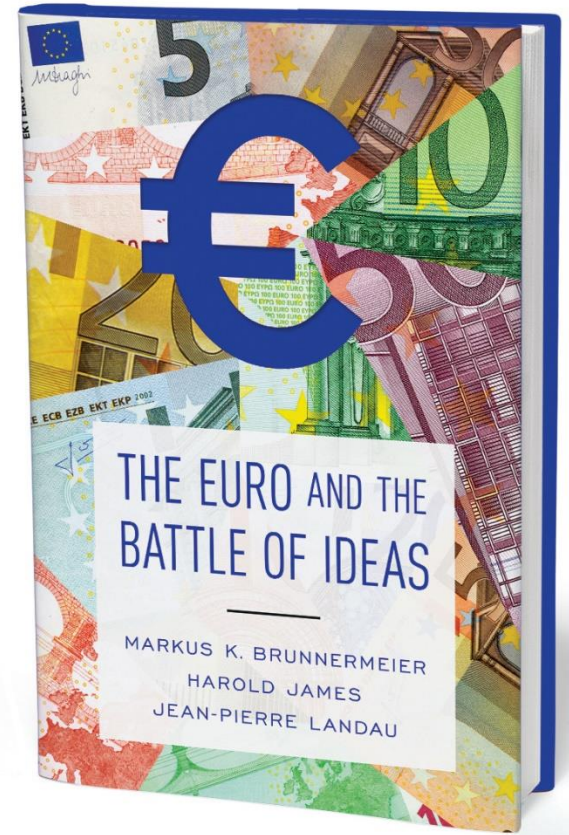


The Euro & The Battle of Ideas

Markus K. Brunnermeier,
Harold James &
Jean-Pierre Landau



Stanford University

Palo Alto, May 5th, 2017

|| 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

} Powershift

■ Monetary and fiscal stability Maastricht's Ghost

■ Financial stability Maastricht's Stepchild

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

Rhine-Divide in Economic Philosophies

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

“French”



“German”



“Rhine-divide”

|| Rhine-Divide in Economic Philosophies

“French”

1. Discretion



“German”

Rules



|| Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

“German”



Rules
Safety/escape valves

|| Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

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Rules
Safety/escape valves

Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

- Not to default

“German”



Rules
Safety/escape valves

- PSI (Greece)



Deauville,
Oct. 2010

|| Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

- Not to default
 - Banks as hostage

“German”



Rules
Safety/escape valves

- PSI (Greece)
 - Banks as insurance providers

Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

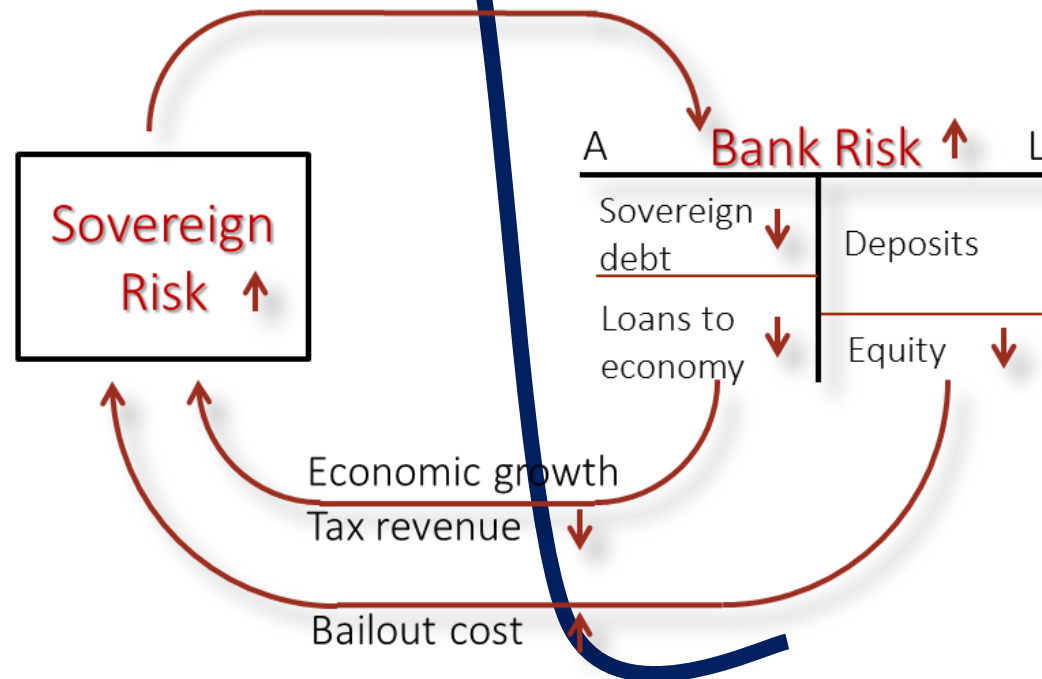
- Not to default
 - Banks as hostage

“German”



Rules
Safety/escape valves

- PSI (Greece)
 - Banks as insurance providers



|| 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

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

Autonomous
Monetary Policy

Fixed ex-
change rate

Free
capital flow



|| Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

2. Solidarity

- Fiscal union
- Eurobond

“German”



- Rules
Safety/escape valves

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

$E[NPV] > 0$, 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”

Draghi speech,
Summer 2012
€ 0 spent on OMT

“German”

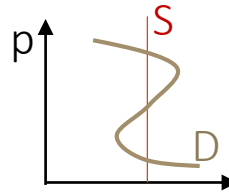


Rules
Safety/escape valves

Liability

Solvency

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



Rhine-Divide in Economic Philosophies

“French”



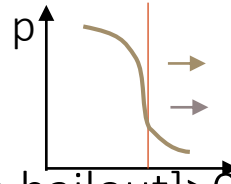
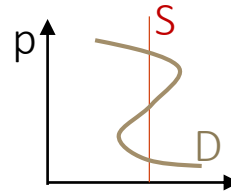
1. Discretion
Straitjacket commitment

2. Solidarity

3. Liquidity

- multiple equilibria
“big bazooka”

- amplification/spirals
 - $E[\text{NPV bailout}] > 0$
 - $E[\text{PV bailout} - \text{PV no bailout}] > 0$



↑
contagion/systemic

“German”



- Rules
Safety/escape valves

- Liability

- Solvency

$E[\text{NPV}] > 0$, at what discount rate?
“throw good money after bad”

Cyprus,
Spring 2013
Bail-in become norm
for banks

Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

2. Solidarity

3. Liquidity

4. Keynesian Stimulus

“German”



- Rules
Safety/escape valves

Liability

Solvency

Austerity/Reform

Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

“German”



- Rules
Safety/escape valves

2. Solidarity

Liability

3. Liquidity

Solvency

4. Keynesian Stimulus

Austerity/Reform



switched sides after WWII
Differences are not caste in stone!

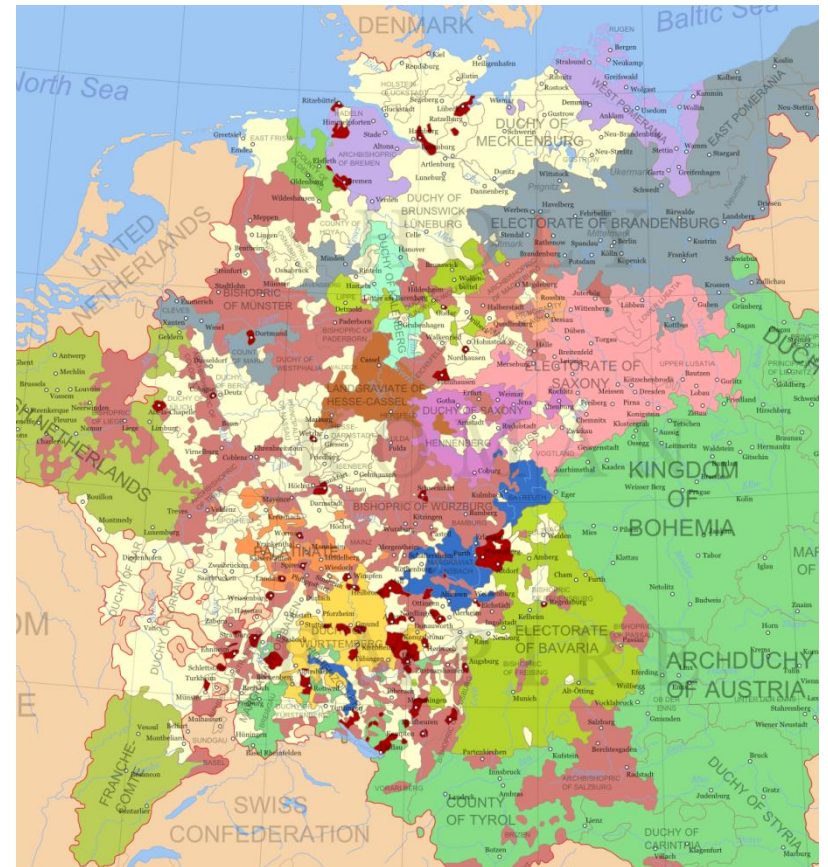
Is difference caste in stone? ... cultural?

■ “French” Absolutism/Centralism



- King Louis XIV, XV, XVI
 - 1643-1715, 1715-1774, 1774-1792 A.D.

■ “German” Federalism



- Holy Roman Empire

||| ... or fickle?

“France”

“Germany”

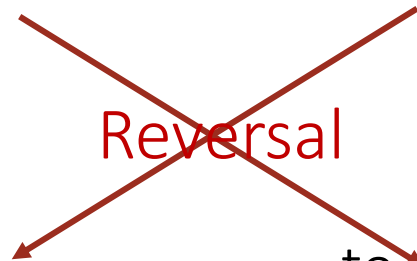
- Early 18th century
Dirigisme/grand design

- 18/19th century
from **laissez-faire**

from **cameralism**/state tradition

- After WW II
to **planisme**

to **Ordo-liberalism**



||| Maastricht's stepchild

1. Contagion, Spillover and Systemic Risk

- Bailout

Bail-in



2. Diabolic (Doom) Loop



Gov. bond is not a safe asset

Maastricht's stepchild

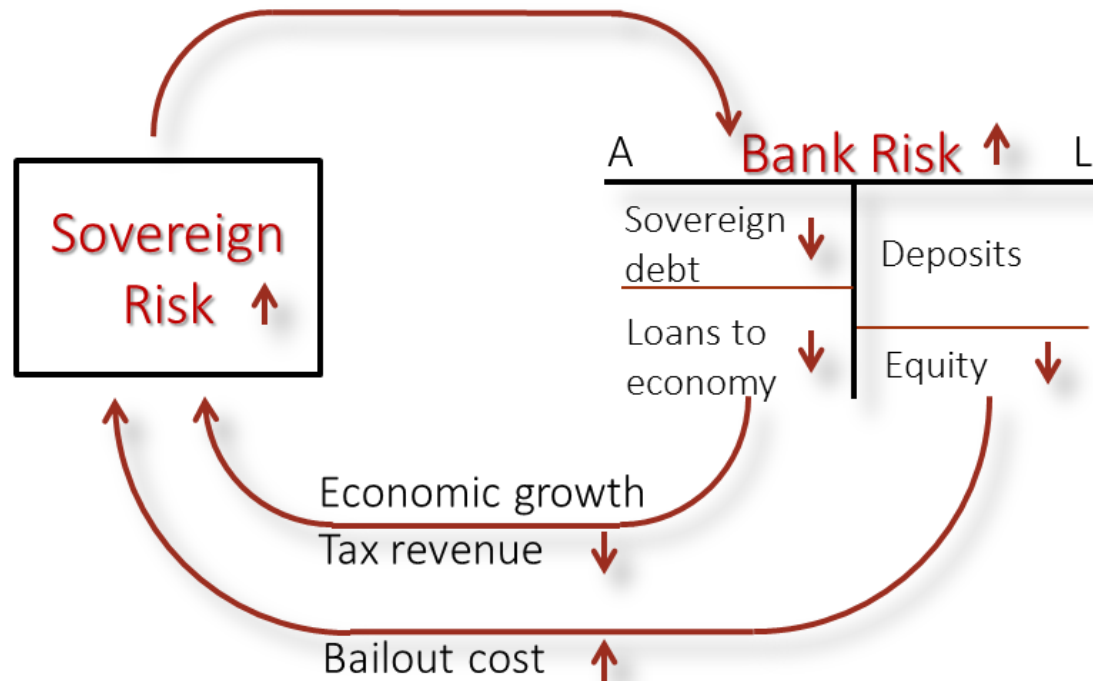
1. Contagion, Spillover and Systemic Risk

- Bailout

Bail-in



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



||| Maastricht's stepchild

1. Contagion, Spillover and Systemic Risk

- Bailout

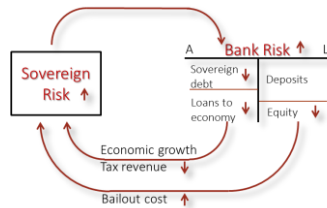
Bail-in



2. Diabolic (Doom) Loop



Gov. bond is not a safe asset



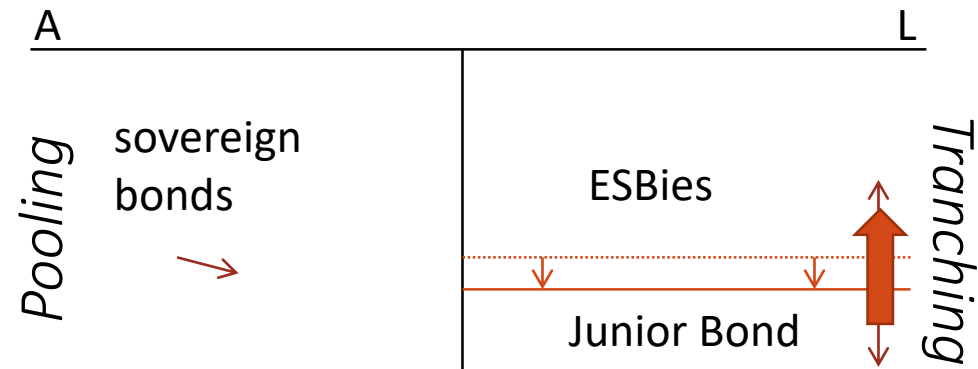
3. Cross-border Flight to safety



no EA-wide safe asset



ESBies/SBS: Safe Asset



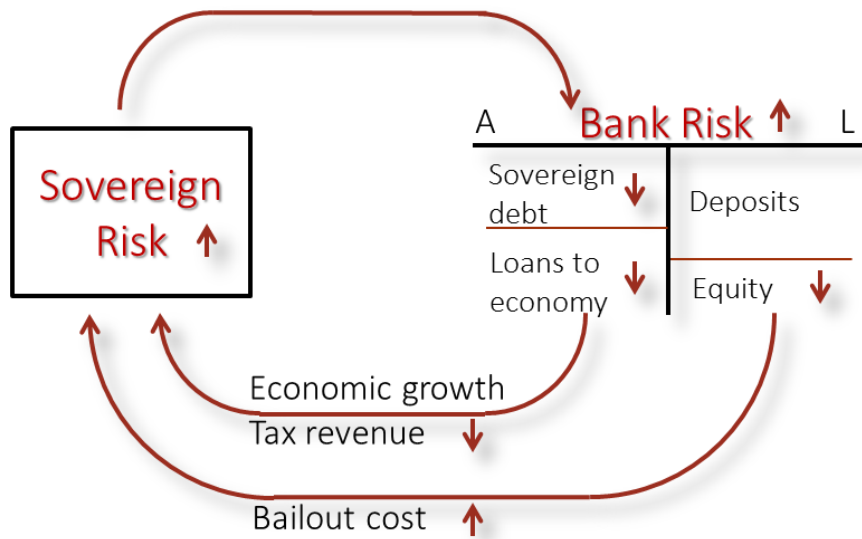
No Joint liability
No Eurobond!

- Euro-nomics Group (2011)

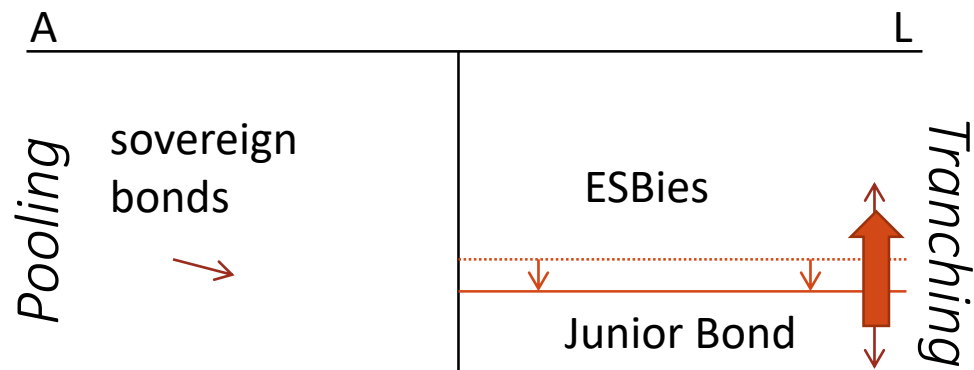
ESBies/SBS: Safe Asset

■ Diabolic loop

- Sovereign-Banking Nexus



- Eliminated

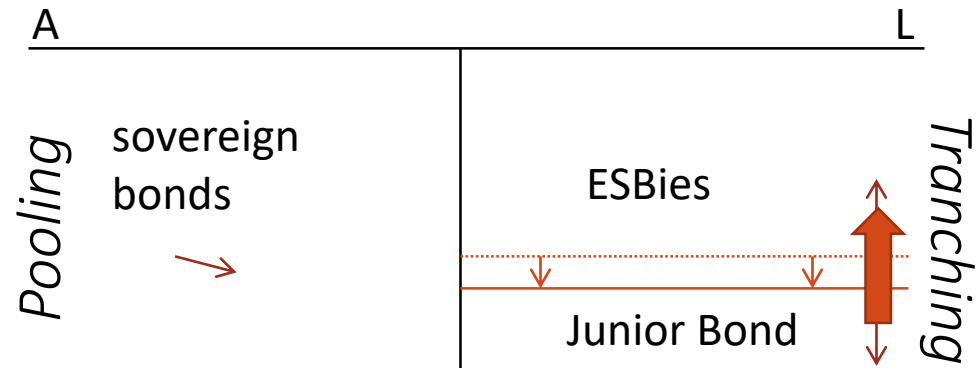


No Joint liability
No Eurobond!

- Euro-nomics Group (2011)

ESBies/SBS: Safe Asset

- Diabolic loop
 - Sovereign-Banking Nexus
 - Eliminated
- Flight to safety
 - Cross-border
 - 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”, ...

