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TOWARD A WORKABLE SOLUTION FOR THE EUROZONE

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Although it didn't originate with an economist, Yogi Berra's malaprop "It's déjà vu all over again" is invariably what springs to mind in the aftermath of virtually any euro summit from the past few years, all of which seem to end with the requisite promise of a so-called "final solution" to the problems posed by the increasingly problematic currency union.

Truth be told, it is hard to get excited about any of the "solutions" on offer, because they steadfastly refuse to acknowledge that the eurozone's problem is fundamentally one of flawed financial architecture. Today's crisis has arisen because the creation of the euro has robbed nations of their sovereign ability to engage in a fiscal counterresponse against sudden external demand shocks of the kind we experienced in 2008. And it is being exacerbated because of the ongoing reluctance of the "troika"—the European Union (EU), European Central Bank (ECB), and International Monetary Fund—to abandon fiscal austerity as a quid pro quo for backstopping these nations' bonds. Germans bearing gifts of promised "fiscal unions," as Chancellor Angela Merkel did the other day, are as dangerous as Greeks bearing Trojan horses. The end result will be more of the sick fiscal austerity that has created a modern-day wasteland in the eurozone.

Yet the one institution that could rescue the European economy—the ECB—steadfastly refuses to use its fiscal capacity (the fact that it has the monopoly rights to issue the common currency) to mitigate the social disasters that are piling up like a train wreck. The ECB occasionally backstops national government bonds via half-hearted purchases, but the quid pro quo for the

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recipient country is to adopt antigrowth policies that just worsen the financial ratios and prospects, and damage the citizenry. It is akin to a dog chasing its own tail.

To be fair to the ECB, it *is* a central bank, and it is effectively being asked to do the heavy lifting on the monetary and fiscal fronts. It was not designed to do this. And in fact, it is not necessary.

Both the leading policymakers within the eurozone and market participants continue to conflate two distinct but related issues: that of national solvency and insufficient aggregate demand. Policymakers want the ECB to do both, but in fact, the ECB is only required to deal with the solvency issue. When you do that in a credible way, then you get the capital markets reopened and you give countries a better chance to fund themselves again via the capital markets. The minute the markets no longer perceive a nation (such as Ireland) as fundamentally insolvent, they will be inclined to lend to such nations again (at substantially less than today's usurious rates), which in itself will facilitate capital market issuance by these same countries to pursue *growth* policies.

How to do this in a credible way? One proposal, suggested before by Warren Mosler[1] and me,[2] is for the ECB to distribute trillions of euros annually to the national governments on a per capita basis. The per capita criterion means that what's proposed is neither a targeted bailout nor a reward for bad behavior. This distribution would immediately adjust national government debt ratios downward, which would ease credit fears without triggering additional national government spending. This would serve to dramatically ease credit tensions and thereby foster normal functioning of the credit markets for the national government debt issues.

As Mosler has noted:

> The 1 trillion euro distribution would not add to aggregate demand or inflation, as member nation spending and tax policy are in any case restricted by the Maastricht criteria. Furthermore, making this distribution an annual event greatly enhances enforcement of EU rules, as the penalty for noncompliance can be the withholding of annual payments. This is vastly more effective than the current arrangement of fines and penalties for noncompliance, which have proven themselves unenforceable as a practical matter.[3]

As far as threats to its "profitability" go, the ECB could easily manufacture "profits" if it continued to buy the bonds of the distressed PIIGS (Portugal, Italy, Ireland, Greece, and Spain) and then did not allow them to default—although clearly, this program would stop once the revenue sharing begins.

But in any case, the notion of a central bank being a profit maximizing institution is absurd. If you are the monopoly supplier of a currency, does the notion of an "impaired balance sheet" have any real meaning? In a 2008 discussion paper—"Can Central Banks Go Broke?"—former Bank of England Monetary Policy Committee member Willem Buiter notes that in the typical institutional arrangements that govern the operation of a treasury and a central bank, there is a unique "national fiscal authority" (treasury) that "stands behind a single national central bank."[4] In this situation:

> There can be no doubt . . . the fiscal authorities are, from a technical, administrative and economic management point of view, capable of extracting and transferring to the central bank the resources required to ensure capital adequacy of the central bank should the central bank suffer a severe depletion of capital in the performance of its lender of last resort and market maker of last resort functions.

Of course, in the current environment in the eurozone, there is not a supranational treasury standing behind the ECB, and the latter is in effect forced by these institutional limitations to adopt a quasi-fiscal role. Still, the ECB is in no way operationally constrained in its ability to create unlimited euros. As far as replenishing its capital base (the other aspect mentioned by Buiter), the ECB, by continuing to buy the distressed debt of the eurozone countries, can ensure that none go insolvent, which means that the assets never become "toxic" or worthless. In effect, the bond purchases from the ECB's Secondary Market Programme allows the central bank to buy deeply discounted bonds from the likes of Italy and Spain, and to use the resultant income stream to rebuild the ECB's stated capital. As long as it continues to buy this debt, the national solvency issue melts away, and the ECB continues to increase its accrual of profits that flow to capital.

Where does the ECB get the euros from? As Buiter notes, the ECB, like any central bank, can always bail out any entity—including itself—through the issuance of base money—if the entity's liabilities are denominated in domestic [currency] and nominally denominated (that is, not index-linked). If the liabilities of the entity in question are foreign-currency-denominated or index-linked, a bail-out by the central bank may not be possible.

Think of it as a rights issue for a heavily indebted company: Company X has a debt-to-equity ratio of 200 percent and the markets will not fund it because of perceived solvency concerns. Somehow, Company X launches a one-for-one rights issue and gets its debt-to-equity ratio down to 100 percent. Market concerns about bankruptcy are alleviated and the capital markets open up to the company again. A similar situation pertains on a national level were the ECB to embrace our revenue-sharing proposal. To reiterate, revenue sharing would not solve the problem of aggregate demand, but it would reduce the solvency concerns and reopen the capital markets to the eurozone countries again.

And the other way you sell it to the German public is that it would make the Stability and Growth Pact (SGP) more credible and enforceable, because now you'd be providing a mechanism to ensure compliance. Rather than fining a miscreant company (try getting an EU official to go to Athens to collect a fine today for violating the SGP; he would be lucky to get out alive), you would withhold funds.

By the same token, a country such as Ireland, which has largely taken a huge amount of harsh medicine and has not tried to game the system via accounting gimmicks (à la Greece or Italy), would not be penalized, as the ECB could continue to credit their national central bank even if another "miscreant" country, such as Greece, refused to abide by the rules. In that way, the contagion effect would be limited.

To anticipate the screams of the hyperinflation hyperventillistas, the revenue sharing proposal would be noninflationary. What is inflationary with regard to monetary and fiscal policy is actual spending. These distributions would not alter the actual annual government spending and taxation levels demanded by the austerity measures and SGP constraints. They would simply address the solvency issue, which has effectively cut the PIIGS off from market funding (because the markets believe they are insolvent).

Once the solvency issue was dealt with in a credible way, it would effectively reopen the capital markets to these countries, allowing them to borrow at substantially less than the usurious rates of interest now prevailing for countries such as Greece, as well as freeing them to some degree from the fiscal-austerity shackles imposed by the ECB. As Greek economist Yanis Varoufakis has suggested, the European Investment Bank is an ideal instrument for developing a modern-day European equivalent of 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.[5]

It goes without saying that it was possible to borrow because there were no issues of national solvency, as the bonds were backed by the full faith and credit of the US government, which had (and still has) an unlimited capacity to create dollars.

To get to that stage, however, solvency issues must be addressed first. And it must be done by the ECB, as it remains the only entity capable of creating an unlimited supply of euros. It would require no Treaty changes, no additional surrender of national sovereignty (i.e., no German-style "stability union" in which a country like Ireland is totally subsumed), but it would work as an effective tourniquet to stop the hemorrhaging that will otherwise kill the European project once and for all.

Notes

1. See Warren Mosler, "A Modern Monetary Theory Approach to Solving Greek Solvency," *Huffington Post*, July 11, 2011.
2. See Marshall Auerback, "The ECB v. Germany," Naked Capitalism Blog, September 22, 2011.
3. Warren Mosler, "The Eurozone Solution for Greece Is a Very 'Clever Bluff'?" *Huffington Post*, March 12, 2010.
4. Willem H. Buiter, "Can Central Banks Go Broke?" Discussion Paper No. DP6827, Centre for Economic Policy Research, May 2008.
5. Yanis Varoufakis and Stuart Holland, "A Modest Proposal for Overcoming the Euro Crisis," Policy Note 2011/3, Levy Economics Institute of Bard College, May 2011.