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A MODEST PROPOSAL FOR OVERCOMING THE EURO CRISIS

YANIS VAROUFAKIS and STUART HOLLAND

1. Introduction

In seeking to placate credit rating agencies (the very agencies whose triple-A ratings of bank-generated toxic debt drove the financial sector into insolvency), the governments of the eurozone are undermining Europe's credibility with electorates, markets, and, ironically, the credit rating agencies themselves, which no longer believe that the European Union (EU) can resolve its sovereign debt crisis. Instead of closing what was already recognized as a democratic deficit, member-state governments are deepening it and, in the process, reinforcing the eurozone's unfolding predicament. Eager to please the markets, Europe's leaders have ignored Treaty commitments to maintain economic and social cohesion and, indeed, undermined them, with a series of decisions (or lack thereof) that have attached a major legitimation crisis onto an already vicious economic crisis. Thus, not only the EU's economic future but that of European democracy is endangered as well.

Not all governments or ministers have been equally compliant. There have been several calls for new institutions for European governance. These fall into two categories: (1) proposals that require greater federalism on the lines of common fiscal policies and fiscal transfers, which are blocked by a general consensus that federalism is either utopian or undesirable; and (2) proposals that, on lines similar to our own (notably, by Luxembourg Prime Minister and Eurogroup Chair Jean-Claude Juncker and Italian Finance Minister Giulio Tremonti), have been kept off the official agenda. Meanwhile, the mixture of policies adopted in response to the crisis comprises

YANIS VAROUFAKIS is a professor of economics at the University of Athens, Greece. Stuart Holland is a visiting professor of economics at the University of Coimbra, Portugal; he previously taught at the University of Sussex and is a former Member of Parliament in the UK. This proposal was first tabled in November 2010. It has since been updated in response to developments within the eurozone and comments by readers.

new expensive loans (to already insolvent member-states), more austerity (which guarantees a reduction in the states' national income), and, possibly, the prospect of some debt buyouts.

One thing is crystal clear: the combination of policies adopted, based on the triptych loans, austerity, and debt buy-outs, is failing both economically and politically. On March 14 and again on March 25, 2011, the EU's leadership failed to agree on how to increase the European Financial Stability Facility Committee (EFSF) bailout fund, deferring their decision (with the fall of the government in Portugal, following that in Ireland) until 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 resist the fiscal transfers necessary under the EFSF and, post-2013, a European Stability Mechanism.

Our main point is that *none of this is even necessary*. As argued below, the euro crisis can be dealt with *without any fiscal transfers*, with *no taxpayer-funded bond buy-backs*, and *without changing existing treaties*. What Europe needs today is:

1. A commitment to stabilize the current debt crisis by transferring a share of national debt to Europe, which (at less than 1 percent of GDP) has next to none (and, until May last year, had none at all).
2. For the European Central Bank (ECB) to hold the transferred debt as eurobonds and offer net issues of such bonds, which would create a highly liquid market in European paper, attract capital from the central banks of surplus economies and sovereign wealth funds. This new, highly liquid market for eurobonds will, in itself, lessen volatility in the remaining bonds of member-states as well as attract funds to the "center" with which to cofinance recovery and turn the eurozone's current weakness into a major strength.
3. To utilize this inward flow of capital, in conjunction with the funds raised by the European Investment Bank (EIB) (from its own bonds issues), to finance the European Economic Recovery Programme. The Union has been committed to this since 2008 but is currently blocked by deflationary policies that risk a double-dip recession, not only in Europe but also in the United States.
4. To achieve such a eurobond-funded recovery (by shifting excess savings into investments, rather than printing money) by drawing on the precedent of the US New Deal; a singular attempt by the Roosevelt Administration to build up a fresh confidence in the ability of governments to govern at a time of crisis (rather than be serial victims of a vicious circle that leaves neither states nor markets in charge).
5. To contribute to a more balanced recovery of the global economy (which is one of the main stated aspirations of the G20) by recycling global surpluses into productive, socially useful and environmentally sustainable investments.

A key to this is not fiscal transfers but rather a *tranche transfer*: transferring a share of national debt and borrowing to eurobonds held and issued by the ECB. A new institution to issue such eurobonds was recommended in a report to Jacques Delors in 1993.[1] The Breughel Institute more recently has done the same. The EIB has declined to issue the bonds, which is sensible, since there is a difference between bonds as instruments of debt stabilization and bonds for investment in recovery.

But the scale of the current debt crisis is such that we do not need a new permanent institution (such as the European Stability Mechanism, or ESM, planned for 2013), nor a temporary institution such as the EFSF, but one which is sufficiently established both to command the respect of financial markets (including global bond markets) and to deter short-term speculation.

If such a tranche transfer of debt were up to 60 percent of GDP (as Policy 1 below recommends), it would reduce the default risk for the most exposed member-states by lowering their debt-servicing costs, and signal to bond markets that governments have a proactive response to the crisis, rather than remaining victims of (unelected) credit rating agencies.

Importantly, the 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. This also would strengthen rather than undermine the Stability and Growth Pact (SGP).

At present, the SGP lacks credibility not only because France and Germany weakened it in 2005,[2] but also because the macroeconomics of debt reduction do not add up. The process by which rating agencies are serially downgrading member-states' sovereign debt, causing them to refinance at a rate of 7–10 percent, is unsustainable, and the edge of the cliff of default.

In contrast, a tranche transfer would ensure that the remaining debt held by most member-states would be within national SGP limits—that is, below 60 percent of GDP. Even in the case of Greece, which is the outlier here, the debt excess in 2012 would be a manageable 27 percent rather than its currently unmanageable 87 percent. (Policies 1 and 2 of the "Modest Proposal" will address this further.)

Yet debt stabilization alone cannot be the complete answer to Europe's political crisis. The eurozone needs to reinvigorate its 2008 commitment to a European Economic Recovery Programme by learning from President Roosevelt's New Deal, whose success gave Harry Truman the confidence to fund the Marshall Plan—of which Germany herself was a principal beneficiary, and which she gained on the basis of debt restructuring and grants (rather than repayable, expensive loan finance).

The key to the New Deal, it must be remembered, was not cutting investments or raising taxes, but borrowing to invest through US Treasury bonds. These bonds do not count toward the debt of US states such as California or Delaware. In parallel, there is no need for eurobonds (which can match those issued on its own account by the EIB) to count toward the debt of EU member-states (see Policy 3 below).

Net issues of ECB eurobonds neither imply 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 50 years 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 achieve a more pluralistic and more secure global reserve currency system.

Both the US and the trade surplus economies (China, above all) would gain if this were part of a European Economic Recovery Programme—as recommended by the European Parliament in March 2009—whereas contraction of the European economy (as an outcome of debt stabilization without such a program) would reduce their exports' risking a double-dip global recession.

Our proposal, therefore, is radical yet modest, since it does not require new institutions. Several commentators have claimed that monetary union without a common fiscal policy is doomed to failure. But EU bond financing for a European "New Deal" would not need the equivalent of a US Treasury, nor common fiscal policies, nor financing from German or other taxpayers, nor a revision of the terms of reference of the European Central Bank, nor a new European economic government. The institutional framework is already in place. Under existing EU Treaty provisions, since Maastricht, the heads of state and government in the European Council can determine "broad economic guidelines" for "general economic policies," which the ECB has been obliged not only "to note" or "to respect" but also "to support." This wording was in fact lifted directly from the constitution of the German Bundesbank. Article 282 of the Lisbon Treaty simplified this to: "The primary objective of the European System of Central Banks (and the ECB) shall be to maintain price stability," but 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."

Some European economies, like others worldwide, are currently experiencing inflationary pressures. But these are not due to excess demand. Rather, they are caused by rising commodity and food prices due to high growth in the emerging economies, structural factors, and, last but not least, speculation. The issue of speculation in particular should be addressed, as French Prime Minister Nicolas Sarkozy has acknowledged. Arguably, more food should be available for consumption rather than for conversion into biofuels. But neither of these issues will be redressed by more European austerity, while with a European recovery program more firms could assure themselves of sustained cash flows from revenues (rather than from raising prices to compensate for lower cash flows in times of recession).

To preempt claims that new terms of reference will be needed for the EIB, let us be clear: they are not needed. Since 1997, on the initiative of then–Portuguese Prime Minister António Guterres,[3] the EIB gained a "cohesion and convergence remit" from the European Council to invest in health, education, urban regeneration, environmental technology, and SMEs.

Since then, the EIB has quadrupled its annual lending to more than 80 billion euros, 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. In this sense, a "New Deal" for today's Europe is much more tangible than Europe's leaders think.

The EIB as the investment arm of a European Economic Recovery Programme therefore already has macroeconomic potential. This is especially the case when investment multipliers are taken into account. As illustrated below, these multipliers can be as high as 3 (i.e., for every euro invested, three euros in additional GDP are generated). Thus, an addition to EU investment of 1 percent of GDP by the EIB is tripled in terms of an investment-led recovery. It generates related investments and sustains rather than drains the private sector.

Finally, the macroeconomic recovery foreshadowed here, to which the EU has been formally committed since 2008, does not need to be monitored or surveyed, either by the European Commission or the ECB. The criteria have already been established by the European Council decisions since 1997. Nor is there necessarily any question about where the demand might come from. The very nature of the current crisis is the coexistence of insufficient effective demand (yielding low growth) and massive latent demand for investments in precisely the social and environmental areas that have been remitted to the EIB since 1997.

2. The Nature of the Crisis

Each response by the eurozone to the sovereign debt crisis has been consistently underwhelming. This includes, back in May 2010, the joint EU–International Monetary Fund operation to "rescue" Greece and the European Financial Stability Facility (EFSF), which was intended to support the rest of the fiscally challenged eurozone members (e.g., Ireland, Portugal, and Spain). More recently, European leaders announced a provisional agreement to create a permanent mechanism (the ESM) to replace the EFSF, as well as a series of measures aiming to stabilize the economies of the eurozone. Yet the crisis intensified.

The reason is that the crisis is both systemic and multidimensional, and includes a sovereign debt crisis, a banking sector crisis, and an underinvestment crisis. The reason the EU's current policies are failing financially, economically, and politically is that they seek to address only one of the crisis's three manifestations—the sovereign debt crisis—while displacing the banking sector crisis and deepening unemployment and recession in all save its core economies.

This exclusive focus on sovereign debt is counterproductive: instead of reducing the debt-to-GDP ratio of the stricken member-states, it makes it worse. The debt burdens of the fiscally stricken nations are compounded by huge, expensive loans to what are effectively insolvent states; new institutions that lack credibility in financial markets, not least since governments have yet to agree on their criteria (e.g., the EFSF); the negative effects of raising the funds to be loaned by utilizing toxic financial instruments, which contain a vicious default dynamic (which increases the likelihood of contagion within the eurozone); and massive austerity drives that reduce employment, income, and revenues for the member-states burdened with these new loans.

But the immediate effect is a worsening of the banking sector and underinvestment crises. Europe's private sector banks are overladen with worthless paper assets (both private and public). They are black holes into which the ECB is pumping oceans of liquidity that only occasionally result in a trickle of extra loans to business, since the banks are using the money to recapitalize without writing down debt that is still toxic. Meanwhile, the EU's policy mix in response to the sovereign debt crisis—founded primarily on austerity drives (as a condition for the new loans), including the aim to halve fiscal deficits by 2013—constrains economic activity further, and fuels the expectation of future sovereign defaults. In fact, the mechanism designed to raise funds for Ireland and Greece not only does nothing to preclude default but also enhances the prospects of other member-states (such as Portugal and Spain) becoming insolvent as well. So the crisis is reproducing itself rather than being resolved.

The problem with loans and bond buy-back schemes is that they do nothing to address either the banking sector crisis or the underinvestment crisis, and have minimal effects on the debt crisis. We therefore propose four main principles for a more comprehensive solution:

> *Principle 1.* The triple debt, banking, and underinvestment crises must be tackled together. National debt stabilization needs to be matched by a restructuring of the banks. Recession of national economies needs to be offset by realizing the formal commitment of the Union to 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 national debt and deficit reduction.
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> *Principle 2.* Shareholders rather than depositors in the banks that caused the financial crisis should share in the pain. Depositors and precautionary holdings in banks by individuals and pension funds should be protected; speculative holdings relying on ECB bailouts should not. Determining these will take time,

but commitment to the principle should be from now. Both bank losses and portions of sovereign debts should be restructured in a transparent and socially equitable manner, rather than making electorates alone responsible for the banks' errors.

Principle 3. The crisis needs structural, proactive change, not reactive responses to exposed sovereign debt. German, Dutch, Finnish, and Austrian taxpayers should not be asked to shoulder new loans for insolvent countries. Fiscal transfers should be within the agreed framework of the Structural Funds through the European Commission's "own resources," rather than a response to the sovereign debt crisis. The structural change should be one by which a major share of national debt is transferred to the EU, to be held by the ECB as eurobonds.

Principle 4. Such a "tranche transfer" to ECB eurobonds should not count toward the national debt of member-states nor need be guaranteed by them any more than are EIB bonds. A key parallel is that US Treasury bonds do not count against the debt of American states nor are guaranteed by them. Therefore, EU eurobonds need not and should not count as part of the debt of EU member-states, nor be guaranteed by them.

3. The Three Main Policies of Our "Modest Proposal"

Policy 1. Stabilizing the sovereign debt crisis
Institution: European Central Bank

1.1 Tranche transfer to the ECB. The ECB takes on its books a tranche of the sovereign debt of *each* member-state equal (at face value) to as much as 60 percent of GDP.

1.2 ECB bonds. The transferred tranche is held as ECB bonds (*eurobonds* hereafter) that are the ECB's own liability.

1.3 Fiscal neutrality (i.e., no fiscal transfer). Member-states continue to service their share of hitherto sovereign debt now held by the ECB. To do so, each participating member-state holds a debit account with the ECB that it services long term at the lower interest rates attainable by the ECB as the Union's central bank. Formerly sovereign national debt transferred to the ECB reduces the debt-servicing burden of the most exposed member-states without increasing the debt burden of the other member-states.

1.4 National debt reduction. The transfer of debt of up to 60 percent of GDP to the ECB means that most European member-states are Maastricht compliant on their remaining national debt and do not need to reduce it within the terms of reference of the SGP. Greece would need to do so, but at some 27 percent of GDP in 2012 rather than 87 percent such a reduction would be feasible, especially if the deflationary effects of current policies are offset by its share of EIB-financed cohesion and convergence investments.

1.5 The SGP and the tranche transfer. The national SGP limits therefore become credible with the tranche transfer to the ECB. For a member-state such as Greece, whose remaining national debt exceeds 60 percent of GDP, the transfer should be conditional on an agreed schedule for its reduction.

Policy 2. Tackling the banking sector crisis
Institution: European Financial Stability Fund

2.1 Rigorous stress tests. These tests should be conducted centrally (rather than by national watchdog authorities) and assume an average haircut of 30 percent for sovereign bonds of member-states with a debt-to-GDP ratio exceeding 70 percent, and a 90 percent haircut for toxic paper found on the banks' books. The degree of recapitalization necessary for each eurozone bank should be computed on the basis of these tests.

2.2 Banks seeking long-term liquidity from the ECB. The ECB, funded by net issues of eurobonds subscribed by the central banks of surplus economies and sovereign wealth funds, can make large, medium-term liquidity provisions to the private banks, conditional on haircuts on the existing sovereign bonds in their portfolio.

2.3 Recapitalization. Recapitalization of banks should be short term, once off, and undertaken by the EFSF rather than a future ESM. It should also be in exchange for equity. If a bank cannot raise the necessary capital to meet the recapitalization target computed above, then the EFSF (and, later, the ESM) should require a swap of capital for public equity in the bank. The financing for this could be from bonds issued by the EFSF/ESM rather than from national taxation. The return on the bonds should come from the dividends on the equity paid to the EFSF.

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 future liquidity into loans to enterprises and households. Currently, if banks were submitted to rigorous stress tests, several might be found to be bankrupt. Thus, Europe needs simultaneously to lean on them to come clean and to help them do so without insolvency.

Policy 3. European Economic Recovery Programme
Institutions: European Investment Bank, European Central Bank, and national governments

3.1 Cofinancing the EIB commitment to cohesion and convergence investments. As indicated earlier, since 1997 the EIB has been remitted to contribute to both cohesion and convergence through investments in health, education, urban renewal and the environment, green technology, and new high-tech start-ups. But while it has done so with success, quadrupling its own borrowing and investments, its investments in many cases—as with the Trans-European Networks, or TENs[4]—have been constrained by the national debt and deficit limits of the SGP.

There is a strong case for maintaining that national cofinancing of EIB investments should not count toward national debt, and that this should be allowed within the 2005 revised terms of the SGP (see below). But just as EIB borrowing for investment through its own bonds is not counted against national debt by any of the major eurozone countries, nor need be so by others, ECB bonds that could cofinance EIB investments—by the analogy with US Treasury bonds—should not do so either.

The analogy with US Treasury bonds, which do not count on the debt of member-states of the American union, should be seized upon. It would take the brake off the TENs and, especially, the high-speed rail networks that in several member-states are still being postponed because national cofinance counts within the current interpretations of the SGP. These in themselves could constitute one trillion euros in investments in the decade to 2020. Also, while their environmental impact in the case of motorways is open to challenge, priority could be given to rail networks that are both less directly polluting and, in the case of shifting freight from road to rail, and for medium distances from air to rail, indirectly so.

3.2 Extension of the role of the European Investment Fund (EIF). The original design for the EIF was that it should issue Union bonds. But a parallel recommendation to Delors for the EIF, and which influenced his gaining consent from the 1994 Essen European Council to establish it, was that it should offer public venture capital for SMEs rather than only equity guarantees. The Council declined this at the time, but Ecofin, the governing body of the EIB Group (which includes the EIF), could remit it to do so.

A similar constraint on EIF finance for SMEs and new high-tech start-ups was that it initially would not consider an application for equity guarantees of less than 15 mecu[5] and then declined direct applications for such guarantees rather than offering them through private sector banks or other financial intermediaries. This was compromised by the concern of private banks to gain loan financing as counterpart packaging of such equity guarantees, and it denied the original design for the EIF that was to enable SMEs to avoid the need for interest repayments during the initial years of a high-tech start-up in which revenue was either nil or negligible.

Ecofin, therefore, should determine that the EIF, cofinanced by both EIB and ECB bond issues, should offer equity rather than only equity guarantees and do so through "one-stop shops" in each of the national capitals of the EU member-states to which SMEs, currently starved of finance while banks focus on recapitalization, can readily have access.

Summary. At a time of fiscal squeeze amongst many member-states, these cofinancing rules severely circumscribe the utilization of the EIB's investment capabilities. However, once member-states have debit accounts with the ECB (see section 1.3 above), there is no reason why the member-state's 50 percent cofinance of a worthy (from a pure banking perspective) investment project should not be funded from that debit account (i.e., against the ECB's eurobonds).

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 has already been remitted by the European

Council to invest not only in infrastructure but also in areas of social cohesion, including health, education, urban renewal, environment, green technologies, and support for SMEs—all of which have been part of the joint EIB-EIF criteria since the Lisbon Special European Council in 2000. Moreover, the EIF—as recommended above—should offer equity capital to new high-tech start-ups in addition to venture-capital guarantees.

4. Regional and Global Implications

Our "Modest Proposal" outlines a three-pronged, comprehensive solution to the eurozone crisis that respects three principles: (1) addressing the three main dimensions of the current crisis rather than only that of sovereign debt, (2) restructuring both a share of sovereign debt and that of banks, and (3) no fiscal transfer of taxpayers' money. Additionally, 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. First, the tranche transfer to the ECB stabilizes the debt crisis. Second, the EFSF is relieved of the role of dealing with the member-states' sovereign debt and, instead, acquires the role of recapitalizing stress-tested banks (in exchange for equity). Third, the EIB is given the role of effecting a New Deal for Europe, drawing upon a mix of its own bonds and the new eurobonds. In effect, the EIB graduates into a European surplus-recycling mechanism, a mechanism without which no currency union can survive for long. But this also has global implications.

There are major structural asymmetries not only within the European Union but also between different regions of the global economy. Some of these range wider than the terms of reference of this proposal.

For example, consider the Ricardian hypothesis that the pursuit of comparative advantage will maximize welfare for all economies. This hypothesis relies (as Ricardo himself demonstrated) on the assumption of perfect capital immobility. This was not the case even in Ricardo's paradigmatic example of English cloth and Portuguese wine, where the port trade was developed by English capital (Churchill's, Croft's, Offley's, and others'). Since World War II, evidence provided by the UN Conference on Trade and Development has shown that it has been foreign direct investment, not comparative advantage, that has driven global trade. China's structural trade surplus is not merely due to its exchange rate. It has combined FDI inflows of high technology capital with a literate but low-cost labor force, and world-class communications and infrastructure. This has realized the conditions for Adam Smith's "absolute advantage" in trade in a manner that cannot readily be offset solely by exchange rate changes. In turn, this makes the recycling of global surpluses more imperative if the G20 is to achieve the more balanced recovery of the world economy to which it aspires and which even a continental economy such as China needs, given that a major share of its GDP is export dependent.

Such a recycling of global surpluses to cofinance economic recovery can ensure that Europe sustains global trade while not putting the Union at risk, in view of the fact that, unlike the United States, it is broadly in balance with the rest of the world. But this also is relevant to a reversal of the beggar-thy-neighbor deflation of mutual spending and demand implicit in current EU responses to the sovereign debt crisis. For Europe now constitutes a third of the global economy. If it combines contraction of its own global demand with a serial default of its most indebted member-states, it would risk the disintegration of the eurozone, which would in turn bring about a terrible crisis of confidence not only in the EU's economic governance but also in markets. Then the risk of a double-dip recession may well exceed that of 2008, spill over to the United States, and restrain the growth and development of emerging economies such as China, Latin America, and India.

Lastly, issues of sustainable development, rather than simply GDP growth, are central to an agenda for avoiding the second trough of a double-dip recession, as are issues of economic and social inclusion—for not only Europe and the United States but also the emerging and less-developed economies. But these should be on the agenda of the G20, with Europe able to show that it can assure its own economic governance rather than be "mastered" by the credit rating agencies and the whims of speculative finance.

5. Discussion

The discussion that follows relates these themes to analytic issues missing from the current debate, and seeks to answer some of the questions that readers of earlier versions of the "Modest Proposal" have put to us over the past months.

5.1 The fallacy of the crowding-out hypothesis. The "crowding-out hypothesis" lies behind every recent EU policy for dealing with the sovereign debt crisis. It assumes that public spending drains rather than sustains the private sector and crowds out private sector investment, jobs, and incomes. The fallacy in this thinking is not that this may be the case, but that even Milton Friedman admitted that this would occur only *at full employment*, which we do not have. So far, every cut in public expenditure in Greece, Ireland, Portugal, and Spain has reduced investment and employment. In short, the EU is adopting policies of cuts based on a theoretical assumption that is false.

5.2 The neglect of negative and positive multipliers. For Friedman to claim that public investment and spending "crowds out" the private sector, he had to ignore John Maynard Keynes's claim for multipliers. Multipliers from public expenditures and investment generate jobs (employment multipliers), incomes (income multipliers), taxes from people engaged in work rather than unemployed and claiming benefits (fiscal multipliers), and demand for both investment goods and services from private sector firms (matrix multipliers).

Under Friedman's influence, the study of multipliers went out of fashion. But recent findings from the Observatoire Français des Conjonctures Économiques show that fiscal multipliers range from over 1 for Germany to nearly 2 for France, with a UK investment multiplier of over 3 (Table 1). This means that negative multipliers from cutting spending and investment would mean a contraction of European economies several multiples above the cuts themselves.

5.*3 Lessons from the New Deal.* As we have repeatedly stressed, a key historical context is the contrast between what eurozone governments are attempting now and what the United States accomplished in the 1930s with the New Deal. 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, in 1938, 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 debt rationally and in a top-down fashion, utilizing innovative instruments in order to channel new borrowing toward the mobilization of investment (both public and private, in which positive multipliers have a key role to play). In the US case, this involved borrowing to invest in infrastructure and social projects through the issuance of US Treasury bills (or bonds).

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 to repay the quasi-bankrupt banks—banks whose books are so problematic that they hoard whatever funding they receive, thus behaving like black holes, absorbing, and wasting, the continent's economic dynamism.

Moreover, to receive these loans, the deficit states are compelled to cut public expenditure at a time of closures of firms and rising 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.

5.4 Not yet federal. Had Roosevelt followed that model, instead of issuing US Treasury bills to fund the recovery, he would have

Table 1 Multipliers from Public Expenditures and Investments

Researchers	Country	Multiplier	Short-Term	Long-Term
Perotti (2004)	Germany	Expenditure	1.3	1.1
Biau and Girard (2005)	France	Expenditure	1.4	1.8
Giordano et al. (2006)	Italy	Expenditure	1.7	–
Creel et al. (2007)	UK	Investment	–	3.1

Source: Observatoire Français des Conjonctures Économiques (2009) 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's predecessor (Herbert Hoover) would have fathomed. And yet, this is precisely what we are witnessing in the eurozone as a type of sinister medicine that, rather than curing, is deepening the current crisis.

In due course, some EU member-states may seek yet closer union on a federal basis. But this is not for tomorrow. The current proposal has the merit of being confederal rather than supranational. But whether Europe is federal or not, it needs immediately to cut its current Gordian knot on debt, rather than vainly seek to unravel it.

Policy 1 of the "Modest Proposal" is strategic but requires no change to existing Treaties (see below). Policy 2 addresses the banking crisis through an existing institution (the EFSF). Policy 3 enables the European Investment Bank to be the driver of a New Deal–modeled recovery.

5.5 The tranche transfer, economic recovery, and the SGP. One of the main implications of a transfer of a tranche of sovereign debt of up to 60 percent of GDP to the EU is that the remaining national debt of most member-states would be SGP compliant without further revision of its rules.

The revised SGP of March 2005 already allows that leeway will be given where countries spend on efforts to "foster international solidarity and to achieving European policy goals, notably the reunification of Europe if it has a detrimental effect on the growth and fiscal burden of a member-state."

There are four provisions within this text. The latter two were called for by Germany because of its own reunification. To take them in order:

(i) The European Economic Recovery Programme clearly is a "European policy goal" that has been adopted by governments and endorsed by the European Parliament.

(ii) There has been a "detrimental fiscal burden" for most member states since they salvaged the toxic debt of major European banks.

(iii) There will be a "detrimental effect on the growth" of member states if fiscal deficits are halved by 2013.

(iv) A beggar-thy-neighbor deflation in a third of the global economy (i.e., in the EU), if not offset by a counter-recessionary recovery program, will do nothing if not "foster international solidarity."

A tranche transfer to the ECB enabling the EU to offset (a) the "detrimental fiscal burden" for most member-states (since they salvaged banks) and (b) the "detrimental effect on the growth" of member-states cutting fiscal deficits therefore is compatible with the revised SGP. Net eurobond issues by the ECB also are compatible with the "European policy goal" of the European Economic Recovery Programme and fostering "international solidarity."

5.6 Does the proposed tranche transfer require Treaty changes? The answer is no. The relevant treaties, from Maastricht to Lisbon, do not allow:

(i) The *purchase* of member-state bonds by the ECB, which effectively rules out the financing of member-states from the "center."

(ii) Cross-financing between member-states—the "no-bailout" clause that renders each member-state wholly liable for its debts (in association with *i* above).

But the treaties therefore do not disallow a tranche transfer, since, at the time, no one had considered that there could be the need for one. Yet nor, therefore, is a Treaty amendment needed for such a tranche transfer now rather than a European Council decision, whether or not on the formal recommendation of Ecofin, that this constitutes a "general economic policy of the Union in order to contribute to the achievement of [its] objectives," of which survival of the eurozone clearly is one and the European Economic Recovery Programme is another.

By contrast, both provisions (*i*) and (*ii*) above have been disregarded as a result of the crisis. The ECB has been forced to purchase bonds (albeit in the secondary markets), while debt buyouts involve cross financing of debt between member states, which our tranche transfer would not.

The same disregard for Treaty provisions is implicit in the provision that an ESM (if established by 2013) should purchase more bonds in the primary markets and, since a new institution, would require a Treaty amendment which not only comes with no guarantees that it will carry the needed consent of all eurozone parliaments but also risks rejection by the German Constitutional Court.

The tranche transfer we are proposing is thus far closer to both the spirit and the letter of the law compared to current practice. It 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 create another one in which the transferred tranches of hitherto sovereign national debt 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. Thus, Policy 1 is not in breach of the Treaties, whereas both the current ECB assets-purchase program and the EFSF are.

Similarly, net bond issues by the ECB to cofinance the European Economic Recovery Programme jointly with the EIB are not purchased by the ECB but would be funded by non-EU central banks and sovereign wealth funds. Nor need they be guaranteed by member-states in a manner that would need to be underwritten by taxpayers' money in the event of a default (any more than EIB bonds or US Treasury bonds are).

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

We propose that there should not, both because this would be strongly deflationary, and also because it is not needed either for the tranche transfer or to achieve a European recovery program.

Take, for instance, ECB Governor Lorenzo Bini Smaghi's proposal to create a European agency that issues, centrally, all government bonds on behalf of the member-states. This is a welcome addition to the debate on eurobonds that has broken out only since parallel proposals were put forward by Juncker and Tremonti in December. But the Smaghi proposal comes with 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 the treasury, allowing a central debt agency (possibly under the aegis of the ECB and the European Commission) to set the limits of member-state borrowing would be extremely deflationary, especially during an economic downturn.

Given that our Policy 1 introduces eurobonds as a 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 have already been approved (on both banking and cohesion criteria) by both the European Council and the European Investment Bank, there is no case for a new, centralized federal debt agency. Member-state borrowing over and above the Maastricht limit will carry its own market-determined risk premium.

5.8 Is Policy 1 inflationary? A response to Policy 1 is that the tranche transfer we suggest may prove inflationary or, at the very least, that it will bring pressure to bear upon the euro's international standing (and, thus, its value relative to the US dollar and other international currencies).

Too much money chasing too few goods can generate demand-pull inflation, but shifting savings into investments does not, unless an economy is already at full capacity—a state of things that is as far from current reality as one can imagine (consider the currently high structural unemployment of the vast majority of member-states).

Scarcity and cost-push pressure can also be inflationary. But there is no cost-push inflation from wages, not even in Germany (where average wage increases have failed to breach the 2 percent level). Where there is inflation this is for other structural and speculative reasons: structural in the sense that demand for fuels from agriculture has pushed up the price of food, while demand for food (and other commodities with high growth) from the successful emerging economies has caused a combination of both precautionary and speculative buying on forward markets.

Rather than a tranche transfer or net issues of eurobonds being inflationary, we submit 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 it will be self-financing (since the member-states, on whose behalf the eurobonds will be issued, will service the eurobonds over the long term).

Second, the issue of long-term eurobonds is not equivalent to printing money but to shifting global savings into European investments through euro denominated paper of the highest calibre.

Eurobonds will attract such investments from the central banks of surplus economies and from sovereign wealth funds and therefore strengthen, rather than weaken, the eurozone. In short, Policy 1 would increase the attractiveness of the euro to the world's money markets. Inversely, a major and sustained European Economic Recovery Programme should ensure that upward pressure on the euro is restrained.

Notes

1. Stuart Holland recommended a new institution to issue such eurobonds in a report to Jacques Delors, president of the European Commission, in 1993. Delors included the proposal as part of his December 1993 White Paper, "Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century," published as supplement 6/93 of the *Bulletin of the European Communities*.
2. The relaxation of the SGP was effected in March 2005, under pressure from Germany and France, in recognition of the Pact's inflexibility during periods of recession. The real reason, of course, behind Germany and France's rethink was the fact that these two countries were the first to violate the SGP's maximum-deficit provisions.
3. Portugal's then prime minister, Antonio Guterres, tabled the 1997 Amsterdam Special Action Programme, which invited the EIB to adopt an expanded role through cohesion investments in health, education, urban renewal, and the urban environment. The Luxembourg European Council confirmed its adoption later that year. In 2000, the Lisbon European Council invited the EIB to extend its role to include financing investments in technology and innovation.
4. The TENs are the large infrastructure networks—comprising transport, energy, and telecommunications—underpinning the developmental and integration goals of the EU.
5. *Mecu* is defined as one million European Currency Units (ECU). The ECU is now considered equivalent in value to the euro.