A MODEST PROPOSAL FOR OVERCOMING THE EURO CRISIS (*)

by

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1. INTRODUCTION

In seeking to placate credit rating agencies,[1] the governments of the Eurozone are undermining Europe's credibility with electorates, markets and, ironically,... the credit rating agencies themselves! Instead of closing what was already recognised as a democratic deficit, they deepen it and, in the process, reinforce the Eurozone's unfolding predicament. Eager to please the markets, Europe's leaders ignore Treaty commitments to economic and social cohesion and, indeed, undermine them with a series of decisions (or lack thereof) which attach 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. They fall in two categories: Proposals that require greater federalism on the lines of common fiscal policies and fiscal transfers. Such proposals are blocked by a general consensus that federalism is either utopian or undesirable. Then there is the second category of proposals which, on lines similar to our own (notably by Jean-Claude Juncker and Giulio Tremonti), they have been kept off the official agenda. Meanwhile, the mixture of policies adopted, by which to face down the crisis, comprises new expensive loans (to already insolvent member-states), more austerity (which guarantees a reduction in their national income) and, possibly, the prospect of some debt-buy outs.

In the present perplexing situation, one thing is crystal clear: That the combination of policies adopted, based on the triptych loans, austerity and debt-buy-outs, is failing both economically and politically. On 14th March, and then again on 25th March 2011, the EU's leadership failed to agree on how to increase the EFSF bailout fund, deferring their decisions (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 is today is:

i. A commitment to stabilise the current debt crisis by transferring a share of national debt to Europe which (at less than one per cent of GDP) has next to none (and until May last year had none at all).
ii. 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

[1] The very agencies whose triple-A ratings of the bank-generated toxic debt drove the financial sector into insolvency.

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 'centre' with which to co-finance recovery and turn the Eurozone's current weakness into a major strength.

iii. To utilise 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 to which the Union has been committed since 2008 but which is currently blocked by deflationary policies that risk a double dip recession not only in Europe but also for the US.

iv. 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 which leaves neither states nor markets in charge).

v. To thereby contribute to a more balanced recovery of the global economy (which is one of the main stated aspirations of the G20) and do so by recycling global surpluses into productive, socially useful and environmentally sustainable investments.

A key to this is not fiscal transfers but a ***tranche transfer***: transferring a share of national debt and borrowing to Eurobonds held and issued by the European Central Bank (ECB). One of us,[2] recommended a new institution to issue such Eurobonds in a report to Jacques Delors in 1993. 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 stabilisation 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, ESM, intended for 2013), nor a temporary institution such as the European Financial Stability Fund (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% of GDP (as **Policy 1** 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 are 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 hazard the Stability and Growth Pact (SGP).

[2] Stuart Holland.

At present the SGP lacks credibility not only because France and Germany weakened it in 2005 but because the macroeconomics of debt reduction do not add up. When rating agencies are serially downgrading member states' sovereign debt, and causing them to refinance at rate of from 7 to 10 per cent, this 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 (except Greece, which is the outlier here) would be **within national SGP limits** (60% of GDP). For countries like Greece, it would be over this but with a manageable excess next year of 27% rather than 87%. **Policies 1&2** of the Modest Proposal 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 up from Roosevelt's New Deal, whose success gave Truman the confidence to fund the Marshall Plan from 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 nor raising taxes but borrowing to invest through US Treasury bonds. These do not count on the debt of US states such as California or Delaware. In parallel, there is no need for the Eurobonds (which can match those issued on its own account by the European Investment Bank (EIB) - see **Policy 3** - to count on the debt of EU member states.

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 fifty 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 plural and more secure global reserve currency system.

Both the US and the trade surplus economies (China above all) would gain if this is part of a European Recovery Programme, whereas contraction of the European economy (as an outcome of debt stabilisation without such a programme) would reduce their exports risking also a double-dip global recession.

Our proposal therefore is radical but modest since it **does not need new institutions.** Several commentators have claimed that monetary union without a common fiscal policy is doomed to failure. But EU bond finance for a European New Deal would not need the equivalent of a US Treasury, nor common fiscal policies, nor finance 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 place already. Within existing Treaty provisions, since Maastricht, the heads of state and government in the European Council can decide 'broad economic guidelines' for 'general economic policies' which the ECB has been obliged not only ‘to note’ or ‘to respect’ but ‘to support’. This wording was in fact lifted direct from the constitution of the 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: ‘[w]ithout 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, are currently undergoing inflationary pressures. But these are not due to excess demand. They are caused by rising commodity and food prices with high growth in the emerging economies, by some structural factors and, last but not least, by speculation. The speculation, in particular, should be addressed, as Nicolas Sarkozy has acknowledged. Arguably more food should be available for consumption rather than for conversion into bio-fuels. But neither of these will be redressed by more European austerity, while with a European Recovery Programme more firms could assure themselves of sustained cash flows from revenues (rather than from raising prices to compensate for the lower cash flow in recession).

To pre-empt 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, and recommended to him by one of us,[3] the EIB gained a 'cohesion and convergence remit' from the European Council to invest in health, education, urban regeneration, environmental technology and small and medium firms.

Since then the EIB has quadrupled its annual lending to over €80bn, 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 Recovery Programme therefore already has **macroeconomic potential**. This is especially the case when *investment multipliers* are taken into account. As illustrated later, these multipliers can be as high as 3 (i.e. for every euro invested, €3 of additional GDP is generated). Thus an addition to EU investment of one per cent of GDP by the EIB registers up to treble this 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 need there be a question of where the demand can come from. The very nature of the current crisis is the co-existence of insufficient effective demand (yielding low growth) with massive latent demand for investments in precisely the social and environmental areas which have been remitted to the EIB since 1997.

[3] Stuart Holland.

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 European Union (EU) - International Monetary Fund operation to 'rescue' Greece and the European Financial Stability Facility or EFSF intended to support the rest of the fiscally challenged Eurozone members (e.g. Ireland, Portugal, Spain). More recently, European leaders announced their provisional agreement to create a permanent mechanism to replace the EFSF (called the European Stability Mechanism, or ESM) as well as a series of measures aiming to stabilise the crisis. Yet the crisis intensified.

The reason is that the crisis is systemic and multiple including:

- a *sovereign debt crisis*, a *banking sector crisis* and an *under-investment crisis.*
- The reason the EU's current policies are failing financially, economically and politically is that they seek to address one of its 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 counter-productive: 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 confronted by:

- huge, expensive loans to, effectively, insolvent states;
- new institutions which lack credibility on financial markets, not least since governments as yet have not been able to agree their criteria (e.g. the EFSF);
- the negative effects of raising the funds to be loaned by *utilising toxic financial instruments* which contain a vicious default dynamic (that 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 other two crises: the banking sector and under-investment crises.

Europe's private sector banks are over-laden with worthless paper assets (both private and public). They are black holes into which the ECB is pumping oceans of liquidity that only occasion a trickle of extra loans to business since the banks are using the money to recapitalise without writing down debt that still is 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.

The mechanism designed to raise funds for Ireland, Greece and now Portugal neither assures them of avoiding default, nor the risk of the same for other member states such as Portugal. 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 (a) the banking sector crisis or (b) the under-investment crisis, and (c) 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 under-investment crises must be tackled together. National debt stabilisation needs to be matched by a restructuring of the banks. Recession of national economies needs to be offset by realising 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.

Principle 2: Shareholders rather than depositors in the banks which 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 bail outs 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 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 Union to be held by the ECB as Eurobonds.

Principle 4: Such a 'tranche transfer' to ECB Eurobonds should not count on the national debt or member states nor need be guaranteed by them anymore than are EIB bonds. A key parallel, as in the recommendation by one of us of Union Bonds to Jacques Delors, which he included in his White Paper of December 1993, is that US Treasury bonds do not count against the debt of the states of the American Union such as New York State or Vermont, nor are guaranteed by them. Therefore EU Eurobonds need not and should not count on the debt of EU member states, nor be guaranteed by them.

3. THE PROPOSAL'S THREE MAIN POLICIES

Policy 1 - Stabilising the sovereign debt crisis
Institution: The ECB (European Central Bank)

1.1 Tranche transfer to the ECB

The ECB takes on its books a tranche of the sovereign debt of *all* member states equal in face value to up to 60% of GDP.

1.2 ECB bonds

The transferred tranche is held as ECB bonds (€-bonds 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 which it services long term at the lower interest rates attainable by the ECB as the central bank of the Union. 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 any of the remaining member-states.

1.4 National debt reduction

The transfer of debt of up to 60% of GDP to the ECB means that most European member states then 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% of GDP in 2012 rather than 87% such 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 such a member state as Greece, whose remaining national debt exceeds 60% of GDP, the transfer should be conditional on an agreed schedule for its reduction.

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

2.1 Rigorous Stress Tests

Rigorous stress tests to be 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. The degree of re-capitalisation necessary for each Eurozone bank should be computed on the basis of these tests.

2.1 Banks seeking long term liquidity from the ECB

Funded by net issues of Eurobonds subscribed by the central banks of surplus economies and sovereign wealth funds, the ECB can make medium term large liquidity provisions to the private banks conditional on haircuts on the existing sovereign bonds in their portfolio.

2.3 Recapitalisation

Re-capitalisation of banks should be short-term, once off and undertaken by the EFSF rather than a future ESM. It also should be in exchange for equity. If a bank cannot raise the necessary capital to meet the re-capitalisation target computed above, then the EFSF (and later the ESM) should require a swap of capital for public equity in the bank. The finance for this could be from bonds issued by the EFSF/ESM rather than 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 liquidity that comes their way in the future into loans to enterprises and households. The problem, currently, is that if banks are submitted to rigorous stress tests, several may be found to be bankrupt. Thus, Europe needs simultaneously to lean on them to come clean but also to help them do so without insolvency.

Policy 3 European Recovery Programme

Institutions: The EIB (European Investment Bank), the ECB (European Central Bank) and national governments

3.1 Co-financing 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 environment, green technology and new high tech start ups.

But while it has done so with success, quadrupling its own borrowing and investments since then, its investments in many cases (as with the TENS) have been constrained by the national debt and deficit limits of the SGP.

There is a strong case for maintaining that national co-finance for EIB investments should not count on national debt and that this should be allowed within the 2005 revised terms of the Stability and Growth Pact (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 which could co-finance 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 which, in several member states, still are being postponed because national co-finance counts within the current interpretations of the SGP.

These in themselves could constitute €1 trillion of 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 which 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

The original design by one of us[4] 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 Essen 1994 European Council to establish it, was that it should offer public venture capital for small and medium firms rather than only equity guarantees. The Council declined this at the time, but Ecofin, which constitutes the governing body of the EIB/EIF Group, could remit it to do so.

A similar constraint on EIF finance for small and medium firms and new high-tech start ups was that it initially would not consider an application for equity guarantees of less than 15 mecu and then declined direct applications for such guarantees rather than offering them through private sector banks or other financial intermediaries.

This was compromised both by the concern of private banks to gain loan finance as counterpart packaging of such equity guarantees and denied the original design for the EIF which was to enable SMEs to avoid the need for interest repayments during the initial years of a new high tech start-up in which revenue was either nil or negligible.

Ecofin, therefore, should determine that the EIF, co-financed by both EIB and ECB bonds 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 from the concern of banks to recapitalise, can readily have access.

[4] Stuart Holland.

Summary: Policies 1&2 will reduce but not eliminate the Eurozone's sovereign debt and private 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 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 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 EIF (European Investment Fund) – as recommended above – should offer equity capital to new high tech start ups rather than only 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 stabilises 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 recapitalising 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 maximise welfare for all economies. This hypothesis relies (as Ricarco demonstrated himself) on the assumption of perfect capital immobility. But in our world nothing is as mobile as capital! Think of the the combination of foreign direct investment and technology transfers from West to East, and especially the combination in China of transferred capital and technologies with a literate but low cost labour force (not to mention world class communications and infrastructure). Such developments have realised the conditions for Adam Smith's absolute advantage in a manner that cannot readily be offset only 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 co-finance economic recovery can ensure that Europe sustains global trade while this does not put it as a Union at risk in view of the fact that, unlike the US, it is broadly in balance with the rest of the world. But this also is relevant to a reversal of the beggar-my-neighbour 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 confidence crisis not only in the EU's economic governance, but also on markets. Then the risk of a double dip recession may well exceed that of 2008, spill over to the US and restrain the growth and development of emerging economies such as China, L. America, India etc.

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 US 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 which follows relates these themes to analytic issues missing from the current debate. In a sense, the current section 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 in 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 it only would be so **at full employment,** which we do not have. So far, every cut in public expenditure in Greece, Ireland, Portugal or Spain has reduced investment and employment. In short, the EU is adopting policies of cuts on a theoretical assumption that is false.

5.2 The Neglect of Negative and Positive Multipliers

For Milton Friedman to claim that public investment and spending 'crowds out' the private sector, he had to ignore Keynes' claim for multipliers. Multipliers from public expenditures and investment generate jobs (employment multipliers), incomes (income multipliers); tax from people 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 one for Germany to nearly two for France, with a UK investment multiplier of over three (see table below). This means that negative multipliers from cutting spending and investment would mean a contraction of European economies several multiples more than the cuts themselves.

Multipliers from Public Expenditures and Investments

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

Source: (2009). Observatoire Français des Conjonctures Économiques.

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 the 1930s New Deal in the United States of America. 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, utilising innovative instruments in order to channel new borrowing toward the mobilisation of investment (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 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 in order to repay the quasi-bankrupt banks; banks whose books are so problematic that they hoard whatever funding they receive, thus behaving like black holes which absorb, and waste, 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 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' predecessor (Herbert Hoover) would have fathomed. And yet, this is precisely what we are witnessing in the Eurozone as a type of sinister medicine which, 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 con-federal rather than supra-national. 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* squares the policy circle neatly and requires nothing more than minimal tampering with existing Treaties. **Policy 2** deals with the banking crisis by utilising one of the existing new institutions (the EFSF). **Policy 3** presses the European Investment Bank into service, turning it into the engine of growth and recovery that Europe is missing sorely.

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% 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 Stability and Growth Pact 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 re-unification. To take them in order:

i. The European Economic Recovery Programme clearly is a ‘European policy goal’ which 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-neighbour deflation in a third of the global economy (i.e. in the EU), if not offset by a counter-recessionary recovery programme, will do nothing not "foster international solidarity".

A tranche transfer 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 are, therefore, compatible with the revised SGP. Furthermore, the net Eurobond issues by the ECB ought to be understood in the context of fulfilling 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 negative. 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 members states from the ‘centre’.
ii. Cross-financing between member states – the no ‘bail out’ clause which 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 of which 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 should 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 of the law' 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 programme and the EFSF are.

Similarly, net bond issues by the ECB to co-finance 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 which would need to be underwritten by taxpayers' money in the event of a default (at least not anymore 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 programme.

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 which has broken out only after parallel proposals were made in December last year by Jean-Claude Juncker, Chair of the Eurogroup (and Prime Minister of Luxembourg), and Italian Finance Minister Giulio Tremonti.

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 Treasury, allowing a central debt agency (possibly under the aegis of the ECB and the 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 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 are centrally approved* (on both banking and convergence and cohesion criteria determined by the European Council for the European Investment Bank), there is no need for central control of all borrowing. Member-state borrowing over and above the Maastricht limit will carry its own, market determined, risk premium. Investors then take that risk and that's the end of the story.

5.8 Is Policy 1 inflationary?

A response to **Policy 1** is that the *tranche tran*sfer 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 rises have failed to breach the 2% 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 both 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, additionally, it will be self-financing (as the member states, on whose behalf the Eurobonds will be issued, will service the Eurobonds long-term).

Secondly, the issue of large quantities of long term Eurobonds will create a highly liquid market for euro denominated paper of the highest calibre, the result being that the euro will attract increasing attention from sovereign wealth funds even to the extent of giving Europe's common currency an edge in the struggle to acquire the kudos of an alternative reserve currency. In short, **Policy 1** would have precisely the opposite effect, boosting the attractiveness of the euro and Eurobonds to the world's money markets. Inversely, a major and sustained European Economic recovery Programme should ensure that upwards pressure on the euro is restrained.