The Euro & The Battle of Ideas

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Ideas versus/and Interests

- **Ideas** - ideologies matter!
  - Different economic philosophies

- **Interests/incentives** are interpreted through the lens of ideas

**Aim of the book:**
- Make differences clear to policy makers
- First step to overcome them
Overview

- Watershed moments
  - 2010, May: EFSF, IMF involvement
  - 2010, Oct: Deauville PSI: contagion
  - 2012: Draghi’s “Whatever it takes” Speech
  - 2013: Cyprus Bail-in
  - 2016: Brexit

- Monetary and fiscal stability
  - Maastricht’s Ghost

- Financial stability
  - Maastricht’s Stepchild

- (Italy, Anglo-American, Global, IMF, ECB, ...)

Powershift
Rhine-Divide in Economic Philosophies

Ideal types (Max Weber) White-black comparison to sharpen contrast

“French”

“German”

“Rhine-divide”
Rhine-Divide in Economic Philosophies

1. Discretion

“French”

“German”

Rules
Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment

   “French”

   “German”
   Rules
   Safety/escape valves
Rhine-Divide in Economic Philosophies

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Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment
   • Not to default

   “French”

   “German”

   Rules
   Safety/escape valves
   • PSI (Greece)
1. **Discretion**
   Straitjacket commitment
   - Not to default
     - Banks as hostage

   **Rules**
   Safety/escape valves
   - PSI (Greece)
     - Banks as insurance providers
Rhine-Divide in Economic Philosophies

“French”
1. Discretion
   Straitjacket commitment
   • Not to default
     ▪ Banks as hostage

“German”
Rules
Safety/escape valves
• PSI (Greece)
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Rhine-Divide in Economic Philosophies

“French”

1. Discretion
   Straitjacket commitment
   • Not to default
     ▪ Banks as hostage
   • To peg currency/EMU

“German”

Rules
Safety/escape valves
• PSI (Greece)
  ▪ Banks as insurance providers
• Flexible exchange rate
1. Discretion

Straitjacket commitment

• Not to default
  ▪ Banks as hostage
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“French”

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Rules

Safety/escape valves

• PSI (Greece)
  ▪ Banks as insurance providers
• Flexible exchange rate

Autonomous Monetary Policy

Fixed exchange rate

Free capital flow

Rhine-Divide in Economic Philosophies
Rhine-Divide in Economic Philosophies

1. Discretion
   - Straitjacket commitment

2. Solidarity
   - Fiscal union
   - Eurobond

“French”

“German”

Liability
   - no transfer union, no-bailout
   - no joint liability!
Rhine-Divide in Economic Philosophies

“French”

1. Discretion
   Straitjacket commitment

2. Solidarity

3. Liquidity

“German”

Rules
Safety/escape valves

Liability

Solvency

\[ E[\text{NPV}] > 0, \text{ at what discount rate?} \]

“throw good money after bad”
Rhine-Divide in Economic Philosophies

“French”
1. Discretion
   Straitjacket commitment

2. Solidarity

3. Liquidity
   • multiple equilibria
     “big bazooka”

“German”

Rules
Safety/escape valves

Liability

Solvency
E[NPV] > 0, at what discount rate?
“throw good money after bad”

Draghi speech,
Summer 2012
€ 0 spent on OMT
Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment

2. Solidarity

3. Liquidity
   • multiple equilibria
     “big bazooka”
   • amplification/spirals
     - E[NPV bailout]>0
     - E[PV bailout – PV no bailout]>0

   Solvency
   E[NPV]>0, at what discount rate?
   “throw good money after bad”

   Contagion/systemic
Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment

2. Solidarity

3. Liquidity

4. Keynesian Stimulus

“French”

“German”

Rules
Safety/escape valves

Liability

Solvency

Austerity/Reform
Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment

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4. Keynesian Stimulus

"French"

"German"
   Rules
   Safety/escape valves

   Liability

   Solvency

   Austerity/Reform

switched sides
Differences are not caste in stone!

after WWII
Is difference caste in stone? ... cultural?

- “French” Absolutism/Centralism
  - King Louis XIV, XV, XVI
    - 1643-1715, 1715-1774, 1774-1792 A.D.

- “German” Federalism
  - Holy Roman Empire
... or fickle?

“France”

- Early 18th century
  Dirigisme/grand design

“Germany”

- 18/19th century
  from *laissez-faire* to *cameralism*/state tradition

- After WW II
  to *planisme* to *Ordo-liberalism*

Reversal
Maastricht’s stepchild

1. Contagion, Spillover and Systemic Risk
   • Bailout

2. Diabolic (Doom) Loop
   Gov. bond is not a safe asset
Maastricht’s stepchild

1. Contagion, Spillover and Systemic Risk
   • Bailout
   - Bail-in

2. Diabolic (Doom) Loop
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Maastricht’s stepchild

1. Contagion, Spillover and Systemic Risk
   • Bailout
   \[\text{Bail-in}\]

2. Diabolic (Doom) Loop
   Gov. bond is not a safe asset

3. Cross-border
   Flight to safety
   no EA-wide safe asset
**ESBies/SBS: Safe Asset**

- Eliminated
- Re-channeled across two European bonds
- Euro-nomics Group (2011)

- No Joint liability
- No Eurobond!

- Pooling
  - sovereign bonds
  - ESBies
  - Junior Bond

- Tranching

• Euro-nomics Group (2011)
ESBies/SBS: Safe Asset

- Diabolic loop
  - Sovereign-Banking Nexus
  - Flight to safety
    - Cross-border
    - Eliminated
    - Re-channeled across two European bonds
      - Euro-nomics Group (2011)

- Sovereign Risk → Economic growth → Tax revenue → Bailout cost → Sovereign debt → Deposits → Equity → Bank Risk → Loop

No Joint liability
No Eurobond!
ESBies/SBS: Safe Asset

- Diabolic loop
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- Flight to safety
  - Cross-border

- Eliminated
  - Re-channeled across two European bonds

No Joint liability
No Eurobond!

- Euro-nomics Group (2011)
# Conclusion

- **Ideas matter!** – not only interest/incentives

- **Powershift** in 2010
  - IMF, EFSF ➔ Intergovernmental
  - Deauville ➔ Paris-Berlin

- **“Rhine Divide”** – switching sides after WWII
  - Price and fiscal stability
  - Financial stability

- **ECB’s philosophy** and recap of banks vs. IMF perspective

- **Proposals**
  - European Safe Bond (ESBies)
  - Fire-walls & “Race away from the bottom”, ...