A Modest Proposal for Resolving the Eurozone Crisis, *Version 3.0*

Yanis Varoufakis[1] *and* **Stuart Holland**[2]

1. Prologue

For two years now, caught up in a Crisis of its own making, Europe is fragmenting.

A euro in a Greek bank has a lower expected value than a euro in a Spanish bank, which, in turn, trails the value of a euro in a German bank account. There can be no better sign of the common currency's disintegration than this.

And it is not just a matter for the Eurozone. The fallout from a Eurozone disintegration will be so severe, the rise of nationalisms so cataclysmic, that it is pure wishful thinking to believe that the European Union can be preserved, except perhaps in name, if the euro-system succumbs to the centrifugal forces it is now experiencing.

Following a sequence of errors, delays and shenanigans, Europe's leadership has stunned the world with its collective incompetence. Most commentators lament the incapacity of Europe's political and bureaucratic elites to act speedily and in a coordinated fashion. While there is truth in this, the recent double-edged political intervention *vis-à-vis* Europe's banks[3] shows that Europe *can* act decisively. The problem, however, is that, so far, it is selecting bad policies which it justifies on the basis of (a) a poor diagnosis of the Crisis' nature and (b) two false dilemmas.

In what follows, we begin by summing up the true nature of this Crisis. Then we present our Modest Proposal for overcoming the Crisis which comprises three simple policies that are immediately implementable and require none of the moves (e.g. fiscal transfers, federation) that Europeans currently find unfathomable. Finally, we juxtapose the logic behind our proposals against the false dilemmas that currently impede clear thinking and immobilise Europe's policy makers.

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[1] Professor of Economics at University of Athens and the Lyndon B. Johnson Graduate School of
[2] Visiting Professor, Coimbra University; formerly MP, House of Commons, Britain
[3] Taking from them with one hand a large slice of Greek debt, and then immediately compensating them with another hand (with new EFSF capital and a trillion euros worth of LTRO liquidity provided liberally by the ECB).

2. The Nature of the Eurozone Crisis

The Eurozone Crisis is unfolding on three interrelated terrains.

Banking crisis: While sparked off by events across the Atlantic, and the English Channel, the problem with the Eurozone's banking crisis was never properly addressed. The reason was the terribly odd arrangement whereby governments, that lack the backing of a national Central Bank, maintain national control over global banks inhabiting within a trans-national currency union. At a time when forced recapitalisation of essentially insolvent banks is of the utmost importance, we end up with the unwholesome sight of fiscally stressed member-states (e.g. Spain) borrowing massively on behalf of the nation' insolvent banks. And because this new public debt stresses their fiscal position further, they are abandoned by private creditors and have to rely on ECB liquidity that comes to them (to the states) *via* the very banks that the states are trying to save! It is abundantly clear that this madness cannot continue. *For this purpose, our Modest Proposal suggests a very elegant, simple, instantly implementable solution – see Policy 1 below.*

Sovereign debt crisis: Again as a result of a design fault, the sudden and catastrophic loss of liquidity that came to be known as the Credit Crunch of 2008, inevitably turned the eurozone's most cherished principle (of perfectly separable public debts) into the 'popcorn effect' that drove three sovereigns into effective insolvency, before putting at least two large member-states in bankruptcy's pre-chamber. Suddenly, reality bit back, reminding us that even though a common currency shields us from runs on individual currencies, our perfectly separable debts were bound to lead to a sequential run on member-state bonds, once panic set in the money markets following the financial sector's implosion. While Europe's leadership now understands this, the (understandable) reluctance of the surplus nations (mainly Germany) to become liable for the debts of the heavily indebted deficit nations gives rise to a certain paralysis. However, the problem caused by the principle of perfectly separable public debts can be addressed without asking of the surplus nations either to lend or to guarantee the loans of the deficit ones. *For this purpose, our Modest Proposal puts forward another simple and elegant solution, one that violates neither the EU's Treaties nor the charter of the ECB – see Policy 2 below.*

Under-investment and imbalances crisis: In addition to the banking and sovereign debt crises, Europe is facing (i) a dearth of aggregate investment (which threatens its long term international competitiveness) and, perhaps more significantly, (ii) a within-Eurozone balance of payments' crisis. The two are intimately linked. As the various regions within the Eurozone grew apart (in terms of competitiveness, investment, unit labour costs) during the period that led to the Crash of 2008, a well hidden (courtesy of open borders and a common currency) imbalance ensures that, when the global Crisis hit in 2008, the Eurozone was ripe for disintegration. Following the massive loss of liquidity everywhere, the burden of adjustment fell on the regions with lower competitiveness and greater deficits, taking the form of swinging cuts and painful austerity. Coupled with the impossibility of devaluations by these member-states, and the lack of new aggregate demand that would pull the deficit regions[4] out the mire, the scene was set for a flight of capital and negative investment in the regions that needed it the most. Thus, Europe ended up with (A) low aggregate investment and (B) an even more uneven distribution of that investment among its surplus and deficit regions. *To counter both problems at once, the Modest Proposal recommends that three of Europe's existing institutions collaborate in order to stimulate investment in the regions of Europe in a manner that requires no tax-and-spend policies but which succeeds in mobilising idle savings and transforming them into profitable investments – see Policy 3 below.*

3. Three political constraints taken for granted by the Modest Proposal

Designing the solution-concept for the current Euro Crisis resembles a constrained optimisation problem.

- First, we must state the objective: *To arrest the Crisis simultaneously in the three terrains (mentioned above) where it is currently progressing unimpeded.*
- Secondly, we need a realistic catalogue of the constraints under which Europe must find a solution. It is our view that the three constraints Europe is facing presently are as follows:

(a) The ECB will *not* be allowed to monetise sovereigns directly (i.e. no ECB guarantees of debt issues by member-states, no ECB purchases of government bonds in the primary market, no ECB leveraging of the EFSF-ESM in order to buy sovereign debt either from the primary or the secondary markets)
(b) Surplus countries will *not* consent to the issue of jointly and severally guaranteed Eurobonds, and deficit countries will *not* consent to the loss of sovereignty that will be demanded on them without a properly functioning Federal Europe
(c) Federation (e.g. the creation of a proper European Treasury, with the powers to tax, spend and borrow) or Treaty Changes cannot, and will not, precede the Crisis' resolution.

The question is: Does a policy mix exist such that it achieves the stated objective without violating any of the three constraints above? We believe that the answer is affirmative. The next section presents the three policies that respect these constraints.

[4] E.g. something akin to US consumer demand growth that, in the mid-1990s, allowed Canada to complete its austerian fiscal adjustment program with reasonable success.

4. THE MODEST PROPOSAL – Three crises, three policies

To respect constraint (c), the Modest Proposal introduces no new EU institutions and violates the letter of no existing Treaty; for that would involve new Treaties whose conception, approval and activation will take so long that it will be hardly worth having. In short, we propose that existing institutions are utilised, perhaps recoinfigured in ways that remain within the letter of European Law but allow for new functions and policies. These institutions are:

- The European Central Bank – ECB
- The European Investment Bank – EIB
- The European Investment Fund – EIF
- The European Financial Stability Facility & the European Stability Mechanism – EFSF/ESM
- The European Banking Authority - EBA

POLICY 1 – Dealing with the banking crisis by means of creating a *Single Banking Area*

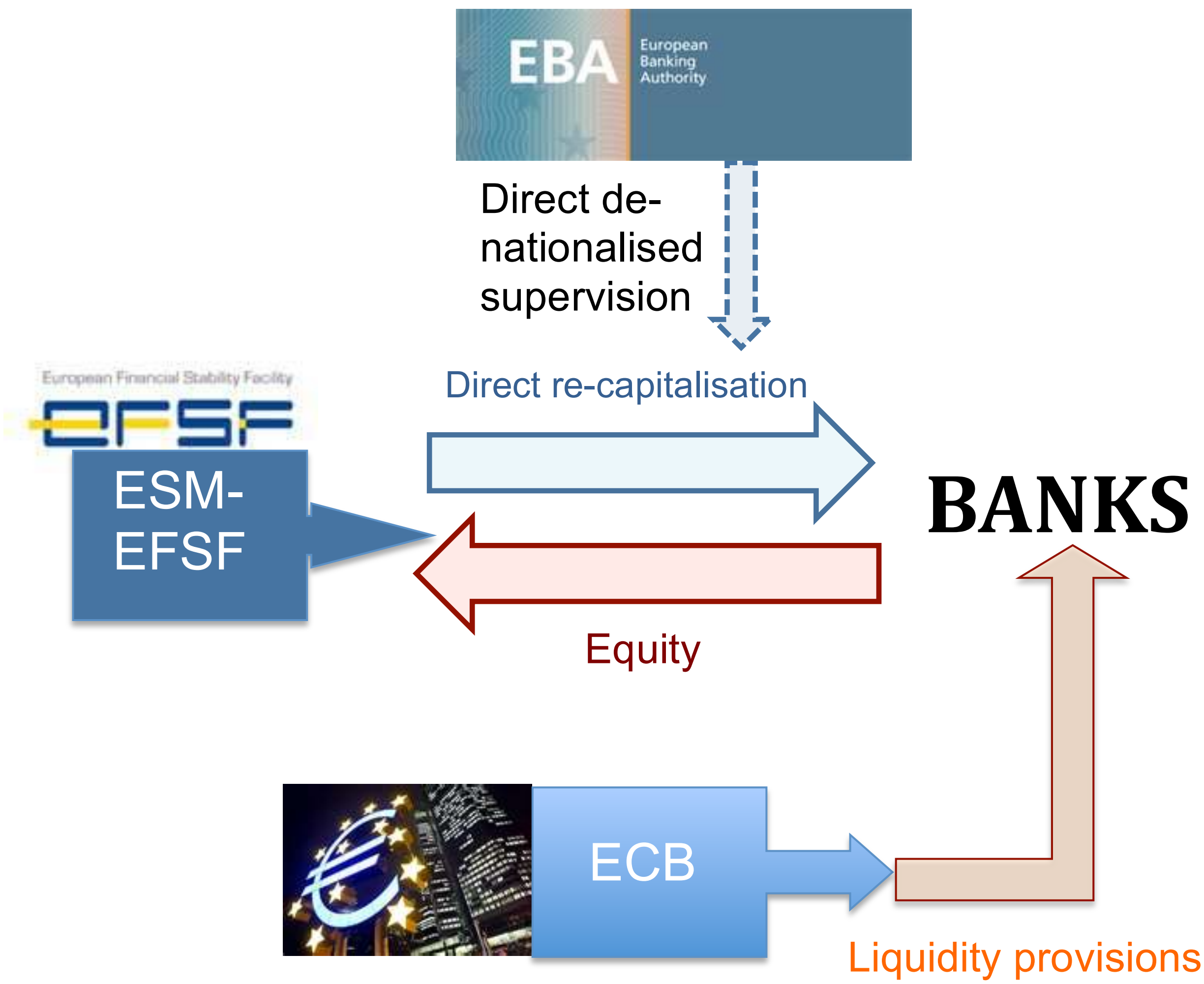
The Eurozone must be turned into a single banking area with a single authority that supervises directly and recapitalises the area's banks. To this purpose, existing national boundaries are to be dismantled, together with national supervisory authorities. The currently confederate EBA is to be re-configured as a unitary agency with a board comprising officials drawn from member-states, plus representatives from the ECB and the EFSF/ESM.

With the EFSF/ESM now relieved of its task to fund the public debt of insolvent member-states, the largest share of its capital is to be used for the purposes of direct bank recapitalisations. These capital injections shall flow directly from the EFSF/ESM, under the supervision of the EBA and the ECB, to the banks but without mediation from the national governments and without these capital injections counting as part of national debt. In exchange, equity in the recapitalised banks is passed on to the EFSF/ESM which is then re-sold to the private sector when the EBA and ECB judge that banks have been sufficiently recapitalised.

In summary (see also the diagram below), banking supervision is Europeanised, the nexus between national (sovereign) debt and banking losses is broken, the 'cosy' (and often problematic) relationship between national politicians and 'national' bankers is interrupted, and in this manner recapitalisation can proceed effectively at the European level.

Participating institutions: EBA, ECB and EFSF-ESM

EFSF/ESM-EBA-ECB mediated Single Banking Area



POLICY 2 – Dealing with the sovereign debt crisis by means of an ECB-EFSM/ESM mediated conversion of member-states' Maastricht Compliant Debt

Each member-state is permitted, by the Maastricht Treaty, to run up sovereign debt up to 60% of GDP. Following the Crisis of 2008, most Eurozone member-states have exceeded this limit. In this sense, sovereign debt per member-state can be divided between a portion that is Maastricht Compliant Debt (MCD) and another portion that exceeds the Maastricht limits. We propose that the ECB offers member-states the opportunity of a Debt Conversion for their MCD the cost of which will be borne fully by the member-states.

MEMBER-STATES' DEBT

Debt in excess of Maastricht Compatible Debt (MCD) - serviced normally by member-states (through the normal issue of government bonds)

Maastricht Compatible Debt (MCD) - subject to ECB-mediated conversion (see below)

The ECB, faithful to the non-monetisation constraint (a) above, does not seek to buy or guarantee sovereign MCD debt through monetisation (direct or indirect). Instead it acts as a go-between, mediating between international and European investors, on the one hand, and member-states on the other. In effect, the ECB orchestrates a *conversion servicing loan* for the MCD and for the purposes of servicing their bonds upon maturity.

The *conversion servicing loan* works as follows: For member-states that wish to participate in this scheme (a scheme that can be enacted through Qualified Majority Voting), and upon maturity of a sovereign bond of the said member-state, the ECB services a portion of the maturing bond that corresponds to the percentage of the member-state's debt which is Maastricht-compliant. E.g. for a member state whose debt to GDP ratio is 90% of GDP, the ratio of its debt that qualifies as MCD is 2/3. Thus, when a bond matures with face value, say, €1 billion, two thirds of this (€666 million) will be paid (redeemed) by the ECB.

To do this, the ECB issues *in its own name* (and without guarantees from any member-state) ECB-bonds. It uses these funds in order to service the MCD part of maturing national bonds (see numerical example above). Simultaneously, the ECB opens *debit accounts* for the member-state whose bond redemption its serviced on the basis of a legal commitment by the latter to service these ECB-bonds upon maturity in full.

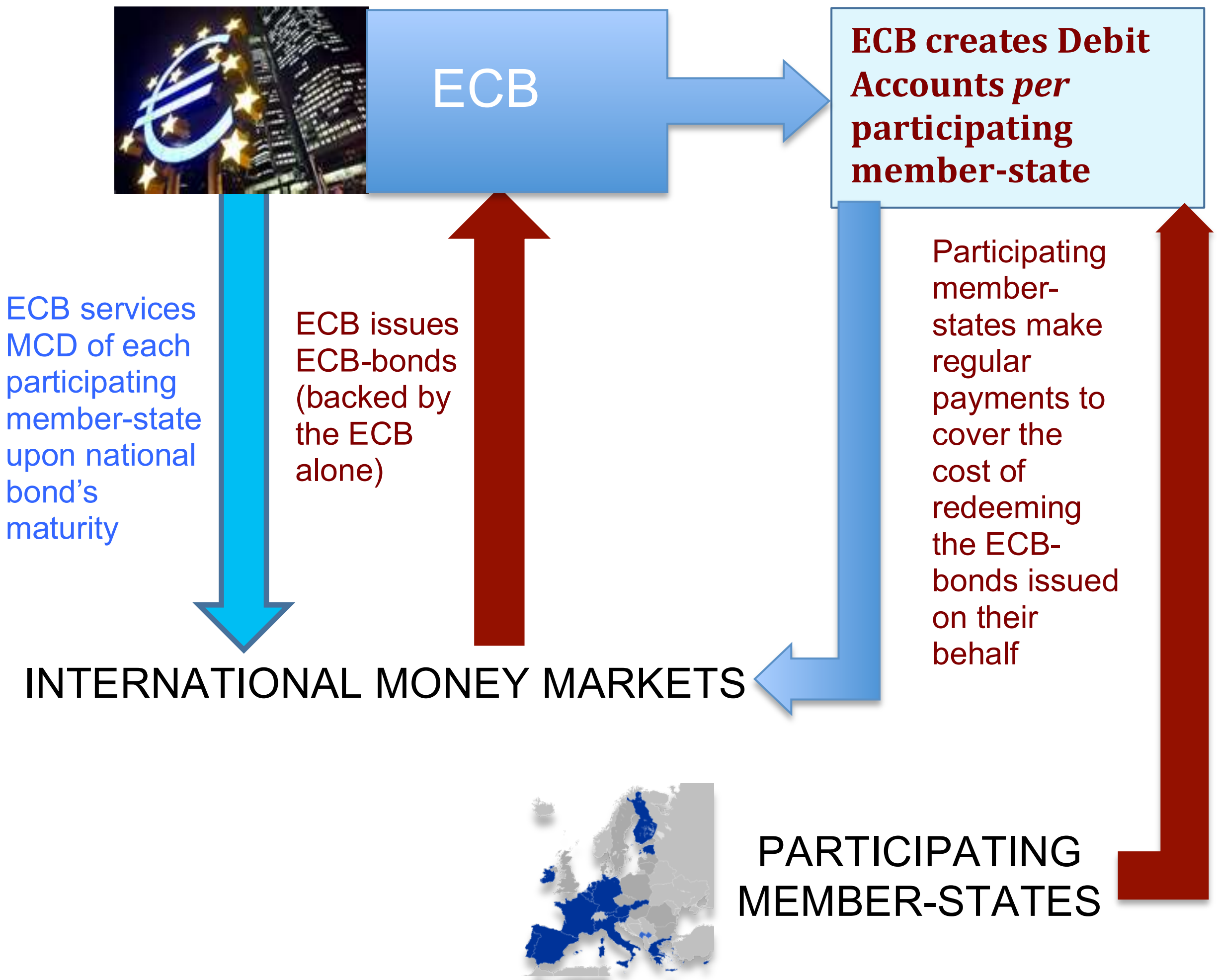
To safeguard the credibility of this conversion, and to provide a backstop (for the ECB-bonds) that requires no ECB monetisation,

(i) member-states agree to afford their ECB debit accounts super-seniority status, *and*
(ii) the ECB's *conversion servicing loan* mechanism is insured by the EFSF/ESM. E.g. if a member-state goes into a disorderly default before an ECB-bond issued on its behalf matures, that ECB-bond payment is covered by insurance purchased or provided by the EFSF/ESM.

Participating institutions: ECB and EFSF/ESM

The following figure sums up Policy 2.

ECB-mediated conversion of participating member-states' Maastricht Compliant Debt (MCD)



ECB-bond Assurance Scheme

1. Participating members agree to their Debit Accounts ***super-seniority status***
2. ESM provides insurance to the ECB in case of insufficient payments by members-states into their ECB Debit Accounts

POLICY 3 – An Investment-led Recovery and Rebalancing Program for the Eurozone as a whole

Debt is only one facet of the Crisis. The other is a mountain of idle savings whose owners lack the confidence or the coordination to channel into productive investments. Thus, the task is not to tax-and-spend but to find ways to energise idle savings both in aggregate and, more importantly, to direct them into the deficit regions that are currently buckling under the unbearable weight of fiscal consolidation thus pushing investment into negative territory (instead of imbuing investors with greater confidence).

To deal with the overall underinvestment crisis, the European Investment Bank (EIB) shall continue funding large scale investment programs while the European Investment Fund (EIF) will fund small and medium sized firms and start-ups, offering venture capital for the purposes of kick-starting growth in high technology, green energy, environmental health, education and urban renewal projects.

Why are the EIB-EIF not doing this now? They do, only the volume of investments is severely circumscribed because of the convention that 50% of project funding be financed by member-states. As member-states are fiscally stressed, the EIB-EIF's growth potential is minimised. Our proposal is that this 50% co-financing, which now acts as a mighty break on growth (courtesy of the indebtedness of member-states), comes from additional, net, ECB-bond issues.

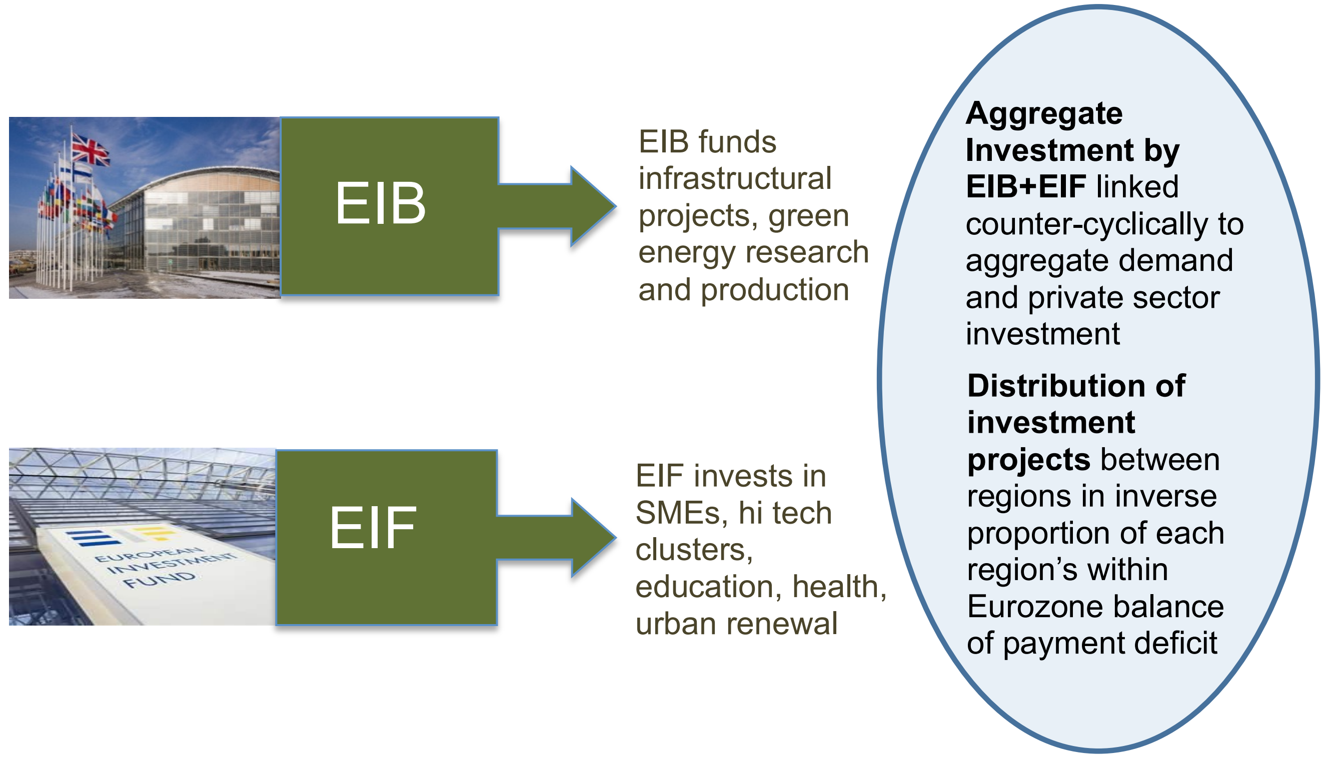
Aggregate investment in the Eurozone thus funded (50% by EIB-bonds and 50% by ECB-bonds) could be calibrated to a level equal to some proportion of total Eurozone GDP while the distribution of funding within the various Eurozone regions (and not just countries) should be designed to counteract the internal imbalances of competitiveness and intra-Eurozone (im)balance of payments.[5]

Summing up (see also the following diagram), the idea here is that investment is Europeanised (just like the banking sector and the Maastricht-compliant debt of member-states). By means of the combination of EIB-EIF bonds (which enjoy a sterling reputation in international money markets) and new ECB-bonds, idle savings can be shifted into productive investments in the European regions where they will help rebalance competitiveness the most, as well as generate the incomes from which the most precarious debts can be repaid. Note too that this policy effectively takes the member-state out of the equation, allowing member-states to concentrate on running a tight ship, providing services and public goods

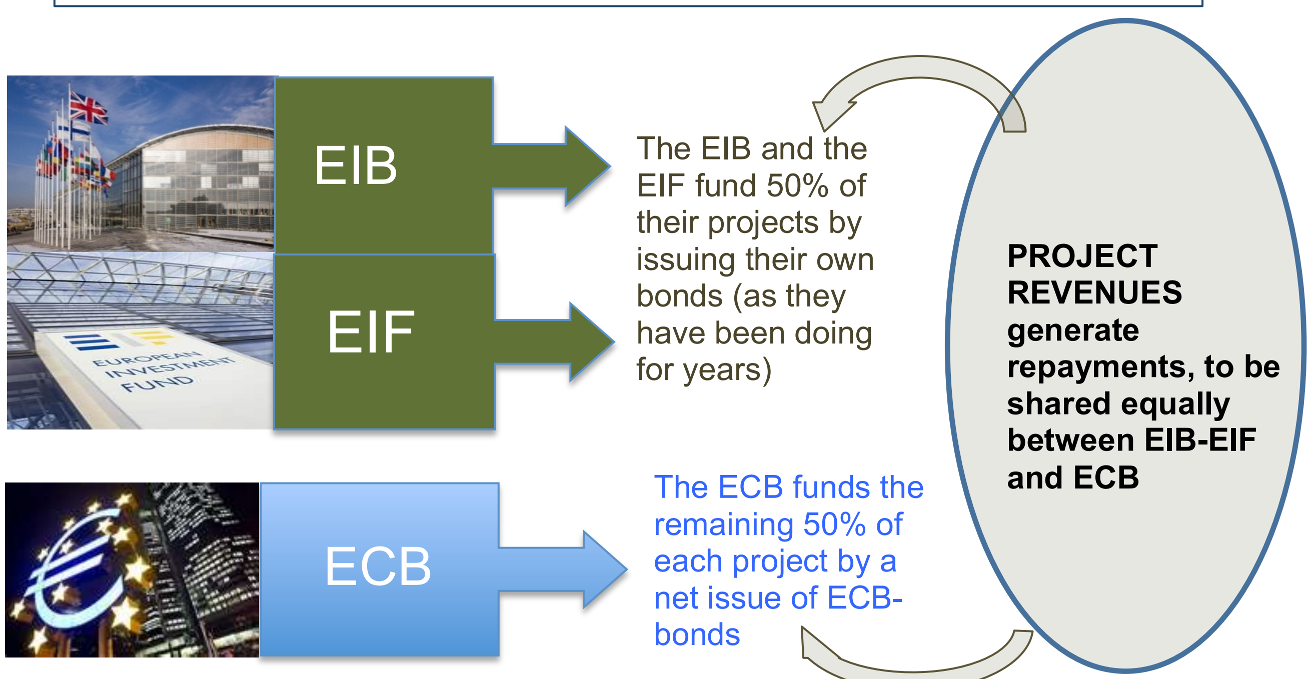
[5] In effect, the EIB-EIF investments will operate in a manner not too dissimilar to Keynes' original idea of a Clearing Union; only in this case it would be an explicit, investment-directed surplus recycling mechanism.

to their electorates with greater effective sovereignty. *Participating institutions: EIB-EIF,* ECB

EIB-EIF-ECB mediated Investment-led Recovery and Rebalancing Program



EIB-EIF-ECB Collaborative Funding Scheme



5. Epilogue: Three policies representing a gestalt shift that can liberate Europe from debilitating false dilemmas

Two years of Crisis have culminated in a clear and present danger that Europe not only experiences another recession and a painful dismantling of the Eurozone but, also, the demise of the European Union, of open borders, of open minds even.

While this process of deconstruction is eating away at the foundations of Europe's potential for shared prosperity, Europeans are imprisoned in three suffocating, quite false, dilemmas.

- We seem to be going around in circles debating the relative merits of austerity versus the charms of tax-and-spend stimulus policies.
- We seem convinced that the issue at hand is how to persuade Germany and the few other remaining surplus countries to bankroll the rest.
- And we fret over the pros and cons of moving toward federation faster than we might have liked as a means of stopping our continent's disintegration.

It is our contention that these are, indeed, false dilemmas that imprison our thinking into a straightjacket which immobilises us and is, largely, responsible for the delays, the false starts, the ill-fated 'solutions'. The Modest Proposal for overcoming Europe's Crisis is based on the observation that:

- the dilemma between austerity and debt-fuelled growth policies is irrelevant
- lax monetary policy on behalf of the ECB, or greater wage/price inflation in Germany and the rest of the surplus nations is unlikely to deal with the Crisis effectively
- Germany and the rest of the surplus nations need not bankroll either a European Recovery and Re-balancing Program nor the management of excessive sovereign debt
- federal moves and Treaty changes are neither desirable nor necessary

On the basis of these observations, the Modest Proposal's three policies are simple, elegant and feasible steps by which to deal decisively with Europe's *banking crisis*, the *debt crisis* and the *investment-imbalances crisis*. In one stroke (Policy 1), by creating a single banking sector, banking losses are separated from stressed sovereign debt and recapitalisation can proceed properly and rationally. In another stroke (Policy 2), the Eurozone's mountain of debt shrinks (through the ECB-EFSF/ESM conversion of Maastricht Compliant member-state Debt). Lastly, with a third stroke, the EIB-EIF become an effective surplus recycling mechanism, of the sort that no currency area can do without.

At the political level, the three policies envisaged by the Modest Proposal constitute a process of *Decentralised Europeanisation*, to be juxtaposed against the kind of hasty, *Authoritarian Federation* that is currently seen, falsely, as the only alternative to the *Authoritarian Disintegration* that is the order of the day. In essence, what we are proposing is that three areas of economic activity are Europeanised: banking supervision, sovereign debt management and planned investment flows. However, our proposed Europeanisation retains a large degree of decentralisation, one that is:

- consistent with maximum sovereignty for member-states combined with the minimal collective rationality required for the effective governance of the common currency area
- commensurate to the principle of balanced budgets at the national level (once banks, debt and investment flows are Europeanised)

While broad in scope and ambition, the Modest Proposal suggests no new institutions and it aims at redesigning the Eurozone with minimal use of new rules, fiscal compacts, pan-European czars, etc. It requires no prior agreement to move in the federal direction while allowing for widespread consent on fiscal rules that are become possible once the crises in banking, debt and investment flows is dealt with. It is in this sense that this proposal is, indeed, modest and rather promising.