NOTES ON THE EUROZONE CRISIS

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1. **The crisis arises out of faulty institutional design** rather than bad policy mix. The faulty institutional design was embedded in the Maastricht Treaty of 1992, with its restrictions on Government deficits and a ceiling on the Government debt to GDP ratio. Underlying this was a conviction that monetary stability meant low inflation, and that the key to low inflation was low Government borrowing. The fault in the institutional design is the ban on central bank holding of Government bonds. This is inspired by the ruling policy doctrines of the pre-War German Reichsbank, whose President in the 1930s Hjalmar Schacht only avoided conviction at Nuremburg because he had been removed by Hitler from his position at the Reichsbank after protesting at the over-issue of German Treasury bills which the Reichsbank was supposed to discount.

   The Schachtian approach reversed an even older tradition in central banking, according to which the central bank is the banker to the Government. The oldest central banks, those of England and Sweden were explicitly set up in order to manage the debts of their Governments. Nevertheless, the high German inflation during the early 1990s (in the wake of German unification) aroused sensibilities around the issue of inflation. The faulty institutional set-up was then validated by the extended period of falling and then low inflation since mid-1990s. Central bankers were not modest in claiming this as their achievement.

   The inadequate institutional arrangements are now fairly obvious and widely noted. The Eurozone has a central bank, without a Government, Governments without central banks, and banks without an effective lender of last of resort. With a regime of low inflation, now turning into deflation, the system has no mechanism for eliminating excessive debt in the economy.

   The deficiencies of the Maastricht arrangements in the present situation are most apparent in the requirement to maintain the present debt to GDP ceiling. Virtually all the countries in the Eurozone are now (October 2011) in breach of that ceiling, including Germany, which has a government debt to GDP ratio of between 82 and 88 per cent. Thus all Governments are obliged to run fiscal surpluses until their debt to GDP ratios are reduced below the ceiling. The fiscal surpluses will of course cause reductions in GDP, unless off-set by trade surpluses or private sector investment. But those trade surpluses and private sector investment would have to exceed the fiscal surpluses for GDP to even begin to rise. Meanwhile actual private sector investment is falling and exacerbating the deflation in the Euro-zone. This illustrates the inappropriateness of the ceiling on government debt: attempts to realise that ceiling can only move the economies in the Euro-zone away from the ceiling, because GDP would start to fall well before governments would be allowed (under present rules) to cease deflating their economies.

2. **Ricardian vs. credit view of money.** Apart from the Schachtian hostility to government borrowing, the more theoretical consideration inspiring and distorting the present arrangements in the Eurozone is a Ricardian theory of money that was in the minds of the politicians and central bankers who set up the monetary system in the Euro-zone. The Ricardian theory of money is one in which money is a commodity, that is not a liability, which has value in exchange. This is exemplified in Robert Mundell's theory of 'optimal currency areas'. In such a view, exchange rate flexibility is a substitute for wage flexibility. Hence the monetary discourse prevalent in the Euro-zone according to which the level of employment in member countries of the Euro-zone is determined by their respective 'competitiveness'. Such 'competitiveness' may be obtained by low wages, or a devalued currency, or both. In the absence of the possibility of devaluation, due to membership of the monetary union, the alternative is reduced wages. This theory therefore provides a teleological rationale for deflation, when deflation has been sufficient to increase the 'competitiveness' of a country's output and thereby increase demand for that output abroad.

   The logical flaw in this argument is of course that lower wages reduce the demand for consumption goods in a country. Only under heroic assumptions of perfect competition (so that lower prices keep real wages constant) and an absence of debt (so that lower prices do not increase the real value of debt) can lower wages fail to reduce output and employment.

   The other reason why such a theory is inappropriate is that we in something much more similar to a Wicksellian 'pure credit' economy, in which money is usually a liability of a bank (a bank deposit) whose counterpart is debt of households, firms or governments. In such an economy, inflation and deflation have their main effect on the economy through decreasing or increasing the real value of debt.

3. **The role of financial integration**

   Basing themselves on Ricardian notions of money, critics of indebted governments and of the current arrangements in the Euro-zone have argued that the way out of the current crisis is either that wages in over-indebted countries must be reduced, to recover 'competitiveness'; or else governments in those countries should default on their debts and exit from the monetary union, to allow a new currency to be depreciated in order to recover 'competitiveness'. As indicated above, the first option of lowering wages would lower demand and decrease employment and output. The second option, of default and exit would cause the collapse of the banking system in the country attempting such a strategy: banks holding government securities would become insolvent, due to the reduction in the value of their assets and the increase, with the devaluation of the new currency, in the value of any Euro liabilities that they may retain. Those banks would also be subject to mass withdrawals of deposits as citizens in the countries exiting from the monetary union try to obtain cash in order to keep their savings in appreciating Euros.

Proponents of default and exit strategies have been inspired by the example of Argentina, whose Government abandoned its obligation to peg the Argentine Peso to the US dollar in 2002, defaulted on its foreign borrowing, and was able to enjoy the political benefits of an economic recovery for the remainder of the decade. However, the important difference between Argentina and the countries in the Euro-zone is in the structure of the banking system. Argentina's banking system was relatively insulated from the international financial system, but constrained by the currency peg. The Argentine crisis was precipitated by a banking crisis, rather than a crisis of government indebtedness (although that Argentina had too, but of foreign indebtedness, rather than in its domestic currency, as in the case of Greece). The banking crisis hinged upon the requirement, under the currency board, for the Argentine central bank to issue only banknotes that were backed by holdings of U.S. dollars. This limited the amount of domestic Argentine credit that could be converted into cash. When doubts about the viability of the currency board emerged, a run on Argentine commercial banks started, as their depositors sought to withdraw their deposits in cash in order to convert them into dollars before the peso depreciated. The run was stopped by coming off the currency board with a massive devaluation of the peso. The devaluation also allowed Argentine commodity exporters to win back markets that had been lost to Brazil and Uruguay, whose currencies had previously depreciated.

The essential difference between indebted countries in the Euro-zone and Argentina is that within the Euro-zone a process of financial integration has taken place which is far more advanced than that which existed (and exists) between the Argentine banking system and the international financial system. The greater financial (including banking) integration in Europe means that a default and exit solution for any individual country, or a break-up of the Euro-zone, cannot be done without catastrophic consequences for bank balance sheets. The catastrophic consequences would arise with the mass withdrawal of Euro deposits while they can still be withdrawn in that currency. With exit from the Euro, the rise in the value of Euro liabilities of banks, relative to the value of assets, and the decline in the value of their assets (with default) would render a large part of the European banking system insolvent.

Paradoxically, this vulnerability of the European banking system, gives power to the indebted governments in the Euro-zone. In effect those governments have a 'nuclear option' of default which can be used in the event of a refusal by the 'troika' (the International Monetary Fund, the European Commission, and the European Central Bank) to refinance their debts. Those governments know that the European Commission and the European System of Central Banks (the coordination arrangements between the European Central Bank and national central banks) cannot walk away from their responsibility for the stability of the European banking system. This means that even, if the 'troika' refuses to refinance governments, it has to refinance banks, and thereby extend credit indirectly to governments. Whether the 'troika' lends directly to governments, or lends to banks which lend to governments, the lending effect is the same.

4. **Institutional innovation:**

Euro-zone institutions have not been prepared for a situation in which the debt/GDP ratios of all governments in the Euro-zone exceed the Maastricht limits. Nevertheless, the obvious threat to the banking system in the Euro-zone is concentrating the minds of European politicians and bankers and forcing through a process of institutional innovation. The obvious innovation has been the setting up of the European Stability Mechanism, earlier the temporary European Financial Stability Fund. Since May 2011, the European Central Bank (ECB) has been buying in government bonds, contrary to the Schachtian principles on which it was set up, as well as lending heavily to commercial banks that have been lending to governments. However effective these measures may have been in financing governments now, that is in providing a primary market for government debt, none of this amounts to an effective solution because there has still not emerged a proper central banking function that would stabilise the secondary market for government securities. Without such secondary market stabilisation, the primary market for government debt cannot be effective because buyers of government bonds cannot have confidence in the value of those bonds.

There are two ways in which such a secondary market stabilisation mechanism may emerge. In the first, the ECB, which now has a very large balance sheet due to securities purchases since 2008, could simply transfer the securities purchased to a specially constituted subsidiary to manage this portfolio like a permanent 'sovereign wealth fund'. The subsidiary could be given responsibility for maintaining the stability of the secondary market in government and have access to ECB credit facilities to do so. This would allow the subsidiary to stabilise capital markets while allowing the ECB to implement monetary policy independently of the impact this might have on the portfolio of assets that it owns.

A more private sector solution would be for commercial banks in Europe to set up their own jointly owned subsidiary, with access to ECB credit facilities, to manage government bond market in Europe. It should also be pointed out that such an inter-bank government bond stabilisation fund, like an ECB subsidiary along the same lines, would be commercially viable. Borrowing at current interbank rates of around 2-3% in Europe to buy government bonds yielding 6% and above, is a profitable activity.

Following ‘stress tests’ on European banks, and with the ruling doctrine in bank regulation being that banks are stabilised by holding large amounts capital, many authorities regard the recapitalisation of banks in Europe as a necessary part of the resolution of the Euro-zone crisis. The issue of recapitalisation is a distraction. As Schumpeter remarked, a banking system can only be as strong as the economy in which it operates. Expanding the capital of a bank does not improve its assets. In the present situation expanded capital will never be enough if the problem of debt is not resolved. As long as European governments in aggregate have fiscal deficits which they need to finance, bank capital adequacy today will turn out to be inadequate for tomorrow. The long-term solution is to turn potentially bad government bonds into good government by reviving the secondary market in those bonds.

5. Reflation

However desirable may be the above institutional innovations, by themselves they will not resolve the present crisis of government finances in Europe. It is worth recalling that the crisis of government finances is not restricted to the Euro-zone, but exists also in the U.K., U.S. and many other countries outside the Euro-zone. As indicated above, those crises will not be resolved by raising taxes and cutting government, since such measures will inevitably reduce GDP before any fiscal surplus is generated from which to repay government debt. The key way of raising the value of Gross Domestic Product, relative to Government debt, must be done by reflating the economy, i.e., promoting economic growth. The private sector will not do this under present circumstances, so a lead by governments and trades unions is necessary. Governments can help by raising wages in the public sector and raising the minimum wage. The cost of this to the public sector could be paid by enforcing greater progressiveness of the income tax structure but also by taxing away the profits that will accrue, as a result of higher incomes, to private sector businesses. More tax revenue could be raised by a tax on commercial balance sheets, with deductions for fixed capital investment. Such a tax would encourage investment, as well as discouraging the proliferation of financial or bank balance sheets, that are the basis of tax avoidance and evasion of regulation. It is vital that wages rise throughout Europe as a way of stimulating retail price inflation that would help rebalance the Government debt to GDP ratio. The European Investment Bank could also contribute to reflation by financing public works.

Overall critics are right to point out the need for more effective fiscal policy coordination. But fiscal policy must not be subordinated to monetary policy, as slavish adherence to the Maastricht Treaty would imply. But nor should monetary policy be simply subordinated to fiscal policy (as some Keynesians have suggested). Instead, monetary and fiscal policies have to be so combined as to allow both to operate effectively. In the present situation, primary fiscal deficits (the balance between government income and expenditure before payments on financial obligations) in Europe must be maintained until the growth of nominal GDP starts to reduce the debt to GDP ratio. If necessary, individual governments must be given target primary fiscal deficits that they would have to maintain until that ratio starts to approach the Maastricht ceiling.

Obviously, if Europe-wide inflation emerges, then this is likely to be a relatively quick and painless operation. If, however, the primary deficit targets are concentrated on those countries that are already experiencing deflation (falling prices) then it is unlikely that reflation will be sufficient to reduce debt/GDP ratios. There will be a more prolonged and difficult reflation of nominal GDP. To support the reflation, the European Central Bank should postpone the achievement of its target rate of inflation target (that in any case is not in the Maastricht Treaty), as the Bank of England has done. The alternative of deflation in pursuit of the present inflation target would eventually destroy large parts of the government bond market and the banking system. This shift in macroeconomic priorities and in the operations of central banks is therefore essential to prevent serial financial and economic crises.