The Modest Proposal Redux (a new version for the turbulent 2011)

As the euro crisis will enter its final stages in this coming year, and the debate on how to end it will heat up, I thought it important to update the Modest Proposal, in preparation. Click here for a copy. The main difference from the last version concerns the first step: Rather than suggesting a tripartite agreement, following a meeting between representatives of indebted states, insolvent banks and the ECB, the Modest Proposal now suggests something simpler: The ECB makes continuing support of the banks conditional on them accepting an immediate haircut on the member-states' debt. No negotiations, no delays, no ifs and no buts. Another difference is extra clarity regarding the role of the EIB and, lastly, a crispier (I hope) preamble. Let 2011 see a rational solution implemented, along these lines or perhaps alternative lines that someone else may sketch. Anything but the current madness will do.

A MODEST PROPOSAL FOR OVERCOMING THE EURO CRISIS

The 2011 version

Preamble

2010 saw the eurozone descend into a critical twin crisis that cast serious doubt upon its very existence:

A. A sovereign debt crisis afflicting many of its member states, *and*
B. A banking crisis that embroiled most of its private banks.

In response to (A) the EU offered[1] hundreds of billions of new expensive loans to the (effectively) insolvent states, compelling them to effect savage budget cuts in the midst of a severe recession.

In response to (B), the ECB provided banks with hundreds of billions of liquidity with no strings attached (accepting collateral of almost minimal value).

By the end of 2010, it had become abundantly clear that these responses not only failed to stem the crisis but, rather, have fuelled it no end. Why?

The reason is simple: While the eurozone has, somehow, generated oceans of liquidity with which it postponed defaults (by states and banks alike), the eurozone has failed to address concerns about the ***solvency*** of both its member-states and of its banks. But by ignoring the solvency issue of states and banks, the EU has only succeeded in causing a steady deterioration in both realms. With every wave of 'migration' of default fears from the banking sector to the sovereign debt domain, and back, the climate of fear extends its iron grip further.

More precisely, over-laden with bonds issued by member-states on the brink of default, and cut off from the global inter-bank credit market, the banks have become hooked on the liquidity pumped into them by the ECB but only let out a trickle of extra loans to business. This worsens the recessionary forces permeating the eurozone, with greatly negative effects on the tax take of the more indebted member-states. Taken together with the depressing effects (upon expectations) of the imposed austerity drives, plus the highly problematic structure of the new form of debt acquired by solvent eurozone members in order to loan to insolvent states (through the EFSF/EFSB), it is clear why these fears lead investors to predict that more and more eurozone member-states will move from solvency to insolvency as growth dips and badly structured new debt mounts. Thus, banks panic further the more member-states are 'bailed out' and, in a never ending circle, more member-states need to be 'bailed out' the more banks and assorted investors panic.

To arrest this twin, escalating crisis, before the eurozone unravels completely, the two parallel solvency crises must be addressed centrally and at once. Our proposal involves three steps that do precisely that *within the EU's current institutional framework*:

Step 1: Restructuring of the Sovereign Debt held by ECB-funded banks

The ECB makes the continuing provision of liquidity to private banks conditional on the latter accepting forthwith a swap of the existing bonds they hold (previously issued by *all* eurozone's member states) for new ones (issued by the same state) with a much lower face value (up to 50% haircut) and longer maturity (up to 2 years extra). No other bonds are affected.

Step 2: ECB-issued eurobonds to cover all member-states' Maastricht-compliant sovereign debt

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. The transfer is financed by ECB-issued bonds that are the ECB's *own liability* (rather than by eurozone members in proportion to their GDP).[2] Member states thus continue to service their debts but, at least for the Maastricht-compliant part of the debt, they pay the lower interest rates secured by the ECB bond issue.

Step 3: Pan-European Investment Recovery Program led by the European Investment Bank (EIB)

Since only sustained growth will see the twin crises well and truly off, Europe must embrace a pan-European, large-scale, eco-social, investment-led, program by which to put in place a permanent counter-force to the forces of recession, especially in peripheries that keep dragging the rest of the currency union toward stagnation. To this end, the EU can summon the services of the EIB. The only one change in the EIB's charter that is necessary is to grant member-states the right to finance their contribution to the EIB-financed investment projects by means of special bonds that the ECB issues on their behalf. With this simple move, the EIB can become the *Surplus Recycling Mechanism* without which no currency union can survive for long.

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[1] And, in Ireland's case, *imposed*!

[2] Just like the US Treasury backs its bills, without reference to California or Ohio, so should the ECB back its own eurobonds. It is high time Europeans were reminded that 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.