TASC

Discussion Paper

May 2011

The Debt and Banking Crisis: Progressive Approaches for Europe and Ireland

Tom McDonnell

TASC discussion papers are intended as a contribution to debate. They are not refereed. Readers are invited to submit comments to the author.

The Debt and Banking Crisis:
Progressive Approaches for Europe and Ireland

Tom McDonnell
TASC Discussion Paper, May 2011

Introduction

Ireland is facing three intertwined crises: a banking crisis, a sovereign debt crisis and, inextricably linked with these, a growth and jobs crisis. The resolution of any one of these crises depends on the resolution of the other two.

In this discussion paper, TASC policy analyst and economist Tom McDonnell examines the likely trajectory of the Euro zone debt crisis and concludes that one or more Euro zone member states will be unable to return to the markets in the medium-term and, consequently, will either have to restructure their debts or remain as wards of the official lenders for the foreseeable future. The author proposes an alternative progressive framework aimed at resolving the banking and sovereign debt crises, while generating investment to stimulate recovery and help break the vicious circle of low growth and high borrowing costs.

The paper is divided into four sections.

Section I provides a brief overview of the overall analysis and recommendations. Section II examines the banking crisis and offers some proposals for protecting deposits, restoring lending and easing the burden on the state. Section III identifies the design flaws inherent in European Monetary Union that have exacerbated the current crisis in the Euro zone, and then suggests some remedies for these flaws. A critique of the Euro zone's official crisis resolution strategy and of its permanent loan facility, the European Stability Mechanism, is also presented. Finally, Section IV identifies the need for a centralised European mechanism which can viably enable fiscally impaired member states to escape the vicious circle of low growth and high debts. To avoid a devastating recession and prolonged period of stagnation, the fiscal consolidation required to end the debt crisis must be accompanied by a countervailing programme of strategic investment designed to create the conditions for recovery. The author suggests ways in which European institutions could be used to provide such investment in what is termed 'A New Marshall Plan for Europe', and how such investment could be funded.

The author would like to thank the members of the TASC Economists' Network and the various independent banking experts who read and commented on drafts of this paper. Their helpful and insightful comments and suggestions were invaluable and greatly strengthened the content of the discussion paper.

TASC discussion papers are designed to stimulate debate. We invite suggestions and criticisms from readers as part of the ongoing process of TASC's policy development.

The author can be contacted directly at tmcdonnell@tascnet.ie.

I. Summary

Banking crisis

Analysis

- Ireland's economic recovery is contingent on the successful resolution of its banking crisis. This crisis can only be resolved multilaterally with European support.
- The collapse of the Irish banking system was principally caused by a failure of regulation and the reckless lending practices of the Irish and European banking system.
- The imposition of the private banking debt on the State is impairing the Irish sovereign's solvency.
- Ireland can avoid a sovereign debt restructuring if it is able to decouple the banking debt obligations from the State's own sovereign debt obligations.
- The public, whether Irish or Europeans, should not be obliged to pay for the private debts of the European banking system. This should be the fundamental principle underpinning any resolution to the banking crisis.
- The transfer of debts from the private banking system to the general public is amongst the largest per capita social transfers in modern economic history and is deeply inequitable.
- The goals for the banking sector should be: the protection of depositors, the minimisation of public liability for private debt, and the restoration of appropriate lending levels to the real economy.

Recommendations

- The starting principle is that Irish and European taxpayers ought not to be obliged to honour any of the private debts of the failed banks. The remaining assets of these banks could be sold off with the proceeds going to the creditors.
- The process of recapitalising the Irish banking system by the Irish sovereign should be halted immediately. In a monetary union the banking system is most appropriately supported by a centralised institution. The appropriate institution in the European Monetary Union (EMU) is the European Central Bank (ECB).
- Thus, to prevent systemic contagion in the European banking system, the ECB should be mandated and sufficiently resourced to recapitalise viable working banks, where required, in exchange for an equity stake in the bank. This recapitalisation should only occur as an absolute last resort where there is clear and demonstrable evidence that failure to recapitalise would lead to even greater costs for the Euro zone economy.
- Ireland's bank guarantee should be removed entirely and immediately replaced by a guarantee covering deposits only.
- A distinction should be drawn between the failed zombie banks of Anglo Irish Bank and INBS, and the salvageable systemic banks that are critical to the Irish payment and credit system. The policy prescriptions are different for these two separate groups of banks.

- The non-systemic insolvent banks should not be further supported. In Ireland this means that, at the very least, Anglo Irish Bank and INBS should be allowed to fail. The €43.5 billion in payments up to 2025 for Anglo Irish Bank's promissory notes should not be paid as scheduled. It is suggested that a strategy of 'extend and pretend' be applied with regard to the promissory notes. The debts would never be officially taken off the books but the repayments would be continuously pushed out into the future. This would reduce the annual debt burden by over €3 billion per annum and would help restore the country to solvency.
- Turning next to the systemically important banks, it is suggested that Special Resolution Regime (SRR) legislation be enacted to create one or more publicly owned and operated 'good banks'. These new institutions could immediately assume the deposits of the systemically important banks.
- On behalf of the new good banks, the State would use a compulsory purchase order to acquire the physical infrastructure of the pre-existing systemic banks (AIB and Bank of Ireland).
- Certain other assets of these banks could be sold off through an open bidding process.
- The remaining assets of the former AIB and Bank of Ireland would come under the collective ownership of the creditors and bondholders using the mechanism of a debt-for-equity conversion.
- The newly created and clean 'good banks' would be able to restore lending to the domestic economy and would also be in a position to offer relief to troubled mortgage holders.
- The success of such a policy would be contingent on the political acquiescence of our European partners as Ireland's economic future is inextricably linked to that of Europe.

Eurozone debt crisis

Analysis

- The crisis has exposed the deep flaws in the design of European Monetary Union (EMU). These flaws helped to generate, and subsequently exacerbated, the crisis afflicting the Euro zone periphery.
- Particularly important fragilities in the design of the EMU include:
    - The impossibility of setting an interest rate appropriate for each of seventeen different heterogeneous economies;
    - The separation of control over monetary and fiscal policy; and
    - The absence of a guaranteed Lender of Last Resort controllable by member states.
- The absence of control over the Lender of Last Resort (LOLR) can generate a liquidity crisis for member states borrowing to support a budget deficit. A loss of confidence by investors can become a self-fulfilling prophecy, and the liquidity crisis can degenerate into a solvency crisis.
- The emergency loan assistance provided by the European Financial Stability Facility (EFSF) is inadequate and has been set at unsustainably high interest rates. The rationale

underpinning the design of the EFSF is flawed because it treats a solvency crisis as a liquidity crisis.

- In Ireland the combination of a large public and private debt overhang, a low level of liquidity available to the private sector, and the exceptional size of the fiscal consolidation measures will prevent a short-to-medium term recovery being established in Ireland's domestic economy. Consolidation by Ireland's major trade partners will inhibit the growth of net exports. Consequently, a low interest rate on Ireland's borrowings is critical to debt sustainability.
- The interest rates charged by the EFSF's proposed replacement in 2013, the European Stability Mechanism (ESM), will remain at unsustainably high levels. The preferential creditor status of the official lenders, combined with the proposed collective action clauses ('private creditor bail-in') on bonds issued after 2013, increases the difficulty for member states wishing to access bond markets at sustainable interest rates.
- The conditionality of extreme austerity imposed on member states wishing to access official lending through the EFSF and the ESM is making it more difficult for the member state to grow itself out of the crisis because states become trapped in a vicious cycle of low growth and high costs of borrowing.
- In the absence of sovereign debt forgiveness in the case of Greece, and a restructuring of the banking debt obligations in the case of Ireland, these two countries will *de facto* remain wards of the official lenders for the foreseeable future as they will not be able to return to the markets at sustainable rates.

Recommendations

- Greece is insolvent. Sovereign debt restructuring should be expedited for Greece.
- A form of Euro bond should be established for Euro zone members. This would involve the collective issuance of bonds, worth up to the Maastricht-compliant 60 per cent of each member's GDP. Individual member states would still remain responsible for issuing that portion of their debt exceeding 60 per cent of GDP.
- Although this would ameliorate the borrowing difficulties being experienced by certain member states, it would not be sufficient to fully eliminate these borrowing difficulties.
- To eliminate the design flaws that have helped fuel the instability in the Euro zone, a Lender of Last Resort (LOLR) should be designated to provide guaranteed liquidity to member states. The ECB is the appropriate institution to fulfil this function.
- To protect against the moral hazard arising from this liquidity guarantee, strict fiscal oversight and supervisory mechanisms will be required. At the least, this would include rolling multi-annual budgets and the establishment of independent fiscal councils in each member state.
- The ECB's monetary policy targets must be expanded to add output, full employment and financial stability to the ECB's current target of price stability.

Crisis in the real economy

Analysis

- Full implementation of the fiscal adjustment necessary to achieve Maastricht compliance will substantially inhibit economic growth and employment creation in the medium term. Without offsetting policies, Greece, Ireland, Portugal and possibly Spain are facing an extended period of stagnant, or at best low, growth in output and employment creation.
- There is an urgent need for a mechanism to operate as a countervailing force to the programme of austerity being undertaken in the Euro zone periphery. The large-scale level of investment required can only be financed at a European level.

Recommendations

- A permanent centralised investment fund is required specifically for Euro zone members. As Greece, Ireland and Portugal total economic output accounts for just six per cent of Euro zone GDP, a programme of investment for the current crisis would be manageable at the Euro zone level.
- In the longer term this 'Eurozone Recovery Fund' should be used counter-cyclically and could be funded by direct monetary transfer from the ECB to the Recovery Fund, and by the introduction of a Financial Transactions Tax (FTT) at Euro zone level.

II. Dealing with the Banks

1. The support of the ECB is crucial to the resolution of the European banking crisis and the ECB's forbearance will be required to credibly pursue any option. Notwithstanding this, under Article 282 of the Lisbon Treaty the European System of Central Banks is obligated to support the general economic policies in the Union in order to contribute to the achievement of the latter's objectives (see Appendix 1). If a pan-European strategy to end the twin sovereign and banking crises can be agreed at political level by European Union governments, the ECB would be obliged to support it.
2. The goals for the European banking sector should be the protection of depositors, the minimisation of public liability for private debt and the restoration of appropriate lending levels to the real economy. As a starting principle European taxpayers should not be obliged to honour any of the private debts of failed banks. The remaining assets of these banks could be sold off with the proceeds going to the creditors.
3. Nevertheless, to prevent systemic contagion in the European banking system, either an existing, or a newly created, European institution must be given the mandate and resources to recapitalise viable working banks which require it in exchange for equity stake in the bank. The European Central Bank is the obvious candidate to fulfil this mandate.
4. The ECB should only recapitalise a bank if it can be demonstrably established that failure to do so would impose even greater costs on the Euro zone economy. At the same time, the European Central Bank could be required, pursuant to Article 282 of the Lisbon Treaty, to provide a temporary guarantee of medium term liquidity for the entire European banking system.
5. Insolvent banks should not be further supported by public funds and should be allowed to fail. In Ireland this means that, at the very least, Anglo Irish Bank and INBS should be allowed to fail. No further payments for Anglo Irish Bank's promissory notes should be made. Anglo doesn't even have any deposits and is of no systemic importance. Instead an indefinite strategy of 'extend and pretend' should be established to deal with the issue of the promissory notes. This strategy would reduce the State's annual debt repayments by €3.1 billion per annum.

6. Ireland is possibly unique in Europe in that its entire banking system has acquired 'zombie' status. Consequently, additional measures are required to restore a functioning credit and payment system in Ireland. Where necessary, these measures can be a model for other Euro zone countries.
7. The current situation in the Irish banking system is that the rise in bad loans has driven them into unprofitability, lending growth has ceased and depositors are so concerned they are withdrawing funds.
8. Existing deposits must be protected because they lay the foundations for renewed lending in the Irish economy. The aim therefore must be to protect the bank deposits by separating them from the rest of the banks' balance sheet. The bank guarantee should be removed entirely, and immediately replaced with a guarantee for deposits only.
9. A good bank model should be pursued for the systemically important portion of the Irish banking system. This good bank model extricates the deposits from the existing bank and protects them, alongside certain assets of the pre-existing banks.
10. The process of fixing the banking system would begin by enacting legislation establishing a Special Resolution Regime (SRR) for the banks. The SRR legislation would remove the deposits (and certain other assets such as first-time mortgages) from the bank creditors, shareholders and bondholders.
11. This legislation would also be used to create one or more publicly owned and operated 'good banks'. These new institutions would assume the deposits of the pre-existing banks. At the same time the State, on behalf of the new good banks, would use a compulsory purchase order to acquire the physical infrastructure of the pre-existing banks. Employment contracts would be transferred. Other assets, such as mortgages, could be sold off through an open bidding process.
12. To provide a competitor to the good banks, a portion of the deposits, physical infrastructure and employees could be transferred to an existing institution, for example An Post.
13. The pre-existing banks would come under the collective ownership of the creditors and bondholders using the mechanism of a debt-for-equity conversion. Alternatively, their assets could be sold off with the proceeds going to the creditors and bondholders.

14. The new good or ‘clean’ banks would be better positioned than the pre-existing institutions to ramp up lending to the domestic economy and to create the conditions for economic recovery.

15. The success of the ‘extend and pretend’ policy and the ‘good bank’ policy would be predicated on the support of our European partners.

III. The Design Failure of the Euro zone

17. It is becoming increasingly apparent that Economic and monetary union has catastrophically failed to meet its first serious challenge. These failures have been both political and economic. The status quo is not compatible with economic recovery in the Euro zone periphery.

18. The Euro zone has fundamental design flaws. One of these flaws is the obvious impossibility of successfully maintaining an interest rate level appropriate to the requirements of seventeen heterogeneous economies. The Euro zone is not an optimal currency area.

19. The one-size-fits-all interest rate amplifies the boom and bust cycle for countries out of sync with Germany's economic cycle. To illustrate the difficulties, Greece is widely acknowledged to be teetering on the brink of a debt restructuring with little prospect of recovery, yet the ECB is currently signalling an interest rate increase which, while arguably suitable for Germany, will actually sharpen Greek difficulties.

20. As De Grauwe (2011) points out, centralising monetary policy, while keeping the other instruments of economic policy in national hands, is incoherent. The effect of this division of authority is to create a heighted level of fragility in national member states. Investor concerns about the national member state's ability to repay its debts, which could be sparked for example by a recession, can quickly transform into a liquidity crisis and then ultimately degenerate into a full-blown solvency crisis (see Appendix 2 for a fuller explanation of how and why this occurs).

21. The absence of a controllable Lender of Last Resort (LOLR) leads to continuously rising costs for rolling over government debt, which constrain the member state's ability to engage in counter-cyclical fiscal policy during a recession. The member state becomes trapped in a vicious circle of low or falling growth coupled with an increasing debt-to-GDP ratio.

22. A further difficulty associated with being a currency user in a monetary union is that currency users have no capacity during a crisis to boost their economy by engineering depreciation in the value of their currency. Currency issuers, such as the United States, do not suffer from this limitation.

23. The implication is that it is harder for members of a monetary union to grow out of a debt crisis than it is for countries with a flexible exchange rate.

24. Consequently the characteristics of the Euro zone have exacerbated the economic crisis in the European periphery and militated against recovery.

25. Because of these difficulties faced by currency users attempting to grow out of a debt crisis, vicious circles of falling growth and spiralling borrowing costs can only be broken through external assistance in the form of transfers, or through an alleviation of the terms of the debt.

26. Once insolvency is diagnosed, delaying its resolution only serves to delay recovery and results in lost economic output which, once foregone, can never be recovered.

The current strategy

27. The official strategy for resolving the Euro zone's debt crisis originally developed in the wake of the Greek crisis in May 2010. The strategy comprises a number of elements. Broadly speaking these elements are:

a. The creation of new fiscal oversight and supervisory mechanisms.

b. The creation of new mechanisms to fund loan facilities (EFSF[1]/ESM[2]).

c. The extension of loan facilities to member states experiencing difficulties accessing the bond markets at sustainable rates.

d. The conditionality of austerity policies on those member states in return for receipt of loan funding.

28. In addition to this official strategy, the European Central Bank has evidently prohibited private sector bail-in (burden sharing) even for insolvent banks. In effect, it is imposing private sector liabilities on a sovereign State. The legal basis for such a position is dubious. There is certainly no economic basis[3].

29. The design of the Euro zone's permanent loan facility, the European Stabilisation Mechanism (ESM), is flawed for a number of reasons. These reasons are as follows:

30. First of all, the interest rates charged under the ESM will be set at unsustainably high levels. Second, the preferred creditor status taken by the official lenders is a disincentive for investors to purchase member state bonds. This exacerbates the difficulty for member states wishing to access the bond market at sustainable rates. Third, the proposed collective action clauses (the creditor bail-ins) on bonds issued after 2013 will increase the difficulty for member states trying to access the bond

---

[1] European Financial Stability Facility

[2] European Stability Mechanism

[3] If the bank guarantee and/or the extension of the bank guarantee were given under fraudulent or coercive conditions then there is also no moral obligation for the Irish state to pay these private debts.

markets at sustainable interest rates in the future. Finally, the conditionality of extreme austerity imposed on member states wishing to obtain access to the EFSF and/or the ESM reduces the ability of the member state to grow out of its crisis.

31. The current strategy has so far failed to improve the status quo and will not resolve the crisis. Greece is clearly insolvent. As Frankel (2011) puts it, *"it is not possible to think of a plausible combination of Greek budget balance, sovereign risk premium, and economic growth rates that imply anything other than an explosive path for the future ratio of debt to GDP."*

32. The bank debt, when coupled with the sovereign debt, may also be an insupportable burden for Ireland (see for example Rogoff, 2011; Portes, 2011; EIU, 2011). De Grauwe (2011) argues that member countries of a monetary union are downgraded to the status of emerging economies in the view of investors. This is because the national member states lack the ability to avoid a liquidity crisis through forcing a Lender of Last Resort to provide them with funding. Reinhart and Rogoff (2010) argue, using a large historical database of sovereign debt crisis experiences, that an 80 per cent to 90 per cent debt-to-GDP ratio is the danger zone for emerging economies. Ireland's debt-to-GDP level will be approximately 120 per cent by 2013.

33. Greece is forecast to have a debt-to-GDP ratio of 158 per cent by 2012 (see Appendix 3). This is undoubtedly an insolvency problem, not a liquidity problem. Without intervention at the European level, it is now merely a question of when and how Greek's debt burden will be restructured.

34. Even if Greece were not insolvent, it would still be necessary to fix the design flaws of the Euro zone to prevent future crises.

Fixing the Euro zone

35. Europe's protean sovereign debt crisis has been aggravated by the lack of a workable system-level solution, at great cost to economic recovery and stability. The fundamental issue is that the individual member state is not a currency issuer and has no control over the Lender of Last Resort (LOLR). This can generate a self-fulfilling prophecy where doubt about debt repayment leads to an exit of money from the domestic banking system, and the ensuing liquidity crisis itself degenerates into a solvency crisis because the member state has no Lender of Last Resort it can force to purchase government bonds.

36. There is no silver bullet solution to the crisis. Fiscal federalism with a Lender of Last Resort in place, and with a political willingness to provide fiscal transfers, would offer a technical solution to the crisis. However, a solution involving large-scale fiscal transfers between member states is politically very challenging in the short-to-medium term.

37. De Grauwe (2011) argues for, among other things, the collective issuance of euro bonds – worth up to 60 per cent of the GDP of each member state. He also argues for collective supervision of financial excesses to reduce the possibility of moral hazard arising from a Euro bond scheme. Similarly, Juncker & Tremonti (2010) argue the need for E-bonds, issued by a European Debt Agency (EDA) as a more viable successor to the failed European Financial Stability Facility (EFSF). This agency would have a mandate to acquire an amount of outstanding government paper equivalent to 40 per cent of European Union GDP.

38. Varoufakis and Holland (2011) propose the ECB take on a tranche of the sovereign debt of all member states equal in face value to the Maastricht-compliant 60 per cent of GDP[4], which would be financed by the ECB issuing bonds (E-bonds) that would be the ECB's own liability. They argue that member states should continue to service their debts to the ECB. This would involve each member state opening a debit account with the ECB which it would service over the long term. This could be at a new lower interest rate equivalent to the rate secured by the ECB during its E-bond issue. Note that this would obviously not be fiscally neutral for the ECB unless haircuts are imposed on creditors.

39. Varoufakis and Holland also suggest that the use of the ECB's longer-term liquidity provision facilities by Euro area banks could be made conditional on the bank agreeing to swap sovereign bonds for equivalent E-bonds at a much lower face value than the original member state's bonds, and with a longer maturity. The new E-bonds would then simply be added to the debit account of the Euro zone member. Alternatively, the ECB could make liquidity provision conditional on the retiring or write-down of sovereign or E-bonds. Through this mechanism, the E-bond programme would gradually move towards fiscal neutrality.

[4] Under the Maastricht Rules a Euro zone member is considered compliant if it has a debt to GDP ratio of 60 per cent or less, as well as a primary fiscal deficit of 3 per cent or less.

40. The effect of the introduction of a form of Euro bond would be to reduce the debt interest repayments of the peripheral Euro zone countries, without requiring a significant fiscal transfer from the Euro zone core. The concept of Euro bonds is likely to form part of any viable plan to fix the design flaws in the Euro zone.

41. The introduction of Euro bonds, although necessary, is unlikely to be sufficient by itself to end the current crisis. Member states would still remain constrained in their ability to engage in counter-cyclical fiscal policy during a crisis.

42. To eliminate the design flaws in the Euro zone that lead to 'vicious circles' of low growth and spiralling borrowing costs in individual member states, the Euro zone will need to designate a Lender of Last Resort (LOLR) which can be relied upon by member states to provide lending to member states. The European Central Bank (ECB) is the appropriate institution to fulfil this function.

43. However, the existence of a reliable Lender of Last Resort creates a moral hazard problem. This is because member states may be incentivised to behave in a fiscally irresponsible manner, knowing they will be subsidised by lower debt repayments.

44. To protect against this outcome, independent fiscal oversight and supervisory mechanisms are required. These could include the establishment of independent fiscal councils and multi-annual budgeting. Much of the requisite framework of oversight and supervisory mechanisms has been installed during the past year.

45. With the fiscal discretion of member states thus constrained, the monetary policy targets of the ECB will have to go beyond price stability, adding output, full employment and financial stability to the list of targets.

IV. Countervailing Austerity: A New Marshall Plan for Europe

46. Ireland needs to articulate a clear strategy for eliminating its primary deficit in the medium term. This strategy should be consistent with the principles of social justice and ability to pay, and should be accompanied by the strategic investment of a large portion of the funds still remaining in the NPRF and in cash balances.

47. Economic recovery in the Euro area periphery is contingent upon the ending of the one-dimensional focus on policies of austerity. This focus ‘misses the wood for the trees’ by mistakenly conflating fiscal consolidation with economic recovery. The IMF (2010) has found that fiscal consolidation has substantial recessionary impacts (see Appendix 4). The pro-cyclical fiscal policies adopted since 2008/2009 have undoubtedly exacerbated the scale of the recessions in the Euro zone periphery.

48. Full implementation of the fiscal adjustment necessary to achieve Maastricht compliance will have a substantial contractionary effect on economic growth and on employment. In addition, the large overhang of private debt in Ireland will continue to inhibit domestic consumption and investment in Ireland for the foreseeable future. Without a positive external shock, Ireland and the other members of the Euro zone periphery are likely to be heading into a long-term period of low or stagnant growth.

49. The yawning fiscal deficits of the Euro zone periphery must be closed in the medium-term. However, this process of consolidation should be accompanied by a countervailing programme of investment designed to offset the recessionary impacts of consolidation and create the conditions for economic recovery.

50. In this context, a newly created ‘good bank’ could become an important vehicle to supply investment funds to the public and the private sector in Ireland.

51. Ireland, together with a number of other Euro zone economies, does not have sufficient resources to fully finance a programme of investment of sufficient size itself.

52. Such a programme, if presented as direct fiscal transfers from the core to the periphery, would understandably be very difficult to achieve support for politically.

Nevertheless, the resources required for recovery will have to come from a European institution[5].

53. The European Investment Bank (EIB), which currently extends loans worth over €50 billion per year for investment purposes, is an obvious model of what such an institution might look like.

54. Such an investment fund would be specific to Euro zone countries and would seek to emulate the success of Roosevelt's New Deal policies in helping bring an end to the Great Depression in the 1930s, and the success of the Marshall Plan in promoting economic recovery in Europe in the aftermath of World War II.

55. There are a number of ways this 'Euro Zone Recovery Fund' could be financed. A direct monetary transfer from the ECB would be the most straightforward method[6]. The downside to this strategy would be to increase inflation in the Euro zone, which would undermine savings and would effectively be a transfer of wealth away from savers. Despite this potential downside, it is often appropriate during a recession to tolerate a higher level of inflation.

56. An alternative method of financing the recovery fund[7] would be through the introduction of a Financial Transactions Tax (FTT). This would be politically popular because it would ensure that the cost of the crisis will ultimately be borne by the sector that is most responsible for causing the crisis. The European Parliament recently overwhelmingly supported the introduction of an FTT.

57. EIB projects are currently funded 50 per cent by the member state. It is suggested that the co-financing requirement on the member state for projects supported under the Euro Zone Recovery Fund fund would be set at a level well below this 50 per cent requirement. This would free up a greater level of investment funding for the fiscally damaged member states.

[5] The IMF (2011a) has recently been re-emphasising the importance of demand management during economic crises as well as making the point that the use of monetary policy is by itself insufficient as a response to a major economic crisis. If individual members of a monetary union are constrained from engaging in fiscal expansion during a recession, then the necessary stimulus will have to come from a centralised fund.

[6] This could be done electronically with the press of a button.

[7] The recovery fund would effectively be a centralised Euro zone wealth fund. It would be added to during periods of economic boom and drawn from during recessionary periods. Each countries annual endowment of funding would be allocated based on the level of funding required to offset domestic austerity programmes. By greatly reducing borrowing requirements it would protect against the possibility of a country entering a vicious circle of low growth and high debt.

V. Conclusion

58. It is not inevitable that Ireland will have to default, and default is not an option that Ireland should unilaterally pursue. The causes of the crisis are regulatory failure of the banking system, the design flaws of EMU, and the mismanagement of the public finances in certain countries, most notably Greece and Ireland. The solutions to the crisis are also European. The design flaws of EMU need to be fixed or the Euro zone will continue to be crippled by periodic crises. For it to work optimally, the Euro zone needs a guaranteed Lender of Last Resort for member states, as well as a European bond market and a system of fiscal oversight to ensure the debt crisis is not replicated in the future. The Euro zone also needs a centralised mechanism for supporting demand management in countries which have become caught in vicious circles of low growth and persistently high deficits.

59. Although Greece is certainly insolvent, the diagnosis for Ireland is less clear. Ireland's prospects for recovery would be greatly improved by the removal of the obligation to pay all of the private banking debts. A viable solution for Ireland requires both the return of lending to the domestic economy, and a programme of investment to offset the process of fiscal consolidation. If Ireland can extricate itself from the private banking debt, then it should be able to return to sustainable debt equilibrium.

60. A good bank model for the Irish banking system would restore lending to the real economy. However the success of such a strategy is dependent upon broader European acquiescence.

61. The current architecture of the EMU is not fit for purpose. Europe must decide if it wants its project of monetary union to survive, if it does it will have to be willing to make the changes needed to ensure that survival.

References

DeGrauwe, P. (2011) "The Governance of a Fragile Eurozone" Available at: http://www.econ.kuleuven.be/ew/academic/intecon/Degrauwe/PDG-papers/Discussion_papers/Governance-fragile-eurozone_s.pdf

Economist Intelligence Unit (2011) "State of the Union: Can the Eurozone Survive its Debt Crisis?"

Available at: http://www.eiu.com/public/topical_report.aspx?campaignid=eurodebt

European Union (2010) "Consolidated Version of the Treaty on the Functioning of the European Union" in *Official Journal of the European Union*, March. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:EN:PDF

Frankel (2011) "The ECB's Three Mistakes in the Greek Crisis and how to get Sovereign Debt Right in the Future", VOXEU, 16 May. Available at: http://www.voxeu.org/index.php?q=node/6517

IMF (2010) "Will it Hurt? Macroeconomic Effects of Fiscal Consolidation. World Economic Outlook, October." Available at: http://www.imf.org/external/pubs/ft/weo/2010/02/

IMF (2011a) "Macro and Growth Policies in the Wake of the Crisis", *March 2011*. Available at: http://www.imf.org/external/mmedia/view.aspx?vid=817404091001

IMF (2011b) 'General government gross debt' in *World Economic Outlook Database, April 2011.* Available at: http://www.imf.org/external/pubs/ft/weo/2011/01/weodata/weorept.aspx?pr.x=31&pr.y=9&sy=2009&ey=2016&scsm=1&ssd=1&sort=country&ds=.&br=1&c=174%2C178&s=GGXWDG_NGDP&grp=0&a=

Juncker, J. C. and G. Tremonti (2010) "E-Bonds Would End the Crisis." Available at:

http://www.ft.com/cms/s/0/540d41c2-009f-11e0-aa29-00144feab49a,dwp_uuid=bd2f85d2-8e90-11db-a7b2-0000779e2340.html#axzz1LN0aOePm

Portes, R. (2011) "Restructure Ireland's Debt." VOX, 26 April. Available at:

http://www.voxeu.org/index.php?q=node/6380

Reinhart, C. M. and K. S. Rogoff (2010) "This Time is Different: Eight Centuries of Financial Folly." Princeton University Press.

Rogoff, K. (2011) "Rogoff Says Debt Restructuring in Greece, Ireland, Spain Is `Inescapable'.", 3 March.

Available at: http://www.bloomberg.com/news/2011-03-02/rogoff-says-debt-restructuring-inevitable-in-greece-ireland.html

Varoufakis, Y. and S. Holland (2011) "A Modest Proposal for Overcoming the Euro Crisis: Version 2.2." Available at: http://varoufakis.files.wordpress.com/2011/04/ceb1-modest-proposal-2-2-6th-april-20111.pdf

Appendices

Appendix 1: Existing Treaty Provisions

Lisbon Treaty Article 282.2:

"The ESCB shall be governed by the decision-making bodies of the European Central Bank. The primary objective of the ESCB shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter's objectives" (European Union, 2010).

Appendix 2: Bad Equilibriums in a Monetary Union

De Grauwe (2011) explains the fragility of the Euro zone. If a country has control over its Central Bank, it can always force the Central Bank to buy up government securities. This ensures that market participants cannot precipitate a liquidity crisis that could force the government into default. As De Grauwe puts it "attempts to export liquidity to other markets sets in motion an equilibrating mechanism, produced by the depreciation of the currency."

However, members of a monetary union issue debt in a currency over which they have no control and this means a liquidity crisis can indeed precipitate a solvency crisis. If investors fear that a member of a monetary union e.g., Ireland, has repayment difficulties, perhaps caused by a recession, the investors are likely to withdraw their euros from that country and invest instead in a safer part of the monetary union e.g., Germany. This effect occurs because there is no flexible exchange rate to prevent the investors from withdrawing the euros. The result of this is that the level of liquidity in the banking system will fall, i.e., the money supply will tighten. This draining of liquidity in turn makes it increasingly difficult for the government to roll over its debt at sustainable interest rates (De Grauwe, 2011). If the liquidity crisis becomes sufficiently pronounced, the government becomes forced to default.

This mechanic makes it very difficult to run budget deficits in a monetary union and it de facto constrains the individual member state's ability to engage in counter cyclical fiscal policy during a recession.

Appendix 3: Debt Projections

Debt as a % of GDP

	2010	2011	2012	2013	2014	2015
Ireland *(Govt. est.)*	96	111	116	118	116	111
Ireland *(IMF est.)**	96	114	122	126	125	123
Greece *(IMF est.)*	142	152	158	157	153	149
* IMF estimates assumes bank capitalisation under the EU-IMF bail-out will eventually fall on the sovereign debt.						

Debt as a % of GNI

	2010	2011	2012	2013	2014	2015
Ireland *(Govt. est.)*	120	140	147	150	148	143
Greece *(IMF est.)**	146	156	162	161	157	153
* Assumes Greece maintains the 2009 proportion of GNI to GDP up to 2015.						

Appendix 4: The Cost of Austerity

Contemporary studies tend to find that aggregate demand does matter. Multipliers are of course context dependent. Nevertheless the most recent empirical findings from the IMF (2010) are unambiguous that fiscal consolidation has a contractionary effect on output. The IMF find that a fiscal consolidation equal to 1 percent of GDP typically reduces GDP by about 0.5 percent within two years and raises the unemployment rate by about 0.3 percentage points. Budget deficit cuts are likely to be more painful if they occur simultaneously across many countries, and if monetary policy is not in a position to offset them, as is the case for Ireland. If interest rates are near zero, the effects of fiscal consolidation are found to be more costly in terms of lost output and because not all countries can increase net exports at the same time, fiscal contraction is likely to be more painful when many countries adjust at the same time.

Thus the current fiscal consolidation strategy will have painful macroeconomic costs. The result will be a prolonged period of low growth and high levels of unemployment that will impact on Ireland's ability to fund its debts.