A MODEST PROPOSAL FOR OVERCOMING THE EURO CRISIS (*)

by

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1. THE NATURE OF THE CRISIS

It is now abundantly clear that each and every response by the eurozone to the galloping sovereign debt crisis has been consistently underwhelming. This includes, back in May 2010, the joint European Union (EU) - International Monetary Fund operation to 'rescue' Greece and, in short order, the quite remarkable formation of a so-called 'special vehicle' (officially the *European Financial Stability Facility*, or EFSF) for supporting the rest of the fiscally challenged eurozone members (e.g. Ireland, Portugal, Spain). More recently, European leaders announced their provisional agreement to create a permanent mechanism to replace the EFSF (called the *European Stability Mechanism*, or ESM)as well as a series of measures for, supposedly, attacking the crisis' causes, thus ensuring that it is not repeated. Alas, no sooner were those measures announced that the crisis intensified.

The reason is simple.

- The eurozone is facing an escalating triple crisis: a *sovereign debt crisis*, a *banking sector crisis* and an *under-investment crisis*
- The reason the EU's current policies failed is that the EU only seeks to address one of its three manifestations, the sovereign debt crisis, while ignoring the other two (the banking sector crisis and the dearth of productive investments in most of its territory)

This exclusive focus on sovereign debt is counter-productive: instead of reducing the debt-to-GDP ratio of the stricken member-states, it makes it worse. Why? The reason is brutally simple: The debt burdens of the fiscally stricken nations are confronted by means of

- huge, expensive loans to, effectively, insolvent states
- new mechanisms (e.g. the European Financial Stability Fund, the EFSF) for raising the funds to be loaned that utilise toxic financial instruments containing a vicious default dynamic (which increases the likelihood of contagion within the eurozone) *and*
- massive austerity drives that reduce the GDP of the nations burdened with these new loans.

But the immediate effect is a worsening of the other two crises: the banking sector and under-investment crises.

Consider, for instance, Europe's private sector banks. Over-laden with worthless paper assets (both private and public), they constitute black holes into which the ECB keeps pumping oceans of liquidity that, naturally, only occasion a trickle of extra loans to business. Moreover, the EU's policy mix against the sovereign debt crisis, founded primarily on austerity drives (as a condition for the new loans), constrains economic activity further and fuels the expectation of future sovereign defaults. To make things worse, the mechanism designed to raise the funds for Ireland, Greece etc. bring closer the default of marginal countries likes Portugal and Spain. Lastly, in this environment of heightened fear and uncertainty, the greatest victim is investment. Especially in the countries that find themselves in the storm's eye (and which are in greatest need of investment), investment dries up well and truly.

Thus, in a never ending circle, the bilaterally negotiated 'bail outs' (e.g. Greece, Ireland) pull the rug from under the bankers' already weakened legs. And so the crisis is reproducing itself at an ever accelerating pace.

2. BASIC PRINCIPLES OF A *COMPREHENSIVE SOLUTION*

So, what should the principles of a truly *Comprehensive Solution* be? Before proposing four simple principles, it is useful to take a look at that which Europe's leaders ought to turn their backs to. Take, for instance, the leaked components of the *Comprehensive Solution* which, as it turns out, the surplus countries have now recoiled from: They were founded on the same misconception as the 'bail out' loans tried out throughout 2010 and involved mere tinkering with the terms of the 'bail out' loans plus voluntary tax-funded market operations (e.g. buy outs of Greek and Irish bonds). The problem with loans and bond buy-back schemes is that (a) they do nothing to address either the banking sector crisis or (b) the under-investment crisis, and (c) have minimal effects on the debt crisis.

So, what should the principles of such a truly *Comprehensive Solution* be? Here we propose **four** such principles:

Principle 1: The triple (debt, banking and under-investment) crises must be tackled in an integrated manner. National debt stabilisation and reduction needs to be matched by the European Economic Recovery Programme and respect for Treaty commitments to economic and social cohesion, both of which are undermined by a strategy focusing only on debt and deficit reduction.

Principle 2: The emphasis must fall equally on the debt crisis of the periphery and on the losses of banks that are increasingly dependent on the ECB for their survival. Both bank losses and portions of sovereign debts must be cancelled out in a rational and fair manner

Principle 3: German, Dutch, Finnish and Austrian taxpayers should not be asked to shoulder new loans for the insolvent countries. The debt crisis requires a structural change, not more loans to be piled up on already weak shoulders while weakening (with little effect) the stronger ones.

Principle 4: The key parallel in the recommendation by one of us of EU Union bonds to Jacques Delors, which he included in his White Paper of December 1993, was with US Treasury bonds which do not count against the debt of American states such as California or Delaware. Therefore Union Bonds need not count on the debt of EU member states.

The strategy in a *Comprehensive Solution* along these lines, is how to strike a fine balance between (a) deep, structural changes in the euro's architecture (that are capable of rising to the occasion) and (b) proposals that can be implemented immediately under the eurozone's *existing* institutional framework (thus bypassing any need for substantial, politically infeasible, Treaty changes).

We believe that the ***Modest Proposal*** below fulfils the three principles above and is politically feasible, in the sense that it requires minimal tampering with existing institutions and Treaties.

3. THE MODEST PROPOSAL'S THREE MAIN POLICIES

Europe is facing three separate, but intertwined, crises: the debt crisis, the banking sector crisis and the under-investment crisis. They must be addressed simultaneously (see **Principle 1** above) by means of three separate, yet well integrated, policies to be put in place at once.

Policy 1 - Addressing the sovereign debt crisis: *Restructuring the eurozone's debt composition at no cost to taxpayers*
Responsible institution: The ECB (European Central Bank)

The policy's components:

- **1.1 Tranche Transfer to the ECB:** The ECB takes on its books, with immediate effect, a tranche of the sovereign debt of *all* member states equal in face value to the Maastricht-compliant 60% of GDP of each
- **1.2 ECB-bonds:** The transfer is financed by ECB-issued bonds (e-bonds hereafter) that are the ECB's *own liability* (rather than by eurozone members in proportion to their GDP).
- **1.3 Fiscal neutrality (i.e. no fiscal transfer):** Member states continue to service their debts to the ECB. To do so, each participating member-state opens a debit account with the ECB which it services long term: it pays back its Maastricht-compliant debt transferred to the ECB at the lower interest rates secured by the ECB e-bond issue and in a manner that utilises well tried amortisation principles to ensure that the Maastricht-compliant debts of member-states are effectively restructured in a manner than reduces the debt burden to at least some of the member-states without increasing the debt burden of any of the remaining member-states (see here for an example on how amortisation can work)
- **1.4 The 'no haircut' case as the default case for existing bonds with ECB-imposed haircuts on banks seeking long term liquidity:** The use by eurozone banks of the ECB's overnight or longer term liquidity provision facilities is made conditional on the banks agreeing to a swap of sovereign bonds that they already hold with ECB-issued e-bonds of a much lower face value than the original member-state bonds and a longer maturity. These e-bonds are then added to the debit account of the respective member-state (thus reducing the latter's debt burden further)
- **1.5 Passing the haircut of bonds already purchased to member-states:** Since May 2010, the ECB has been purchasing periodically stressed sovereign bonds (mainly Greek, Irish, Portuguese and Spanish) at a discount. This discount should be passed on to the member-states in the form of credits in their e-bond debit accounts

Summary: The objective of **Policy 1** is to restructure the eurozone's sovereign debt at no cost to the German taxpayer (or to any of the surplus member-states taxpayers) but at some cost to the banks that draw liquidity from the ECB without posting creditworthy collateral.

The motivating idea is that the ECB helps member-states, at no cost to itself, to reduce their Maastricht-compliant debt. Recall that each member-state is 'permitted' by Maastricht to bear debt equal to 60% of its GDP. Let's call this

Maastricht-compliant debt. Member-states ought to be allowed to apply to the ECB for a tranche transfer of that Maastricht-compliant debt (see **1.1** above). These bonds can be registered (by the bondholders) with a division of the ECB which undertakes to service them.

The ECB then issues its own long term e-bonds (which are its sole liability; i.e. no requirement for any member-state to issue any guarantees or cash) - see **1.2** above. Judging by the fact that the sale of the problematic e-bonds issued by the EFSF in December 2010 yielded particularly low interest rates, the ECB's e-bonds will sell at rates no greater from the German bunds. Member-states will, thus, be indebted to the ECB but their debts will be amortised and paid annually and in the long term at low effective interest rates reflecting those of the ECB's e-bonds - see **1.3** above.

The fact that the bonds of each participating member-state are registered with a division of the ECB means that the ECB can make medium term large liquidity provisions to the private banks conditional on haircuts over the existing sovereign bonds in their portfolio - see **1.4** above. This measure, together with the passing on to member-states of prior haircuts exacted by the ECB on bonds purchased in the context of the ECB's bond purchasing scheme effective since last May - see **1.5** - will reduce the overall debt burden of the eurozone's member-states *at zero cost to taxpayers*.

Policy 2 - Tackling the banking sector crisis: *Clearing the banks' asset books of questionable assets and recapitalising them (where necessary)*

Responsible institution: The EFSF/ESM (European Financial Stability Fund or European Stability Mechanism)

The policy's components:

- **2.1 Real Stress Tests:** Real stress tests to be conducted centrally (as opposed to by national watchdog authorities) that assume an average haircut of 30% for sovereign bonds of member-states with debt-to-GDP ratio exceeding 70% and a 90% haircut for toxic paper found in the banks' books. On the basis of these rigorous tests, the degree of recapitalisation necessary for each eurozone bank to be computed.
- **2.3 Forced recapitalisation financed either by the private sector or by the EFSF/ESM in exchange for equity:** If a bank cannot raise the necessary capital to meet the recapitalisation target computed above, then the EFSF/ESM imposes upon it a swap of capital (raised by the EFSF/ESM, in the way in which the latter has already been financing its activities) for (public) equity in the bank.

Summary: The purpose of **Policy 2** is to cleanse the banks of questionable public and private paper assets so as to allow them to turn liquidity that comes their way in the future into loans to enterprises and households. The problem, currently, is that if the banks come clean, they will most probably have to declare themselves bankrupt. Thus, Europe's authorities need simultaneously to lean on them to come clean but also to help them do so. Effective stress tests plus the imposition of recapitalisation for banks that fail them achieves the former. EFSF/ESM capital will help with the latter. Naturally, if taxpayer money is used for the purpose of recapitalising a bank, it is only fair to expect that the

European taxpayer is given equity in the said bank. Once the cleanup of the banking sector is complete, the EFSF/ESM can orchestrate the resale of the acquired equity and thus repay, possibly with interest, its loans and any loans that member-states took out, or guaranteed, on its behalf.

Policy 3 - A European Recovery Program to counter the under-investment crisis: ***Utilises existing EU mechanisms to promote genuine development***
Responsible institution: The EIB (European Investment Bank)

The policy's components:

- **3.1 Co-financing the national component of EIB projects by means of ECB's e-bonds:** Member-states, regardless of whether they have chosen or not to participate in the tranche transfer of their Maastricht-compliant debt (see **Policy 1**) are now invited to finance investment projects that are approved by the EIB through an e-bond account held by the ECB. The ECB issues the e-bonds necessary for the purpose on behalf of the member-state, this new debt does not count as part of the national debt but, however, it is serviced by the member-state by means of long term amortisation of their existing debit account at the ECB.
- **3.2 Extension of the role of the European Investment Fund:** The original design by one of us for the EIF included that it should offer public venture capital for small and medium firms rather than only equity guarantees. It now should do so on a major scale rather than only offer venture capital guarantees via national financial intermediaries.

Summary: **Policies 1&2** will reduce but not eliminate the eurozone's sovereign debt and banking sector burdens. Only development and real recovery will do the trick. Thus, the eurozone (especially the periphery that has been in the doldrums for years) requires a productive investment drive. This is a task well suited to an existing institution: The EIB.

The EIB has a formal commitment to contribute to both cohesion and convergence, where key cohesion areas include health, education, urban renewal and the environment. However, at the moment, EIB investment projects are co-financed on a 50-50 split between the EIB and the member-state in question. The EIB's 50% does not count against national debt but the 50% of the member-state's contribution, if borrowed, does.

At a time of fiscal squeeze amongst many member-states, these co-financing rules severely circumscribe the utilisation of the EIB's investment capabilities. Once, however, member-states have debit accounts with the ECB (see **1.3** above), there is no reason why the member-state's 50% co-financing of a worthy (from a pure banking perspective) investment project should not be funded from that debit account (i.e. against the ECB's e-bonds).

Thus, while the ECB is the guardian of stability the EIB is the safeguard of recovery through investments funded by its own bonds and from transfers to it of net issues of Eurobonds by the ECB. It already has been remitted by the European Council to invest not only infrastructure but also areas of social cohesion including health, education, urban renewal, environment, green technologies and support for SMEs – all of which are in the joint EIB-EIF criteria since Lisbon 2000 (the EIF is now part of the EIB Group). Moreover, the EIB's offshoot, the EIF (European

Investment Fund) – as recommended above – should offer equity capital to new high tech start ups rather than only venture capital guarantees.

4. OVERALL SUMMARY

Our ***Modest Proposal*** outlines a three-pronged *Comprehensive Solution* to the eurozone crisis that respects three principles: that it is comprehensive (dealing with all facets of the crisis at once), that it helps cancel out bank losses and portions of the member-states' sovereign debt (without imposing a general haircut on bonds) and, lastly, that it requires not one cent of (German) taxpayers' money. Moreover, it requires no moves toward federation, no fiscal union and no transfer union. It is in this sense that it deserves the epithet *modest*. Three existing European institutions are involved in this:

First, the ECB plays the (self-financing) role of mediating a restructure of the Maastricht-compliant sovereign debt of member-states. This restructuring involves the parallel issuing of e-bonds by the ECB and the creation of amortised loans repayable to the ECB by the member states. In the process, it conditions its medium term liquidity provisions to banks on 'voluntary' haircuts by the latter which help reduce sovereign debt further.

Secondly, the EFSF/EIB is relieved of the role of dealing with the member-states' sovereign debt crisis and, instead, acquires the role of recapitalising the banks (in exchange for equity).

Thirdly, the EIB is given the role of effecting a new Marshall Plan for Europe, one aimed at building needed infrastructure but also at green technologies, venture capital, and social cohesion; a role that is made possible by allowing the member-state's financing of these projects to utilise the new ECB financial instruments. By empowering the EIB to fund, drawing upon a mix of its own bonds and the new eurobonds, a pan-European large-scale eco-social investment-led program can come into play with the long term result of putting in place a permanent counter-force to the forces of recession in peripheries that keep dragging the rest of the currency union toward stagnation. In effect, the EIB graduates into a European *Surplus Recycling Mechanism*; a mechanism without which no currency union can survive for long.

In recent months, much ink was spilled in debates about debt buy-back schemes, new loans by the EFSF to indebted member-states, changes in the terms of existing EU loans to Greece and Ireland etc. The dust that these debates generated clouded our judgment and hid from our vision a simple truth: That no large scale crisis (like that occasioned by either 1929 or 2008), especially within a currency union, can be overcome by means of loans and other market operations. President Roosevelt did not fight the Great Depression by buying up the debt of California or Delaware, nor by asking them to guarantee Treasury Bills. Our ***Modest Proposal*** attempts to apply this simple lesson to the current eurozone institutional design and to recommend politically feasible policies that rationally restructure sovereign debt, effectively deal with our troubled banking sector and promote development in areas that are essential for Europe's long term well being.

5. DISCUSSION

5.1 The State of Play

The current euro crisis has been taxing the EU's leadership greatly. It must be said that, over the past year or so, the EU has moved a long way from its original state of denial that there was something the matter with the design of the eurozone and its basic institutions. Many of the taboos have crashed and burnt, under the pressure of the unfolding euro crisis, and some new institutions have been pieced together in the piecemeal manner that is the EU's trademark. Nevertheless, we are deeply worried that one taboo, indeed the most debilitating, has not been challenged yet. And that until it goes, the euro crisis will worsen and the European project will continue to unravel, this time under the pressure of not only the economic crisis itself but also of the accompanying political storm from which only xenophobia and the enemies of European democracy benefit.

What is this surviving taboo? It is an unstated assumption upon which the EU's policy mix for dealing with the sovereign debt crisis (which has been the same over the past year or so) is founded: The 'crowding out hypothesis'. The idea is simple: As public debt rises, it crowds private investment and expenditure out of the economy; it, effectively, steals the private sector's thunder, pushes interest rates up and, generally, discourages business and potentially productive individuals from genuine income generation.

5.2 The 'Crowding Out Hypothesis' behind the EU's anti-crisis policy mix

To see that this 'crowding out hypothesis' lays behind every recent EU policy for dealing with the public debt crisis, consider the EU's stated objective ever since Greece was 'bailed out' last May: To help indebted countries service their debt by lending them large amounts of money (at relatively high interest rates) on condition that they reduce their public expenditure so as to enable the private sector to enter the scene and provide the engine of growth. In other words, the idea is that, as the state drastically recedes (reducing its expenditure and privatising public assets), the private sector will pick up the pieces left behind, rally to the national cause, and over-compensate for the loss of aggregate demand. How is it meant to do that? By generating enough expenditure and jobs not only to replace the losses in employment and investment but, indeed, to create more of each so that the economy re-enters a period of growth (without which the debt to GDP ratio will never shrink).

But is this right? So far, every cut in public expenditure in Greece, Ireland, Portugal or Spain has reduced investment and employment. This would not have surprised John Maynard Keynes who famously pronounced that "[t]he modern capitalist is a fair-weather sailor. As soon as a storm rises, he abandons the duties of navigation and even sinks the boats which might carry him to safety by his haste to push his neighbour off and himself in." [1] It is a fate that the European periphery is experiencing to its

[1] John Maynard Keynes (1932). 'The World's Economic Outlook', *The Atlantic Monthly*

detriment as we speak. The debt-recession combination gets worse, the storm is gathering strength, and the more government expenditures are cut the greater the tendencies of the captains of industry to bail out.

Proponents of the 'crowding out hypothesis' argue that the problem is that the state has not retreated sufficiently. That the medicine will work if the dosage is increased, even if for the time being it causes a worsening of the symptoms. But what are the grounds for such confidence? The first serious proponent of the 'crowding out hypothesis' in the postwar era was Milton Friedman. However, his belief in this hypothesis did not extend to periods of mass unemployment and negative net investment. Indeed, he had little to say in favour of cutting public spending or of the 'crowding out hypothesis' in periods of recession. To the contrary, recessions require the state to annul the escalating gloom and doom via the expansion of 'easy money' that will bolster the psychology of consumers and producers and do battle against the self-confirming, highly recessionary, expectations of entrepreneurs. Without such interventions, Friedman warned, a double dip recession, a second slump even, are in the offing.

To sum up, the EU is assuming that the eurozone is subject to the 'crowding out hypothesis'. Our leaders do not say so explicitly yet they base every policy move upon it. What are the scientific or even discursive arguments in favour of their veiled assumption? It is hard to answer the question. The thought of John Maynard Keynes does not support the idea that 'crowding out' is a sound hypothesis during a recessionary period. Even Milton Friedman, the main advocate of the said hypothesis, would not have proposed it for a juncture like the one we find ourselves in. So, who would raise their hands in its support? The answer is: Only those who believed before the Crash of 2008 that the private sector is incapable of crashing out like it did in 2008!

In short, the EU is adopting one policy after the other for the purposes of dealing with a major crisis on the basis of a theoretical assumption that is accepted only by economists whose mindset was (and remains) incapable of explaining the crisis. It is a little like employing flat-earthers as navigators on a round the world sailing expedition.

5.3 Lessons from the New Deal (that Europe is refusing to learn)

A key historical context is the contrast between what Eurozone governments are attempting now and the 1930s New Deal in the United States of America. The Roosevelt administration did not seek to put the US economy on a path to recovery by cutting public expenditure. Indeed, when it temporarily sought to balance the federal budget, based on evidence that the crisis had subsided in certain states and sectors of the American economy, recovery stalled and the crisis was back with a vengeance everywhere.

Europe, we are afraid, is about to learn the same lesson the hard way. But there is another, even more crucial, lesson that European leaders must learn: the only way of dealing with a debt crisis during a recession is by restructuring it and by channelling new borrowing toward the mobilisation of investment (public and private). In the US case, this involved borrowing to invest in infrastructure and social projects through US Treasury bills (or bonds). In Europe no such mechanism exists and, alas, none is being debated by our leaders.

At this point, it is important to compare and contrast the two approaches: Europe is forcing upon its surplus states the task of raising (or guaranteeing) loans for the deficit states that are to be used not for investment purposes but in order to repay the quasi-bankrupt banks. Banks whose books are so problematic that they hoard whatever funding they receive, thus behaving like black holes which absorb, and waste, the continent's economic dynamism.

Moreover, to receive these loans, the deficit states are compelled to cut public expenditure at a time of bleeding firms and burgeoning unemployment. In turn, the accelerating recession causes a greater shift of capital and people from the deficit to the surplus states while, in aggregate, demand falls throughout the Union. Had Roosevelt followed that model, instead of issuing US Treasury Bills to fund the recovery, he would have forced California and the State of New York to guarantee loans for Illinois and Ohio that would be dispensed if only the latter experienced reduced state and federal investment on their territory. It would have been a recipe for disaster that not even Roosevelt' predecessor (the hapless Herbert Hoover) would have fathomed. And yet, this is precisely what we are witnessing in the eurozone masquerading as an antidote for the crisis.

The natural counter-argument to make here is that EU is not a federal state. Be that as it may, the problem it faces respects no labels. Whether Europe is federal or not, it sports a common currency that binds surplus and deficit states together, with the latter caught up in a vicious debt-recession cycle and the former suffering under the strains of a banking crisis. Our Modest Proposal offers a simple way of cutting the Gordian Knot. Of allowing the eurozone to restructure its public debt as if it were a Federation without having to become a Federation. **Policy 1** of the Modest Proposal squares the policy circle neatly and requires nothing more than minimal tampering with existing Treaties. **Policy 2** deals with the banking crisis by utilising one of the new institutions (the EFSF now and the ESM after 2013); institutions unfit for the purpose they were ostensibly designed (to lend to the bankrupt states) but perfectly good for acting as a bulwark by which to recapitalise the banks. Lastly, **Policy 3** presses the European Investment Bank into service, turning it into the engine of growth and recovery that Europe is missing soarly.

5.4 Does the proposed tranche transfer require changes to the Maastricht and Lisbon Treaties?

The answer is negative. We came to this conclusion after carefully re-reading the various relevant Treaties, from Maastricht to Lisbon. Though not legal experts, we trust that a tranche transfer *is* allowed, provided of course the political will is there. Our reading of the treaties is that they ban outright two things:

1. The *purchase* of member-state bonds by the ECB, which effectively rules out the financing of members states from the 'centre'.
2. Cross-financing between member states – the no 'bail out' clause which renders each member-state wholly liable for its debts (in association with 1 above)

The point of these two prohibitions was, of course, to preempt any attempts to free ride (that would have inflationary effects) and to segregate fully and unequivocally monetary control from control of member-state budgets. If the 'letter of the law' was to preclude direct ECB member state bond purchases and transfers between member-states, the law's spirit was about maintaining the fabled discipline.

Interestingly, in terms of the 'spirit of the law', both objectives have broken down as a result of the crisis: Despite these strict provisions, discipline broke down, the ECB has been forced to purchase bonds (albeit in the secondary markets), the ESM has been empowered to purchase more bonds in the primary markets after 2013 and the Greek deal and the EFSF have been, for some time now, been 'bailing out' (admittedly at penal interest rates) Greece and Ireland. In short, the Treaty prohibitions already lay in ruins. Of course our leaders have been very skilful at packaging the EFSF/ESM loans in a manner that allows them to argue that the no bail out clause is respected. But our point here is that the tranche transfer we are suggesting is far closer to both the 'spirit of the law' and the 'letter of the law' than current practice.
The reason is straightforward: The tranche transfer is neither a bond purchase nor a form of direct financing. If the ECB could create, under current Treaties, a portfolio of bonds purchased in the secondary markets, it can surely create another one in which the transferred tranches will reside. These are not new bonds, they are not bonds *purchased* by the ECB, and they do not constitute any form of fiscal transfer as long as they continue to be serviced, long term, and, in a fiscally neutral manner, by the member-states.

To recap, **Policy 1** of our Modest Proposal (which stipulates a tranche transfer of the Maastricht compliant member-state debt with a parallel issue of e-bonds by the ECB) is far less in breach of the Treaties than both the current ECB assets purchase program and the EFSF shenanigans.

5.5 Do we need a common debt agency that issues all euro-area bonds under strict rules (e.g. debt breaks, constitutional amendments and balanced budget conditions)?

No, we do not. Take for instance Lorenzo Bini Smaghi's proposal to create a European agency that issues centrally all government bonds on behalf of the member-states, in return for strict central control of member-states finances. Given that the EU is not a Federal State, and thus does not feature a democratically accountable Department of Treasury, allowing a central debt agency (possibly under the aegis of the ECB and the Commission) to set the limits of member-state borrowing would be extremely deflationary, especially during a downturn. Given that **Policy 1** introduces eurobonds as means of financing only the Maastricht-compliant debts of member-states, and Policy 3 extends the use of these ECB-issued eurobonds only for investment projects that are approved, on strict banking criteria, by the European Investment Bank, there is no need for central control of all borrowing. Member-state borrowing over and above the Maastricht limit will carry its own, market determined, risk premium. Investors then take that risk and that's the end of the story.

5.6 Is Policy 1 inflationary?

A standard response to **Policy 1** by those who are defiantly clinging on to a crude quantity theory of money view of the world is that the *tranche tran*sfer we suggest may prove inflationary or, at the very least, that it will bring presure to bear upon the euro's international standing (and, thus, its value relative to the US dollar and other international currencies). We think the opposite to be true. First, the *tranche transfer* we recommend will be monetarily neutral for two reasons: it will require no money supply increase (indeed, it will reduce the current pressures on the ECB's money supply since it will render unnecessary the continuation of the ECB's bond purchases in the secondary markets) and, additionally, it will be self-financing (as the member states, on whose behalf the e-bonds will be issued, will service the e-bonds long term). Secondly, the issue of large quantities of long term e-bonds will create a highly liquid market for euro denominated paper of the highest calibre, the result being that the euro will attract increasing attention from sovereign wealth funds even to the extent of giving Europe's common currency an edge in the struggle to acquire the kudos of an alternative reserve currency. In short, **Policy 1** will, if anything, have precisely the opposite effect, boosting the euro's prestige and attractiveness in the world's money markets.

5.7 Interpreting the Modest Proposal through the lens of European politics

If we are right, exactly why are the European powers-that-be so opposed to policies of the kind included in our Modest Proposal? The simple answer is threefold: (1) Because the surplus countries do not want to forfeit their right of exit from the eurozone (a right that renders them extremely influential, within the EU, at a time of crisis[2]), (2) because of a general reluctance to admit to the true state of their banking sector, and (3) because they find it easier to muddle through rather than to coalesce around a far-reaching redesign of the euro's architecture.

A further key political context is that, in seeking to placate rating agencies (which famously deemed toxic debt in banks and hedge funds as triple AAA until they proved insolvent), governments are convincing electorates that markets rule rather than that they govern. This poses a major legitimation crisis not only for the future of the eurozone but of democracy itself. It is no accident,

[2] Presently, and given that every euro of debt currently corresponds to one member-state (with, perhaps, the sole exception of the sovereign bonds purchased in the secondary markets by the ECB), Germany or Holland can up their tent and move out of the eurozone. They, obviously, do not want to do this. But, given the unfolding crisis, the fact that they can do it (unlike deficit countries that are well and truly locked in), gives them inordinate power and authority within the EU decision making units. See this post for more.

in such a context, that Martine le Pen has overtaken Nicolas Sarkozy in opinion polls in France; a sad fact that caused the French President to bomb Libya at the great cost of restoring a modicum of legitimacy back to the Despot of Tripoli.

The democratic and political deficit that the EU's policies help expand highlights not only the need for technical solutions (such as we address in the case for a 'tranche transfer' of national debt to Europe) but also a 'learning up' both from the New Deal and realisation that, while Europe is in a Gordian knot of debt and banking losses, trying to untie it by market-based means will simply not work: Only cutting it will do the trick. The way to cut the knot and stabilise the Eurozone is not by fiscal transfers but by transferring a share of national debt to Eurobonds issued by the European Central Bank.

Our simple point is that member-states are deep in debt while the EU itself had none until the ECB started its bond purchase program last year. Now, at this point, orthodox austerians climb on the rooftops and scream two words at us: Moral hazard! Their point is that, if the ECB takes on its books part of the periphery's debt, this will give member-states an incentive to lessen their efforts to reduce debt and, in the future, spread the word that they can spend freely with an accommodating ECB picking up the bill(s). Well, this is nonsense. For if the transfer were up to 60% of GDP (as **Policy 1** recommends), it would not give the highly indebted countries (e.g. Greece and Ireland) any leeway to indulge morally hazardous profligacy. All it would do is reduce the default risk for the most exposed member states, lower their debt servicing costs, and signal to financial markets that governments have a proactive response to the current crisis, rather than are victims of unelected credit rating agencies.

Moreover, such a *tranche transfer* would not be a debt write-off. The member states whose bonds are transferred to the ECB would be responsible for paying the interest on them, but at much lower rates and in the fullness of time that the ECB can secure for them. By the transfer, the remaining debt held by most member states would be within national SGP 60% limits. For countries like Greece, it would be over this but with a manageable excess next year of 27% rather than 87%. If the objective is to preclude a disorganised Greek default without strangling the country or encouraging moral hazard, **Policies 1&2** of the Modest Proposal are a perfect suit.

Yet debt stabilization alone is not the answer to Europe's political crisis. The eurozone needs to realise its 2008 commitment to a European Economic Recovery Programme by learning up from Roosevelt's New Deal, whose success gave Truman the confidence to fund the Marshall Plan from which Germany herself got the chance of an astounding rebirth. The key to the New Deal was not debt reduction through cuts and further cuts. The key was borrowing to invest through US Treasury bonds. Interestingly, these do not count on the debt of US states such as California or Delaware. In exactly the same manner, there is no need for the eurobonds (that we suggest as tools for energising the European Investment Bank (EIB) - see **Policy 3** of the Modest Proposal) to count on the debt of EU member states.

To those who find fiscal transfers and a fiscal union unacceptable, our message is simple: Net issues of ECB-issued e-bonds that will (a) partially fund EIB investments into Europe's recovery and (b) reduce the debt burden of effectively bankrupt member-states *neither implies fiscal transfers nor a buying out of national debt nor national guarantees*. The EIB, already double the size of the World Bank, has issued bonds for decades without such guarantees. Eurobonds issued by the ECB would, in addition, attract surpluses from the Central Banks of the emerging economies and from Sovereign Wealth Funds eager to diversify out of the dollar.

These modest changes to Europe's existing institutions would transform the eurozone's currently debilitating weaknesses into major strengths. Some readers queried the EIB's significance by arguing that it has a history of funding large scale infrastructure of questionable productive potential (e.g. bridges to nowhere). But even if the EIB has funded some white elephants, it need not do so in the future. In fact, the EIB, since 1997, has a cohesion and convergence remit from the European Council to invest in health, education, urban regeneration, environmental technology and small and medium firms. Since then it has quadrupled its annual lending to over €80bn, or two thirds of the 'own resources' of the European Commission, and could quadruple this again by 2020, making a reality of the European Economic Recovery Programme and a New Deal for Europe. The EIB investments that we envisage, matched by globally subscribed eurobonds (see Policy 3), can, in this context, be targeted, of medium scale, and with a view to promoting real value creation that will benefit both the member-state in which they take place and the eurozone at large.

On 14th March, and then again on 25th March 2011, the EU's leadership failed to agree on how to increase the EFSF bailout fund, deferring their decisions (At great expense to Portugal and the rest of the periphery) until next June. The surplus countries (Germany, Finland, Austria and the Netherlands) are objecting to open-ended, unlimited liability lending to the fiscally challenged periphery. Germany and Finland are objecting to the fiscal transfers necessary under the EFSF and, post-2013, the ESM. Mrs Merkel, all of a sudden, began reeling under the pressure of having to put tens of billions into the ESM at a time (2013 and beyond) when her ruling coalition wants to be offering the electorate tax cuts. Thus the German Chancellor finds herself in a bind: On the one hand she has agreed to these fiscal transfers and yet, on the other, she cannot mobilise enough support within her government coalition to sign on the dotted line (not to mention the threat she is facing from a constitutional court challenge). Meanwhile in Finland the rise of the xenophobic True Fins party has effectively blocked that government's assent to the extra cash and guarantees that Finland has committed to the EFSF.

Our main point is that ***none of this is needed***. As argued above, the euro crisis can be dealt ***with without any fiscal transfers***, with ***no taxpayer-funded bond buy-backs*** and without even changing the existing Treaties. All it takes is a commitment to end the crisis and to kickstart Europe's recovery. Our Modest Proposal has a simple purpose: To explain how this can be achieved. And, in the process, to spread hope in what is becoming an increasingly hopeless eurozone. Hope that a rational alternative to the EU's current policies exists. That the speedy resolution of the eurozone crisis is feasible. Hope that the forces of Unreason, Xenophobia and Discord can be dealt with efficiently and in a manner that unites all of Europe's progressive forces at a time when the European project is at its most vulnerable.

TECHNICAL APPENDIX

Policy 1 details:

When a member-state's Maastricht-compliant debt is tranche transferred to the ECB, it is important that the default case is the no haircut case. To ensure that this is so, we need the following: First, that the bond holders register with the ECB, stating their identity, nature (e.g. whether they are banks, hedge funds etc.) and precise identity of the bonds that they are transferring to the ECB's books. Secondly, the ECB will have to issue e-bonds of a total face value that exceeds the tranche transfer, so that, potentially, it can service the transferred tranches to the full (i.e. no haircut). The more haircuts it chooses to impose on some of the registered bondholders (e.g. banks that ask the ECB for liquidity without having creditworthy collateral to post in return) the smaller the total face value of the e-bonds that it will have to issue over and above the face value of the tranche transfer.

More precisely, supposing that the nominal value of the tranche transfer is €T billion, then the ECB will *eventually* issue e-bonds worth up to €$T(1+r^e)^{10}$ billion, where r^e is the interest rate that the ECB succeeds in securing in the money markets (around 3.5%) and 10 years is the e-bonds' projected maturity. E.g. in the case of Greece, 60% of GDP is around €138 billion. Assuming that it was paying interest rates of about 6% until its exit from the money markets last May, and that average maturity of these bonds was 8 years, the capital actually borrowed by Greece (to incur this tranche-transferable debt of €138 billion) was around €94 billion. After the tranche transfer of these bonds to the ECB, the ECB issues e-bonds periodically (whenever the transferred bonds are about to mature). If the e-bonds' maturity is 10 years, then in the fullness of time the ECB will have issued e-bonds of €195 billion to service these Greek bonds.

What does Greece pay back to the ECB? Greece pays back the original capital C_i = €94 that it borrowed plus interest calculated at rate r^e (around 3.5), rather than the interest rate of its own bond issues that was in excess of 4,5% before 2009 and in excess of 7% after that. Supposing that r^e = 3.5% and Greece's average interest rates on the tranches transferred to the ECB equal r = 6%, then the tranche transfer has reduced Greece's total liabilities by about 6 billion. Not a lot but not insignificant either.

Now, to the key question is: When and how is Greece going to pay these monies back to the ECB? Here lies the great benefit. First, Greece will no longer have to repay in lump sums, and in short order, its existing high interest debt. (As things stand, Greece must repay €211 billion between 2013 and 2015!) Secondly, its debt of €132 billion to the ECB can be repaid by means of what we used to call in the UK an endowment mortgage; or an amortised debt: Greece could make repayments on a quarterly or annual basis for a period of 20 or 30 years paying only the ECB lower interest rate plus an insurance fee. When its debts mature, the debts will pay themselves off! (See this article for more on the matter.) In effect, the tranche transfer will be tantamount to a magnificent debt restructure. And so far with no haircut whatsoever. Thirdly, the ECB could simply retire 20% of the bonds of Greece, Ireland, Portugal and

Spain that it has already taken on its books as collateral from banks seeking liquidity.

The problem with the above is that the tranche transfer is not revenue neutral, as we insist it should be (if only for political purposes). The ECB will be facing a significant shortfall the present value of which, in the case of Greece, equals the €6 billion reduction in the latter's debt. Since it is of the utmost political importance (though economically far less pressing) that the whole scheme is fiscally neutral from the ECB's perspective, there are two ways in which this shortfall can be covered.

First, the countries whose Maastricht-compliant debt will be transferred to the ECB, could be paying higher installments to the ECB so as to cover for the shortfall themselves. Given enough room to keep rolling over the debt, the annual debt burden of these countries will still be far lower - especially if amortised. Their repayments will be smoothened out (no longer facing a lumpy repayment schedule) and the lower interest rates will apply to these rolling issues, in sharp contrast to the huge rates they now face when they dare enter the money markets.

Secondly, there is the prospect of imposed haircuts. For instance, when ECB-reliant banks approach the ECB to register their bonds, the ECB can insist that they retire at least 30% (or up to 50%) of these bonds. These written off debts of Greece and the other participating member states continue to service but the ECB does not issue e-bonds against, thus potentially eliminating the shortfall and rendering the whole tranche transfer scheme fiscally neutral.

Note: Every time some bank requests liquidity injections from the ECB without 'proper' collateral, the ECB could ask the bank to tear up a certain number of existing bonds that the bank has refused to register with the ECB. This will help reduce the debt of countries like Greece for whom most bonds will remain outside the tranche transfer (as their Maastricht-compliant is far less than total debt].

Policy 2 details:

According to this version of the ***Modest Proposal***, the banks will be forced to come clean in three ways: First, by means of the real stress tests which will force them to come clean regarding their toxic paper. Secondly, by being forced to hand over to the ECB sovereign bonds that they hold in exchange for liquidity that they are getting anyway without posting any credit worthy collateral. Thirdly, by accepting as losses/debts the money owed to the ECB. Of course, these losses, once registered, will push many of the eurozone's banks to insolvency. A good working assumption is that our banks will need something in the region of €400 billion, after the ECB imposes on them all the various haircuts mentioned above.

Note that these €400 billion happens to be the sum that the EFSF has been endowed with! Naturally, this 'coincidence' offers an excellent opportunity to find a new, non-toxic, role for the EFSF and its successor, the ESM: Use it to force banks to issue fresh shares that the EFSF buys thus killing three birds with one stone: (1) Re-capitalising the banks after all the relevant haircuts have been imposed, (2) Watering down the equity of existing shareholders, by transferring large amounts of equity to the Luxemburg institution, and (3) Giving the EFSF a non-toxic role to perform.

Granted that the EFSF-issued e-bonds are toxic when their purpose is to 'bail out' states like Ireland, they are far less so when they are used to buy equity in banks. As for the concern regarding the possibility of some losses (following the closure of a bank or two), the risks are low enough to be discarded. And if the EFSF plays its cards right (following proper stress tests) it can always infuse capital into banks *after* the merger of bankrupt banks has been allowed to happen. Just like the Korean government did in 2001.