Italy THEN and NOW

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Review and Conclusion

OFFSHORE

- Italy THEN was the issuer of its currency and, as such, the solvency problem was of perception only. Therefore, the solution was to ignore the imagined problem.
- Italy NOW is a currency user, with an impossible debt ratio and an actual solvency problem. The solution to the solvency issue is the support of the ECB, the issuer of the currency, or Mosler Bonds.
- Italy NOW, and the euro zone in general, also has an unemployment problem, currently requiring a relaxation of the SGP deficit limits, along with ECB support or Mosler Bonds to obviate solvency issues.

Macro vs Micro

- Send 100 dogs into a room with only 95 bones in it
- 5 will come back without bones
- Education, training and individual effort, while beneficial, don't change that outcome

- ***Unemployment is a case of dogs and bones***

Tax Driven Currency

- Government desires to provision itself
- Government decrees tax liabilities payable in its currency of issue
- Tax liabilities create sellers of real goods and services in exchange for the needed currency
- Government can then spend its otherwise worthless currency to provision itself

Turning Paper into Money

- My business cards have no intrinsic value
- Requiring them as a tax to exit this room, properly enforced, in the first instance causes unemployment
- The value of my cards, once I impose a tax, is what I demand, at the margin, in exchange for the needed cards

Turning Paper into Money (cont.)

- As issuer, I have to spend them first to be able to collect them as taxes or to borrow them
- Any desire to save my cards means I can spend more than I tax
- My deficit- spending more cards than I collect- is exactly equal to the cards saved by everyone else

Unemployment

- Unemployment is the
- evidence that deficit spending is
- too low to meet the need to pay taxes and the desires to net save

Origins of MMT - Early 1990's

- Double digit short and long term interest rates
- Debt to GDP well over 100%
- BTPs 2% over cost of matched lira funding
- Markets were pricing in default risk
- Academics were certain of default
- The profit potential got my attention!

Epiphany!

- What is the difference between the private sector buying Treasury securities from the Treasury or from the Central Bank?
- The funds are wired to the same place
- The same securities are owned by the private sector

Epiphany! (continued)

- There is no difference to the private sector!
- But buying from the Treasury is considered 'fiscal' - the funding of expenditures
- And the CB selling the same securities is considered 'monetary' - controlling interest rates
- They can't both be right - the private sector shouldn't care what they call it
- It's just how they account for it on 'their side of the ledger'

Epiphany! (continued)

- The answer is, it's all monetary
- As discussed with Professor Luigi Spaventa, MOF
- Italy THEN sold BTP's and CCT's not to fund expenditures, but because if Italy spent lira and didn't issue securities, rates would fall below the Bank of Italy's support rate
- With a floating exchange rate and a fiat currency, funding the deficit was nothing more than what was called a reserve drain

Italy THEN- No Actual Solvency Problem!

- Proclamation following the MMT discussion with Professor Spaventa:

No extraordinary measures will be taken;
all payments will be met on time!

Crisis over!

Italy NOW

- Same debt to GDP ratio
- Lower annual deficit
- Interest rates far lower
- Academics are far less certain of default

What Has Changed?

- Italy THEN was the issuer of its currency, the lira
- Italy NOW is not the issuer of the euro
- Italy NOW is only a user of the euro

Currency Issuer Dynamics

- Currency issuers are not (operationally) revenue constrained
- Currency issuers necessarily spend first, then collect taxes or borrow
- Any spending constraints on currency issuers are necessarily self imposed

Interest Rates

- Currency issuers necessarily set their own interest rates

Why do Governments Run Deficits?

- Answer first:

  To accommodate savings desires

Why do Governments Run Deficits?

- Any non convertible currency is a case of 'inside money'
- If any one entity's net nominal savings goes up, another's must go down
- If you have $100 in your pocket, whoever gave it to you has $100 less
- Bank loans create equal bank deposits, but not net financial assets

Why do Governments Run Deficits?

- Total sales = Total income
- Unspent income means unsold output
- If any agent spends less than his income, another must spend more than his income, or the output doesn't get sold

Why do Governments Run Deficits?

- Most governments support powerful tax incentives to not spend income
- Contributions to pension funds, individual retirement accounts, and corporate reserves held as financial assets represent unspent income and 'demand leakages,' and are often tax advantaged
- For example, well over 20% of Italian public sector compensation is withheld as pension contributions
- Therefore offsetting deficit spending by the private and/or the public sector is required in order to sell the potential output of the economy

Why do Governments Run Deficits?

- Government deficits function to offset net private sector 'demand leakages'
- ***The output gap (unemployment) is the evidence that total private sector and public sector deficit spending is insufficient to offset the demand leakages***
- However, ***only the issuer of the currency is not revenue constrained*** and free to act counter cyclically at all times

Deficits and Currency Users

- Italy NOW, and the other euro zone members, are currency users
- US states, for example, are also currency users and subject to the same types of market forces

Deficits and Currency Users (cont.)

- Currency users are revenue constrained
- Spending is dependent on revenue from taxing or borrowing
- Deficit spending is limited by market forces

Deficits and Currency Users (cont.)

- Market forces limit currency users to relatively small deficits
- California has solvency issues with a debt to GDP ratio of about 5%
- Markets limit nations with foreign currency debt to GDP ratios of 30% or less

Before the Euro

- Member nations with their own currencies were not revenue constrained
- Member nations, as with all currency issuers, ran deficits approximately equal to the ‘savings desires’
- As currency issuers, there were no solvency issues

Entering the Euro Zone

- The new euro members became currency users
- But they entered the euro with debt ratios they had incurred as currency issuers
- These ratios were and remain dramatically out of line with what markets allow for currency users

Entering the Euro Zone (cont.)

- Only currency issuers are free to act counter cyclically
- As revenue constrained currency users, the new euro zone members were not capable of supporting their banking systems during a crisis
- The new euro members were not free to conduct counter cyclical fiscal policy

The European Central Bank

- The ECB is the issuer of the euro
- The ECB is not revenue constrained
- The ECB can spend and distribute euro at will, without notional limit
- The ECB has no inherent solvency issue

The ECB

- The euro zone is in ‘Ponzi’ until the ECB ‘writes the check’
- All banking systems are funded by the issuer of the currency
- Only the ECB, the issuer of the euro can support the deficit spending needed to offset savings desires

From ‘Rites of Passage’

- Water freezes at 0 degrees C. but very still water can be cooled well below that and stay liquid until a catalyst, such as a sudden breeze, causes it to instantly solidify. Likewise, the conditions for a national liquidity crisis that will shut down the euro-12’s monetary system are firmly in place. All that is required is an economic slowdown that threatens either tax revenues or the capital of the banking system. (May 1, 2001)

Why Was the Euro Set Up This Way?

- Politics
- Moral Hazard

The Euro Zone NOW

- The domestic sector desires to net save nearly 100% of GDP, largely due to public sector pension withholding, and tax advantaged private savings plans and corporate reserves
- The trade balance is about flat, with not much chance of foreigners deficit spending euro to grow net euro zone exports
- The public sector's debt of about 100% of GDP is 'supplying' the 'savings' of the domestic sector

The Problem

- Without support from the ECB, the euro members are not fiscally sustainable
- The euro member deficits can't go down without either net exports or private sector credit expansion increasing by that same amount
- The euro banking system needs ECB support for liquidity the same way the US banking system needs the FDIC (federal deposit insurance) for liquidity

Recent Developments

- March 20 - Greece implements PSI - an EU sanctioned 100 billion euro tax on all Greek bond holders apart from the ECB
- Faced with either tax hikes, spending cuts, or implementing a similar bond tax, what might voters in Portugal, Ireland, Spain, and Italy support?
- ECB bond buying is now 'poison' for the remaining bond holders

Talk of Dropping Austerity

- Without ECB support, markets force pro cyclical austerity and self destruction
- There is no political support for abandoning the euro
- It's not 'obvious' the euro is the problem
- Nations don't trust their own governments to run their own currencies

Fixing the Euro Zone

- ECB per capita distributions
- ECB funded employed labor buffer stock
- Mosler Bonds

ECB Per Capita Distribution Proposal

- The ECB makes annual euro payments of 10% of total GDP on a per capita basis to member governments
- This ends the liquidity crisis
- Member nations must comply with the Growth and Stability Pact or payment will be withheld
- This addresses the moral hazard issue

ECB-Funded Employed Labor Buffer Stock

- The ECB would fund a minimum wage transition job for anyone willing and able to work
- The member nations would manage but not fund the specifics of the program
- This alternative to unemployment would result in net ECB counter cyclical spending
- As the economy improves, and private sector borrowing increases, these workers would likely become employed at higher wages elsewhere

Mosler Bonds

- Mosler Bonds are nearly identical to bonds currently being offered by euro member nations
- The one difference is that in the event of non payment, the Mosler Bonds, plus interest, can be used at any time to pay taxes to the government of issue
- This ensures value for the bond holders, allowing the government to fund itself at competitive interest rates

Obstacles

- Misplaced fear of inflation
- (It’s not about inflation expectations)

INFLATION!!!

- Any tax driven currency is a public monopoly
- Monopolists are what are called ‘price setters’
- Therefore, as a point of logic:

The price level is necessarily a function of prices paid by the Government when it spends, and/or collateral demanded when it lends

Inflation and the Euro

- The ECB, the issuer of the euro, does not tax
- The ECB, for purposes of this analysis, doesn’t materially spend euro on goods and services
- The ECB accepts only financial assets as collateral when it lends
- This leaves prices paid at the margin by the member nations as the ultimate source of the price level

Inflation and the Euro (cont.)

- In a market economy only one price need be set, allowing the rest to reflect relative value
- The value of the euro is defined by what the member states pay for labor at the margin

Inflation and the Euro (cont.)

- Current fiscal policy is highly deflationary
- The Greek solution was highly deflationary
- It should be no surprise the euro remains relatively strong even with mass exits by portfolio managers
- If all taxing in euro ceases, the value of the euro goes to 0

Inflation and the Euro (cont.)

- Market prices can rise from increased costs or from increased demand
- Costs include taxes and changes in import prices, including foreign monopolies controlling energy costs
- Increased demand tends to drive up prices when capacity limits are approached

Inflation and the Euro (cont.)

- Monetary aggregates per se do not cause prices to change
- All problematic inflations have been traced to:
  - Deficit spending beyond capacity limits
  - 'Excessive' public sector indexation that drove spending past capacity limits
  - Cessation of taxing authority
- Many currency collapses have led to 'one time adjustments' and not hyper inflation

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