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ABSTRACT

All of the attempts to end the euro crisis and to return the Eurozone countries to healthy growth rates of income and employment have failed. The options that are currently being discussed are not likely to be more successful.

If there is a politically feasible way out of the crisis, it will be through revenue neutral fiscal incentives adopted by the individual Eurozone countries. I describe some of these fiscal options after reviewing the history of failed attempts and the options that are currently on the table.

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ENDING THE EURO CRISIS?

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There may be no way to end the euro crisis. That was true even before the recent political developments in Greece. The euro faced difficult challenges from the beginning: an attempt to force a heterogeneous group of countries to use a single currency with a single exchange rate despite the lack of the de facto labor mobility and the large interstate fiscal transfers that allow the United States to operate successfully with a single currency.

All of the attempts to end the euro crisis since it began and return the Eurozone countries to healthy growth rates of income and employment have failed. The options that are currently being discussed are not likely to be more successful.

If there is a politically feasible way out of the crisis, it will be through revenue neutral fiscal incentives adopted by the individual Eurozone countries. I will describe some of these fiscal options after reviewing the history of failed attempts and the options that are currently on the table.

The Origins

The creation of the euro resulted in an immediate fall in the interest rates in those countries like Italy and Spain that had previously had high rates of inflation and interest. The lower rates of interest led to a surge in mortgage financed home building and in debt financed government spending. Financial markets came to believe that all Eurozone government bonds were essentially equivalent, causing interest spreads among those bonds to be very small.

All was well until the Greek government revealed that it had previously underestimated the size of its national debt by a considerable amount.

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The market responded with a sharp jump in the interest rate on Greek debt followed during the next year by increased interest rates in the other Eurozone countries that had large amounts of government debt.

By 2011 the government debts of Ireland, Portugal, and Italy exceeded 100 percent of their GDP and the interest rates on ten year bonds were over 12 percent in Ireland and Portugal and over 7 percent in Italy. With those interest rates, government budgets were in deficit and debt to GDP ratios were rising.

Failed Attempts

The Eurozone officials in Brussels and German Chancellor Angela Merkel responded to this situation by declaring that the crisis had to be solved at the level of the Eurozone, adding that the crisis was an opportunity to increase Eurozone solidarity. Their emphasis on higher taxes and budget austerity had the opposite effect: weakening economic activity in the peripheral countries, undermining solidarity, and producing strong anti-German sentiment. Despite the higher tax rates, the resulting decline in economic growth failed to reduce fiscal deficits and to stop the rise in the ratio of debt to GDP.

Financial market participants then began to fear that the rising debt ratios would weaken the stability of the Eurozone itself, causing one or more of the member countries to leave the Eurozone and create a new national currency. European Central Bank (ECB) president Mario Draghi then came to the rescue in July 2012, declaring that the ECB would "do whatever it takes to save the euro." The ECB then authorized financial support to those high debt countries that would present a credible plan for reducing their fiscal deficits. Although no country applied, the potential availability of the ECB funds was enough to cause interest rates to fall sharply, dropping to less than three percent in Italy and Spain.

In an important sense, this dramatic move by Mario Draghi and the ECB succeeded too well. In reducing the sovereign bond interest rates to such low levels, it removed pressure on national politicians and on union groups to make serous structural reforms.

Even with these low interest rates, the euro crisis continued with very weak growth and no reduction in the debt to GDP ratios. Germany, the European Commission, and the IMF continued to call for austerity as the necessary path to recovery and as a condition for financial assistance.

The European Commission then attempted to put itself in charge of the rescue by putting forward a three part plan: a fiscal compact, a banking union, and a budget review process.

The fiscal compact, formally adopted by all of the nations, required countries to reduce their deficits to three percent of GDP and move their debt to GDP ratios toward 60 percent. Countries that failed to comply were to be fined. In fact, several countries still continue to have deficits above three percent and deficits that are over 100 percent and rising. No country has been fined.

The proposed banking union was supposed to include a shift of banking supervision from national authorities to the ECB, a Eurozone resolution authority for failed banks, and deposit insurance at the level of the Eurozone. Far less was achieved and none of it served to increase cross boarder bank lending or to stimulate growth.

Giving the European Commission authority to review and modify national budgets was simply a step too far to even get serious consideration by the Commission itself.

ECB to the Rescue

After the failure of such ambitious plans on the part of the Commission, the ECB began pursuing its own strategy for stimulating demand in the hope that faster GDP growth would lead to lower fiscal deficits and reduced ratios of debt to GDP. A key feature of the ECB strategy has been to lower interest rates in order to cause the euro to fall relative to the dollar and other currencies. Since roughly half of the exports of the Eurozone countries are to markets outside the Eurozone, a weaker euro can stimulate demand and GDP in the Eurozone. In addition, the resulting increase in the cost of imports can raise the rate of inflation that is now close to zero.

At the time of writing this (the end of December 2014), the euro/dollar exchange rate has fallen from 140 in 2011 to 120, a decline of 14 percent. But with the concurrent currency depreciation in Japan and Britain, the broad real effective exchange rate index has fallen much less, down about four percent in 2014 and just back to about the same level that prevailed in 2011.

Mario Draghi's remarks in Jackson Hole in August of 2014 emphasized that the ECB will continue to aim at a more competitive value of the euro by keeping the Eurozone interest rates low while rates in the U.S. rise in 2015 and after.

The ECB has also pursued a variety of other strategies to inject funds into the European banks and therefore into the economy. For example, the ECB has been buying asset backed securities to inject funds into the Eurozone markets. Although this is a positive stimulus, the magnitude is very small because the market for asset backed securities in Europe is much smaller than in the United States. The ECB has also been offering to lend funds with four year maturities to commercial banks at a very low interest rate to provide low cost funds for the banks to lend to commercial borrowers. The uptake of these funds by the commercial banks has been very small because of the banks' concerns about their capital ratios and the low quality of the borrowers seeking bank credit.

A Three Part Strategy

Looking ahead, Mario Draghi has said that ending the euro crisis requires a three part strategy: structural reforms to increase productivity, increased fiscal deficits in those countries that have the fiscal room to do that, and expansionary monetary policy. The first two of these are not likely to happen, undermining the strategy as a whole.

It is clear that the countries like Italy and France that are most in need of structural reforms are not able to achieve such reforms. Substantial labor reforms in Italy have been rejected by the labor unions, with widespread strikes. Government proposed reforms in France have been prevented by the French bureaucracy.

Germany, with a nearly balanced budget, is the only country with the capacity for expansionary fiscal policy. But for reasons rooted in its history, Germany is determined to achieve and maintain a balanced budget for itself and is opposed to allowing other Eurozone countries to continue their fiscal deficits. Even if Germany did run a fiscal deficit, its impact on Eurozone growth would be relatively small.

So Draghi's three-part strategy is not going to happen. All that is left is more expansionary monetary policy. Draghi has indicated that the ECB may decide in January to buy large amounts of the existing government bonds of Eurozone countries, what the ECB calls "quantitative easing."

Quantitative Easting

Lawyers in the Eurozone are now debating the legality of such large-scale purchases of sovereign bonds by the European Central Bank. Financial analysts and economists are worrying about the future stability costs of continuing the current extremely low level of sovereign interest rates.

The ECB is considering this politically controversial and financially risky strategy for stimulating the Eurozone economies because individual member countries of the Eurozone cannot change their interest rates or their exchange rates. The peripheral countries that are most in need of stimulus also cannot use government spending or tax cuts because they already have very high national debts. Quantitative easing therefore seems to the ECB to be the only option.

If it is tried, it may not succeed. Large scale purchases of government debt stimulated the United States economy largely by driving down long-term interest rates, leading to higher equity prices and higher house prices. The resulting $10 trillion rise in household net worth in 2013 triggered increased consumer spending and a broader recovery of demand. But interest rates are already extremely low in Europe with the rate on ten year German bonds at only 0.7 percent. Even the Italian and Spanish ten year bond rates are less than two percent. Quantitative easing by the ECB cannot repeat the strategy that worked for the Federal Reserve.

Revenue Neutral Fiscal Incentives

Fortunately, quantitative easing by the ECB is not only risky but also unnecessary. This brings me at last to what may be the only feasible way of stimulating Eurozone growth: revenue neutral fiscal incentives enacted by the individual Eurozone countries. The key to this approach is to reduce the relevant cost of funds to businesses and households --- i.e. the net of tax rate of interest and the net of tax cost of equity funds -- and to increase the net of tax return on investments.

There are many ways that changing tax rules can increase aggregate spending without raising the fiscal deficit. Investment in plant and equipment can be stimulated by a temporary increase in the tax-deductible depreciation rate on new investments in plant and equipment or by an enlarged investment tax credit. It would also be possible to reduce the net cost of funds by converting the deduction for business interest to a refundable credit at a higher effective rate. The cost of equity capital could be reduced by allowing deductions for dividends on common stock or preferred equity.

The resulting revenue loss could be balanced by a temporary rise in the corporate tax rate, effectively taxing the return on old capital while stimulating new investment. The necessary rise in the corporate tax rate could be adjusted after seeing the favorable effect of the policy on economic activity and tax revenue. The specific changes would have to be done carefully to deal in an equitable way with unincorporated businesses.

Tax changes could also be used to stimulate the construction of new housing as a substitute for the lower mortgage interest rates brought about in the U.S. by the Fed's unconventional monetary policy. A direct tax incentive to home builders would be passed through to prospective buyers. Alternatively, mortgage interest payments could be made deductable in calculating taxable income (as they are in the United States) , extended to non-itemizers where deduction is currently allowed, or converted to an optional tax-credit at a higher rate. The revenue cost could be offset by adjusting tax rates in a revenue neutral and distributionally neutral way.

Yet a further alternative to QE for the Eurozone countries is to modify their value added taxes with revenue neutral offsets in the income tax. For example, an individual Eurozone country could commit to raise its value added tax rate by two percentage points a year for the next five years with the extra revenue returned in the form of lower income tax rates. The prospect of future increases in the value added tax would stimulate consumers to spend before prices rise and would also raise the rate of consumer price inflation.

Any of these fiscal changes could be enacted at the level of the individual Eurozone country. There is no need for authorization from the Commission or from other countries in the Eurozone. Although the creation of the euro ended the possibility of separate monetary policy and separate exchange rates for Eurozone countries, it did not stop the possibility of distinct tax rules and the resulting fiscal incentives.

The strategy of revenue neutral fiscal incentives might not be politically feasible and, if pursued, might still not reignite growth in the Eurozone. If that proves to be true, there may be no way to end the euro crisis while preserving the euro.

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