

Rome, 26 October, 2012

## National Government Debt Dynamics- Causes and Policy Options

I'll first address what I believe is the most misunderstood question, which is why the euro national governments debts are as high as they are.

The answer begins with the absolute fact that government debt is equal to global 'non government' accumulations of euro financial assets. For any given 'closed sector' the euro is a traditional case of 'inside money', as with a 'giro' or 'clearing house.' The only way an agent could have net euro financial assets would be for another to be net borrowed. For every euro asset there is a euro liability. The net is always 0.

This type of system famously can't accommodate a net desire to save, unless there is a provision for net financial assets to enter the sector in question. In the case of the euro, this means the non government sector requires government deficit spending to satisfy its net savings desires, should there be any.

Additionally, note that all government spending is either used to pay taxes or remains as net savings in the economy, in one form or another. And unemployment, as defined, is the evidence that the economy does not have sufficient euro income to pay its taxes and fulfil its net savings desires.

The answer to why national government debt is so high continues with an investigation of the 'savings desires' that generate the need for net financial assets.

European institutional structure includes powerful incentives to not spend income, and to instead accumulate financial assets. Historically these have been called 'demand leakages', and include tax advantaged as well as mandatory requirements for income to go into retirement funds, corporate reserves, as well as actual cash in circulation. Without an equal expansion of private sector debt by other agents spending more than their incomes, these savings desires can't be realized, unless governments spend more than their income.

In the years immediately before the euro, the member nations with today's high debts had their own currencies. As currency issuers, whether they realized it or not, they had no solvency issues, they set their own interest rates, and they accommodated domestic savings desires with government deficit spending, which allowed them to sustain growth and keep unemployment relatively low.

The point here is that high deficits were offsetting the high demand leakages built into the institutional structures. And that requirement has not gone away, as the traditional demand leakages remain. And note that the nation with the lowest deficit, Luxemburg, never had its own currency, and instead market forces caused them to fund their net financial assets with net exports.

What changed with the euro, and the 'divorces' from the national central banks, was the ability to fund national deficits. The euro nation's financial dynamics became very much like the US states. They can no longer 'print the money', and are instead revenue constrained. However, the difference is that, unlike the US states, the euro members entered the euro with the higher debt levels incurred when they were issuers of their currencies, not constrained by revenues, and acting to offset demand leakages as required to sustain output and employment.

Today, the ECB is the central bank for the euro. I often call it the 'score keeper' for the euro. The ECB system spends and lends euro simply by crediting accounts. These euro don't 'come from' anywhere. They are 'data entry'. As Chairman Bernanke responded when asked where the hundreds of billions of dollars lent to the banks came from: '...we simply use the computer to mark up the size of the account they have with the Fed.'

In fact, any central bank, operationally, can make any size payments in its own currency. When the ECB makes a 500 million euro securities purchase, no one asks where the euro came from, whether it was taxpayer money, or whether the ECB somehow borrowed it from China. Central banks are not revenue constrained in their own currency. This puts them in the unique position of being able to act counter cyclically during a down turn in the economy.

Conversely, the euro members, like the US states, are not financially capable of reacting counter cyclically to increased savings desires when private sector credit expansion fails and economies slow. Only the ECB can, as I like to say, 'write the check' to allow for the provision of the net financial assets demanded by the institutional structure, as evidenced by the rate of unemployment and the output gap in general.

Given the state of private sector credit and net export potential, the euro zone currently needs even higher levels of government deficit spending than otherwise to sustain growth and employment. And only the ECB can write that check. And yes, I realize the political difficulties this implies, the most pressing issue being that of moral hazard.

Given the necessity of more national government debt and with only the ECB ultimately capable of writing the check, I'll now discuss policy options for closing the output gap, and their associated risks.

A simple ECB guarantee of national government debt and an expansion of Maastricht limits to perhaps 7% of gdp would trigger an immediate surge of sales, output, employment, and general prosperity. However, without adequate enforcement of limits, it would also surely trigger an inflationary race to the bottom, as the nation managing to run the largest deficits would benefit the most in real terms. So the challenge is to allow the right level of fiscal expansion to accommodate the demand leakages of the independent member nations, but without the direct central fiscal control of a currency union like the US.

Tax credit bonds are another option. These are bonds that have the same characteristics of today's sovereign debt, but in the case of non payment (there is no default condition) these fully transferrable bonds can be used for payment of taxes to the government of issue. This means that taxpayers of other members will never be asked to pay any other member's obligations, which I presume would have wide political appeal.

A third option is for the ECB to make 'cash' distributions to the member nations on a per capita basis of perhaps 10% of euro zone GDP annually. This would begin a systematic reduction of member deficits towards 0 over a multi year period. It would also have to include strict spending limits to regulate aggregate demand. To that end, the ECB could withhold payment to violators, which is far easier to do than imposing and collecting fines, as is the case today.

20 years ago I was in Rome at the finance ministry meeting with Professor Luigi Spaventa, along with my colleague Maurice Samuels of Harvard Management. Those, too, were dark days for Italy. Debt was

over 100% of GDP, interest rates over 12%, the global economy was weak, and Professor Rudi Dornbusch had been making the rounds proclaiming that Italian default was certain. I asked Professor Spaventa, rhetorically, why Italy was issuing CCT's and BTP's. Was it to fund expenditures, or was it because if the treasury spent the lira, and did not issue securities, and the Bank of Italy did not sell securities, the overnight rate would fall to 0? There was a long pause before Professor Spaventa answered 'no, rates would only fall to ½% as we pay interest on reserves' indicating full and sudden understanding that there was no default risk. He then immediately rose with an attack on IMF conditionality. A great weight had been lifted. The next week it was announced 'no extraordinary measures would be taken- all payments will be met on time' and the debt crisis receded.

Solving that debt crisis was relatively easy, as in fact there was no debt crisis. Today the situation is both more serious and more complex. The economic problem is that deficits are too small, while the political understanding is that deficits are too large. And the consequential ECB funding with conditionality translates into lower rates and higher unemployment.

Note that I have made no mention of interest rates or monetary policy in general. My 40 years of experience as an insider in monetary operations tells me they matter very little for growth and employment. And for nations with high deficits, I've come to expect high rates from the CB to function to promote inflation from both the interest income channels, and through the general cost structure of the economy.

I will conclude with very brief word on inflation. Just like the dollar, yen, and pound, the euro is a simple public monopoly. And any monopolist is necessarily price setter, not price taker.

Furthermore, a monopolist sets two prices. First is what Marshall called the 'own rate' which is how the monopolist's thing exchanges for itself. For a currency that is the interest rate set by the CB.

The second is how that thing exchanges for other goods and services. For a currency we call that the price level. I say it this way- the price level is necessarily a function of prices paid by the government of issue when it spends, and/or collateral demanded when it lends.

What this means for the euro zone is that inflation control ultimately comes down to limiting government spending by limiting selected prices member nations are allowed to pay when they spend. Like central banking, it's about price, and not quantity.

Thank you.