The Euro Crisis as a Twin Recycling Problem: A New Rationale for the "Modest Proposal"

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1. Introduction: The Twin Recycling Problems in Brief

Europe's crisis is caused by its institutional failure to confront two recycling problems: a *debt recycling problem* and a *surplus recycling problem*.

- The *debt recycling problem* emerged after the Crash of 2008. Banking losses, following the implosion of the market in securitized derivatives, led to increased government deficits, which in turn (aided and abetted by the panicky credit rating agencies' downgrades) caused (i) doubts on the capacity of some peripheral countries to fund their debt, and (ii) uncertainty on the capacity of banks exposed to the stressed governments' debt (on top of preexisting holdings of toxic debt) to survive under the strain of a hypothesized sovereign default. The rest, as they say, is the sad history of the euro crisis.

- The *surplus recycling problem* has been a permanent feature of the eurozone from its very inception. Its nature is simple: in every currency union there will always co-exist regions (or member-states) that are permanently in surplus with the rest and others that will be in deficit. Given that the deficit regions cannot devalue to keep their deficits in check, there must be some mechanism by which the surpluses are recycled from the surplus regions into the deficit ones, not as fiscal transfers but as productive investments that lessen the divergence and promote cohesion. The eurozone has always lacked such a surplus recycling mechanism.[1]

These two problems are not being addressed by the European Union, the result being a euro crisis that is spiraling out of control. The *debt recycling problem* is causing a vicious cycle of the government debt crisis and the banking losses crisis. Meanwhile, at a time when growth is more needed than ever, the *debt recycling problem* is highlighting, and boosting, the *surplus recycling problem*. The trick is how to deal with both problems at once. It is a trick that the **Modest Proposal for Resolving the Euro Crisis** is well suited to perform.

2. The Debt Recycling Problem

Europe's banks are replete with bad (or, at least, "not-so-good") debts. Some of these are private (paper assets that still bear toxic prices[2]); others are public (e.g. Greek, Irish, and Portuguese government bonds). On the other hand, the eurozone has excess savings that are on the lookout for good, steady returns. This is a typical case of a mismatch. Therefore, the eurozone's overall government debt is highly manageable. But it is unevenly distributed. Indeed, most of it is weighing down the eurozone's weakest shoulders. These two cases of mismatch, taken together, constitute the eurozone's overall *debt recycling problem*. A rational response to this problem would be to find ways to re-balance the existing debt-loss combination in a manner that (a) shrinks the sum of debts and bank losses without (b) giving rise to so-called moral hazard problems (that is, without creating incentives to those responsible for the debts and the losses to create some new debts and losses in the hope of another "cavalry" coming to the rescue). The **Modest Proposal** provides exactly this combination of (a) and (b) by means of its Policies 1 and 2.

The reader can peruse the **Modest Proposal** to see how exactly the proposed mechanism would work. Here, we just want to focus on the essence of what is proposed:

- For the troubled governments: A **conversion loan** for the part of their debts that do not exceed the EU's limits (see Policy 1 of the **Modest Proposal**).

- For the troubled banks: **Fresh capital** raised from European taxpayers (through the European Financial Stability Fund) in return for shares, the future sale of which will repay the taxpayers with interest (see Policy 2 of the **Modest Proposal**).

Let's take these two suggestions one at a time, beginning with the second point. The idea is crystal clear and it is summed up in the **Modest Proposal**'s Policy 2: banks must be cleansed and re-capitalized. Since the existing stockholders will resist any such process tooth and nail (so as to retain their hold over "their" banks), they must be expropriated by the EU. For it would make a nonsense of all the talk of moral hazard should those owners (who allowed their banks to become utterly dependent on the kindness of the European Central Bank for their survival) be allowed to continue to pose as owners, courtesy of an endless stream of public monies. The sole solution that simple capitalist principles dictate is for the European Union to force the banks that fail proper solvency tests to receive EFSF capital in exchange for equity that the EFSF holds until the day when its sale will pay back the European taxpayers (with interest). End of story.

Let us now turn to the idea of what effectively amounts to a **conversion loan** to indebted states -- one that is financed by eurobonds issued by the ECB (see Policy 1 of the **Modest Proposal**). Under the current arrangement (the massive Greek loan, the EFSF loan for Ireland, the one that is now being prepared for Portugal, etc.), the weakest states are indebted to the strongest lenders. But -- and this is crucial -- in the process, this arrangement, systemically, makes collateral victims of the marginal member-states which are dragged into effective insolvency, following the domino chain from weaker to stronger. Ultimately, there is no breaking mechanism that will stop this chain reaction from culling even the strongest.

Our Policy 1 is the equivalent of a *conversion loan* that efficiently effects transition from overhang and overleveraging to fiscal and financial viability. It charts the conversion's institutional implementation thus: The European

Central Bank, upon request, accepts a transfer of Maastricht compliant tranche (up to 60% of debt to GDP) euro-sovereign debt from euro-member countries' liabilities to its own liabilities, and services this debt to maturity when it returns the capital obligation to the respective member states for repayment. The ECB may finance this operation by issuing its own time-profile family of bonds. It thus conducts monetary policy according to its mandate and in pursuit of its own target.

At this point of our narrative, a poignant objection will be heard: "Your proposal asks of the ECB to perform not monetary policy, which is its remit, but fiscal policy! This is not allowed! It is beyond the pale!" But is it beyond the pale? Is it true that Policy 1 falls under the heading of "fiscal policy" and thus outside the realm that is the ECB's natural habitat? We most certainly do not think so. Let us explain:

Collective debt management in our European currency union is a kind of interface, as much monetary as fiscal policy. It is fiscal policy when debt is newly *issued*. However, once it is issued, the manner in which it is *serviced* can be another matter. To be blunt, *debt management* is part and parcel of *monetary*, not fiscal, policy. According to Policy 1, the ECB will not be issuing member-country sovereign debt. It will be issuing its own supra-sovereign eurozone debt, as and when it deems right in pursuit of its own monetary policy objective, the monetary counter-inflation targeting rule.[3]

To further underline the nature of this defining *differentia specifica*, the ECB does not (strictly speaking) *need* to issue its own new debt in order to service seasoned debt. It could just as well do this by creating new money (as the Fed has been doing). What Policy 1 is proposing is that, instead of quantitative easing US-style, the ECB borrows from the market for monetary policy purposes, recoup these monies long-term from the eurozone's member-states and *make money in the process* (therefore strengthening its own balance sheet). How much clearer can this be? And why is this inconsistent with the ECB's remit?

3. The Surplus Recycling Problem

The surplus recycling problem is fundamentally different from the budget recycling problem. One difference is that, as mentioned in the introduction, it is a problem that was built into the very architecture of the eurozone: a currency union lacking a surplus recycling mechanism.[4] Nonetheless, the Crisis not only brought up the *debt recycling problem* but it also highlighted the great importance of solving the pre-existing *surplus recycling problem*. Thankfully, the solution to the former opens up a broad window into a remedy for the latter.

The crux of the *surplus recycling problem* is a foundational asymmetry within a currency union: especially after a crisis hits, countries on the deficit side of payments suffer deflation while countries on the surplus side do not suffer inflation. The problem is thus cumulative as the debt crisis forces deficit countries to adopt austerity measures of increasing savagery which, unsurprisingly, exacerbate further the *surplus recycling problem* -- the result being an increasing debt-to-GDP ratio (courtesy of the worsening *debt recycling problem*) and decreasing growth (courtesy of the accelerating *surplus recycling problem*).

The reader, at this point, would be excused to think that a solution to the eurozone's *surplus recycling problem* may be a bridge too far. That to sort out a long standing original sin of a problem when the eurozone is struggling with its *debt recycling problem* is simply to ask too much. Not so. The institution that could solve the *surplus recycling problem* at a time when growth is most needed not only exists but it is twice the size of the World Bank: the European Investment Bank (EIB).

But if it exists, we hear the reader ask, why has it not been solving the eurozone's *surplus recycling problem* all along? For a very simple reason: because, as things currently stand, every investment project financed and supervised by the EIB requires 50% of its cost to come from the member-state that benefits from it. And since the member-states that need investment most are those that have the least cash to invest, the EIB is itself constrained from investing into potentially lucrative projects in the European periphery. Hence our Policy 3, which makes a simple, uncontroversial suggestion: that the 50% of project funding, which so far must be sourced by means of national borrowing by the member-state, should be funded by the ECB's net eurobond issues, and not count as part of the member-state's national debt. This way, the combined forces of the ECB and the EIB act as a major boost to the recycling mechanism that the eurozone is so sorely missing. Indeed, the EIB (with ECB backing) metamorphoses into the surplus recycling mechanism, the engine of growth, that the eurozone craves.

4. A Note on Debt Restructuring

In recent weeks, the debate we should have had long ago finally began: After a year or so of being in denial, Europe's powers that be began to mention the forbidden terms "debt restructuring," "haircut," etc. Greece provided the opening for this discussion but, we are convinced, the issue extends well beyond the Hellenic borders. **Elsewhere** we have explained why the debt restructure is as inevitable (given the present course that the eurozone is following) as it is threatening. Now, a most appealing facet of the **Modest Proposal** is that it renders the whole debt restructuring question almost irrelevant. In effect, it throws this destructive debate into history's dustbin.

Why? Because, if the **Modest Proposal** is adopted, all sovereign debt is honored, full stop. In addition, the banks will cease to function as a flock of albatrosses around the ECB's neck. One ought to remember that finance is not like a nuclear power station, whose meltdown necessarily entails costly solutions that burden really existing and suffering taxpayers. It is a *convention* and like all conventions is governed by *authority* -- the other name of confidence. So long as Europe has authority, which in practical terms means so long as the ECB has authority, the euro problem has a financial solution in the form of Policies 1 and 2 as per the **Modest Proposal**. An appropriately designed equivalent to a *conversion loan* (financed by an issue of ECB-backed eurobonds) and a bank recapitalization by the EFSF will kill off the threatening sovereign debt overhang which is, simultaneously, a solvency (not just illiquidity) problem of the private financial sector. Thus, the whole mountain of Europe's government debts and banking losses will be effectively restructured without a single nosebleed.

5. Conclusion

The point of our piece was to demonstrate that the **Modest Proposal** for Overcoming the Euro Crisis is: (a) *modest* (in that it is explicitly designed to not require any EU Treaty changes whatsoever, in particular the no-fiscal-transfer and no-bailout provisions), and (b) *practical* (in that it simultaneously tackles the three related levels of the euro crisis: the banking system, sovereign debt, and competitiveness-through-investment).

We argue that the proposed remedy for the debt crisis of the European periphery involves no fiscal transfer whatsoever. It offers strictly a financial solution to the strictly financial *debt recycling problem* -- without fiscal cost for any taxpayer. In effect, the proposed intervention *decouples* the decentralized *fiscal* process of issuing new debt from the *financial* necessity to issue new debt in order to service existing debt -- and thus leaves the second to be dealt with by exclusively *financial* means (without excusing the debt obligation of the original issuer). The debt overhang is thus *decoupled* from the moral burden of the original debt -- moral hazard is made explicit and serves to constrain all debt beyond the Maastricht compliant transferable tranche. Therefore, the mechanism is also *efficient* at the eurozone level in that it strengthens the armory of eurozone centralized monetary policy while usefully relieving the profoundly structural burden on eurozone member-states, thus providing the needed remedy to the euro's faulty design: its fundamental architecture which deprives members of a monetary instrument without a countervailing substitute.

By dealing with the sovereign debt issue without any new loans to insolvent states, the **Modest Proposal** frees the European Financial Stability Fund from the awful task of lending to insolvent states (at usurious interest rates) and thus allows it to play a new, thoroughly decent role: that of recapitalizing the eurozone's failing banking sector. And in the same breath, it creates a new instrument (the ECB-backed eurobond) which breathes new life into the European Investment Bank and allows it to be transformed into Europe's surplus recycling mechanism.

But then again, if the solution is so simple, why is Europe resisting it? Why are "moral hazard" and the "sanctity of debt" used as hefty sticks by which to beat proposals like this back into their pen and off the discussion table?

The true answer is one that involves political considerations,[5] simple incompetence, a misguided identification of the surplus countries' ruling class's perceived self interest with 'fiscal discipline', pure and simple concerns about the effect of a crisis resolution on the elites' capacity to keep their working class' aspirations bottled up, tension between financial and industrial capital, and a great deal of the misanthropic (and xenophobic) discord that all large scale crises occasion. But above all components of the answer, one sticks out: Germany's determination to retain its option to exit the eurozone and to keep the truth about its banking sector under wraps (see **this**). A determination which, in truth, is quite at odds with the **Modest Proposal**.

Endnotes

1 See G. E. Krimpas, **"The Recycling Problem in a Currency Union"** (Levy Economics Institute Working Paper No. 595, May 2010) for a full explanation of this argument.

2 Unlike in the USA, Europe's banks have not been made to account for the true market value of their private paper. The private collateralized assets that remain on their books retain their pre-2008 toxic prices. We choose not to call them toxic assets because their true problem is the toxicity of their *prices*: if their *actual -- i.e. market -- prices* are used, the banks' assets will be shown to be so low as to threaten the said banks with insolvency.

3 The ECB holds, by its very constitution, the joint-and-several guarantee of the joint-and-several entity which is enshrined in the founding treaties of the EU and EMU.

4 See Krimpas, **"The Recycling Problem in a Currency Union,"** for an analysis of why such a mechanism is indispensible.

5 Some of those political considerations are explored in Yanis Varoufakis, **"Why Is Europe Dithering? Our Politicians Caught in a Classic Buridan Conundrum"** (January 19, 2011). An unknown commentator on a professional and professionally published comment, dated March 23rd, 2011, wrote: " . . . [P]ublic debt is not the issue: it was not the issue in 1947 in Britain, when public debt was 240% of GDP [due to war debts to the US], and Britain created the National Health Service, improved social security provisions, public education, restructured the economy from war goods to consumer goods, sent women home from factories and found jobs for ex-soldiers, built houses for returning servicemen, etc. etc. . . . If Britain could do all that, why is Greece's public debt of a puny 140% of GDP all of a sudden such a big problem -- when all they need to do is tax the rich." Persons uneasy with the apparent facility of the above may wish to recall the value in retrospect of several recorded Plans -- such as the Versailles reparations plan, the Dawes plan, the Schacht plan, the Funk plan, the Morgenthau plan, the Keynes plan, the White plan, the Marshall plan, or indeed the Lend-Lease stratagem -- and think which of these plans and stratagems may offer some guidance for hope or fear for what is ahead.