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Conference: "The Eurozone Crisis, Greece, and the Experience of Austerity",

November 8-9, 2013, Athens, Greece

"LOST AT SEA: THE EURO NEEDS A EURO TREASURY"

MESSAGE AND STRUCTURE OF PRESENTATION

- Euro-zone remains stuck in existential crisis. Current policy course means eventual shipwreck.
- Euro Treasury has to complement ECB to create strong CB-Treasury axis at center for euro to survive and prosper.
- € Treasury plan delineates minimalistic but functional fiscal (but not transfer) union that would resolve crisis & foster recovery.

- Structure
  1. Euro regime flaws, vulnerabilities, and crisis
  2. Wrong-headed crisis management & recent regime reforms
  3. What to do then?
  4. The Euro Treasury plan
  5. Concluding observations

Buba baggage haunting the euro

1. EURO REGIME FLAWS, VULNERABILITIES, AND EXISTENTIAL CRISIS

EURO REGIME FLAWS

1. No proper defenses against *symmetric* shocks
   - Normal downturn ('global slowdown') in 2001
   - Global recession in 2008-9

2. No prevention of *endogenous asymmetric* shocks
   - German wage repression & intra-area divergences

3. Defenseless against systemic financial crises
   - The divorce between monetary and fiscal authorities is deeper underlying cause of vulnerability
   - Euro is a currency without a state, a monetary union but not a fiscal union; *Euro Treasury is missing*

VULNERABILITIES

TREASURY-CENTRAL BANK AXIS UNTIED (FLAW NO. 3)

- "Divorce" leaves everyone involved vulnerable!
  - National treasuries
    - Bank bailouts, public debt surges, no monetization option ("QE").
  - National central banks
    - Prohibited from being LOLR to government.
    - Under ECB control, merely facilitate bank bailouts (except ELA).
  - ECB
    - Prohibited from being LOLR to governments.
    - In practice, ECB can extend emergency liquidity to system as a whole but supporting particular institutions or MS problematic.
      - Who & how would ECB recapitalization work in case of losses?
      - *ECB is missing Euro Treasury partner*! (Goodhart 1998)

AND EXISTENTIAL CRISIS

- A balance-of-payments crisis
  - Divergences and imbalances (flaw no. 2)
  - Sudden stop/sudden reversal
- A banking crisis
  - Common market without common policy
  - Asset price bust and recession (flaws nos. 1-3)
- A sovereign debt crisis
  - Largely a consequence of the above (Greece special case)
- Plus: "growth crisis" (or: debt deflation)
  - Consequence of misdiagnosis & mismanagement of crisis

Myths rather than theory and facts continue to inspire policy

2. Wrong-headed crisis management & ill-guided regime reforms

CRISIS MISMANAGEMENT

- In absence of central fiscal backstop, and given the "no-bail-out clause", official support was less than prompt
- Initially ECB's emergency liquidity support quite flexible
- But – lacking proper LOLR mandate and fiscal partner (deep pockets) – ECB became more hesitant as solvency issues (both banking & sovereign) became apparent
- ECB's de facto quasi-fiscal role highly problematic
- Paired with "expansionary" fiscal austerity and "growth-enhancing" structural reforms the outcome is nothing but disaster!

REFORMS THAT ARE NO FIX

- So-called "Stability & Growth Pact" strengthened
  - "Six-Pack"
  - "Fiscal Compact"
  - "Twin-Pack"
  - …
- Essentially, reforms aim at more discipline, more constraints on national fiscal sovereignty.
- Based on belief that lack of discipline ("fiscal profligacy") was problem ("sovereign debt crisis"). *Misdiagnosis!*
- No regime fix at all!

CURRENT EURO REGIME UNWORKABLE

- Essentially, eurozone is now aiming at running balanced budgets forever
  - Defies "golden rule" of public finance.
  - National public debt ratios would fall to very low levels.

- In closed economy public sector can only balance its books if private sector does too, which is rarely so.
- Following a financial crisis (= excessive leverage) the private sector typically aspires large financial surplus.
- Hence austerity is bound to cause recession – unless large and persistent CA surplus an option.

- Eurozone too large and global recovery too fragile!!!
  - Eurozone reneging on G-20 commitment
  - U.S. Treasury not amused about Germany …

Need for creative solution

3. WHAT TO DO THEN?

HOW ABOUT OTHER REFORM PROPOSALS?

1. Eurobonds
   - Some debt mutualization

2. Fiscal union of kinds
   - More discipline & austerity, but with some risk sharing

3. Recovery programs
   - Public investment as stimulus
     - "Marshall Plan for Europe", "Europe 2020", "Modest Proposal"

STRAIGHT-FORWARD SOLUTION POSSIBLE!

- A solution that:
  - Fixes the flawed regime ("missing element")
  - Secures public investment in Europe's future
  - Establishes low borrowing costs for all members
  - Allows effective discipline "carrot-type"
  - Provides immediate recovery boost
  - Fosters more symmetric rebalancing
  - A fiscal union that is NOT a transfer union
    - Gives us Eurobonds (= safe assets for financial system) but without mutualization of existing national public debt
- How is that magic supposed to work then?

Establishing strong Central Bank-Treasury Axis at center

3. THE EURO TREASURY PLAN

EURO TREASURY PLAN AS REGIME FIX

- Establish Euro Treasury as a means to pool eurozone public investment spending and have it funded by proper eurozone treasury securities.
  - Say, 3% of GDP, growing at 5% annually
  - A "fixed rule" (no discretion since political union missing)
- Euro Treasury gives grants to member states based on their GDP shares (say, 5-year average)
- And Euro Treasury collects eurozone tax to service euro treasury debt on basis of MS GDP shares
  - No redistribution! Separate from EU budget!
- Member states must balance their *structural current* budgets, or get their investment grants cut ("carrot")
- Continuous deficit spending from center – based on age-old "golden rule" of public finance – turns flawed euro regime into a viable one – *Euro Treasury as the missing element!*

STEADY-STATE OUTCOME
EURO TREASURY: FIXED ('GOLDEN') RULE

Convergence to steady state of central and national debt ratios

euro deficit ratio (lhs) | national deficit ratio (lhs) | euro debt ratio (rhs) | national debt ratio (rhs)

6.00% 5.00% 4.00% 3.00% 2.00% 1.00% 0.00% -1.00%

120.00% 100.00% 80.00% 60.00% 40.00% 20.00% 0.00%

2013 2015 2017 2019 2021 2023 2025 2027 2029 2031 2033 2035 2037 2039 2041 2043 2045 2047 2049 2051 2053 2055 2057 2059 2061 2063 2065 2067 2069 2071 2073 2075 2077 2079 2081 2083 2085 2087 2089 2091 2093 2095 2097 2099 2101

Outcome resembles Maastricht stability ideal and U.S. reality in normal times

KEY ROLES OF EURO TREASURY

1. Safeguards Europe's infrastructure & common future by using straight-forward funding
   - Eurobonds without debt mutualization
     - Financial system needs safe assets; also intern. reserves

2. Anchors stability of financial system
   - Banking Union needs Fiscal Union: € Treasury = backstop
     - Euro Treasury replaces unwieldy ESM
     - Provides common euro Treasury yield curve = basis for common market!

3. Anchors national fiscal stabilization
   - Enables decline in national debt ratios, thereby creating space for free working of automatic stabilizers
     - Perhaps boosted from center in deep (common) recessions
   - Provides conduit for mutual insurance scheme in case of *exogenous* asymmetric shocks
     - Complemented by "golden rule" of currency union (ULC-trends aligned) to prevent emergence of *endogenous* asymmetric shocks

€ TREASURY PLAN AS RECOVERY BOOST

- Direct boost
  - Boost of public investment: Proposed 3% exceeds current 2%
  - Refocusing on structurally balanced CURRENT budget = less austerity
- Indirect boost
  - As national debt ratios set on decline, *funding costs decline*
  - €treasury debt provides common treasury term structure, creating level playing field independent of borrowers' nationality *at reduced rates*
- Germany will see stimulus, allowing for more symmetric (i.e. less deflationary) rebalancing
- Also, ECB gets chance to get 'clean' again and will only deal in euro treasury but not national debts (no bailout clause upheld!)
- BUT: No burden sharing of debt legacies in crisis countries
  - As Euro Treasury plan is not a transfer union
  - Hopefully better performance will foster solidarity in due course

End delusion and denial – This crisis is not nearly over – It's high time to get serious!

5. CONCLUDING OBSERVATIONS

THAT MISSING LINK

- Crisis misdiagnosis still prevails. Regime flaws and German conduct rather than fiscal profligacy caused crisis.
- Current euro regime, including recent reforms, remains deeply flawed, dysfunctional, and unworkable.
  - Euro still on track for eventual breakup (sorry Mr. Draghi)
- Other proposals found lacking

- Euro Treasury offers straight-forward solution
  - Secures public infrastructure and provides safe Eurobonds
  - Backstops "banking union", replacing SMP
  - Enables effectiveness of national "automatic stabilizers", facilitates risk sharing
  - Provides minimalistic but functional fiscal union that is not (much-dreaded) transfer union!

- Establishes vital Treasury-CB axis at Euroland's center!
  - The missing link and condition sine qua non.

BACKGROUND RESEARCH

- This presentation is based on my study "Lost at sea: The euro needs a euro treasury". See here:
  - Levy: http://www.levyinstitute.org/pubs/wp_780.pdf
  - IMK: http://www.boeckler.de/pdf/p_imk_study_35_2013
  - LSE Financial Markets Group, Special Paper SP227,
  - http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP227.pdf

- Other recent research papers by myself on the euro crisis:
  - (2013) Germany and the Euroland crisis: The making of a vulnerable haven, Levy Economics Institute, Working Paper no. 767, June.
  - (2013) The German wages problem - a world problem, New America Foundation, 14 June.
  - (2013) "On the Franco-German euro contradiction and ultimate euro battleground", Contributions to Political Economy 32: 127-49. (Levy Economics Institute, Working Paper no. 738, April.)
  - (2013) "At the crossroads: The euro and its central bank guardian (and savior?), Cambridge Journal of Economics, 37(3): 609-26; (Levy Economics Institute, Working Paper no. 738, November 2012).

- For more information see my homepage at:
  - http://www.skidmore.edu/~jbibow/
  - http://www.levyinstitute.org/scholars/?auth=20