

Stephan Schulmeister
Austrian Institute of Economic Research

The European Monetary Fund

A systemic problem needs a systemic solution

Abstract

The deepening of the debt crisis in the euro area is due to three systemic causes which national governments are not able to overcome on their own. First, being members of a monetary union euro states cannot reverse the rise in public debt (caused by the financial crisis 2008) through devaluations. At the same time, they have no access to funds from a national central bank. Second, under “finance-capitalistic” framework conditions, speculators systematically exploit and strengthen the fiscal troubles in the weakest countries by driving up CDS premia and interest rates to unsustainable levels. This (potentially) transforms a liquidity crisis into a solvency crisis. Third, these speculative activities widen the interest rate differentials within the euro area drastically thereby endangering the economic and political cohesion of the EMU and even of the EU.

A systemic solution which restores the primacy of politics over speculation needs to stabilize interest rates for all euro countries. It is proposed to transform the European Financial Stability Facility (EFSF) into the European Monetary Fund (EMF). The EMF provides euro governments with financial means by selling Eurobonds. These bonds are guaranteed by all euro countries to an unlimited extent. The EMF stabilizes Eurobond interest rates at a level slightly below the level of medium-term economic growth (in nominal terms). The Eurobonds are held by investors with the EMF, they are not tradable but can be liquidated at any time. The EMF helps to restore sound public finances in euro countries in close cooperation with the ECB, the European Commission and national governments. To this end, the EMF provides funds for the euro states according to clear criteria (“conditionality”) which are not exclusively restrictive.

JEL: E000, F330, G280

Keywords: Euro crisis, monetary union, dynamic budget constraint, finance capitalism

Vienna and Patmos, October 20, 2011

Stephan Schulmeister

The European Monetary Fund

A systemic problem needs a systemic solution

For the third time since 1990 an economic crisis which originated in the US (1990, 2000, 2007) affects the European economies much stronger than the US. This time, the crisis even endangers the economic and political cohesion of the European (Monetary) Union. These troubles are closely linked to the loss of orientation on behalf of the economic and political elites. On the one hand, a policy based on the neoliberal paradigm had paved the way for the financial crisis, on the other hand, the (austerity) measures to overcome the crisis are derived from the same paradigm.

This contradiction is much more pronounced in the EU than the US. In the EU, e. g., fiscal and monetary policy is bound by rules as prescribed by monetarist theory (in contrast to the US). At the same time, however, actors in financial markets can expand their “finance alchemy” activities without being restricted by rules (the US at least passed the Frank-Dodd act).

The spill-over of a fiscal crisis in a small economy like Greece to the euro area as a whole is the most telling example of this contradiction. The radical austerity policy in Greece (called for by the Maastricht rules) has caused the economy to shrink for 4 consecutive years. Speculators were able to exploit this development by driving up CDS premia and interest rates which in turn made fiscal consolidation impossible. As a consequence, the EU had to set up the rescue fund (EFSF). The rules of the “financial games”, however, remained unchanged. Thus, the interest rate epidemic reached more and more countries.

European Policy reacted to the deepening of the crisis by intensifying the symptom therapies, i. e., strengthening the rescue fund and adopting more austerity measures. Since government bonds of Spain and Italy have already come under speculative attacks, causing interest rates to rise, market participants consider these measures as insufficient. The ECB tries to mitigate the situation by buying again bonds of euro countries under attack. In order to accommodate “the markets”, governments set up new savings packages in Spain, Italy, France and Greece.

All these symptom cures can at best provide short-term relief. To overcome the crisis, market actors desperately hope for new concepts. As politicians have only to offer “more of the same”, they in fact make the situation worse, in particular by causing stock prices to enter into a new bear market. If the spreading of the interest epidemic in Europe and of the global stock market decline cannot be stopped, the European Monetary Union could collapse and the world economy might slide into a depression.

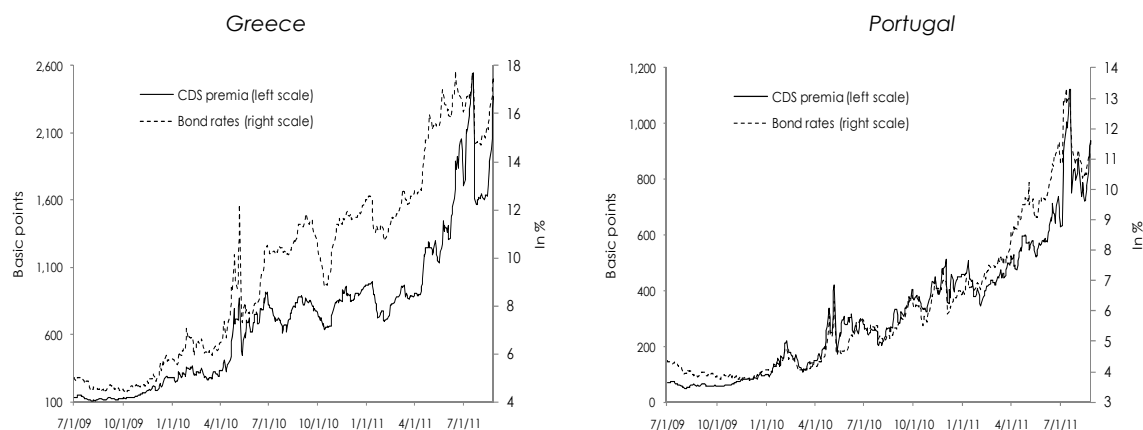
These dangers call on politicians to develop a comprehensive concept which restores the primacy of politics over “finance alchemy”, which overcomes the crisis in a sustainable

manner and which will pave the way towards a new prosperity phase. Such a “New Deal for Europe” needs to be based on a diagnosis of the systemic causes of the great crisis.

One core component of a “New Deal for Europe” is the “European Monetary Fund” (EMF). It manages public finances of euro countries through the emission of Eurobonds. In contrast to the concepts proposed so far, Eurobonds are sold by the EMF at fixed interest rates and they are not tradable (like credits taken up by the IMF). Instead, Eurobonds are held by investors with the EMF. In this respect, Eurobonds are similar to German “Schatzbriefe”, however, they are fully liquid (investors can always exchange them for cash at the fixed price).

Such a proposal might seem too radical from the (still) prevailing economic paradigm. However, such a proposal can directly be derived from a systemically oriented analysis of the crisis. So we start with that.

Figure 1: CDS premia and interest rates on government bonds



Source: Thomson Reuters.

A synopsis of the present conundrum

Destabilizing speculation against sovereign states

Since November 2009 interest rates on government bonds have risen dramatically in an increasing number of euro countries. This development is brought about by the interaction between the downgrading by rating agencies on the one hand, and speculation by banks and hedge funds in the CDS and bond markets on the other hand. Purportedly, the interest rate rise just reflects higher risk premia. However, if this were the true reason, significant interest rate differentials between euro countries should have existed from the very beginning of the EMU, and they should have widened already years ago (and not just in fall 2009).

Also the stepwise spreading of the “interest rate epidemic” from Greece to Ireland, Portugal and recently to Spain, Italy and France suggests that speculation is the key force, driving up in tandem CDS premia and bond rates (figure 1). Those banks and hedge funds which are

specialized in “making money out of money” took advantage of high public indebtedness, a fragile banking system and/or the lack of competitiveness. CDS speculation against sovereign states has become the most profitable game over the past two years.

Speculation based on rational expectations would drive prices towards their fundamental equilibrium values. As in other asset markets, this was not the case in the CDS and bond markets: Within few months, interest rates rose to levels 10 percentage points above that level of economic growth (in nominal terms) which can reasonably be expected for countries like Greece or Portugal over the medium run. Such interest rate levels are unsustainable, they do not serve as an enforcement of fiscal discipline but rather as a macroeconomic “death sentence”. Even an interest rate level of “only” 6% for Spanish and Italian bonds is not sustainable since the economies of both countries will grow at a much smaller rate.

To put it differently: The stepwise increase in interest rates in several euro countries has produced additional (default) risks rather than just compensating for already existing risk.

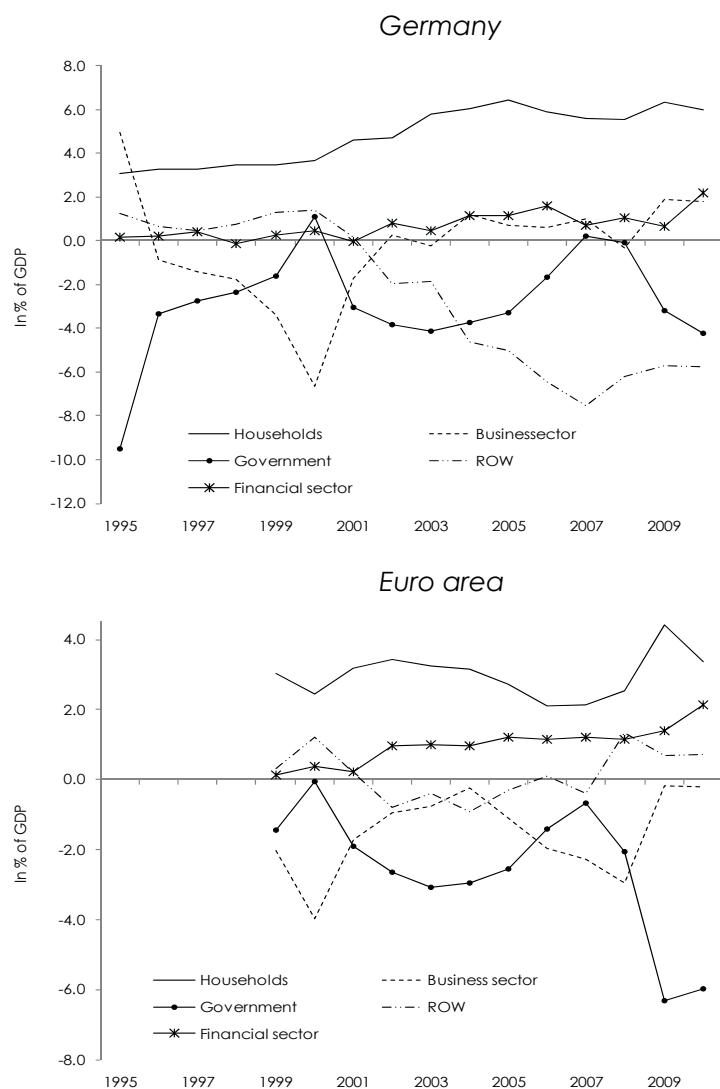
Role of the interest-growth-differential

The reason for that is simple: If the rate of interest exceeds the rate of growth (in nominal terms), any debtor (sector) has to run a primary surplus in order to stabilize the debt-GDP-ratio (“dynamic budget constraint”). To achieve such a surplus, the non-financial business sector reduces real investment in favour of financial accumulation. At the same time, also financial businesses and households run primary surpluses (e. g., private households – a creditor sector - save usually more than their net interest income).¹⁾

Under this condition, the government can achieve a primary surplus only if the rest of the world runs/accepts a current account deficit (the primary balances of all sectors of any country sum up to zero). Since the current account (minus net interest payments) of the euro area as a whole is roughly in balance (figure 2), only governments of countries with (large) current account surpluses (like Germany) have a good chance to achieve primary surpluses. The other euro countries do have such a possibility only under very restrictive conditions (e. g., if households save less than their interest income). Conclusion: As long as the rate of interest exceeds the rate of growth significantly, more government saving will rather reduce economic activity than the public debt.

¹⁾ Figure 2 shows the inverse relationship between the financial balances of the non-financial business sector and the government sector for Germany and the euro area as a whole (the higher is the willingness of the business sector to take up credits the easier it is for the government to reduce its deficit. In the case of Germany, the fluctuations of the public budget are to a rising extent also counter-balanced by the current account (the higher the demand of the rest of the world for German products as compared to German demand for foreign goods and services, the easier becomes fiscal consolidation in Germany, and the more difficult it becomes in the partner countries). Figure 2 also shows that the non-financial business in Germany has been running surpluses already since 2004, its primary surplus is even higher (as a debtor sector, net interest payments of non-financial business are positive).

Figure 2: Financial balances in Germany and the euro area



Source: Eurostat.

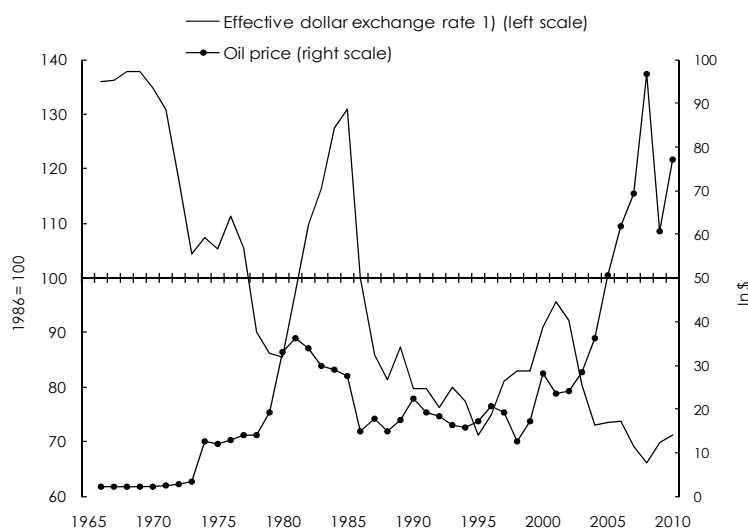
The relevance of the interest-growth-differential for the sustainability of private and public debt accumulation is confirmed by the empirical evidence. Over the 1950s and 1960s, this differential was significantly negative; at the same time the public debt declined almost continuously relative to GDP (in spite of the fact that the welfare state was strongly built-up at that time). Since the early 1980s, the interest-growth-differential has been almost continuously positive in European countries, and the debt-GDP-ratio doubled in spite of a more restrictive fiscal policy (figure 5). Also the development in the euro area since 2000 clearly demonstrates the relevance of the interest-growth-differential for the dynamics of the public debt (compare the development in Germany and Spain in figure 6).

Real capitalism and finance capitalism

The switch in the relation between the rate of interest and the rate of growth was just one important component of the transformation process which fundamentally changed the incentive conditions of market economies between the early 1970s and the early 1980s.

During the "golden age of capitalism", e. g., over the 1950s and 1960s, stable exchange rates and commodity prices together with a negative interest-growth-differential and almost "dormant" stock markets channelled the search for profit to the real sphere of the economy ("real capitalism"). The business sector used household savings to finance the continuous expansion of real investment. Given strong and stable economic growth at full employment, governments could easily achieve a balanced budget over the medium run (it was the business sector which ran permanent deficits). Given the negative interest-growth-differential, the public debt declined continuously relative to GDP (figure 5). Even the extremely high debt-GDP-ratio of the US, the UK and France (the heritage of WWII) could easily be reduced.

Figure 3: Dollar exchange rate and oil price fluctuations



Source: OECD, IMF. - 1) Vis-a-vis DM, Franc, Pound, Yen.

Over the 1970s, the instability of exchanges rates, in particular of the dollar rates, and the related instability of commodity prices dampened business investment (the two oil price shocks were the OPEC reaction to the two preceding dollar depreciations – figure 3). This effect was strengthened by the switch in the interest-growth-differential in the early 1980s (due to an extremely restrictive monetary policy in order to fight inflation – figure 5). At the same time, financial innovations, in particular derivatives of all kinds, facilitated profit-seeking in financial markets. The sequence of "bulls" and "bears" in stock markets (their "manic-depressive fluctuations") is the outcome of (increasingly) short-term speculation under the framework conditions of "finance capitalism" (figures 3 and 4 – see also *Schulmeister, 2010A*).

All these developments together caused the business sector to shift investment activities from the real sphere to the financial sphere of the economy. This shift caused four long-term effects which reinforced each other (figures 2, 4 and 5):

- First, non-financial business in all industrial countries reduced its financial deficits, in some countries the business sector became even a surplus sector (e. g., in Germany, the UK, the Netherlands, USA – the primary surpluses of the business sector became even higher).
- Second, economic growth declined and unemployment rose in spite of the significant expansion of atypical employment of many kinds.
- Third, governments suffered from chronic deficits (the households' surpluses were no longer used up by the business sector).
- Fourth, given the positive interest-growth-differential, the public debt rose faster than GDP, in spite of strong efforts to limit this process (in particular in the EU since the early 1990s).

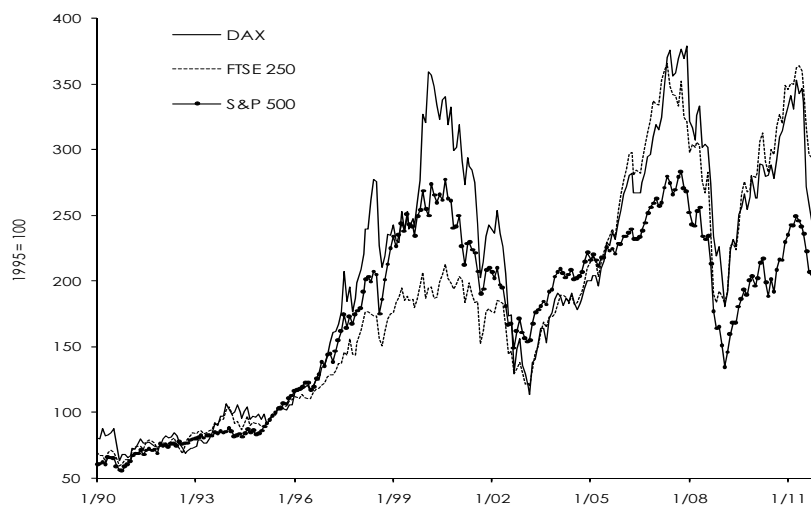
Hence, the empirical evidence suggests that the development of public finances is embedded into the overall economic performance (i. e., endogenous). As a consequence, governments need to take into account the repercussions of their fiscal policy on the private sector. Cutting expenditures and/or raising taxes is neither a necessary nor sufficient condition for consolidation. If private demand is weak, an austerity policy will even worsen the fiscal stance. This “thrift paradox” had become apparent during the depression of the 1930s, in particular due to the savings policy adopted in Germany by chancellor Brüning in 1931.

Finance capitalism and neoliberalism

From a systemic point of view, re-channeling the search for profit from the financial to the real sphere represents the most efficient and sustainable consolidation policy. However, such a strategy is difficult to implement for two reasons. First, one has to develop a coherent and comprehensive set of measures which would dampen “finance alchemy” and would reward entrepreneurial activities. Second (and more difficult), one has to emancipate oneself from the economic paradigm which has been prevailing over the past decades. This is so because the economic policy derived from this paradigm has shifted the search for profit progressively from the real sphere of the economy to the financial sphere.

The most important steps in the transition from a “real capitalistic” to a “finance capitalistic” incentive structure were the giving-up of a system of stable exchange rates (instead of repairing the flaws of the Bretton Woods rules), the adoption of a monetarist policy of extremely high interest rates (causing a switch in the interest-growth-differential), the progressive deregulation of financial markets, the boom of financial innovations (derivatives of all kinds), and the privatization of social security, in particular of the pension system.

Figure 4: Stock markets in Germany, United Kingdom and the USA



Source: Yahoo Finance (<http://de.finance.yahoo.com/m8>).

All these steps were legitimated by the neoliberal paradigm. At the same time, the new incentive structure caused the business sector to reduce real investment in favour of financial investment. As a consequence, economic growth declined relative to the “real capitalistic” period, unemployment and the public debt kept rising (figure 5). The prevailing diagnosis and therapy of these problems are again derived from the neoliberal paradigm. In the case of the public debt the diagnosis is: Governments have control over their financial balance and they just live beyond their means. The therapy is: Cut public spending.

Development of the current crisis

Under a “finance capitalistic” incentive structure, “bulls” and “bears” of asset prices become increasingly pronounced and exert an increasing influence on the real economy. The pre-history of the current crisis is an excellent example:

- The boom of stock prices in the 1990s and again between 2003 and 2007 as well as the boom of house prices between 1998 and 2005 stimulated the US economy through positive wealth effects. At the same time, however, the “twin booms” laid the ground for the subsequent “twin busts”.
- After the outbreak of the sub-prime mortgage crisis the third “bull market”, i. e., the commodity price boom, accelerated, mainly driven by speculation of financial investors in commodity derivatives markets.
- Since mid 2008 the devaluation process of stock wealth, housing wealth and commodity wealth was globally “synchronized”. This process set free several contraction forces, not only through wealth effects and balance sheet compression but also via import reductions on behalf of commodity producers.

The fall of stock prices and commodity prices has been strengthened by trend-following technical trading via taking huge short positions in the respective derivatives markets. Due to the extraordinary strength of these “bear markets”, hedge funds using these models reported higher returns than ever before.

The systemic causes of the crisis, e. g., the coincidence of three “bear markets”, were not recognized due to the predominance of the “free-market-Weltanschauung”. Instead, the crisis was attributed to the misbehaviour of certain (groups of) agents, be they greedy bankers and hedge fund managers, irresponsible central bankers or governments. Hence, the “finance-capitalistic” rules of the game remained basically unchanged.

When the global economy approached the brink of collapse in fall 2008, economists and politicians activated their long-term memory. They reacted to the economic contraction how policy should have reacted in the beginning of the Great Depression: The banking sector was saved and stimulus programs were adopted. However, it was not taken into account that (pseudo-keynesian) deficit spending policies cannot do their job under “finance-capitalistic” framework conditions. Banks took advantage of low interest rates to borrow from central banks and use the funds for speculation (also against sovereign states) instead of financing the real economy. In a similar way, non-financial corporations would not use additional funds due to tax reductions for real investment but could again engage in the game “let your money work”. And stock prices as well as commodities prices started to boom again.....

As a consequence, the cost-benefit-ratio of the stimulus measures turned out to be very disappointing. They prevented the crisis of 2008 from turning into a depression but they could not pave the way towards a self-sustaining recovery. At the same time, this “pseudo-keynesian” policy increased the public debt significantly providing the evidence for a re-interpretation of the crisis as a genuine “public-debt-crisis”. The unsustainably high debt levels in some countries like Greece or Portugal (where public indebtedness had already been too high when hit by the crisis) seemed to confirm this perception.

The different extent of the indebtedness of euro states provided the opportunity for financial investors to speculate on the default risks of sovereign debtors. Understandably, Greece became the first target: Its indebtedness got as high as that of Italy and Belgium, and at the same time the Greek government had hidden the truth (with the help of Goldman Sachs). Between October 2009 and May 2010, CDS premia and interest rates on Greek bonds soared (figure 1) forcing the EU to set up EFSF. However, this measure could not prevent the interest epidemic to spill over to Ireland, Portugal, Spain, Italy and France (step by step). In order to please the markets, austerity measures were strengthened but it did not help: CDS premia and interest rates continued to rise, economic growth started to decline, and this provided the justification for further interest rate increases.

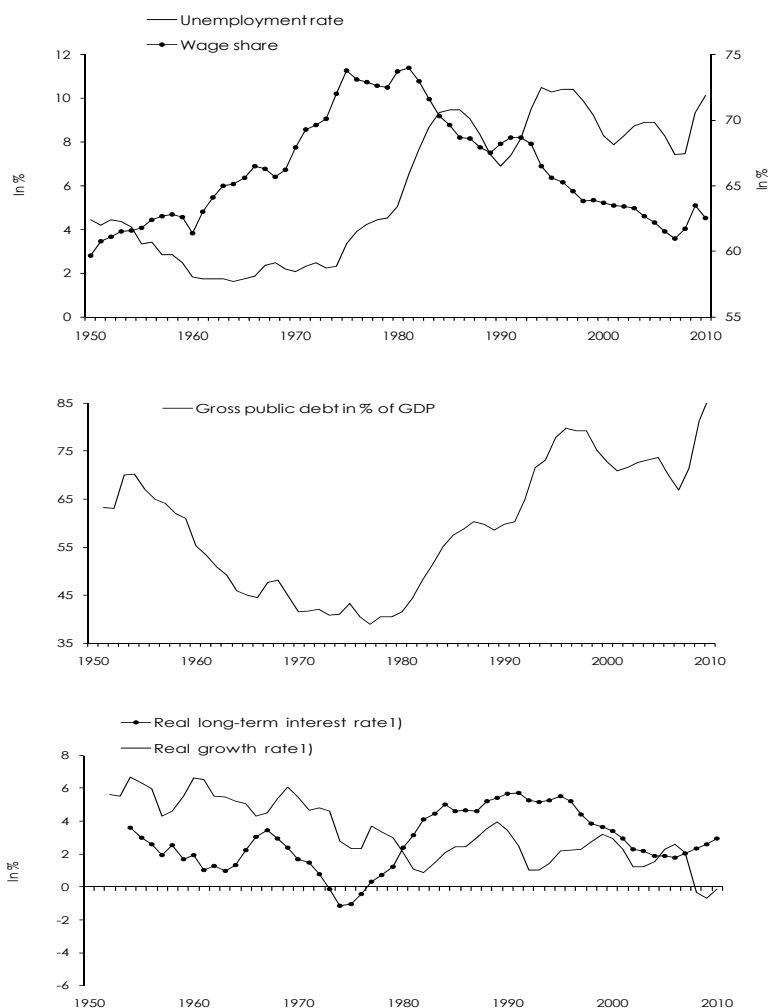
Thrift paradox and the stock market decline

Even though the symptom therapy of austerity is much simpler to communicate than the systemic approach, it has two shortcomings. First, it does not work under the conditions which

prevail in reality. Second, market participants lose confidence in a political leadership which has no other solution to offer but the prescription of “more of the same”.

The fast deepening of the “Greek crisis” is a clear example: As result of a too radical austerity policy, the economy shrinks so strongly that the fiscal consolidation falls behind the targets (the “free-market-paradigm” does not know about the “thrift paradox”). As consequence, the “troika authorities” call for more austerity measures. This reaction in turn intensifies tensions and fears in financial markets as agents know: More of the same won’t work.

Figure 5: Interest rate, growth rate and economic performance – Western Europe



Source: OECD. - 1) 3-years moving average, GDP deflators are used for both series.

The ongoing decline in stock prices confirms this presumption. Due to quarrels over the permissible debt ceiling in the US, stock prices started to retreat in the last week of July. This process was tremendously accelerated when the compromise between Democrats and Republicans was announced on August 1: The US government should cut expenditure by

1.5% of GDP over a period of 10 years, tax increases were excluded. Within a week, stock prices fell by 13% (S&P 500) and 19% (DAX). After a short recovery, share prices fell again after Merkel and Sarkozy announced on August 16, that every euro country should implement the so-called "debt brake". The third downward run was triggered on August 31 when it became clear that Greece would miss the budget targets and would intensify the savings policy.

These coincidences suggest the following. The distrust in the capability of political leaders to overcome the debt crisis and the disappointment that they only offered the old recipes, triggered waves of sell-offs. The attempt of individual stock investors to save the value of their wealth caused in the aggregate a dramatic devaluation of stock wealth (figure 4).

This paradoxical development reflects the loss of orientation on behalf of many owners and managers of financial wealth. They no longer strive for high returns, they would even accept no returns at all if only their capital as such would be safe. Hence, they sell bonds of "problem states" and buy US or German bonds, Swiss assets or gold. Owners of financial wealth desperately hope for clear signals of political leadership, they would welcome Eurobonds if only the institutional setting were stable and based on a political consensus.

Unfortunately, the political leaders have lost orientation themselves. Instead of conceptualizing new approaches to tackle the most oppressing problems like financial instability, public debt and unemployment in a comprehensive manner (all these problems are interlinked), politicians aim at pleasing "the markets" by adopting the old recipes.

In more general terms: The sub-system "politics" and the sub-system "financial markets" have both lost their orientation and seek "navigation advice" from the other system. Under this condition the overall system can easily slide into a downward spiral.

Position of the current crisis in the "long cycle"

In order to answer the question "where do we stand?" it is necessary to locate the position of the current crisis in the context of the latest "long cycle".

The trough phase of this cycle was the Great Depression of the 1930s and its consequences, i. e., the transition period from the "finance-capitalistic" conditions of the 1920s to the "real-capitalistic" conditions of the 1950s.

The learning process enforced by this crisis resulted in a new macro-economic theory (Keynesianism), an active economic policy focusing on stable growth and full employment, stable exchange rates ("Bretton Woods"), de-regulation of goods markets (e. g. though the GATT rounds), but strict regulation of financial markets. The essential characteristic of the system ("real capitalism") was the following: The driving force of capitalist development, striving for profits, was systematically directed towards activities in the "real economy". Under these conditions the "golden age of capitalism" was realized over the 1950s and 1960s.

The "monetarist counterrevolution" of the late 1960s got support from "big business" because permanent full employment had strengthened trade unions as well as the welfare state (too much). The stepwise realization of the monetarist/neoliberal demand for de-regulation of

financial markets (pushed forward by Friedman and Hayek) changed the "rules of the game" fundamentally. Under the condition of widely fluctuating exchange rates and commodity prices, and of a high interest-growth-differential, financial and non-financial business shifted activities from the "real economy" to financial investment and short-term speculation ("finance capitalism"). This shift was supported by the tremendous amount of financial innovations (i.e., derivatives of all kinds) which have been realized since the 1980s.

From this perspective, the current crises which has been deepening since 2007 marks the early phase of a transformation process from "finance-capitalistic" to "real-capitalistic" framework conditions – in other words: The beginning of the trough phase in the long cycle.

A "more-of-the-same" scenario

If the political leaders in the EU are unable to propose a fundamentally new approach to overcome the debt crisis, and rely on "more of the same" instead, the following development is plausible:

- The slide in stock prices develops into a genuine bear market, devaluating stock wealth by up to 70% relative to their peaks in spring 2011 (as already twice since 2000 – figure 4).
- Entrepreneurs and households reduce their investments and consumption, the latter in particular in reaction to the devaluation of their pension fund wealth.
- Prices of government bonds of euro countries like Spain, Italy, Belgium and France continue to fall, interest rates continue to rise. At the same time interest rates on government bonds of Germany and their "good satellites" decline even further.
- The economic and political split within the euro area widens, thereby weakening not only the euro and the EMU, but also the political coherence of the EU.
- Rating agencies continue to downgrade the most indebted euro states as well as those banks which hold a large part of government bonds of the respective countries. The whole banking system in the EU comes close to a collapse.
- The ECB and the governments fight this danger by increasing the "fire power" of the EFSF – they intensify the symptom therapy (necessary but not at all sufficient).
- The price of gold and other "safe-haven-assets" continue to rise.
- This is particular true for US government bonds. That country from which the great crisis originated will enjoy the lowest interest rates. There are three reasons for this paradox. First, investors are confident that the Fed will buy US government bonds to an unlimited extent (if necessary).²⁾ Second, the weakness of the EMU strengthens the authority of the Fed. Third, the dollar remains the unchallenged key currency in the global economy.

²⁾ De Grauwe (2011B) documents in a very recent paper that the Fed and the Bank of England have served as „lender of last resort“ to their governments to a much larger extent than the ECB. This behaviour has obviously strengthened the credibility of both central banks and also the attractiveness of US and British bonds.

- The "safe-haven-assets" cannot absorb the flight of finance capital out of stocks and bonds. Demand for cash rises which is hoarded at banks. At the same time, the asset side of the banks' balance sheet shrinks due to the devaluation of stocks and bonds, the banks' equity is wiped out.
- Commodity prices continue to fall. The related decline in (import) demand on behalf of commodity producers dampens (international) trade and production. As in 2008/2009, this effect is stronger than the (positive) real-income-effect of falling prices.
- Governments lack financial means to fight the symptoms of the crisis by a primitive deficit-spending-strategy as in 2009/2010.

The interaction of these developments and conditions will lead into a recession, probably followed by some kind of depression. The simultaneous devaluation of different types of wealth (stocks, government bonds, commodities, and eventually houses once again) strengthens the contraction process as between 2007/2009 and 1929/1933.

Challenges of the current situation

The transition from "finance-capitalistic" to "real-capitalistic" framework conditions, triggered by a stock market crash (e. g., 1873, 1929, 2007ff), usually takes many "depressive" years (e. g., 1873 to ~1890, 1929 to ~1948) as the old "rules of the game" don't work any longer but new rules have not yet been designed and implemented.

The dramatic events of recent months show: The attempts to restore the "finance-capitalistic" game by "pseudo-Keynesian" means have failed. Preventing a further deepening of the crisis, developing a systemic concept for a sustainable recovery, and putting such a concept into practice, is almost a "mission impossible".

However, a similar challenge was met after WW II (and in part already earlier through Roosevelt's New Deal): By learning the lessons from the Great Depression, economists and politicians were able to design new framework/incentive conditions which formed the basis for the "golden age of capitalism" in the 1950s and 1960s. Why shouldn't we be able to learn the lessons before a depression takes place?

Such a concept for new "rules of the game" or "New Deal for Europe" has to deal with the following issues:

- The fears of people that their financial wealth, in particular their pension capital, will be devalued a third time since 2000, must be contained (stock indices still stay roughly 25% below their 2000 peaks in spite of two bull markets).
- Confidence must be built up that the political leaders will be able to overcome the debt crisis and the euro crisis in a stepwise process.
- The incentive structure has to be changed so as to favour entrepreneurial activities and to dampen all kinds of "self-referential" accumulation of financial wealth, in particular short-term speculation unrelated to market fundamentals ("finance alchemy").

- The cohesion of the EU must be strengthened, at the same time no country should be put at a disadvantage through a new crisis strategy (otherwise the resistance against such a strategy would be too strong within member states).
- All that has to be achieved rather quickly and should not need large amounts of money.

The most urgent challenge concerns the global slide of stock prices. If it cannot be brought to a halt, a severe recession seems unavoidable. The most important prerequisite for stopping the bear market is the political consensus on a pragmatic concept for overcoming the euro crisis. Such a concept needs to stabilize interest rates in all euro countries at a sustainable level. To this end, the capability of speculators to drive up interest rates on government bonds of euro countries must be restricted.

This is necessary also for political reasons. These activities play euro countries off against each other and, hence, undermine the economic and political cohesion of the European (Monetary) Union: The more interest rates rise in the "problem countries", the lower they get in the "good countries" in particular in Germany. Instead of correctly valuating risk, bond and CDS speculation produces additional risk, in particular with respect to the EMU as a whole.

In a similar manner, short-term speculation causes exchange rates and commodity prices, in particular crude oil and food prices, to widely overshoot their fundamental equilibrium values. As part of new framework conditions also these prices need to be stabilized by economic policy in order to foster the real economy at the expense of "finance alchemy".

It is no coincidence that the two prices which intermediate between the real sphere and the financial sphere of the economy, i. e., the exchange rate (in space) and the interest rate (in time), were stabilized by economic policy in those periods/countries when/where the economic performance was particularly successful. These conditions prevailed over the 1950s and 1960s and also in present times in successful "real-capitalistic" economies like China.

The theoretical benchmark for stabilizing interest rates would be the (nominal) rate of economic growth to be expected over the medium run, for exchange rates the benchmark should be purchasing power parity of internationally traded goods and services (tradables). As an intermediate step regarding currency markets, the central banks of the US, the euro area, Japan and China (eventually also the UK and Switzerland) should commit themselves to stabilize their exchange rates within tight bands (e. g., +/-2%), taking the averages over the recent past as means (e. g., the average exchange rates since the creation of the euro).³⁾

³⁾ It might take some time to find a compromise on „fair“ exchange rate values, in particular, as the estimates of tradables PPP would imply a significant revaluation of the US dollar and a corresponding devaluation of the euro (as long as one does not also take into account the different degree of external indebtedness). In any case, exchange rate stability as such would strongly facilitate entrepreneurial activities and restrict speculation. This is particularly clear if one recapitulates how strongly currency fluctuations have hampered the real economy since the early 1970s. E. g., the overshooting of the dollar exchange rate and of the oil price are inversely related to each other, at least during periods of marked "bull markets" and "bear markets" (since crude oil is priced in dollars, depreciation of the key currency devalues real oil export earnings - this valuation effect in turn strengthens the incentive for oil-producing countries to increase the price of their most important export good as 1973 and 1979).

As regards crude oil prices, one has to take into account two peculiarities. First, crude oil is an exhaustible resource the price of which needs to increase in equilibrium with the rate of interest stronger than the general price level (Hotelling rule). Second, the use of crude oil is the most important cause of climate change. To compensate for these externalities, economic theory suggests that oil prices should become permanently more expensive than all other goods (which do not cause negative externalities). In reality, however, the wide fluctuations of crude oil prices bring about a waste of this resource, a deterioration of the environment and hamper investment in energy saving technologies.

Even though one cannot precisely quantify by which margin crude oil prices should rise faster than the general price level, it is clear that any bargaining solution between OPEC and the EU which causes the real oil price to rise steadily would do a better job than the market which produces price changes of 50% and more (upward and downward) within a few months.

The most urgent challenge is the stabilization of interest rates on government bonds at a level below the rate of economic growth as this is a prerequisite for fiscal consolidation over the medium and long run, and, hence, for restoring confidence in the political and financial system in the EU. The markets have proved unable to provide sustainable long-term interest rate levels. Therefore, this task has to be taken over by the European Monetary Fund in a similar way as the ECB controls the level of the short-term interest rate.

Features of the European Monetary Fund

The European Monetary Fund (EMF) coordinates and manages public finances of euro member countries in such a way that the crisis in Europe can be overcome in a sustainable manner. This crisis is not just an economic crisis but also a social and political crisis. It calls for the implementation of new framework conditions which would reward entrepreneurial activities on all levels (macroeconomic policy, tax policy, regulatory policy, etc.) more than finance alchemy. The EMF is one core component of such a "New Deal for Europe".

Scope and principles

A systemic problem needs a systemic solution which restores the primacy of politics over speculation. It is proposed to transform the European Financial Stability Facility (EFSF) into the European Monetary Fund (EMF). The scope of the EMF is fourfold:

- The EMF provides euro governments with financial means by selling Eurobonds in the capital markets. These bonds are guaranteed by all euro countries to an unlimited extent. In addition, the EMF has full backing by the ECB (if necessary, the ECB buys Eurobonds from the EMF).
- The EMF stabilizes Eurobond interest rates at a level slightly below the level of medium-term economic growth (in nominal terms). The Eurobonds are held by investors with the EMF, they are not tradable but can be liquidated at any time. In these two respects the present proposal differs most from Eurobond concepts already put forward.

- The EMF helps to restore sound public finances in euro countries according to a systemic approach and, hence, in close cooperation with the ECB, the European Commission and national governments. To this end, the EMF provides funds for the euro states according to clear criteria ("conditionality") which are not exclusively restrictive.
- The EMF overcomes the split between euro countries caused by widening interest rate differentials and strengthens thereby the cohesion and credibility of the EMU and of the EU as a whole.

The fundament for achieving these goals has already been built by European leaders: The European Financial Stability Facility (EFSF) set up in May 2010 could be transformed into the European Monetary Fund. Simply enlarging the "fire power" of the EFSF or implementing the European Stability Mechanism (ESM) already in 2012 won't be sufficient by any means.

Motives

With the deepening of the fiscal crisis in some euro countries several proposals have been made to introduce new instruments for financing (in part) euro governments (*De Grauwe - Moesen, 2009; Gros, - Micossi, 2009; Delpla - von Weizsäcker, 2010; Gros - Mayer, 2010; Palley, 2011*). These Eurobonds should be sold up to a certain limit (e. g., "Maastricht debt limit" of 60% of GDP) either by the single countries or by a new institution, backed by the guarantee of all 17 euro states.

The main argument in favour of Eurobonds is as follows. In a monetary union, member states do no longer have the possibility to devalue their currency in case of a (asymmetric) shock and the governments do no longer have access to financial means provided by "their" central bank. "As a result, a loss in confidence of investors can in a self-fulfilling way drive the country into default" (*De Grauwe, 2011A, p. 32*).

The main argument for limiting the access to Eurobond financing for the single countries lies in the "disciplining effect of the higher marginal cost of borrowing" (*Delpla - von Weizsäcker, 2010, p. 4*). This is so because having fully used the capacity of Eurobond financing ("blue bonds" in the terminology of *Delpla - von Weizsäcker, 2010*), the single countries need to sell national ("red") bonds in the capital markets. The markets then would discipline irresponsibly acting governments through high interest rates.

Palley (2011) proposes the foundation of a "European Public Finance Authority" (EPFA) which "would continuously issue bonds as part of assisting euro zone countries with normal budget deficit financing. The goal is to make this a normal element of budget deficit financing." (*Palley, 2011, p. 17*).

The EMF concept - sketched in *Schulmeister, 2010B* - is similar in spirit to the EPFA proposal but goes beyond it in two respects (the first politician who coined the term "European Monetary Fund" was the German finance minister *Wolfgang Schäuble* in spring 2010, the first paper on an EMF concept is *Gros - Mayer, 2010*):

- The EMF fixes the interest rate on Eurobonds, i. e., it determines the long-term interest level in a similar way as the ECB determines the level of the short-term interest rate.
- The Eurobonds are held by investors with the EMF, they can always be liquidated but they are not traded in capital markets.

There are two main reasons for making also the long-term interest rate a target as well as an instrument of economic policy.

First, this approach enables economic policy to stabilize the interest rate on future credits of euro states at a level below the (expected) medium-term growth rate (in the EPFA proposal, this could be indirectly achieved through open market operations of the ECB). In this way, also the interest rate on corporate bonds would be reduced. Such an improvement in the financing conditions for the business sector and the government sector is a precondition for a sustained recovery and, hence, for a gradual reduction of public indebtedness.

Second, controlling the long-term interest rate enables the EMF in cooperation with the ECB and the EC to set the interest rate close to the level enjoyed by the "good countries" like Germany. This will help to overcome the resistance from national-populist politicians and media within the "good countries" against Eurobonds.

Eurobonds should not be traded in capital markets because otherwise financial investors might start to speculate against or in favour of Eurobonds relative to government bonds of the US, the UK, Japan or some smaller states. Even though this game would be less easy than playing off member countries of a monetary union against each other, it is nevertheless superfluous. If this proposal were put in practice, CDS with reference to debts of euro governments would disappear as neither hedging nor speculation makes sense any longer.

In addition, banks would no longer get rents by borrowing at the ECB at low rates and investing in government bonds at high rates. This business does not add any value to the overall economy (just profits to the banks), in contrast to financing firms where the banks' seeking for the best investment opportunities can – in principle – improve the allocative efficiency. It seems reasonable that investors finance governments directly. This possibility exists already in many countries (German "Schatzbriefe" etc.), it should be generalized at the level of the EMU through the foundation of the EMF (Eurobonds could therefore also be conceived as fully liquid savings deposits of financial investors held with the EMF. The ECB serves as lender of last resort, however, to the EMF as intermediary which substitutes private banks).

Stabilizing the values of government bonds might also mitigate the fluctuations in the valuation of corporate bonds. The experience since the 1970s suggests that changes of asset values and the related wealth effects have strongly contributed to shifting striving for profits from entrepreneurial activities to financial speculation. Stabilizing the value of government bonds will help to gradually change the incentive structure in favour of the real economy.

But what about the price discovery process provided by capital markets? Don't they fairly evaluate the performance of states and, hence, their credibility, supported by rating

agencies? The answer is: No. The reason for this is simple: States are not corporations. The purpose of the latter can – in principle – be reduced to making profits and future profits can be reflected in just one variable, the stock price, for which markets (supported by rating agencies) can – in principle – bring about unbiased estimates. States have multiple functions, none of which relates to profit making. Hence, the performance and credibility of a state can – in principle – not be measured by just one price, the bond price (rate of interest).

If one conceives financing the “res publica” as an investment opportunity like any other, one can of course become trapped in mixing up firms and states. Once the (economists’) elites have emancipated themselves from this neoliberal heritage they can devote their intellectual capacity to the complex task of improving the management of public affairs. Letting the market punish the “delinquents” for mismanagement or reckless spending by raising interest rates to “death sentence” levels only makes the situation worse (in particular for those who have nothing to do with economic policy or “finance alchemy”).

Governance

All euro countries are members of the EMF. The contribution to the fund's equity as well as the voting rights could be allocated according to the economic strength of the members or the population (or some combination). This issue is left open to the political decision process.

The EMF is governed by the finance ministers of the member states (a counter-balance to the ECB where central bankers dominate), they decide together on the amount of Eurobond sales and their distribution among its members. The latter is strictly bound to several criteria. This conditionality ensures that no member country can act as free rider.

In contrast to most Eurobond proposals (but in line with *Palley, 2011*), there should be no general limit for Eurobond financing, it should become the normal way to fund euro states as they are members of a monetary union.

If a country does not comply with the criteria for EMF funding, it will not get funds and, hence, has to rely on selling their national bonds for which they would have to pay unsustainably high interest. Knowing this in advance, highly indebted governments will stick to the consolidation measures accorded with the EMF and the EC. In other words, the disciplinary power of the EU authorities is much higher if government financing is provided by the EMF as compared to the extant situation where governments could rely on the reckless lending by banks.⁴⁾

The common and unlimited guarantee of Eurobonds by all 17 euro states together with the backing by the ECB ensure that defaults on Eurobonds are only possible if the whole financial

⁴⁾ A thought experiment might clarify this issue. If any additional credit to an euro government had needed the permission of the EC, countries like Greece or Portugal would have had much smaller budget deficits than they actually did. It were „the markets“ which completely failed to discipline the debtors. After supporting the misbehavior of governments for years, „the markets“ all of a sudden turned from „no punishment“ to „death sentences“. This behavior is in line with the two fundamental diseases from which the invisible hand suffers in financial markets: Over the long run, it suffers from manic-depressive illness, and over the short run from strong Parkinson.

system collapses (in which case it does not matter). In this way, the EMU would achieve a similarly strong position vis-a-vis financial investors as the US where the Fed backs government bonds to an unlimited extent. This is the main reason for the attractiveness of US bonds in spite of the weakness of the US economy. Investors know that given the Fed's support, default on US government bonds is (almost) impossible.

The present proposal provides the same degree of security for Eurobonds. Hence, global demand for these instruments will be strong. There are two additional reasons for that. First, only the US would supply a comparable amount of public securities to big investors in the global economy like central banks and pension funds. Second, the real economy in the euro area is stronger than in the US (the European weakness stems from fundamental inconsistencies in the financial sphere which would be overcome by the EMF).

Stabilizing long-term interest rates in the euro area at a level below the rate of economic growth will stimulate real investment as a prerequisite for a sustained recovery. Only under this condition can the fiscal stance be improved over the medium and long run. Such a development would prevent sovereign defaults and, hence, the necessity of "good" countries to bail out the "bad" ones.

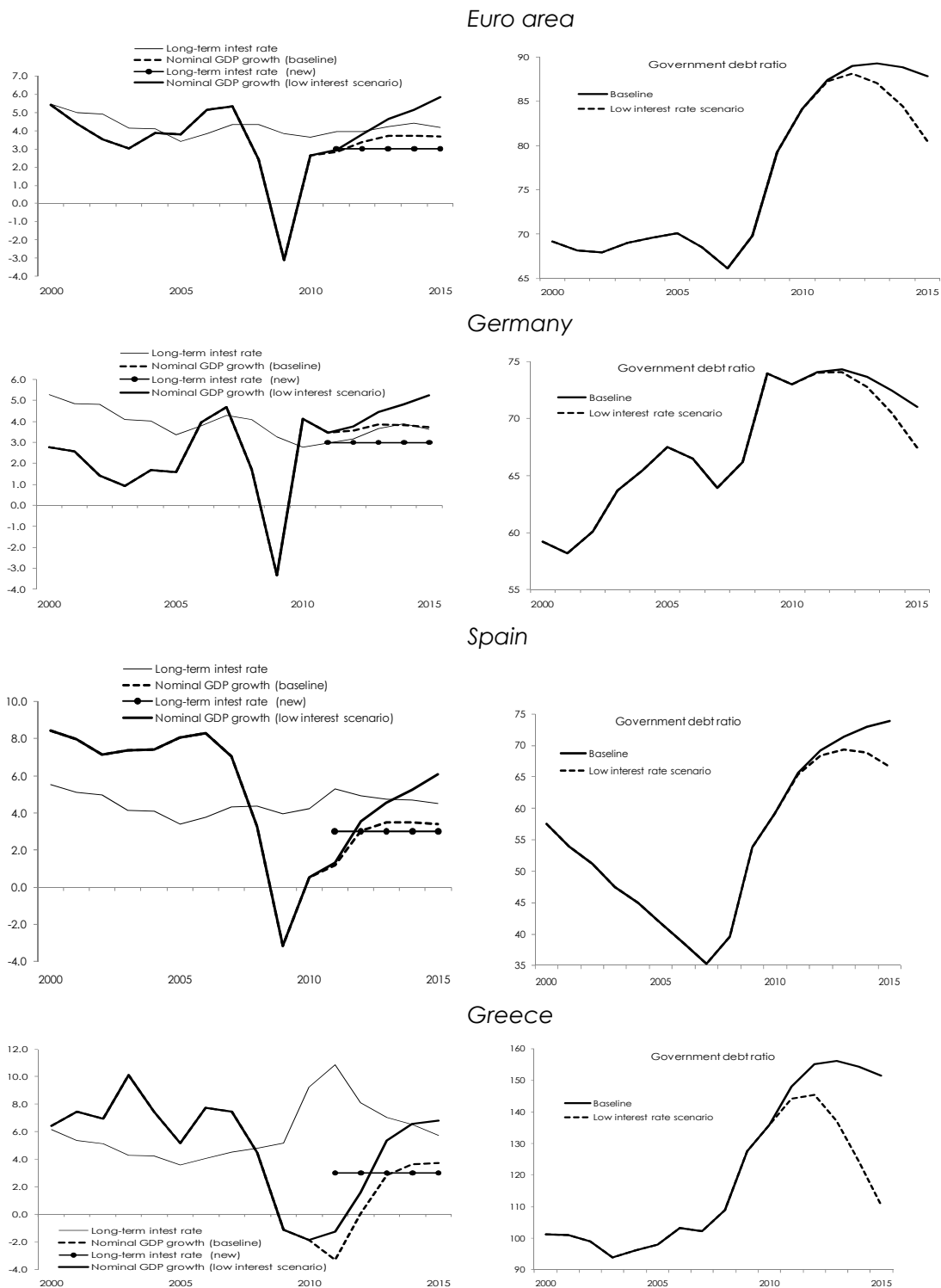
If, by contrast, policy accepts the formal insolvency of an EMU member state, much more capital has to be mobilized. Even though it might be politically easier to put through tax increases within a single nation state to save "our" banks (victims of the reckless policy of "bad" countries....) than to bail-out countries like Greece or Portugal (no transfer of "our" money to "lazy" people.....), not preventing defaults will be much more costly - not only financially but also socially and politically.

The resistance of nationalist-populist media and politicians could be overcome if one shows that avoiding defaults does not need tax-payer's money but a change in economic policy, i. e., transforming the long-term interest rate from a market price to an instrument variable. Such an idea will meet strong resistance from mainstream economists (like the financial transactions tax). This resistance can be mitigated in three ways:

- By looking concretely how the interest rate is determined in the CDS and bond markets and which role destabilizing speculation plays in this process.
- By showing that stabilizing long-term interest rates in all euro countries provides the basis for a gradual overcoming of the financial and economic crisis.
- By clarifying that there is no alternative (TINA) to stabilizing interest rates.

As regards the second point, I shall summarize the results of an econometric exercise. In spring 2011, I simulated the effects of stabilizing long-term interest rates in all euro countries at 3% using the medium-term econometric model of Oxford Economics ("Oxford model").

Figure 6: Interest rate, growth rate and debt ratio in the euro area, Germany, Spain and Greece



Source: Oxford Economics, WIFO.

The effects of stabilizing long-term interest rates in the euro area at 3%⁵⁾

At first, we look at the relevance of the interest growth differential (figure 6). Between 2000 and 2005 this relation was strongly positive in Germany: Despite sizeable efforts to cut spending the government debt ratio increased markedly. In Spain, by contrast, the level of long-term interest rates was significantly below the nominal growth rate: Despite strong increases in spending, government debt decreased substantially until 2007.

The most important “channels” via which the interest growth differential affects the debt trend are not the direct effects (reduction of the government's interest payments), but the indirect effects due to companies increased or reduced willingness to invest.

The results of the model simulation elucidate these relationships. If the short-term and long-term interest rates in the euro area were stabilized at 1.5 % and 3 %, respectively, aggregate output (GDP) in the euro area would be 5 percentage points above baseline in 2015. Correspondingly, the unemployment rates would decline markedly as well as public deficits and debt. At the same time, inflation would be 0.7 percentage points higher on average than in the baseline. The interest growth differential would thus become even smaller, i. e., more negative (dynamic feedback effect – figure 6).

A stabilization of euro area interest rates at a low level contributes the more to an improvement of public finances, the higher the initial level of government debt and of bond yields. Correspondingly, until 2015 government debt ratios would decline most in Greece, Ireland and Italy. However, even in countries like Germany and France a determined low interest policy would entail substantial consolidation effects. This is the case, because, unlike a policy of spending cuts or higher taxes, a low interest strategy facilitates consolidation by economic expansion.

In a recent paper *Cline (2011)* shows that Greece could reduce its debt-GDP-ratio gradually, provided the rate of interest is kept at 3.5% as decided by the EU Council in July 2011. If all euro countries would profit from lower interest rates, such a debt reduction could be achieved even easier due to positive feed-backs within and between euro countries.

As the debt situation has been worsening over recent months, causing interest rates to rise further in countries from Greece to Italy, and to fall in Germany below 2%, it would be advisable to stabilize the interest level at 2% (as in the US). In this case, the positive effects on the real economy and on the gradual reduction of the debt-GDP-ratio of governments would be significantly higher than shown in figure 6.

From the creditors' point of view a comprehensive low interest policy means foregoing part of their interest income. In this way they enable the debtor states to service their debt in the long run. The creditors' overall loss will turn out much smaller than in the case of (abrupt) restructuring (“haircuts”).

⁵⁾ This exercise was part of a joint project of three research institutes, IMK (Düsseldorf), OFCE (Paris) and WIFO (Vienna) published in IMK (2011). This section draws on this report.

There is no alternative to stabilizing interest rates

Most proposals for overcoming the financial and economic crisis in the euro area perceive the problem primarily as a "Greek debt crisis" - the systemic causes are widely neglected. As a consequence, the therapies aim at providing some relief for Greece and attempt to isolate the other "problem countries" from contagion. These symptom therapies do not provide a sustainable solution as the key issue remains untouched: The markets set interest rates at unsustainable levels and drive more and more wedges between euro countries by widening the interest rate differentials.

If economic policy cannot achieve direct control over long-term interest rates the following vicious circle seems inevitable:

- The economies are already heading for recession so that the consolidation targets will not be reached.
- This causes rating agencies to downgrade states as well as banks. The latter have to be recapitalized.
- The economic slow-down and the additional funds needed for stabilizing the banking system cause the fiscal stance of euro countries to deteriorate markedly.
- CDS premia and interest rates rise for many "problem countries", including Spain, Italy, Belgium and France.
- The attempt to "please" the markets by adopting additional austerity measures deepens the recession.

In addition, one has to keep in mind that an "orderly" default of a sovereign state on its debt is impossible if a large share of this debt is held by foreigners. The reason is simple: There are no rules and supranational institutions to manage such a default in an orderly manner. This might change due to the implementation of collective action clauses but will concern only debt taken up in the future.

In addition, it is more than doubtful if collective action clauses help at all. *De Grauwe* argues convincingly that these provisions would make individual member countries of a monetary union more vulnerable to debt crises triggered by a change in confidence: "Instead of alleviating this problem the collective action clauses will intensify it, because with each decline in confidence bondholders will 'run for cover' to avoid losses, thereby triggering a crisis." (*De Grauwe*, 2011, p. 25).

How to organise short-term debt relief for Greece and other "problem countries"

The best way to provide the urgently needed debt relief for countries like Greece or Portugal and to calm financial investors consists of exchanging government bonds of the respective countries for new instruments at a significant discount (and/or longer maturities or lower interest rates. These bonds (they might be termed "Merkel-Sarkozy-Bonds") would be guaranteed by the EFSF and enable the creditors to smoothly restructure their balance

sheets. At the same time, also the level of public debt in the “problem countries” would gradually decline.

This type of “soft” debt restructuring was successfully practiced in the late 1980s to help debtor countries in Latin America as well as their foreign creditors to restructure their financial balances (“Brady bonds”). Soft solutions always work better in times of financial distress than abrupt cuts (“shock therapies”). A good example for that is the “Vienna initiative” of 2009 which avoided large-scale defaults of debtors in Eastern Europe by softening credit conditions.

Conclusion

The main causes of the deepening of the euro crisis are systemic. The financial crisis of 2008/2009 deteriorated the fiscal stance of all countries. However, euro countries as member of a monetary union became specifically vulnerable to shift in investors' sentiments as they have neither the possibility to devalue nor to rely on central bank funding (systemic factor I). Under “finance-capitalistic” incentive conditions, short-term profit-seeking brings about “manic-depressive” fluctuations of exchange rates, commodities prices, interest rates and stock prices. Speculative activities caused interest rates on government bonds of several euro countries to rise to unsustainable levels since fall 2009 (systemic factor II). At the same time, interest rate differentials within the euro area widened drastically. This development endangers the economic and political cohesion of the EMU (systemic factor III).

A systemic problem needs a systemic solution which restores the primacy of politics over speculation. It is proposed to transform the European Financial Stability Facility (EFSF) into the European Monetary Fund (EMF). The EMF provides euro governments with financial means by selling Eurobonds in the capital markets. These bonds are guaranteed by all euro countries to an unlimited extent. The EMF stabilizes Eurobond interest rates at a level slightly below the level of medium-term economic growth (in nominal terms). The Eurobonds are held by investors with the EMF, they are not tradable but can be liquidated at any time. The EMF helps to restore sound public finances in euro countries in close cooperation with the ECB, the European Commission and national governments. To this end, the EMF provides funds for the euro states according to clear criteria (“conditionality”) which are not exclusively restrictive (they should comprise “Marshall-plan-elements”).

Such a solution does not cost much money. What it costs is the efforts to reconsider the most fundamental assumptions of that economic “Weltanschauung” which has been restored over the past four decades. Admitting errors is painful, sticking to them even more (for others).

References

- Cline, W. R., Sustainability of Greek Public Debt, Peterson Institute for International Economics, October 2011.
- De Grauwe, P., The Economics of Monetary Integration, Oxford University Press, 1992.
- De Grauwe, P., Moesen, W., "Gains for All: A Proposal for a Common Euro Bond", in: *Intereconomics*, 44 (3), 2009, pp.132-135).
- De Grauwe, P. (2011A), A Fragile Eurozone in Search of a Better Governance, CESifo Working Paper No. 3456, May 2011.
- De Grauwe, P. (2011B), The European Central Bank: Lender of Last Resort in the Government Bond Markets? CESifo Working Paper No. 3569, September 2011.
- Delpla, J., von Weizsäcker, J., The Blue Bond Proposal, Bruegel Policy Brief 2010/3, May.
- EC White Paper on Growth, competitiveness, and employment. The challenges and ways forward into the 21st century, (COM (93) 700 final).
- Gallagher, K. P., The New Vulture Culture: Sovereign debt restructuring and trade and investment treaties, IDEAs Working Paper Series, Paper 2/2011.
- Gros, D., Micossi, S., A bond-issuing EU stability fund could rescue Europe, *Europe's World*, spring 2009.
- Gros, D., Mayer, T., Towards a European Monetary Fund, CEPS Policy Brief, 2010.
- Gros, D., Mayer, T., Debt Reduction Without Default, CEPS Policy Brief, 2011.
- Holland, S., The European Imperative: Economic and Social Cohesion in the 1990s. Foreword by Jacques Delors, Nottingham: Spokesman Press, 1993.
- IMK, The euro area at the crossroads, First joint analysis of the Macro Group (IMK, OFCE, WIFO), IMK Report 61, April 2011.
- Jones, E., A Eurobond proposal to promote stability and liquidity while preventing moral hazard, ISPI Policy Brief, number 180, March 2010.
- Palley, T. I., Monetary Union Stability: The Need for a Government Banker and the Case for a European Public Finance Authority, IMK Working Paper, 2/2011.
- Peirce, P., Micossi, S., Carmassi, J., On the Tasks of the European Stability Mechanism, CEPS Policy Brief, 2011.
- Schulmeister, S. (2010A), Boom-Bust Cycles and Trading Practices in Asset Markets, the Real Economy and the Effects of a Financial Transactions Tax, WIFO Working Paper presented at the IMF on March 15, 2010.
- Schulmeister, S. (2010B), Mitten in der großen Krise – ein ‚New Deal‘ für Europa, Picus Verlag, Wien, 2010.