How *to* Save the Euro

Start with a complete fiscal dis-union.

By Richard C. Koo

When Europeans voted to join the euro two decades ago, it was believed that they were only giving up sovereignty over monetary policy. Subsequent events, however, have shown that member governments have lost sovereignty over fiscal policy as well, leaving them unable to respond to voter demands and putting their economies and democratic institutions at risk. This unintended consequence of the euro has both institutional and financial causes that must be addressed.

THE EURO'S INSTITUTIONAL DEFECT

The Maastricht Treaty, which caps the fiscal deficits of member countries at 3 percent of GDP, never envisioned a world in which the private sector was saving more than 3 percent of GDP at a time of zero interest rates. Proponents of the Treaty, along with most of the economics profession in the 1990s, assumed the private sector would be borrowing, not saving, at such low interest rates.

But when the housing bubble burst on both sides of the Atlantic in 2008, the private sector of almost every country—both inside and outside the eurozone—rushed to deleverage, saving far more than 3 percent of GDP even after central banks had lowered interest rates to zero or even negative levels. Spain's private sector, for example, has been saving over 7 percent of GDP on average since 2008. And if someone is saving money, someone else must borrow and spend those savings to keep the national economy going.

However, the Maastricht Treaty allowed the Spanish government to borrow only 3 percent of that 7 percent, opening up a deflationary gap equal to 4 percent of GDP and plunging the country into a horrendous recession and internal deflation. Even today, the Treaty says nothing about what a government should do when the private sector is saving more than 3 percent of GDP at a time of zero interest rates.

Richard C. Koo is Chief Economist of the Nomura Research Institute and author of The Other Half of Macroeconomics and the Fate of Globalization *(2018).*

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www.international-economy.com
editor@international-economy.com

DIFFICULT FINANCING REALITY

An obvious way to rectify this institutional defect is to allow member governments to borrow more than 3 percent of GDP when the private sector is saving more than 3 percent of GDP at zero interest rates. But even if such a correction is made, member governments will still face an unforgiving financing constraint that has drastically reduced their fiscal space. This limitation stems from the fact that all government bonds issued by eurozone members are denominated in the same currency.

If we are to save the euro, which represents one of humanity's greatest achievements, and rebuild voters' trust in the democratic institutions of the eurozone, a complete fiscal dis-union is needed.

In a non-euro country, pension funds and other institutional investors who are unable to take on substantial foreign exchange risk or put all their money in equities are drawn to government bonds because they are the safest fixed-income asset denominated in the home currency. That, in turn, allows the government to utilize the nation's savings to fund fiscal expenditures, which can be used to fight recessions.

Eurozone investors, in contrast, can choose from eighteen government bond markets because they are all denominated in the same currency. Given this option, many investors will dump the bonds of any country that deviates from the "fiscal norm" and shift their funds to bonds issued by other governments that are fiscally better behaved.

This was amply demonstrated during the 2010 eurozone crisis, when investors sold off the government bonds of many peripheral countries even though all the affected countries except Greece were generating more than enough domestic savings to finance their budget deficits. A similar sell-off was also observed in the Italian government bond market in 2018. The fear of such capital flight means no member country can utilize fiscal policy to a greater extent than the eurozone's best fiscal performer, which at present happens to be Germany.

This eurozone-specific, market-imposed fiscal straitjacket has taken away the fiscal sovereignty of member countries. If member countries cannot even utilize the (recession-inducing) excess savings of their own private sectors to fight an economic downturn, voters will feel they are not in control of their economic destiny and will lose confidence in democratic structures.

FISCAL DIS-UNION NEEDED

One way to resolve this two-tier problem is to replace the current 3 percent rule with a rule allowing only the citizens of a country to hold bonds issued by its government. While it might sound outrageous at first blush, such a rule would not only stop the capital flight problem described above but would also restore full fiscal sovereignty to member governments.

More specifically, by making the funding of fiscal expenditures an entirely internal matter, it removes the justification for Brussels or Ecofin to meddle in the fiscal policy of member countries. Only the Greeks will suffer if the Greek government goes bust.

Democratic institutions will be strengthened once member governments regain the ability to respond to recessions and voter demands with their own fiscal policies. All efficiency gains from the free movement of capital within the eurozone will also be retained by the private sector because the proposed capital control applies only to one asset class that lies outside the private sector: government bonds.

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Eurozone residents' loss of the right to buy the government bonds of other member countries, and member

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governments' loss of the right to sell their bonds to foreigners, would be a small price to pay for the restoration of fiscal sovereignty. After all, foreign holdings of government bonds have never proven to be the best use of capital.

This internalization of fiscal policy would also impose discipline on individual governments because they would no longer be able to blame their troubles on international banks or the International Monetary Fund. This is as it should be: a government that cannot even persuade its own people to hold its bonds has no reason to expect foreigners to buy those bonds instead. Those who were unhappy with the profligate fiscal policies of member countries in the past should welcome this new arrangement.

Transitioning to and enforcing the new framework will involve additional costs. A separate arrangement will also have to be made to allow the European Central Bank to hold member governments' bonds for the conduct of monetary policy. But these are not insurmountable issues in the digital age, where the owners of government bonds can be easily identified. Even if some manage to find ways around the new rule, the destabilizing capital flight that plagued the eurozone for so long will be minimized as long as most institutional investors abide by it.

FISCAL DIS-UNION WILL ALSO NORMALIZE MONETARY POLICY

This proposal would also provide a big relief to the European Central Bank, which was forced to carry out quantitative easing, negative interest rates, and other unconventional monetary policies precisely because the two-tier problem prevented member governments from providing the fiscal support their economies so badly needed.

Unfortunately, there is no reason why monetary easing should work when a recession has been caused by private-sector deleveraging. Funds supplied by the central bank will never reach the real economy when borrowers are paying down debt to remove the debt overhang created by the bursting of a debt-financed housing bubble. This loss of monetary policy effectiveness has been amply demonstrated by the European Central Bank's continued failure to meet its inflation target despite astronomical amounts of quantitative easing and negative interest rates.

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That will free the European Central Bank from an impossible burden and allow it to exit from some of the ineffective and unpopular easing measures it has been forced to implement. That should be welcome news for those who were unhappy with the central bank's accommodative policies. In other words, the proposed framework will help normalize not only the fiscal policies of eurozone member countries but also the monetary policy of the European Central Bank.

Making monetary union work without fiscal union was not meant to be easy. If we are to save the euro, which represents one of humanity's greatest achievements, and rebuild voters' trust in the democratic institutions of the eurozone, a complete fiscal dis-union is needed. ◆