PREDICTABLE AND AVOIDABLE: WHAT'S NEXT?

Ivo Pezzuto*

Abstract

The author of this paper (Dr. Ivo Pezzuto) has been one of the first authors to write back in 2008 about the alleged "subprime mortgage loans fraud" which has triggered the 2008 financial crisis, in combination with multiple other complex, highly interrelated, and concurrent factors. The author has been also one of the first authors to report in that same working paper of 2008 (available on SSRN and titled "Miraculous Financial Engineering or Toxic Finance? The Genesis of the U.S. Subprime Mortgage Loans Crisis and its Consequences on the Global Financial Markets and Real Economy") the high probability of a Eurozone debt crisis, due to a number of unsolved structural macroeconomic problems, the lack of a single crisis resolution scheme, current account imbalances, and in some countries, housing bubbles/high private debt. In the book published in 2013 and titled "Predictable and Avoidable: Repairing Economic Dislocation and Preventing the Recurrence of Crisis", Dr. Ivo Pezzuto has exposed the root causes of the financial crisis in order to enables readers to understand that the crisis we have seen was predictable and should have been avoidable, and that a recurrence can be avoided, if lessons are learned and the right action taken. Almost one year after the publication of the book "Predictable and Avoidable: Repairing Economic Dislocation and Preventing the Recurrence of Crisis", the author has decided to write this working paper to explore what happened in the meantime to the financial markets and to the financial regulation implementation. Most of all, the author with this working paper aims to provide an updated analysis as strategist and scenario analyst on the topics addressed in the book "Predictable and Avoidable" based on a forward-looking perspective and on potential "tail risk" scenarios. The topics reported in this paper relate to financial crises; Government policy; financial regulation; corporate governance; credit risk management; financial risk management; economic policy; Euro Zone debt crisis; the "Great Recession"; business ethics; sociology, finance and financial markets. This paper aims to contribute to the debate about the change needed in the banking and finance industries and to supervisory frameworks, in order to enhance regulatory mechanisms and to improve global financial stability and sustainability.

Key Words: Financial Crisis, Eurozone Debt Crisis, Financial Stability, Credit, Derivatives, Financial Regulation, Financial Frauds, Economic Outlook, Economic Policy, Corporate Governance, Risk Management, Macro Strategy Analysis, Scenario Analysis, Business Ethics, Finance

** Swiss Management Center University, Balz Zimmermannstrasse 7, 6302 Zug, Zug, CH-8302, Switzerland*
Email: i.pezzuto@gmail.com

The author of this paper still remember perfectly well that day of September 2008 (September 15th) when the financial services firm Lehman Brothers filed for Chapter 11 bankruptcy protection mainly due to the eroding confidence in the valuation of its assets by the repo counterparties who decided to drain their liquidity supply thus leaving the investment bank insolvent. (Pezzuto, 2013; US Bankruptcy Court Southern District of New York – Examiners' report, 2010, pp. 2-14)

That dramatic event and other ones in the industry, which followed the burst of three interconnected bubbles (e.g. US housing bubble, mortgage lending bubble, and shadow banking bubble), generated a liquidity conflagration in the wholesale banking market (and write-downs) which, in conjunction with massive credit ratings' downgrades and investors' panic selling, have led to Wall Street' biggest crisis since the Great Depression. (Pezzuto, 2013)

On October 7, 2008, a few days after Lehman Brothers' demise and the decision of the US Government to launch the **Troubled Asset Relief Program** rescue package, commonly referred as **TARP,** the author wrote and posted a paper titled ***"Miraculous Financial Engineering or Toxic Finance? The Genesis of the US Subprime Mortgage Loan Crisis and its Consequences on the Global Financial Markets and Real Economy."*** (Pezzuto, 2008)

In that paper of 2008 he has explained that from his point of view the root causes of the financial crisis were a combination of multiple, complex, and highly interrelated factors which ultimately resulted in the confidence and liquidity crisis (due to systematic liquidity risk). Those factors, however, were originated by lax lending standards and massive adverse selection; a badly controlled expansion of innovative and "creative" mortgage lending products and financial engineering instruments/securitizations (**Asset-Backed Securities - ABS)**; excessive risk taking (and the transfer of risk of the **ABS** to others through the sale of MBS and CDOs - e.g. **Originate-to-Distribute model**); a dramatic failure of financial firms' corporate governance, audit, risk management and regulatory oversight; low interest rates; poorly rated assets classes by rating agencies; conflicts of interest at all levels; excessive and perverse executive and traders' compensation schemes and incentives; a lightly regulated and overleveraged shadow banking sector (**opaque, off-balance sheet operations on special purpose vehicles – SPVs and SIVs**, over-the-counter derivatives' trading - e.g. CDS, RMBS, CDOs, CLOs, structured finance and synthetic CDOs, and so on); maturity mismatching and excessive reliance on short-term funding; and the increased promotion of methods helping to hide "tail-risks" (e.g. VaR) (Pezzuto, 2008, 2010, 2013). The findings and the underlying assumptions that the author has reported in his paper of 2008 have been confirmed in January 2011 by the **Final Report of the US Government - Financial Crisis Inquiry Commission.** (FCIC, 2011)

Since 2009, big banks in the U.S. and Europe have paid at least ***$128 billion*** *to regulators (but a significant portion of the fines and settlements paid have been tax-deductible as a business expense), according to data compiled by the Wall Street Journal, Reuters, and The Huffington Post for issues tied to the housing collapse and other financial misdeeds, including aiding and abetting money laundering and tax evasion.* (Short, Gongloff, 2014)

In the same paper of 2008 the author has also written that it was quite likely that a crisis of this magnitude could eventually trigger a **potential crisis in the Euro zone due to the excess of debt (private and/or sovereign) of some weaker countries, an expected long recession and spill-over effects, current account imbalances, and other structural economic problems.** Unfortunately his prediction became a reality in 2010 after approximately a couple of years. (Pezzuto, 2008; 2010a)

As he has also explained in 2009 in his chapter (chapter 16) titled ***"Miraculous Financial Engineering or Legacy Assets"*** published in Prof. Robert W. Kolb's book ***"Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future"*** (Prof. Robert W. Kolb's is Frank W. Considine Chair of Applied Ethics and Professor of Finance at Loyola University, Chicago), and as he has also reported in an interview of January 2010 with a leading Brazilian news agency (**Agência Estado**), the Financial Crisis in the USA, which was triggered by a Wholesale Banking Crisis (e.g. Liquidity and Confidence crises due to the distrust among banks and unwillingness to lend to each other), was probably over in 2010, thanks primarily to the timely, aggressive and non-conventional measures undertaken by the Fed, US Government, FDIC, and other stakeholders." (Pezzuto, 2010a; 2013)

As hundreds of billions in mortgage-backed securities went bad, banks became suspicious of one another's undisclosed potential credit losses and preferred to reduce their exposure in the interbank markets. **This withdrawal caused the increase of interbank interest rates, spreads, and credit default swaps, and massive credit crunch and liquidity shortage**. The author has also mentioned that the bail-outs would eventually have a sizable impact on the countries' sovereign debts (shifting the burden of the risk generated by **the burst of the three bubbles**, the **meltdown of the financial sector**, and the consequent **'Great Recession'** to the sovereign debt), and the huge increase in sovereign debts and/or deficits could eventually trigger **additional crises (e.g. tail risk) or fiscal challenges.** This became quite evident in Europe in 2010 with the **Euro Zone Debt Crisis** in the peripheral countries due to high sovereign debts, deficits, slow GDP growth, lack of **structural reforms (pension, welfare, labor market, bureaucracy, lobbies/corporatism, education, tax system, industrial policy, and properly capitalized banks**), lack of a single crisis resolution scheme; current account imbalances, and in some countries, housing bubbles/high private debt). (Pezzuto, 2008; 2010; 2010a)

When the peripheral European countries joined the euro in the late 1990s (the European Monetary Union), the interest rates they paid fell sharply as market participants judged that the value of investments in these countries would no longer be vulnerable to erosion through currency depreciation (competitive devaluations aimed at boosting exports). Low interest rates, however, spurred heavy foreign borrowing by both the public and private sectors in the countries and triggered bubbles and debt crises. **The problem was that foreign capital was used to support domestic consumption or housing booms rather than productivity enhancing investments**. Thus, these countries engaged in substantial foreign borrowing for a number of years. In other words, in spite of the fact that the economic fundamentals and business environment were not particularly brilliant (e.g. moderate GDP growth rates in some countries, or higher ones, but driven mainly by the housing and lending bubbles; high sovereign debts, and in some countries also high budget deficits; low productivity/higher unit labor costs in manufacturing, low investments in innovation, and decreasing competitiveness; current accounts imbalances and stronger exchange rates which eroded competitiveness; and bureaucracy and clubby systems/"cosy elite" defending their status quo), these states had a wide availability of very cheap interest rates, just like in the "core" Northern European countries, since investors and financial markets had limited perception of a potential underlying higher sovereign risk (risk premium), which could be triggered by severe and prolonged financial and economic shocks (e.g. the global financial crisis), without a lender of last resort (ECB), or without a fiscal and banking union, and solidarity mechanisms among member states. This has led in a number of peripheral countries to the ***"Easy Credit"* euphoria** and to heavy borrowing engagements from foreign private investors, which has ultimately allowed domestic spending to outpace incomes. Then, as it is well known, there was the perceived debt crisis (e.g. “Grexit”) which reflected a loss of investor confidence in the sustainability of these countries' finances and caused a spike in domestic interest rates. (Pezzuto, 2013; Higgins, Klitgaard, 2011)

Furthermore, when the **Financial Crisis** hit the Eurozone and the **Debt Crisis** sparked panic among investors, numerous large banks operating in the region have been under **considerable pressure with their existing business models** due to the systemic shock and its aftermath **(e.g. "Great Recession”, record unemployment rates, low aggregate demand, dramatic fall in investments, very low inflation, low levels of confidence, capital flight of investors, tough austerity measures, banks' deleveraging process, etc.).** Most of all, however, a number of banks have faced significant challenges to cope with the **financial regulation on liquidity ratios, capital requirements, leverage ratios, and other criteria** (which have been also "softened" over the years to help bolster the recovery). The real issue, however, was that a number of these banks at the time of the crisis were **oversized, overleveraged, undercapitalized, heavily exposed to sovereign bonds of the countries affected by the perceived debt crisis, or exposed to "toxic assets"** (e.g. structured products, complex derivatives, and shadow banking activities booked prior to the 2008 financial meltdown). Last but not least, a number of banks have been also affected by the **rising NPLs** of firms badly hit by the financial crisis and the **"Great Recession."** Furthermore, differently from the USA, some banks have not done, soon after the crises, all the **write-downs** they could have done (or the sale of poor quality assets), in order to **clean up their balance sheets, boost their capital, and immediately help revamp lending and investment opportunities for business and households with the support of the massive and "generous" liquidity received from the ECB, and other stakeholders (e.g. bank recapitalizations), over the years**. (Pezzuto, 2013; Plateroti, 2014)

European Banking Authority President, Andrea Enria, was quite clear on this concept when he stated in an interview on September 14th, 2014 the following insightful statements:

We’re trying to exit a crisis unlike any other, a balance sheet recession driven by an excessive expansion of debt. Even in recent years, the indebtedness of the private sector has continued to grow. Businesses and households are suffocated by the weight of debt and delay spending, even for investments. ***The recognition of losses on banks’ loans is necessary to reduce the debt burden on the private sector****, it is the other side of the coin. A quick balance sheet cleaning—which in the United States, admittedly, was greatly aided by public support mechanisms, such as Fannie Mae and Freddie Mac—and a restructuring of the banks create space for new loans to new initiatives.* ***If banks continue to maintain assets valued at unreasonable prices on their balance sheets, we take away resources for new investment****. This is also a lesson coming from the experience of crisis management in the Nordic countries in the early 90s’.* Furthermore, **Mr. Enria has also remarked that “dangerous banks should be allowed to fail. He also added: “keeping them artificially alive only prolongs the agony and penalizes savers.”** (Plateroti, 2014)

In the author’s new book of 2013 titled ***“Predictable and Avoidable: Repairing Economic Dislocation and Preventing the Recurrence of Crisis”*** published by Gower, which has been classified as *‘Research Essential’* by **Baker & Taylor YBP Library Services,** as *'Relevant Money Laundering and Fraud Title'* by **the UK IMLPO (The Institute of Money Laundering Prevention Officers)**, and ‘valuable work of interest to academics, industry experts and students alike’ by **The Economist Intelligence Unit. World: Finance bookshelf, December 2013,** he has reported all the analyses and research findings he has undertaken since 2008 on the topic. In the book he has also proposed new frameworks, policies, and rules on how to help prevent other systemic crises in the future.

Conventional wisdom, basic economics theories, and empirical evidence lead us to believe that financial and economic crises, by definition, are most of the times difficult, if not impossible to predict and avoid. Even though it is well known that economics is not a pure “science” and that not all crises can be predicted and avoided, it is quite clear to any reader of the author’s new book that the 2007 – 2009 global financial crisis was certainly predictable and avoidable. (Pezzuto, 2013)

His new book ***“Predictable and Avoidable"*** has been enriched with the precious contributions of selected **"Global Thought Leaders"** and Industry Experts. These world-class thought leaders are prominent scholars and industry experts of the following institutions: **University of Chicago, Stanford University, NYU Stern School of Business, IESE Business School, Ukrainian Academy of Banking of the National Bank of Ukraine, Bocconi University, Catholic University Milan, State University of Milan, University of**

Pisa, Financial Times, Bloomberg LP, London School of Economics, (Fed) Federal Reserve Bank, Wharton Financial Institutions Center, Intesa Sanpaolo Bank, Unicredit, Citibank, Sorbonne University, Barclays, (Ulster Bank) Royal Bank of Scotland, Iason Ltd, Temenos, Oracle, Eurointelligence, and other leading institutions.

Almost six years went by from the date in which numerous countries have been hit by the worst financial crisis since the Great Depression, and almost four years have passed from the date (July 21, 2010) in which a new comprehensive, high-level regulation was signed into law in the USA (the **Dodd-Frank Wall Street Reform and Consumer Protection Act)** aiming to introduce a sweeping overhaul of US banking rules and to help prevent the recurrence of a crisis similar to the one of 2007 – 2009 or even worse.

Even in Europe since 2010 regulators have introduced new risk governance frameworks, regulations and compliance rules (e.g. **Basel III**; **Capital Requirements Directive - CRD IV**;**Capital Requirements Regulation – CRR; European Market Infrastructure Regulation – EMIR**; **Mortgage Credit Directive 2014/17/EU**; **Markets in Financial Instruments Directive - MIFID II** and the **Markets in Financial Instruments Regulation - MiFIR; Financial Transaction Tax – FTT**; the **European General Data Protection Regulation; Target 2-Securities – T2-S, etc.**) in order to enhance risk mitigation techniques, to make the financial system more efficient, transparent, and resilient to financial and economic shocks, and to strengthen the protection of investors.

In spite of the massive and expensive overload of new regulatory requirements recently introduced, however, few in the global financial services industry and in the academic world apparently believe that this new alleged comprehensive and forward-looking regulation will be able to prevent the recurrence of other financial and economic crises in the future. Some analysts even argue that overregulating the financial services industry will eventually lead to more complexity, bureaucracy, fragmentation, and discretionary decisions. They also claim that the overload of rules will also generate higher operating costs and advisory fees for financial firms, more ex-post supervisory controls for authorities, and more “political” interference in the financial markets (e.g. revolving doors, lobbying activity, power networks).

Trying to avoid **the risk of overregulation** (which by now it is no longer a risk but probably a reality), or perhaps more correctly, **the risk of not regulating all the real causes of the financial crisis**, today policy makers and regulators should be mainly concerned with three very simple and straight-forward questions:

(1) Is the new financial regulation able to help prevent the recurrence of systemic crises and other bail-outs (rescue with taxpayers’ money)?

(2) Have financial firms managed to strengthen their risk culture, transparency, corporate governance's accountability, and the risk appetite frameworks of their organizations?

(3) Are the record civil settlements so far reached between major banks, the Department of Justice, the Securities and Exchange Commission, and states’ attorneys-general, adequate deterrents to help prevent future wrongdoings, financial fraud charges, and to hold banks effectively accountable for triggering financial crises?

The author certainly hopes so; keeping in mind, as he has already stated, that not all crises can be avoided.

In an interview he has had in 2011 with **Agência Estado**, he has reported that a generalized approach of contractionary fiscal policies in the Peripheral European Countries, based only on tough national austerity programs; rigid budget discipline, fiscal consolidation, state-owned assets and shareholdings' dismissal, and higher taxation; with limited or no commitment also to contracyclical measures towards growth (investments on innovation, education, infrastructures, tax breaks and tax wedge reduction); effective structural reforms, spending cuts (to fill the 'competitive gap' and to revamp productivity and expectations), and some degree of flexibility to reach budget and fiscal consolidation targets during adverse economic cycles, would eventually turn a bad situation into a worse one (***self-defeating strategy***) or prolonged recession ('Great Recession') or stagnation. Furthermore, as well-known, within a Monetary Union (Euro Zone) macroeconomic and current account imbalances are difficult to fix without a fiscal, political, and banking union and a fiscal transfer mechanism; during prolonged periods of generalized stagnation/low inflation; without a central bank with a "lender of last resort" mandate or a strong commitment also towards growth and employment targets. (Pezzuto, 2011a) Even the monetary policy of the ECB during the period 2009 - 2011 has not been adequate and aggressive enough (non-conventional) to offset the risk of the 'Great Recession.' At the end of the day, even aggressive and non-conventional monetary policies that do not reach the real economy (e.g. due to credit crunch, credit rationing, higher borrowing costs and higher loan loss reserves) during prolonged periods of recession or slow growth (due to an ineffective monetary policy transmission mechanism or liquidity trap), when are combined with weak or contractionary fiscal policies, financial strains, low consumer spending, firms with high debts/NPLs that do not invest (due to greater uncertainty, anxiety, and a confidence crisis), record unemployment, near record underemployment and low participation rates, and ineffective or delayed structural reforms, may eventually end up generating a fragile and anemic economic growth, forcing weak countries to a long period of slow nominal GDP growth, painful structural reforms, high social costs, difficult macroeconomic adjustments, and difficult to sustain fiscal consolidation plans. In other words, a **QE solution** (that is based on newly created money used to buy government bonds or other financial assets) **alone might not work in the long run without also well-developed capital markets in the peripheral Eurozone countries for SMEs' financing needs, the timely and effective implementation of structural reforms, bold fiscal stimuli and investments by the European Union, lower taxes, agility to rethink the Eurozone fiscal policy (e.g. temporarily delaying efforts to shrink Eurozone countries' budget deficits and allowing surplus countries to reduce taxes, boost demand, and promote employment), and radical changes in the countries' business and economic models, governance, culture, and mindset. Deflation** might turn out to be a **very "tricky" situation** for the Eurozone if not solved rapidly. Furthermore, currently the ECB faces also the risk of a **liquidity trap,** since **nominal interest rates/yields on bonds are very low** and in some weak peripheral economies the **demand for loans is anemic** due to the prolonged stagnation, weak aggregate demand, and a generalized risk aversion. The ECB has announced on September 4th, 2014 aggressive new measures, within the limits of its mandate, to help mitigate the threat of a stagnation-deflation spiral. The proposed measures consist of additional non-conventional monetary programs such as, **Targeted LTRO, private asset-buying program – ABS, negative deposit rate, and refinancing rate cut, but perhaps may also include the purchase of non-Eurozone foreign currencies, assets, Treasuries, etc.).** Of course, reckless investors and financial markets might be very happy for a while scrabbling for yields, thanks to the additional massive liquidity injections of ultra-accommodative monetary policies. Nevertheless, as the author has stated in **the book *"Predictable and Avoidable,"*** he believes that an optimal decision would be to launch a **full-blown quantitative easing program** in the Euro Zone, or preferably, a ***"Printing Money" Program*** **based on newly created money supply to directly fund EU spending** (**changing EU Treaty and ECB mandate**) in order to revive economic growth in the region, raise medium-term inflation expectations, depreciate the euro exchange rate relative to other currencies, and help prevent the threat of a deflationary spiral, if well-orchestrated and balanced with timely and effective **fiscal stimuli and "real and mandatory" structural reforms (e.g. labor market, tax breaks and tax wedge reduction for firms, public expenditures cuts, drastic decrease of tax evasion and tax avoidance, simplified legal system, merit-based competition, and improved productivity and competitiveness).** At least, if the ECB will eventually opt for a QE solution, or preferably, a "Printing Money" Program (if available), the monetary policy maker should not be faced with the immediate risk of runaway inflation. (Pezzuto, 2013; Zingales, 2014) Yet, as well known, the "Printing Money" Program solution is currently classified as **"Mission Impossible"** due to political constraints (existing EU Treaty and current ECB mandate). Furthermore, to support an increase in aggregate demand of the Eurozone which has been hampered by severe stagnation and very low inflation, 'the ***European Parliament*** *could decide to* ***co-fund a public mechanism to support job flexibility in countries with high unemployment***.' (Zingales, 2014)

British economist ***John Maynard Keynes*** *argued decades ago that a fixed exchange rate system could only function effectively over the long run if there were mechanisms in place to promote adjustment in countries with surpluses as well as those with deficits* (Higgins, Klitgaard, 2011)

In spite of the need of **urgent structural reforms** in the weaker European countries; of additional **non–conventional monetary policies** to reduce the **threat of deflation**; and of the acceptance of **some degree of flexibility to reach budget discipline and fiscal consolidation targets**, if the weaker economies do not recover soon (e.g. increasing GDP growth rate, rising inflation rate, lower unemployment rate and sovereign debt, etc.), these countries might be forced, sooner or later (**if deflation sets in**), to seek the ECB and the European Commission's support to work out financing (**ESM or EIB)** through a broad **debt restructuring plan** (or to use their **gold reserves** as collateral), in order to reduce their huge sovereign debts. Alternatively, they might also seek the **ECB, EIB, IMF** and other stakeholders' support (private banks, venture capitalist, credit funds, government-owned development banks, privatization plans, and other investors) and **governments guarantee schemes** to finance bold long-term infrastructural and investment projects to revamp economic growth and to assure a long-term sovereign debt sustainability. The problem, however, is that currently the majority of the **sovereign debt is owned by** the same countries' citizens, and mostly, by **banks.** Thus, **John Mauldin** argues that these countries urgently need a **banking union** in order to move some or all European debt (**debt mutualization**) to the balance sheet of the European Central Bank, in lieu of a classical restructuring and default, such as happened in Greece (Mauldin, 2014a). Nevertheless, the scope of a potential **full-blown quantitative easing program** in the Euro zone could be also to reduce the concentration of sovereign bonds in the peripheral Eurozone countries' banks portfolios and to boost lending. After all, given the current anemic GDP growth in the Euro zone and very low inflation (**disinflation**), well below the medium-term inflation expectations (five-year swap rate which averages inflation expectations over five years in five years' time), it may also prove useful to German companies to have **higher "core inflation"** and a **euro**

depreciated (thanks to a full-blown QE or a credit easing program) in order to improve their global competitiveness. A potential **debt restructuring option** or even a **potential "Euro zone exit"** of weak economies like **Italy (unlikely in the short-term),** which are currently stuck in a ***"deadly debt trap",*** might eventually lead to **devastating consequences for the global financial and economic stability and sustainability.**

In another interview of 2011 with **Agência Estado**, the author has reported his recommendation to rapidly set up a **Single Crisis Resolution Mechanism (burden-sharing mechanism)** in the Euro Zone for weak and potential failing banks. Furthermore, he has also suggested the introduction of a ringfencing mechanism to avoid potential Spill-Over Effects (systemic risk contagion resulting in higher bond yields/spreads) from countries with high perceived solvency risk (e.g. "Grexit") to other countries, due to the **vicious circle between Sovereign Risk (e.g. Greece) and Bank Risk, long lasting structural macroeconomic problems, and drastic downgrades of credit rating agencies.** In the same interview, he has also suggested the immediate introduction, like during the most acute phase of the financial crisis in the USA, of **several investment programs that would help stabilize the economies on the brink** (e.g., to unfreeze the markets that provide credit to businesses and families; rapidly clean up banks' balance sheets and to require recapitalization of troubled banks in order to avoid worsening the 'Great Recession' in the region through: 1) additional credit crunch/higher borrowing costs for "Peripheral Euro Zone Countries"; 2) tough austerity programs: 3) current account imbalances; 4) and the potential risk of low inflation or deflation). Finally, he has also raised attention, in the same article, on avoiding in the future other poorly reliable **"stress tests"** in the Euro Zone (e.g. **macroeconomic adverse scenarios and their underlying assumptions**) in order to increase investors' trust in the resilience of the financial system to financial and economic shocks. (Pezzuto, 2011b)

Furthermore, the corporate world in the last few years has pursued **massive leverage strategies** issuing trillions of dollars of **corporate bonds**. This practice has been facilitated by the excess of liquidity and cheap funding guaranteed by the central banks, and has allowed corporations to **lever up (e.g. higher leverage) their balance sheets and to conduct stockholder-friendly actions, like buying back stock or paying dividends**. As a result of these strategies, the corporate world has **artificially increased the profitability of their businesses (and their earnings per share)** for common stockholders and not for bondholders, but without changing also the fundamentals of their businesses through **investments in capital expenditures** (e.g. using debt to finance economic growth and to bolster competiveness and higher employment rates) (Dillian, 2014).

What's Next?

At the beginning of 2013, while the author was working on Chapter 4 of his book **"*Predictable and Avoidable,*"** he wrote the following outlook which seems to fit quite well the current environment (September 2014):

"In 2013 there is still a high level of uncertainty in the global economy which makes the long-term scenario quite complex to be predicted. Some of the highly interconnected factors that contribute to this scenario are: (1) the encouraging economic data in **the US** and the opportunity to start the **"exit strategy";** (2) the recent **ultra-aggressive fiscal and monetary policies of Japan;** (3) the uncertainty about a **change of pace of the so-called emerging markets** and the threat of **China's credit bubble and its huge "shadow banking" sector**; (4) the impact of new innovations and developments in the **natural resources and energy industry**; (5) structural economic issues related to the **ageing of population and the sustainability of the welfare systems** in the western economies; (6) the high level of uncertainty generated by the **Eurozone countries' anemic growth;** (7) the need for a better global **harmonization of the financial regulation**; and (8) the **political instability in the Middle-East**. (Pezzuto, 2013)

Looking forward, today, he believes that it is important to keep an eye on the following additional items:

Unsolved structural economic problems, economic slacks, **anemic GDP growth, low inflation, and fiscal challenges; consumer and corporate debt-led growth** (e.g. **investment** grade and **high-yield bonds/junk bonds,** and **CLO, CDO, ABS mezzanine and equity tranches,** and low liquidity in secondary markets) based on increased borrowing (leveraged loans and credit markets vulnerability) (Gallo, 2014); Differently from the stock market, the corporate bond market, in general, is far less liquid and tends to perform quite poorly during periods of rising interest rates; New creative and innovative derivatives (e.g. total return swap - TRS) which *allow investors to gain exposure to a portfolio of bonds or loans without actually having to stump up the cash needed to own such assets. Investors pay money to a bank or other counterparty in exchange for income linked to the performance of the underlying basket of securities* (Alloway; Mackenzie, 2014); **heavy debt burden (debt traps), medium-to-long-term sovereign bonds adjustments (longer maturities) and monetary policy divergence among central banks and the consequent carry trade operations (speculation)**; overleveraged sectors; massive use of **special-purpose vehicles (SPVs)** for offloading financial and insurance firms' risk; **excessive risk-taking (e.g. Investors are becoming complacent about risks in financial markets as loose monetary policy spurs a search for yield), loosen lending standards, lightly-regulated financing, circumvented financial regulation, and implicit or explicit governments' guarantees or subsidies (funding advantages) to revamp growth** (Alloway, 2014); **banks' secrecy agreements, insider dealing, and market manipulation** (Ross, 2014); **circumvented remuneration rules by some Euro zone banks**; **welfare and pensions funds sustainability, and unconventional risk appetite of pension funds and insurance firms; potential bubbles** (housing market and other asset classes) and the impact of interest rate hikes (and spill-over effects); **creative accounting statistics** (e.g. as part of an EU-wide accounting overhaul, criminal activities will now play a part in GDP calculations); and **liquidity, geo-political issues and other externalities, and global imbalances.** All of these changing factors might eventually become triggers of new potential systemic risks in a medium to long-term time horizon.

Since the 2008 financial crisis, central banks have done a great job to **reduce inflation and volatility**, but their ultra-aggressive policies will probably not prevent the recurrence of new systemic shocks in the long run when monetary policies and interest rates will start normalizing, **since debt (private and public debts) and risk-taking will probably remain quite high**; structural reforms might not be completed; fiscal problems might still be partially unsolved, and the lack of global competitiveness might still force some weaker countries to anemic growth, high deficits, and painful consolidation plans. Under this adverse scenario, the Eurozone survival could be at risk in the long run without a greater co-ordination of fiscal policies across the euro area, full-blown quantitative easing programs, and the effective implementation of critical structural reforms to revamp competitiveness. An alternative but not less gloomy adverse scenario for the Eurozone could be the one of a regional area trapped in a long-lasting and painful recessionary and deflationary or disinflationary environment with no way out.

Furthermore, since the burst of the financial crisis, volatility in the markets (and in particular in the foreign exchange markets) has been mainly repressed by a prolonged period of monetary policy alignment in the advanced economies. Looking forward, however, this extremely low (realized and implied) volatility in the markets is harder to maintain in light of increasing economic and policy divergences. For this reason, it is critical to raise attention on the potentially disruptive consequences that policy divergences might generate on global financial stability and the sustainability of investor gains in financial markets. (El-Erian, 2014).

However, it is not only the widening monetary policy divergence that might affect the future global financial stability and sustainability, but also the monetary policy normalization process, which plays a critical role in achieving such goals.

For example, if **monetary policy normalization in the USA** is not completed smoothly and carefully, in spite of improved productivity and corporate profits, there could be the potential risk of a **strong correction in the markets**, since the **prices of corporate bonds and equities have been "artificially" inflated since 2008 by six years of consecutive close to zero percent Fed Funds rates and three rounds of massive QEs** (Pezzuto, 2013).

Furthermore, it is interesting to notice that at the end of August 2014 some weak peripheral countries of the Eurozone (e.g. Italy) have reached **the lowest spreads on 10-year sovereign bond yields relative to the German benchmark** (sovereign bonds) and a **record high level of assets under management (AUM) by the asset management industry**, despite their persistent dramatic macroeconomic fundamentals (e.g. recession, deflation, declining average income, decreasing industrial production, slow-moving structural reforms, huge sovereign debt, record unemployment rate, increasing CDS prices, etc.) and stagnant or declining indicators of economic sentiment. The unemployment rate in Italy has increased from 6 percent of 2007 to approximately 12 percent of 2014. Italy cannot longer rely on competitive devaluations to boost growth and competitiveness (e.g. lowering its domestic interest rate; allowing the central bank to monetize its debts, or devaluating its exchange rate). But apparently, investors do not seem to worry too much about it, since they probably have some level of confidence in the current government's commitment to implement the necessary structural reforms, but mostly because they are fully aware of **Mario Draghi's famous pledge** to do ***"whatever it takes to keep the currency union intact,"*** and also because they know that Italy's huge public debt is **"Too-Big-To-Fail" for the Eurozone's survival** (and it could potentially trigger a ***"tail-risk" event*** on a global scale**)**, thus they are fully aware that in the worst case scenario, the **UE, ECB, IMF** and other related stakeholders (e.g. **ESM, EIB, government-owned development banks, etc.**) would not let it fail (default).

In fact, the current low level of sovereign bonds' spreads is mainly explained by the investors' confidence in the recent **ECB's (European Central Bank)** decision to offer a package of extraordinary measures to help boost Eurozone growth and recovery and to ward off Euro zone deflation threat (in August 2014, Euro zone inflation slowed to 0.4 percent). For a number of analysts, however, the decision announced by the ECB on September 4th, 2014 to launch the **purchase of a broad portfolio of simple and transparent asset-backed securities (ABSPP), with underlying assets consisting of**

claims against the euro area non-financial private sector (e.g. not just ABS backed by business loans but also residential mortgages), and a broad portfolio of euro-denominated covered bonds issued by MFIs domiciled in the euro area (CBPP3), might not be sufficient to revamp the **aggregate demand** in the Euro zone and to reduce the **threat of deflation.**

The recent ECB policy measure to **purchase ABSs (Credit Easing)** includes also the previously announced decision to offer ultra-cheap funding to SMEs through the **TLTRO** (Targeted Long-Term Refinancing Operations), and **a further cut of its official interest rates** (e.g. a cut of its main refinancing rate, the repo rate, from 0.15 percent to 0.05 percent; a cut of its marginal lending facility - or emergency borrowing rate - to 0.30 percent; and an increase in the amount the ECB would charge lenders for overnight deposits to 0.2 percent).

As stated by ECB President, Mario Draghi, *"The purchase of ABS will involve both newly created and existing ABS and would also include the real estate, the RMBS, real estate ABS. It would also include a fairly wide range of ABS containing loans to the real economy."* (ECB, 2014)

The new program (asset-backed securities) and the recent extension of eligible collateral requirements to additional and riskier credit claims, e.g. **Additional Credit Claims (Acc),** might probably result quite useful to help **clean up Eurozone banks' balance sheets**, and to provide additional credit for the region's households and businesses through the purchase of new and prior issuance of asset-backed securities. The end of the concurrent **Asset Quality Review (AQR)** and the **Stress Test** exercises in the Fall of 2014, which have been undertaken respectively by the ECB and the European Banking Authority (EBA), seem to match quite effectively and timely the need to **strengthen the Eurozone financial system** following the aftermath of the global financial crisis. The sooner will be completed the clean-up process of banks' balance sheets, through the **ABS purchases or QE rounds** (with or without governments' guarantees), the faster probably will be restored the business lending activity in the Euro zone. Unfortunately, however, restoring the regular lending process in the Eurozone might not be sufficient in the short-term to revamp economic growth and employment in the weaker Southern European economies.

As stated by Eurointelligence president and associate editor of the Financial Times, **Wolfgang Münchau**, *"the ABS programme is .... quantitative easing on a small scale. The assets including covered bonds – bonds issued by banks with a collateral guarantee – and asset-backed securities. The latter are securities issued by banks against loans they have given, for example, to individuals and companies. A purchase guarantee for those bonds should make it easier for banks to lend because they can pass on the risk to the ECB – and ultimately the Eurozone taxpayers if the borrowers default on their loans."* (Münchau, 2014)

Furthermore, give the current adverse market conditions (e.g. macroeconomic challenges, stagnant GDP growth rates, record high unemployment rates, and prospective deflation), a number of governments of the Eurozone countries are also encouraging the purchase by institutional investors **(e.g. pension funds and insurance companies)** of **corporate bonds**, **mini-bonds** for SMEs, and **other corporate and SME-linked securities**, in order to significantly increase the offer of lending facilities to SMEs, and to limit banks' risk concentration in the corporate/SME segment of the lending market, and the burden of non-performing loans (NPLs).

On the positive side, it is worth mentioning that in the Eurozone apparently the securitization activity seems to be less risky than in the USA as default rates are lower. It is well known that securitization in itself is not a systemically risky practice, the risk comes with the way it is performed (as it is well known, the reckless use of ABSs, opaque off-balance sheet vehicles, OTC trading, high leverage ratios, limited capital, unfit funding strategies, and poor oversight have led to the 2008 global financial crisis). Thus, the European Central Bank's plan to revive the Eurozone's dormant securitisation market, through the purchase of a ***"broad portfolio of simple and transparent asset-backed securities"*** might be a move in the right direction to bolster economic recovery and reduce the threat of deflation, although it is not sure whether this plan will succeed in stimulating economic growth and bank lending, without adequate actions by governments (e.g. greater co-ordination of fiscal policies across the euro area) and the timely and effective implementation of critical structural reforms. (ECB, 2014)

In an interview the author has had with **CNBC Europe** on September 3rd 2014 (the day before ECB announced to launch new unprecedented policy measures to help boost business lending), while expressing great appreciation for the innovative and daring policy decision, given the existing constraints of the ECB mandate, he has also warned about a few potential shortcomings of the expected new measures (e.g. ABS purchases and Targeted LTROs, etc.). The potential shortcomings he has envisioned in his analysis during the interview include:

- The current record low volumes of the European market of ABS backed by SME loans, even if the residential mortgages market is instead quite big and attractive for potential ABS purchases;
- The inadequate, fragmented, and small-sized capital markets in the Eurozone for SMEs;
- The SMEs' perception of securitization as a relatively expensive funding source;

- The risk that banks will not use the TLTRO funds to provide lending to SMEs. In fact, banks that don't lend the TLTRO funds to firms are obliged to repay them after two years. In other words, banks are allowed to use the TLTRO funds for purposes other than lending to SMEs as long as they will repay the funds within two years;
- Some banks might decide to take the new TLTROs only to replace their previous funding sources, that is because the previous LTROs are reaching the expiration date;
- Larger firms and more attractive large investment projects might have better chances to get the new TLTRO funds than SMEs since they have higher credit ratings and are more appealing to banks;
- Lending to SMEs requires higher capital requirements than holding sovereign bonds in their portfolios. Thus, banks might decide to hold on to the "risk-free" sovereigns in their portfolios (which currently offer very low yields) despite also the massive availability of additional liquidity for business lending (up to €400bn in ultra-cheap four year loans - TLTROs - at zero percent interest rate), because the latter currently impose higher capital charges. Furthermore, although numerous banks are still packed with NPLs and might potentially have an advantage to sell these loans through the securitization process (ABS), many still prefer to hold on to their NPLs because they do not want to sell them accepting major write-downs. Thus, perhaps for this reason they prefer to wait for the outcome of AQR and Stress Tests before making any decision on their NPLs portfolios since they might be worried over potential capital shortfalls;
- An additional impediment is that the ECB's negative deposit rate might discourage banks to take funds unless they have loans ready to originate;
- Ultimately, the combination of lower capital charges and higher potential capital gains from price appreciation of long-term sovereign bonds, which have been purchased during the most acute phase of the debt crisis, might generate for banks a more than reasonable profit target;
- The pressures of banking regulators to bolster banks' capital ratios may lead them to hold back lending and to continue to hold on to "risk-free" sovereign bonds since they already have a high level of liquidity;
- The limited ABS supply on the market is also hampered by the high capital charges imposed by regulators since the financial crisis. A potential decision by the regulators to "water-down" capital charges for these products (ABS) in order to help revamp their market attractiveness, might help solve SMEs credit crunch but it might also have unintended consequences on the region's future systemic risk. Should that be the case, regulators and supervisory authorities should carefully monitor who will be bearing the potential higher risk (e.g. the ECB, member states, or even insurance firms, pensions funds, asset management firms, money managers, hedge funds, "vulture funds", credit funds, individual investors, etc.) in order to improve their risk mitigation strategies and to require adequate capital requirements;
- High debts, worsening confidence level of firms (sentiment indicators), and declining business activities might also contribute to discourage the SMEs' request of additional borrowings;
- Banks might also be reluctant to use TLTRO funds to boost business lending until ECB will receive governments' guarantees on the riskier ABS tranches, especially in the Southern Euro zone states, since they are packed with NPLs.
- Procedures, rules and practices related to ABS operations in the Eurozone are still quite different among the member states and need to be harmonized;
- The liquidity trap (which now seems to be improving) in the Eurozone might also reduce the effectiveness of the TLTRO program;
- A number of firms and households might decide not to borrow the funds for their investments and consumption decisions due to risk aversion and the lack of creditworthiness of their projects;
- Perhaps banks are waiting for aggressive outright asset purchases by the ECB (with or without governments' guarantees) aimed at cleaning up bank balance sheets, freeing up capital for lending, and taking on credit risk. The ECB has already indicted its intension to return to the size of balance sheet it had at the beginning of 2012.
- The purchase of unfit and risky assets to fight the risk of deflation might represent a manifest breach of the Eurozone treaties (Maastricht Treaty restrictions) which could probably spark political tensions among member states.

The extraordinary measures announced by the ECB might probably provide additional credit to the real economy (e.g. small and medium-sized enterprises) and might help relieve the burden on weakened banks, but it is still difficult to determine whether they will be sufficient to prevent the fall of the Eurozone into a dangerous deflationary slump, or long stagnation, especially if not combined with **"mandatory", effective, timely, and bold fiscal policies, structural reforms, and solidarity mechanisms in the Euro zone**. Probably the ECB, in spite of its independence, under the current political pressure of some powerful Eurozone member states, aims to test how the new programs will perform first before taking a potential next step: a **full-blown QE** (if necessary), hoping that in the meantime the USA might start its **"Exit Strategy"** (e.g. end of **Tapering** and **gradual normalization of the interest rates** and of the **Fed's oversized balance sheet**), so that the rising interest rates in that Country will contribute to strengthen the US$/Euro exchange rate, and ultimately, the economic recovery and the export in the Eurozone through **currency depreciation**. Ongoing geo-political tensions, the goal to pursue full-employment and a higher participation rate, and the current global slowdown fears, however, might further delay the Fed's decision to raise its benchmark rate since monetary policy leaders aim to achieve a long-term self-sustaining recovery in the USA. In addition, while the Federal Reserve is near the **end of its quantitative easing** other major world economies (e.g. Japan, Eurozone) will probably take the lead in ensuring a very high level of liquidity for the years to come with their ultra-aggressive monetary policies.

John Mauldin reported in his article titled ***"Europe Takes the QE Baton,"*** the following concept on the potential risk of a massive QE program in the Euro zone:

It is probably only a coincidence that just as the Fed ends QE, Europe will begin its own QE program. Note that the ECB has reduced its balance sheet by over $1 trillion in the past few years (to the chagrin of much of European leadership). There is now "room" for the ECB to work through various asset-buying programs to increase its balance sheet by at least another trillion over the next year or so, taking the place of the Federal Reserve. Draghi intends to do so. ***Risk-takers should take note. European earnings per share are significantly lower than those of any other developed economy. Indeed, while much of the rest of the world has seen earnings rise since the market bottom in 2009, the euro area has been roughly flat.*** (Mauldin, 2014d)

Furthermore, ECB President, Mario Draghi, has also anticipated at **the 2014 Jackson Hole Economic Policy Symposium** that the Eurozone might **accept a softer stance on austerity,** due to the current lower inflation expectations and difficult and slow economic recovery. If this stance will be confirmed, this potential flexibility granted by the Eurozone might help reformulate the fiscal measures for a few years, (e.g. **higher than expected budget deficit targets and more flexibility than agreed in the short-term to comply with the Fiscal Compact and other UE Treaties' agreements, due to the adverse economic cycle; the access to additional resources - EU Structural and Investment Funds - project bonds, and the use of a potential "golden rule" for new innovative and productive investments).** This higher flexibility, however, will probably require a more binding commitment by the weaker Euro zone countries to assure **a drastic cut of unproductive public expenditures; a sweeping overhaul of the "generous" welfare privileges and entitlements of the elites; and a strong reduction of tax evasion, tax avoidance, and corruption.** Thus, the EU might grant to the weaker peripheral Eurozone economies some more time to complete their reforms, to revamp economic development projects, and to recover from the current stagnation/recession and very low inflation. Nevertheless, however, even an **ultra-aggressive monetary policy** of the ECB alone might not be sufficient to assure a bold economic revival, given the current economic condition in the Eurozone, even though the package of extraordinary measures recently announced by the ECB (September 4th, 2014) **are expected to have at least some of the positive effects of a QE Program,** which include among other things, the increase of the monetary base. Thus, it is quite obvious that **unprecedented fiscal stimuli** (**big European tax cut and bold investment programs**) in conjunction with **ultra-aggressive monetary measures**, and timely and effectively **structural reforms** are also needed to boost a reliable and sustainable long-term economic turnaround in the Union. Of course, as it is well-known, structural reforms require a considerable amount of time to prove effective and, evidently, in the short-term growth is not likely. Furthermore, currency depreciation in the Eurozone is not easy to consolidate since the Eurozone already runs a current-account surplus and other leading global economies are also struggling to remain competitive with their currencies through massive QE wars and aggressive policies. The Eurozone countries need to increase domestic demand but this is difficult to achieve due to the current high debt levels (e.g. private debts in some countries and public debts in others) and severe fiscal consolidation programs, which reduce consumption, investments, and increase risk aversion. Furthermore, currently in the Eurozone there are countries that are running current account deficits (Southern European countries) and others running current account surpluses ("Core" European countries), thus it is critical and urgent to reduce the dangerous build-up of imbalances within the Euro zone through fiscal policies and structural policies on either side of the region.

ECB President, Mario Draghi, however, reported that the central bank's governing council was ready to take further measures if needed (e.g. quantitative easing, or broad-based purchases of government bonds or other assets) to fulfil the ECB mandate of price stability and to avert the threat of deflation. He also said *the ECB would buy riskier "mezzanine" tranches of ABS if they were backed by guarantees (**Eurozone governments' guarantees on the riskier ABS tranches**). That is more important than it might seem. The ECB worries about taking too much risk on to its own balance sheet, but its top policy makers believe* ***Eurozone governments could expand guarantee schemes significantly, for***

instance via development banks, further increasing the pool of assets it could buy. (Atkins, 2014)

One potential shortcoming of governments' guarantees on the riskier ABS tranches, especially for countries with high debt, recession, or slow and anemic GDP growth, deflation, or very low inflation, and a numerous other structural economic problems, **is that** apparently, **it does not completely end the vicious circle between sovereign risk and financial institutions' risk** (e.g. retail and commercial banks, insurance firms, pensions funds, asset management firms, money managers, credit funds, national development banks, the ECB, or other public institutions), which has contributed in the previous years to generate in the financial markets a perceived **higher systemic risk**. Furthermore, during the current adverse economic cycle (e.g. weak economies, geo-political risks, and other potential externalities), it could be also a real challenge for economies with a huge debt burden (high public debt), slow GDP growth rates or recession, risk of deflation, and weak and declining economic fundamentals and levels of confidence (consumer and business) to take on additional risk through governments' guarantees, since in a **worst case scenario (tail-risk),** it might generate, directly or indirectly, additional **social costs to taxpayers**.

Unlike the gloomy (but not impossible) prediction of John Mauldin on potential plans for **restructuring the debt of some peripheral European economies** (e.g. Italy) currently pressured by troubling macroeconomic fundamentals, European leaders towards the end of the summer of 2014 seem to have a slightly more optimistic outlook on the future of the Eurozone, or at least they hope that the worst might be over soon. In fact, they probably expect to be able to successfully complete a number of concurrent measures and policies that might restore investors' confidence in its banking system and in the ability of its economic and political governance to revamp a sustainable recovery and long-term growth. More in particular, they probably plan to implement a few critical and urgent monetary, fiscal, and structural measures in 2014, and onward, that might help the entire Economic and Monetary Union to establish a leadership role in the global markets and economic and social development, closer to its true output potential. To achieve this challenging goal and to get out of the doldrums of recession and stagnation, Eurozone countries, however, must have the wisdom, pragmatism, and restless commitment to turn the current difficult moment of high uncertainty and political tensions into an unprecedented opportunity for greater integration.

To reach such an ambitious objective, the ECB must be able to accomplish in the last quarter of 2014 a successful completion of the **banks' stress test** (EBA) and **asset quality review (AQR)** exercise (a process aimed at bolstering banks' capital ratios), and to mandate immediate bank recapitalizations (if required). Furthermore, it has to grant massive additional liquidity injections, through non-conventional monetary measures, in order to assure low borrowing costs to banks and the real economy, until the inflation rate will be below but close to 2 percent annual target rate and, hopefully, also until the employment rate and GDP growth rate will be normalized in the member states. For this scope, **very ambitious investment programs** should also be launched by the European Union in order to generate **a disruptive economic revitalization of the Eurozone** (e.g. new competences and skills; better education; dynamic internal competition; infrastructures; privatizations and liberalizations; a more agile and adaptive labor market; simplified norms and a reduced tax burden on firms; a more efficient public administration and reduced bureaucracy and corruption; incentives for SMEs' internationalization; innovation of technology, products, and services; and attractive incentives for foreign investors). Finally, the single member states should also effectively complete their structural reforms in order to reduce the high costs of unproductive expenditures and to reinvest the resources to improve competitiveness and debt consolidation.

As stated by **John Mauldin** in his article ***"Bubbles, Bubbles Everywhere,"*** since the financial crisis numerous economies have experienced relatively weak or stagnant GDP growth, inflation well below target level, and aggressive monetary policies. The growth in the money supply did not go to driving up prices for convenience goods like toothpaste, haircuts, or cars. It mainly drove up, instead, prices of real estate, bonds, and stocks. Excess liquidity creates money beyond what the real economy needs, thus, the surplus of money that is not absorbed by the real economy. When the money supply is growing faster than nominal GDP, then excess liquidity tends to flow to financial assets and from asset class to asset class. Mauldin, also states: '*Booms and busts around the world happen whenever central banks tighten or loosen monetary policy' and affect money supply. 'Central banks aim to engineer a recovery by inflating asset prices. The objective is to create a "wealth effect" that will make those who invest in stocks feel wealthier and then decide to spend money and invest in new projects. This will eventually be felt throughout the economy generating GDP growth, employment rate, inflation rate, and other key structural economic factors close to target levels. This "trickle-down" monetary policy, argues Mauldin, has been successful in creating wealth for those who were already rich (and for the banks and investment management firms who service them) but has been spectacularly a failure in creating good jobs and a high-growth economy'* (Mauldin, 2014c).

Since the 2008 financial crisis, asset prices and debt levels have increased much faster than the overall level of economic growth in a number of countries and this might lead to a boom-bust scenario in conjunction with changing monetary policies and other macroeconomic factors.

Michael Snyder, in July 2014 reported the following statements: "*at this moment in the United States we are simultaneously experiencing a stock market bubble, a government debt bubble, a corporate bond bubble, a bubble in San Francisco real estate, a farmland bubble, a derivatives bubble and a student loan debt bubble." Probably at some point, shortly,* ***a massive correction*** *might be coming. (Snyder, 2014; Mauldin, 2014b). John Mauldin made the following remarks in his article titled '**Central Bank Smackdown**:' " I don't know what the trigger for the next debt crisis will be, but whatever it is, it will result in an even* ***deeper liquidity crisis than we saw in '08****. That is just the nature of the beast* (Mauldin, 2014b). He also added: "the life insurance market is creating special-purpose vehicles (SPVs) for offloading their risk that are then guaranteed by the parent company. This is the subject of a very sobering report from the Minnesota branch of the Federal Reserve. Up to 25% of such debt may be subject to selfguarantees, and this debt is getting very high ratings (Mauldin, 2014b).

As reported by the Financial Times in June 2014, "***The Bank for International Settlements has warned that "euphoric" financial markets have become detached from the reality of a lingering post-crisis malaise,*** *as it called for governments to ditch policies that risk stoking unsustainable asset booms. While the global economy is struggling to escape the shadow of the crisis of 2007-09, capital markets are "extraordinarily buoyant", the Basel-based bank said, in part because of the ultra-low monetary policy being pursued around the world.* ***Leading central banks should not fall into the trap of raising rates "too slowly and too late," the BIS said****,* ***calling for policy makers to halt the steady rise in debt burdens around the world and embark on reforms to boost productivity****. In other words, as explained by John Mauldin, the "BIS pointed out that despite the easy monetary policies around the world, investment has remained weak and productivity growth has stagnated. There is even talk of secular (that is, chronic) stagnation"* (Mauldin, 2014b).

In its ***2014 annual report, the BIS*** *also warned of the risks brewing in emerging markets, setting out early warning indicators of possible banking crises in a number of jurisdictions, including most notably China. 'Particularly for countries in the late stages of financial booms, the trade-off is now between the risk of bringing forward the downward leg of the cycle and that of suffering a bigger bust later on,' it said. The BIS, the bank for central banks, has been a longstanding sceptic about the benefits of ultra-stimulative monetary and fiscal policies and its latest intervention reflects mounting concern that the rebound in capital markets and real estate is built on fragile foundations"* (Fleming; Jones, 2014; BIS, 2014).

According to **Peter Schiff of Euro Pacific Capital Inc.**, who predicted the 2007 – 2008 financial crisis in 2006*, "the current 'misplaced optimism' in the financial markets, and in particular in the housing market, will lead to a 'worse collapse than in 2008.'* Peter Schiff's views are based on a philosophical notion that fiat money, and the actions of central banks like the Federal Reserve, are destabilizing and bubble-inducing". "*The day of reckoning will come when the Fed starts to tighten, according to Schiff. As the central bank will no longer buy big chunks of the debt issued by the Treasury, with interest rates surging and bond prices falling, banks will be left with depreciating assets (Treasuries) and stuck with low yielding long-term loans. As the 'rug is pulled from under the banks,' the housing market will collapse as well, Schiff believes. The housing market will also breakdown.*" (Fontevecchia, 2013).

NYU Professor Nouriel Roubini, who predicted the 2007 – 2008 financial crisis in 2005/2006, in an interview on February 22, 2013 with The Daily Ticker, predicted the risk of an asset bubble bigger than the one of 2003-2006. Roubini's rationale is that the Federal Reserve is going to be even more reluctant to pull back the accommodating monetary policy (slow exit strategy) than in 2003-2006, given the fact that national and global economic growth is still not fully stabilized and that inflation is still below target (Task, 2013).

Nobel Laureate Thomas Sargent has called the US **Fed the world's largest hedge fund** and also questioned the effectiveness of forward guidance as a pillar of monetary policy (after all, interest rates depend on supply and demand). Sargent is the American economist who shared the 2011 Nobel Prize in Economics with Christopher Sims for modelling the impact of central bank and government policies on macroeconomic growth. **"The central bank from the country where I come from (Sargent said) is the biggest hedge fund in the world. It borrows short, it has no liquidity problem because it prints it ... It takes term structured risk and it takes collateral risk."** (Cheng, 2013). The US Fed's portfolio of securities and other assets has swelled to more than $4 trillion since the financial crisis, growth driven largely by several rounds of bond purchases aimed at lowering long-term borrowing costs to spur more spending, investment and hiring. In January 2014 the Fed reported it made an estimated $79.5 billion in net interest income, a total largely driven by the $90.4 billion in interest income it made on its portfolio of Treasuries, mortgage bonds (**ABSs**, **Legacy Assets or "Toxic Assets" of the financial crisis)** and other securities. (McGrane, 2014)

As recently pointed out by **Dallas Fed President Richard Fisher**, who warned about the effects of easy money, regulators have been so far complacent with high risk-taking in credit markets in order to strengthen banks. (Gallo; Mackintosh, 2014) Furthermore, **“Too Big to Fail” banks** are now **34% bigger** than they were in 2007, and they grew significantly more than nominal GDP (including inflation); 0.2% of U.S. banks control **70% of industry assets; the top 1% of Americans have reaped 90% of the income gains since 2009. The S&P 500 index reaches new records and the average income of the top 1% of the population continues to increase, while underemployment and income inequality for the average household also increase, and the productivity of the American workforce continues to improve.** (Mengel, 2014) **Big banks, spread across thousands of subsidiaries, still generate profits from a complex, highly leveraged web of activities at home and abroad, and rely on inherently volatile wholesale funding markets to stay afloat.** (Dayen, 2014)

Thomas Hoenig, vice chairman of the FDIC, claims that ‘Too Big to Fail’ Bank Bailouts Could Happen Again. He stated with regards to the recent second round of **Dodd-Frank's *'Living Wills'*** (e.g. the **Crisis Resolution Mechanism** to handle systemically important financial institutions' orderly liquidation/bankruptcies, that is, for those banks with assets above $50 billion) that “**despite the thousands of pages of material these firms submitted, the plans (*Living Wills*) provide no credible or clear path through bankruptcy that doesn't require unrealistic assumptions and direct or indirect public support.**” (Dayen, 2014)

The risk of potential bank failures, should not be casually ignored by exuberant investors since in Europe, for example, the **‘bail-in regime’ – the Bank Recovery and Resolution Directive** – is expected to impose losses from bank failures on bondholders (bank creditors) rather than taxpayers. Nevertheless, the drastic reduction in bank spreads/yields of the recent years suggests that investors still rely significantly on the **implicit “public subsidy” of assumed government support in case of banks’ failures; on the potential governments’ guarantees for cheap funding to business and households; and on a long-lasting ultra-convenient and accommodative monetary policy of the Central Bank.** Savvy investors should not, however, challenge too much their luck or put all their hopes on the renowned ***“revolving doors”* practices** and on **implicit governments’ guarantees** because things could turn out to be horribly awry when the markets are suddenly hit by systemic shocks.

Not to mention that a "real" critical component of the **Dodd-Frank Act,** the famous **"Volcker rule" (**inspired by the Glass-Steagall Act of 1933 - a law that first recognized the inherent dangers of financial entities extending commercial and investment banking services at the same time – which consisted of a mere 37 pages**),** which is supposed to ban in-house trading operations that specialize in speculating on markets, or proprietary trading, **has been partially watered-down** over the years (**exemptions**). Furthermore, as reported by the Wall Street Journal, banks are lobbying U.S. policy makers for a delay of up to seven years from a provision requiring them to sell investments in private-equity and venture-capital funds, since the **"Volcker rule"** restricts banks’ ownership stake in hedge funds and private equity funds (Reuters, 2014). In an effort to minimize possible conflicts of interest, financial firms, according to the **"Volcker rule"** are not allowed to trade proprietarily without sufficient **"skin in the game."**

Main objectives of the Dodd-Frank Act include improving accountability and transparency, reduce systemic risk, end **“Too-Big-To-Fail”** financial firms, protect consumers and put an end to taxpayer funded bailouts. The Dodd-Frank Act is an enormously complicated piece of legislation. As of today, the Act implementation is only partially completed and it counts approximately 9000 pages versus the previous Act - Glass-Steagall Act of 1933 - 37 pages).

The Dodd-Frank Act provides a glaring loophole for banks that claim to be **"hedging" their bets**. In theory, a hedge is a market position that consequently lowers the inherent risks of an underlying position. So long as a bank declares it is operating in this manner, it can engage in proprietary trading with riskier groups of assets. (Pezzuto, 2013)

Still, according to **Eric Rosengren, the President of the Boston Federal Reserve**, “given the widespread support provided to broker-dealers and the difficulties they encountered during the crisis, a comprehensive re-evaluation of **broker-dealer regulation** is overdue.” He also added: "Broker-dealers need to reduce risk and increase capital if they don’t want to end up like Bear Stearns or Lehman Brothers. To prevent a run on a fund or reduce risk, broker-dealers need to hold significantly more capital.” (Patel, 2014)

Deming Wu of the Office of the Comptroller of the Currency, the United States Department of the Treasury and Stanford Professor **Han Hong**, have confirmed in 2012 in their paper titled *“Liquidity Risk, Market Valuation, and Bank Failures”* that **systematic liquidity risk** was the major predictor of bank failures in 2008 and 2009. According to them “this finding has important implications for the current discussion of the new **Basel III liquidity risk standards.** To enhance the safety and soundness of the banking system, an effective liquidity risk management framework needs to target liquidity risk at both the **idiosyncratic and the systematic levels**. (Wu; Hong, 2014)

In the Eurozone, in spite of a relatively anemic growth/stagnation and very low inflation, the

Sovereign Debt as a percentage of GDP in 2013 was above **90%** versus the **60% rule** of the Maastricht Treaty. In the USA in 2013 an emerging threat was the **"Sequester, Fiscal Cliff, and Debt Ceiling"** while inflation was below target, the economy was improving, and the S&P 500 index was reaching new records (overvalued). The Sovereign Debt as a percentage of GDP in the USA in 2013 has almost **doubled from approximately 60% of 2007 to approximately 110%** (Pezzuto, 2013). Even, the **Fed's Balance Sheet**, thanks to the quantitative easing ("QE") programs, has increased to **$4.4 trillion** at the end of June 2014—five times its pre-crisis size (Labonte, 2014), and it is now **40%** the size of the entire U.S. banking system. The

Federal Reserve's balance sheet is comprised of long-term investments funded largely by overnight or one-week term bank deposits. (Carfang, 2014).

Furthermore, in August 2014 the **FT/Economist Global Business Barometer survey** reported that geopolitical threats are starting to weigh on executives' confidence in the global economic recovery. *'The proportion of executives who believed the global economic environment would worsen over the next six months has nearly doubled to 18 per cent, nearly one in five respondents, from just 9 per cent at the end of last year."* (Cadman, 2014)

In this complex and challenging phase, policy makers and regulators will have to be very savvy to dodge **bubbles and Lawrence Summers' "secular stagnation"** (e.g. the result of inequality, shrinking labor-force participation, private-sector debt overhangs, technological innovation, and decelerating productivity), and political leaders will have to pursue rigorous and reliable long-term growth and fiscal consolidation plans, with the critical support of central banks and other key stakeholders, in order to strike a balance between structural reforms; economic recovery measures, tax breaks, and productivity; effective spending cuts and growth plans (e.g. infrastructure investments); increasing inflation/raising inflation targets, employment/participation rates, and the threats of unexpected higher inflation, the speed of interest rate hikes (the **Federal Open Market Committee - FOMC,** has maintained the target range for the **Federal Funds** rate at a record low of **0% to 0.25%** from December 2008 to 2014), high credit growth as a percentage of GDP growth, high debt, high leverage, imbalances, and potential bubbles. **Ultimately, political leaders, policy makers, and regulators need to stabilize their economies while monetary policy should be gradually normalizing.** Yet, this task is made even more challenging given the current **geo-political instability, nationalistic, Eurosceptic, and independence movements (and their unintended consequences)**, the increasing interconnectedness of global markets, the bursting of potential bubbles, and the urgent need to assure a sweeping overhaul of banking rules to help prevent the recurrence of systemic crises and **other bail-outs in the future** (perhaps called by another name).

For the periphery countries of the Eurozone it is critical to *boost their competitiveness in export- and import-competing industries, and the pace of demand growth in the euro area core countries and in the rest of the world. The evidence to date has been mixed, with overall growth still weak but with some early gains in labor productivity. The downside risk is that failure to achieve sustained productivity gains would leave adjustment to occur only through lower wages and slower growth in domestic consumption and investment spending*. Eurozone leaders should not easily discount the risk that high social costs may impose to their citizens, due to the painful adjustments, since this situation in the long run might lead, if not properly managed, to unexpected consequences. (Pezzuto, 2013; Higgins, Klitgaard, 2011)

We have learned from history and we have confirmation today from recent events (the sudden and unexpected rise of independence and populist movements in Europe – e.g. the "Yes Campaign" in Scotland, the far right National Front party in France, the Catalan separatist movement, etc.) that during prolonged periods of severe crises, unconscious fears, uncertainty, and adverse market conditions, local interests (e.g. nationalism, protectionism, Euroscepticism, anti-globalization) might tend to prevail over national and regional geo-political goals. As the author has warned in his interview with **CNBC Europe** dated May 19th 2014 on the future of the Euro zone (a few day before the 2014 European Parliament Elections of May 25th, 2014), in spite of his strong European identity, he fears that Eurozone leaders might underestimate the devastating effects of a potential tail-risk scenario (e.g. the Eurozone dissolution) which could be triggered by the inability of the national and regional governance to provide timely, reliable, and effective solutions to the growing discontent and lasting structural problems perceived by many Eurozone citizens (e.g. higher unemployment, recession, stagnation, low inflation or deflation, draconian austerity measures, spending cuts, high public debt or deficits, the fear of a potential debt mutualization, massive foreign immigration, etc.). During the interview the author has also stated the following words: *"we are probably reaching a point of no return: either the Eurozone's governance will provide to its citizens a compelling vision and realist action plan for a common destiny of peace, growth, and prosperity, or otherwise sooner or later, it will be doomed to a future of irreversible dissolution or permanent stagnation, discontent, rising inequality, distrust towards leaders, and social unrest."* After all, in spite of the fact that no one would reasonably argue the need for urgent and radical structural reforms and debt consolidation plans in some weaker peripheral countries, it is still quite difficult to determine whether the implementation of the expected reforms will be sufficient to guarantee a long-term growth of these economies and a superior global competitiveness of the entire Union. The euro zone might achieve these challenging goals in the long-term but it will probably need also to strengthen its political, fiscal, banking, and financial markets' integration to make it happen. The Euro zone countries need to pursue their structural reforms, in conjunction with very aggressive (and non-conventional) monetary and fiscal policies, but they also need the support of massive public and private investment projects (e.g. infrastructures) to help stimulate growth, employment, and aggregate demand. It is also necessary some degree of solidarity mechanism among member states (**fiscal union and fiscal transfers**); a central bank with a lender of last resort mandate; national and regional policies to help boost productivity and competitiveness; to cut taxes and red tape; to reduce the cost of labor, and to simplify public administration and judiciary systems. **In particular, these countries need to focus their most critical resources on long-term development projects, strategic industries, infrastructures, new economic and business models, and innovative cultural and managerial paradigms in order to gain new competitive advantages and to achieve global competitiveness.** The shift toward a more integrated and interdependent world economy, with falling barriers to cross-border trade and the progressive globalization of markets and consumer tastes, are rapidly forcing western economies to rethink the sustainability of their economic and social models. Thus, the so-called advanced economies, and in particular the Euro zone countries, need to pursue their challenging goals of economic revival while trying at the same time to avoid generating the following negative consequences:

- destabilizing social cohesion and trust among member states;
- decreasing consumer and business confidence;
- increasing distrust in national and regional political and economic leaders;
- rising levels of inequality and social exclusion.

In the last chapter of his book *"Predictable and Avoidable"* (2013) the author has stated the following sentences:

With approximately seven billion people living on Earth and a rapidly growing and ageing population, an unprecedented struggle among several developed and emerging markets is taking place for growth, scarce resource allocation, access to superior higher education, innovation, increased productivity, and global competitiveness. This globalization phenomenon is becoming a great opportunity (that is new markets with huge growth potential to serve but also low cost countries where to place firms' production process or international supply chains networks) but also a real challenge for many nations, communities, households, and individuals, as it imposes sustained growth rates to absorb the needs of a fast-growing global population and higher expected per capita consumption rates. These global forces are seriously challenging the global economic and environmental sustainability and the social cohesion among more and less developed and competitive countries in the global battlefield. Increased debt (public and private) alone and the use of massive unconventional monetary and fiscal policies to solve liquidity and solvency crises cannot be the only sustainable cure for an overcrowded world with different consumption, interest, productivity, and growth rates that often continue to consume more resources that it can afford to. New regional or global economic frameworks and paradigms will probably be necessary to improve global economic sustainability and to rethink the current global competitiveness of a number Western economic regions. (Pezzuto, 2013)

Conclusion

This paper aims to demonstrate that, in spite of the artificially reduced volatility in the markets of the past years, systemic risks have not been reduced after the global financial crisis and that, currently (September 2014), adverse scenarios seem to be much more likely than previously expected by regulators and supervisory authorities, due to the prolonged massive accommodative monetary policies, the increased economic and geo-political risks, some incomplete or unfit financial regulation, and a widespread and rising short-term oriented global culture which seems to reinforce the dominance of perverse financial incentives, excessive risk-taking, self-interest, and collusive behaviors (e.g. conflicts of interest and moral hazard). Thus, the stress testing models, their underlying assumptions, and the supervisory authorities' oversight practices should be probably revised to take into account the rising risks of the new emerging scenario.

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