A MODEST PROPOSAL FOR OVERCOMING THE EURO CRISIS
Version 2.1

The Nature of the Crisis

- 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.

Basic principles of a *Comprehensive Solution*

So, what should the principles of a truly *Comprehensive Solution* be? Before proposing three 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.

The Modest Proposal

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)

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 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**.

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**. 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*.

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

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)

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.

The policy's components:

- **2.1 Real Stress Tests:** Real stress tests are 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 is 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.

Policy 3 - A Recovery Program to counter the under-investment crisis: *Utilises existing EU mechanisms to promote genuine development*

Responsible institution: The EIB (European Investment Bank)

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.

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.

Conclusion

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.

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.