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How to Avoid A Eurozone *Breakup*

BY RICHARD C. KOO

Solve two key problems.

It has been said that the eurozone needs a new idea to avoid an eventual breakup. With Irish fiscal consolidation efforts resulting in larger budget deficits, smaller GDP, higher bond yields, and more onerous credit default swap spreads, it is obvious that orthodox, single-minded efforts to reduce budget deficits are not the solution to the problem. The fact that the European Union had to offer financial support to Greece instead of collecting fines from the country for going over the 3 percent Maastricht limit on budget deficits also suggests that the current rules are not working.

The eurozone is an artificially created currency zone. In putting this grand scheme together, its founding fathers had to impose conditions on members so they would not take actions that could undermine the credibility of the common currency. In particular, they wanted to make sure that member countries would not run profligate fiscal policies by taking advantage of the ease in attracting foreign funds in a single currency arrangement. This concern led to the limit on budget deficits of 3 percent of GDP. Recent events in Greece and Ireland, however, have proven that this limit not only failed to prevent problems from happening, but is also making the situation worse for many countries. As a result, the European Central Bank and European Union are now forced to fight economic fires in one country after another, week after week, and talk of eventual breakup is growing louder by the day. Is there a way out of this mess?

Yes, if we go back to the basics. Actually two separate problems must be solved, only one of which was anticipated by the founding fathers. In the current crisis and contagion, the two problems are intertwined to the point where the solution must address both problems together.

The problem that was anticipated was the problem of profligate fiscal policy financed by foreigners. This is the problem Greece has created for itself.

The problem that was not anticipated was the problem of fighting balance-sheet recessions triggered by massive private sector deleveraging following the bursting of debt-financed bubbles. This is the problem Ireland and Spain are facing now, together with the United States and the United Kingdom. During this type of recession, the collapse in asset prices forces the private sector to minimize liabilities in order to repair its battered balance sheets. That makes monetary policy largely powerless, because those with balance sheets underwater are not interested in

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increasing borrowing at any interest rate, and not many will want to lend, either, especially when the lenders themselves have balance-sheet problems.

But if everybody is saving and nobody is borrowing and spending those saved funds, the economy will continue to lose demand equivalent to the amount of unborrowed savings. The fact that there is so much deleveraging going on in the above-mentioned countries in spite of record low interest rates suggests that the private sectors of these countries are suffering from serious balance-sheet problems.

In order to stabilize these economies, the government—the only borrower left—must take up the excess savings in the private sector and put them back into the economy's income stream. In other words, a proactive fiscal policy is necessary. Unfortunately, this rare type of recession that happens only after the bursting of a nationwide asset price bubble was not foreseen when the Maastricht Treaty was negotiated in the 1990s.

The problem of profligate fiscal policy requires fiscal discipline. But the problem of the balance-sheet recession needs fiscal flexibility. This time around, however, the first problem triggered the contagion, forcing the countries facing the second problem into premature fiscal consolidation. That, in turn, brought their economies far worse trouble.

GAME-CHANGING NEW RULE

The eurozone can overcome both of the above challenges by first announcing that, after a transition period, member countries will be able to sell government bonds only to their own citizens. This new rule will impose discipline because if the country's citizens are not convinced of the need for the government to run large deficits, the government will not be able to run that deficit. It also internalizes the fiscal issue to individual countries—if the Greek government defaults, only Greek citizens will be affected. This means those protesting in the streets of Athens are no longer able to blame everything on rich, fat, foreign bankers. Instead, protestors must redirect their energy toward convincing their neighbors, relatives, and friends to buy more Greek government bonds or face further cuts by the government.

By internalizing fiscal deficit problems to individual countries themselves, the European Union and European Central Bank will be freed from worrying about the fiscal condition of individual countries. That will allow the European Central Bank to concentrate its efforts on running monetary policy.

By replacing the original 3 percent limit with this new limit on selling government bonds only to a country's own citizens, individual governments also regain fiscal flexibility as long as they are able to convince their citizens that a larger deficit is needed. This is particularly important during a balance-sheet recession, when monetary policy is largely ineffective and the government's fiscal action is needed to stabilize the economy.

The eurozone was never created to offer member governments more opportunity to run irresponsible deficits.

Indeed, nothing causes worse trouble than premature fiscal consolidation during a balance-sheet recession. When the Japanese government under Prime Minister Ryutaro Hashimoto tried to cut spending and raise taxes in the middle of private-sector deleveraging in 1997, the economy collapsed first and the deficit increased by a whopping 68 percent. It took Japan nearly ten years to climb out of that hole, with an entirely unnecessary $1 trillion added to its public debt in order to heal its damaged economy. The United States suffered the same fate in 1937 when President Franklin Roosevelt retracted his New Deal fiscal policies while the private sector was still repairing balance sheets following the 1929 crash. The result was an immediate collapse of the economy, which literally needed the Japanese attack on Pearl Harbor in order to recover. Today, Ireland and Spain are also finding out that the harder they work to reduce the deficit, the worse the economy and deficit become.

NAVIGATING THE TRANSITION PERIOD

The first order of business for policymakers today, therefore, is to end the enforced fiscal consolidation for those economies that are in balance-sheet recessions. This is not going to be easy because some of the countries are already experiencing financing difficulties. Moreover, with a huge proportion of government bonds now held by foreigners, many countries will need time to move from the present regime to the one where government bonds are sold only to a country's own nationals. Greece, for example, has 70 percent of its government liabilities held by foreigners.

One way to overcome these problems is for the Greek government to announce today that beginning in five years' time, its bonds will be sold only to its own people. Such a commitment should go a long way toward assuring the international financial community that the country is really serious about rebuilding its finances. Protests in the streets of Athens are also likely to die down following the announcement. In turn, this will give Greece the necessary breathing space to make needed adjustments.

Nothing causes worse trouble than premature fiscal consolidation during a balance-sheet recession.

For Ireland, Spain, and others, a new diagnosis together with a schedule of treatments must be offered. In particular, the respective governments, the European Union, and the European Central Bank should jointly announce that, first, because of massive private-sector deleveraging in spite of record low interest rates, these countries are in balance-sheet recessions requiring sufficiently large fiscal stimuli to stabilize the economies. The European Union and European Central Bank should also make it clear that they stand ready to help.

The authorities should also highlight the often-overlooked fact that, because of private sector deleveraging, these countries are actually generating huge amounts of private savings. In all of the countries mentioned, the increases in savings have been larger than increases in budget deficits. For example, according to the flow of funds data and measured from the recent trough in private-sector savings, the household and corporate sectors in Spain increased savings to the tune of 18.3 percent of GDP compared with an increase in Spain's budget deficit to the tune of 12.8 percent of GDP (measured from 2007). The same figure for Ireland is 21.9 percent versus 16.9 percent (from 2006), and for Portugal, 8.0 percent versus 6.5 percent (from 2008). Incidentally, the figure for the United States is as high as 13.3 percent versus 8.5 percent (from 2006), and for the United Kingdom, 10.5 percent versus 7.8 percent (from 2006). In other words, all of these countries are generating huge savings that could go a long way toward financing their own government deficits. Indeed, these countries are in recession precisely because their private sectors are increasing savings faster than their governments are borrowing and spending.

Finally, the governments should announce that once their countries are out of balance-sheet recessions, only their own nationals will be able to buy government bonds. This last pledge is to assure the investors both at home and abroad that past mistakes will not be repeated.

In Europe today, raising taxes and cutting spending is the only game in town. For those countries in balance-sheet recessions, that game is resulting in devastating vicious cycles, with the Spanish unemployment rate above 20 percent, and Irish GDP down 20 percent from its peak. As long as fiscal consolidation is the only game in town, bond market investors should be worried, because premature withdrawal of fiscal stimulus during a balance-sheet recession will only make things worse.

Once a different diagnosis is offered in combination with the pledge that past mistakes will not be repeated, bond market investors may conclude that the vicious cycle is finally behind them and that the yields on those countries' bonds are attractive, especially with both the European Union and European Central Bank offering support if necessary.

Limiting sales of government bonds to a country's own citizens should not affect efficiency gains obtained from the free movement of capital, because all private financial flows not headed for government bonds will remain unconstrained. German banks will still be able to buy Greek corporate bonds, for example. Since government bonds always offer the lowest yield, the inability to buy government bonds of another member country is not a great loss to the citizens of member countries.

The eurozone was never created to offer member governments more opportunity to run irresponsible deficits. The Maastricht Treaty, however, never considered the possibility of balance-sheet recession, resulting in self-destructive policy responses in many member countries facing this type of recession today.

Policymakers should address the present challenges by first announcing to the public that member countries will ultimately limit the sale of government bonds to citizens, and work out the path to get there for individual countries. For Greece, where private sector deleveraging is minimal, it will have to be through fiscal consolidation. Those countries in balance-sheet recessions will need a two-stage process in which fiscal policy is mobilized until private-sector balance sheets are repaired. Once the private sector moves away from debt minimization and returns to profit maximization, the public sector will move toward fiscal consolidation.

Once the new game plan is announced, with full support from both the European Union and the European Central Bank if not the International Monetary Fund, private-sector investors should feel much safer returning to their markets as the risk of an endless vicious cycle is removed. In retrospect, limiting the sales of government bonds to citizens should have been the key provision of the Maastricht Treaty from the very beginning of the euro.

It is well known that revising the Treaty is a very difficult task. But if the alternative is a breakup of euro which could have devastating consequences far beyond anything we have seen so far, any effort to make the Treaty responsive to balance-sheet recessions while instilling discipline for individual countries is well worth the effort. ◆