A MODEST PROPOSAL FOR EUROPE

A two-part plan for overcoming the eurozone's crisis, re-designing its crumbling architecture, and reinvigorating the European Project

by

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1. PREAMBLE

An accelerating crisis that must be arrested

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 Eurozone-IMF operation to 'rescue' Greece and, in short shrift, the quite remarkable overnight formation of a so-called 'special vehicle' (officially the *European Financial Stability Facility*, or EFSF), worth up to €750 billion, 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 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.

2. THE TWO SIDES OF THE CRISIS

A Gordian Knot of Mounting Debts, Deficits and Bank Losses

The reason why is simple. The eurozone is facing an escalating twin crisis but only acknowledges one of its two manifestations. On the one hand we have the sovereign debt crisis which permeates the public sector in the majority of its member countries. On the other hand we have Europe's private sector banks many of whom find their own viability in question because of exposure to a risk of default by southern European countries and Ireland. Over-laden with paper assets (both publically and privately issued) which are worth next to nothing, they constitute black holes in which the European Central Bank (ECB) keeps pumping oceans of liquidity that, naturally, only occasion a tiny trickle of extra loans to business. Meanwhile, the eurozone's leadership steadfastly refuses to discuss the private debt crisis, concentrating solely on the need to curtail public debt through a massive austerity drive. In a never ending circle, these fiscal cuts constrain economic activity further and, thus, pull the rug from under the bankers' already weakened legs. And so the crisis is reproducing itself.

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3. THE NEED FOR A RATIONAL POLITICAL RESPONSE

The current response constitutes a clear and present threat for Europe

From its very inception the 'European project' was always political. Its *raison d' être*, lest we forget, was, initially to render another war "not only politically unthinkable but materially impossible",[3] and eventually, to create a community based on the 'twin pillars' of an internal market and economic and social cohesion.[4] These political aims continued to hold sway in Europe in the 1990s and underpinned politically the efforts to create a currency union. Alas, the architecture chosen for the new common currency, the euro, was always missing an important pillar. The *Crash of 2008* was the earthquake that revealed the euro' structural deficits. It put the eurozone in its current vicious circle by exposing the imbalances that were expanding during the boom years.

The time has now come to orchestrate a political response to the crisis that is equal to the task. So far, the political response has been anything but. The political debate in Europe, about how to react to the worst economic crisis since the *Great Depression*, has been limited to what should be cut. Meanwhile sixteen million are registered unemployed, millions more either do not qualify for unemployment benefits (because a partner still is working) or are severely underemployed, and a whole generation of young people are losing faith both in Europe and in the ability of its democracies to govern. The unemployed, the under-employed and especially this next generation should not have to live through another *Great Depression* before Europe realises it needs a *New Deal*.

It is our profound worry that the exclusive focus on austerity measures and enhanced 'fiscal discipline' for the heavily indebted will not only further inflame the debt crisis, rather than alleviate it, but that it will, in so doing, seriously undermine the 'European Project' in its totality. After all, what the *Great Depression* taught us is that, in the absence of a collectively agreed political response to a debt crisis, common currencies (the Gold Standard then, the euro now) break up and a war of all against all looms. Our proposal below aims to offer the foundation for a minimalist (and thus modest) political response that arrests the current crisis, paves the ground for recovery, and returns rational politics to their rightful place.

4. OUR PROPOSAL

A two-part plan for stabilising the euro and promoting cohesion and recovery

PART A: STABILISATION - A Tripartite Agreement to defuse the current crisis

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[3] Recall the *Schumann Declaration for a Coal and Steel Community.* Also, recall the words of Walter Hallstein, former German Foreign Minister and first President of the European Commission, who, upon taking office, declared that "we are not in commerce but in politics".

[4] That was the commitment undertaken by the member states during the first revision of the Rome Treaty in the Single European Act of 1986.

The crisis has two manifestations and the time has come to address both of them at once. So long as Europe is continuing to target the crisis' one manifestation (the sovereign debt crisis), while ignoring the other (the crisis in the stricken banking sector and its recessionary effects), things will deteriorate until the euro's breaking point is reached. In short, Europe desperately needs a two-pronged plan for tackling *at once* the deficit states' debt *and* the banks' problematic assets. Until this is done, markets will continue to speculate on which will be the next domino pieces to fall and thus the crisis will be reproducing itself.

The two-pronged attack at the current crisis can take a very simple form: A politically mediated Tripartite Negotiation between the following participants:

A. Representatives of all high deficit countries that will, potentially, require assistance during the next five years (e.g. not only Greece and Ireland but also Spain, Ireland, Italy).
B. The heads of the ECB and the eurozone, who will effectively be representing, as is their wont, the interests of the more dominant, low deficit, countries (e.g. Germany, Austria, Finland, Holland).
C. Representatives of all the main European banks holding the majority of the high deficit countries' bonds

THE TRIPARTITE NEGOTIATION

By bringing these three sides to the same table, it will become possible to tackle the problem in its entirety; to avoid squeezing it in the domain of public debt only to see it balloon in the banking sector; or vice versa. Here is an example of a possible Grand Agreement that the Tripartite Negotiation might bring about:

1. European banks agree to limit their demands over the debt of the high deficit countries (i.e. to restructure the debt of Greece, Ireland etc.)
2. High deficit countries agree to implement reforms that reduce waste, corruption and parts of their deficit whose reduction will have limited impact on poverty, social cohesion and long term productivity growth (e.g. defence procurement, tax breaks for wealthier citizens, subsidies on environmentally damaging agriculture)
3. The Eurozone-ECB undertakes to come to the assistance of European financial institutions that are stressed by (1) above and, crucially, to utilise the European Investment Bank (EIB) to increase productive investment throughout the continent, but more so in its recession-hit regions.

A POSSIBLE GRAND AGREEMENT

Note how such an agreement would reduce the total amount of debt and would instil confidence in the banks. Currently, under the Greek rescue plan and the EFSF, deficit countries borrow at high interest rates (5% plus) to pay existing bank debts to banks. That money is itself borrowed by the rest of the eurozone at various interest rates (depending on each country's credit worthiness). Meanwhile, the banks (who are already borrowing at less than 1% from the ECB) have no confidence that the deficit countries will manage to continue meeting their payments beyond 2012. Thus they hoard funds and refuse to lend to businesses at decent rates. This merry-go-round reinforces the crisis and, in fact, increases the overall burden of debt. The Agreement above would both:

- deflate the gross debt [by combining: (a) a partial, multilaterally negotiated, haircut that is born *only* by banks which are already being drip-fed by the ECB, with (b) increased liquidity into the banks by the ECB at interest rates of 1% or less] *and*
- make banks more confident and thus more willing to lend [by removing the prospect of a series of much worse, and totally unilateral, haircuts on the bonds that they hold after 2012-3].

PART B: A NEW DESIGN - Three simple steps for re-designing the eurozone's architecture to enable recovery, offset future crises and promote cohesion

Once the current fire is put out, Europe needs to think of ways to speed up recovery, ensure that our European house does not catch fire again, and reinvigorate the 'European Project'. Unfortunately, the present political debate offers no prospect of the above being accomplished. By focusing exclusively on fiscal discipline and what is to be done with countries that go into debt, Europe is, once again, missing the point.

If the current euro crisis reveals anything, it is the simple truth that our currency union was never equipped to deal either with a large crisis or with the demands placed upon it during a future recovery. Put simply, the eurozone's current triptych of 'no default, no bail out, no exit' is not credible. Nor is the German proposal, being discussed at EU level now, of allowing default while the 'no bail out' and 'no exit' clauses remain intact. Granted that it is politically suicidal to expect the German taxpayers to pay for Ireland's or Greece's bonds, it is equally utopian to expect member states to default and remain within the eurozone. But, then again, if the 'no bail out' clause is to remain, and exit becomes possible, a vicious domino effect will rear its head and speculation about which country will exit next will wreck the eurozone and demolish its chances of recovery.

Would a European Monetary Fund (EMF) help? Not in the slightest. Such an institution has one purpose: To rescue an economically failed state by imposing austerity upon it. We note that, even if we are prepared to ignore the fact that that approach has caused great misery everywhere it was tried (by the IMF), IMF-style rescue plans require, to succeed, a large depreciation of the stricken economy's currency. But this is, by definition, impossible within the eurozone. In any case, the IMF-like institutions are all about lending to failed economies on condition of austerity. The point here is to come up with safeguards against such failures and in order to prevent any need for such loans.

In short, the eurozone faces a dilemma:

(A) Break up *or*
(B) Re-design its architecture by moving well beyond the question of fiscal discipline and of how to build new mechanisms (e.g. an EMF) for lending troubled countries.

Regarding (a), no one seriously considers a break up. Low debt, high trade surplus countries, like Germany, will be devastated by the euro's demise if, in the middle of a sluggish world economy, they acquire a new currency whose value will, no doubt, shoot up *viz.* the dollar, the remnibi, the yen etc. Equally, the high debt, high trade deficit countries of the eurozone will fall further into the debt-recessionary hole. Nonetheless, even though it is in the eurozone's collective interest to avoid a break up, the idea of re-designing the euro's architecture stumbles upon the argument that nothing short of Federation will do the trick. Although Federation may, indeed, be a solution, it would be political lunacy to link the euro's fate with such a maximalist political project in the middle of the present crisis. For exactly this reason, the attraction and modesty of our proposal is that its implementation will achieve the reinforcement of the eurozone without requiring a politically infeasible move toward Federalism.

Our starting point is that a currency union, in addition to a common monetary policy and good fiscal discipline, requires two further mechanisms without which it is, sooner or later, bound to enter into a tailspin: (1) A mechanism for managing sovereign debt centrally and (2) a mechanism for recycling surpluses and savings. Without these mechanisms, the eurozone will be vulnerable to crises, like the present one, and, worse, it will grow far less than its productive forces allow. The social consequences of this will be dire for the whole continent. But how can these missing mechanisms be introduced with minimal institutional change and without Europe getting bogged down in an endless debate on the merits and demerits of a formal fiscal union or, even worse, of Federation? Here is our proposal of how this can be achieved modestly and without much fanfare:

1. A tranche of 60% of the sovereign debt of all member states (the limit nominally recognised by the Stability and Growth Pact) be transferred immediately and costlessly to EU bonds
2. The European Investment Bank (EIB) be authorised (a) to embark upon a large scale investment drive on Europe's green technologies, efficiency enhancement, infrastructure, and poverty reduction with an explicit remit to channel investment to regions of negative or sluggish growth, and (b) to co-fund these investments using the ECB-issued EU bonds (which will, naturally, not count as part of the member states' debt).
3. Agree to new rules regarding fiscal discipline of member states

REINFORCING THE EUROZONE WITHOUT A TREATY CHANGE

The first thing to note regarding the above is that these three simple steps, of which only the third is currently being considered, can be effected without any formal institutional change. All that is necessary is political will and clear thinking. To see how they would introduce the missing mechanism to the euro's design, and help Europe recover economically, socially and politically, consider the following:

Regarding 1 above, it would create a level playing field and reduce the debt's uneven impact on interest rate differentials. The creation of EU bonds for the levels of debt already allowed for by the Maastricht Treaty (60% of a country's GDP) will pool Europe's borrowing resources together and ensure that, as long as a country stays within the Maastricht debt limits, it will be paying the same interest on its debt. Compared to the EFSF, which generates terrible risks similar to those of the toxic derivatives on the basis of interest rate differentials (see Appendix A), this simple tranche transfer will lower systemic risks significantly. Moreover, 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. Additionally, by issuing EU bonds (something already recommended by Jacques Delors in his 1993 White Paper), it would attract investments from the Central Banks of surplus economies (i.e. China, Japan,) and also sovereign wealth funds (e.g. Chinese, Norwegian, UAE) which are seeking to diversify the way their surpluses are invested. Indeed, that could herald the rise of the euro as a true reserve currency.

Regarding 2 above, the new role suggested here for the European Investment Bank (EIB) requires no tinkering with any of the EU's institutions. Already, since the Luxembourg European Council, and since its remit was enlarged in the Lisbon European Council (2000) to include investment in health, education, urban renewal and the environment, the institutional framework for the EIB allows it to play this new role as a surplus recycling mechanism. One should not forget that the EIB is no weakling. In fact it is twice the size of the World Bank. It is high time that it played a role within the eurozone as significant as that of the ECB. Presently, the EIB issues bonds which are its liability rather of member states, which is why national governments need not count funding from it on their national debt. This reality can be used today, without any Treaty changes or legal tampering, to provide a much needed investment stimulus.

Note that there is nothing radical in this proposal: From 1997 the EIB has been given a joint cohesion and convergence remit by the European Council to invest in health, education, urban regeneration, green technology and support for small and medium firms. Since then it has quadrupled its annual lending to €80 billion or two thirds of the 'own resources' of the European Commission and could quadruple this again by 2020. Were it to do so, its impact would be equivalent, in funding terms, to postwar Marshall Aid.

The one change that would help enormously the EIB to play a leading role in promoting European recovery and cohesion would be this: Presently, the EIB only co-finances investments, requiring that member states put up a proportion of the funding from own funds. At a time of extreme fiscal pressure, governments (i.e. Greek, Irish, Portuguese) can ill afford to do so. All we need change here is that the member state's share could be replaced by net issues of EU bonds by the ECB. Who would buy these EU bonds? Mostly Central Banks and Sovereign Wealth Funds of surplus and emerging economies seeking to diversify their portfolio.

Are changes 1 and 2 above against the current Lisbon Treaty? Do we need a new Treaty? A pan-European government? Fiscal union? If we did, our proposal would be a non-starter, in view of the near impossibility of staging a new round of Europe-wide referenda and/or Parliamentary votes. Thankfully, no such legal changes are necessary. While the Lisbon Treaty confirms that the ECB's primary objective shall be to maintain price stability, it also states unequivocally that "without prejudice to that objective, it shall support the general economic policies of the Union in order to contribute to the achievement of the latter's objectives". So it runs out that Europe neither needs fiscal federalism nor the 'economic government' called for by Nicholas Sarkozy. The institutions and powers to implement our proposal are already in place.

5. Conclusion

Europe is at an unforgiving crossroads. The current mix of policies will cause the crisis to accelerate and, sooner or later, will lead to the breakup of the eurozone. Such an event would leave all its members shattered and the 'European Project' in tatters. Democracy and cohesion on the continent will have been dealt a serious blow.

Most fair minded observers recognise the need for two interventions to stave off this real and present danger: An intervention to stabilise the debt crisis and a longer term intervention that re-designs eurozone's problematic architecture. However, no sooner have they made this diagnosis that paralysis follows at the thought that both interventions require profound institutional changes deemed to be politically infeasible. Most believe, falsely, that nothing short of Federalism would do the trick. But since Federalism is not on the cards, they quickly recoil into a shell of pessimism.

Our proposal has a simple aim: To stir up optimism that the two interventions necessary are feasible within the existing institutional arrangements, that they are implementable here and now, and that they would, if so implemented, arrest the current freefall.

- Part A of our proposal aims at Debt Stabilisation (of both the public and the private sectors) through a Grand Agreement.
- Part B offers a simple three point plan for redesigning the euro's architecture by utilising ***existing*** institutions which can be re-calibrated in order to facilitate net borrowing for productive purposes (rather than for repaying existing mountains of debt).

To sum up, Europe is labouring under a twin debt mountain and must extricate itself from it. It must do so by tackling both manifestations of that debt at once. It must realise the opportunities presented to it by the fact that the EU itself has next to no debt. And it must seek ways to re-design its common currency. The preceding proposal offers answers to all these questions without requiring politically infeasible institutional changes. We think that it deserves a hearing from all fair-minded Europeans.

Appendix A: What is wrong with the EFSF and, by extension, with the new permanent mechanism that is meant to replace it?

The problem is that it bears an uncanny similarity with the circumstances that gave rise to the dodgy CDOs in the United States and, later, their European counterparts. Looking back to the US-issued mortgage-backed CDOs, we find that the trick therein was to bundle together prime and subprime mortgages in the same CDO, and to do it in such a complicated manner that the whole thing looks like a sterling (triple A rated) investment to potential buyers. Something very similar had occurred in Europe after the creation of the euro: CDOs were created that contained German, Dutch, Greek, Portuguese bonds etc. (i.e. debt), in such complex configurations, that investors found it impossible to work out their true long term value. The tidal wave of *private money* created on both sides of the Atlantic, on the basis of these two type of CDOs, was the root cause, as we have seen, of the *Crash of 2008*.

Seen through this prism, the EFSF's brief begins to look worrisome. Its 'bonds' will be bundling together different kinds of collateral (i.e. guarantees offered by each individual state) in ways that, at least till now, remain woefully opaque. This is precisely how the CDOs came to life prior to 2008. Banks and hedge funds will grasp with both hands the opportunity to turn this opacity into another betting spree, complete with CDSs taking out bets against the EFSF's bonds etc. In the end, either the EFSF bonds will flop, if banks and hedge funds stay clear of them, or they will sell well thus occasioning a third round of unsustainable *private money* generation. When that *private money* turns to ashes too, as it certainly will, what next for Europe?

In light of the above, Ireland's hesitation to seek shelter in EFSF's bosom is not illogical.

Appendix B: Why Germany should embrace the idea of EU bonds being used to finance, at least partly, the EIB's investment projects

The key to President Roosevelt's *New Deal* was that it was based on the issuing of US Treasury bonds. It used the monies borrowed in that way, at fixed interest rates, in order to invest in America's recovery. Notice that these debts do not count on the debt of US states such as California or Delaware. Of course, the US is a federal state whereas the eurozone is not. Nevertheless, there is no logical reason, nor any legal imperative, why EU bonds should count on the debt of EU member states in which the EIB's projects unfold. The reader may ask: Why do we need the EIB to invest in deficit regions? Why can we not leave it to the market to decide where investment goes? The simple answer is that we can *never* bank on balanced trade within an economy's regions. Germany will, come what may, have a trade surplus with Portugal. And so will Stuttgart relative to some East German state. So, if the currencies of the two regions are to be locked up indefinitely, keeping the balance sheets balanced requires either a steady transfer of capital from Germany to Portugal, or from Stuttgart to East Germany, or a constant diminution in Portuguese or East German wages. Though both phenomena are possible, and often observable, life has proved that neither the capital flows nor actual wage reductions are ever strong enough to avert the ever-growing imbalances between deficit and surplus

Eurozone regions and countries. In short, either the currency union will break up or a political-*cum*-institutional solution will be found. Our proposal here is that the EIB plays the role of recycling the surpluses. Not in the form of loans-to-laggards but in the form of productive investments in the deficit, low productivity regions. Without such recycling of savings and surpluses, both Germany and Portugal will suffer in the long run and the whole eurozone will be going from weakness to weakness. But there is another reason for which we think Germany has good cause to accept this new role for the EIB. Lest we forget, the New Deal stalled when President Roosevelt temporarily tried to balance the federal budget. He also was challenged by the Supreme Court to end the policy mix involved. But when Roosevelt won a second term he gained confidence and got recovery going again. And the result? The recovery convinced a generation of Americans that governments could deliver. A bond-funded economy allowed the US to fight WW2 and emerge with the dollar as the global reserve currency. The New Deal's success inspired the Marshall Plan which helped rebuild a shattered Europe. Germany is a major beneficiary of this. It owes itself and the rest of Europe, if not the world, to re-learn a lesson once better understood.