GKr – On the Modest Proposal – 15.04.2011

THE THREE HEADS OF THE HYDRA

[An Addendum to Varoufakis-Holland – http://yanisvaroufakis.eu/]

[With an Appendix on Bini Smaghi's PROVOCATIVE proposal]

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The Modest Proposal is

a/ MODEST, in that it is explicitly designed so as not to require any treaty changes whatever, including the treaties governing the EU and EMU and in particular the no-fiscal-transfer and no-bail-out provisions, and

b/ EFFICIENT, in that it simultaneously tackles the three related levels of the euro-crisis: the financial system, sovereign debt and competitiveness.

[N.B. Looked at in appropriate time/space perspective, the EURO-CRISIS is, in fact, itself 'modest' – it is an order of magnitude smaller than the GLOBAL CRISIS [a multi-polar quasi-system looking for its rules] or to the DOLLAR CRISIS [upholding the threatened globally necessary reserve status of the dollar until hierarchical multilateralism relieves the inherent pressure] – compared to these the Euro-Crisis is PROVINCIAL. Unfortunately, it has also been dealt with in a provincial manner.]

THE CRUX OF THE PROPOSAL IS:

a/ to fix the sovereign debt overhang simultaneously with the banking crisis and,

b/ to underpin the potential turn-around of the European economy from deflation to expansion.

We call these, respectively,

THE DEBT RECYCLING PROBLEM [DRP] – **a financial problem needing a financial solution** and,

THE SURPLUS RECYCLING PROBLEM – **a real problem needing a real solution** [SRP].

a/ Debt Recycling Problem [DRP]:

Sovereign debt overhang is not, in the nature of the case, evenly distributed and nor are those threatened by its emergence. The weakest states are indebted to the strongest lenders. But there is scope for collateral victims, systemically following the domino chain from weaker to stronger up to and including the strongest. The proposal is based not on moral, perhaps moralistic rhetoric, nor on what might have been a solution, say between the Lehman moment of 2008 and the sigh of relief a mere six months later – the banks' rescue was a triumph of political action which was in a sense too good, the soporific effect overwhelmed the magnitude of the immediate fright, but we have now moved on, no punishment for the errant is now likely therefore solving the technical financial problem is the only effective political priority: what is in substance needed is the equivalent of a CONVERSION LOAN - from overhang and overleveraging to fiscal and financial viability. The Proposal charts the CONVERSION'S institutional implementation, thus:

The European Central Bank, upon request, accepts a **transfer** of the Maastricht compliant ***tranche*** [up to 60% of debt to GDP] euro-sovereign debt from euro-member countries to its own liabilities, and services this debt up to maturity, at which point it returns the capital obligation to the respective member states for full repayment at face value. The ECB may finance this operation by issuing its own time-profile family of ECB/EMU-BONDS, as well as, on its own decision, by new money. It thus conducts monetary policy according to its mandate and in pursuit of its own monetary target.

<u>Objection</u>: This is not monetary but fiscal policy, not allowed. <u>Answer</u>: not so. Debt management is the interface, as much monetary as fiscal policy. It is fiscal policy only when debt is newly issued, not by the manner it is subsequently serviced. The latter, i.e. debt **management** *stricto sensu* is **monetary**, not fiscal policy. The

ECB is **not** issuing member-country **new** sovereign debt, it is issuing its own supra-sovereign EMU-eurodebt, as and when it deems right in pursuit of its own monetary policy objective, the monetary counter-inflation targeting rule. The ECB holds, by its very constitution, the joint-and-several guarantee of the joint-and-several entity, as enshrined in the founding treaties of the EU and EMU.

To further underline the nature of this defining *differentia specifica*, the ECB does not strictly *need* to issue its own new debt in order to service seasoned debt, new money issued under its own foundational prerogative will do equally well - but it *may* borrow from the market for monetary policy purposes, **and make money in the process**, how much clearer can this be? Just as it can buy and sell in the market anything it likes - how else are open market operations to be conducted and how else can monetary policy be effected?

In fact, the [exclusively ***caretaking***, ***managerial***] **transfer** [not purchase] of member-country debt to the ECB provides the ECB with a new and efficient instrument for managing and maintaining a deep and liquid debt market with which to target the whole maturity curve of interest rates. A positive collateral benefit being the potential of indirectly securing liquidity for the financial system.

Given the present setting of profound confusion, it is worth pointing out once again that, in conducting this debt-management policy **on behalf** of euro-member states, **the ECB is actually making money** and thus **strengthening its own balance sheet**: its borrowing rate will be definitely lower than whatever rate was historically secured by the original sovereign borrowers. By servicing seasoned sovereign debt the ECB is also thereby mopping up excess liquidity, that swirling torrent of money wishing for a safer haven, no longer monopolized by the dollar, and thus also extending a helping hand to the dollar. It is altogether a **global policy**, in line with the euro's prospective reserve standing in the multi-polar global monetary system.

To underline yet again the specific and unambiguous nature of this financial mechanism, **this 'conversion' policy is not a fiscal transfer**, it is rather a strictly financial solution to the strictly financial debt recycling problem – **without fiscal cost for any taxpayer**.

In effect, the proposed mechanism **decouples the decentralized fiscal process** of issuing new debt from the decentralized financial necessity of issuing new debt in order to service existing debt - and thus leaves the latter to be dealt with by **a centralized financial mechanism** – without excusing the debt obligation of the original issuer but in fact essentially guaranteeing its repayment in full. The debt overhang is thus also decoupled from the moral burden of the original debt while 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 armoury 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 – that fundamental architecture which deprived members of a monetary instrument without providing for a countervailing substitute.

Finally, the proposal doubtless involves a political decision but not one requiring treaty changes or tampering therewith, in fact it is the opposite: instead of accepting collateral junk to offer the banks precarious liquidity or, worse, firefighting the fiscal problem with marginal intervention, the ECB kills off the prospect of insolvency [of sovereign states] and thus restores solvency as well as financial liquidity [of private sector banks], with one stone. The legitimacy of such a political decision is in fact designed into the treaties providing for central bank independence. It is included in the ECB's mandate and must be respected by all member states.

Objection: The ECB's constitution is that of **a bankers' bank**, **not that of a sovereign's bank**. It is specifically precluded from operating in the primary sovereign bond market. Answer: Indeed, but this is no problem. For Maastricht compliant sovereign debt is already issued and thus second hand. What malign difference is there between offering liquidity to private owners on collateral overhang burdened by prospectively increasing risk *versus* offering management services to ultimate sovereign debtors relieved of burdensome overhang - at a certain profit? In fact, the ECB's mandate is more powerful than even its own adopted rules, by exception self-declared and imposed, imply: its inflation objective, even beyond the means of achieving it, are truly Euro-sovereign. By the proposal, **the ECB does not**

become a sovereigns' bank, it consolidates its role as a bankers' bank and imposes its inflation objective on its sovereign members more effectively.

[N.B. It is an entirely separate question, though one which may be legitimately, perhaps temptingly, coupled to the above, as to whether the ECB, upon request, may become the underwriter of **new** sovereign debt issues, a policy which would lower **every** sovereign's borrowing interest rates, showing the markets the guiding hand of firm government; but, as insisted from the beginning, no proposal involving treaty changes is allowed in the present discussion and such temptation is therefore strictly irrelevant, indeed forbidden in the current discussion – but see the Appendix on the Bini Smaghi 'provocative' proposal.]

Finally, addressing today's 'delicate' or perhaps provocative question: **What about sovereign debt <u>RESTRUCTURING</u>?**

The proposal throws this **destructive** question to the dustbin. Leaving aside the multifaceted confusion as to the meaning of this much abused term, **there is simply no need for any restructuring whatsoever**. By the proposal, **all sovereign debt is honoured, *punkt*.** Finance is not like butter, which goes sour, or nuclear power stations, that get angry – with overwhelmingly **real** costs and costly solutions, those that **real taxpayers** are burdened with. It is a **convention**, and like all conventions is governed by authority – the other name of confidence, leaving room only for ideological, **fictitious taxpayers**. 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 an appropriately designed equivalent to a **conversion loan** - to kill off the threatening sovereign debt overhang which is, simultaneously, a solvency not just illiquidity problem of the private financial sector.

[Digression: Does this all mean that the crisis, and the euro-crisis in particular, is a virtual, un-real phenomenon? No. The crisis has already taken its real toll threefold, in terms of output, employment and potential. But there is no need that it should take a further toll because of financial management blindness. Sovereign states do not go bankrupt in the same sense that private economic entities may disappear into thin legal air. Even when dismembered and moved about the map [for example, Poland was twice partitioned and twice moved right and left by more than a hundred landmiles but it is still there, wonderfully]; sovereign states are, as their name implies, above instituted law, their sovereign existence is simply recognized as such by their peers and that is all. Business school thinking, which so clearly distinguishes illiquidity from insolvency, is simply on a different [truly provincial] league from political economy, and dangerously irrelevant if illicitly taken to its logical consequences. Sovereign solvency or insolvency is a sovereign matter, a political thing not a market thing, unless there is a political decision to let the markets take over by altogether relegating political sovereignty to the dustbin. But even this great achievement can only be accomplished, wittingly or unwittingly, by sovereigns.]

By this stage in the unfolding crisis, any and all forms of restructuring are destructive. The clearcut solution is a form of conversion loan. The proposal charts out the simplest.

Finally, and to once again underline the obvious: the proposal's simplicity hinges on a policing rule – such as that which is now in operation vis a vis Greece, Ireland and Portugal. But this need not be penal. As the outgoing Bundesbank president has noted, a reprofiling of debt from 3 to 30 years is not unreasonable, indeed why not a consol at 3 per cent of par? But the proposal transcends all of this: the costless guarantee of solvency without any form of restructuring makes it so, the debt overhang will vanish and so will the financial sector crisis. Regretting that insolent banks will not share the pain is gratuitous; regretting the real losses is by now just regretful, in company with the crocodile's tears.

[Footnote: As for a comparison, from an unknown commentator to a professional and professionally published comment, dated March 23rd, 2011:
" … public 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, for example, the Versailles reparations plan, the Dawes plan, the Schacht plan, the Funk plan, the Morgenthau plan, the Keynes plan and the White plan, the Marshall plan … , or indeed the Lend-Lease strategem – and think which of these plans and strategems may offer some guidance for hope or fear for what is ahead].

b/ The Surplus Recycling Problem [SRP]

The surplus recycling problem is fundamentally different from the budget recycling problem but not to the naked eye because, in a Currency Union, it is not readily observable. It is nonetheless at the roots of the ongoing crisis and constitutes its real as distinct from financial underpinning. The crux of the surplus recycling problem is its foundational asymmetry, countries on the deficit side of payments suffer deflation while countries on the surplus side do not suffer inflation, the problem is thus cumulative. Inevitably foreign account deflation feeds into deficitary private and public sector accounts, thus conjoining the financial *cum* sovereign crisis which was the subject of the proposal so far. Handling the problem directly is beyond European institutions as presently constituted [*]. But a substitute solution holds strong promise: it consists in activating the European Investment Bank to a different level of authority – once again, without changing or tampering with the treaties. In conjunction with the ECB, the EIB can provide the mechanism for recycling the surplus to secure viably balanced EMU and EU growth. The restitution of real forces is the necessary counterparty to the restitution of financial forces in the process of overcoming the three-fold [with twin-engine failure] euro-crisis.

[This part of the proposal is elaborated in “The Recycling Problem in a Currency Union”, www.levy.org, Working Paper 595, as well as in the Modest Proposal formulation by Yanis Varoufakis and Stuart Holland, now maturing for its Version 3.0, http://yanisvaroufakis.eu/]

Conclusion: [*] The ESFS and EFS are inappropriately designed to face either problem of the euro-crisis. Rather than targeting the sovereign debt overhang, which they are incompetent to confront [watch for the rain in Spain that does **not** fall only in the plain], they had better be redesigned to recapitalize the banks. Instead of pushing losses on them – while protecting pension funds etc. – recapitalizing banks at the systemic eurozone level will restore their ability to lend to the real economy. It is too late for punishment but none too early for proper activation. Such private sector financial restructuring would also usefully involve bank diversification between deposit institutions and speculators.

Musings concerning a 'European IMF' seem also misplaced. The Keynes plan was killed not on the grounds of logic but power. A symmetric solution of the surplus recycling problem is, perhaps disgustingly, unthinkable – provincial European politics is well below the standard of even faulty pre-Bretton Woods disjunctures. When the debate has degenerated to the dilemma between several but not joint guarantees as against both joint and several guarantees it might as well invoke Wittgenstein's silence. The substitute to the Keynes plan is the activation of the EIB in conjunction with the full deployment of ECB constituted power. And as for musings of restructuring, there must be a muzzle.

APPENDIX [12.05.2001]:
THE BINI SMAGHI 'PROVOCATIVE' PROPOSAL

This appears on page 6 of a speech delivered on last March 11th by Lorenzo Bini Smaghi, Executive Member of the ECB. As it was only momentarily mentioned [e.g.

by the FT, with virtually no comment] it did not get the attention it deserves, so here it is in full:

"The best way to prevent euro countries from defaulting is to lay down rules for debt which have constitutional weight. These rules may have Community status or be incorporated in national constitutions, as is already the case in some countries. But how to make sure that such rules are followed? How to make sure that the inevitable margins for discretion are not bypassed?

"One way to ensure that the discipline is actually binding is to empower a supranational entity in the euro area to issue government bonds for the Member States. The countries would in fact no long have the capacity, technically or politically, to issue public debt on the market. This could be a first step toward a single European bond, which would be emitted by the supranational agency to finance public budgets of all countries, or those which share similar characteristics such as the highest rating. This development would not necessarily require an integration of budgetary policies, or therefore an integrated tax system. What is in common is just the tap, i.e. an integrated system of securities for issuing on the market the proceeds from which are then allocated to individual countries, according to joint decision-making mechanisms. The European Council of Ministers, in accordance with a procedure to be specified, should decide how much debt can be issued by the agency as a whole and how to distribute it to individual states. In fact, by controlling the volume of emissions, the Council would have the power to decide the budgetary balance of individual countries. It might seem at first glance to be a premature step in the euro area's integration policy. In reality, the current procedures already envisage the Council approving thee budgets of individual countries, as part of the stability programmes presented each year by them. Its opinion however is not binding, while in our case it would indeed be so, through the decision on whether to issue debt securities. A key issue is the decision-making mechanism with which the Council would approve the total volume and that of the individual states. It is therefore necessary to maintain the overall discipline of the system and avoid having to keep pace with financing larger public deficits. On the other hand, countries should have a strong incentive to limit the indebtedness of others to avoid becoming 'contaminated'.

“I will stop here with this proposal which, I admit, is almost a provocation. Surely there is need for more thought. But the goal must to make financial crises less likely.”

And so endeth the sermon. It is not ‘provocative’ but wonderful, or perhaps wanderlustfull as well as a rhetorical triumph. It does deserve more thought, here to be conducted in contrast to the Modest Proposal as argued above. However, the rhetoric of the provocation must be stressed as of value in its own right [repetition through deconstruction being the mother of all learning] thus:

“The **best way** to prevent euro countries from defaulting is to lay down **rules** for debt which have **constitutional weight**. These rules may have **Community status** or be **incorporated in national constitutions**, as is already the case in some countries.” [Best way or ultimate way? Rules beyond discretion, so no room for politics or even constitutional courts, heavy.]

“But how to make sure that such rules are followed? How to make sure that the **inevitable margins for discretion** are not bypassed?” [Inevitable indeed, so skip the above.]

“**One way** to ensure that the discipline is actually binding is to **empower a supranational entity** in the euro area to **issue** government bonds **for the Member States**.” [One way indeed, only the hardest possible way, effectively devastating Treaty revision imposing Versailles on the victors - even so turning the screw tighter in what comes below.]

“**The countries would in fact no long have the capacity, technically or politically, to issue public debt on the market**.” [Way beyond the Federalist Papers, possibly beyond Alexander Hamilton’s wildest dream.]

“This could be **a first step** toward **a single European bond**, which would be emitted by the supranational agency **to finance public budgets** of **all countries**” [If this is the ‘first’ step, there is not much need for a ‘second’, sovereigns have by now yielded not only monetary but also macro-fiscal authority to an enshrined hyper-sovereign authority of their own making which nullifies their own, a hyper-Hobbesian Leviathan beyond their control - Dr Schacht and Dr Funk are somewhat frightened and dare not speak, though inwardly delighted and perhaps chuckling.]

"or **those which share similar characteristics such as the highest rating**." [This particular tack is somewhat incredible: the markets and their agencies are brought in as adjudicators of 'similarily' and therefore potential architects of the efficient Leviathan governing Sovereigns, surely a slip of a tongue deep in cheek.]

"This development would not necessarily require an integration of budgetary policies, or therefore an integrated tax system." [Indeed, local/regional government of sorts would be a compleat substitute for what passes as national government, with social policy perhaps exempt insofar as relative longevity etc are somewhat geographic.]

"What is in common is *just* the tap" [**JUST** is here the deathly ultimate rhetorical understatement, only the **DEAD DODO** is missing – the ultimate Cartalist, unique money issuing authority, is here constructed by unanimity of its consequent monetary slaves, wonderfully the ultimate insult to deadly dead private-money men such as von Hayek.]

"i.e. **an integrated system** of securities **for issuing** on the market" [*ditto.*]

"**the proceeds from which are then allocated** to individual countries" [This is where the turning of the screw draws blood, distribution in the guise of allocation is where the balance of power is unbalanced, no rules whatever, just discretion.]

"**according to *joint* decision-making mechanisms**." [**JOINT** is where the distributive battle is joined, enjoy.]

"The European Council of Ministers, in accordance with **a procedure to be specified**, should decide **how much debt can be issued** by the agency **as a whole** and **how to distribute it** to individual states." [A PROCEDURE is here the misnomer for *warre of all against all*, it involves both scale and proportion, a feat worthy of an

Iktinus and Pheidias when contemplating the construction of the Parthenon, the Virgin Temple. As for the Council – surely misplaced - *vs* the Eurogroup, see below.]

"In fact, by controlling the **volume** [{missing here is the potential **allocation** – and the implicit **terms**}] of emissions, the Council would have the power to decide the **budgetary balance** of individual countries." [Indeed, new money is out by the terms of EMU, here taken as given, now national debt policy is out as well, hence a binding national budget constraint, given the volume and allocation thereof, hence local government is left alone to finance garbage collection and the like – by taxing the poor and the rich, preferable the former, as the former might move away.]

"It might seem at first glance to be **a premature step** in the euro area's **integration policy**." [If there were such a thing as the euro area's integration policy, the premature step would be an immense teleological leap all the way from original alpha to final omega.]

"**In reality**, the current procedures already envisage the Council approving the budgets of individual countries, as part of the stability programmes presented each year by them." [For 'reality' read 'actuality'. Note also here the slip between 'Council' – which is strictly irrelevant - and 'Eurogroup': the former can decide, the latter can only suggest – fuzzy logic embedded in splendid rhetoric.]

"Its opinion however is **not binding**" [so the fuzz is operationally useless.]

"while **in our case it would indeed be so**, through the decision on whether to issue [{missing again is the allocational destribution}] debt securities." ['Our case' is altogether incongruent to 'reality' or rather politically riveted actuality.]

"A **key issue** is the decision-making mechanism with which the Council would approve **the total volume and that of the individual states**." [A key issue indeed, better ***the key issue***, though perhaps the other way round, from allocation to total.]

"It is therefore **necessary** to maintain the **overall discipline** of the system and avoid having to **keep pace** with financing larger [{'larger' in terms of distribution disturbing what?}] public deficits." [In truth, there is not much left that needs a discipline. This is not a rhetorical slip, but a 'yes' to hawks via 'overall' supervision so that 'larger' little local difficulties can be smothered in the name of All for One thus One for All.]

"On the other hand, countries should have a **strong incentive** to limit the indebtedness of others to avoid becoming **'contaminated'**." [They do, beggar thy neighbour is an ever present incentive, particularly when it pays with every miscreant condemned and suffering the waterboard treatment.]

"I will stop **here** with this proposal which, I admit, is **almost a provocation**." [Yes, well earned.]

"Surely there is **need for more thought**." [Yes, you have provided plenty of food.]

"But the goal must to make **financial crises** less likely." [A good sermon must end in a Calvinist note, but how lustful the sermon was.]

The above constitutes a constructive deconstruction. An intelligent provocation from inside the ECB should invite joy and hope. Yet: ***everything*** that Bini Smaghi wishes for can be accomplished without a **Warre** of all against all: the Modest Proposal is sufficiently immodest to oppose any Treaty change as prerequisite to the solution of the euro crisis. In fact, as compared to the PROVOCATIVE PROPOSAL, the MODEST PROPOSAL is almost coy.   In gratitude to Bini Smaghi and with best wishes to his potential new posting as Governor of the Italian Central Bank once his able compatriot Mario Draghi succeeds the excellent Jean-Claude Trichet at the helm of the ECB, this deconstruction is a small tribute.

G E Krimpas [Professor Emeritus – University of Athens]
gkrimpas@econ.uoa.gr