

Deficit easing – an alternative to severe austerity programmes in the eurozone

Richard Douthwaite,

Feasta, the Foundation for the Economics of Sustainability, Ireland

Introduction

There is a widespread perception that, apart from three or four delinquents who are causing problems for everyone else, the eurozone is doing well. That is not the case at all. Without exception, every euro-using country is running a budget deficit bigger than the Stability and Growth Pact allows and only five small countries have debt-GDP ratios below the 60% ceiling. As a result, all are planning budget cuts which, because they are being implemented simultaneously, could make matters worse by reducing national incomes at a time when national debts are still going up.

This collective austerity programme will do little or nothing to save the problem countries - Ireland, Greece, Portugal and Spain - from default and the rescue fund set up by the IMF and the ECB will only buy time before they do so. If that time is wasted and radical relief methods are not tried, the defaults will cause French, British and German banks to suffer massive losses and require further state support. However, this paper argues that a limited, targeted injection of non-debt-based euros could provide a neat and swift solution to a debt problem the whole eurozone shares.

(i) The problem with austerity as an approach to the eurozone's debt problems

Every country in the eurozone is currently running a budget much greater than the 3% allowed under the Stability and Growth Pact. As a result, every government is now trying to cut its spending and increase its taxes so that the amount it has to borrow each year eventually gets back below the 3% limit. The combined efforts of these governments amount to a co-ordinated austerity programme.

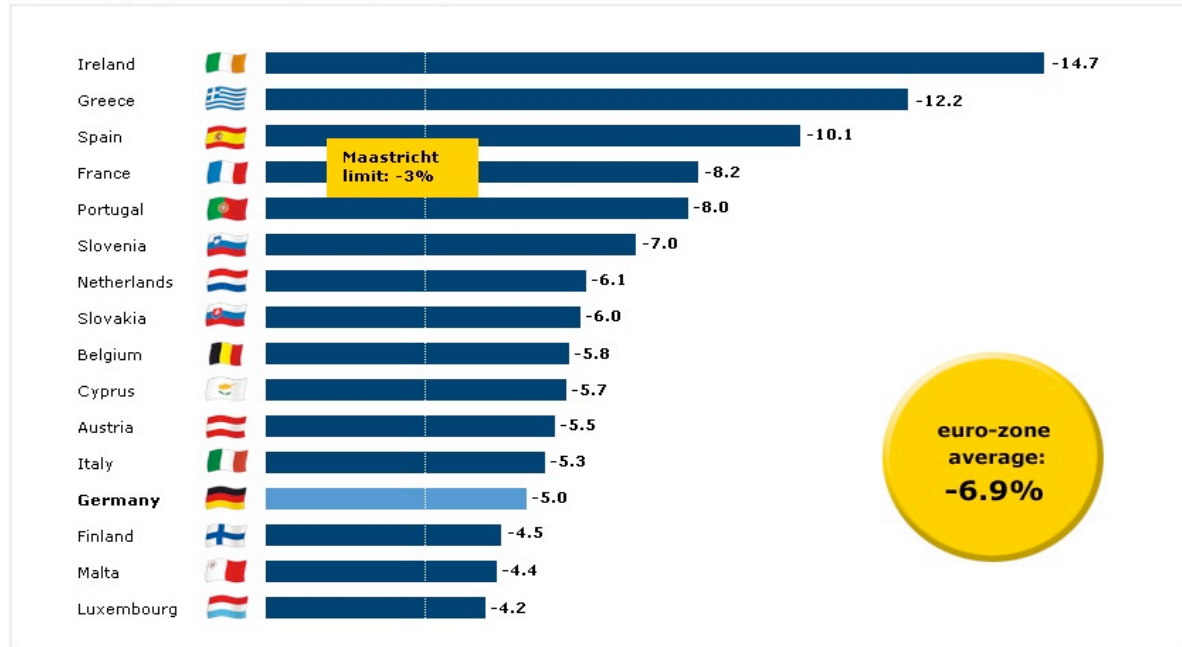
Unfortunately, the programme is being carried out at a time when it seems unlikely that increases in exports and in private sector demand – and borrowing – will be enough to replace the demand and the borrowing that the governments would have provided had they been able to continue spending at the rate they are at present. If exports and private sector demand do not increase sufficiently to counterbalance the cuts, the austerity programme will cause the eurozone economy to contract. The hoped-for decrease in deficits will not materialise and in some countries imbalances may even increase. In addition, banking systems will continue to suffer loan losses, some of which governments will be compelled to make up.

In other words, the austerity strategy being pursued could make matters worse, not just for governments and the financial system but also for large numbers of people who could see their incomes shrink and/or their employment vanish. There is a significant risk that the strategy will drag the eurozone into a long-run cycle of decline

and deflation. Indeed, that decline may have already begun. As Ambrose Evans-Pritchard wrote in *The Sunday Telegraph* on 31 Oct 2010 “An ominous pattern has emerged across

Budget deficits of euro-zone countries in 2010

As percentage of gross domestic product (forecast)



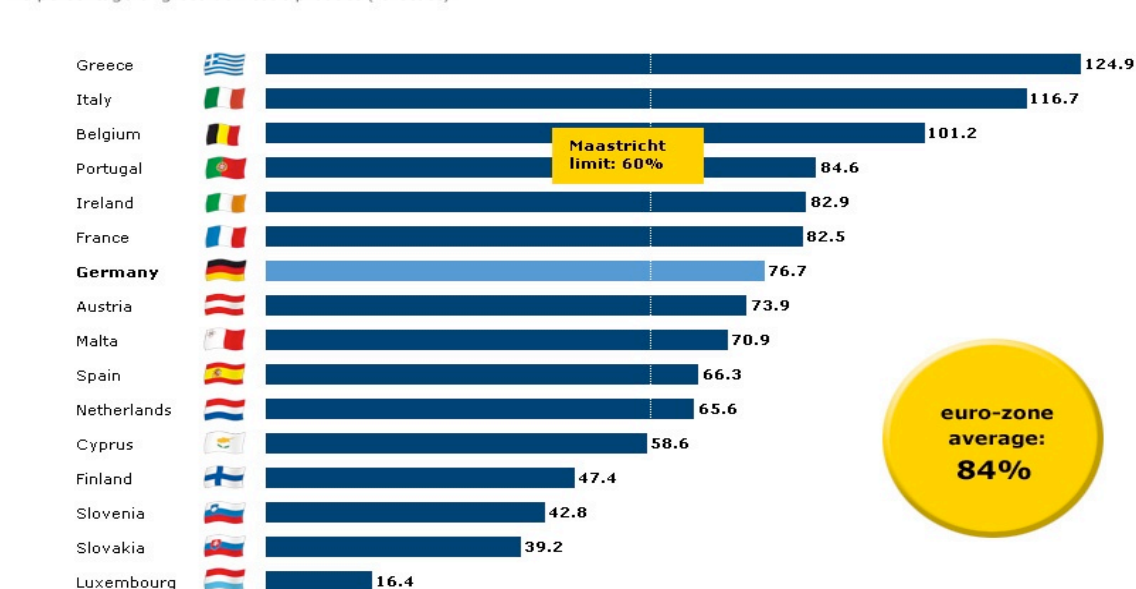
Source: European Commission

Chart 1: The majority of eurozone countries did not deliberately plan to run deficits in 2009 that exceeded the 3% limit. They ran them only because the world financial crisis caused their tax revenues to slump while, at the same time, they had to spend more on unemployment relief and, in some cases, on rescuing their banks.

much of the eurozone periphery: tax revenue keeps falling short of what was hoped. Austerity measures are eating deeper into the economy than expected, forcing further fiscal cuts. It goes too far to call this a self-feeding spiral, but such policies test political

Sovereign debt of euro-zone countries in 2010

As percentage of gross domestic product (forecast)



patience to snapping point.”

Table 1 - Government revenue and spending in the euro area (EA16)					
		2006	2007	2008	2009
GDP at market prices	(million euro)	8 553 600	9 003 902	9 258 895	8 977 933
Government deficit	(million euro)	-112 048	-55 723	-181 176	-565 111
		-1.3 % of GDP	-0.6 % of GDP	-1.9% of GDP	-6.3 % of GDP
Government expenditure	(% of GDP)	46.7	46.0	46.8	50.7
Government revenue	(% of GDP)	45.3	45.4	44.9	44.4
Government debt	(million euro)	5 842 888	5 940 433	6 424 615	7 062 625
		68.3% of GDP	66.0% of GDP	66.4% of GDP	78.7% of GDP

Table 1 shows that, on average, eurozone deficits were well under control until 2009 when the zone’s GDP and tax revenue fell but governments’ expenditure climbed. Global economic conditions were to blame.

(ii) The impact of the debt crisis on the eurozone’s money supply

Most eurozone governments’ deficits are of very recent origin. As Table 1 shows, their collective deficit increased dramatically from an acceptable 1.9% in 2008 to a worrying 6.3% in 2009. This happened as a result of the 3% decline in the eurozone’s GDP within that 12-month period. This decline, which was very much bigger in some countries than others, was due in turn to the global financial crisis, which began in 2008.

The extra borrowing caused the governments’ debt-to-GDP ratio to increase from an average of 69.4% at the end of 2008 to 78.7% at the end of 2009. This was a serious development because, unlike countries with their own currencies, eurozone members cannot boost their economies and their tax take by reducing interest rates, or by devaluing their currency to increase their export earnings.

Nor can individual eurozone countries create money out of nothing by quantitative easing. Only the European Central Bank has that power but it has not yet used it to inject money into the system without withdrawing an equal amount. Consequently, every cent in use in eurozone economies has to have been borrowed by someone somewhere, at home or overseas. As a result, while countries with their own currencies can handle a debt-to-GDP ratio of over 100% because they have the tools to do so (Japan’s is approaching 200%), countries using a shared currency must keep well below that figure unless they can agree that their shared central bank should use its interest rate, exchange rate and money creation tools in the way that a single country would.

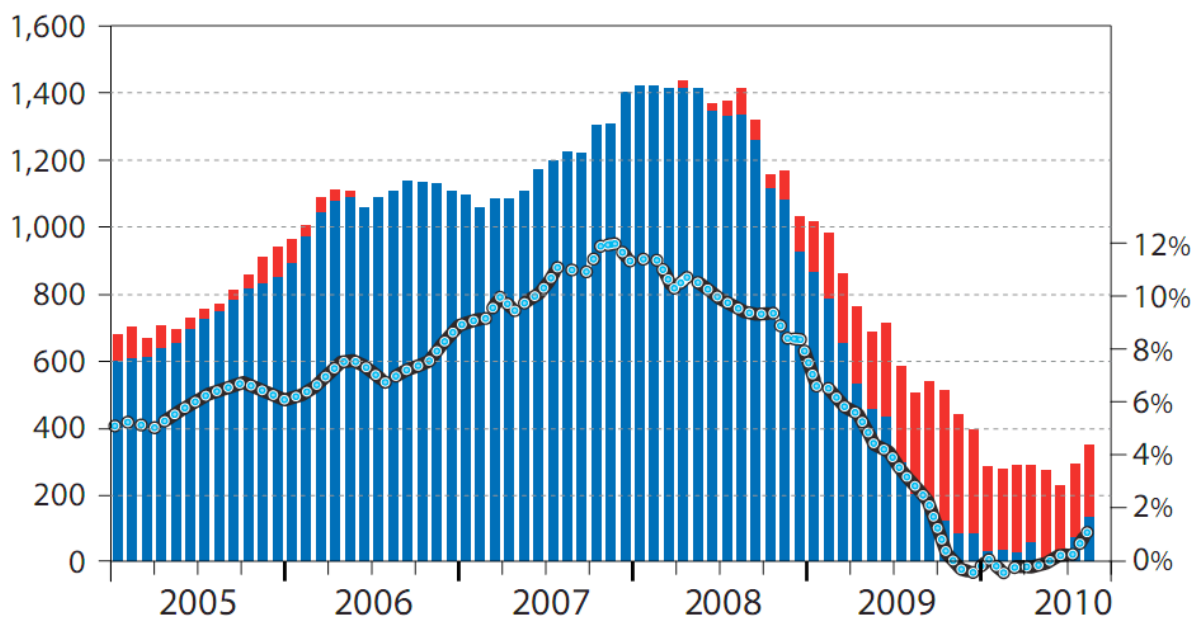


Chart 3: The blue bars show the amount by which private sector borrowing has been increasing recently in the eurozone. Each bar, which is measured in billions of euro on the left hand scale, shows what the increase that month would have been had it continued for a full year. In other words, it is the actual monthly increase, corrected for seasonal factors, times twelve. The red bars represent government borrowing on the same basis. The chart clearly shows that additional government borrowing did not begin on any scale until private borrowing had started its precipitate decline. The dotted line running through the bars represents the percentage rate at which the M3 money supply was changing, shown on the right hand scale. It will be seen from the experience of late 2009 and early 2010 that at least €300 billion needs to be borrowed each year by either the private sector or the public one or by a combination of the two in order to maintain a constant money supply. This figure needs to be treated with caution, however, because the graph is a simplified version of one which appeared in the ECB's Monthly Bulletin for October 2010 (Chart 2, p.26) and which also shows changes in net external assets, longer-term financial liabilities and capital and reserves. Changes in these explain why M3 began to decline six months before private borrowing started to fall.

In addition to cutting the governments' tax-take, the financial crisis has reduced the public's confidence in its future prospects, making firms and individuals much less willing to borrow, and much more eager to save. This effect has been compounded by the collapse in asset values, which has meant that individuals have less security to offer for loans. As chart 3 shows, net private sector borrowing in the eurozone was negligible during late 2009 and early 2010. While government borrowing increased from zero at the start of 2008 to an annual rate of €400 billion in September 2009, it was insufficient to replace the loans which the private sector had repaid. As a result, the amount of money in circulation (M3) began to fall slightly. M3 is generally considered the broadest measure of the money supply. It incorporates M1 (notes and coins, travellers' cheques and demand

deposits) and M2 (savings deposits and time deposits) with large-denomination time deposits and balances in institutional money funds, repurchase agreements, and Eurodollars.

iii) Why a shrinking supply of euros is extremely damaging

The importance of maintaining an adequate money supply in the eurozone cannot be over-emphasised, as a renewed fall in its supply would be disastrous for governments, for business and for the banking system. It is not generally recognised that a shrinking money supply means shrinking business profits simply because there is less money available to appear in corporate accounts at the end of the year. This means less tax is paid.

Shrinking profits also destroy business confidence, making firms unlikely to borrow to invest. Moreover, less money in circulation makes it harder to trade. The required liquidity is no longer there. A firm cannot re-order until it has paid a supplier's previous invoice and it won't supply its customers until they have paid it. Inadequate liquidity therefore makes the whole trading system extremely sluggish. Borrowing to invest becomes even less likely as the lower level of demand means that most firms have surplus production capacity.

Moreover, for as long as old bank loans are repaid without being replaced by new ones, the money supply continues to contract. This makes it progressively more difficult for firms to service their outstanding debt. This in turn threatens the banking system as, if a firm goes into liquidation as a result of its inability to service its debts,

its bank will find that the assets against which its loans were secured have a greatly reduced market value because other firms are not in a position to buy them. This is the downward self-feeding spiral to which Evans-Pritchard of *The Sunday Telegraph* referred and which the co-ordinated austerity programme risks exacerbating.

It is a spiral, which works well when an economy is growing, with increased demand leading to increased investment. This in turn entails increased borrowing, which provides the purchasing power for a further increase in demand. Moreover, asset values rise, providing the security for the increased lending. But the spiral is equally strong, and quite alarming, on the way down. This paper argues that rather than running the risk of setting off a downward spiral with a collective austerity programme within the eurozone, an alternative policy option should be considered that would have less serious consequences should it fail.

It must be stressed that it is not enough that the money supply does not fall. Even if the economy is not growing and no extra money is needed in circulation to lubricate additional trade, the money supply needs to increase each year to allow for the fact that, because of interest, borrowers repay more money to banks and other lenders than they were originally loaned. The funds required to enable them to make these additional payments have to be made available if the money supply is not to shrink. In the current system, this therefore means that borrowers, whether public or private, have to take on extra debt to match the part of the interest that the lenders retain as profit. In other words, we cannot have a profitable banking system without an increasing money supply unless the system makes its profits at the expense of the rest of the economy, an arrangement that could not persist for long before the banks undermined themselves.

Chart 3 shows that there was some net private sector borrowing in the third quarter of 2010 and that this enabled M3 to increase a little. However, the danger is that the cuts in government spending under the austerity programme will outweigh this increase in private sector borrowing, particularly as they are likely to destroy potential borrowers' confidence in their ability to repay and thus their willingness to incur further debt.

(iv) How to stop the money supply shrinking

The money supply problem in the eurozone can be explained another way. Euros enter into circulation as a result of debt. They are borrowed into use. Normally, the private sector does the borrowing with the banks acting as gate-keepers, controlling the flow. However, from time to time the private sector may be unwilling to borrow because it is worried about its ability to repay, or because its current level of debt is too great in relation to its turnover. Alternatively, the banks may be unwilling to approve enough private-sector loans. If the level of new loans is inadequate to replace the money being taken out of circulation as old loans are repaid, the money supply will then contract.

In these circumstances, governments need to step in and act as borrowers of last resort, injecting enough money into the system to maintain the money supply until private sector borrowing returns to the required level. If they fail to do this, or if they fail to borrow on a sufficient scale, they will not stop the contraction and prevent the consequences we have just discussed. Governments therefore have a responsibility to maintain the money supply by acting as liquidity providers.

Although the eurozone governments were borrowing at an annual rate of €400 billion in September 2009, this was inadequate to halt the decline in the money supply. A total borrowing rate, public and private, of around €800 billion a year might be needed to keep a constant amount of money in circulation. If the public sector had to incur all this debt, the average eurozone budget deficit would be over 10% and the debt-to-GDP ratio would rise to over 100% in less than two years.

A protracted compensatory borrowing strategy is therefore unworkable if governments have to act alone. The sums involved are just too large. The private sector has to be induced to borrow too. But what would the private sector borrow for in current circumstances since its corporate element has excess capacity while the consumer element is already highly indebted and worried about its future? The only possibilities are (1) an increase in demand for eurozone exports and (2) a more rapid rate of expansion of a new area of demand.

1. Exports. There seems to be only a slim chance that a surge in export demand for eurozone goods and services will increase investment by exporting firms - and thus private sector borrowing - by a significant amount. One reason for saying this is that two major export markets – the US and the UK – are also experiencing budgetary problems and may shrink rather than grow. A second reason is that the euro's exchange rate against sterling and the dollar has strengthened recently as a result of the ECB's refusal to undertake quantitative easing on the same basis and scale as the Bank of England and the Federal Reserve. This not only hampers sales in Britain and America, but damages prospects in other markets as well.

2. Energy. Increased investment in energy- saving and non-fossil energy sources offers much better prospects for inducing substantial private sector borrowing but member states would have to give bankable assurances about future energy prices to bring the investments forward. There is also a problem of scale, A draft of the EU's 'Energy 2020' strategy, which was leaked to Reuters in October 2010, suggested that the EU as a whole needs to invest €1,000 billion before 2020 to meet its energy and climate targets. This means an investment rate of €100 billion a year, far too little to do much to reduce the governments' level of borrowing to an affordable level. Even doubling the rate of investment would not be enough, particularly as the inevitable planning delays would mean that the big spending – and borrowing – could not occur for a period of perhaps four years.

So, while energy investments should be encouraged, they will not be enough. Some other way by which governments can provide the necessary liquidity needs to be found.

(v) Deficit easing - an innovative solution to the current crisis in the Eurozone

If sufficient money to maintain its supply cannot be created and injected into the economy through debt because no one is prepared to assume the levels of debt involved, a non-debt way of achieving the same result must be found. The neatest solution would be for the European Central Bank to create money and to give it (rather than lend it) to governments in proportion to their populations, This would allow further public spending cuts to be avoided and, in countries with relatively small budget deficits, national debts to be reduced.

We call this approach 'deficit- easing'. Governments with smaller deficits would also have the option of passing some of the money they received from the ECB on to each of their citizens to reduce their personal borrowings. Everyone would get the same amount and we suggest that people with no debt should be required to invest their gift in green industries to speed the EU's transition to a low-carbon economy. If this course was followed, the money would be distributed as euro-denominated credits which could not be used directly for consumption spending.

The public, which has been angered by the fact that the banks are being bailed out while ordinary families with debts or in negative equity have been ignored, would be enthusiastic about their debts being reduced in this way. They would regard the scheme as fair, as everyone in the countries in which credits were issued would be given the same amount. They would also welcome the fact that their public services were not being cut.

The implementation of a 'deficit-easing' approach on these lines would involve carefully controlled amounts of non-debt money being injected into the eurozone economy. This would occur at regular intervals until public and private debt levels had been brought into better balance with public and private incomes, and private sector borrowing had picked up enough to make further additions unnecessary.

The immediate effect of this quick-and-easy-to-implement approach would be to take pressure off the banks. Their bad debts would be reduced and the additional economic activity the new money generated would make it easier for their customers to service their remaining debts. Asset values would cease to fall and might even begin to rise again, thus improving the banks' security. Also, as their outstanding loans were repaid,

their capital-adequacy ratio would improve. The stabilisation of asset values would increase the public's confidence and its willingness to begin borrowing again. In short, both the banks and the public would be equipped to resume their normal relationship.

It is hard to say what effect injecting money in this way might have on the value of the euro. Its value might fall initially because of fears of inflation. However it would recover later when it became clear that the eurozone economy was doing well, and that the banks and public finances had been stabilised. Any fall in the value of the euro would help with recovery, of course, as it would increase the eurozone's competitiveness and mean more internal production for internal use.

Deficit easing would also foster greater use of the provisions of the EU Services Directive. Export-led businesses within member states would focus to a much greater extent on exporting to markets within the EU. This would lead to the consolidation and strengthening of the EU's Single Market..

Country	Public sector debt as a proportion of GDP in 2009
Italy	115.2
Greece	113.4
Belgium	97.6
France	77.5
Portugal	76.9
Germany	72.1
Malta	69.4
Austria	69.3
Netherlands	62.2
Ireland	57.7
Cyprus	56.2
Spain	53.2
Finland	44
Slovakia	37.1
Slovenia	31.8
Luxembourg	14.9

(vi) Austerity alone cannot save Greece

It is hard to see how austerity programmes can work for countries like Ireland, Greece and Portugal, which have both a high government deficit and a limited borrowing capacity because of their high public debt-to-GDP ratios. Consider Greece. There is a widespread view that - despite the ECB/IMF rescue arrangements - it will not be able to avoid having to default and get its creditors to agree to write down their loans substantially. The view is based on IMF figures that show that Greece's public and private overseas debt amounts to 171 per cent of its national income. Once the €110 billion being lent by the IMF and other eurozone countries over the next three years has been drawn down, its foreign debt-to-GDP ratio will be at least 223 per cent and could be much higher if its national income shrinks as a result of the drastic spending cuts the government is being required to make.

A 223 per cent ratio means that even if Greece only has to pay the 5 per cent rate set for the money being made available under the rescue plan on all of its debt, its overseas interest payments in 2013 would swallow up more than 10 per cent of its national income and 150 per cent of its current export income. Such huge payments are clearly impossible.

So if extreme austerity and the rescue package can only delay a Greek default but not prevent it, whom does it help? The answer is that the rescue package is buying time for the eurozone banks which ignored the country's limited overseas earning capacity and lent Greece €143 billion. Almost half of this, €59 billion, came from banks in France, and €34 billion from their German counterparts. A Greek default would inevitably mean expensive bank bailouts for both countries' taxpayers.

Moreover, if Greece had been left to collapse in May 2010, the other over-indebted eurozone economies - Ireland, Portugal and Spain - would almost certainly have collapsed too. This would have meant such a massive markdown on the €1,600 billion the four countries owe to EU banks that the entire European banking system would have imploded.

Germany was exposed for about a quarter of this huge amount loaned to Greece, France for 18 per cent and Britain 17 per cent, according to the Bank for International Settlements' September 2010 issue of its *Quarterly Review*. Essentially, the Greek bailout is a holding measure to allow other solutions to be found for what is a massive EU-wide debt problem rather than for a problem that only affects a handful of countries like Ireland.

***Ad hoc* rescue efforts such as those applied to Greece and which involve indebted eurozone members borrowing funds to lend to fellow-members when the bond market has them in its sights, do not solve anything. They only buy time for something unexpected to turn up or for real solutions to be found.**

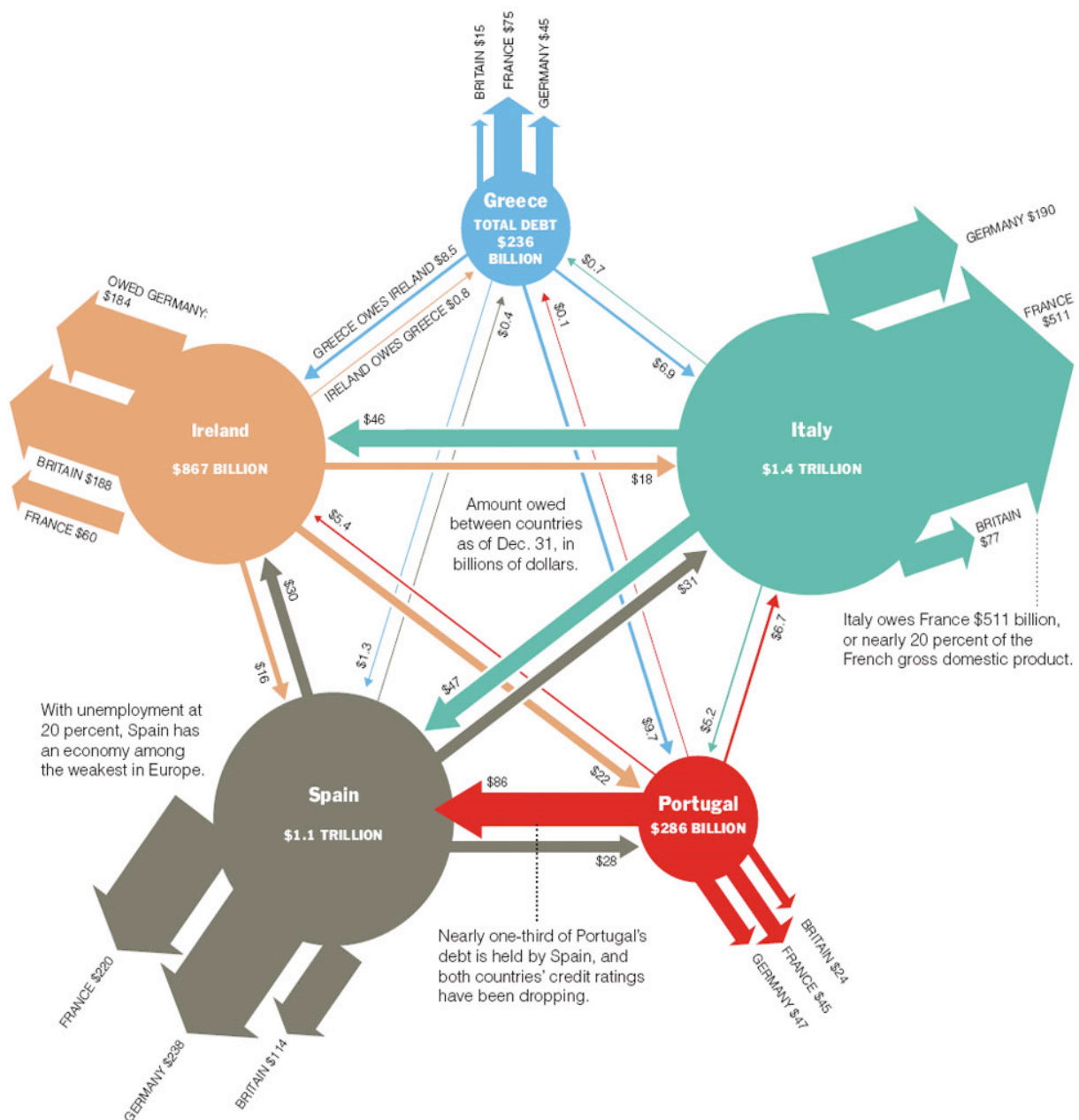


Chart 4: We are all in this together. This Bank for International Settlements diagram shows how a default in one country makes bank bailouts and defaults in other countries much more likely. For example, it shows that Ireland's public and private foreign debt is \$867 billion and that, of this, \$124 billion is owed to Germany, \$188 billion to Britain and \$80 to France, with smaller sums to other countries including those in the eurozone which are also in financial trouble. If Ireland defaulted and the value of its debts were marked down, the knock-on problems faced by the financial institutions which had lent it the money would be severe and government bailouts might be required. A collective solution is therefore required.

(vii) Conclusion - common sense must prevail

It makes sense for a single country to cut its spending in order to balance its budget when its trading partners are doing well, and when it knows that their demand for its exports will quickly compensate for the reduction in economic activity that will be caused by its cuts. However, it makes no sense at all for a group of countries to cut their spending simultaneously at a time when their major trading partners are also implementing cuts.

Moreover, even in the unlikely event that the eurozone's cuts eventually have the desired effect, they cannot do so in time to prevent Greece defaulting and doing serious damage to the French and German banking systems. Ireland and Portugal could conceivably escape defaulting but they cannot be expected to emerge from what will at least be a ten-year struggle to get their finances in order without doing great harm to their citizens' education, life expectancy and life prospects. The whole of the eurozone will suffer from the austerity programme too. It faces a decade of decline or - at best – a period of economic stagnation at a time when much of Asia is powering ahead technologically. **A period of austerity now could prevent Europe from ever regaining its current position in the world.**

The public's view that you can't just create money out of nothing and give it to governments to spend, the German folk memory of the disastrous inflation after World War 1 and most central bankers' innate conservatism are three serious obstacles in the way of cautiously issuing a small part of the eurozone's money on a debt-free basis. They are attitudes that must be overcome for the sake of millions of EU citizens.

=====

Frequently asked questions about deficit easing

1. Would injecting debt-free money into the eurozone economy via deficit easing be inflationary?

There is no risk at all of a significant inflation developing. This is because if prices began to rise at an unacceptably high rate, no further debt-free money would be issued. This would be enough to prevent further price rises unless private-sector borrowing had really taken off and, as a result, conventionally-issued debt-money was causing the inflation problem. In this case, governments could use conventional methods of control such as increasing taxation in order to run a budget surplus, or raising the banks' capital-adequacy ratios.

If the injection of debt-free money caused the exchange rate of the euro to fall, it would raise the cost of imports and this would have a mildly inflationary effect. On the other hand, exports would rise and there would be more eurozone production for eurozone use, thus increasing incomes and employment. This would give most people, but perhaps not particular groups, the resources to cope with the slightly higher prices and any seriously

disadvantaged groups could be protected since the money would be there. After all, which is better, the present problem of dealing with constant prices out of declining incomes, or a possible future problem of dealing with slowly rising prices out of rising incomes?

The overall point needs to be made – there is a lot of surplus capacity in the eurozone economy and consequently, a lot of additional spending will have to take place before shortages bad enough to start driving prices up begin to appear. It would therefore be a long time before any general inflation happened. By that time, private borrowing should have resumed and allowed the introduction of debt-free money to be phased out.

2. How would savers be affected?

Those who save would do very well from a deficit-easing approach. At present, their money is probably held in shares and bank deposits, either personally or through their pension funds. Their shares would do well if the eurozone economy improved as a result of the monetary injections. Their bank deposits would be much safer than they would be under the austerity programme because, if the latter caused some eurozone countries to default, the banking systems in all eurozone countries would be endangered and their governments might not have the resources either to bail them out or to honour the deposit guarantees they have given. Moreover, if a saver lives in a country that decides to distribute some of the debt-free money to reduce personal debt, all the payment he/she receives would be available to invest in a low carbon-related project. This payment should more than offset any erosion of the purchasing power of the savings they held in the bank.

3. Who would lose out under a deficit-easing approach?

It is hard to see how anyone would lose out. At present, everyone is losing because resources are being wasted, whether these are the human resources of people who are under/ unemployed or the lost production of under-used factories. Issuing debt-free money to put these resources to use would stop the losses. So we are not in a zero-sum game. No one has to be worse off for others to gain. Everyone could benefit if the arrangements were well designed. .

This question points to a major difficulty that has to be overcome before deficit easing can be adopted. Not only will most people believe that someone has to lose as a result of the proposal but they will also feel that the promised results are too good to be true. It can't be that easy to get the eurozone economies into shape, they will think. They will also feel that money can't be created out of nothing and just given away, that there has to be something more substantial to money than that. But the fact is, of course, that the only thing that gives a euro its value is that someone else will accept it from the holder and give them something of value for it. And the person accepting the euro only does so because he or she knows that someone else will give them something of value for it too. As a result, since the new, debt-free euros will be indistinguishable from the debt-based ones, not only can they be created out of nothing but they can work just as well.

4. Why should public money be given away in the eurozone to allow private debts to be reduced?

Private debt is damaging economically even if it is owed to creditors in the eurozone because if the eurozone carries more debt in relation to its GDP than its competitors, it will have higher costs. This is because if the rate of interest is the same in both economies, businesses in the more heavily indebted one will have to allow for higher interest charges per unit of output than the other when calculating their operating costs and prices. Any additional interest costs therefore affect the eurozone's international competitiveness in exactly the same way as would higher wages. Indeed, they are the wages of what a Marxist would call 'the rentier class'; a class to which anyone who, directly or indirectly, has interest-bearing savings belongs. Using money created out of nothing to pay down private debt is a rapid, cost-free way of making the eurozone economy more efficient, just as cleaning away weed and barnacles improves the speed of a ship.

5. Will deficit easing give rise to moral hazard?

No, it will not. No country is rewarded for having been profligate in managing its affairs because each one gets exactly the same payment per head of its population. Countries with low deficits and low levels of public sector debt will still be able to use the funds they get through deficit-easing to their citizens' long-term advantage.

6. What is the difference between quantitative- easing and deficit- easing?

Both approaches involve central banks creating money. With quantitative easing, the new money is generally used to buy securities from the banking system, thus providing the banks with more money to lend. Unfortunately that is where problems have been arising in the US and the UK. Because the public has been unwilling to borrow, or the banks have been unwilling to lend, quantitative easing has not increased the supply of money in circulation in the US, where M3 began to decline in the second half of 2009 and was still falling a year later. In the UK, M4 (a version of M3 but with additional categories of money) increased by only 0.9% in the same period and actually fell by 0.3% during September 2010.

Deficit-easing avoids this 'won't-borrow-won't-lend' bottleneck by giving the new money to governments to spend into use, or to pass on to their citizens to reduce their own debts or to invest in approved ways.

But quantitative easing has not failed to work completely in Britain and America. It has lowered interest rates and weakened both currencies, thus improving the countries' international competitiveness. The relative strength of the euro as a result of the ECB's refusal to run a quantitative easing programme along similar lines is handicapping the eurozone's recovery. (The ECB launched an asset purchase scheme called the Securities Market Programme in May 2010 but denied that this was quantitative easing because it promised to use other programmes to remove the liquidity this injected.)