There is a way out of the Eurocrisis, and this, I sugge...

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I have already written about how the Euro area might get out of the mess it is in, but having discussed it with others they asked me to write it as succinctly as I could, so let me write again.

The long term can wait The Eurozone has long term economic problems that make it unlikely that it can survive as a single currency area unless there is an unambiguous social policy associated with the currency of redistributing income and wealth from its high income earning areas to its peripheral areas that will always have lower incomes. To put it another way: unless Germany is willing to redistribute a significant part of its trade surpluses to Greece, Italy, Spain, Portugal, Ireland and others then the Euro project is destined to fail and always was. That, however, is an issue for another day. The Eurozone crisis that exists now is about current wealth distribution, how we recognise it and what we do about it. **Why we got here** Fundamentally the Eurozone crisis has developed because Germany has over expanded whilst the other parts have, comparatively underdeveloped. That is, of course, little more than a statement reiterating the observations in the previous paragraph, but without any redistribution of the resulting surpluses and deficits having occurred to date, as will be required in the future if the project is to survive, the consequence has been a massive wealth imbalance that underpins all the problems we have in Europe now. Germany, by running surpluses on its trade account with the rest of Europe since the Euro began accumulated vast Euro surpluses in its banks. All other significant Euro countrdid, in effect, run deficits with Germany. Under the rules of the Eurozone these surpluses and deficits did not have to be cleared through cash payments (if they had been the imbalances could not have reached the current crippling levels, but that's another thing to address in the future and not cry about now). The result was that German banks lent the banks of other European countries the cash they needed to fund their deficits with Germany And because the cash in those countries was not needed to pay Germany, whose low interest rates also reduced interest rates also reduced interest rates throughout the Eurozone three further things happened. First, fiscal deficits, many caused by tax evasion, were not tackled because there was no pressure to do so; German banks provided the money needed by government instead. Second, banks in the Eurozone outside Germany had much less reason to but their national bonds than would have been the case if the Germans weren't buying them, so many lent on property instead. It was the next safest thing to do in their view. Third, property values in non-German Eurozone countries rose as a result, in effect but not always directly financed by German banks. **When you're in a hole look for the ladder** The result was German banks became laden with debt owing by Eurozone but not German governments whilst the banks of the non-German Eurozone became laden with property loans. Now, of course, nothing is quite as simple as that, and this situation is not, but when you're in a deep hole what you need is a clear view of a ladder, and in this case simplification within the fair parameters of reality helps identify just where the ladder we need might be. **First, the banks** Now we have two problems. Post 2008, and the US property crash which in turn created a banking crash, Europe has had a property crash. It's not happened everywhere of course, but where it has the hole left in banks has been enormous. This is the Spanish crisis and the Irish crisis for example (it's also the UK banking crisis, though we have yet to acknowledge it). It's not been all the Greek crisis, where inappropriate belief in building infrastructure and borrowing without securing the public revenue to repay the debt, coupled with corruption, seems a bigger part of the problem, but let's also acknowledge that the Greek issue is a small issue for Europe. Where there's been a property crash in Europe then it has followed without fail that there has been the need for a banking bail out (Spain and Portugal are simply not recognising this inevitability). So let me discuss these banking crises because they are, in turn, the cause of government funding crises. The banking crisis is a solvency crisis, not a liquidity crisis. Property loans are by their nature long term; they are not repaid in the short term but over much longer periods than most other loans whether to individuals or businesses. So, current repayments in relation to loans are small. However, if the value of the property on which the loan is secured falls heavily (as has happened) then at some point - maybe several years or even decades in the future, although sometimes sooner, of course. Prudent banking rules used to require that these losses be recognised as soon as they could be anticipated. Under the accounting rules in use since 2006 however, promoted by the Big 4 firms of accountants via the International Accounting Standards Board, these losses do not need to be anticipated but are recognised as they actually arise. This has meant that banks have acted imprudently since 2008 and have refused to recognise losses that they knew would inevitably arise. After four years those losses have now arisen and are growing. This is why we have a banking crisis in Spain and Portugal now: blame the auditors is a simple explanation to this one. And now the losses are crystallising the assets of the banks are being written down and the inevitability of more losses cannot be avoided. As such the banks have now, technically (and maybe actually) reached a position of insolvency. This does not mean they can't pay out now. They quite probably can. What it does mean that overall they have fewer assets by value than they have liabilities - the amount they owe. As I say, that does not necessarily mean they cannot pay out now; what it does mean that they anticipate not being able to do so at some time in the future. That is enough to make them insolvent, even if they are liquid now in the sense that they can pay out anyone who demands cash at present. The trouble is, once you begin to recognise the losses (as is now happening) and that in turn leads to an acknowledgement of the extent or property devaluation in the economy, what was a gradual recognition of the losses under the rules devised by accountants keen to support their banking clients becomes a rout. And that's happened in Ireland and is happening in Spain and Portugal now. This means almost all banks appear insolvent near enough all at the same time. Despite which they can still function. **Restoring solvency** What is needed to ensure banks can survive is that their balance sheets be restored to solvency. This can only be done in two ways. One can be by generating profit - which in the current environment and given the scale of losses arising in the economies in which these banks are working is unlikely to happen - or it can be done injecting new capital into these banks. In double entry terms (and I am an accountant) this means that assets are injected into the balance sheet matched by share capital. Let me deal with that capital side first: since share capital is only repaid in exceptional circumstances this capital is not a liability due for repayment, and that is vital, because that means that the assets injected to pay for that capital fill the hole in the bank balance sheet and ensure that the bank is solvent again. So what are those assets used to pay for that capital? The obvious answer is that they should be new government bonds. There are problems however. Firstly directly issuing bonds for this purpose is contrary to EU regulation. Bonds have to be issued for general purposes and be made available to markets to trade, via commercial banks who in the UK at least give an undertaking to acquire the bonds the government issues in exchange. The result is that bonds can't be used to plug this hole; cash has to be. And whilst that cash might be used to buy bonds there is no guarantee that they will be. And this means that the government has to raise this cash to then give it to a bank with no guarantee that the banks will use this in the way the government wants, and all this to make good the deficit that the banks created by their own bad lending. The result is that the banks are now both solvent and certainly liquid, but that is at the cost of the liquidity and maybe solvency of the governments who have bailed those banks out. There is an obvious answer, of course, and that is to make sure of three things. The first is that the asset injected is a government bond, and one that can only be marketed and so become liquid when the bad loans it is replacing in the bank balance sheet would have become repayable. That way whilst there is an asset which is underwritten and guaranteed it does not give rise to an immediate liquidity demand on the government that issues the bond, so immediately reducing market stress, which is the second part of this equation. The third part is a simple one, which is that the government issuing the bond has to take over and manage the bank to ensure that its solvency and liquidity are managed within these constraints. This means nationalisation; nothing else will do. Banks cannot be allowed to continue under their own management with a pretence that they are still under private ownership when quite clearly they failed and can only survive with state aid. That means that those needing bail out need to be state controlled, and those that aren't have to be heavily regulated to make sure that they do not abuse this situation, which would be all too easy. **Just change the rules** Only in this way can we rebuild banking without breaking governments and at its core there is a need for a change in regulation to allow the direct injection of new government bonds direct into failing banks to provide liquidity when it is needed, and not immediately, and all under state control. It sounds incredibly simply, but such a regulatory change is at the core of saving banks, and our governments with it. **And then move on to government** So let's move to the position of those governments. They borrowed for three reasons. Firstly, because they could! Money was being thrown at them - not least by Germany. Second they needed to borrow because they were running national deficits both on external and internal accounts. And finally, they borrowed to try to keep their living standards up in an economic area where comparison was all too easy. In this respect they were like all those people whose incomes failed to increase in the last decade but who saw an eilte enjoying ever rising apparent well being and who borrowed to try to keep up with that elite. It is always dangerous to compare households and economies; on this occassion it is acceptable, but I won't make a habit of it because most economies can print their own money and so get out of their problems. The trouble was that was not possible in the Eurozone, which is why on this occassion the comparison can be made. But that's also why the conventional way out of the crisis where so many European governments have found themselves is also not possible in this case: they cannot print their own money to solve their deficit problem, even if at cost to inflation. And this is the nub of the crisis they face. They can't default because their currency is the same as that of other countries. And their bonds can be directly and immediately traded and arbitraged with those of other states. The constraints are artificial but at the same time incredibly real. So what can be done about this? The need is to ensure that in effect the balance sheets of these states can also be restored. There are ways to do this, but only in a spirit of cooperation. First, Germany has to recognise that like it or not it is owed a fortune by the countries now being bailed out in Europe. The pressure could be reduced if it, and the EU allow them to bail out their banks in the way described above, but the reality is that this debt is also not worth what it was. Like the property's whose values have fallen to create the banking crisis the economies of these states have now been recognised to have fallen in value and right now they are not worth what they were. That's a fact. It is a fact that may change: values can rise as well as fall, but the reality is that the fall is real at present and if Germany does not come to terms with the fact that the debts it is owed cannot be repaid at present there is no way out of the situation we're in. It can demand repayment - but in a very real way can only have it by seeking to take over these states and manage them to ensure repaying Germany is the only priority in their economic management. That might be quite acceptable for banks, but it is not for states. A greater Germany cannot be an acceptable solution to this crisis for anyone, not least the Germans because they too must know how unacceptable and so unstable this would be. Instead the debt has to be acknowledged, and be acknowledged to be due as nothing else will satisfy the German public. It must also be deferred. And it must also carry an affordable rate of interest. Dealing with this last point first, the inter government debts of these countries have to carry a rate of interest no higher than ECB base rate. Indeed, 1% seems more than enough. And no roll up of the underpayment should be allowed: this rate should be what is payable. That way the liability is recognised but at such an interest rate let's also be honest, inflation will cover the cost. **From here to eternity** And as for the capital? Ideally of course this would be written off as we know bank assets have been written off, but that's not possible. These assets can't be written off that way so they do instead have to have their terms rewritten. They have basically to be allowed to role over indefinitely, with the debt being repurchased steadily by the ECB through a programme of qualitative easing to supply the liquidity to the banks that require it as and when those bonds would otherwise be repayable. That is how the UK is paying for its deficit: that is how the EU will have to pay for its too.   And let's address the German fear of inflation. Whilst the EU as a whole remains so massively underemployed the chance of any serious inflation is remote in the extreme. As and when it happens, the debts bought under the QE programme for the Euro could be resold if need be to counter that risk. But in the meantime the assets would have to stay on the ECB balance sheet indefinitely.   Such a programme could work: indeed, I am certain it would work. We could have banks that work, albeit under state control.   And we could have states that could be restored to viability.   And then the question of how Europe must support its peripheries in the future must be addressed. But that can only be done when the current crisis can be addressed.   And banking reform, bond issue reform. ECB reform and QE for Europe could achieve that stability, now. It just takes political will.   The alternative is failed banks, failed economies, more austerity, more unemployment, failed states, failed democracies, a greater Germany that would be politically impossible, and worse than all that, the inevitable threat that this could and would lead to bloody conflict.   It's a choice then: nationalised banks and a viable central bank for Europe or a failure of our democracies and all they represent.   It's not really a choice.   But there are those who refuse to embrace it.   ***NB: This blog may be subject to editing and correction in due course.***