THE EUROPEAN MONETARY FUND[1]
A SYSTEMIC PROBLEM NEEDS A SYSTEMIC SOLUTION

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The deepening of the debt crisis in the euro area is due to three systemic causes which national governments are not able to overcome on their own. First, being members of a monetary union euro states cannot dampen or even reverse the rise in public debt through devaluations. At the same time, they have no access to funds from a national central bank. Second, under "finance-capitalistic" framework conditions, speculators systematically exploit and strengthen the fiscal troubles in the weakest countries by driving up CDS premia and interest rates to unsustainable levels. This development might transform a liquidity crisis into a solvency crisis. Third, these speculative activities widen the interest rate differentials within the euro area drastically thereby endangering the economic and political cohesion of the EMU and even of the EU.

A systemic solution which restores the primacy of politics over speculation needs to stabilize interest rates for all euro countries. It is proposed to transform the European Stability Mechanism (ESM) into an agency for financing euro states, the European Monetary Fund (EMF). It would provide governments with financial means by selling Eurobonds. These bonds are guaranteed by all euro countries to an unlimited extent. The EMF would stabilize Eurobond interest rates at a level slightly below the level of medium-term economic growth (in nominal terms). The Eurobonds are held by investors with the EMF, they are not tradable but can be liquidated at any time. The EMF helps to restore sound public finances in euro countries in close cooperation with the ECB, the European Commission and national governments. To this end, the EMF provides funds for the euro states according to clear criteria ("conditionality") which are not exclusively restrictive.

Keywords: Euro crisis, Monetary union, Dynamic budget constraint, Finance capitalism.

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For the third time since 1990 an economic crisis which originated in the US (1990, 2000, 2007) affects the European economies much stronger than the US. This time, the crisis even endangers the economic and political cohesion of the European (Monetary) Union. These troubles are closely linked to the loss of orientation on behalf of the economic and political elites. On the one hand, a policy based on the neoliberal paradigm had paved the way for the financial crisis, on the other hand, the (austerity) measures to overcome the crisis are derived from the same paradigm.

This contradiction is much more pronounced in the EU than the US. In the EU, e.g., fiscal and monetary policy is bound by rules as prescribed by monetarist theory (in contrast to the US). At the same time, however, actors in financial markets can expand their "finance alchemy" activities without being restricted by rules (the US at least passed the Frank-Dodd act).

The spill-over of a fiscal crisis in a small economy like Greece to the euro area as a whole is the most telling example of this contradiction. The radical austerity policy in Greece (called for by the Maastricht rules) has caused the economy to shrink for 4 consecutive years. Speculators were able to exploit this development by driving up CDS premia and interest rates which in turn made fiscal consolidation impossible. As a consequence, the EU had to set up the rescue fund (European Financial Stability Facility, EFSF). The rules of the "financial games", however, have remained unchanged. Thus, the interest rate epidemic reached more and more countries.

European Policy reacts to the deepening of the crisis by intensifying the symptom therapies, *i.e.*, strengthening the rescue fund and adopting more austerity measures. Since government bonds of Spain and Italy have already come under speculative attacks, causing interest rates to rise, market participants consider these measures as insufficient. The ECB tries to mitigate the situation by buying bonds of euro countries under attack and by injecting liquidity into the banking system. In order to accommodate "the markets", governments set up new savings packages in Spain, Italy, France and Greece.

All these symptom cures can at best provide short-term relief. To overcome the crisis, market actors desperately hope for new concepts. Having only to offer "more of the same", politicians in fact make the situation worse. As a consequence, the euro area has become the only region in the global economy which slides in 2012 in a recession again. This might cause stock prices to enter into a new bear market. The reinforcing interaction between the widening of interest differentials in the euro area, the intensifying of austerity measures and a global devaluation of stock wealth (eventually also of commodity wealth) could cause the European Monetary Union to collapse and the world economy to slide into a depression.

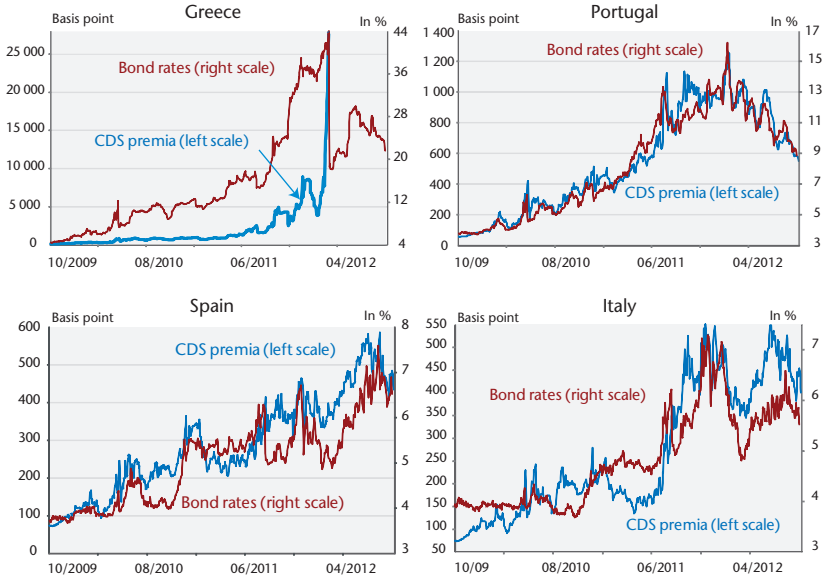
These dangers call on politicians to develop a comprehensive concept which restores the primacy of politics over "finance alchemy", which overcomes the crisis in a sustainable manner and which will pave the way towards a new prosperity phase. Such a "New Deal for Europe" needs to be based on a diagnosis of the systemic causes of the great crisis.

One core component of a "New Deal for Europe" should be the "European Monetary Fund" (EMF). It manages public finances of euro countries through the emission of Eurobonds. In contrast to the concepts proposed so far, Eurobonds are sold by the EMF at fixed interest rates and they are not tradable (like credits taken up by the IMF). Instead, Eurobonds are held by investors with the EMF. In this respect, Eurobonds are similar to German "Schatzbriefe", however, they are fully liquid (investors can always exchange them for cash at the fixed price).[2]

Such a proposal might seem too radical from the perspective of the (still) prevailing economic paradigm. However, such a proposal can be derived from a systemically oriented analysis of the crisis and of the process of its deepening over the recent past.

2. "Schatzbriefe" are time deposits at interest rates which are fixed over the entire maturity of 6 or 7 years. These instruments are held with the "Finanzagentur des Bundes" (agency for the management of government finances in Germany) by private households or enterprises. Since the financing costs for the German government have declined so strongly in recent times, it was decided that this instrument would only be available until December 31, 2012.

Figure 1. CDS premia and interest rates on government bonds



Source: Thomson Reuters.

1. A synopsis of the present conundrum

1.1. Destabilizing speculation against sovereign states

Since November 2009 interest rates on government bonds have risen dramatically in an increasing number of euro countries. This development is brought about by the interaction between the changes in the perception of risk, the downgrading by rating agencies and speculation in the CDS and bond markets. On the one hand, the interest rate rise reflects higher risk premia, on the other hand, speculation increases default risks by driving up interest rates (if the perception of risk had been the main reason for the interest rate boom, significant interest rate differentials between euro countries should have existed from the very beginning of the EMU, and they should have widened already years before fall 2009).

Also the stepwise spreading of the "interest rate epidemic" from Greece to Ireland, Portugal and then to Spain, Italy and France suggests that speculation is the key force, driving up in tandem CDS premia and bond rates (Figures 1 and 7). Those banks and hedge funds which are specialized in "making money out of

money" took advantage of high public indebtedness, a fragile banking system and/or the lack of competitiveness. CDS speculation against sovereign states has become the most profitable game over the past two years.

Speculation based on rational expectations would drive prices towards their fundamental equilibrium values. As in other asset markets, this was not the case in the CDS and bond markets: Within few months, interest rates rose to levels 10 percentage points above that level of economic growth (in nominal terms) which can reasonably be expected for countries like Greece or Portugal over the medium run.[3] Such interest rate levels are unsustainable, they do not serve as an enforcement of fiscal discipline but rather as a macroeconomic "death sentence". Even an interest rate level of "only" 6% for Spanish and Italian bonds is not sustainable since the economies of both countries will grow at a much smaller rate

To put it differently: The stepwise increase in interest rates in several euro countries has produced additional (default) risks rather than just compensating for already existing risk.

1.2. Role of the interest-growth-differential

The reason for that is simple: If the rate of interest exceeds the rate of growth (in nominal terms), any debtor (sector) has to run a primary surplus in order to stabilize the debt-GDP-ratio ("dynamic budget constraint"). To achieve such a surplus, the non-financial business sector reduces real investment in favour of financial accumulation. At the same time, also financial businesses and households run primary surpluses (e.g., private households—a creditor sector—save usually more than their net interest income).[4]

3. Rating agencies then strengthen the rise in interest rates as their downgrading mostly follows interest rate movements rather than triggering them (Tichy, 2011).

4. Figure 2 shows the inverse relationship between the financial balances of the non-financial business sector and the government sector for Germany and the euro area without Germany (the higher is the willingness of the business sector to take up credits the easier it is for the government to reduce its deficit). In the case of Germany, the fluctuations of the public budget are to a large extent also counter-balanced by the current account. The high and, until 2007, rising deficit of the rest of the world (vis-à-vis Germany) facilitated fiscal consolidation in Germany (Figure 2). The opposite was the case in most other euro countries due to their current account deficit rising significantly between 2003 and 2008. Figure 2 also shows that the non-financial business in Germany has been running surpluses already since 2004, its primary surplus is even higher (as a debtor sector, net interest payments of non-financial business are positive).

Under this condition, the government can achieve a primary surplus only if the rest of the world runs/accepts a current account deficit (the primary balances of all sectors of any country sum up to zero). Since the current account (minus net interest payments) of the euro area as a whole is roughly in balance (Figure 2), only governments of countries with (large) current account surpluses (like Germany) have a good chance to achieve primary surpluses. The other euro countries do have such a possibility only under very restrictive conditions (e.g., if households save less than their interest income). Conclusion: As long as the rate of interest exceeds the rate of growth significantly, more government saving will rather reduce economic activity than the public debt.

The relevance of the interest-growth-differential for the sustainability of private and public debt accumulation is confirmed by the empirical evidence. Over the 1950s and 1960s, this differential was significantly negative; at the same time the public debt declined almost continuously relative to GDP (in spite of the fact that the welfare state was strongly built-up at that time). Since the early 1980s, the interest-growth-differential has been almost continuously positive in European countries, and the debt-GDP-ratio doubled in spite of a more restrictive fiscal policy (Figure 5). Also the development in the euro area since 2000 clearly demonstrates the relevance of the interest-growth-differential for the dynamics of the public debt (compare the development in Germany and Spain in Figure 6).

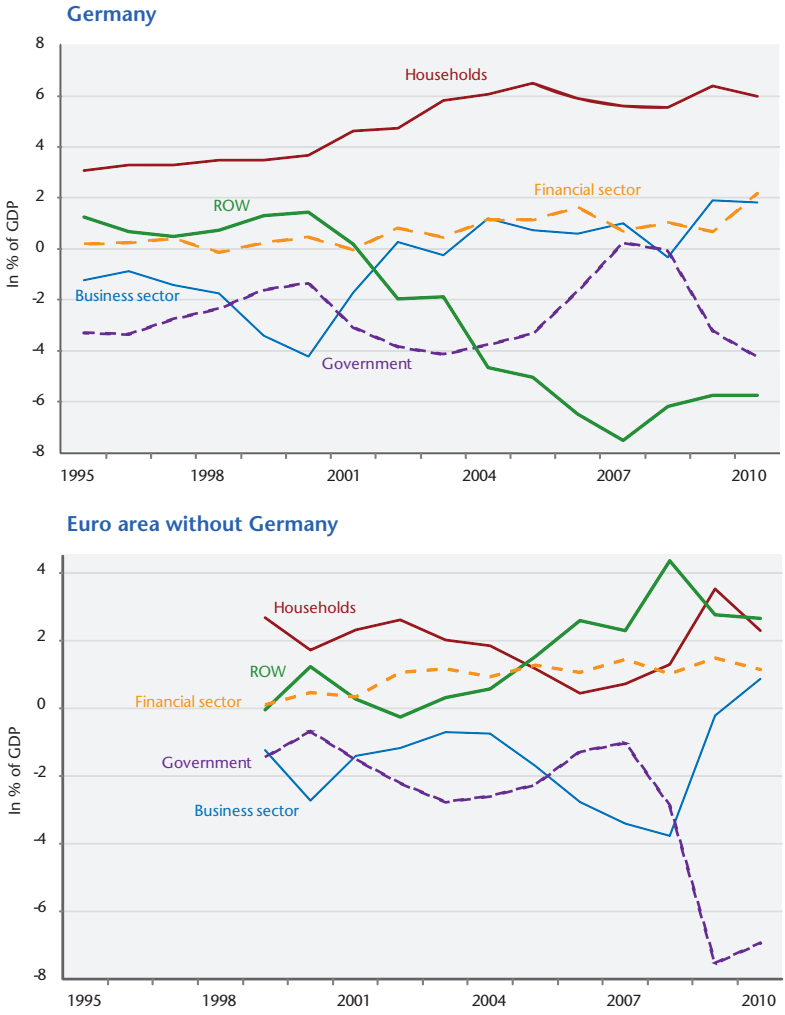
1.3. Real capitalism and finance capitalism

The switch in the relation between the rate of interest and the rate of growth was just one important component of the transformation process which fundamentally changed the incentive conditions of market economies between the early 1970s and the early 1980s.

During the "golden age of capitalism", e.g., over the 1950s and 1960s, stable exchange rates and commodity prices together with a negative interest-growth-differential and almost "dormant" stock markets channelled the search for profit to the real sphere of the economy ("real capitalism"). The business sector used household savings to finance the continuous expansion of real investment. Given strong and stable economic growth at full employment, governments could easily achieve a balanced budget over the medium run (it was the business sector which ran permanent defi-

cits). Given the negative interest-growth-differential, the public debt declined continuously relative to GDP (Figure 5). Even the extremely high debt-GDP-ratio of the US, the UK and France after WWII (in part exceeding 200% of GDP) could easily be reduced under "real-capitalistic" conditions.

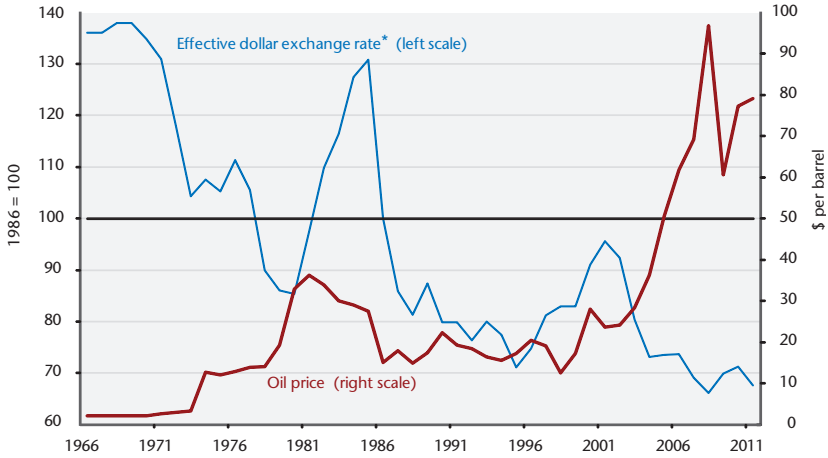
Figure 2. Financial balances in Germany and the euro area



Source: Eurostat.

Over the 1970s, the instability of exchanges rates, in particular of the dollar rates, and the related instability of commodity prices dampened business investment (the two oil price shocks were the OPEC reaction to the two preceding dollar depreciations—Figure 3). This effect was strengthened by the switch in the interest-growth-differential in the early 1980s (due to an extremely restrictive monetary policy in order to fight inflation—Figure 5). At the same time, financial innovations, in particular derivatives of all kinds, facilitated profit-seeking in financial markets. The sequence of "bulls" and "bears" in stock markets (their "manic-depressive fluctuations") is the outcome of (increasingly) short-term speculation under the framework conditions of "finance capitalism" (Figures 3 and 4—see also Schulmeister, 2010a).

Figure 3. Dollar exchange rate and oil price fluctuations



* *Vis-a-vis* DM, Franc, Pound, Yen.
Sources: OECD, IMF.

All these developments together caused the business sector to shift investment activities from the real sphere to the financial sphere of the economy. This shift caused four long-term effects which reinforced each other (Figures 2, 4 and 5):

— First, non-financial business in all industrial countries reduced its financial deficits, in some countries the business sector became even a surplus sector (e.g., in Germany, the UK, the Netherlands, USA—the primary surpluses of the business sector became even higher).

— Second, economic growth declined and unemployment rose in spite of the significant expansion of atypical employment of many kinds.

— Third, governments suffered from chronic deficits (the households' surpluses were no longer used up by the business sector).

— Fourth, given the positive interest-growth-differential, the public debt rose faster than GDP, in spite of strong efforts to limit this process (in particular in the EU since the early 1990s).

Hence, the empirical evidence suggests that the development of public finances is embedded into the overall economic performance (*i.e.*, endogenous). As a consequence, governments need to take into account the repercussions of their fiscal policy on the private sector. Cutting expenditures and/or raising taxes are neither a necessary nor sufficient condition for consolidation. If private demand is weak, an austerity policy will even worsen the fiscal stance. This "thrift paradox" had become apparent during the depression of the 1930s, in particular due to the savings policy adopted in Germany by chancellor Brüning in 1931.

1.4. Finance capitalism and neoliberalism

From a systemic point of view, re-directing the search for profit from the financial to the real sphere represents the most efficient and sustainable consolidation policy. However, such a strategy is difficult to implement for two reasons. First, one has to develop a coherent and comprehensive set of measures which would dampen "finance alchemy" and would reward entrepreneurial activities. Second (and more difficult), one has to emancipate oneself from the economic paradigm which has been prevailing over the past decades. This is so because the economic policy derived from this paradigm has shifted the search for profit progressively from the real sphere of the economy to the financial sphere.

The most important steps in the transition from a "real capitalistic" to a "finance capitalistic" incentive structure were the giving-up of a system of stable exchange rates (instead of repairing the flaws of the Bretton Woods rules), the adoption of a monetarist policy of extremely high interest rates (causing a switch in the interest-growth-differential), the progressive deregulation of financial

markets, the boom of financial innovations (derivatives of all kinds), and the privatization of social security, in particular of the pension system.

All these steps were legitimated by the neoliberal paradigm. At the same time, the new incentive structure caused the business sector to reduce real investment in favour of financial investment. As a consequence, economic growth declined relative to the "real capitalistic" period, unemployment and the public debt kept rising (Figure 5). The prevailing diagnosis and therapy of these problems are again derived from the neoliberal paradigm. In the case of the public debt the diagnosis is: Governments have control over their financial balance and they just live beyond their means. The therapy is: Cut public spending.

1.5. Development of the current crisis

Under a "finance capitalistic" incentive structure, "bulls" and "bears" of asset prices become increasingly pronounced and exert an increasing influence on the real economy. The pre-history of the current crisis is an excellent example:

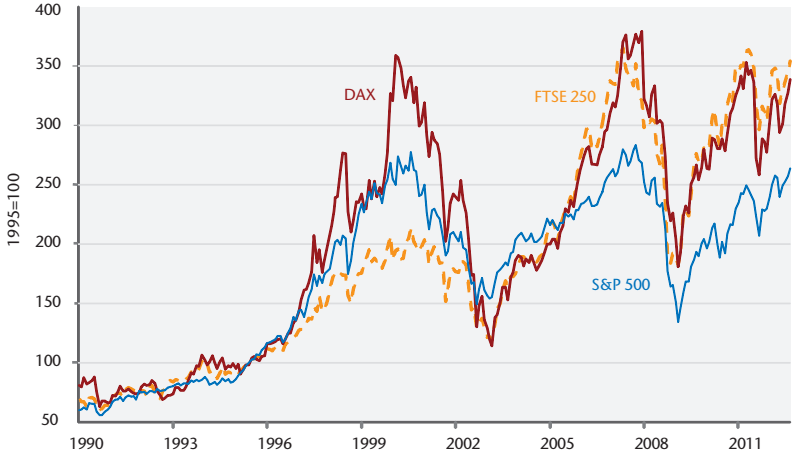
— The boom of stock prices in the 1990s and again between 2003 and 2007 as well as the boom of house prices between 1998 and 2005 stimulated the US economy through positive wealth effects. At the same time, however, the "twin booms" laid the ground for the subsequent "twin busts".

— After the outbreak of the sub-prime mortgage crisis the third "bull market", *i.e.*, the commodity price boom, accelerated, mainly driven by speculation of financial investors in commodity derivatives markets.

— Since mid 2008 the devaluation process of stock wealth, housing wealth and commodity wealth was globally "synchronized". This process set free several contraction forces, not only through wealth effects and balance sheet compression but also *via* import reductions on behalf of commodity producers.

The fall of stock prices and commodity prices has been strengthened by trend-following technical trading *via* taking huge short positions in the respective derivatives markets. Due to the extraordinary strength of these "bear markets", hedge funds using these models reported higher returns than ever before.

Figure 4. Stock markets in Germany, United Kingdom and the USA



Source: Yahoo Finance (http://de.finance.yahoo.com/m8).

The systemic causes of the crisis, e.g., the coincidence of three "bear markets", were not recognized due to the predominance of the "free-market-paradigm". Instead, the crisis was attributed to the misbehaviour of certain (groups of) agents, be they greedy bankers and hedge fund managers, irresponsible central bankers or governments. Hence, the "finance-capitalistic" rules of the game remained basically unchanged.

When the global economy approached the brink of collapse in fall 2008, economists and politicians activated their long-term memory. They reacted to the economic contraction as policy should have reacted in the beginning of the Great Depression: The banking sector was saved and stimulus programs were adopted. However, it was not taken into account that (pseudo-Keynesian) deficit spending policies cannot do their job under "finance-capitalistic" framework conditions. Banks took advantage of low interest rates to borrow from central banks and use the funds for speculation (also against sovereign states) instead of financing the real economy. In a similar way, non-financial corporations would not use additional funds due to tax reductions for real investment but could again engage in the game "let your money work". And stock prices as well as commodities prices started to boom again….

As a consequence, the cost-benefit-ratio of the stimulus measures turned out to be very disappointing. They prevented the crisis of 2008 from turning into a depression but they could not pave the way towards a self-sustaining recovery. At the same time, this "pseudo-Keynesian" policy increased the public debt significantly providing the evidence for a re-interpretation of the crisis as a genuine "public-debt-crisis". The unsustainably high debt levels in some countries like Greece or Portugal (where public indebtedness had already been too high when hit by the crisis) seemed to confirm this perception.

The different extent of the indebtedness of euro states provided the opportunity for financial investors to speculate on the default risks of sovereign debtors. Understandably, Greece became the first target: Its indebtedness got as high as that of Italy and Belgium, and at the same time the Greek government had hidden the truth. Between October 2009 and May 2010, CDS premia and interest rates on Greek bonds soared (Figure 1) forcing the EU to set up EFSF. However, this measure could not prevent the interest epidemic to spill over to Ireland, Portugal, Spain and Italy (step by step). France was not really hurt. In order to please the markets, austerity measures were strengthened but it did not help: CDS premia and interest rates continued to rise, economic growth started to decline, and this provided the justification for further interest rate increases.

1.6. Thrift paradox and the stock market decline

Even though the symptom therapy of austerity is much simpler to communicate than the systemic approach, it has two shortcomings. First, it does not work under the conditions which prevail in reality. Second, market participants lose confidence in a political leadership which has no other solution to offer but the prescription of "more of the same".

The fast deepening of the "Greek crisis" is a clear example: As result of a too radical austerity policy, the economy shrinks so strongly that the fiscal consolidation falls behind the targets (the "free-market-paradigm" does not know about the "thrift paradox"). As consequence, the "troika authorities" call for more austerity measures. This reaction in turn intensifies tensions and fears in financial markets as agents know: More of the same won't

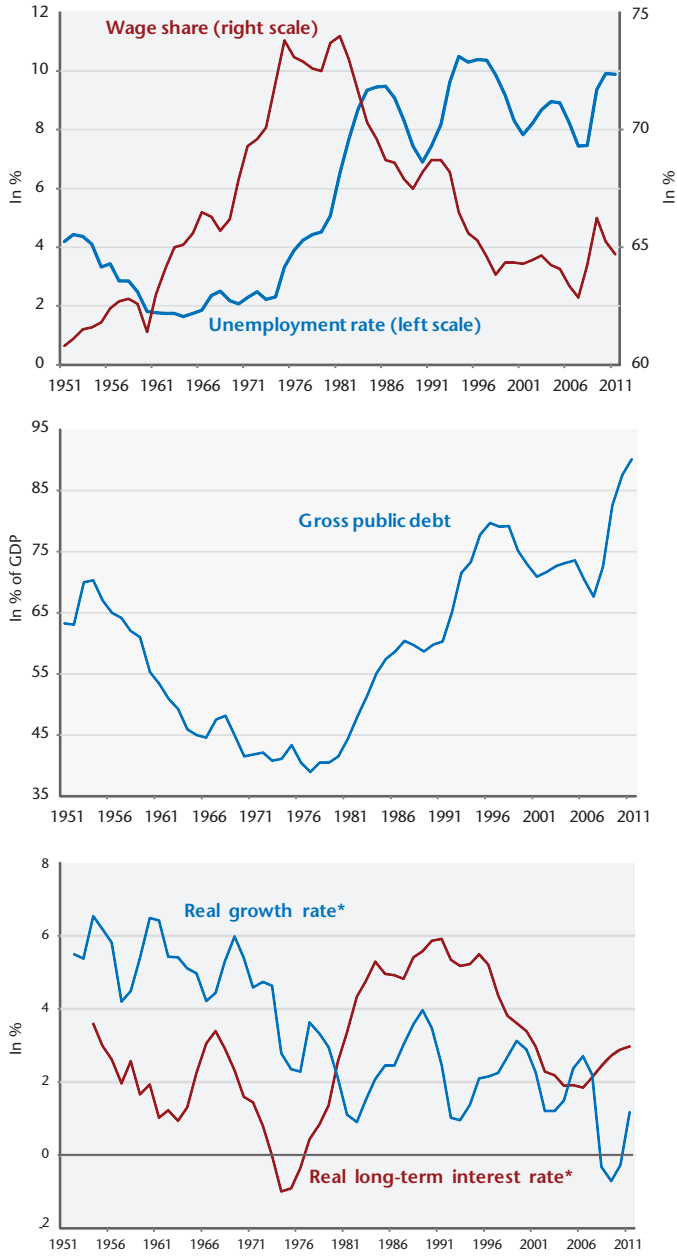
work. At the same time, also the Greek people who initially accepted the austerity measures, lost faith in the efficacy of this policy (not least because of the tremendous rise in unemployment). The elections of May 6, 2012 sent a clear signal to EU leaders: We are willing to pay back our debts, we want to remain in the EMU but we can't stand the austerity measures any longer!

If the EU leaders react by turning off the transfer of EFSF funds and thereby forcing Greece into bankruptcy they will trigger a chain reaction leading probably to the collapse of the EMU. Germany will regain its monetary hegemony, however, at very high costs for all.

The developments in global stock markets seem to confirm the fear of investors that more austerity measures will deepen the crisis. In July 2011, quarrels over the permissible debt ceiling in the US caused stock prices to retreat. This process was accelerated when the compromise between Democrats and Republicans was announced on August 1: The US government should cut expenditure by 1.5% of GDP over a period of 10 years, tax increases were excluded. Within a week, stock prices fell by 13% (S&P 500) and 19% (DAX). After a short recovery, share prices fell again after Merkel and Sarkozy announced on August 16, that every euro country should implement the so-called "debt brake". The third downward run was triggered on August 31 when it became clear that Greece would miss the budget targets and would intensify the savings policy.

In May 2012, the victory of Francois Hollande in the presidential elections in France, the results of the Greek parliamentary elections which were seen as rejection of further austerity measures by the Greek people, and the insistence of Merkel on continuing such a policy were the most important reasons why stock prices declined by almost 10% over just two weeks. These developments suggest the following. The distrust in the capability of political leaders to overcome the debt crisis and the disappointment that they only offered the old recipes, triggered waves of sell-offs. The attempt of individual stock investors to save the value of their wealth caused in the aggregate a dramatic devaluation of stock wealth (Figure 4).

Figure 5. Interest rate, growth rate and economic performance – Western Europe



* 3-years moving average, GDP deflators are used for both series.
Source: OECD.

This paradoxical development reflects the loss of orientation on behalf of many owners and managers of financial wealth. They no longer strive for high returns, they would even accept no returns at all if only their capital as such would be safe. Hence, they sell bonds of "problem states" and buy US or German bonds, Swiss assets or gold. Owners of financial wealth desperately hope for clear signals of political leadership, they would welcome Euro-bonds if only the institutional setting were stable and based on a political consensus.

Unfortunately, the political leaders have lost orientation themselves. Instead of conceptualizing new approaches to tackle the most oppressing problems like financial instability, public debt and unemployment in a comprehensive manner (all these problems are interlinked), politicians aim at pleasing "the markets" by adopting the old recipes. The fiscal compact signed by 25 EU head-of-states on March 2, 2012, is the most instructive example.

In more general terms: The sub-system "politics" and the sub-system "financial markets" have both lost their orientation and seek "navigation advice" from the other system. Under this condition the overall system can easily slide into a downward spiral.

1.6.1. Position of the current crisis in the "long cycle"

In order to answer the question "where do we stand?" it is necessary to locate the position of the current crisis in the context of the latest "long cycle".

The trough phase of this cycle was the Great Depression of the 1930s and its consequences, *i.e.*, the transition period from the "finance-capitalistic" conditions of the 1920s to the "real-capitalistic" conditions of the 1950s.

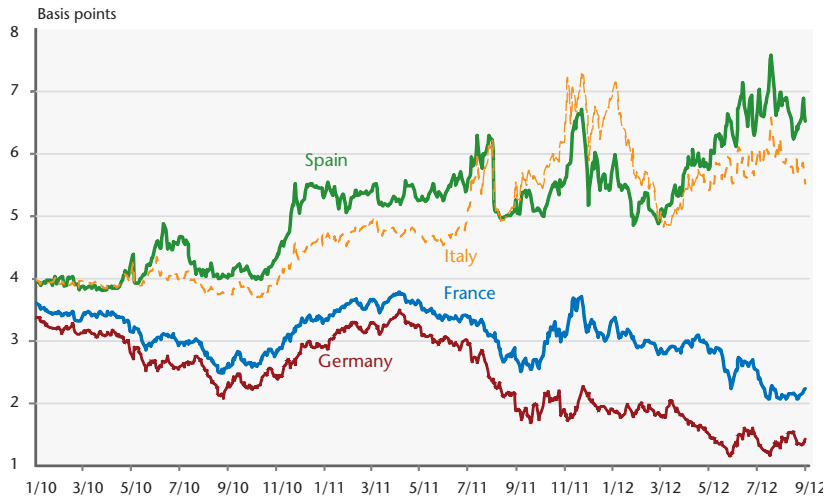
The learning process enforced by this crisis resulted in a new macro-economic theory (Keynesianism), an active economic policy focusing on stable growth and full employment, stable exchange rates ("Bretton Woods"), de-regulation of goods markets (e.g. through the GATT rounds), but strict regulation of financial markets. The essential characteristic of the system ("real capitalism") was the following: The driving force of capitalist development, striving for profits, was systematically directed towards activities in the "real economy". Under these conditions

the "golden age of capitalism" was realized over the 1950s and 1960s.

The "monetarist counterrevolution" of the late 1960s got support from "big business" because permanent full employment had strengthened trade unions as well as the welfare state (too much). The stepwise realization of the monetarist/neoliberal demand for de-regulation of financial markets (pushed forward by Friedman and Hayek) changed the "rules of the game" fundamentally. Under the condition of widely fluctuating exchange rates and commodity prices, and of a high interest-growth-differential, financial and non-financial business shifted activities from the "real economy" to financial investment and short-term speculation ("finance capitalism"). This shift was supported by the tremendous amount of financial innovations (*i.e.*, derivatives of all kinds) which have been realized since the 1980s.

From this perspective, the current crisis which has been deepening since 2007 marks the early phase of a transformation process from "finance-capitalistic" to "real-capitalistic" framework conditions—in other words: The beginning of the trough phase in the long cycle.

Figure 6. Interest rates on government bonds



Source: Thomson Reuters.

2. A "more-of-the-same" scenario

If the political leaders in the EU are unable to propose a fundamentally new approach to overcome the debt crisis, and rely on "more of the same" instead, the following development is plausible:

— The recent (mini)boom in stock prices—triggered by the announcement of the "outright monetary transactions" program of the ECB (OMT) in September 2012 - turns into a genuine bear market, devaluating stock wealth by up to 70% relative to their peaks in spring 2011 (as already twice since 2000—Figure 4).

— Entrepreneurs and households reduce their investments and consumption, the latter in particular in reaction to the devaluation of their pension fund wealth.

— Prices of government bonds of euro countries like Spain, Italy, Belgium and France start to fall again, interest rates rise (Figure 6). At the same time interest rates on government bonds of Germany decline even further.

— The ECB cannot prevent the widening of interest differentials in the euro area as Spain and Italy refuse to accept further austerity measures demanded by the European Stability Mechanism (ESM), the ECB is trapped by its promise to purchase only bonds of those countries which subordinate themselves under the ESM directives). In addition, internal opposition led by the president of the Bundesbank hinders the ECB to strengthen confidence through a clear leadership.

— The economic and political split within the euro area widens, thereby weakening not only the euro and the EMU, but also the political coherence of the EU. This development could endanger even the German-French axis if interest rates rise in France during the coming recession but stay much lower in Germany.

— Rating agencies continue to downgrade the most indebted euro states as well as those banks which hold a large part of government bonds of the respective countries. The whole banking system in the EU comes close to a collapse.

— The conflicts within the ECB as well as between EU governments intensify over how to overcome the euro crisis. As a

consequence, any potentially efficient measures against the aggravation of the economic situation are politically blocked.

— The US from which the great crisis originated, will enjoy the lowest interest rates. There are three reasons for this paradox. First, investors are confident that the Fed will buy US government bonds to an unlimited extent (if necessary).[5] Second, the weakness of the EMU strengthens the authority of the Fed. Third, the dollar remains the unchallenged key currency in the global economy.

— The "safe-haven-assets" like gold cannot absorb the flight of finance capital out of stocks and bonds. Demand for cash rises which is hoarded at banks. At the same time, the asset side of the banks' balance sheet shrinks due to the devaluation of stocks and bonds, the banks' equity is wiped out.

— Commodity prices continue to fall. The related decline in (import) demand on behalf of commodity producers dampens (international) trade and production. As in 2008/2009, this effect is stronger than the (positive) real-income-effect of falling prices.

— Governments lack financial means to fight the symptoms of the crisis by a primitive deficit-spending-strategy as in 2009/2010.

— The EMU breaks down, Germany regains the monetary hegemony in Europe—be it in the form of a "Northern euro" or the deutschemark—which it had sacrificed in the early 1990s to the integration of the former GDR. The economic and political tensions rise dramatically within the EU.

These developments will probably lead into a depression deepened by the simultaneous devaluation of different types of wealth (stocks, government bonds, commodities, and eventually houses once again) as between 2007/2009 and 1929/1933.

3. Challenges of the current situation

The transition from "finance-capitalistic" to "real-capitalistic" framework conditions, triggered by a stock market crash (e.g., 1873, 1929, 2007ff), usually takes many "depressive" years (e.g., 1873 to

5. De Grauwe (2011b) documents in a recent paper that the Fed and the Bank of England have served as "lender of last resort" to their governments to a much larger extent than the ECB. This behaviour has obviously strengthened the credibility of both central banks and also the attractiveness of US and British bonds.

~1890, 1929 to ~1948) as the old "rules of the game" don't work any longer but new rules have not yet been designed and implemented.

The dramatic events of recent months show: The attempts to restore the "finance-capitalistic" game by "pseudo-Keynesian" means have failed. Preventing a further deepening of the crisis, developing a systemic concept for a sustainable recovery, and putting such a concept into practice, is almost a "mission impossible".

However, a similar challenge was met after WW II (and in part already earlier through Roosevelt's New Deal): By learning the lessons from the Great Depression, economists and politicians were able to design new framework/incentive conditions which formed the basis for the "golden age of capitalism" in the 1950s and 1960s. Why shouldn't we be able to learn the lessons before a depression takes place?

Such a concept for new "rules of the game" or for a "New Deal for Europe" has to deal with the following issues:

— The fears of people that their financial wealth, in particular their pension capital, will be devalued a third time since 2000, must be contained (stock indices still stay roughly 10% below their 2000 peaks in spite of two bull markets).

— Confidence must be built up that political leaders will be able to overcome the debt crisis and the euro crisis in a stepwise process.

— The incentive structure has to be changed so as to favour entrepreneurial activities and to dampen all kinds of "self-referential" accumulation of financial wealth, in particular short-term speculation unrelated to market fundamentals ("finance alchemy").

— The cohesion of the EU must be strengthened, at the same time no country should be put at a disadvantage through a new crisis strategy (otherwise the resistance against such a strategy would be too strong within member states).

— All that has to be achieved rather quickly and should not need large amounts of money.

The most urgent challenge consists in preventing the downward spiral in many euro countries from spilling over to the EU as a whole due to the interaction between widening interest

differentials and stronger austerity measures. Bringing this process to a halt requires in the first place a political consensus on a pragmatic concept to stabilize interest rates in all euro countries at a sustainable level. To this end, the capability of speculators to drive up interest rates on government bonds of euro countries must be restricted.

This is necessary also for political reasons. These activities play euro countries off against each other and, hence, undermine the economic and political cohesion of the European (Monetary) Union: The more interest rates rise in the "problem countries", the lower they get in the "good countries" in particular in Germany. Instead of correctly valuating risk, bond and CDS speculation produces additional risk, in particular with respect to the EMU as a whole.

In a similar manner, short-term speculation causes exchange rates and commodity prices, in particular crude oil and food prices, to widely overshoot their fundamental equilibrium values. As part of new framework conditions also these prices need to be stabilized by economic policy in order to foster the real economy at the expense of "finance alchemy".

It is no coincidence that the two prices which intermediate between the real sphere and the financial sphere of the economy, *i.e.*, the exchange rate (in space) and the interest rate (in time), were stabilized by economic policy in those periods/countries when/where the economic performance was particularly successful. These conditions prevailed over the 1950s and 1960s and also in present times in successful "real-capitalistic" economies like China.

The theoretical benchmark for stabilizing interest rates should be the (nominal) rate of economic growth to be expected over the medium run, for exchange rates the benchmark should be purchasing power parity of internationally traded goods and services (tradables). As an intermediate step regarding currency markets, the central banks of the US, the euro area, Japan and China (eventually also the UK and Switzerland) should commit themselves to stabilize their exchange rates within tight bands (e.g., +/-2%), taking the averages over the recent past as means (e.g., the average exchange rates since the creation of the euro).[6]

As regards crude oil prices, one has to take into account two peculiarities. First, crude oil is an exhaustible resource the price of which needs to increase in equilibrium with the rate of interest stronger than the general price level (Hotelling rule). Second, the use of crude oil is the most important cause of climate change. To compensate for these externalities, economic theory suggests that oil prices should become permanently more expensive than all other goods. In reality, however, the wide fluctuations of crude oil prices bring about a waste of this resource, a deterioration of the environment and hamper investment in energy saving technologies.

Even though one cannot precisely quantify by which margin the price of crude oil should rise faster than the general price level, it is clear that any steady and reliable increase of oil prices above the general inflation rate would do a better job than the market which sometimes produces price changes of 50% and more within a few months.

To give a concrete example: OECD studies conclude that the price of greenhouse gas emissions should rise to 370 € per ton $CO_{2\text{-eq}}$ if the increase in climate temperature is to be restricted to 2° C (with such a price increase one would be on the safe side of the "low carbon scenario"—EC, 2011a). At a world market price of oil price of 100$ these additional cost would translate into an oil price for users of 248$.

If this target is to be reached by 2020, the oil price needs to rise by roughly 12% per year. Such a stable and reliable price path can neither be brought about through emissions trading schemes nor through carbon taxes. If, however, the EU would set such an obligatory price path for all users of crude oil (primarily refiners which

6. It might take some time to find a compromise on "fair" exchange rate values, in particular, as the estimates of tradables PPP would imply a significant revaluation of the US dollar and a corresponding devaluation of the euro (as long as one does not also take into account the different degree of external indebtedness). In any case, exchange rate stability as such would strongly facilitate entrepreneurial activities and restrict speculation. This is particularly clear if one recapitulates how strongly currency fluctuations have hampered the real economy since the early 1970s. E.g., the overshooting of the dollar exchange rate and of the oil price are inversely related to each other, at least during periods of marked "bull markets" and "bear markets" (since crude oil is priced in dollars, depreciation of the key currency devalues real oil export earnings - this valuation effect in turn strengthens the incentive for oil-producing countries to increase the price of their most important export good as 1973 and 1979).

would then increase their output prices accordingly) by introducing a flexible tax which amounts to the difference between the world market price and the target price according to the long-term price path, a wave of investments in energy saving would be triggered, from isolation of buildings to new forms of mobility.

The reason for that is simple: These investments become much more profitable than today (in terms of avoiding opportunity costs) and the rates of return on these investments become calculable. The latter is extremely important as the amortization periods of energy saving investments are particularly long.

In the present situation, the most urgent challenge is the stabilization of interest rates on government bonds at a level below the rate of economic growth as this is a prerequisite for fiscal consolidation over the medium and long run, and, hence, for restoring confidence in the political and financial system in the EU. The markets have proved unable to provide sustainable long-term interest rate levels. Therefore, this task has to be taken over by the European Monetary Fund in a similar way as the ECB controls the level of the short-term interest rate.

4. Features of the European Monetary Fund

The European Monetary Fund (EMF) coordinates and manages public finances of euro member countries in such a way that the crisis in Europe can be overcome in a sustainable manner. This crisis is not just an economic crisis but also a social and political crisis. It calls for the implementation of new framework conditions which would reward entrepreneurial activities on all levels (macroeconomic policy, tax policy, regulatory policy, etc.) more than finance alchemy. The EMF is one core component of such a "New Deal for Europe".

4.1. Scope and principles

A systemic problem needs a systemic solution which restores the primacy of politics over speculation. It is proposed to transform the European Financial Stability Facility (EFSF) into the European Monetary Fund (EMF). The scope of the EMF is fourfold:

— The EMF provides euro governments with financial means by selling Eurobonds in the capital markets. These bonds are guaranteed by all euro countries to an unlimited extent. In addition, the EMF has full backing by the ECB (if necessary, the ECB buys Eurobonds from the EMF).

— The EMF stabilizes Eurobond interest rates at a level slightly below the level of medium-term economic growth (in nominal terms). The Eurobonds are held by investors with the EMF, they are not tradable but can be liquidated at any time. In these two respects the present proposal differs most from Eurobond concepts already put forward.

— The EMF helps to restore sound public finances in euro countries according to a systemic approach and, hence, in close cooperation with the ECB, the European Commission and national governments. To this end, the EMF provides funds for the euro states according to clear criteria ("conditionality") which are not exclusively restrictive.

— The EMF overcomes the split between euro countries caused by widening interest rate differentials and strengthens thereby the cohesion and credibility of the EMU and of the EU as a whole.

The fundament for achieving these goals has already been built by European leaders: The European Financial Stability Facility (EFSF) set up in May 2010 could be transformed into the European Monetary Fund. Simply enlarging the "fire power" of the EFSF or implementing the European Stability Mechanism (ESM) already in 2012 won't be sufficient by any means.

4.2. Motives

With the deepening of the fiscal crisis in some euro countries several proposals have been made to introduce new instruments for financing (in part) euro governments (De Grauwe and Moesen, 2009; Gros and Micossi, 2009; Delpla and von Weizsäcker, 2010; Gros and Mayer, 2010; Palley, 2011). These Eurobonds should be sold up to a certain limit (e.g., "Maastricht debt limit" of 60% of GDP) either by the single countries or by a new institution, backed by the guarantee of all 17 euro states (Varoufakis and Holland, 2011, propose to transfer part of the public debt to the ECB).

The main argument in favour of Eurobonds is as follows. In a monetary union, member states do no longer have the possibility to devalue their currency in case of a (asymmetric) shock and the governments do no longer have access to financial means provided by "their" central bank. "As a result, a loss in confidence of investors can in a self-fulfilling way drive the country into default" (De Grauwe, 2011a, p. 32).

Pisani–Ferry (2012) argues that "an impossible trinity of no-coresponsibility over public debt, strict no-monetary financing and bank-sovereign interdependence is at the core of Euro area vulnerability" (p. 14). In other words, the three conditions, namely, the "no bail-out clause", the prohibition of financing euro governments through the ECB and the fact that public finance relies to a large extent on the banking system which in turn depends on the governments' fiscal stance (*via* the market valuation of their bonds) are inconsistent and undermine the stability of the euro, in particular in the case of shocks.

Pisani–Ferry (2012) discusses the "corresponding three options of reform—a broader mandate for the ECB, the building of a banking federation, and fiscal union with common bonds…." (p. 14). These options are by no means mutually exclusive, yet, all of them are difficult to put in practice for legal, political and economic reasons.

This paper argues that the fundamental contradiction does not prevail between the stability of a monetary union and the "trinity conditions" but between the former and speculative activities which drive interest rates up to unsustainable levels in some countries and to extremely low levels in others, thereby strengthening the economic divergence in the union as a whole. This becomes clear if one assumes that policy succeeds in stabilizing interest rates on government bonds at a level below the rate of economic growth. In this case, the problems related to the "trinity conditions" would become much less oppressing and easier to handle.

The recent massive transfers of deposits from Greek banks to banks from other euro countries (almost exclusively to German banks), and the take-off of similar developments in Portugal, Spain and Italy demonstrate the incompatibility between the stability of

a monetary union comprising economies at different stages of development/specialization on the one hand, and completely unrestricted financial markets on the other hand. In case of an exit of Greece from the EMU these transfers would blow up the target2-imbalances to an extent which might cause the whole system to collapse.

The economic performance under the "real-capitalistic" framework conditions of the 1950s and 1960s provides further evidence in favour of this incompatibility hypothesis. This is so because the Bretton Woods system can be conceived as a forerunner of a monetary union insofar as exchange rates were pegged (managed adjustments occurred rarely). This arrangement together with a strict regulation of short-term capital movements and the stabilization of interest rates below growth rates brought about stable growth and economic convergence.

Most Eurobond concepts propose limits to the access to Eurobond financing for the single countries. The main argument lies in the "disciplining effect of the higher marginal cost of borrowing" (Delpla and von Weizsäcker, 2010, p. 4). This is so because having fully used the capacity of Eurobond financing ("blue bonds" in the terminology of Delpla and von Weizsäcker, 2010), the single countries need to sell national ("red") bonds in the capital markets. The markets then would discipline irresponsibly acting governments through high interest rates.

Palley (2011) proposes the foundation of a "European Public Finance Authority" (EPFA) which "would continuously issue bonds as part of assisting euro zone countries with normal budget deficit financing. The goal is to make this a normal element of budget deficit financing." (Palley, 2011, p. 17).

The EMF concept—sketched in Schulmeister, 2010b—is similar in spirit to the EPFA proposal but goes beyond it in two respects (the first politician who coined the term "European Monetary Fund" was the German finance minister Wolfgang Schäuble in spring 2010, the first paper on an EMF concept is Gros and Mayer, 2010)[7]):

7. For the global economy, Dirk Solte has made a similar proposal already in 2009. His proposal focuses on two requirements of a "world financial system in balance", the need of a global lender of last resort and the need to prevent hoarding of international liquidity. The IMF should become the global lender of last resort and a "liquidity circulation fund" should be established to channel overflowing liquidity to those countries which are in need of liquidity. For further details see Solte, 2009.

— The EMF stabilizes the interest rate on Eurobonds, *i.e.*, it determines the long-term interest level in a similar way as the ECB determines the level of the short-term interest rate.

— The Eurobonds are held by investors with the EMF, they can always be liquidated but they are not traded in capital markets (like savings accounts).

There are two main reasons for making also the long-term interest rate a target as well as an instrument of economic policy.

First, this approach enables economic policy to stabilize the interest rate on future credits of euro states at a level below the (expected) medium-term growth rate (in the EPFA proposal, this could be indirectly achieved through open market operations of the ECB). In this way, also the interest rate on corporate bonds would be reduced. Such an improvement in the financing conditions for the business sector and the government sector is a precondition for a sustained recovery and, hence, for a gradual reduction of public indebtedness.

Second, controlling the long-term interest rate enables the EMF in cooperation with the ECB and the EC to set the interest rate close to the level enjoyed by the "good countries" like Germany. This will help to overcome the resistance from national-populist politicians and media within the "good countries" against Eurobonds.

Eurobonds should not be traded in capital markets because otherwise financial investors might start to speculate against or in favour of Eurobonds relative to government bonds of the US, the UK, Japan or some smaller states. Even though this game would be less easy than playing off member countries of a monetary union against each other, it is nevertheless superfluous. If this proposal were put in practice, CDS with reference to debts of euro governments would disappear as neither hedging nor speculation makes sense any longer.

In addition, banks would no longer get rents by borrowing at the ECB at low rates and investing in government bonds at high rates. This business does not add any value to the overall economy (just profits to the banks), in contrast to financing firms where the banks' seeking for the best investment opportunities can—in principle—improve the allocative efficiency. It seems reasonable that investors finance governments directly.

This possibility exists already in many countries (German "Schatzbriefe" etc.), it should be generalized at the level of the EMU through the foundation of the EMF. Eurobonds can therefore also be conceived as fully liquid savings deposits of financial investors held with the EMF. The ECB serves as lender of last resort, however, to the EMF as intermediary which substitutes private banks.

Stabilizing the values of government bonds might also mitigate the fluctuations in the valuation of corporate bonds. The experience since the 1970s suggests that changes of asset values and the related wealth effects have strongly contributed to shifting striving for profits from entrepreneurial activities to financial speculation. Stabilizing the value of government bonds will help to gradually change the incentive structure in favour of the real economy.

But what about the price discovery process provided by capital markets? Don't they fairly evaluate the performance of states and, hence, their credibility, supported by rating agencies? The answer is: No. The reason for this is simple: States are not corporations. The purpose of the latter can—in principle—be reduced to making profits and future profits can be reflected in just one variable, the stock price, for which markets (supported by rating agencies) can—in principle—bring about unbiased estimates. States have multiple functions, none of which relates to profit making. Hence, the performance and credibility of a state can—in principle—not be measured by just one price, the bond price (rate of interest). As a positive side-effect of establishing an EMF, the upgrading or downgrading of the new Eurobonds by rating agencies would become largely irrelevant.

If one conceives financing the "res publica" as an investment opportunity like any other, one can of course become trapped in mixing up firms and states. Once the (economists') elites have emancipated themselves from this neoliberal heritage they can devote their intellectual capacity to the complex task of improving the management of public affairs. Letting the market punish the "delinquents" for mismanagement or reckless spending by raising interest rates to "death sentence" levels only makes the situation worse (in particular for those who have nothing to do with economic policy or "finance alchemy").

4.3. Governance

All euro countries are members of the EMF. The contribution to the fund's equity as well as the voting rights could be allocated according to the economic strength of the members or the population (or some combination). This issue is left open to the political decision process.

As is the case with the ESM, the EMF is governed by the finance ministers of the member states and by the European Council as regards fundamental decisions (a counter-balance to the ECB where central bankers dominate). As regards the operative business, the EMF acts as an independent institution (like the IMF). The fiscal programs for the member states—aiming at macroeconomic stabilization and financial consolidation—are set up in close cooperation with national governments. The distribution of funds is strictly bound to several criteria which, however, are not exclusively restrictive. This conditionality ensures that no member country can act as free rider.

In contrast to most Eurobond proposals (but in line with Palley, 2011), there should be no general limit for Eurobond financing, it should become the normal way to fund euro states as they are members of a monetary union.

If a country does not comply with the criteria for EMF funding, it will not get funds and, hence, has to rely on selling their national bonds for which they would have to pay unsustainably high interest. Knowing this in advance, highly indebted governments will stick to the consolidation measures accorded with the EMF and the EC. In other words, the disciplinary power of the EU authorities is much higher if government financing is provided by the EMF as compared to the extant situation where governments could rely on the reckless lending by banks.[8]

8. A thought experiment might clarify this issue. If any additional credit to an euro government had needed the permission of the EC, countries like Greece or Portugal would have had much smaller budget deficits than they actually did. It were "the markets" which completely failed to "discipline" the debtors. After supporting the misbehaviour of governments for years, "the markets" all of a sudden turned from "no punishment" to "death sentences". This behavior is in line with the two fundamental diseases from which the invisible hand suffers in financial markets: Over the long run, it suffers from manic-depressive illness, and over the short run from strong Parkinson.

The common and unlimited guarantee of Eurobonds by all 17 euro states together with the backing by the ECB ensure that defaults on Eurobonds are only possible if the whole financial system collapses (in which case it does not matter). In this way, the EMU would achieve a similarly strong position vis-a-vis financial investors as the US where the Fed backs government bonds to an unlimited extent. This is the main reason for the attractiveness of US bonds in spite of the weakness of the US economy. Investors know that given the Fed's support, default on US government bonds is (almost) impossible.

The present proposal provides the same degree of security for Eurobonds. Hence, global demand for these instruments will be strong. There are two additional reasons for that. First, only the US would supply a comparable amount of public securities to big investors in the global economy like central banks and pension funds. Second, the real economy in the euro area is stronger than in the US (the European weakness stems from fundamental inconsistencies in the financial sphere which would be overcome by the EMF).

There are three important questions as regards the key objective of the EMF, namely, to stabilize the interest rate on government debt at a level below the (expected) rate of medium-term economic growth. First, what serves as the benchmark for the growth rate given the great differences in economic performance between euro countries and the related differences in the initial conditions? Second, by which margin should the targeted interest rate level be lower than the benchmark growth rate? Third, how can the EMF enforce (international) investors to buy Eurobonds at such (low) interest rates?

Over the coming years, the EMF should focus on the growth potential of the "problem regions" in the euro area, *i. e.,* of the Mediterranean countries. If one does not only consider supply-side factors for economic growth, one will conclude that the GDP of these countries will hardly expand faster than by 1% per year over the medium run. Taking explicitly the growth potential of the weaker regions as basis (and not the expected average over the whole euro area) provides additional stimuli for the better performing regions, in terms of both, real growth and inflation (for the transition period of turning the downward trend into an upward

trend, an inflation rate exceeding 2% should be tolerated as it helps to reach two targets, fiscal consolidation and improvement of the competitiveness of the "problem economies" in the euro area).

The optimal size of the targeted interest-growth-differential cannot precisely be quantified as it not only depends on the (different) debt-to-GDP ratios as part of the initial conditions but also on the state of confidence with respect to entrepreneurs, households and (international) investors. For the first years of EMF operations, this differential should be kept at a maximum (in absolute terms) which is compatible with the willingness of investors to buy Eurobonds. A pragmatic approach would be to set nominal interest rates between 1% and 2%. This implies slightly negative real rates. The example of the US and Germany shows that investors are willing to accept such low rates if they believe in the security of their investment. The unlimited guarantee of all outstanding Eurobonds by all euro states is therefore a necessary condition for successfully selling these instruments at very low rates.

The second condition for achieving investors' confidence is the guarantee of the ECB to buy Eurobonds in case the private demand falls short of supply at the targeted/fixed interest rate (therefore, the EMF determines the nominal Eurobond interest rate in close communication/coordination with the ECB). Such a guarantee directly contradicts the traditionally monetarist stance of the ECB. However, when struggling for survival even conservative institutions are capable of changing their position and trying new strategies—the policy of the ECB itself over the last two years is an excellent example.

Given the double guarantee of Eurobonds by governments and the ECB, Eurobonds would enjoy the same "security conditions" as US bonds and might even become more attractive than the latter. This could be so because to many big investors like the Bank of China the real economy seems to be stronger in the EU as compared to the US (only/mainly the inability of euro governments to manage their "internal" financial affairs has rendered debt instruments of many euro states less attractive in recent years).

The main channel through which the ECB guarantee will foster the attractiveness of Eurobonds concerns investors' confidence. Hence, it might not even be necessary for the ECB to actually buy

Eurobonds to such a large extent as the Fed has been doing in recent years. And even if such purchases would be needed to stabilize interest rates at a very low level they would not contradict EU law as the ECB finances the EMF as a supranational EU institution and not directly member states.

4.4. Costs of not controlling interest rates on euro governments' bonds

Stabilizing long-term interest rates in the euro area at a level below the rate of economic growth will stimulate real investment as a prerequisite for a sustained recovery. Only under this condition can the fiscal stance be improved over the medium and long run. Such a development would prevent sovereign defaults and, hence, the necessity of "good" countries to bail out the "bad" ones.

If, by contrast, policy accepts the formal insolvency of an EMU member state, much more capital has to be mobilized. Even though it might be politically easier to put through tax increases within a single nation state to save "our" banks (victims of the reckless policy of "bad" countries….) than to bail-out countries like Greece or Portugal (no transfer of "our" money to "lazy" people……), not preventing defaults will be much more costly—not only financially but also socially and politically (see, e.g., Cline, 2011; Niechoj *et al.*, 2011).

The resistance of nationalist-populist media and politicians could be overcome if one shows that avoiding defaults does not need tax-payer's money but a change in economic policy, *i.e.*, transforming the long-term interest rate from a market price to an instrument variable. Such an idea will meet strong resistance from mainstream economists (like the financial transactions tax). This resistance can be mitigated in three ways:

— By looking concretely how the interest rate is determined in the CDS and bond markets and which role destabilizing speculation plays in this process.

— By showing that stabilizing long-term interest rates in all euro countries provides the basis for a gradual overcoming of the financial and economic crisis.

— By clarifying that there is no alternative (TINA) to stabilizing interest rates.

As regards the second point, I shall now summarize the results of an econometric exercise which simulates the medium-term economic development under the rules of the fiscal compact on one hand, and under the condition of stabilized interest rates on the other hand.

5. Austerity policy *versus* interest rate stabilization—two model simulations[9]

This section summarizes the results of an econometric simulation of two scenarios using the global model of Oxford Economics (OEF, version of February 2012). In the first case it is assumed that the rules of the fiscal compact are implemented, beginning in mid-2012. In the second case it is assumed that the interest rate on euro government bonds is stabilized at 2%.

The fiscal pact scenario is simulated as follows:

— The annual consolidation requirements of the individual EU countries are identified on the basis of data for 2011 (including the EC estimates of structural deficits).

— It is assumed that the target of a maximum structural deficit of 0.5% of GDP is to be reached by 2016 (in analogy with the German "debt brake").

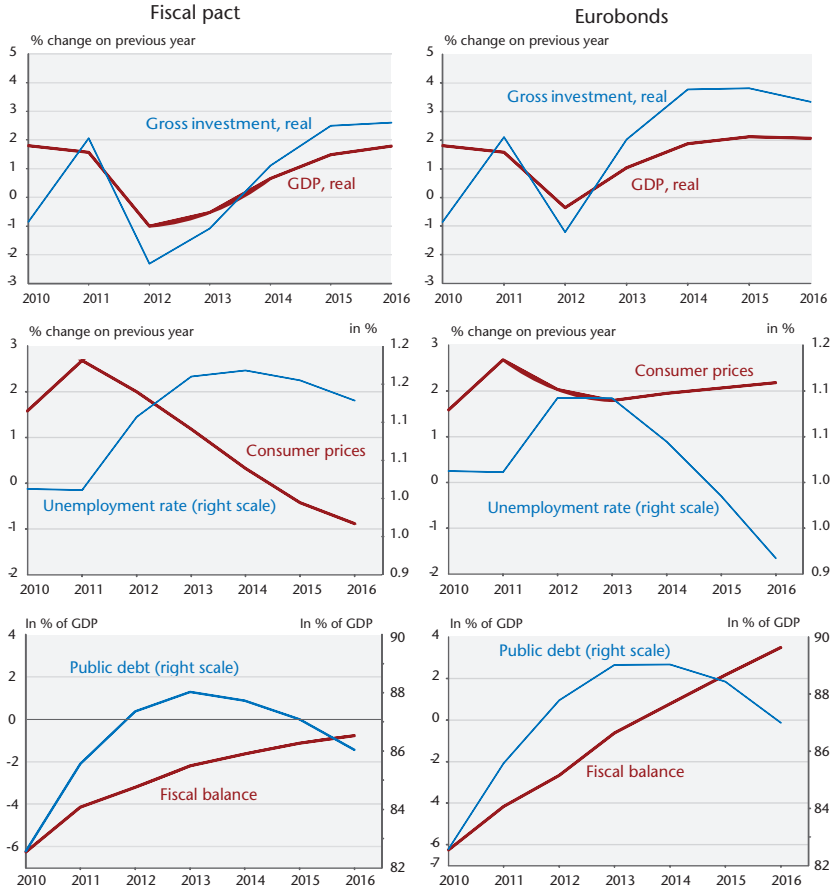
— 70% of the consolidation measures consist of spending cuts in government consumption, public investment and government transfers and 30% consist of increases in direct and indirect taxes as well as employees' social security contributions.

— The consolidation policies are adjusted on the basis of the simulation results for 2013. If, for instance, the deficit criterion no longer indicates any consolidation requirement, but the debt criterion does, the austerity policy is continued.

The simultaneous austerity policies in almost all EU countries would have a strong negative effect on economic growth in the euro area GDP would shrink for two years (gross capital formation would be most affected), unemployment would rise to more than 12% in 2014 and from 2015 consumer prices would start to decline

9. This exercise was part of a joint project of three research institutes, IMK (Düsseldorf), OFCE (Paris) and WIFO (Vienna) published in IMK (2012). See this report for further details.

Figure 7. Two scenarios of macroeconomic performance in the euro area



Source: Simulations with the OEF-Model.

(Figure 7). Southern euro area countries would be hit most by the implementation of the fiscal pact as they are already in a recession.

The disastrous effects of a synchronous austerity policy in the EU become obvious in the comparison with an alternative strategy: In this simulation, the baseline of the OEF model (February 2012) is adjusted in just one respect. It is assumed that the level of long-term interest rates in all euro countries is stabilized at 2% over the entire forecast period (no discretionary austerity measures are implemented besides those which were already implemented in the February version of the OEF model—this version does not include measures called for by the fiscal compact). Under this

condition a much more favourable trend would result. The economy in the euro area would pick up fast, mainly as a consequence of a rebound of investment activity and the unemployment would decline steadily from 2013 onwards (Figure 7).

Although net borrowing of the government would improve more sharply in the fiscal pact scenario than in the euro bond scenario, the government debt ratio would not. The latter would be even slightly higher in the fiscal pact scenario than in the low interest scenario, because nominal GDP growth would be significantly higher in the second case (Figure 7).

6. Conclusion

The main causes of the deepening of the euro crisis are systemic. The financial crisis of 2008/2009 deteriorated the fiscal stance of all countries. However, euro countries as members of a monetary union are specifically vulnerable to shifts in investors' sentiments as they have neither the possibility to devalue nor to rely on central bank funding (systemic factor I). Under "finance-capitalistic" incentive conditions, short-term profit-seeking brings about "manic-depressive" fluctuations of exchange rates, commodities prices, interest rates and stock prices. Speculative activities caused interest rates on government bonds of several euro countries to rise to unsustainable levels since fall 2009 (systemic factor II). At the same time, interest rate differentials within the euro area widened drastically. This development endangers the economic and political cohesion of the EMU (systemic factor III).

A systemic problem needs a systemic solution which restores the primacy of politics over speculation. It is proposed to transform the European Financial Stability Facility (EFSF) into the European Monetary Fund (EMF). The EMF provides euro governments with financial means by selling Eurobonds in the capital markets. These bonds are guaranteed by all euro countries to an unlimited extent. The EMF stabilizes Eurobond interest rates at a level slightly below the level of medium-term economic growth (in nominal terms). The Eurobonds are held by investors with the EMF, they are not tradable but can be liquidated at any time. The EMF helps to restore sound public finances in euro countries in close cooperation with the ECB, the European Commission and

national governments. To this end, the EMF provides funds for the euro states according to clear criteria ("conditionality") which are not exclusively restrictive (they should comprise "Marshall-plan-elements").

Such a solution does not cost much money. What it costs is the efforts to reconsider the most fundamental assumptions of that economic paradigm which has been restored over the past four decades. Admitting errors is painful, sticking to them even more (for others).

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