

Further fiscal union not needed in Europe

Richard A. Werner/ Special to *The Daily Yomiuri*

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The August market volatility was unusual for the holiday period. But it followed a familiar pattern, begun in May 2010: When government bonds of a "peripheral" eurozone member state approach maturity, investors sell its bonds--occasionally spurred by a ratings downgrade or bad economic data. This pushes up yields, rendering the worries self-fulfilling, as rolling over debt becomes more costly and the country's fiscal position deteriorates.

The obvious solution is to exit from the euro and default, or split the eurozone. This would allow currency depreciation, boosting exports and raising competitiveness, while default removes the debt burden. Hence the often-heard prediction that the euro is doomed.

But this prediction is likely to be wrong: The euro can survive, because currency systems are established by political and legal arrangements, not market forces. And politicians may not follow the most economically rational course of action.

Nothing demonstrates this better than the introduction of the euro itself. Until about five years before that event, most German economists were unanimous in their assessment that such a monetary union would not make economic sense. Hence it would not happen, they thought. But the management boards of the German banks decreed that no report critical of the introduction of the euro could be published, while governments spent millions on enlightening their electorates on its alleged benefits.

Politics dominated economics. We can expect no less in these volatile times, especially as European Central Bank President Jean Claude Trichet, one of the authors of the Maastricht Treaty, in his speech in Aachen, Germany, in June revealed himself to be primarily motivated by the political agenda to create a unified European state.

European leaders (backed by the U.K. chancellor) have decided that they will not tolerate exit from the euro and debt default. Most observers argue that this only leaves the option to enhance the European Financial Stability Facility (EFSF) and to work towards the introduction of common government bonds and the establishment of an embryonic centralized European finance ministry with the power to fix budgets, taxes and bond issuance.

Some go further and now talk openly about the long-standing plan to create a United States of Europe, hatched in the US in the 1940s and pursued doggedly by Jean Monnet.

But the argument that the euro is doomed is wrong. So is the argument that there is no other option than to centralize further. Even supporters of "more Europe"--Brussels-speak for further transfer of sovereign powers to the EU--concede that using a beefed-

up EFSF creates the wrong incentives, including moral hazard: Profligate governments and politicians will be rewarded, while thrifty governments and their taxpayers have to shoulder the burden, worsening their own debt situation.

All this is worth the cost, say the supporters of further European centralization--especially since there is no alternative, if one finds exit from the euro and default politically unacceptable. But this is not true.

There is a viable and economically superior alternative--one that would allow the politicians to continue with their euro experiment, while avoiding default, and without the need to beef up the EFSF or transfer more powers to the EU.

Here it is: Let us remember that the trigger for each bout of European "crisis" is the moment when indebted nations in the periphery want to issue new bonds to fund maturing debt or interest payments. The solution is not to issue new bonds.

Where, then, should the governments get the money from to repay the maturing bonds? Access to the ECB is not an option, since this would violate the ECB's rules (although it has broken them already).

There is a superior alternative that conforms with the rules: The governments can enter into loan contracts to borrow the money from the banks in their respective country. The borrowing rate would be fixed for the term of the loan (say, three years), leaving banks with a comfortable earnings margin over their funding costs, while borrowing costs would remain far below bond market yields--say, at 3 percent. Those short-term loans can then be rolled over on a regular basis.

But can the weakened periphery banks provide the credit? The surprising answer is: Yes, they can. While it is often thought that the money supply is created by the central bank, it creates only about 3 percent of the money supply. About 97 percent is created by commercial banks through the process of credit creation. So when banks extend credit to the government, no money is taken away from other parts of the economy, but banks create new money.

There are many benefits. Firstly, government refinancing costs would be sharply lower. Secondly, funding costs would be more predictable and governments could not be held hostage by hostile markets demanding elevated yields.

Thirdly, government credit rating downgrades could not be caused by rising issuance yields. Fourthly, the banking sector would benefit, as its core business, the extension of credit, would be boosted--to the lowest-risk borrower at that, favored by the Basel capital rules.

Fifthly, the resulting incentive structure is preferable to that of the EFSF or eurobonds: funding remains transparent and the liability of each government. Taxpayers from other countries are not asked for direct transfers.

Sixthly, there would be significant macroeconomic benefits: Bank credit creation has weakened in most European countries, reducing growth and tax revenues. By

switching the public sector funding method from bond markets to bank credit, demand will be boosted.

Would this be inflationary? If growing bank credit is used for productive purposes and while governments tighten their belts, it cannot be inflationary. But it will stimulate nominal GDP growth, tax revenues and employment at a time when fiscal tightening is working in the opposite direction. This measure would avoid the feared debt deflation spiral and buy several years of valuable time, during which fiscal restructuring could be implemented.

There is an additional benefit, namely the signaling effect for other countries where such a policy would also be beneficial.

I am especially thinking of Japan. Although Japan does not have a sovereign funding problem, despite its vast debt, it shares some problems with Europe: Like in Europe, Japan's economy has been damaged by an unsuitable monetary policy that produces the wrong rate of credit creation, for which a recalcitrant and uncooperative central bank has been responsible.

I have proposed to Japanese bureaucrats and politicians many times, and argued in the media in Japan since the mid- to late 1990s, that the economy can be kick-started without additional costs and even without the cooperation of the central bank, by simply shifting the government's funding method from bond issuance to borrowing from the private-sector banks. Anemic bank credit growth would be jump-started and the economy would experience a full-blown recovery with 3 percent to 4 percent growth less than a year later.

The hope would be that if a European finance ministry first adopts this policy to borrow from the banks, Japanese bureaucrats would finally summon the guts to do the same. Long gone, it would seem to me, is the samurai spirit of courage and determination among Japanese bureaucrats. I have the impression that nowadays they prefer to follow, even if they follow a herd of sheep running into an abyss.

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