionary shocks and micro-behavioural factors relating to strategic default.

Mylonas & Magginas (2017) are interested in the macroeconomic drivers of NPLs, both economy-wide and those affecting in particular mortgage and business loans. Researching the Greek case for the period 2008-2015 they find that the main factors of rising NPLs, especially in the long run, are the collapse in economic activity, the real effective lending rate and the rise in unemployment. Other important factors, especially in the short run, include the procyclical fiscal policy, prolonged liquidity shortages and high uncertainty concerning possible Grexit. In addition, moral hazard seems to have played a significant role in NPLs formation. The authors indicate the need for changes in the institutional framework to reduce moral hazard. According to them among the key sources of NPLs in the Greek economy are deficiencies in structural adjustment programs' implementation and design along with economic imbalances.

Finally, Asimakopoulos et al. (2017) are interested in the characteristics of strategic defaults among Greek borrowers and especially, the percentage of businesses that can be classified as strategic defaulters and the determinants of such strategic behaviour. They answer these questions by using annual data on company information for the period 2008-2015. They conclude that strategic defaulters as percentage of all borrowers have increased during that period of economic uncertainty. On the contrary, strategic defaulters as percentage of all defaulters have slightly declined due to prolonged recession and liquidity constraints. In addition, there are differences in strategic defaults among different sectors of the economy. Moreover, determinants of strategic default include economic uncertainty and outstanding debt since higher debt levels increase the incentive for defaulting. Finally, strategic default is more likely in medium-sized and middle-aged firms.

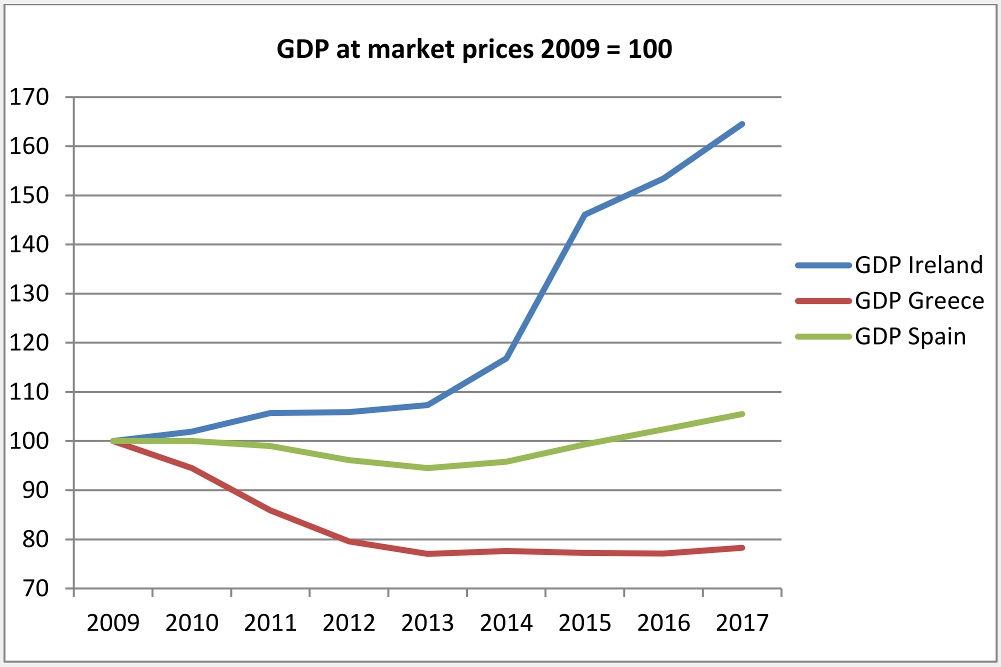
The above literature survey indicates the particularities of the Greek case. Are these able to inform successful policies? The link between theoretical perceptions and specific policy options is given in the next section.

4. Policy options

Some, if not all, mainstream economists consider a short-lived government intervention necessary at least as far as depressed markets are concerned (Kalfaoglou, 2016). In these cases, governments usually act so as to uphold confidence and perk up expectations held by agents in both financial and product markets. In this context, there is the "active" and the "passive" way to affect the NPLs' ratio (Balgova, Nies & Plekhanov, 2016). The "active" relates to the volume of NPLs and the numerator of the ratio. The "passive", on the other hand, concerns credit growth which affects the denominator of the NPLs' ratio. Hence, policy proposals such as setting up Asset Management Companies, are associated with the "active" way, whilst the renewed interest in development banking seems to be of the "passive" type.

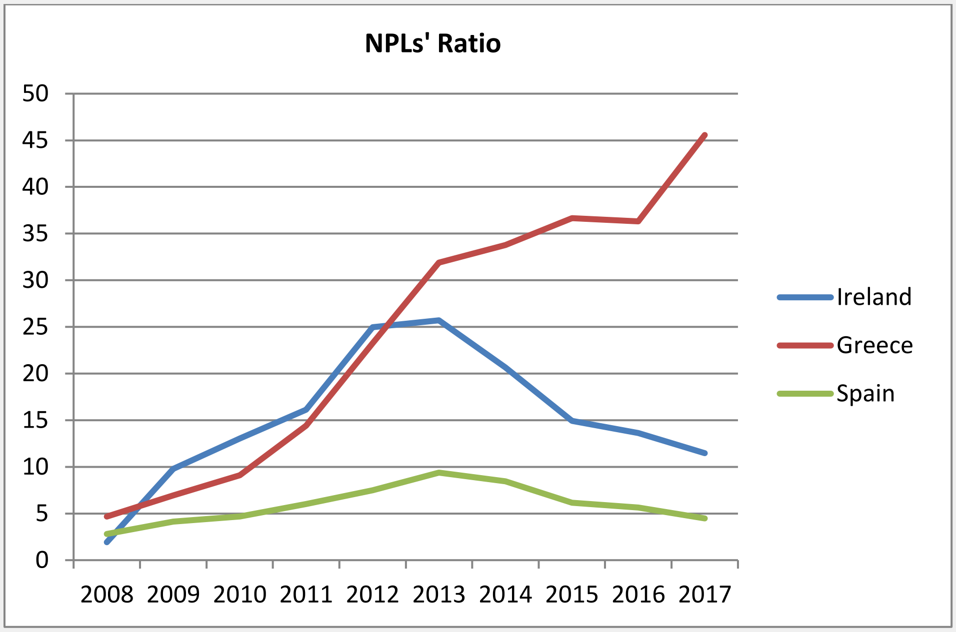
Observing the above solutions under the light of European experience provides a sense of country specificity. For example, home mortgages were treated differently in Ireland and Spain because of institutional diversities between the two countries (Rubio Gouveia & Álvarez, 2017; Coffey, 2017). On the other hand, development banks worldwide acted anti-cyclically and raised considerably their lending activity during the period 2010-2015, despite their enduring problems concerning corporate governance and financial viability (De Luna-Martinez, 2017; De Luna-Martinez & Vicente, 2012). Besides, *The Economist*'s article of March 7th, 2019 entitled "National development banks are back in vogue" indicates the importance of these organizations in the post-crisis era.

Table 1: GDP index: Ireland, Spain and Greece



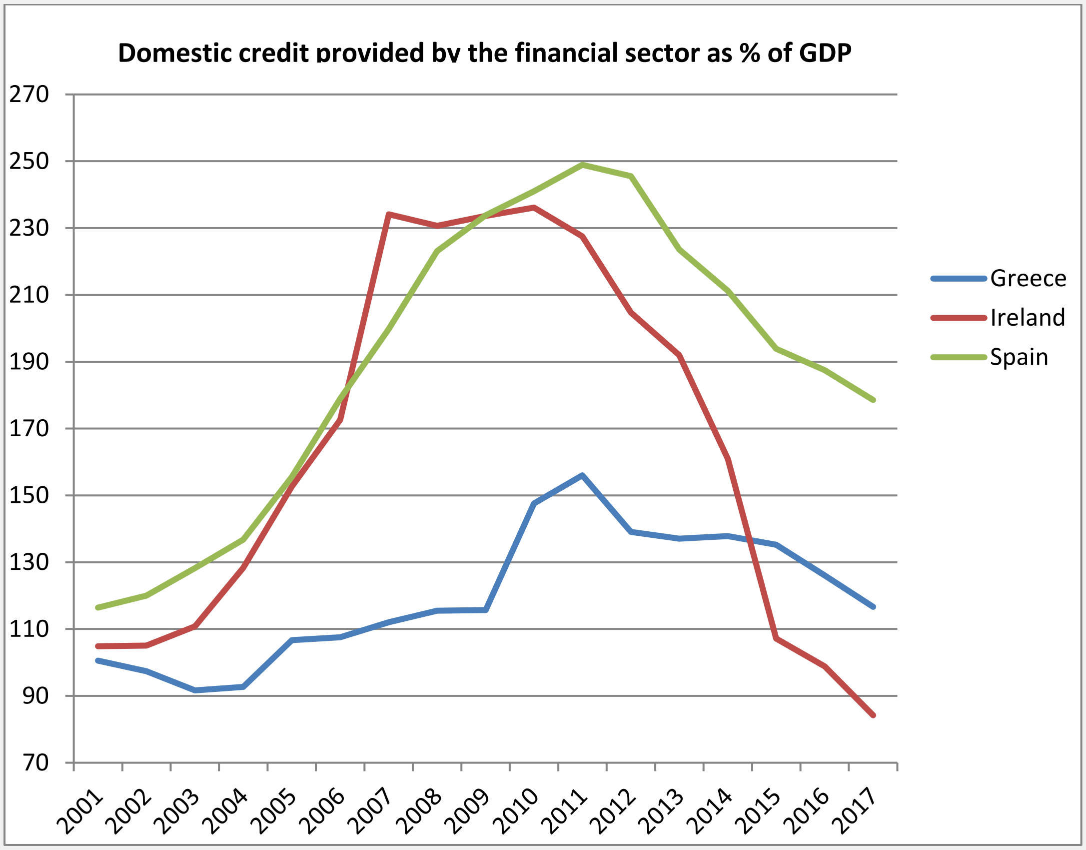
Source: Eurostat (2019)

Table 2: NPLs' ratio: Ireland, Spain and Greece



Source: World Development Indicators; World Bank (2019c)

Figure 1: Domestic credit provided by the financial sector as % of GDP



Source: World Development Indicators; World Bank (2019b)

Country specificity relates to differences in policies to cope with the crisis. These different policies, in turn, stem from particularities which are characteristic for each case and emerge from the historical evolution that shaped institutions and agents' mentalities in different countries. Eventually, solutions can only be country-specific because of the unique regulatory, economic, social and cultural environment in each country. However, country specificity should blend with the theoretical framework described above for an alternative policy response to take shape.

Greece, the most severely recession-hit European country during the last decade, has yet to learn by its fellow-European experiences. The graphs above show how the Greek economy differed from the Spanish and the Irish economy during the last decade. Greece has had the larger and most enduring fall in GDP as compared to the other two economies. As a consequence, it experienced the highest NPLs ratio accompanied with a rising trend as opposed to lower levels and falling trends for the other two economies. Domestic credit growth as percentage of GDP was much lower in the Greek economy throughout the whole period 2001-2017. Nevertheless, all three economies faced almost the same falling pattern in domestic credit from 2010 onwards.

The above indicate the severity of the problem in the Greek economy and the need for the government to step in both in the process of reducing NPLs and in promoting policies that would encourage long term growth. In this respect, alternative policies should include both those of the "active" and the "passive" kind. Setting up a centralized Asset Management Company seems to be necessary. Yet Greece is still hesitating among two plans, the one originally proposed by the HSFS and the other by the Bank of Greece (Hope, 2019). Yet, even if one of these plans is finally chosen, this would be half the solution and certainly not a long-term one. According to my opinion, a successful comprehensive policy would opt for the establishment of a development bank to boost targeted credit growth in the Greek banking system and secure economic recovery. In this vein, recently the Greek parliament voted a Bill for the establishment of Hellenic Development Bank which seems to satisfy, at least partly, the above criteria (Loizos, 2019).

Conclusion

Concluding this short note let me express my argument in a nutshell. The Greek problem of non-performing loans has its own particularities concerning the factors that fueled bad loans during the last decade. Such determinants included the deteriorating macroeconomic environment along with institutional and behavioural factors that contributed to a rising proportion of strategic defaults. This paper argues that taking into account these generators of NPLs within a heterodox theoretical framework that stresses credit growth, provides the tools for an alternative long-term successful policy towards a solution to the NPLs' problem in Greece.

References

Asimakopoulos, I., Avramidis, P., Malliaropoulos, D. & Travlos, N. (2017) "Micro-behavioral Characteristics in a Recessionary Environment: Moral Hazard and Strategic Default", in Monokroussos, P. & Gortsos, C. (eds.) *Non-Performing Loans and Resolving Private Sector*

Insolvency. Experiences from the EU Periphery and the Case of Greece, Palgrave Macmillan.

Bank of Greece (2019) "Total Greek Banks (Commercial and Cooperatives. Evolution of Total Loans and Non Performing Loans (Solo Basis-On Balance) [NPLS_2002_2018H1_FINAL_BoG_ENG]", Retrieved from *Bank of Greece*; https://www.bankofgreece.gr/Pages/en/Statistics/loans.aspx.

Balgova, M., Nies, M. & Plekhanov, A. (2016) "The economic impact of reducing non-performing loans", *European Bank for Reconstruction and Development*, Working Paper No 193, (October).

Coffey, S. (2017) "Non-performing loans in Ireland: Property development versus mortgage lending", in Monokroussos, P. & Gortsos, C. (eds.) *Non-Performing Loans and Resolving Private Sector Insolvency. Experiences from the EU Periphery and the Case of Greece*, Palgrave Macmillan.

De Luna-Martínez, J. (2017), "Findings of the 2017 Global survey on Development Banks, presentation at the World Bank Group Global Knowledge and Research Hub", Malaysia, September 19.

De Luna-Martínez, J. and Vicente, C. L. (2012), "Global Survey of Development Banks", World Bank Policy Research Working Paper No. 5969, Washington, DC: World Bank.

Eurostat (2019) "GDP and main components (output, expenditure and income), [nama_10_gdp]", retrieved from https://ec.europa.eu/eurostat/search?p_auth=k6iourSr&p_p_id=estatsearchportlet_WAR_estatsearchportlet&p_p_lifecycle=1&p_p_state=maximized&p_p_mode=view&_estatsearchportlet_WAR_estatsearchportlet_action=search&text=GDP+and+main+components+%28output%2C+expenditure+and+income%29+%5Bnama_10_gdp%5D%09%09%09%09, 15/052019.

Hope, K. (2019) "Greek banks play long game on road to recovery", *The Financial Times,* May, 20.

Kalfaoglou, F. (2016) "Alternative NPLs Resolution Regimes. A Case Studies Approach", *Bank of Greece Economic Bulletin*, No. 41 (July), pp. 45-70.

Kapopoulos, P., Argyropoulos, E. & Zekente K.-M. (2017) "Financial Distress, Moral Hazard Aspects and NPL Formation Under a Long-Lasting Recession: Empirical Evidence from the Greek. Crisis", in Monokroussos, P. & Gortsos, C. (eds.) *Non-Performing Loans and Resolving Private Sector Insolvency. Experiences from the EU Periphery and the Case of Greece*, Palgrave Macmillan.

Keynes, J. M. (1936) The General Theory of Employment, Interest and Money, reprinted in The Collected Writings of J. M. Keynes, Vol. VII, 1973, Macmillan.

Loizos, K. (2019) "Breakthroughs in development financing: The Hellenic Development Bank", *Greek Economic Outlook* (39:47-49).

Magnus, M. Deslandes, J. and Dias, C. (2018) "Non-performing loans in the Banking Union. Stocktaking and challenges", *European Parliament* Economic Governance Support Unit, Briefing, October, PE 614.491.

Minsky, H. P. (1982) Can "It" Happen Again? Essays on Instability and Finance, Armonk, New York: M. E Sharpe.

Monokroussos, P. & Gortsos, C. (eds.) (2017) *Non-Performing Loans and Resolving Private Sector Insolvency. Experiences from the EU Periphery and the Case of Greece*, Palgrave Macmillan.

Monokroussos P., Tsomakos, D., Alexopoulos, T. & Tsioli E.L. (2017) "The Determinants of Loan Loss Provisions: An Analysis of the Greek Banking System in Light of the Sovereign Debt Crisis", in Monokroussos, P. & Gortsos, C. (eds.) *Non-Performing Loans and Resolving Private Sector Insolvency. Experiences from the EU Periphery and the Case of Greece*, Palgrave Macmillan.

Mylonas, P. & Magginas, N. S. (2017) "Non-performing Loans in the Greek Banking System: Navigating Through the 'Perfect Storm'", in Monokroussos, P. & Gortsos, C. (eds.) *Non-Performing Loans and Resolving Private Sector Insolvency. Experiences from the EU Periphery and the Case of Greece*, Palgrave Macmillan.

Niggle, C. (2006) "Evolutionary Keynesianism: A Synthesis of Institutionalist and Post Keynesian Macroeconomics", *Journal of Economic Issues*, 40(2), pp. 405-412.

Roubini, N. & B. Rosa (2018) "Is the next financial crisis already brewing?", *The Financial Times*, September, 11.

Rubio, A., Gouveia, O. & Álvarez, J. M. (2017) "The Spanish Experience", in Monokroussos, P. & Gortsos, C. (eds.) *Non-Performing Loans and Resolving Private Sector Insolvency. Experiences from the EU Periphery and the Case of Greece*, Palgrave Macmillan.

The Economist, "National Development banks are back in vogue", *The Economist*, March 7, 2019.

The Economist, "The next recession. How bad will it be?", *The Economist*, October 13, 2018.

The Economist, "The rise of millennial socialism", *The Economist*, February 16, 2019.

World Bank (2019a) "Bank Non-Performing Loans to Gross Loans for Euro Area (DISCONTINUED) [DDSI02EZA156NWDB]", retrieved from FRED, *Federal Reserve Bank of St. Louis*; https://fred.stlouisfed.org/series/DDSI02EZA156NWDB, February 4, 2019.

World Bank (2019b) "Domestic Credit Provided by Financial Sector (% of GDP), World Development Indicators, [API_FS.AST.DOMS.GD.ZS_DS2_en_excel_v2_10475413]", retrieved from *World Bank Group*, https://data.worldbank.org/indicator/FS.AST.DOMS.GD.ZS, February 4, 2019.

World Bank (2019c) "Bank nonperforming loans to total gross loans (%), World Development Indicators, [API_FB.AST.NPER.ZS_DS2_en_excel_v2_10363405]", retrieved from *World Bank Group*, https://data.worldbank.org/indicator/FB.AST.NPER.ZS, February 4, 2019.

Income Inequality and Financialisation: A brief sketch for interpreting the Greek crisis

Vlassis Missos

Abstract

The paper offers a brief sketch for interpreting the 2009 Greek economic crisis based on the relation between income inequality and financialization. In the absence of a public sector investment policy to boost aggregate demand, the growing dependence of the Greek state on financial intermediation was politically justifiable on the grounds of its social role in providing the funds necessary for the incessant operation of the welfare system. Through this process, the inherent tendency of income inequality to rise was overlaid by the level of social transfers. However, in sharp contrast to the mainstream approach, the cause of public debt increase is to be found on the insufficient level of tax revenues rather than excessive social expenditures. The imposed measures of austerity policy have placed the burden of fiscal adjustment to the lower parts of income distribution, while at the same time, Europe's institutional framework and rigorous fiscal policy rules did not permit of any other viable way out of this debt-inequality trap.

1. Introduction

The general level of economic activity in Europe seems to have been quite moderate and unable to overcome the causes of the 2007/8 crisis, which may be found in the long-run developments of income inequality since the early 1980s. Particularly in Greece, the inherent tendency of income distribution towards inequality was mitigated by the easiness with which governments were having access to inexpensive funding offered by the international capital markets. For almost a decade, external public debt was piling up and new government bonds were issued at yields which were relatively lower in comparison with these which would have been, unless Greece had kept its own devalued currency and hadn't decided joining the Eurozone back in 2002. But access to low interest funding is the one side of the story. The other is how these funds were being repaid.

Up to 2009, the combination of high growth, decent real wages and generous cash welfare transfers were able to maintain the purchasing power of the population whose standards of living were – in the meantime – significantly improved. Income increase, however, was proved unstable and openly exposed to various sorts of international risks. A year later, immediately after the announcement concerning the level of fiscal deficit that was settled down to 15.1%, the Greek government bonds were unanimously excluded from the international capital markets and it was until 2017 that the first hesitant attempts to roll over old debt were being launched by the issuance of new bonds. That incident, i.e. the exclusion from the capital markets, has gathered much of attention and has certainly played a critical role in marking the beginning of an unprecedented drop in the standards of living. The true causes of labor depreciation, however, are lying in the broad historical trend of financialisation, the present forms of which have reached fruition within the era of neoliberalism (Sawyer, 2014).

At an international level, the institutional structure of financial intermediation has gone through some significant changes not only in its scope, but also in its potentials. Since the early 1980s, public agencies were gradually losing their legitimacy and authority in financing their governments. From a political economy perspective, the last four decades have witnessed the formation of a new and unregulated framework through which, the spread of the crisis to other economies has been facilitated. As it has been argued, "the associated collapse of the mortgage bond and derivatives markets [in the USA] precipitated a worldwide flight to safety, which in Europe developed into the crisis of sovereign debt for Greece, Ireland, Portugal, and Spain" (Galbraith, 2012, p. 4). On that account, the exceptionally long period of recession in Greece may be seen as the repercussion of some broader institutional changes occurring at the centers of international finance, that were capable of concealing the fragile state – as well as the reasons behind – of the relatively lower income inequality, documented before 2009 in Greece.

It is not necessary to appeal to some radical and thought-provoking arguments in order to understand the manner in which financialization and inequality are intermingled. Following a Kaleckian tradition, Eckhard Hein (2012, p.1) has maintained that "the severity of the financial and economic crises can only be understood if the changes in income distribution over the last decades […] are taken into account". It has thus become a common ground that the subject matter of inequality is directly related with several aspects of financial operations. In the current essay the combined effects of financialisation and income inequality are underlined, as an attempt to make their association apparent. More precisely, it is asserted that the basic trends of inequality in Greece were affected by the state's imposed financing techniques failing to provide support to an unstable and fragile level of income that was largely maintained by the issuance of new public debt. These – along with other – major technical and political developments have been embedded in a set of policies that have ended up promoting national and international financial markets' deregulation.

2. Financialisation as a new phase of capitalist accumulation

According to a widely used rationale, financialisation is directly connected with "the increasing role of financial motives, financial markets, financial actors and institutions in the operation of the domestic and international economies" (Epstein, 2005, p. 3). In this respect, the growing dependence of the state on financial intermediation has particularly characterized a historical era in which, financial practices have dominated over all other forms of economic activity and have become the main vehicle for funding the deficits generated by the system of social welfare. Particularly for the case of Greece, high public deficits can primarily be attributed to the low level of public revenues as well as to the unbalanced dynamics of the system of social welfare, whose level of expenditures could no longer be sustained without resting on the issuance of new debt.

Leaving Greece and other specific country-cases aside, we may refer to the work of Zwan (2014) and Palley (2007) according to which financialisation is approached in three different but complementary, ways. Firstly, the importance of finance has been understood as a new regime of capitalist accumulation. Other authors have also called this new phase as "finance-led capitalism" (Lapavitsas, 2011) or "financial capitalism" (Tridico, 2017) to capture the increasing role of the *rentiers*, i.e. the prosperous social class whose interests are associated with making less funds available for investment in the manufacturing or in the primary sector of the economy. Secondly, financialisation has also been characterised by the increasing power of the shareholders – as opposed to that of workers – in influencing the process of decision-making. In a substantial manner, financialisation has been tackled as a factor contributing towards the adjustment of investors' behavior. All different types of market participants have engaged themselves in seeking opportunities for yielding large potential payoffs within the shortest possible period of time.

Lastly, financialisation is being understood as a particular way our everyday life has been shaped, so as to think, take decisions and act in a financial manner. As a result, people have acquainted certain skills and thought concepts for evaluating the terms of their private retirement schemes for example or, deciding whether the so called "private investment strategies" are for their own interest (for example, bank clients are asked to select whether to place their savings in a bank account or in corporate bonds etc). Our perception concerning the market is constantly co-formed by the easiness with which we daily get ourselves involved in legal contracts containing financial arrangements. These practices contribute in making us more open and receptive to the idea of a freely operating market system founding upon the basis of equality. Due to a widely shared idea, the bargaining that takes place between individual debtors and institutional creditors is developed upon a mutually beneficial relationship of fairly distributed information between them. However, this idea is out of touch with the way things really are.

The lack of a solid and reliable regulatory framework to ensure confidence between individuals and financial institutions usually places an uneven burden of responsibility to the former. Undoubtedly, the most striking example of this unsymmetrical relation is to be found in the burst of the subprime mortgage loans bubble of 2007. At the end of the day, rather than having a state of capitalism which is described by the so called “euthanasia of the rentier” as Keynes has suggested, financialisation is supposed to have led to the opposite outcome of enhancing the authority of the *rentiers* at the detriment of the wage-earners. In this context, employees’ consumption is all the more based on debt that becomes necessary to compensate for the depressing demand effects of this financial stage of capitalist accumulation.

This rather complicated process may be attributed to the role of the stock market on the one hand and on the other to the housing price booms, each contributing towards a rising amount of wealth upon which households are given the opportunity to borrow. From that perspective, financialisation corresponds to the development of various new and innovative instruments through which the lower household income brackets gain access to finance. For example the practice of home-equity lending is an instrument with a multiplicity of political extensions. A household borrows from a commercial bank in order to buy a house, the value of which allows for the household to have access to credit. This transaction concerns a house or a flat which the borrower wouldn’t have bought if he didn’t have the money loaned in the first place. But this is not a problem *per se*. The problem begins when this risky practice remains poorly regulated and becomes the basis upon which other financial products are being linked, such as mortgage-backed securities, which may have significant consequences in the manner a crisis is being unfolded.

3. How inequality and financialization are associated?

In the recent literature it has been indicated that the channels relating inequality and financialisation to each other appear to be numerous and even complex. Among the various approaches followed by several studies, a widely shared view focuses on the potential outcome of financialization to compensate for the depressing trends of the aggregate demand. Here, the interpretation of the financialisation-inequality debate maintains that household borrowing was facilitated by a lax financial regulation that was able to repress and control for the inherent tendency of income distribution to worsen. Some countries have relied on a debt-led private consumption demand as one of the main drivers of aggregate demand and GDP growth that has also allowed them for many years to sustain rising deficits in their trade and current account balances.

On the other hand, the practice of issuing new private and public debt in order to maintain overall consumption at a level appropriate for the rate of employment to be sustained, has scaled the fragility of economic performance upwards. According to Palley (2012), after 1980s, the gradual deregulation of the general legal framework within which financial institutions were operating, unveiled a process that was characterized as a “race to the bottom”. As the neoliberal era of unrestricted financial capital mobility was unfolded, governments, in their attempts to attract funds and in order to enhance fix capital formation, were more and more forced to shift the tax burden on the shoulders of the wage earners. These broadly historical and political economic developments have contributed to the establishment of a more volatile state of income distribution and have contributed in the transformation of the general growth model so as to rely further on debt and asset price inflation to drive demand. In another fashion, Liberati (2007) has argued in favour of the efficiency hypothesis, i.e. the negative relation between capital openness and the size of government expenditures. His study has concluded that the increasing rate of capital mobility may affect the level of taxes while render the task to maintain the magnitude of social spending, more difficult. In that way, governments may choose to apply fiscal consolidation policies that will eventually affect the amount of social transfers to be redistributed.

From that point of view, the idea of a long-run declining trend of income tax progressivity in favour of the top income percentiles that has been pointed out by Atkinson et al. (2009) exhibits another interesting effect of the broad changes that occurred during the era of financial capitalism. Income concentration at the upper socio-economic group may be expected to have an impact on the overall demand, as the top income groups are anticipated to reduce their spending shares on consumption. Cynamon and Fazzari (2013) have examined the relation between the bottom 95% and the top 5% of the income distribution, suggesting that the main reason why demand growth did not significantly fall in the US during the neoliberal era at the same time as inequality was rising, should be attributed to the increase of the household debt of the lower 95% that kept the level of consumption high while generating a broad environment of financial fragility.

Moreover, Hein (2012) has proposed an approach that combines several aspects of the vast literature on the subject. In this context, redistribution takes place in three distinctive dimensions, as functional, personal and one which concerns the development of the top incomes. The first one, he suggests, constitutes the primary basis for the changes in all other types or dimensions. In addition, financialization affects the level of income distribution via three other channels:

i) Through the changes that have occurred in the sectoral composition of the economy which shifts the economic activity and gross value added, away from non-financial and governmental corporations.

ii) Through the increase in top management salaries. This includes the interest payments as well as rises in profit claims which are imposed on the corporate sector by shareholders.

iii) Through the weakening of the bargaining power of workers and trade unions. The latter has also become apparent in Greece where the new flexible types of labo*u*r contrac*ts are under-unionis*ed.

As shown in Table 1, the magnitude of the adjusted-wage share or the ratio between nominal compensation per employee over gross value added per employee is designated for countries that belong to the group of EU-15. It appears that, with the exception of the UK, during a period which extends from mid-1980s to mid-2010s, the share of wages has declined substantially (see last column) in all other countries. Particularly in Greece, the wage-share seems to have been stable for the whole period under consideration, but its level has remained the lowest in comparison to all countries except for Ireland whose relevant share has receded heavily during the years of the crisis. Hence, within the last four decades the distribution between wages and profits has become more unequal. It is also worth mentioning that during the years of growth (mostly before 2009) the intensity of wage share contraction was higher than that which took place during the years of recession. This result is an indication that the growth model was inherently unequal in its core, judging from the manner in which the growing production was distributed to labor.

Table 1: Adjusted wage-share for EU-15

	Avg. 1980-1989	Avg. 1990-1999	Avg. 2000-2009	Avg. 2010-2018	Change 1980-1999	Change 2000-2018	Overall change
Austria	69.8	67.0	61.9	62.4	-2.7	0.5	-7.3
Belgium	69.2	68.7	67.1	66.8	-0.5	-0.3	-2.4
Denmark	68.4	64.6	64.8	64.7	-3.8	-0.2	-3.7
Finland	70.3	65.8	60.2	63.2	-4.5	3.0	-7.1
France	72.1	66.2	64.7	66.9	-5.9	2.2	-5.2
Germany	67.1	58.0	62.3	62.3	-9.1	0.1	-4.8
Greece	59.3	55.1	57.6	58.3	-4.3	0.6	-1.0
Ireland	68.2	60.2	53.2	45.9	-8.0	-7.3	-22.3
Italy	64.7	61.4	59.5	61.0	-3.4	1.4	-3.8
Luxembourg	59.2	56.8	58.9	58.9	-2.5	0.0	-0.3
Netherlands	69.9	67.5	64.4	64.7	-2.4	0.3	-5.2
Portugal	65.5	66.7	66.7	61.0	1.1	-5.7	-4.5
Spain	68.1	66.3	63.1	61.2	-1.8	-1.8	-6.9
Sweden	63.2	61.1	60.9	62.1	-2.1	1.1	-1.1
United Kingdom	63.1	61.4	64.9	66.3	-1.7	1.5	3.2

Source: European Commission

4. Public debt and inequality

Up to a point, the international developments in the sphere of financial instruments and intermediation can be found responsible for the particular manner public debt is managed and understood. According to the mainstream point of view, public debt growth is attributed to the government's hesitant stance to apply a set of disciplinary fiscal policies such as the rationalisation of social expenditures.[24] It should go without saying that under the particular circumstances and especially under the multiple restrictions included within the Fiscal Pact, the main aim of fiscal policy in Europe has been targeted on the drastic reduction of budget deficits, to levels that would allow the credit rating agencies to approve for the creditworthiness of the state. In addition, financialisation, as a concept which characterises a historical phase of the capitalist economies, has seldom been extended so as to incorporate the changing attitude of the institutional bodies involved in the process of managing public debt. Apart from the introduction of several novel techniques surrounding market practices and the channels through which governments can have access to finance, further attention should be drawn upon the framework describing the options the European member-states really possess when deciding the issuance of new debt – especially in the case when the overall tax revenues do not suffice for their annual financial needs to be covered.

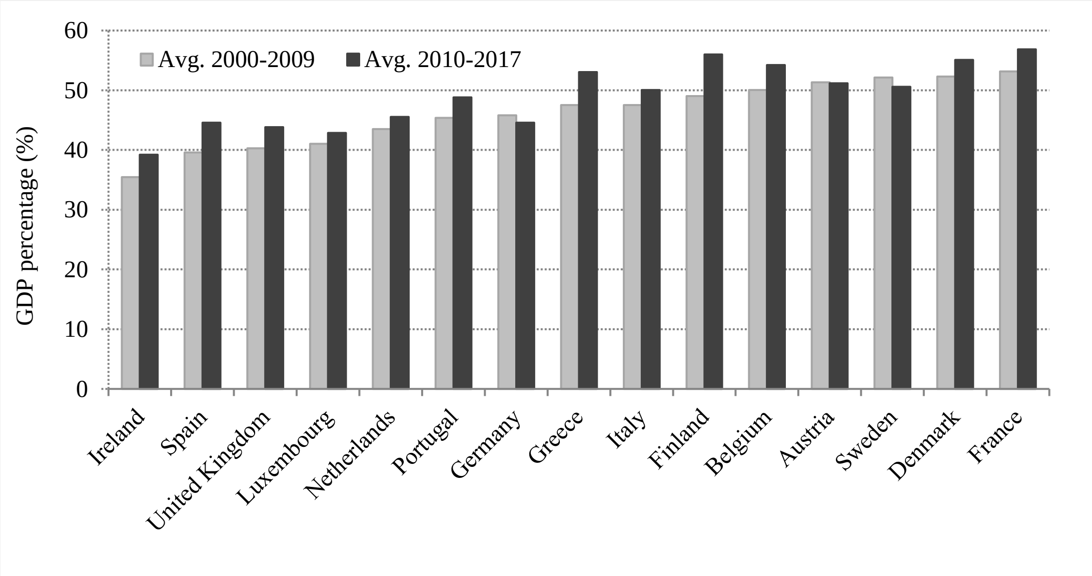
Long established practices such as financing the state directly through a fully fledged system of central banking facilities, or setting the level of interest rates administratively have changed over the years and have given way to open market activities. Due to the current state of economic affairs, the scope of the European Central Bank has been limited between monitoring inflation and setting the basic interest rate. That is another way of interpreting the essence of the relevant parts of the Maastricht Treaty in which the basic monetary tasks performed by the ECB are officially identified (art. 107). Early critiques of the Treaty (Buti and Sapir, 1998) have also argued that the ECB's institutional independence cannot be sufficiently evaluated unless it is separated between two parts, the political and the economic one. The first concerns the manner in which deflationary targets are determined, while the second focuses on the process of choosing the means for the achievement of these targets. Hence, public debt can only be serviced, managed and issued by adherence to private actors and through open market agreements.

The widely spread idea that public debt is primarily the outcome of excessive and generous expenditures of the welfare state lacks strong and sufficient empirical evidence, if not justification. According to a different view on the subject, it can be argued that during the last two decades, the level of annual budget deficit in Greece was mostly attributed to a relatively low level of taxes rather than to a high level of expenditures. In Figure 1 countries of EU-15 have been classified from left to right, according to their level of general government expenditures,

[24] For a critique on this view, see Minsky et al. (1994).

distinguishing between the average of two successive periods. The first period stretches from 2000 to 2009 covering the years of high growth while the second one is extended from 2010 to 2017, including mainly the years of recession or low growth in Europe. Clearly, as far as the level of general government expenditures is concerned, Greece stands in the middle of EU-15. During the first period the average amount of public expenditure in Greece was estimated around 47.5 per cent of GDP, whereas in Denmark the same magnitude was 52.3 and 53.2 percent for France. As a consequence, the Greek government expenditures were very close to the European average, an indication which clearly suggests that its performance was far from being designated as excessively high. Accordingly, the abrupt derailment of public debt cannot be exclusively attributed to the level of expenditures.

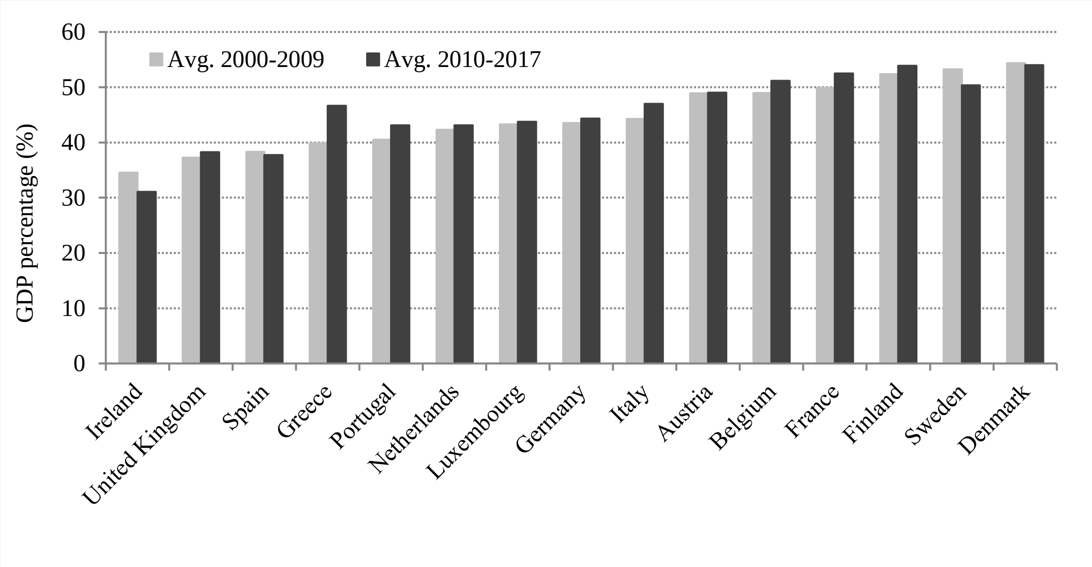
Figure 1: Total public expenditure as GDP percentage (%), two periods averages for 2000-2009 and 2010-2017, EU-15



Source: Eurostat

From the revenues point of view, the general picture is somewhat different. Following the same way of presenting the government data, Figure 2 depicts the two-period averages of public revenues in terms of GDP percentage points for the countries of EU-15. From this side of the deficit and for the period between 2000 and 2009, the Greek public revenues were estimated to be close to 38.3 per cent of GDP, which is the fourth lowest percentage level after Ireland, UK and Spain. On the other side, the average ratio for Germany, France and Denmark was 43.5, 49.9 and 54.3 per cent, respectively. Combining the two figures, we come to conclude that the level of deficit in Greece was associated more with the relative lack of revenues rather than of exaggerated expenditures.

Figure 2: Total public revenues as GDP percentage (%), two periods averages for 2000-2009 and 2010-2017, EU-15



Source: Eurostat

To conclude, the upsurge of income inequality that took place within the years of high and persistent recession in Greece (2009-2016), is inextricably connected with the loss of confidence and the concomitant exclusion of the Greek state from the international credit markets. Hence the Greek public debt could no longer be refinanced at a sustainable rate of interest and Greece was eventually defaulted. After that major financial incident which took place during the first months of 2010, it became apparent that the financial sources of the social welfare system were inadequate to support for the level of social expenses needed to maintain the previous amount of cash transfers to households as well as to individual beneficiaries. The mix of imposed austerity and internal devaluation measures were thus imposed as the only politically accepted way out of this impasse, that was furthermore respected the rules and regulations of the EU. Any other proposal confronting the rules of the EMU's fiscal policy was beyond the range of a politically manageable possibility. During the course of the recessionary period in Greece, people's disposable income was unequally contracted and the burden of fiscal and economic consolidation was disproportionately fallen on the shoulders of the lower income brackets.

References

Atkinson, A., Piketty, T. and Saez, E. (2009) *Top incomes in the long run of history*, Cambridge, MA: National Bureau of Economic Research.

Buti, M., Sapir, A. and Ravasio, G. (1998) *Economic policy in EMU*, Oxford: Clarendon.

Cynamon, B. and Fazzari, S. (2013) "Inequality and household finance during the consumer age", Working Paper n. 752, Levy Economics Institute.

Galbraith, J. K. (2012) *Inequality and instability*, Oxford: Oxford University Press.

Epstein, G. (2005) *Financialization and the world economy*, Cheltenham and Northampton: Edward Elgar.

Hein, E. (2012) *Macroeconomics of financed-dominated Capitalism*, Cheltenham and Northampton: Edward Elgar.

Lapavitsas, C. (2011) "Theorizing financialization", *Work, Employment & Society*, 25(4), pp. 611-626.

Liberati, P. (2007) "Trade openness, capital openness and government size", *Journal of Public Policy*, 27(2), pp. 215-247.

Minsky, H. Delli Gatti, D. and Gallegati, M. (1994) "Financial institutions, economic policy and the dynamic behavior of the economy", Working paper, n. 126 (October), Levy Economics Institute.

Palley, T. (2007) "Financialization: what it is and why it matters", Working Paper n. 525, Levy Economics Institute, N.Y.

Palley, T. (2012) *From financial crisis to stagnation: the destruction of shared prosperity and the role of economics*, Cambridge: Cambridge University Press.

Sawyer, M. (2014) "What is financialization?", *International Journal of Political Economy*, 42(4), pp. 5-18.

Tridico, P. (2018) "The determinants of income inequality in OECD countries", *Cambridge Journal of Economics*, 42(4), pp. 1009-1042.

Zwan, N. van der (2014) "Making sense of financialization", *Socio-Economic Review*, 12(1), pp. 99-129.

Part III – Alternatives

The EU as a source of causes for financial crises – what can be a productive debate on left alternatives, and what could be meaningful left alternatives?

Or: Let's be revolutionary realists and talk about financial crises!

Judith Dellheim

Abstract

The specific question I addressed is the following: Which elementary insights can followers of Marx's epistemological and political perspectives gain from a critical re-reading of the EuroMemorandum documents (EuroMemo(s)) since 1997 – specifically concerning the causers and causes of financial crises and the debate about specific alternatives to the current Euro system? My critical re-reading of the past „Euro-Memos" should help to understand, on the one hand, developments and problems of the conditions for acting politically by democratic alternative forces, while, on the other hand, challenging the on-going work on political strategies and societal alternatives in the EU and Europe.

I have arrived at the following main conclusions:

1. *The EuroMemo Group should a) organise a permanent collective reflection process of its own work and its efficiency and b) take a closer look on actors and agencies which are already (or may possibly develop to be) interested in the EuroMemo Group.*
2. *The further work of Marxian scientists within and beyond the EuroMemo Group should focus on a) the actors/agencies of the socialisation processes driven by the accumulation of capital and leading to the setting, modifications and the reproduction of societal hierarchies, b) a debate on alternatives to the current Euro system, based on an historical approach and oriented on changing actors/agencies and the relations between them, c) a renewed understanding of socialist policy, combining pragmatism with principles, knowledge on detail and concrete scientific insight with the structural findings of political economy in a critical Marxian tradition.*

1. Some preliminary considerations

The noun “alternative” was borrowed from the French word “alternative” in the 17th century. The original meaning was "alternating, forming another possibility", offering a choice between two “alternatives“. But very often, the term now refers to one of several existing possibilities.[25] Here, in our argument, “alternative” is understood as a possibility alternative to actually existing reality (and referred back to Ernst Bloch’s usage of the term as a key philosophical category). With reference to Aristotle, he distinguished two forms of possibility: the "being in possibility", i.e. being in latency and tendency, and the "being according to possibility", which can be made possible in accordance with the given, actually existing reality. Bloch differentiated four dimensions of the category of possibility referring to the work on changing reality:

1. The formally possible – that which consists in the affirmation of all that does not contradict the requirements of logic (= formally permissible).
2. The objectively possible – that which is possible according to our state of knowledge about objective reality (= epistemologically presumable).
3. The objectively possible according to the object – i.e. that which is theoretically possible according to the object (= open according to the object).
4. The objectively possible according and appropriate to the object – the latency and tendency within existing reality which can be realised in dynamic processes (= corresponding to the real potential of material processes) (Bloch, 1959; Bloch, 1975).

In Bloch‘s understanding the challenge we face here is to look for all circumstances in order to politically make use of them, in order to change the existing social reality towards the great historical possibility, as discovered by Marx – i.e. the historical possibility to realise a society of free and equal people, living together in solidarity and in respect towards nature. This possibility will arise when the capitalist mode of production has stopped to be necessary for the organisation of the societal production, because the wage labourers have become able to take over this process by themselves. In the establishment and development of the domination of the capitalist mode of production the organizing function assured by capital so far has grown independent from capital ownership. But these workers must be effectively willing to build up such a society and, in so doing, to act in solidarity among themselves and with the other

[25] https://de.wikipedia.org/wiki/Alternative.

oppressed and exploited categories of modern bourgeois societies, above all the colonialised people. Marx has also stressed the real tendencies which could destroy this historical possibility: The wage labourer could be integrated into the accumulation process of capital, without generating any desire to break with his role, she/he could be also integrated by the everyday life of modern bourgeois societies, excluding any idea and activity of re-constructing society in a transition process to human liberation, and she/he could be also simply destroyed, and their natural living conditions could, indeed, be destroyed. The decisive question, here, will be about the organisation of the collective will and the power of a critical mass of people struggling democratically and solidaristically to overcome the destructive tendencies of societal development.

The European Union as such constitutes a political challenge in this respect and it offers space for these struggles. Accordingly, there is always the question of how to organise the broadest possible and the most radical political alliances. They will need, of course, as many alternative economists as possible. Talking about „alternative“ has three relevant meanings here: *first*, being in difference to the political mainstream, being oriented towards a decent life for everybody; *second*, being in difference to the especially scientific (or medicinal) mainstream; *third*, working together in order to make different political and theoretical positions and approaches aiming at collectively creating viable alternatives to the established mainstream. These three meanings may coincide with an understanding of “alternative“ derived from Bloch’s “possibility“.

The "objectively possible according and appropriate to the object", with regard to the EU, however, will only become visible, and will be discussed and realised by the activities of actors or agencies acting within the EU. The existing EU is, *on the one hand*, a result of a societal development according to the laws of the political economy. It means that the EU is a result that cannot be explained only by Marx’s *Capital*, but it cannot be understood without it: The EU is a contradictory political, social, cultural and political organism within a territory. The economic interests of the different ruling forces are based on capitalist production relations in specific historical forms and constellations. At the same time, on the other hand, it is the result of such possibilities having been realised, brought about and made use of (or not brought about and not made use of) by very specific actors or agencies. Societal development is significantly based and connected with the socialisation of labour, i. e., among other things, with the development of a rising complexity of contexts in the very process of societal labour. The specific shape and organisation of this process determine the quantum of societal labour spent by an average organically functioning element within the societal system of the division of labour in the production of a specific good which has then to be "realised" on the market. There is a tendency towards an exchange of equivalent quantities, but these quantities are not the quantities of labour spent by the real collectives of working people, but quantities of spent labour, as it is needed for the accumulation of a certain average capital under normal conditions. It is a question of technology, and of the labour force organised by capital, i.e. of how much capital is needed for the production of a commodity which will then be realised or not realised on the market in correspondence with the quantum of capital which has been spent in its production. Furthermore, there are the competing interests of money capitalists and of industrial capitalists which effectively determine the quantity of societal labour spent in a unit of time for a specific kind of production and, thereby, determine the process of the accumulation of capital. Providing the measure for capital spent and the instrument for exchanging commodities, in order to circulate and to accumulate capital, all these functions pertain to money as a very special commodity.

The Euro is a highly contradictory measure of (modified) value[26] and pricing scale in the Eurozone and, furthermore, in the entire EU, where a very broad scale of different producers are at work. The introduction of the Euro has been caused by a power constellation of actors connected with specific interests arising in the process of capital accumulation, indeed calculating on favourable possibilities to achieve gains from globalisation in a sustainable way. The Euro underlies the monetary system of the Eurozone, which also includes in particular the determination of the coins and notes system within this currency area.

The Euro as a currency, however, is also the symbol of money recognised by the states and institutions of the Eurozone (the legal tender of the countries). Therefore, a Eurozone member cannot easily say: "We are tired of the euro and therefore leave the Eurozone". That is even less possible if (parts of) the economy had already collapsed as a result of the introduction of the Euro, or of the crisis or austerity politics which it has entailed. And if the winner or leader of the Euro system should want to leave the Euro zone, this would hurt the present losers within the system even more sharply.

A common currency system, however, also requires a common fiscal, finance and transfer system, to be backed by the leading forces, in order to enable an adequate development of each part of the system and of the system as a whole. These systems do not exist. This situation of the

[26] In the end, the price is derived from the spent capital plus a certain amount of surplus labour.

absence of such systems, as it is effectively given now, and the resulting restrictions of choices for dealing with it, result in the following: Either there will be structural reforms of the existing Euro system, filling these gaps in some way, or it could crash respectively be destroyed by its internal “winners”. But those winners are not interested in any reform which would cost more than a crash. Any crash and any further avoidance of the urgently needed reform will be, above all, a threat for the internal “losers”, i.e. the weaker Euro member countries. Financial crises are critical moments where different scenarios are possible and can become critical caesuras in history. Financial crises can arise when, at least, one significant part of the money or currency system – a bank, a state, a stock market, a large investor – has become unable to realise its function, and with its functional failure draws other relevant components of the system into a partial and temporary ruin or brings about a total systemic collapse. The problem seems to be easy to handle: At one moment, the surplus of liquidity that is already huge increases still further, speculation beyond any “reasonable limits“ is unfolding, and the suddenly disappearing, and finally missing liquidity of the other moment, proceeds to bankrupt a significant agent/agency of the system and causes a chain reaction of failures. This can take place via “normal“ speculation or lead to exacerbated waves of betting, to mass panic, crimes, misguided incentives; it brings about an unsustainable indebtedness of the weaker agents and agencies, and a further concentration of income, wealth and property, a tax policy reinforcing these effects, a liberation and deregulation of “markets“ (resp. of the participants in these markets), and then functions as an incentive for further privatisation processes, especially in the forms of a mounting privatisation of social security systems and of housing; it leads to the emergence of large amounts of unsaleable assets; and it even tends to bring about, or at least to exacerbate, natural disasters and ecological crises, as well as catastrophic famines, epidemics and technical collapses. This catastrophic development of the capitalist mode of production leads to economic crises of various kinds: crises of over- or underproduction, structural crises, cyclical crises and other varieties of economic crises, resulting in missing resource transfers, mass unemployment, poverty and structural imbalances in international trade and accounts, while scandals of large corporations, trade wars, a mounting militarisation, terrorist attacks, and wars mark its further “development” – with the result that social upheavals, social revolutions and other deep shocks or failures of reproduction conditions mark its way; again finding expression in turbulences of prices, interest rates and/or currency exchange rates, as well as inflation and/or deflation shocks – which, again lead to capital flight from one currency in another one, to an unwillingness or an inability, brought about by immediate legal, political, budget, economic and intellectual factors of ruling political actors/agencies to deal with the facts just enumerated or to face these strengthening tendencies towards a catastrophic development.

All these many and very different factors are effectively relevant for the complex and complicated processes of societal regulation taking place already, with their different and interacting societal hierarchies, especially by interacting with the hierarchies related to the command of labour resp. working people, as they determine the appropriation of the results of labour and the resulting expropriation of people. In this perspective, finally, the “competing teams" of the industrial and the finance capitalists (respectively of agencies representing both capital functions) tend to occupy a central role. And these are, of course, closely connected with the actions of state agencies. However, finally, any unbiased look at the crisis factors referred to will show: Dealing with them, working on a foreseeable financial development as a basis for planning constitutes an important challenge to the complex economic and, moreover, societal policies, as they are, more or less continuously, being elaborated and implemented. Accordingly, in the last analysis, the key question turns out to be about struggling actors/agencies with their specific and strategic interests of reproducing their domination over the process of the accumulation of capital.

The Euro crisis in 2010 as well as the persisting problems of finance in the immediately subsequent years has been an immediate consequence of a global finance crisis which came about after a bank crash in the USA leading to a global banking crisis. This moment of structural crisis had become a moment of a potential *critical caesura*, i.e. a moment when the objective possibility has been given to challenge a special historical form of the capitalist mode of production accumulation, also on the level of the patterns of everyday life which it had created. This moment could, indeed, have opened the way towards a deep process of societal transformation on the way to a socially and ecologically sustainable development of modern societies. The left wing forces, however, have not been able to make use of this moment – when large parts in many modern societies have been interested in abolishing a model of capital accumulation based on financial markets, with its orientation to speculation and with the resulting instability as a constitutive principle. The leftwing forces were not prepared to take up this challenge – simply because they lacked the resources to be secured by way of a permanent, on-going analysis of the really existing possibilities for effective political action.

2. A modest and selective stocktaking of the EuroMemoranda since 1997

The first EuroMemorandum, published in 1997, has already made clear that the planned EMU, as it had then been conceived, would increase social and economic problems in most of the member states, within the EU and in its neighbourhood. The main reasons for this diagnosis have been the economic differences within and the nonexistence of decisive elements needed for a sustainable system of money and finance. The prognosis formulated, that increasing competition would ruin many producers and workers and redistribute income, resources, property, has been solidly grounded and, accordingly, has been borne out by actually real developments. At the same time, it has been foreseen that this approach will bring about and further strengthen a dominating role for Germany. As a realistic alternative, the EuroMemo Group has proposed a new form of a European Monetary System (EMS2) described in detail that could become a stable European Currency System.

Instead of the restrictive and highly discriminatory regime, as it has then been implemented, the EMS2 would have operated either as a co-operation mechanism between EMU insiders and outsiders, or, if the start of EMU were postponed, as a general framework for monetary co-operation within the EU and with the associated CEE countries. This system of the EMS2 has been conceived so as to be protected from speculative attacks from inside or outside the EU (role of its non-Euro-members), as capable of flexible reactions to arising problems and to a solidarity-based internal and global co-operation. Its underlying fiscal regime was conceived to be the basis for the decision about a common budget of approximately 5 per cent of the GDP of the EU member states. The common budget policy, as it has been conceived, has been proposed as being oriented towards finding solutions for common problems, especially, for the urgent issue of unemployment. All of the measures and demands proposed have been backed up by referring to specific articles of the European Treaties and they have been concretised, already in the EuroMemo 1997, and in the later EuroMemos, in such a way that they would have provided an adequate basis for action programs to be defined and implemented by national governments and by European institutions (Euromemo, 1997).

The EuroMemo Group has focused on social consequences, on employment, solidarity, integration and cohesion, on a decent life for everybody. Its strategic idea has – also and especially – been oriented towards dealing with the factors named above, as they had been causing the outbreak of the great financial crisis. The specific pluralism of the EuroMemo Group, however, has hardly left sufficient room for dealing with ecological and global problems in a really consistent and effective way, based upon a radical critique of domination of the capitalist mode of production. Since 2001 there has been a certain development of the positions taken by the EuroMemo group. On the one hand, clear learning processes have been going on. But, on the other hand, a rising contradiction has begun to work effectively. While discussing ecological problems, the orientation on growth in the "real" economy, i.e. in producing rather unspecified material goods within the existing economic and societal structures, has remained unchallenged. Only the EuroMemo 2009/10 has begun to discuss this issue seriously and the EuroMemos 2008 and 2011 have included important positions based on this insight. But these elements have not been fully integrated into the overall conception of the EuroMemo and they have not been further developed as such. Similarly, the issue of militarisation and war continues to be rather marginalised within the EuroMemos. They are only mentioned from time to time, in a blatant and sharp contradiction to the declared aims and to the very self-understanding of the EuroMemo Group, although the real problems in this respect have dramatically increased over the years since 1997.

In spite of these critical remarks, it is to be underlined and acknowledged that the following early and stable proposals and demands of the EuroMemo Group for preventing or dealing with financial crises continuously have been and continue to be highly significant. On the basis of a more integrated monetary and financial system, the EU member states and the EU should exercise stronger supervision and control over internal and external financial transactions and protect the member states from unnecessary disturbances to their investment processes. Several methods for achieving this have been discussed and proposed in the EuroMemos:

i) To reinforce bank supervision through an agreement among BIS (Bank for International Settlements)members or European legislation;

ii) Making a common European currency the exclusive medium for all business activities with third countries, while, at the same time, maintaining some individual currencies and the EMS2 regime within the EU; in order to protect the common external medium, a higher transaction tax on flows involving third countries than within the EU should be established and counteract speculations and short time money flows which would increase instability;

iii) A tighter European monetary co-ordination should lead to a reassertion of a more equitable fiscality concerning capital and capital revenues; a unified system of financial supervision should address the problem of taxing property income in a more effective way. Concerning the international financial co-

> operation, a new international regime, comprising all major currencies, should be re-established. Essential elements of such a regime should be the following: an internationally issued and administered reserve medium; a mutual commitment to maintain international payments balances, or to restore balance in the case of a temporary disequilibrium; an agreement to control international capital flows and to take measures discriminating against, and thus reducing, short term flows. This means, that the factors which should be controlled by these measures have been regarded as potential factors of crisis.

Already in 1998, the EuroMemo Group had to react to financial crises in Asia and Russia, and it could refer to the far-going positions, demands and proposals it had developed at its very starting point. Consequently, the Group has emphasized the need for a self-protection of the EU and its constructive approach to international co-operation, especially with the US and with Japan. Its conception started with fully and strictly insisting in using the possibilities to act against financial crises offered by the EU law and, accordingly, in dealing with speculative financial flows from third countries. Administrative restrictions on capital imports or exports should not be avoided irrationally. The following statement has been significant for the attitude of the EuroMemo: "… the EU should make it clear to the financial world that it is determined to apply strict capital controls if necessary" (Euromemo, 1998). A regulation which "*makes the business of offshore branches or subsidiaries of European financial institutions fully subject to the rules of their home countries and of the EU" (ibid)* and its realisation have been explicitly demanded. In this context, the highly relevant position of the EuroMemo has been clearly stated: "The ECB should make it clear that it will act to ensure the stability as the lender of last resort, whenever necessary. But the ECB should also act to minimise the further socialisation of private losses and conduct a strong policy against any misbehaviour of banks and other financial institutions" (ibid).[27] In order to provide the EU with the necessary competence and flexibility to fulfill its co-ordination task, especially when facing financial crises, it has been defended by the EuroMemo Group that it be allowed to run a deficit of one per cent of GDP on its own Budget, so that debt service by the EU could not develop into a future problem. This allowed deficit could then be used to help member states facing cyclical downturns in order make it possible for them to finance specified

[27] The EuroMemo Group proposed a tax reform to increase the EU budget up to the level of five per cent of the GDP, while the budgets of the member states had to deal with explicit budget constraints – even strengthened by tax competition within the EU – and made binding by the Stability and Growth Pact (SGP) .

programmes. Another efficient instrument of budgetary co-ordination would be a contingency budget line within each member state's budget which would be implemented in the case of an unexpected downturn. The Eurocouncil or the Eurogroup should be equipped with more rights and resources to carry out their tasks, especially while facing crises.

But this demand by the EuroMemo Group needs a clarification: How does the Group propose to make sure that the additional and reinforced competencies would be sustainably used in the interest of all members and of the union as a whole? But of course, reasserting control over exchange is of strategic importance in the world economy, and control over its differential impact on the economies of the EU member countries, is a key to a co-ordinated European economic policy. The same can be said about the establishment of a system of "flexible target zones" between the euro, the dollar, and the yen. Finally, all these measures converge in the aim that a more effective control should be gained over financial markets. Accordingly, the rights and powers of the institutions of the member states and of the Euro system should be increased, while making them democratically accountable (Euromemo, 2000).

As a consequence of all this we can come to the relevant conclusion that the EuroMemo Group, from its early beginning, has already been conceptually well prepared to participate in the scientific and political debates about the emerging financial crises. It is quite obviously relevant for its important status in intellectual debates that it has regarded speculation, the missing political will to deal with speculation, law and budget constraints to interventions as prime causes and effects of financial crises. This, of course, leads to an unavoidable follow up of questions about the decision makers and their conditions – which a group of primarily economists is not well equipped to answer. Another question is how the Group has been able to make use of its relative leading position subsequently, intellectually and politically, and why this has turned out as it effectively has.

Already at this point at least three remarks seem to be justified: The continuity in the work of the EuroMemo Group has been the highest one in the field of finance. Thanks the Group, other social actors could become aware of significant inter-relations existing in this field as it has later become obvious in the global financial crisis. There was a strong co-operation between at least some members of the EuroMemo Group and of Attac. The question of the way in which both have focused on the Tobin tax without a stable and clear focus on the use to be made of the income from the tax cannot be avoided, however.

In reaction to the decision on the Lisbon strategy, the Group has focused on the democratisation of the European Union and the need for a sharp turning away from neoliberal policies towards a social orientation of EU politics. It has addressed not only the institutions of the EU and its member states, but sometimes also looked at actors, agencies, especially at social movements, above all at those struggling for the introduction of the financial transaction tax. In 2002 the EuroMemo Group added inter alia: "To secure member countries' revenue potentials, the coordination of national tax policies is indispensable; … to finance certain interventions ... we propose a fundamental reform of the system of own resources. The major part of the EU revenues must stem from GNP-related transfers from the member countries to the EU accounting for member countries' relative income positions and thereby exerting interregionally redistributive effects. As an additional revenue source we propose a harmonised tax on securities transactions" (ibid) – this is declared to be even more relevant, as "today, an international financial crisis can erupt unpredictably, triggered by the actions of a few speculators, such as banks or investors, or a fiscally imprudent government" (EuroMemo ibid). "Achieving financial stability" is a "matter of implementing coercive policies, such as taxation of speculative transactions or control of capital flows" (ibid). It is also a matter of preventing and dealing with imbalances in the trade and payment accounts enlarging the scale of crisis causes. "Imbalances of current and capital accounts between developed and developing countries are to a certain extent reasonable in order to provide development finance to countries with insufficient saving rates and/or weak credit institutions. However such imbalances can also reflect speculative capital flows; or they can lead to unsustainable positions on the side of debtor countries … In the long run balanced international relations should be reflected in current and capital account structures which avoid the continuous accumulation of external debt on the side of the weaker countries – which is unsustainable in the long run" (Euromemo, 2004). But while looking at the global problems, the question about the reasonable extension of the "long run" in time should also be posed.

As another factor of financial crises, the issue of price turbulence has been discussed by the EuroMemo Group. The oil price increases are a further factor of instability and risk, which require short-term management and long-term strategies for a shift of the energy system towards the use of renewable energy sources. Finally, the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) have repeatedly formulated their preoccupations about potential new risks for systemic financial instability. It seems that the lessons from financial crises in the 1990s have been largely forgotten and financial speculation – which drives the redistribution of income towards the top of the pyramid and creates insufficient demand – is on the rise again, including a new tide for hedge funds and other speculative instruments. Apart from China, high corporate profits do not translate into increased investment, thus illustrating a situation of persistent post-bubble problems and excess capacities in the "real economy" (EuroMemo, 2005).

The Euromemos 2005 and 2006 clearly have shown the danger of an emerging global financial crisis, by their analysis of economic developments especially in the USA. But they have also provided an orientation of the institutions in the EU on short and long term action perspectives. And also "worrying tendencies" (EuroMemo, 2006) within the EU have also been addressed (the order of enumeration does not imply any ranking): 1. "the rapid escalation and historic high levels of house prices in Britain and Spain", 2. "a move towards a more market-oriented financial system" that "makes the economy more exposed to fluctuations in asset prices", 3. "huge profits being made by certain financial groups". These profits are "the root cause of a continuing inflation of the rewards of corporate leaderships, particularly in the financial sector", 4. the "continued expansion in the activities of hedge funds" with their "particularly speculative positions, including short positions in certain assets which can lead to unlimited losses and highly geared positions which involve a heightened risk of default". They invest in a wide range of assets in and beyond organized security markets. In some of these "peripheral" markets liquidity is limited and can disappear altogether after a shock, leaving investors with unsaleable assets. These funds should therefore be required to provide full and frequent statements of their position to the authorities. Hedge funds have recently embarked on a new strategic line: they "buy themselves into large corporations and develop intense "shareholder activism" with the intention to boost share prices and to enforce disbursements of high dividends. This behaviour has a disastrous contagion effect on traditional institutional investors who are increasingly engaging in similar short-term pressures upon the management of the companies in which they have invested the many billions of contributions to pension funds and insurance companies. This has consequences … for the safety of income for pensioners in the future but also … effects upon the workers and employees in the corporations which are put under such enhanced pressure" (EuroMemo, 2006).

Consequently, the Group has demanded specific measures for a "re-orientation of financial market policies away from exclusive emphasis on lower costs, higher velocity, and shareholder protection towards systemic financial stability" (ibid). The following elements of such a re-orientation have been put forward:

A) The information system among member state authorities and informal procedures for coordinated interventions should be strengthened in three ways: the preservation of stability should be "a merely implicit concern of the ECB and … an explicit responsibility which would even justify, in the case of a grave emergency, a change in general monetary policy". New powers to regulate banks and financial corporations "with a view to avoiding the build-up of dangerous exposures" should be established and include "the power to require a financial institution to unwind a position that menaces its own stability or that of others". The ECB should accept "a certain responsibility for the stability of the global financial system". Accordingly, it should be "explicitly put in charge of macro-prudential regulation to tackle systemic risks, while banking supervisors and the Basel Committee are in charge of micro-prudential regulation dealing with individual risks". Because the context of the global finance will be "a multi-polar international economic system", more co-ordination and a stronger representation of economic interests of developing countries are demanded. EU leaders should work for an "institutional reform to improve the governance of international finance and to reduce the risks to stability".

B) The "need for effective international capital taxation" is considered to be obvious: tax havens have to be closed. And something like the Tobin Tax has to be introduced on a broad international level.

C) CEE countries should be "actively encouraged to develop public sector and cooperative banks", in order to achieve a correct functioning of their financial systems. The ECB should help to protect the currencies of these countries from the pressure of a declining dollar, also by introducing temporary capital controls.

D) The priority needs to be shifted towards social priorities. Binding international standards on ethical, social and environmental goals are required in order to take Corporate Social Responsibility "beyond voluntarism". There is also a need for a "European legal framework which enforces supervision and accountability for the overall impact of corporate behaviour".

E) "Financial integration needs to be combined with measures to satisfy the financial needs of small enterprises and the poor … Public sector and cooperative banks can provide credit to those threatened with exclusion and also support the finance of other public goods. Their role in European finance therefore needs to be strengthened and supported".

F) The position of the consumers needs to be strengthened by „strong minimum standards, requiring that providers of financial services to carefully investigate the interests of their customers". Informative strategies of corporate marketing and a standardization for basic financial products are demanded (ibid).

One year later, after the outbreak of the financial crisis, the EuroMemo Group could seamlessly link up with their own previous analysis. It could explain how the chain between a deficit of decent and payable flats for "normal" people, housing credits, dependence on a monthly income of a certain amount, the pressure and sudden inability to pay mortgages, the unknown nesting of countless credit lenders in countless financial relations in broadly deregulated markets, where speculation is an unwritten rule, can suddenly and easily come to a point of rupture and lead a world banking system, embedded in a global financial system, into a crash which ushers in a global economic crisis. The EuroMemo Group could show that the two main channels by which the crisis has taken hold of the EU have been (a) the bank losses and (b) the collapses in the provision of trade credits. The Group has repeated and concretised its demands and proposals to make use of the law (EU directives and other binding forms of EU regulation) and other effective possibilities to deal with the crisis.

The EuroMemo written in 2007 has explained the three levels on which policies against financial crises should be developed. Firstly, they should draw lessons from the recent events and the concrete mechanisms which led to the build-up and international proliferation of the current financial crisis. On the second level, they should envisage further reaching and preventive measures to stabilise the international financia lsystem and democratise its central institutions. On the third level they should address the nonfinancial causes for the pressures and recurrent disruptions in the financial system (EuroMemo, 2007). A fourth level should be added here, that of addressing the actors and agencies interested in a deep socio-ecological transformation.

With regard to the first level the "lack of transparency, securitisation and trading of loan packages, highly leveraged financial investment and the failure of rating agencies" have been specifically addressed. Consequently, a stronger information system, improved supervisory bodies on different levels, prohibition of transactions beyond the Basle framework, changed accounting rules, standards for the required liquidity and limits of leverages for banking were the subject-matter discussed in more detail. But the fact that the three big US rating agencies are transnational corporations (TNC) should show that the demand for stronger public control is not sufficient: Rating agencies should not be allowed to be private corporations. On a second level, the inclusion of offshore centers (OFC) within all territories should be more restricted, the democratising reform of the IMF, an enlarged and improved co-operation for managing exchange rates and the introduction of a flexible currency transaction tax have been the main topics discussed. The third level has concerned policies for a more just and egalitarian distribution of income and wealth respectively their redistribution and the introduction of strong social minimum standards, especially for pension. But it should have been a surprise that the housing sector and public goods are not even mentioned here. The privatisation of public goods and the deficits accruing to public budgets have been factors contributing to the financial crisis.

As a result of its critical stance, the EuroMemo Group has been able to formulate the need to retain a certain base of public financial institutions with democratic governance and clear economic and social missions on the national, regional and local level. In 2009 the Group developed another interesting idea when it asked about the interest of the people in the finance system and answered: a reliable payments system, a safe repository for deposits, a means of mobilising monetary resources for large household purchases, and for investments that promote social and ecological goals (EuroMemo, 2009).

Concluding remarks

The later EuroMemos have been capable of showing very clearly: the “Greek crisis” and the “Euro crisis” could have been prevented, if the causes and the producers of the financial crisis 2007 in the EU would have been fought effectively, when the laws existing the crisis would have been made use of, when only the political will to do so had existed.
The big jump in government debt is, therefore, not a cause of the crisis but rather a result of measures taken to rescue the banks, expansionary policies to counter the slump, and a sharp decline in tax revenues. But as government debt has risen, the very financial institutions that benefited from the rescue seized on imbalances in the euro area, speculating against the weakest links (EuroMemo, 2012).

But even when Euro crisis fully broke out, the real possibility for another way of reacting to it has also existed but the political imperative has prevailed that the very producers of this crisis, especially in Germany and France, should not really be touched. These very producers of the crisis are still strong enough to determine or influence the ruling policy in a way that the different causes for an over-accumulation of liquidity and an ensuing sudden disappearance of liquidity are not seriously tackled. But even while looking only on the purely financial factors, it is quite obvious and the EuroMemos have stated it in a more or less detailed and extensive way: Regulation, surveillance and supervision of financial agencies are not institutionalised and put into practice in really consistent, persistent and sufficiently effective and strong enough forms. This concerns especially the banking union. In addition, the capital union, as it is being realised, means even new deregulation. There is no really effective strategy to fight against speculation: The quantitative easing has been put into practice in a way that banks have effectively been looking for new sources of profits in the form of interest. And, partly at least, they really have to do so, because they have been effectively weakened. The banks and other financial agencies have been trying to gain from the Juncker Plan, with its orientation on public-private partnerships, the in-built leverage for highly important credit operations and the (partly highly complicated) construction of infrastructure projects and their implementation ....These facts do then stimulate new speculation and, as overproduction of liquidity has been even reinforced by austerity measures, when new privatisations and redistribution of income (and assets) have moved assets from the bottom to the top fields of concentration of wealth. Any kind of justice-oriented tax reforms and any sustained and coherent fight against tax fraud and tax havens are still very far from being realised. The persistent imbalances in the trade balances and in the balance of payments, as well as the still unsettled many bad loans add to a gloomy picture. Accordingly, the crisis factors are further continuing to work. And the “tiny elite” which has gained from the “expansion of the financial sector through the process of innovation and deregulation to appropriate an ever large share of national income” (EuroMemo, 2009/10) can act further. Here EU and G20 serve indeed to reinforce each other. But the biggest rating agencies on a global scale are owned by agents of the global “tiny elite“. They are among the owners of any of the 500 biggest American corporations. This means that they gain not only from their ratings, but also from the profits of their shares which again relate back to these ratings. The biggest corporations are led by managers who are very carefully looking at these ratings. The EuroMemo 2008/2009 has discussed the development of TNCs and, in so doing, has stressed the role of capital structures and agencies. This analysis has been mostly discontinued, as the urgency of discussing the factors of the financial crisis became imperative in debates on economic policy. But there is a deep connection between the two, which the EuroMemo 2008/2009 has at least touched: the very linkage existing between the mode of capital accumulation and the agencies behind it.

Finally, the role of the Big American rating agencies and their relations to other agencies on the market and to the national governments and EU institutions has become apparent, showing us that we have to deal with an oligarchy, i.e. with capitalist oligarchies which dictate its development to society, according to their own specific interests. Capitalist oligarchies are not a new phenomenon, but they have been connected to large corporations/capital companies since their very beginning. They have, however, reached a new dimension as a result of the accumulation of capital by agencies which have been developing in connection with their accumulation of their capital.[28]

Looking at the factors referred to as causes of financial crises above, we may now see that the capitalist oligarchies essentially generate these crises. This insight concerns not only the direct causes of the processes on the financial markets, but also the indirect causes which are indeed connected with these financial markets. But the backbone of these modern oligarchies is constituted by the TNCs. And in this respect, the issue of the "continuity" existing in the work of the EuroMemo Group should be underlined again: The analysis of TNCs given in the Euromemo 2008/2009 urgently needs to be continued. These capitalist oligarchies, however, should focus on the further work of Marxian scientists within and beyond the EuroMemo as we have recommended in the beginning of this text.

Ultimately, we may speak about a socio-ecological transformation, but the complex production and consumption structures are continuously being built by the oligarchies, with their capital and the TNCs. In this vein, the energy system, elementary materials, transportation, agribusiness, military-security industry, financial industry and the High Tech determine everything and especially the violence being used against people and against nature. Because these oligarchies determine our way of living, we should also look at the countless cases where we are forced to participate in processes of social and ecological destruction. But we should also look at the countless activities which reactively have already begun to deal with this and even to organise first steps towards a common search for ways to force the states and the political

---

[28] I therefore speak of capital oligarchies, when social groups develop with finance capital as merged industrial and money capital at their core, but they are also composed by officials from politics, the administration, the military, culture and academia, the media, the legal professions, from counseling, accounting, lobbying and civil society, which are of central importance to the functioning of finance capital. This process of capital accumulation starts its globalised exploitation of labour force with actions on the finance market and other financial operations. And this accumulation includes not only the exploitation of labour force in the working process but also redistribution of property, assets, income. All are involved and also the double exploited wage labourers participate in the exploitation of weaker and they have do so …

institutions to act against these oligarchies. The best possibilities for such a common search have been found so far in on-going campaigns like Change Finance, UN binding treaty, corporate capture on the one hand and activities to realise the two big UN agreements the EU helped to bring about in 2015: the Sustainable Development Goals (SDGs) by 2030 and the Global Warming Goals or Paris Climate Deal. The EU has ratified these agreements, which means that it has undertaken to implement them under international law. Consistent implementation would change the priorities in EU policy or in European policy as a whole in a relevant way – as well as the way in which this policy becomes effective. This means that we have to be intelligently pragmatic, and intelligently radical, at the same time.

References

Bloch, E. (1975) *Experimentum Mundi. Frage, Kategorien des Herausbringens, Praxis*, Frankfurt am Main: Suhrkamp.

Bloch, E. (1959) *Das Prinzip Hoffnung*, Frankfurt am Main: Suhrkamp.

EuroMemos (1997-2018). See: http://www.euromemo.eu/euromemorandum/index.html.

EuroMemo (1997) *Full Employment, Social Cohesion and Equity for Europe - Alternatives to Competitive Austerity*, pp. 14-32.

EuroMemo (1998) *Full Employment, Solidarity and Sustainability in Europe - Old Challenges, New Opportunities for Economic Policy*, pp. 7, 11, 14.

EuroMemo (2000) *Full Employment with a Strong Social Constitution - Alternatives for a New Economy in Europe*, pp. 49-54.

EuroMemo (2002) *Better Institutions, Rules and Tools for Full Employment and Social Welfare in Europe*, pp. 1, 4-31, 42-43.

EuroMemo (2004) *Beyond Lisbon - Economic and social policy orientations and constitutional cornerstones for the European Social Model*, p. 20.

EuroMemo (2005) *Democratic Policy against the Dominance of Markets - Proposals for an Integrated Development Strategy in Europe*, pp. 10, 12-15.

EuroMemo (2006) *A Democratic Economic Policy Alternative to the Neo-liberal Transformation of Europe*, pp. 2-5, 11, 16-19, 21, 38-39.

EuroMemo (2007) *Full Employment with Good Work, Strong Public Services, and International Cooperation - Democratic Alternatives to Poverty and Precariousness in Europe*, pp. 36-38.

EuroMemo (2008/2009) *Democratic transformation of European finance, a full employment regime, and ecological restructuring - Alternatives to finance-driven capitalism*, pp. 33-36.

EuroMemo (2009/2010) *Europe in Crisis: A Critique of the EU's Failure to Respond - Dedicated to the memory of Jörg Huffschmid (1940-2009), Founder and guiding spirit of the EuroMemorandum Group*, pp. 33, 37-38.

EuroMemo (2012) *European integration at the crossroads: Democratic deepening for stability, solidarity and social justice*, pp. 5, 22.