

THE SOVEREIGN DEBT CRISIS THAT ISN'T: OR, HOW TO TURN A LENDING CRISIS INTO A SPENDING CRISIS AND POCKET THE SPREAD

by

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Introduction

It's a testament to the power of ideas in politics that the ongoing policy disaster in Europe is still referred to, by academic as well as popular commentators, as the European Sovereign Debt Crisis. That there was a crisis *in* European sovereign debt markets in 2010 through the middle of 2012 is not in doubt. That it was a crisis *of* European sovereign debt markets generated by 'too much spending' should be very much in doubt. The ongoing European economic crisis is in fact a transmuted private sector banking crisis first exacerbated and then calmed by central bank policy, the costs of which have been asymmetrically distributed across European mass publics.

Despite the prognostications of senior European policy figures, many academics, and even more journalists, there was actually no orgy of government spending in Europe that suddenly came due in 2010 and that was met with yield spikes from bond market vigilantes. This is little more than a politically inspired myth to cover up the fact of reckless over-lending by core European banks whose balance sheets are multiples of their sovereign's GDP, sovereigns that lack the capacity to bail out those self-same banks. What happened instead was that the funding crisis of highly levered financial institutions that began in the US in 2007 finally hit Europe in middle of 2009 when the European Central Bank (ECB) signaled to the markets that it would not act as the lender of last resort for the European banking system.

Unsurprisingly, yields on government bonds became more volatile and began to creep up, accelerating in 2010 and 2011 as the market re-priced the risk of sovereigns with no printing presses that suddenly found themselves facing too big to bail banking systems just as liquidity in the banking system began to dry up. After two years of stuttering policy

responses and over twenty summits where the Germans and the ECB played ‘pass the hot potato,’ the ECB finally began a program of quantitative easing under the guise of the Long Term Refinancing Operation (LTRO) and Emergency Liquidity Assistance (ELA) programs that finally reduced bond yields, quite apart from, and despite the now much larger debt loads of the affected sovereigns. Meanwhile, having cast these events as a story of profligate sovereigns that needed to be disciplined, the policy response of governments, budgetary austerity and more fiscal rules, continues to make the situation worse as debt loads increase rather than decrease the more public spending is cut. Why then continue to spin this as being a public sector debacle rather than a private sector crisis? Three reasons stand out.

The first is ideology. Given the neoliberal and ordoliberal ideas that underpinned the major institutions of European governance, ideas that saw sovereigns as the objects in need of strict control while the private sector needed no such restraints, it was almost impossible for policymakers to admit to this as being a private sector crisis without calling into question the entire economic architecture constructed over the past 20 years, which would rather obviously leave the architects of this order in malodor.

The second is self-interest. Once it became apparent that policymakers faced a continent-wide banking crisis with completely inadequate national level resolution mechanisms – around early 2011 - the only policy response that remained plausible, despite it being the wrong diagnosis, was ‘squeeze, add liquidity and pray,’ while playing an indefinite game of ‘extend and pretend’ with the balance sheets of major European banks.

Third, by bailing out the banks in this way, by pumping central bank cash around the system to stop a liquidity problem becoming a solvency problem by de facto sterilizing

government debt, a bank run around the bond markets and commercial banking sectors of Europe was avoided. But the price of doing so was, as correctly foreseen by the ECB back in 2009, as more even debt. As the ECB governor Jean Claude Trichet put it in May 2009, “the fiscal impact of financial sector support measures will lead to significantly higher government debt to GDP ratios,” and indeed it did.¹ The debt generated through this process, which is basically a stealth bailout of the assets and the incomes of the top thirty percent of the income distribution of these countries and a guarantee for senior and junior bondholders of protected financial institutions, has to be paid by someone, but certainly not those so affected since they vote and fund elections. Instead it was, and continues to be, paid for by the two thirds of the population of these countries that do not have such assets, through cuts to government consumption via austerity macroeconomics. In the language of finance, this should be called what it is: a class-specific put option.

To make this case this paper proceeds in three parts. The first section examines the claim that what caused the crisis was the overspending of sovereigns and why this was politically reconstructed as a sovereign debt crisis. The next section explains this as a crisis of (absent) European institutions. It then goes on to detail the necessary conditions of the crisis, over-lending and balance-sheet expansion by core European banks based upon a too big to fail business model. We then examine how and why budgetary austerity in the public sector is a necessary compliment of bailing the private sector before examining, in conclusion, what other options are available to Europe to resolve this on-going slow motion banking and growth crisis.

¹ Jean Claude Trichet, “Introductory Comments with Q and A,” European Central Bank, Press Conference, May 7th 2009. <http://www.ecb.europa.eu/press/pressconf/2009/html/is090507.en.html>

Too Much Debt Caused the Crisis?

What is perhaps the canonical statement of how excessive government spending caused the Euro crisis was given German finance minister Wolfgang Schäuble in the *Financial Times* on the 5th of September 2011 when he asserted that “it is an undisputable fact that excessive state spending has led to unsustainable levels of debt and deficits that now threaten our economic welfare. Piling on more debt now will stunt rather than stimulate growth in the long run. Governments in and beyond the Eurozone need not just to commit to fiscal consolidation and improved competitiveness – they need to start delivering on these now.”²

The causality in this claim is important. Excessive state spending has led to unsustainable debts and deficits, not as Trichet had it two years previously, that the bailing out of banking systems would *cause* excessive debts. If Schäuble is correct however, we should be able to see two things in the data. First, a long and sustained rise in expenditure above growth levels and/or the rise of structural deficits. Second, an increase in government debts in the run up to the crisis and a subsequent fall in debts as austerity kicked in around 2010. The curious thing is that this really is not what we see in the data at all. Figure one shows Euro area average gross debt to GDP through 2013.

² Wolfgang Schäuble, “Why Austerity is the Only Cure for the Eurozone,” *Financial Times*, September 5th 2011, <http://www.ft.com/intl/cms/s/0/97b826e2-d7ab-11e0-a06b-00144feabdc0.html#axzz2nHuKIbsB>



This first oddity is that *debts seemed to have been going down, not up, on average, just prior to the crisis of 2008*, with the rise in debts from 2008-2009 merely bringing them back up to the prior five year moving average of around 70 percent debt to GDP. The spike in debt begins and accelerates after 2010 when serious bank bailouts began and economies fell into policy induced recessions. In sum, debts increased when the Eurozone began to cut its budgets, not before, which seems to suggest that cutting government consumption leads to more, not less, debt.

A more fine-grained analysis makes Schäuble's claim odder still. The much commented upon case of Greece surely conforms to picture offered by Schäuble. After all, everyone knows that they clearly overspent, right? Actually, not quite. Although Greek debt to GDP was higher than the eurozone average, it had hovered at around 100 percent of GDP since 1994, with a low of 94 percent in 2000 and a high of 105.4 percent in 2008; there was no giant leap in the 2000s.³ On a five year moving average prior to 2008 it's stable. So if there was overspending it must be through a structural deficit where taxes are insufficient to meet expenditures. Indeed, Greece has such a structural deficit, but the size of the overall budget deficit varied, with it decreasing through the 1990s to a low of -3.2

³ All figures in this section come from the Trading Economics database, <http://www.tradingeconomics.com/>. Averages are author's calculations.

percent in 1999 doubling to -6.5 percent in 2007 at the eve of the crisis. Yet if the markets were worried about these deficits, either structural or cyclical, it simply didn't show up in the Greek bond yields, whose spread to German bunds stayed flat and absurdly close throughout this period.

Moreover, any structural deficit has to be seen in relation to two other variables: the GDP growth rate and the rate of change in public spending. The former averaged around 3.3 percent in the seven years up to the crisis while the latter increased at around 4 percent per annum, which together with low interest rates on government borrowing hardly signals an orgy of government expenditures, even in the supposedly worst offender of Greece, just a larger than average deficit. Greece of course was also accused of padding the public payroll to absurd levels. Yet in actual fact Greece appears in the middle of the distribution of OECD countries public employment as a percentage of GDP in 2009 with the very efficient Scandinavians, and even the UK employing a much higher percentage of their population via the public purse in central government.⁴

Similar patterns can be found in other supposedly offending countries. Spanish government expenditures certainly went up during the 2000s, more than doubling over a ten year period. But that was from a very low level in comparison to the European average, and at the same time Spanish debt to GDP fell from 59.3 percent in 2001 to a low of 36.1 in 2008. So Spain spent more while paying back its debt on the back of a GDP CAGR for the decade of just under four percent. Again, this hardly evidences an orgy of spending.

Ireland shows the same pattern, with debts falling from a high 48.5 in 2001 to a low of 24.8 in 2007 while expenditures increased by about 40 percent, which is high, but it

⁴ OECD, Government at a Glance 2009. V. Public Employment. Employment in General Government and Public Corporations. Version 1. Last Updated 14th November 2010.

occurred on an average growth rate of around six percent since the mid 1990s. In fact, the only major state in the Euro area that has seen a sustained increase in debt to GDP over the past decade from 60 percent in 2000 to 80 percent in 2013 plus a smaller but consistently increasing rate of government expenditure coupled to low growth has been Germany - and Germany is most certainly not in the dock for profligacy.

This is an odd picture to say the least, and it raises some questions of greater concern than European policymakers' understandings of causality. Government debts in Spain and Ireland fell dramatically before the crisis and in Greece they stayed more or less flat. Spending went up, but from low levels, on the back of higher than average growth rates. There were in some cases structural deficits, but the markets never seemed to price them in. Given this, how could excessive spending that didn't actually happen end up producing a sovereign debt crisis? The answer is, it didn't. So what did?

To answer this we need to stop looking at sovereigns and start looking at banks. But to get there we have to remember how and why this crisis was politically constructed as a crisis of excessive spending in order to understand why banks are the critical factor behind the crisis - and why that fact must be denied at all costs by Europe's political elites. There is a simple distributionary politics story at the heart of all of this that remains oddly invisible that is the pan-European class-specific put option. To get us there we start with the official story of the European crisis and then switch gears to examine why European politicians shy away from telling us the real story of the crisis, which is all about quietly resolving a banking crisis bigger than the states supposed to resolve it.

Welcome to the Over-Lending Crisis

In August 2007 IKB, a Dusseldorf-based lender, had to be rescued after suffering losses on its U.S. subprime investments. Following this it seemed, for a while, that all was quiet on the European front until the rescue of Hypo Real Estate bank in 2008. Such minor rumbles apart, Europe seemed to have none of the convulsions of the UK and USA with systemically important firms such as Northern Rock and Lehman going to the wall. By late 2008 Europe thought it had survived the worst of the meltdown in ‘Anglo-Saxon banking’ that, as then German Finance minister Peer Steinbrück put it, was (correctly) seen as the cause of the crisis. As he put it, the “irresponsible overemphasis on the ‘*laissez-faire*’ principle, namely giving market forces the most possible freedom from state regulation, in the Anglo-American financial system,” which had led to a crisis of overlending.⁵ The European banking model, in contrast, was said to be much more sound due to its more conservative funding and lending practices, so there was no need to throw money at the problem as the United States and the UK had done. As German Chancellor Angela Merkel put it in late 2008, “cheap money in the US was a driver of this crisis...I am deeply concerned...[with]...reinforcing this trend...[and wonder]...whether we could find ourselves back in five years facing the same crisis.”⁶

Banks and over-lending were then, at this point, correctly seen as the problem: not over-spending. Armed with a supposedly better banking system, Europe, especially Germany, had no need to worry. Unlike the United States and the UK, there was no need to turn the money pumps on to fuel recovery. Little wonder then that the Germans looked on in horror, as the United States and the UK seemed to do just that. Indeed, one of the

⁵ Leon Mangasarian, “U.S. Losing Financial Superpower Status, Germany Says,” *Bloomberg*, September 25, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahUuZ8Z5rkDA&refer=germany>.

⁶ Angela Merkel quoted in Abraham Newman, “Flight from Risk: Unified Germany and the Role of beliefs in the European Response to the Financial Crisis,” *German Politics and Society* 28, 2: 158.

oddest aspects of the first stage of financial crisis was the sudden embrace of Keynesian economics by, apart from the ECB and the German government, almost everyone...but for only about twelve months. A large part of the reason for the return to Keynesianism was that governing neoliberal ideas stressed the singular importance of inflation control, the futility of fiscal policy, the importance of policy credibility, and the efficiency of markets, the sum of which pretty much denied such a crisis could ever happen, especially in the private sector. Given what was rather obviously occurring in the world, and with the entire global payments system at stake, a policy of ‘leave it to the market’ was really not seen as a tenable response. Given this “governments quickly came to believe that monetary policy was insufficient on its own to help the real economy.”⁷

The results were both immediate and dramatic as countries as diverse as Brazil, China, and the United States lined up to stimulate their economies. China led with 13 percent of GDP. Spain promised 7 percent while the United States committed around 5.5 percent of GDP. Even Germany stimulated to the tune of just under 3 percent of GDP. As Keynes biographer Lord Skidelsky put it in a book celebrating this rediscovery of Keynes in 2009, we had witnessed ‘the Return of the Master.’⁸ The only problem was that by the time the Master returned some very important folks had already left the building: the Germans, followed by the British and the Canadians. As a consequence the global return of Keynes was to last only a year from start to finish. One more question was relevant at this juncture however, where was the ECB in all this?

⁷ Henry Farrell and John Quiggin, “Consensus, Dissensus and Economic Ideas; The Rise and Fall of Keynesianism During the Crisis,” unpublished manuscript, 2013, p. 24.

⁸ Robert Skidelsky, *Keynes: The Return of the Master* (New York: Public Affairs, 2009).

Then the ECB Cocked the Gun

Unlike the British Treasury and the US Federal Reserve, both of which were extremely active in not just bailing, but through their bailouts deleveraging and recapitalizing their banking systems, the ECB sat on the sidelines and did very little in the initial stages of the crisis, for two reasons. First, there didn't appear to be much of a European banking crisis until 2010, so there was nothing to fix. Having decided that this was an Anglo-Saxon problem, all the ECB sought to do was to ensure that credit channels in the economy stayed open. And in that regard they didn't even cut rates aggressively to offset the contractionary effects of the credit crunch until March 2009. Second, given that its job was by statute to fight an inflation that clearly wasn't there, there didn't seem to be all that much to do on that front either.

But globally markets were seizing up regardless of statutes as credit market inter-linkages fed the crisis into Europe. Meanwhile, the financial markets finally began to notice that the Eurozone lacked most of the traditional mechanisms for resolving banking problems. Thanks to the Euro, national central banks no longer had many instruments to deal with the crisis, such as the ability to set short-term rates or print money to bail their banks. As such, financial markets, as seen in asset volatility and CDS spreads, began to worry about the risks that were really embedded in European assets, especially Eurozone sovereign bonds. Normally seen as AAA risk weighted and the instrument of choice for interbank lending in Repo transactions - and therefore crucial for how banks actually fund themselves (which, as we see below, becomes hugely important in 2011) - sovereign debt, the one thing that you didn't have to worry about in your portfolio - suddenly became a bit

of a worry. Consequently, yields became more volatile in early 2009 and spreads began to widen.

In response in May 2009, the ECB under Trichet decided to cut rates and intervene to the tune of 60 billion Euros in the market for what are known as ‘covered bonds’ under the guise of a program called ‘credit easing.’ This was a very odd response. The rate cut was standard, but why covered bonds? They are a small part of the non-sovereign market, and E60 billion was around four percent of the Eurosystem’s balance sheet.⁹ Much more important than the program however, was what Trichet said in the press conference Q and A at the time of this announcement. When asked if this program was the ECB’s equivalent to the UK and US quantitative easing schemes, he replied, “we are not at all embarking on quantitative easing.”¹⁰ In saying that the ECB just cocked the gun for the sovereign debt crisis that would really kick off less than a year later.

To see why what Trichet said was so important you have to think about quantitative easing (QE) as a banker would in a moment of distress. Whether or not it’s inflationary or money printing or inequality generating through its effect on asset prices is secondary to what it does for your bank’s balance sheet. For a banker QE is a Godsend that allows you to swap toxic assets for cash, thereby allowing the state to both delever and recapitalize your bank without you taking any formal losses. This also allows the state to do bailouts without failing the bank or ‘really’ doing any money printing on the proviso that the debt generated by the asset swap will eventually swapped back for the cash lent when the economy recovers, thus sterilizing the money printing aspect. QE is de facto the

⁹ Frank Oland Hansen, “Euroland: Credit Easing Versus Quantitative easing” *Danske Bank Research Note*, 12th May 2009.

¹⁰ See footnote 1 for reference.

sterilization of government debt, which is why Trichet balked at the suggestion that the ECB should start doing it. Whether or not the free-lunch/sterilization part of this policy works remains an open question, probably not. But the first part had proved tremendously successful in triaging the US and UK banking systems and stabilizing their balance sheets.

This is why what Trichet said was hugely significant. In saying that QE was not on the cards for Europe since the ECB as a transnational central bank had no mandate to back national bonds, Trichet just told global financial markets that the ECB did not stand behind banking-book asset values, even of AAA sovereign assets, and they would not act as a classic lender of last resort. As Eric Lonergan, fund manager and financial author put it, this “superficially innocuous decision – to openly reject QE and embark on a trivial program of covered bond purchases – may in fact be the precise trigger for the profound loss of confidence in peripheral Eurozone government bonds, which accelerated through the end of the year and into 2010.”¹¹ I would go further and argue that this was the trigger that allowed the development of a slow motion bank run.

The timing of events here is very important. After the ECB eschewed QE in May 2009 and just before the snap Greek election of October 2009 revealed that Greek public finances were in a mess (more on this below), the September 2009 German general election saw the coalition with the SPD fall and a new CDU-FDP coalition arise that was to take a much harder line on austerity going forward. Outgoing SPD Finance Minister Steinbrück had declared that Greece would not be allowed to fail. By early 2010 not only that failure possibility, it seemed to be an emergent policy. Consequently, as Lonergan argues, a slow motion bank run began “in classic fashion...with the weakest link – Greece – in mid-2009,

¹¹ Eric Lonergan, *Money*, 2nd edition (London: Acumen Publishers 2014) – forthcoming, postscript on Eurozone crisis, p. 21.

spreading first to Ireland and Portugal, then in increasingly severe waves to Spain, and Italy. As in all panics, ultimately the mighty succumb. In November 2011, bond markets in all eurozone countries froze and credit spreads widened rapidly on all sovereigns including Germany.”¹²

The crisis indeed came to Europe, but not from the direction the politicians were expecting. That is, while this was most definitely a crisis *of* sovereign bond markets, it was decidedly not caused *by* the mere existence of those bonds or *by* excessive spending in the states that issued them. It was caused by locally-rational central bank policy by the ECB and rather ideological thinking by the German government exacerbating the fears of highly levered financial institutions that a rather large solvency problem was heading straight for them. When the Eurozone’s biggest creditor, Germany, said in March 2010 that there was no bailout provision in the Eurozone, the onrushing headlights just got a bit brighter. But how did all this become a crisis of state spending? To answer that, we need to leave Brussels and travel to Iqaluit in northern Canada, and then to Toronto.

Finding Bullets in Canada

In the spring of 2010, shortly after the Germans inadvertently said ‘go on, short it’ to the markets, but with the immediate danger of financial collapse abated and the new threat of sovereign contagion yet to fully emerge, a new ideological alignment began to take shape. Some of the neoliberal old guard, in both Europe and the United States, began to strike back against the Keynesian response.¹³ Increasingly-on-the-defensive Keynesians

¹² Ibid. P. 23

¹³ For example, see Alan Greenspan, “Inflation—The Real Threat to Sustained Recovery,” *Financial Times*, June 25, 2009, <http://www.ft.com/intl/cms/s/0/e1fbc4e6-6194-11de-9e03-00144feabdc0.html#axzz1rw5D7xpm>.

faced off against a coterie of conservatives, neoclassicals, and fellow travelers on the issue of surging government debt. Significantly, major German politicians began to join forces with the ECB to send a common message. As ECB Chief Jean Claude Trichet put it in a much-reported broadside in the *Financial Times*, “stimulate no more – it is now time for all to tighten.”¹⁴

A week before any full G20 meeting the group’s finance ministers get together to lay-out the agenda. By the time of the June 2010 finance ministers meeting in Busan, South Korea, the G20 finance ministers now thought that, “recent events highlight the importance of sustainable public finances...growth friendly measures, to deliver fiscal sustainability.”¹⁵ This turn of policy in Busan was made possible by preparatory work done at the G7 finance ministers meeting in Iqaluit, in the extreme north of Canada where, as Neil Irwin put it, sitting in an igloo eating raw fish from blocks of ice (seriously) “the leaders of the world economy collectively agreed that their great challenge had shifted. The economy seemed to be healing; it was time for them to turn their attention away from boosting growth. No more stimulus.”¹⁶

Coincidentally, days before the G20 meeting, ECB chief Trichet explicitly rejected Keynesian demand deficiency arguments citing the need for the reduction of debt. Two days later Schäuble published an extended piece in the *Financial Times* stressing the need for “expansionary fiscal consolidation,” stating that Germany will not respond to the crisis

¹⁴ Jean-Claude Trichet, “Stimulate No More—It Is Now Time for All To Tighten,” *Financial Times*, July 22, 2010, <http://www.ft.com/intl/cms/s/0/1b3ae97e-95c6-11df-b5ad-00144feab49a.html#axzz1rw5D7xpm>.

¹⁵ Chris Giles, “G20: All Change on the Fiscal Front,” *Financial Times*, June 5, 2010, <http://blogs.ft.com/money-supply/2010/06/05/g20-all-change-on-the-fiscal-front/#axzz22zcCMeF9>.

¹⁶ Neil Irwin quoted in Paul Krugman, “How the Case for Austerity Crumbled.” *New York Review of Books*, June 6th 2013. <http://www.nybooks.com/articles/archives/2013/jun/06/how-case-austerity-has-crumbled/>

by “piling up public debt.”¹⁷ Given these well-timed flanking maneuvers, by the time the G20 meeting took place in Toronto the tide had already turned. The Canadians and the British sided with the Germans, leaving the Americans isolated. The final communiqué of the Toronto meeting repeated the meme authored by Trichet and amplified by Schäuble of “growth friendly fiscal consolidation.” Seen at the time as a fudge between the Keynesian and orthodox positions, what it actually signaled was not just the end of global Keynesianism, but a recasting of the crisis away from banks and towards sovereigns.

Greece Pulls the Trigger and the Markets ‘Run’

The slow motion bank run that was triggered by Trichet’s remarks in May 2009 that was galvanized by the change in German politics in September 2009, gained strength in October 2009 the incoming Greek government revealed that the reported fiscal deficit of 6.5 percent of GDP was in fact closer to 13 percent of GDP. No good deed goes unpunished and the low interest rates that Greek debt had enjoyed since joining the Euro shot up as investors re-priced Greek bond risk in this more uncertain environment, which made a difficult interest payment environment very suddenly awful. Piling on the pressure, the ratings agencies downgraded Greek bonds from A to BBB-, which compounded their debt burden by lowering prices and spiking yields further. As a result the economy began to contract such that outstanding debt increased, GDP collapsed, and insolvency loomed.

In such a situation bond market investors face a dilemma. If they believe that Greek bonds are going to fall further in value, they should get rid of them as soon as possible.¹⁸

¹⁷ Wolfgang Schäuble, “Maligned Germany is right to cut spending,” *Financial Times*, June 24, 2010, <http://www.ft.com/intl/cms/s/0/9edd8434-7f33-11df-84a3-00144feabdc0.html#axzz22sXtZh8H>.

¹⁸ Or buy CDS protection on the bonds, or go short on them to make money on the downside, but eventually you want to get out.

But if they do they risk everyone else holding these assets doing the same, thereby creating a self-defeating contagion fire-sale. This risk of systemic contagion loomed large in late 2009 when the anticipation of a possible mass dumping of Greek assets because of these events led to a further collapse in their price and another spike in their yields. This is why the Greek market froze. Not because of over-spending but because of their risk as a contagion trigger to other sovereign assets. Given that core Eurozone core banks were stuffed full of periphery bonds (how stuffed is revealed below) any such fire sale would likely spread to Portugal, Ireland, and, it was feared, maybe even Spain and Italy.

Given all this, the ideal policy back in late 2009 would have cost around fifty billion Euros, less than the covered bond program. It would have required either the ECB to buy the secondary market Greek debt that was subject to near-term rollover risk and bury it somewhere deep in its balance sheet and walk away, much as the US Fed had done with its banks in 2008 with programs such as TALF. So why didn't they do so?¹⁹ The popular answer of the time was 'German politics.' With a regional election coming up and a new more austerity-inclined coalition, it was politically easier to blame the Greeks for being lazy than it was to explain to the German public that the ECB needed to bail international holders of Greek debt for reasons of systemic risk.

While plausible, another answer lies in the ECB statutes that forbid one country to bail out another for fear of generating moral hazard. These are, except in exceptional moments (the treaty in question mentions 'natural' disasters) not allowed. The refrain was often heard in 2010 and 2011 that the ECB only has one problem to fix, price inflation, and

¹⁹ Ironically, the ECB ended up using hedge funds as its hidden toxic balance sheet a year later when it sold Greek debt at cents on the dollar to the hedge fund community. Last year (2012/3) one of those funds made half a billion dollars on the trade. See <http://www.ft.com/intl/cms/s/0/a11f5be4-4940-11e2-b25b-00144feab49a.html#axzz2nHuKIbsB>

one tool to do it with, the rate of interest. As such, the argument goes that the ECB was constitutionally unable, while the Germans were politically unwilling, to take responsibility. Yet this is not a wholly satisfactory explanation either. The treaty provisions in question actually say something quite different from what was often reported.

Article 127 of the Treaty on the Functioning of the European Union says that, “the primary objective of the European System of Central Banks (hereinafter referred to as ‘the ESCB’) shall be to maintain price stability.” Further, it continues that “without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.” So what does article three say? It says, *inter alia*, that “The Union shall...work for the sustainable development of Europe based on balanced economic growth and price stability...aiming at full employment and social progress, and a high level of protection...It shall promote economic, social and territorial cohesion, and solidarity among Member States.” The inclusion of the goals of growth, full employment, protection and solidarity, opens the tent to some rather large interventionist elephants into the fiscal tent alongside price stability. That the ECB chose not to do more given its statutes can be sustained. That it was unable to do more given its statutes is simply unsupportable.²⁰

Hewing to this narrow interpretation of its mandate had severe unintended consequences. Far from promoting recovery by instilling confidence in global investors as the G20 finance ministers had hoped it would, investors began to price in the risk of contagion and the consequences of austerity budgets on growth, and hence future debt

²⁰ I thank Marco Capitão Ferreira of the University of Lisbon Law School for this key insight into the crisis.

payments, and the yields on all periphery bonds began to rise dramatically. This is how Portugal, Ireland, Spain and Italy got lumped together with Greece. The PIIGS-collective was born in the fires of contagion risk and a voluntary and misguided contractionary policy.

With yields spiking to unsustainable levels in Greece, Ireland and Portugal, each country received a bailout from the EU, ECB and the IMF as well as bilateral loans on condition that they accept and implement austerity packages to right the fiscal ship. Yet they wouldn't have needed these loans or the policy packages (which were the wrong medicine anyway) had the ECB chose to stand behind Euro denominated sovereign debt in the first place.

In May 2010 Greece received a 110 billion Euro loan in exchange for a twenty percent cut in public sector pay, tax increases, and a ten percent pension cut. The lenders, the so-called troika of the ECB, the European Commission, and the IMF, forecast growth returning by 2012. Instead, unemployment reached 21 percent in late 2011 while the economy continued to contract. In November 2010 Ireland needed a bailout and received 67.5 Billion Euros for a 26 percent cut in public spending. In March 2011 it was Portugal's turn to received 78 billion Euros in exchange for a similar packet of reforms. However, given the contraction in all these economies and persistent fear of contagion, yields on Portuguese ten-year debt reached 17 percent in early 2012 while their 10-year bonds were downgraded to BBB-, otherwise known as junk.

Far from being stabilized by the original package of loans and cuts, Greece's financial position continued to deteriorate and required a second bailout in July 2011. Another 110 billion Euros of debt, which became 130 billion in October 2011, was added to the Greek public sector balance sheet while another 20 percent wage cut was enforced

along with similar across-the-board reductions in public spending and more tax increases. Eventually, even private sector bondholders had to take a haircut (a loss) on the value of Greek debt of around 75 percent, plus write-offs of around 100 billion Euros.²¹ Just to keep things on track, democratically elected governments in Greece and Italy were deposed and replaced in November 2011 by unelected technocrats to keep the reforms going in the heart of democratic Europe.²²

Meanwhile Politicians Play 'Blame the Victim'

It is once again worth noting the timing of events here. Opposition to Keynesian policies intensified in the spring of 2010 just as the Greek crisis really became newsworthy and after the Germans had doubled down on the ECB's backstop error. In the UK, Germany, and the United States, politicians in favor of austerity as a good thing in and of itself zeroed in on the Greek crisis as a metaphor for the perils of Keynesianism. 'Becoming Greece' became a scare-story to justify cutting back at home. George Osborne, the new Conservative British Chancellor of the Exchequer, made repeated comparisons to the fiscal situation of Greece and the UK as soon as he was elected.²³ Ex-IMF chief economist Simon Johnson argued around the same time that the UK and Greece were essentially similar, despite the fact that they manifestly were not.²⁴ The UK has a real central bank armed with its own currency, a fact clearly seen in UK bond yields, which barely moved during this

²¹ Despite these austerity binges, Greek debt is projected (if all things remain equal for the next eight years, which will never happen) to reach 120 percent of GDP by 2020. The IMF thinks 145 percent by 2020 is more likely.

²² Mark Blyth and Matthias Matthijs, "Only Germany can Save the Euro" *Foreign Affairs*, December 2011.

²³ "You can see in Greece an example of a country that didn't face up to its problems, and that is the fate that I want to avoid" being a typical example. "UK to Dodge Greek Fate with Tough Budget-Osborne," *Reuters*, June 20, 2010, <http://uk.reuters.com/article/2010/06/20/uk-britain-osborne-budget-idUKTRE65J0UX20100620>.

²⁴ "UK Economy Faces Crisis," *BBC News*, February 7, 2010, <http://news.bbc.co.uk/2/hi/8503090.stm>.

period. Meanwhile, conservative historian Niall Ferguson likened Greece to the United States, with collapse just over the horizon just as the debt-obsessed Tea Party rose to prominence.²⁵ Consequently, congressional Republicans in the United States leapt upon on such comments with glee, while media outlets picked up and amplified the story throughout the spring of 2010.²⁶ In Europe, the ECB repeatedly honed in on Greece as the future of all European states unless budgets were cut.²⁷

Austerity's moment in the sun had arrived courtesy of the Greeks, yet all the Greeks ever really did was tell the truth about their budget deficit, and that only mattered because the ECB told that markets that Europe had no lender of last resort and the Germans insisted on no bailouts. Quite understandably, the markets reacted to the fear of break up risk generated by such flawed institutions and locally rational, but collectively disastrous policies, not the size of Greek public spending, but that didn't matter politically. The offensive against Keynesianism at a global level was married to the discovery of the Greek debt crisis and amplified via the threat of contagion to establish fiscal austerity as only 'reasonable' way forward. So established only with the proviso that this was all a crisis of spending, which it never was. But this rebranding exercise nonetheless enabled the greatest bait and switch in modern history, which is what brings us back to the banks and why all of this is really just a continuation of the banking crisis that began in the US in late 2007.

²⁵ Niall Ferguson, "A Greek Crisis Is Coming to America," *Financial Times*, February 10, 2010, <http://www.ft.com/intl/cms/s/0/f90bca10-1679-11df-bf44-00144feab49a.html#axzz1syduMdbA>.

²⁶ Tellingly, googling "US like Greece Spring 2010" gets over 62 million hits.

²⁷ Peter Wise, "Trichet Calms Fears of Debt Crisis Spread," *Financial Times*, May 6, 2010, <http://www.ft.com/intl/cms/s/0/df61c58e-00f7-11df-a4cb-00144feabdc0.html#axzz1syduMdbA>; and Ralph Atkins, Kerin Hope, and David Oakley, "ECB Warning to Debt-ridden Governments," *Financial Times*, January 14, 2010, <http://www.ft.com/intl/cms/s/0/63b15724-5926-11df-adc3-00144feab49a.html#axzz1syduMdbA>.

The Greatest Bait-and-Switch in Modern History

The result of all this opportunistic politicking was to cover up the greatest bait and switch operation in modern history where private sector debt generated by highly levered financial institutions (HLFI's) was rechristened as 'the debt' generated by 'out-of-control' public spending. Yet, as demonstrated above, there was no orgy of public spending. It's a myth. The fiscal crisis in all of these countries that was apparent by mid 2010 was the *consequence* of this deeper financial crisis, *not its cause*. To continue to make the opposite case is to quite deliberately confuse cause and effect. Carmen Reinhart and Kenneth Rogoff, no friends of Keynesian policy, note that 80 percent of the time there is a banking crisis it is followed by a sovereign debt crisis.²⁸ More strongly, Moritz Schularick and Alan Taylor have shown that sovereign debt crises are almost always "credit booms gone bust."²⁹ They develop in the private sector and end up in the public sector. The causation is clear. Banking bubbles and busts *cause* sovereign debt crises. Period. So why all of this myth making if the reverse is true?

To really understand why the eurozone has been slashing itself to insolvency in the name of solvency we need to acknowledge how the Euro as a currency enabled the development of a system of banks that is *too big to bail*. That is, no sovereign can cover the risks generated by their own banks because the banks are too big and the sovereign no longer has a printing press.

In this regard HILFI's are like nuclear meltdowns waiting to happen. The firm, in doing its everyday business, generates externalities that it can never hope to internalize

²⁸ Carmen M. Reinhart and Kenneth S. Rogoff, "Banking Crises: An Equal Opportunity Menace," *National Bureau of Economic Research Working Paper Series* 14587 (December 2008).

²⁹ Moritz Schularik and Alan M. Taylor, "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870-2008," *American Economic Review* 102 (2) April 2012 pp. 1029-1062.

through normal bankruptcy procedures. In such a world there can be no bail out big enough to save the system if it starts to fail, unless the only central bank standing issues a blanket guarantee, which in this case it steadfastly refused to do since it was beholden to no sovereign. Consequently, when the real extent of the crisis became clear by early 2011, politicians knew that the system could not be allowed to fail, but were reduced to employing means that made the situation worse rather than better. This is what generates the bait and switch at the heart of all this, which is why Europe turned a lending crisis into a spending crisis - to save its banks - and it's still saving them today.

Bad Convergence

The project of bringing Europe even closer together through a common currency, the Euro, was supposed to work on two levels. First, economies that were not well integrated, had different business cycles, and had little specialization according to their relative economic strengths, would converge simply by using the same unit of account. Second, having different currencies meant different exchange rates, which had different consequences for states, people, and firms. For people and firms the transactions costs of changing currencies reduced both travel and trade. For states, different rates generated currency volatility that was hard to hedge. It also created incentives for weaker currencies to devalue against their stronger trading partners to improve their competitiveness, which many European states did, repeatedly.

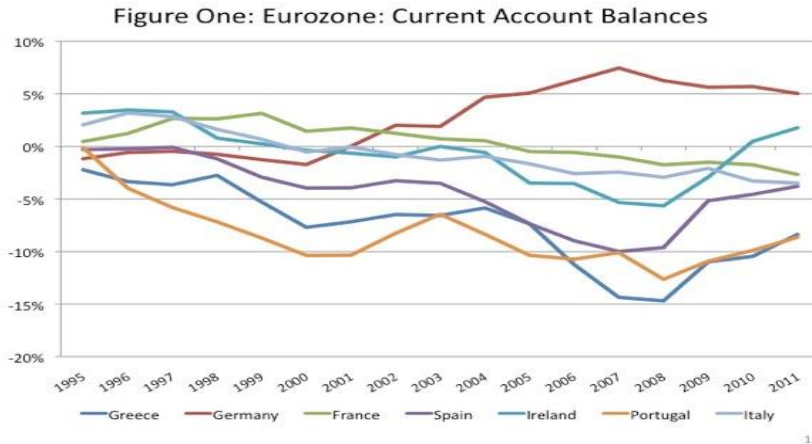
The problem with devaluation as an adjustment policy is not only that it beggars-
thy-neighbor, it also leads to import inflation in the countries that devalue.³⁰ European
leaders struggled with these inflation/devaluation/volatility problems building successively
more elaborate exchange rate arrangements to keep their currencies together. Currency
arrangements called ‘snakes’ were replaced by ‘snakes in tunnels’ and then by formal
‘exchange rate mechanisms’ to discipline sovereigns. They all failed. After the ERM failed
in 1992 after the famous raid on the Bank of England by George Soros, European
policymakers decided to go all in.

The Euro, the successor to the European Exchange Rate Mechanism, would become
a one-time internal fix of all the different European currencies in exchange for one external
floating currency, with one important difference. Rather than pegging and retaining
national currencies and printing presses, after the fix the national currencies would be
abolished and the printing presses would be handed over to the ECB to remove inflation
and devaluation as policy options. Instead, armed with a new independent central bank that
had, as we saw, many goals but chose to prioritize only one, keeping inflation low, prices
and wages, it was assumed, would automatically adjust to the external balance. This is a
hard constraint and many economists predicted that the Euro would fail, just as prior
arrangements had failed. It didn’t fail, but it did cause problems that remained hidden for
almost a decade that were liquidated away by an unexpected Tsunami of cheap money.
Specifically, instead of creating convergence, the introduction of the Euro created a great

³⁰ Italy became the poster child for these problems having devalued the Lira every year between 1980 and
1987, save 1984, thereby suffering much higher than average inflation than the rest of Europe while
effectively reducing the average Italian’s real wage through the inflationary back door.

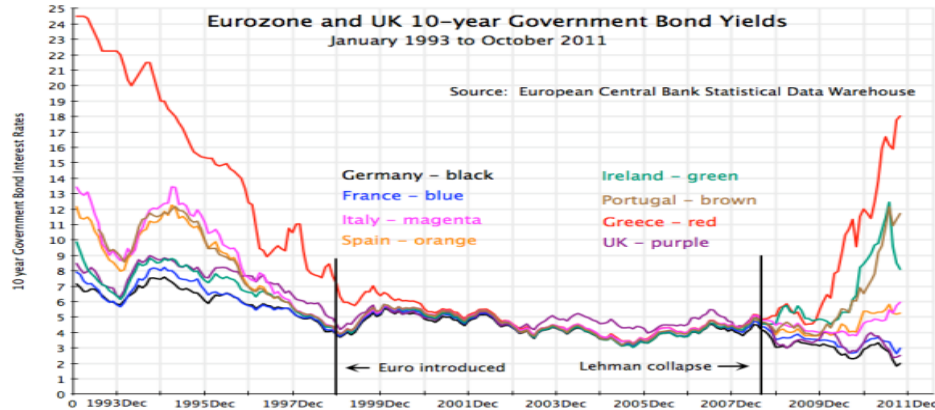
divergence between European economies, in almost everything except their bond spreads and balance of payments.

Figure One: Eurozone Current Account Imbalances



Notice that before the introduction of the Euro, France was the only country with a current account surplus. After its introduction France held on until 2005 before moving into deficit. Germany moved into surplus in 2001 and the rest of the Eurozone moved further into deficit. There was a convergence of sorts. Everyone except Germany started to run deficits. To see why this happened, we need to turn to how such deficits were financed, which takes us into the realm of sovereign debt markets, and what the introduction of the Euro did to the incentives of European banks.

Figure Two: Eurozone Ten Year Government Bond Yields



On the left hand side of figure two we see what the markets used to think of sovereign bonds before the Euro was introduced. Greek 10 year bond yields started out at nearly 25 percent in 1993, fell to 11 percent in 1996, and then came within 50 basis points (half a percent) of German bonds by 2001. Similarly, Italian bonds fell from a high of 13 percent in 1994 to becoming ‘almost German’ in 2001 in terms of yield. Yet it is manifestly obvious that neither Greece nor Italy, nor anyone else, actually became Germany, the economic convergence predicted simply didn’t happen. So why then did we see this convergence in bond yields?

The most common answer is because the introduction of the ECB took both foreign exchange risk and inflation risk off the table via its determined credibility and narrow constitution. This despite the fact that national bonds were still issued by the same national governments that now had no printing presses. Given this free-lunch (in terms of risk) banks and other financial players could now load up with them, assuming that the risks we saw on the left-hand side of figure two had all been removed by admission to the Euro. As yields fell but remained positive over Bunds, the periphery was flooded with cheap money, swamping local wholesale funding markets, thereby pumping up private sector indebtedness.

In short, northern lenders lent to southern banks and southern consumers used this tsunami of cheap cash to buy northern products, hence the current account imbalances noted above. But why did these bond buyers believe that this new and untested institution, the ECB, would in fact guard the value of their bonds that national governments didn't matter anymore, and that Greece was now functionally Germany? The answer was, they didn't need to believe anything of the sort, at least until Trichet disabused them of the notion in May 2009, because what they were actually doing was the mother of all moral hazard trades.

The Mother of all Moral Hazard Trades

If you were a European bank back in the late 1990s and you saw sovereign bond yields falling, you also saw a source of easy profits was disappearing. Yet if the ECB really did get rid of exchange rate and inflation risk then these new Euro denominated bonds really were a banker's dream – a free option – safe assets with a positive upside – albeit with lower yields. So you would be a fool not to load up on them, especially before they yields fell any further, and load up on them they did thus bloating balance sheets and prompting industry consolidation to profit more from economies of scale. Erik Jones reports that in 1985 there were 12,526 Euro area credit institutions. By 2006 that number had fallen to fewer than 7000. Meanwhile, in 1985 the average ratio of bank assets to GDP was 177 percent. By 2006 it was over 300 percent, with some major countries having even higher exposures, a point we examine in detail shortly.³¹

³¹ Erik Jones, "The Forgotten Financial Union," in Matthias Matthijs and Mark Blyth (eds.), *The Future of the Euro*, p. 5-6 – forthcoming in 2014.

But as yields converged you would have to buy more and more of these assets to make the same amount of money with them. There was however a small but significant difference in yield between the bonds of Northern European sovereigns and those of the periphery even after the yields converged. So, if you swapped out your low yield German and Dutch debt and replaced that with as much PIGS debt as you can find, and then turbocharged that by running operating leverage ratios as high as 40:1 – typical in the European banking system and higher than those reprobate ‘Anglo-Saxon’ banks mentioned above, you would have one heck of an institutionally guaranteed money machine. But what makes this a moral hazard trade?

Imagine that you knew Greece was still Greece and that Italy was still Italy and that the prices quoted in the markets represented the bond buying activities of banks pushing down yields making this convergence trade rather than any true estimate of the risk of the bond itself. Why would you buy such securities if the yield did not reflect the risk? Well, you might realize that if you bought enough of them, if you became really big, and those assets were to lose value, you would become a danger to your national banking system, and you would have to be bailed out by your sovereign. If you were not bailed out, given your exposures, cross-border linkages to other banks and high leverage, you would pose a systemic risk to the whole European financial sector. As such, the more risk that you took onto your books, especially in the form of periphery sovereign debt, the more likely that your risk would be covered by the ECB and your national government, or both, regardless of what they said and their official statutes maintained. This would be a moral hazard trade on a continental scale. The Euro may have been a political project, and as such a political

intervention that provided the economic incentive for such a trade to take place. But it was private sector actors that jumped at the opportunity.

It was until recently hard to prove that this was in fact guiding the behavior of European major banks. After all, admitting this would be, in many jurisdictions, a criminal offense. However, the recent Anglo-Irish ‘tapes’ scandal where senior executives of the now defunct bank of the same name were caught out discussing how they would lie to the government about how indebted they were provides some direct evidence. The plan was to bring the government in such that once they had “got skin in the game” they could then reveal much bigger debts, dump them on the sovereign - being too big to fail - and then walk away.³² This is clear evidence a moral hazard play of exactly the type mooted above, so why should it be confined to the single case of Ireland?

Now either because large banks really believed that the untested ECB had magically removed all risk from the system, or because they saw the possibilities of a moral hazard trade and acted on them, or both, major European banks took on as much periphery sovereign debt (and other periphery assets) as they could. Indeed, these banks were incentivized by the European Commission to get their hands on as many of these periphery bonds as they could to use them as collateral in repo transactions, thereby upping the demand for them still further.³³ There was however one slight flaw in the plan. While bank lending and borrowing may be cross-border in the eurozone, bank resolution and bailout responsibilities (notwithstanding the still languishing proposal for an EU banking union

³² See <http://www.independent.ie/business/irish/tapes-that-reveal-what-really-led-to-national-collapse-29366839.html>

³³ Daniela Gabor and Cornel Ban, “Fiscal Policy in (European) Hard Times: Financialization and Varieties of Capitalism,” Paper presented at the Understanding Crisis in Europe Workshop, Bristol Business School, May 11, 2012.

that does little to fundamentally address these problems) are still national.³⁴ So while any individual bank could play this moral hazard trade, if they all did it together then what was individually ‘too big to fail’ became very quickly to ‘big too bail’ as a whole. Once again, what was locally rational was collectively disastrous.

Private Debt – Sovereign Risk

To get an idea of the risks involved in this trade for the sovereigns involved recall that if you take the combined assets of the top six U.S. banks in the third quarter of 2008 and add them together it comes to just over 61 percent of U.S. GDP. Any one of these banks, on average, could then claim to impact about 10 percent of U.S. GDP if it failed. Add the risk of contagion discussed above and you have a ‘too big to fail’ problem. Now do the same with European banks in the fourth quarter of 2008 when the crisis was just about to really take off.

In late 2008 the top three French banks had a combined asset footprint of 316 percent of France’s GDP. The top two German banks had assets equal to 114 percent of German GDP. By 2011 at the peak of the crisis and after two years of ECB inactivity those figures were still 245 percent and 117 percent respectively. Deutsche Bank alone had an asset footprint of over 80 percent of German GDP and ran at an operational leverage level

³⁴ The proposed EU wide banking union of September 2012 seeks to address this problem by making the ECB the monitor for all systemically important banks in the Eurozone – some 5000 entities. The main problem with the proposal, apart from the fact that the UK will most likely torpedo it, is that supervision alone does not solve a problem of solvency. Unless the ECB is willing to become the direct lender of last resort to individual banks across the Eurozone, then simply telling a national regulator that a bank with .8 of GDP is about to blow-up will do nothing to solve the problem if the national regulatory does not have the cash to deal with the problem. Bailing indirectly through the new European Stability Mechanism (ESM) is limited by the size of the ESM. In short, you can’t credibly commit to providing unlimited liquidity with an instrument that is cash limited. By the time of writing this problem has still not been addressed despite the ‘single supervisory mechanism’ and ‘the common rulebook’ being agreed in late 2013.

of around 40:1 in 2012.³⁵ This means a mere three percent turn against its assets impairs its whole balance sheet and potentially imperils the German sovereign. One bank, ING in Holland, had an asset footprint that is 211 percent of its sovereign's GDP in 2011. The top four UK banks had a combined asset footprint of 394 percent of UK GDP that same year.

The respective sovereign debts of these countries of around 80 percent of GDP pale into insignificance. Sovereign debt is ultimately and credibly backed by the inter-generational capacity to tax. Private debt levered off sovereign debt is backed by nothing except the central bank.³⁶ So when the central bank says it's not going to back the system and the system is three times the size of the underlying economies and twice as levered as the entire US banking system, you have a system where European banks have become *too big to bail*.³⁷ No sovereign, even with its own printing press, can bail out bank with exposures of this magnitude.³⁸ So if you have signed up to a currency arrangement where you gave yours away, you really are in trouble. As Simon Tilford and Philip Whyte put it

³⁵ Aaron Kirchfeld, Elena Logutenkova, and Nicholas Comfort, "Deutsche Bank No.1 in Europe as Leverage Hits Valuation," *Bloomberg*, March 27, 2012, <http://www.bloomberg.com/news/2012-03-26/deutsche-bank-no-1-in-europe-as-leverage-hits-market-valuation.html>.

³⁶ All figures here are calculated from bank filings in years 2008 and 2011. <http://media.bnpparibas.com/invest/annual-reports/ra2008en/default.htm> <http://www.credit-agricole.com/en/Finance-and-Shareholders/Financial-reporting/Credit-Agricole-S.A.-financial-results/2008> https://www.db.com/ir/en/content/sec_filings_2008.htm https://www.commerzbank.com/en/hauptnavigation/aktionaere/service/archive/unternehmensberichterstattung/2009_8/u_berichte_09_01.html <http://www.ing.com/Our-Company/Investor-relations/Annual-Reports/Annual-Reports-Archive.htm> <http://group.barclays.com/about-barclays/investor-relations/financial-results-and-publications/annual-reports> http://www.investors.rbs.com/report_subsidary_results http://www.lloydsbankinggroup.com/investors/financial_performance/company_results.asp#2008

³⁷ All of these figures are author's calculations culled from Bank annual reports, BIS reports, IMF GFSR reports and similar.

³⁸ Which goes some way to explaining Germany's hesitancy on banking union proposals and the thorny issue of 'legacy assets' – aka – bad loans. EU bank assets are just over E45 trillion. EU GDP is around E15 trillion. German GDP is only E3.5 trillion. They are simply not big enough to flush away the bad assets even if they wanted to. See Mark Blyth, "Deutschland schafft das nicht." *Der Spiegel*, (42) 14th October 2013, pp. 130-134.

bluntly, the Eurozone crisis is “a tale of excess bank leverage and poor risk management in the core...[and]...the epic misallocation of capital by excessively leveraged banks.”³⁹

Right from the start the Euro was a banking crisis waiting to happen. One trigger for the crisis was Trichet’s denial of lender of the ECBs lender of last resort function. Germany’s insistence on ‘no bailouts’ was another. Greece’s moment of transparency and the discovery of the discovery of contagion/break-up risk was another. The political responses of the European governing classes who opportunistically turned a banking crisis into a public debt crisis at exactly the wrong moment was still another. But the final trigger was one that lay deep within the banking system itself. It was one that centered upon the use of government bonds as repo collateral for the funding of banks. And once again, what is now portrayed as a public sector crisis is in fact, at its core, an almost entirely private (banking) sector problem that quietly became a public sector liability.

Collateral Damage – European Style

So let’s imagine that you are a big European bank and you have executed a giant moral hazard trade against EU sovereigns. To make this work you would need to run very high levels of leverage to profit from it. So where would you get the money to run such levels? Generally speaking, banks can fund their activities in two ways, through increasing deposits and issuing equity on the one hand, and through increasing debt on the other. If more equity is issued the value of each share falls, so there is a limit at which equity

³⁹ Simon Tilford and Philip Whyte, “Why Stricter Rules Threaten the Eurozone,” *Center for European Reform* (November 2011): 5-6. As they further note, “the very countries that have insisted on wrenching economic adjustments in the debtor countries have often been the ones that have done the most to conceal the fragility of their own banks.” Ibid. 8.

issuance becomes self-defeating. Raising deposits, especially in an economy where savings rates are falling, also has limits. Debt has no such limit.

So where can European banks find huge amounts of cheap debt to fund themselves? The overnight sale and repurchase (repo) markets were one source, where enormous sums of money are lent overnight at very low rates of interest against collateral. And where else highly levered European banks borrow short term to fund lending 30 years out? The U.S. money-market funds that were looking for positive returns in a low interest rate world after 2008 provided another conduit. After all, those conservative European banks were nowhere near as risky as those U.S. banks we were told, so why not buy lots of their short-term debt? After all, the ECB will never let them fail – right?

Unfortunately, appearances can be deceptive. As the 2000s progressed those supposedly conservative European banks increasingly switched out of safe, local deposit funding and loaded up on as much short-term internationally sourced debt as they could find. After all, it was much cheaper than relying on Oma's savings. So much so that according to one study, by "September 2009, the United States hosted the branches of 161 foreign banks who collectively raised over \$1 trillion dollars' worth of wholesale bank funding, of which \$645 billion was channeled for use by their headquarters."⁴⁰ U.S. banks at this time sourced around 50 percent of their funding from deposits, whereas for French and British banks the comparable figure was less than 25 percent.⁴¹ By June 2011, \$755 billion of the \$1.66 trillion dollars in U.S. money market funds was held in the form of

⁴⁰ Hyun Song Shin, "The Global Banking Glut and Loan Risk Premium," (paper presented at the Mundell-Fleming Lecture, 2011 IMF Annual Research Conference, November 10-11, 2011): 17. Available at http://www.princeton.edu/~hsshin/www/mundell_fleming_lecture.pdf.

⁴¹ Gabor and Ban, "Varieties of Capitalism for all Seasons: Fiscal Policy in the European Crisis." Unpublished Manuscript (Spring 2012): 9 Figure 1.

short-term European bank debt, with over \$200 billion being issued by French banks alone.⁴²

As well as being funded via short term borrowing on U.S. markets, it turned out those risk-averse European banks hadn't missed the U.S. mortgage crisis after all with the asset side of their portfolios. In fact, over 70 percent of the special purpose vehicles (SPVs) set up to deal in U.S. 'asset backed commercial paper' (mortgages) were set up by European banks.⁴³ 2008 may have been a crisis of U.S. mortgage markets, but it had European funders and channels, and most of those devalued assets remain stuck on the balance sheets of European banks domiciled in states with no printing presses and that were now worried about their sovereign holdings. By early as 2010 then, just as the sovereign debt yields began to move apart, the ability of European banks to fund adequately themselves evaporated in a manner that was an almost perfect re-run of the United States in 2008.

Just as had led to the collapse of Bear and Lehman in 2008, when the collateral being posted for repo by European banks began to lose value, more collateral had to be posted to borrow the same amount of money. While the collateral of choice for U.S. borrowers in the U.S. repo markets in 2008 was AAA rated mortgage-backed securities, for European borrowers in London in 2010 and 2011 it was AAA rated European sovereign debt. Just as U.S. borrowers needed a substitute for T-Bills and turned to AAA mortgage bonds so they could lend more and more, so European borrowers had too few nice safe German bonds to pledge as collateral, and so they began to pledge the periphery debt that they had purchased *en masse*, which was, after all, rated almost the same, a policy that was turbocharged by the European Commission directive mentioned above that "established

⁴² Shin, "The Global Banking Glut," 20.

⁴³ Shin, "The Global Banking Glut," 21.

that the bonds of Eurozone sovereigns would be treated equally in repo transactions,” in order to build more liquid European markets. By 2008 PIIGS debt was collateralizing 25 percent of all European repo transactions.⁴⁴ You can begin to see the problem if that collateral lost value, which is exactly what happened in 2008 in the US and happened again in 2010 and 2011 in Europe.

As investors increasingly fretted about European sovereigns, credit ratings agencies started to downgrade their bonds, which is their job. But that meant more of the same bonds had to be pledged to get the same amount of cash in a repo. Unfortunately, with around 80 percent of all such repo agreements using European sovereign debt as collateral, when those bonds fell in value the ability of European banks to fund themselves and keep their highly levered structures going began to evaporate.⁴⁵

Banks that had healthy assets might have been able to withstand this sudden loss of funding, but European banks were stuffed full of other rapidly devaluing periphery assets thanks to the policy induced recession in the periphery. By early 2010 Eurozone banks had a collective exposure to Spain of \$727 billion, \$402 billion to Ireland, and \$206 billion to Greece.⁴⁶ French and German bank exposures to the PIGS were estimated in 2010 to be nearly one trillion dollars. French banks alone had some \$493 billion in exposures to the PIGS, which was equivalent to 20 percent of French GDP. Standard and Poors estimated French exposures to be as high as 30 percent of GDP, all told.

Again, the vast majority of these exposures were private sector exposures while the sovereign component of these figures was comparatively small. But what mattered was

⁴⁴ Gabor and Ban, “Varieties of Capitalism,” 12.

⁴⁵ *Ibid.*, 14.

⁴⁶ Bank of International Settlements, *Quarterly Review* (June 2010), p. 19.

how levered these banks were and how important those sovereign bonds were for funding these banks. Once these bonds lost value, European banks were effectively shut out of U.S. wholesale funding markets and a general bank-run was just around the corner. Meanwhile, sovereign yields were going up and up regardless of how much sovereigns cut since the problems they faced lay in the banking sectors' use of sovereign debt for funding, and not at all in the fiscal stance of the governments in question.

Doing "Whatever it Takes" (Whatever the Cost)

What stopped that bank run was a change at the top of the ECB from Jean Claude Trichet to Mario Draghi. Trichet saw what was going on and launched the Long Term Refinancing Operations (LTROs) of the ECB in late 2011 where a trillion Euros of cheap funding at one percent for three years flooded Euro banking circuits to replace the funds from the short-term money markets. This unorthodox policy of quasi-quantitative easing offered effective but temporary respite. Yet within two months of the first LTRO sovereign bond yields were rising again, and the banks those sovereigns were responsible for now had even more sovereign debt on their balance sheets since they used the money to buy distressed bonds and pocket the spread. That doing so also brought down yields and allowed periphery banks to clean up their non-performing loans one book at a time was part of the strategy.⁴⁷

In early 2012 Draghi decided to do it again, just to make sure, with LTRO2, which was another half a trillion in funding, and he followed this up in the fall of 2012 with an expansion of the Emergency Liquidity Assistance Program (ELA), which added another

⁴⁷ One might call this a policy of 'borrow at one percent, buy at ten percent, use the spread to bury the dead, and cash it in a four percent.' This is in essence the ECB's stealth QE/ bank resolution mechanism.

half a trillion in liquidity, to periphery banks in particular. He then made his famous promise in 26th July 2012 to “do whatever it takes to save the Euro.”⁴⁸ Yields fell and stayed down on Draghi’s promise. The crisis of the bond markets was over, for now.

Draghi did what Trichet could not bring himself to do. Not because of any newfound love for the other goals written into articles 127 and 3 of the Treaty on the Functioning of the European Union. He did it because the entire European banking system was about to go the way of Lehman Brothers and there was quite simply no way that was going to be allowed. Too many assets and incomes, as well as investments in bank equity and debt, were at stake. But how could the ECB, and the different European governments involved, justify what is essentially a bailout of the assets and incomes of the top end of the European income distribution by the bottom end? They could do so because by the time all this occurred the entire crisis had already been reduced to and narrated nothing more than a sovereign debt crisis caused by too much overspending that had to be met by firm budgetary austerity. That, after all, was the hymn sheet that emerged from Toronto, which now provided cover for the greatest bait and switch in modern history.

It was the greatest bait and switch in modern history because the private debts of the European banking sector became the public debts of European sovereigns smaller than the banks they bailed. They did this the hard way, through off the books liquidity assistance, bailouts, loans, a policy-induced recession, a collapse in taxes and GDP, and a commitment to austerity that has resulted in more debt, not less. The irony, of course, being that if this really was a sovereign debt crisis bond yields and debt loads would move in the same direction. That they move in opposite directions, debt goes up and yields go down, right

⁴⁸ <http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>

across the Eurozone once Draghi intervened, shows perhaps most clearly that this was a crisis of central banks and central bank policy and not a crisis of budgets.⁴⁹ But someone has to pay for that all that debt and it's not going to be those that benefitted from the bailouts, so budgets must be slashed, not to restore confidence or reduce yields as apologists would have it, but to pay for the largest class specific put option ever constructed.

And just how much is that going to cost? Putting aside the cost of austerity policies in terms of lost GDP and unemployment, and focusing only the costs of bailing the banks, Oliver Wyman's latest report on European banking estimates those costs as follows. Of the E700 billion that European banks have raised since 2007, "E350 billion has come from the public sector...In fact, total state support approved for the EU financial sector totals more than E5 trillion, equivalent to 40 percent of [eurozone] GDP."⁵⁰ Of capital injected into banks to keep them afloat, "only about 10 percent of the original capital injected has been repaid."⁵¹ Returns on equity have collapsed to around 4 percent while cost bases have risen, all of which implies without official support these banks would be bankrupt. Again, as Oliver Wyman put it bluntly, "otherwise insolvent banks have been recapitalized and the monetary policies of the ECB and national central banks have allowed themselves at low cost."⁵²

⁴⁹ It was as Paul DeGrauwe and Yuemei Ji showed in a manner that supports this thesis, it was also a crisis of mutually reinforcing panics between markets and policymakers that had almost nothing to do with underlying budgetary positions save the initial position of the spread. See Paul DeGrauwe and Yuemei Ji , "From Panic Driven Austerity to Symmetric Macroeconomic Policies in the Eurozone," *Journal of Common Market Studies*, 51, 2013.

⁵⁰ Oliver Wyman, "The Shape of Things to Come: What Recent History Tells US About the Future of European Banking." Oliver Wyman Consulting Group, August 2013, p. 14

⁵¹ Ibid.

⁵² Ibid. p. 3

Given the costs involved of both the bailouts and the recessionary policies that accompany them, why then do European governments cash in this class specific put option and blame it all on sovereigns who have spent too much? Basically, it's because you could hardly come clean about all this in a democracy and expect to survive. Imagine, just for a moment, if a major European politician tried to actually explain what's going on, why a quarter of Spain needs to be unemployed, and why the whole of periphery Europe needs to sit in a quasi-permanent recession - just to save a piece of paper that has only existed for a decade - and of course the assets of the top end of the income distribution.

When a banking system becomes too big to bail by any one state but its bailed out nonetheless, the moral hazard trade that started it all becomes systemic 'immoral hazard' - an extortion racket begun by banks but aided and abetted by the very politicians elected to serve our interests.⁵³ When that trade takes place in a set of institutions that is incapable of resolving the crisis it faces, the result is a politics of perma-austerity, low growth and much diminished expectations, which is where Europe finds itself today.

Conclusion

Resolving this crisis is in principle quite easy since what begins with the banks must end with the banks. First, stop doing austerity. The fact that yields and debt loads are *negatively correlated* with an r^2 of .96 shows that the size of the deficit is not driving the cost of borrowing.⁵⁴ So long as central bank policy on liquidity is deemed credible, then

⁵³ This brings to mind a perversion of Charles Tilly's classic description of the state as a protection racket where states provided protection from their own predations in exchange for revenue. Now we live in world where politicians (usually unelected) protect banks that run too big to fail/bail extortions rackets against global taxpayers. I thank Matthias Matthijs for this insight.

⁵⁴ See <http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications>

there is room to grow. Portugal and France grew in Q2 2013 because they missed their deficit targets. The automatic stabilizers kicked in and GDP recovered. The next quarter they tightened and growth disappeared. The latest growth figures of Q 2013, once one factors out Germany and similar missed targets (France) is basically flat. This is not a recovery, despite the spin. However, in such a context restoring growth does not require a massive Keynesian stimulus. Simply not self-harming, Hippocrates rather than Keynes, would be a major start.

Second, policymakers need to get the stalled banking union, the institutional reform at the core of all this, sorted beyond the common rulebook and the single supervisory mechanism. German prevarications notwithstanding, today's legacy assets – mainly the bad loans stuck in the Spanish and related banking sectors - need to either be asset swapped out or recorded as losses. To avoid the systemic implosion this would incur, which is why policymakers are hesitant to make progress here, some form to debt mutualization, ECB special purpose financing vehicle, or extension of the European Stability Mechanism is needed. City of London internal estimates place “the mismarking of European banks’ “pretend and extend” on non-performing loans (NPLs) as somewhere between 1.5-2 trillion Euros.”⁵⁵ As bond dealer Bill Blain put it, in its current form, “the Euro 60 billion in the ESM [is] about enough to cover the first 20 seconds of the next European financial crisis when the NPLs are in the region of 1.5 trillion.”⁵⁶ Policymakers must face up to this challenge in order to get Europe out of perma-austerity or risk another crisis.

⁵⁵ Bill Blain, Porridge Newsletter, Bond Markets, December 10th 2013.

⁵⁶ Bill Blain, Personal Communication, December 11th 2013.

Third, and perhaps most importantly, Europe is not a single economy. It is constituted by different varieties of capitalism that work on orthogonal principles.⁵⁷ The current path of recovery via structural reform and new treaty commitments ignores this fact, trying to make very different sets of national institutional complementarities into one set of complimentary trans-national institutions. We must realize that such an effort cannot work. Economies are historically specific complexes of institutions and ideas. The current attempt to turn the whole of Europe into a net exporter in the German image cannot work once one recognizes this. Just as allowing one set of banking institutions to cover the continent ended badly, we risk doing the same now with a flawed one-size fits all fiscal reform agenda. Given how much damage these institutions have already suffered through this crisis, the least we can do is to begin to acknowledge this fact and to admit, that underneath it all, this is a lending, and not a spending crisis.

⁵⁷ Peter Hall, "Varieties of Capitalism and the Euro Crisis."