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Eurozone reform: A proposal

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Current events surrounding the Greek debt crisis call for further thought about the stability of the Eurozone as a system. There must be something fundamentally wrong if the possible default of a country engaged in irresponsible fiscal policy and accounting for only 3% of the Eurozone's GDP can raise questions about 'saving the euro' and the survival of Eurozone. Where is the logic?

In June 2009, the state of California handed employees IOU's, so-called vouchers, for payment. The incident has not been recognised as a default only because banks have honoured the vouchers thus far; but costlier and incontestable default still lies ahead as a significant probability. This is reflected in the spreads on the credit default swaps on state bonds and the credit ratings of the bonds. The Californian economy is four times larger relative to the US than the Greek economy is relative to the Eurozone. Yet nothing remotely resembling the concern and turmoil in Europe about Greece has occurred in the US regarding California. Nor have California's recent or prospective future breaches of contract caused a ripple in the US financial sector, not even the part of it heavily implanted in California. Any reference to a problem for the US dollar would court ridicule. What is the difference?

Is it that the Greek deficit is a threat to independent monetary policy of the ECB? Yet the Maastricht Treaty rules out any influence of member governments on the ECB's policies and there is not the vaguest sign of such influence. Quite the contrary, the ECB has maintained exemplary monetary control during recent months of exploding government deficit spending. No critics have thus far faulted the ECB for excessive monetary laxity under the pressure of deficit spending by member governments.

Is it that Greeks cannot count on help from the rest of the euro members whereas Californians can rely on help from the rest of the nation? One might think so judging from the press. But ironically, the opposite is closer to the truth. The Greek government has already received significant aid through the commitment of Eurozone governments to lend below market rates and now stands a good prospect of last-resort assistance from the rest of the Eurozone while any form of aid to California by the US federal government remains in the dark. Of course, given the dimension of both governments' deficit problems, default could still follow in Greece and help could still come from the rest of the US to California. But what explains the sense of pressing danger in one case but not the other? There is a no bail-out clause in the Maastricht Treaty, which should have ruled out some of the recent discussion. Why is a Greek government default such a threat in the Eurozone that some way to avoid it must be found - even at the price of the resulting political frictions that are now convulsing the whole system?

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Perhaps the difference has to do with network externalities and the payments system. There may be something to this. The Californian economy may be much larger than the Greek one in absolute size and relative to the common currency area to which it belongs, but the size of the looming default in California is smaller than the one in Greece. The financial impasse in California quoted in the press after the problem blew wide open last June was around $20/$30 billion during the then-current fiscal year while the corresponding figure for Greece was around €50/€60 billion (around $70/$85 billion) when the Greek problem made the headlines this February. Therefore, the entire financial system may be less at risk in the US than it is in the Eurozone.

But this reasoning can be questioned. US states have lower tax powers than Eurozone national governments, and therefore a Californian default might threaten deficit financing by other US states more markedly than a Greek default can threaten deficit financing by other national governments in the Eurozone. On the other hand, the ratio of deficit spending to GDP by national governments in the Eurozone is much higher than the similar ratio of deficit spending to state output by state governments in the US. In addition, most of Californian debt is held within the state (largely because of the federal tax exemption for residents), while about 70% of the Greek debt is held outside of Greece (The Economist 2010). Further, the Federal Reserve has more power to deal with liquidity problems of individual banks in the US than the ECB has to deal with similar problems in the Eurozone. These last considerations are serious and make it difficult to dismiss the thesis of the wider implications of a Greek default than a Californian one for finance in the two respective currency areas and I will propose a European reform that bears on this reasoning.

Explaining the difference

Still, in my opinion, the main explanation for the difference lies elsewhere. The European problem is largely self-inflicted. There have been repeated affirmations by the ECB and government officials in Eurozone member countries that fiscal discipline and the Stability and Growth Pact are the very foundation-stone of the Eurozone. This can only mean that Greek default is a big problem for the euro. On this view, the Eurozone is partly a victim of its own self-representation.

In the past, supporters of the Stability and Growth Pact may have felt that their doctrine was simply good politics. The doctrine could only encourage fiscal discipline, which was highly desirable in any event. Those who questioned the central role of the Pact in the monetary union - largely academics like myself - could treat the doctrine as relatively harmless since the manifest violations of the Stability and Growth Pact had had no visible impact on the performance of the ECB and the euro. But recent events surrounding the Greek crisis cast grave doubt on both of these attitudes.

> **Government defaults are a fact of life. If the Eurozone cannot endure them, it has no long-run future**

Financial markets clearly give credence to the official view that any government default in the Eurozone would weaken the monetary union . What these markets believe makes a lot of difference. We see the evidence everywhere, not only in the spreads on credit default swaps that emerged on Portuguese and Spanish government bonds earlier this year, and the rise in the risk premium on the Portuguese government debts that has persisted since January, but probably (though some of us doubted it at first) in the depreciation of the euro since January. Financial markets can act quickly enough to make their fears come true.

We must therefore directly confront the question of the connection between government defaults and the soundness of Eurozone as a monetary system. Government defaults are a fact of life, as Reinhart and Rogoff (2009) have recently reminded us. If the Eurozone cannot endure them, it has no long-run future. Even if the system lasts another decade, the question is not if but when the system will fold. History may offer many examples of monetary systems that survived government defaults but none of them resemble the Eurozone. If substantial political unification is the price that must be paid for the survival of Eurozone, as some respected observers think, then once again, the Eurozone probably has no long-run future. The Eurozone can only be a stable monetary arrangement if it can tolerate an occasional default by a member government without much further political unification. But in that case, must that not also be official doctrine?

That is the point of this note. So far as I can see, there is little reason why Eurozone should view government defaults with any greater alarm than any other central bank management in the world would view government defaults within its territory. To the contrary, the Eurozone is particularly well armed to deal with such defaults, since its own central bank has no large central government to contend with, the Maastricht Treaty guarantees the central bank's independence and member governments are explicitly forbidden to bail-out one another. There is almost no prospect that a Greek default, even if it were succeeded by a Portuguese one, would raise the risk premium on German, French, Dutch or Austrian government debts. The only problems posed by government defaults for any monetary union come from financial instability and loss of monetary control. Those are the only problems the Eurozone should recognise.

Accordingly, must not the official doctrine change? Should it not be that nothing so manageable as a Greek government default can upset Eurozone? In the event of a Greek government default, the system would assure the stability of the Greek financial sector, and concern itself with any bank runs or bank failures in the country, but not with the Greek government's difficulties. In step with this doctrine, government bail-outs will never be contemplated. The Stability and Growth Pact will continue to serve as a code of good fiscal conduct for all members of the EU. But if any individual member government engages in irresponsible fiscal conduct, contrary to the Pact, its taxpayers and the creditors will bear the consequences. The Eurozone will only act to assure the stability of the financial sector in the Eurozone and the lack of any repercussions of undisciplined government spending behaviour on the risk premiums that the rest of the governments in the Eurozone need to pay. There has been some confusion on this matter in the past; there will be none in the future.

The ECB as a guardian of financial stability

In accordance with this doctrine, it may be important to shore up the claim that the euro financial sector can withstand the shock of a sovereign default. With that issue in mind, I propose a reform that aims to strengthen the ECB as a protector of financial stability in the Eurozone. It is true that the ECB is not as fully equipped today as some other central banks in the world to confront problems of prudential behaviour and lack of liquidity of individual banks. My proposed reform would change that. It would provide the ECB a supervisory role over banks in the Eurozone and power to act as lender of last resort. Nothing in the Maastricht Treaty forbids either change.

The propagation of moral hazard is flagrant and must be addressed. Eurozone governments clearly have more hope now than ever before of a bail-out in case of difficulty.

All banks in the Eurozone would acquire the possibility of adopting an EU charter. EU-chartered banks would become sole tax subjects of the EU. The EU would collect all taxes on these banks and return the receipts to the member governments, just as it does for seigniorage. As described thus far, the change is simply an extension of the treatment of seigniorage to cover bank deposits. The system could be devised so that in the initial year of adoption of an EU charter by a bank its tax obligations and the current home government's income receipts remain exactly the same. Thereafter, changes would come based on a formula that would leave no scope for discretion by the EU, as in the case of seigniorage. Some important legal aspects would need separate attention. For example, the reform must not open the door to tax evasion and therefore EU-chartered banks would still need to comply with home-government regulations about tax collection from bank clients.

Next, all EU-chartered banks would come under EU supervision. The ECB would not necessarily be the sole supervisory authority but could share this authority with current national ones (who possess valuable experience and firsthand knowledge of individual banks). Finally, the ECB would be able to provide lender-of-last-resort services to EU-chartered banks. This package of reforms would then render the ECB as well armed as any other major central bank today to deal with problems of financial stability.

There are four basic benefits of the programme.

- First, and very significantly, it would reinforce the proposed change in official doctrine.
  The Stability and Growth Pact could still be vaunted on its own merits. Fiscal discipline could still be treated as a major collective good contributing to financial stability in the Eurozone. But the new message would be that the Eurozone is fully prepared to maintain monetary and financial order in the face of imprudent government spending behaviour by a minority.
- Second, financial markets would know that governments in financial straits would lose their ability to burden their financial sector at home in order to manage their problems.
  Governments in difficulty often lean heavily on their home financial sectors for emergency liquidity and income by forcing them to hold government debt, through legal reserve requirements, or required bond holdings, etc. Home banks with EU charters would be shielded from such potential future exactions. Even if some such protection is already formally present, not all of it is, and there is much to be said for sharpening the distinction between the protection of member-country banks against insolvency (not capital losses) and the protection of member governments against default.
- Third, the reform would permit some Eurozone-wide bank supervision at last. The lack of such supervision is and has been a valid criticism of the system.
- Finally, all of EMU would be safer if the ECB could provide services of lender of last resort. The provision of these services is a time-honoured function of central banks, and it is totally consistent with central bank independence from national Treasuries and government financing.

Naturally, the reform could only carry these benefits if there was significant adoption of the EU charters. But if country members of Eurozone can agree to the reform, there should be little difficulty to get them to agree on measures assuring the large-scale adoption of EU charters. Besides, adoption might follow readily. Banks under the jurisdiction of governments facing serious difficulties of financing should find the tax provision of the EU charters attractive. Banks located in several Eurozone countries might prefer being under a unified supervisory authority. The possibility of lending-of-last-resort protection should also appeal to all banks in the Eurozone.

Is default such a bad thing?

One of the many problems posed by the creed that a government default is anathema for the euro is the difficulty of aiding a country in trouble. The claim that the help is conditional on adherence to any strict set of rules loses all credibility. The application to Greece is clear: it should have been possible to provide as much help as the country has received thus far (acceptance of Greek debts as collateral for credit at the central bank and assurance of government loans at penalty rates below market levels) following the endorsement of its programme of debt stabilisation in February without fuelling moral hazard, or at least while fuelling much less of it. In the circumstances, the propagation of moral hazard is flagrant and must be addressed. Eurozone governments clearly have more hope now than ever before of a bail-out in case of difficulty . My proposed reform package addresses this problem while requiring a minimum of further political unification and a minimum of further interference with national fiscal policy. These are important advantages, to my eyes.

Lastly, once default or bail-out becomes the only possibility, default may be the superior alternative. That is another reason for embracing the possibility. 'Too grisly to contemplate,' says The Economist about default (2010). Nonsense! Even the closing paragraphs of the article, concerning recent world experience with restructurings of sovereign debts after defaults, say the exact opposite.

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