

## **Banking or Macroeconomic Regulation? Cross-border issues in the EU crisis**

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### **Abstract**

The chapter deals with the monetary and financial dimensions of the EU crisis in a global context. It presents a brief but essential critique of risk-based prudential regulation, arguing that in a financial capitalist economy, it is real activity that creates the cash flows needed to support debt structures. Specifically, debt structures need macroeconomic imbalances, rather than equilibrium, in order to support debt structures. In the European Union macroeconomic imbalances are necessary because of the processes of banking and financial integration that were encouraged by the European Commission since the 1990s. The recent financial operations of the European Central Bank and the Banking Union are first steps towards a more integrated system of regulation of banking and financial markets. But even this will fail without accommodating macroeconomic imbalances. The fundamental question in a post-Keynesian perspective as well as in political economy is whether imbalances are 'forced' on the real economy, or whether credit markets are regulated to allow economic recovery and stable economic growth.

### **Introduction**

The thinking and policy on financial regulation since the 1980s has been resolutely focused on the notion that credit is a commodity exchanged on a voluntary basis between a financial intermediary and a 'consumer' of credit services. At the high point of financial deregulation (around the middle to end of the 1980s) it was widely believed that the only pretext for regulation could be consumer protection (because by the time a consumer discovered the true value of a pension or life assurance contract, it was too late) or contract enforcement. In the wake of the 2008 financial crisis, we know better. Threats of insolvency or illiquidity in the financial system were supposed to be dealt with by encouraging the 'prudent' management of balance sheets, so that banks and financial institutions limited the 'risks' of their assets or liabilities. Foremost among the instruments that are supposed to constrain bank managers to limit their risks are supposed to be capital requirements, enshrined since 1988 in the banking rules recommended by the Bank for International Settlements in Basel. Forcing banks to hold

more capital is supposed to make 'risky' assets more costly, and provide shareholders' funds to meet the costs of balance sheet losses.

The crisis of 2008, and its predecessors in the emerging market crises of the 1990s, and the Third World Debt crisis on 1982, changed the discourse on financial regulation by introducing a new concept of risk. In addition to the well-known incidental risks associated with changes in the prices of assets, exchange rates, or interest rates, a new concept of risk was introduced; that of 'systemic risk'. In the terminology of finance theory, risk was now divided up into idiosyncratic risk, deemed to be an intrinsic property of particular assets, and 'systemic' risk, that is the risk that all, or a large number of, markets may experience declines in prices, or all, or a significant number of financial institutions may become insolvent. Idiosyncratic 'risk' is supposed to be the result of portfolio choices, that is the choices made by fund managers to hold particular assets, and not others, in a given portfolio. Systemic 'risk' is now most commonly attributed to interlocking balance sheets, that is the tendency of financial firms to hold as assets the liabilities of other financial firms or banks. This is the foundation of the 'network' theory approach to financial risk that is now widely accepted by central banks and financial regulators (European Central Bank 2010). This approach to 'risk' then reinforces balance sheet regulation as a way of eliminating risk.

In the chapter that follows, it is argued that this approach to banking regulation fetishizes risk and the role of balance sheet decisions in financial outcomes, at the expense of the macroeconomic imbalances that drive cash flows around the economy. A section on methodological considerations discusses the role of risk and uncertainty in the financial system. This is followed by a section that discusses the current European context for banking regulation, in which deals 'macroeconomic' imbalances are treated as the cause of the crisis, but somehow separate from issues of banking regulation. A third section considers banking

regulation in the European Monetary Union. A final section concludes by pointing out that macroeconomic imbalances are essential for eliminating banking risk.

### **1. Methodological considerations**

The most common approach to banking regulation is founded upon a conviction so widespread that it is virtually never questioned, that bank balance sheets are the results of voluntary individual ‘saving’ decisions and fund or bank managers’ portfolio and funding choices. These are all supposed to be ‘rational’ choices using risk-return considerations of venerable lineage, even if some of the mathematical formalisation dates back to merely the last half-century (see Poitras 2007). There is of course the problem of unintended consequences, a problem that is especially acute in the case of financial contracts. Such contracts, like fixed capital investment, require certain financial commitments now, in exchange for returns whose value, in real or nominal terms, may be unknown. When those returns are negative and involve some kind of a loss, this is attributed to ‘risk’. Most of finance theory consists of learned discussions on the statistical distribution of such ‘risk’.

This is of course how the matter appears to an individual investor or fund or bank manager. But this cannot be a systematic approach to the way in which the economy functions, because the key economic activities that create and distribute income take place outside banking and financial markets, even if using existing bank liabilities (deposits) as means of payment. Somewhere in that economy lie the roots of financial gains and losses. But not being visible to an individual investor or bank manager, these inexplicable events appear as ‘risks’. The assumption of such learned ignorance by economists with serious pretensions was nicely expressed by Marx: ‘... How insipid the economists are who, when they are no longer able to explain away the phenomenon of over-production and crisis are content to say that these

forms contain the possibility of *crises*, that it is therefore *accidental* whether or not crises occur and consequently their occurrence is merely a *matter of chance*.' (Marx 1974, p. 512).

If it is not abstracted 'risk' that causes outcomes to deviate from expectations, then what does cause unexpected losses in the economy? There is a particular business cycle tradition which explains those losses and attributes them to shifts in macroeconomic 'fundamentals' specifically, the effect of business investment on income and cash flow. In this business cycle analysis profits do not 'automatically' accrue, subject to some abstracted 'risk' factor. Capital does not naturally expand to give a return: it is naïve to believe that the mere of my money to someone else makes that money expand in value. Instead that return has to be generated by some kind of production and market process that brings about the return as a money flow in the form of a surplus of sales over costs. By simply assuming that the return occurs naturally, but is subject to risk, economists, bankers and financial regulators are evading the necessity of finding out the causes of financial returns or losses in favour of a generalised statement of ignorance ('risk'). Faced with darkness they prefer to they prefer to talk about disconnected things that happen in darkness, rather than seeking means of illumination. This is especially true of those 'experts' who regard the whole financial system as a system for managing risk, much as they might regard lighting as a system for managing darkness, rather than illumination.

This is of course an oversimplification. There are plenty of theorists who, for example, classify 'risk' according to the circumstances under which particular losses may arise, exchange rate risk, counter-party risk, market risk etc. There are even theorists who will expatiate learnedly about the skewed distributions, fat and thin 'tails' in which crises may happen with unexpected frequency, and so on. A particular kind of mystification has been the outcome of much New Keynesian scholarship around the idea of 'asymmetric information'

(the notion that financial contracts are between parties whose access to information is unequal), and ‘adverse selection’ (the notion that particular arrangements give rise to more risky contracts). The flaws in the analysis are usually two-fold. In the first place it is assumed that bank or financial contracts have some kind of inherent ‘objective’, but unknown risk, whose realisation causes the problem. Yet we know from common observation that this ‘risk’, that is supposed to be inherent in a financial or monetary instrument, is not independent of what happens to other financial or banking institutions that are not parties to that instrument. This is the ‘contagion’ that was widely noted in the wake of the emerging market crises of the 1990s.

The second weakness of this kind of analysis is its dependence on the credulity of the practitioner, regulator, or theorist. Because key variables in the analysis cannot be observed (‘risk’, ‘adverse selection’, ‘contagion’, ‘information’) but must be inferred from the data provided as evidence of these variables, the analysis becomes circular: If you believe that categories of ‘risk’, ‘adverse selection’, ‘contagion’, and ‘asymmetric information’ explain the incidence of bank asset deterioration, then you will find the data to support your explanation in those categories. All of them may explain the statistical frequency of losses or defaults in the financial system.

But the process by which bank asset deterioration arises in a modern capitalist economy is essentially a monetary process, rather than a statistical one. This process can only be investigated by examining monetary circulation in the economy, because it is that monetary circulation that provides the cash flow which settles the financial or credit obligations that are bank assets. There are two levels of abstraction in this analysis. On the sectoral level (that is taking as aggregates households, firms and the government, whose financial obligations are the assets, net of inter-bank or inter-financial institution claims, of the financial system) it was

shown a long time ago by Kalecki and Keynes that the cash flows constitute the income of these sectors is principally determined by the investment expenditure of firms ('capitalists earn what they spend'), plus the fiscal deficit, plus the trade surplus (Kalecki 1942, Keynes 1931).

Steindl developed this analysis to show how it explains financial risk, in the sense that for expected profits to be realised in the economy, the sum of investment, plus the fiscal deficit, plus the trade surplus, must reach a certain threshold set by saving behaviour in the economy. If that threshold is not reached, then expected profits are not realised and firms fall into difficulties with their financial obligations (Steindl 1941, 1945a). Steindl went further and showed that the respective distributions, of profits and debt, among firms concentrates financial risk among smaller borrowers (Steindl 1945b, chapter IV). Minsky was later to express this as debt structures and cash flows. Following Irving Fisher, Minsky argued that a modern credit economy consists of a system of production and distribution, well-known from economics textbooks and, along-side that system, a system of debt contracts, summarised in balance sheets. Minsky showed, in a similar way to Kalecki, that the risk of financial intermediaries is essentially determined by the cash flows generated from business investment, the fiscal deficit, and the trade surplus (Minsky 1986, pp. 141-157). In this analysis, the price system is not merely the vector that brings supply and demand into equilibrium throughout the economy. The price system also sets the parameters by which cash flows are distributed around the economy. Precisely because that price system is determined by supply and demand it is not integrated with debt structures in such a way as to ensure that existing financial obligations are adequately serviced.

There are therefore two alternative views on financial risk. One ascribes the failure of financial or banking assets to generate expected returns to nebulous factors (information

asymmetries, moral hazard, adverse selection, contagion) affecting the *statistical* distribution of such risk. The other view, derived from Kalecki, Keynes, Steindl and Minsky, points to the inconsistencies that arise in a modern credit economy between monetary or cash flows, and debt structures in that economy. The first view derives from the perceptions of finance practitioners. For them, indeed, risk is something ‘out there’. The individual bank manager, creating a bank deposit by issuing a loan to a customer, has no way of knowing how that bank deposit will circulate further in the economy (this is the foundation of theories of asymmetric information – Stiglitz and Weiss 1981). The second view derives from a careful examination of how those bank deposits will circulate in the economy, and the incomes that will be created in that process.

These alternative views affect crucially the scope and possibilities of banking regulation. If the first view is correct, then it should be possible by a combination of statistical research and prudential regulation, to determine the distribution of financial risk and restrict its appearance in bank balance sheets *independently* of what happens in the rest of the economy. Indeed, it may even be possible, by means of prudent financial regulation, to stabilise the capitalist economy, through restricting the financing of *risky* activities. Herein lies that notion that risk is inherent in particular activities or particular balance sheet combinations – maturity transformation, investment banking, hedge funds or private equity are the usual suspects today. In the alternative view, financial risk is an outcome of particular macroeconomic conjunctures affecting the circulation of money and the incomes generated through that circulation given debt structures inherited from the past. At the margin these debt structures may be altered by financial operations (refinancing on different terms with different maturities). But the risk arises in the gap between cash flows and those refinancing possibilities.

## 2. The European Context

International banking adds particular complications to the questions of financial stability and the distribution of risk. In the old international portfolio analysis from the 1950s to the 1970s, cross-border lending offered opportunities for diversifying portfolios and stabilising balance sheets in this way. With the crises of the 1980s, a whole range of new risks were discovered, exchange rate risk, political risk, and so on. For the information-theoretic New Keynesians, the obvious source of the difficulty is the absence of reliable information on conditions and future returns in foreign countries. In other words, the difficulty arises because financial intermediaries do not know the distribution of future returns. Such returns in foreign countries are held to be more opaque because ‘agents’ are assumed to have knowledge that is geographically localised. Hence it is supposed to be more difficult to ‘know’ the true risks of financial assets issued abroad.

There are numerous flaws in this kind of reasoning. While it may appear plausible, in fact the absence of information on conditions abroad may be overcome by institutional techniques, such as having a partner in the country where an investment is undertaken. This then reduces the information problem to a ‘principal-agent’ problem of trust and concordant incentives between the partners. But even if such inconsistencies could be eliminated, and all information were known, there is a much more fundamental logical flaw in the information-theoretic approach to financial risk. Financial contracts are long-term, in relation to the current period. That is, they are claims on future income, or obligations to pay out of future gross (before interest and dividends) income. Can that future income be known? No. Because future income is not just derived from natural endowments whose amount and productivity may be known today. One of those endowments, or factors of production, capital is a produced good. The return on that capital depends on how much capital is produced today.



And the day after tomorrow, the amount and productivity of capital will depend on how much capital investment is undertaken between today and then. In other words, future returns, and the distribution of financial risk is contingent upon decisions taken in the future as well as today. And even if it were possible to know those future cash flows, the assumption that debt structures can be aligned to those cash flows fails precisely because financial contracts are not reconstructed every day to match future cash flows. If financial commitments match future cash flows then, logically, today's debts match today's cash or income flows, and the problem of asset failure disappears. In this sense the information-theoretic approach is an argument that assumes away the problem.

In this regard the analysis of debt structures and the cash flows validating them stands on weaker ground. There is, with minor exceptions (Steindl 1989, Minsky 1989), no literature on international debt structures and cash flows. This is substituted by a very Ricardian kind of analysis that examines foreign borrowing against trade balances. (I refer to it as Ricardian, because like David Ricardo it assumes that money is an imported commodity and that, therefore, the only way to service foreign debt is through a trade surplus). Nevertheless, although undeveloped, this approach of analysing international cash flows and debt structures is crucial for understanding bank failure on an international level. Its implications for macroeconomic management in the European Union remain largely undeveloped, with the signal exception of authors both on the left and the right who consider that the financial crisis in Europe must have something to do with the trade imbalances of the member countries (on the left, Uxó, Paúl and Febrero 2011, on the right Mayer 2012)

In the absence of analysis and instruments of macroeconomic management as ways of stabilising bank balance sheets, the European Union is turning more towards bank regulation as a way of dealing with the consequences, in those bank balance sheets, of what are

perceived to be macroeconomic imbalances. However, the question of financial regulation in the European Union presents an unique set of regulatory dilemmas. On the one hand, it has superficial similarities to the fragmented system of regulation in the United States of America, where states have their own regulatory institutions enforcing regulations within particular states, but there also exists a federal regulatory superstructure in the form of the Federal Reserve, the Securities and Exchange Commission and so on. But Europe does not yet have any federal regulatory superstructure.

This lack of federal regulation has far-reaching consequences for the structure of banking in Europe. Because of this, banks in Europe, even international banks like Deutsche Bank, or Unicredit, are overwhelmingly organised in subsidiaries, subject to national regulation and national capital requirements, as opposed to having cross-border branches. As a result most cross-border lending is in the form of securities issued in a given country and purchased by a bank abroad.

There is, however, an even more striking absence in the financial system that is being created for the European Union. This is the lender of last resort that is supposed to keep the financial system from collapsing due to temporary illiquidity. Until 2008, it was widely believed in bank regulatory circles that such a facility is unnecessary and constitutes a form of ‘moral hazard’. Banks were supposed to take responsibility for the liquidity of their balance sheets, making lending decisions on the assumption that loans would stay on bank balance sheets until repaid. Bank illiquidity was best dealt with in inter-bank markets by banks themselves (with the best ‘local’ information about the causes of any illiquidity). Central bank liquidity should not be provided because central banks cannot distinguish between situations of illiquidity and insolvency. The provision of such liquidity would inevitably end up supporting ‘failed bank business models’.

Accordingly, until 2008, the European Union's policy on bank regulation was the orthodox one of standardising regulation in different countries, to allow for the creation of a true single market in financial services. This has mostly benefitted larger banks that have been encouraged to expand, through mergers and acquisitions, into large international banks, e.g., Deutsche Bank, Unicredit, Société Générale (Grahl 2009). In this way, the European Union recreated a similar situation to the classic English system under the Bank Charter Act of 1844: The central bank's functions were restricted to guarding the value of money, leaving banks to take the moral and legal responsibility for their debts or, what amounts to the same thing, for the liquidity of their customers. In a moral and political climate, created by, or perhaps reflected in, the Maastricht Treaty of 1992, stigmatising excessive debt, a crisis of illiquidity was inevitable precisely because such a crisis can only be overcome by more lending and more debt, not less.

### **3. Regulatory Innovation**

The inevitable crisis occurred in 2008, not so much because of 'contagion' in the wake of the collapse of Lehman Brothers in September 2008, as because the freeze-up of the inter-bank market since earlier that year, and the congestion in the capital market as banks lined up to raise additional capital, left financially exposed a number of large multinational companies (Tata Brothers, GEC, Arcelor Mittal, Rio Tinto Zinc) that had financed major corporate acquisitions with short-term borrowing which they now could neither roll over or refinance into the capital market. The companies responded predictably by cutting back drastically their investment programmes. As economic activity slowed down, so too did income generation and the ability of firms and households to service existing debt commitments. Inevitably this showed up in deteriorating loan books of banks. In Spain, Portugal and Ireland, banks that had extended loans to speculative construction booms found themselves suddenly illiquid.

As with the 1844 Bank Charter Act, the default provider of liquidity, or lender of last resort, turned out to be the government. Spanish and Irish government finances that, before the crisis, had been well within the Maastricht limits, were now overstretched by the need to support their banks in order to prevent the collapse of their financial systems. The decisions to support their banks and their failing economies were policy decisions, rather than the result of fiscal indiscipline or government profligacy. As a result, the crisis was transformed from a banking or commercial crisis into a crisis of government finances that exposed the structural interdependence between bank balance sheets and cash flows in the rest of the economy.

The crisis of government finances in its turn drained what little liquidity was left in banks, if only because government bonds that cannot be sold at a fair price must be held to maturity in order to preserve their value. It was recognition that a crisis of government finances could not be confined to government borrowing that finally persuaded the European Central Bank to emulate belatedly the ‘quantitative easing’ of the US Federal Reserve and the Bank of England. In December 2011, and in the following March, the European Central Bank allotted a total of just over €1 trillion of three year loans to banks at rates of interest of just under 1 per cent, virtually doubling the size of the ECB’s balance sheet. These Long-Term Refinancing Operations (LTROs) were a very effective move. Not only did it relieve the liquidity of banks in Southern Europe. It also offered European governments the next best facility to central bank financing of a fiscal deficit, namely central bank financing of commercial banks’ lending to governments. As long as the yield on government bonds exceeded the rate on central bank borrowing, it was going to be profitable for banks to finance governments.

The LTROs came in the wake of the Vienna Initiative of 2009 that showed the limitations of the earlier attempts at regulating banks. The Vienna Initiative was a much less formal

arrangement under which European banks engaged in cross-border lending (Italy's Unicredit, France's Société Générale, Austria's Raiffeisen International) were given 'financial support packages' by the World Bank, the EBRD and the EIB in return for commitments not to reduce their lending in Central and Eastern Europe. Close to €33bn of public money was lent to the commercial banks. Far from keeping their lending to Europe's new member states constant, the banks reduced their lending and managed to secure a postponement of required capital increases (Toporowski 2012).

In many respects, the Vienna Initiative showed how fatally compromised was the long-standing strategy of standardising bank regulation in member states of the European Union, in the face of the deflation that was spreading through Europe. The parallels with attempts at international coordination of bank regulation were obvious. In difficulty, banks have to be rescued if a run on the financial system is to be avoided. But bank rescue also makes banks less dependent on regulators, whose inconvenient demands can always be postponed until circumstances improve. The only way out of the dilemma is macroeconomic management to ensure cash and income flows in the economy are adequate to meet debt obligations and that requires management of the business cycle in an open economy, rather than just management of debt.

The next attempt to revive bank regulation as an alternative to countercyclical policy, was the European Commission's proposal of a Banking Union. At the beginning of 2012, the European Commission had set up a High Level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen. This reported remarkably quickly, in October 2012, advising the usual diet of balance sheet management (higher capital adequacy, separation of investment from commercial banking functions) for stabilising banks in Europe (High Level Expert Group 2012). But it also endorsed the European Commission's Directive

on a common recovery and resolution procedure for troubled European banks, subsequently passed by the European Parliament (European Parliament 2014). This was part of a European Commission proposal for establishing a Banking Union within the European Monetary Union with a common regulator, to be developed within the European Central Bank, and a common way of dealing with failing banks (European Commission 2014).

In principle the European Banking Union is supposed to ‘domesticate’ the problem of cross-border lending in Europe, reinforcing the single market. A lender of last resort is proposed in the form of a ‘recovery and resolution’ mechanism, under the control of the ECB, which will offer necessary liquidity to banks facing liquidity problems. But, apart from the poor condition of European banks, these latest initiatives are motivated implicitly by an urgent desire to ‘depoliticise’ bank rescues. The practical necessity for this arises out of the European Commission’s and European Central Bank’s desire to take bank resolution (as rescues are called in banking circles) out of the hands of national governments in order to stop such resolutions from derailing government finances, as they clearly did in the cases of Spain and Ireland. But behind this is also a desire to prevent governments from backing the ‘failed business models’ of their national banks. Underlying this is the thinking described above, that the ‘risk’ associated with bank assets is exogenous and outside the control of governments.

Much as military coups to ‘depoliticise’ government end up politicising the military, this latest effort to remove government as a lender of last resort can only end up politicising the European Central Bank even further through its proposed bank resolution mechanism. Two aspects of this proposed system are deeply political. First of all, the allocation of costs of bank rescues between bank shareholders and bondholders, depositors, and public funds has to be a political decision, negotiated between all concerned. This is already exemplified in the rescue of Cyprus in 2013. In the second aspect, costs imposed on residents in any one country will

inevitably be seen as reflecting the standing of that country's government within the European Union. There is no purely 'technical' way of resolving bank difficulties.

## **Conclusion**

In the international monetary system, and its European sub-system, the 'natural' way of strengthening banks is through an investment boom, redistributed to neighbouring countries' economies through appropriate trade and fiscal imbalances. Europe needs effective mechanisms of macroeconomic management to create the macroeconomic imbalances (fiscal and trade imbalances) and investment activity that will generate the cash and income necessary to support debt structures. In such a system, government debt is a necessary instrument of banking regulation, to control the level of liquidity in banking and financial markets. The present approach of providing liquidity to banks and regulating balance sheet proportions (capital adequacy) can provide the means of survival, but cannot strengthen a banking system weakened by deflation in Europe.

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