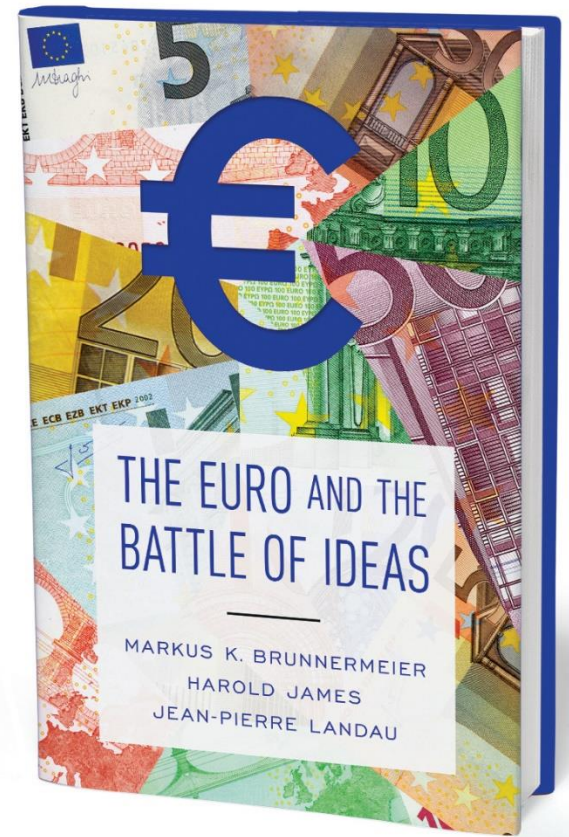


The Euro & The Battle of Ideas

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



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

|| Euro crisis “Watershed Moments”

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

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 (autonomous)



|| Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

“German”



Rules (autonomous)
Safety/escape valves

Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment
- No debt restructuring mech.

“German”



- Rules (autonomous)
Safety/escape valves
- PSI (Greece)



Deauville,
Oct. 2010

|| Rhine-Divide in Economic Philosophies

“French”



1. Discretion
Straitjacket commitment

- No debt restructuring mech.
 - Banks as hostage

“German”



Rules (autonomous)
Safety/escape valves

- PSI (Greece)
 - Banks as insurance providers

Rhine-Divide in Economic Philosophies

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1. Discretion
Straitjacket commitment

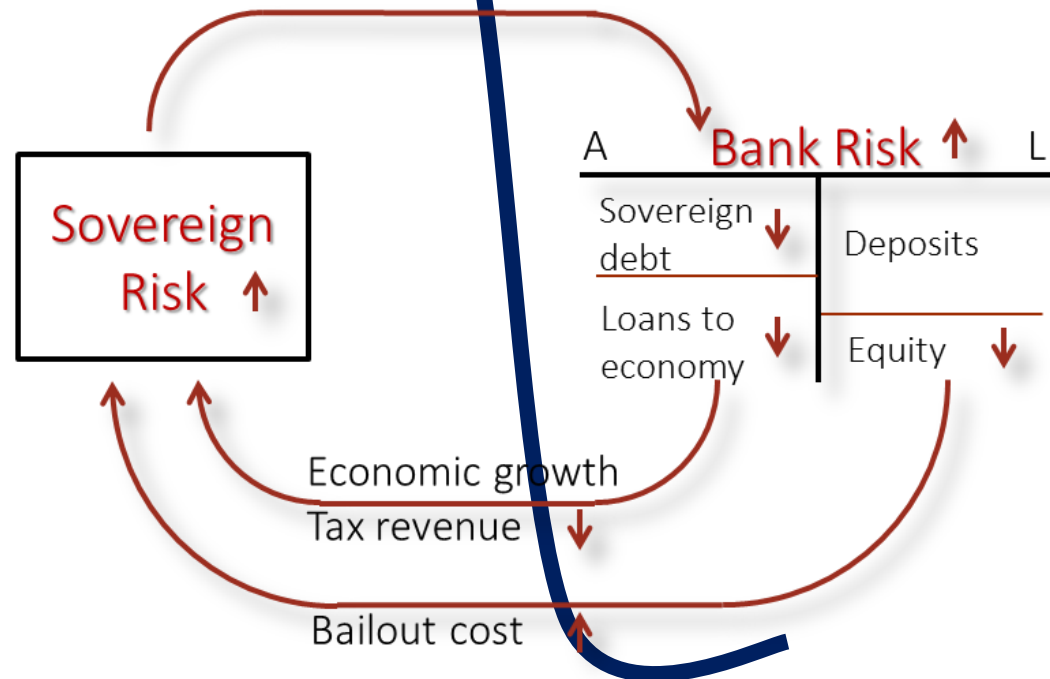
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Rules (autonomous)
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1. Discretion Straitjacket commitment

- No debt restructuring mech.
 - Banks as hostage
- No EMU exit rules
Currency peg

“German”



Rules (autonomous) Safety/escape valves

- PSI (Greece)
 - Banks as insurance providers
- Flexible exchange rate

Rhine-Divide in Economic Philosophies

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1. Discretion Straitjacket commitment

- No debt restructuring mech.
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Rules (autonomous) 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”



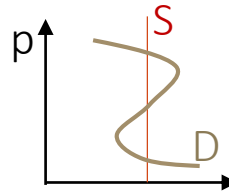
1. Discretion
Straitjacket commitment

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?
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Rhine-Divide in Economic Philosophies

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1. Discretion
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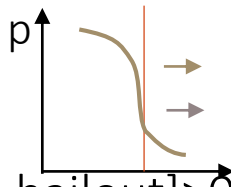
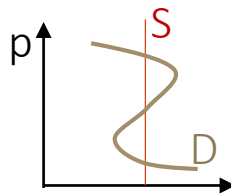
- multiple equilibria

“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!

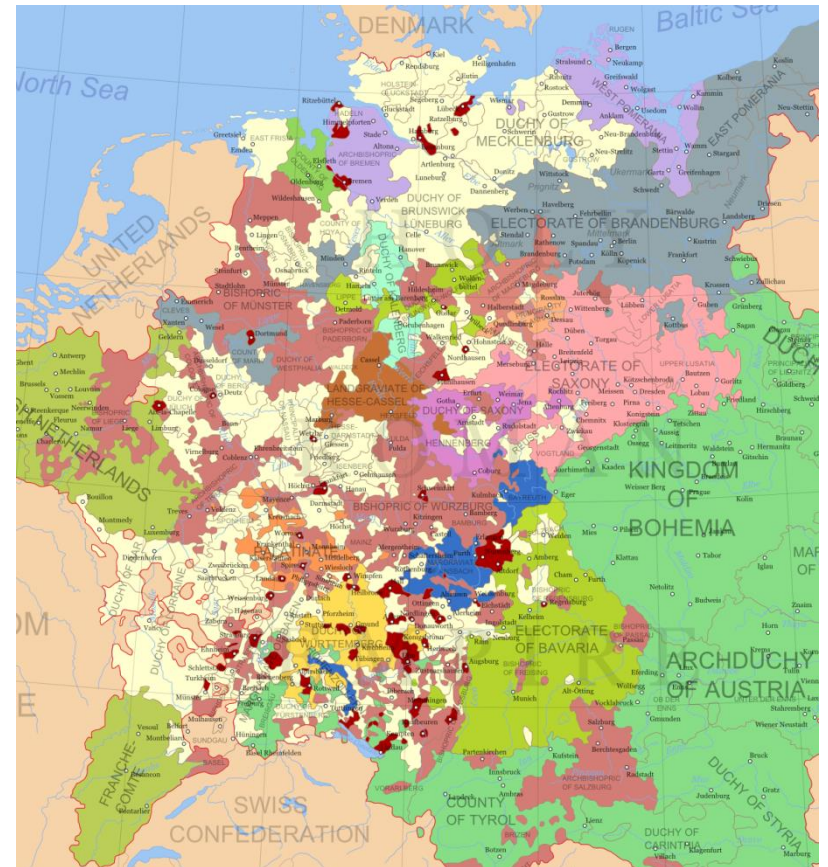
Is difference cast in stone? ... cultural?

■ “French” Absolutism/Centralism



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

■ “German” Federalism



- Holy Roman Empire

||| ... or fickle?

“France”

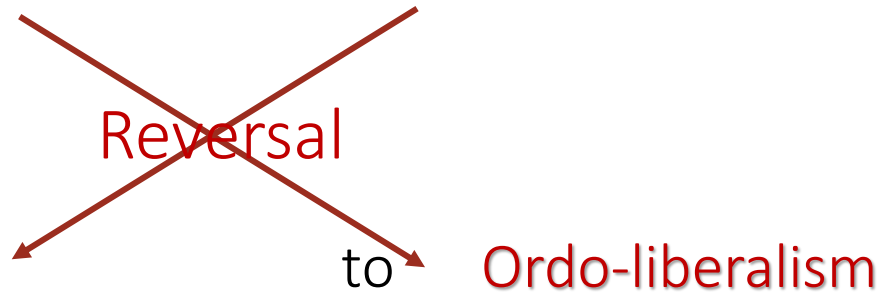
“Germany”

- Early 18th century
Dirigisme/grand design

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

- After WW II
to **planisme**

from **cameralism**/state tradition



Italy

■ Economic Philosophy

- Piero Sraffa (Cambridge)
- Franco Modigliani (MIT)

Luigi Einaudi (Banca d'Italia)



■ Italian “Mezzogiorno-transfer union” (North & South)

- Convergence until 1960s
- Divergence after 1970s
 - Role of “central wage setting”

||| Maastricht's stepchild: Financial Stability

- Why was financial sector ignored in early 1990s?
 - Large growth EU banks became global banks
 - Whole-sale funding cross-border funding

- Liquidity Spirals, Fire Sales, Spillovers, Systemic Risk
 - Southeast Asia crisis only occurred in 1997/8

- Disinflationary Spiral
 - Japan experience was not absorbed
 - Deflation if banks don't lend to productive firms (only to zombies)
 - Money multiplier collapses

||| 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

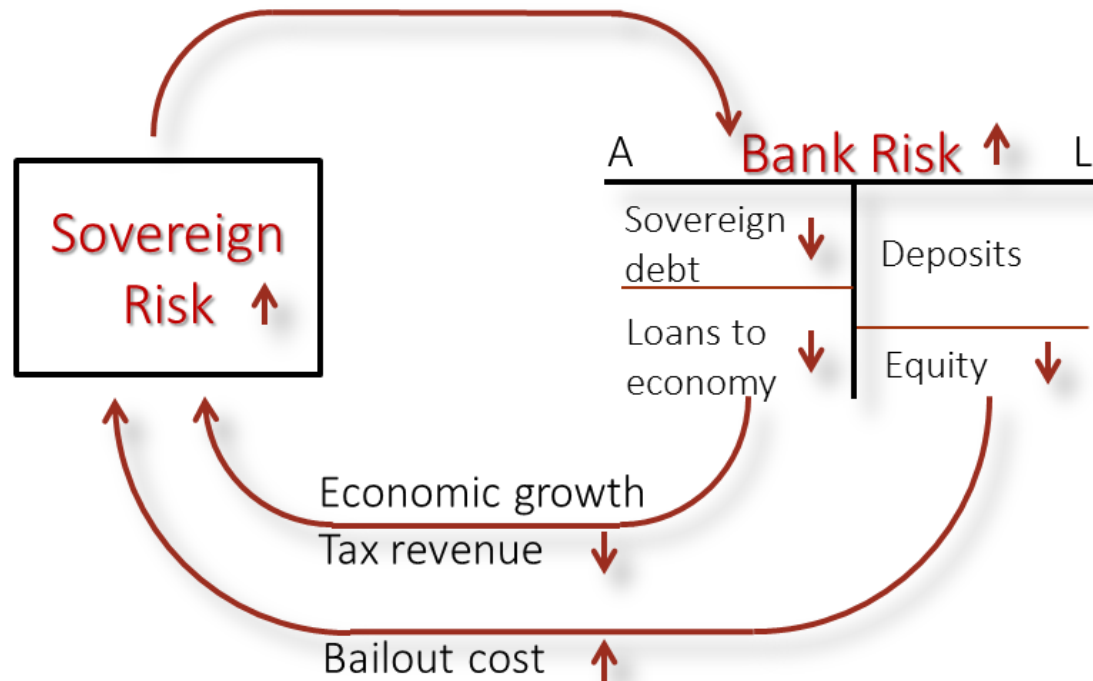
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2. Diabolic (Doom) Loop ← Gov. bond is not a safe asset



||| Maastricht's stepchild

1. Contagion, Spillover and Systemic Risk

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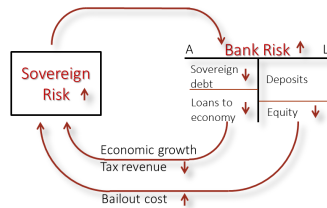
Bail-in



2. Diabolic (Doom) Loop



Gov. bond is not a safe asset



3. Cross-border Flight to safety

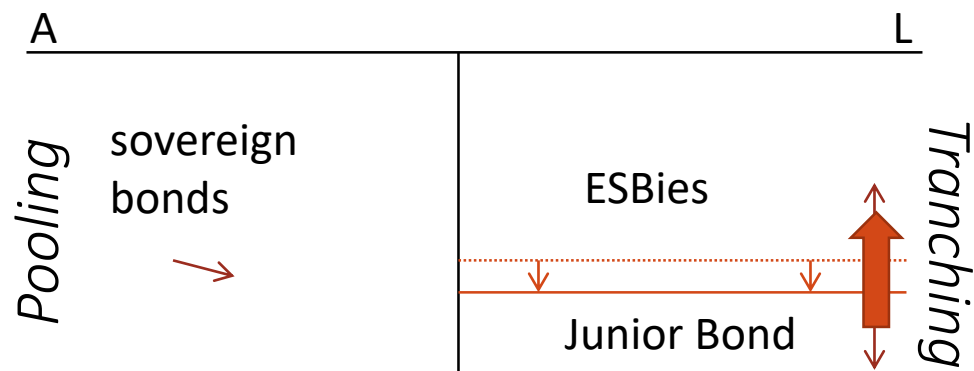


no EA-wide safe asset



ESBies/SBBS: Safe Asset

Sovereign Bonds Backed Securities



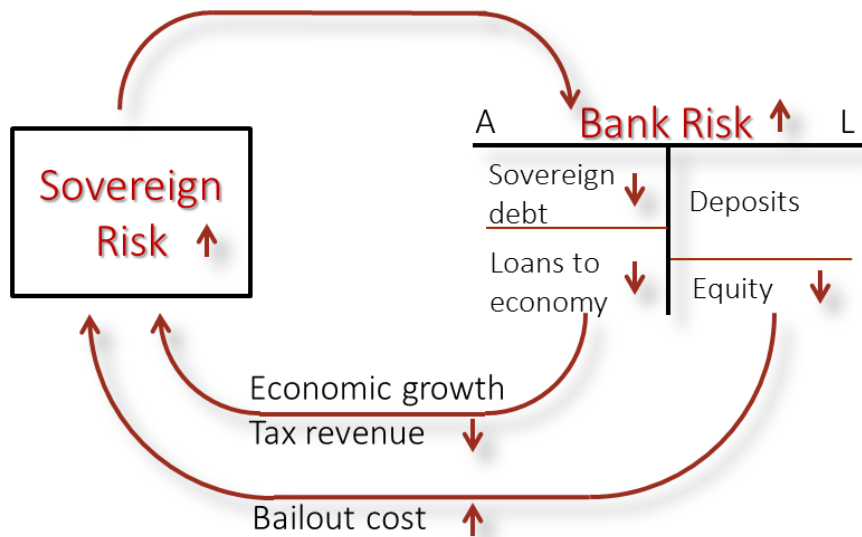
*No Joint liability
No Eurobond!*

- Euro-nomics Group (2011)

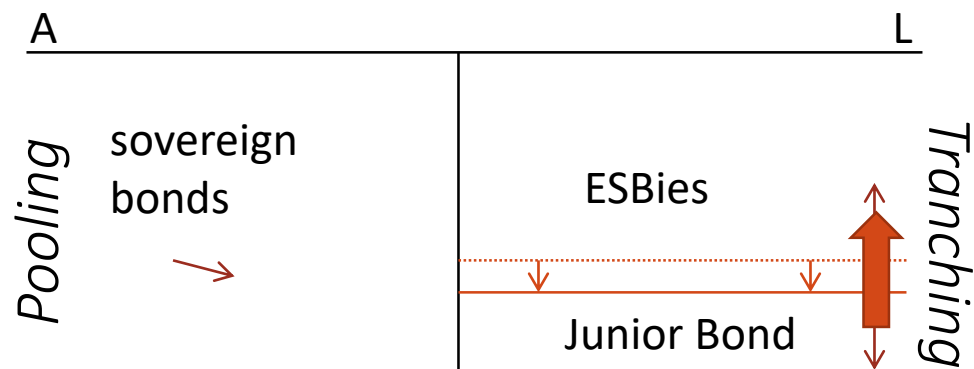
ESBies/SBBS: Safe Asset

Diabolic loop

- Sovereign-Banking Nexus



- Eliminated

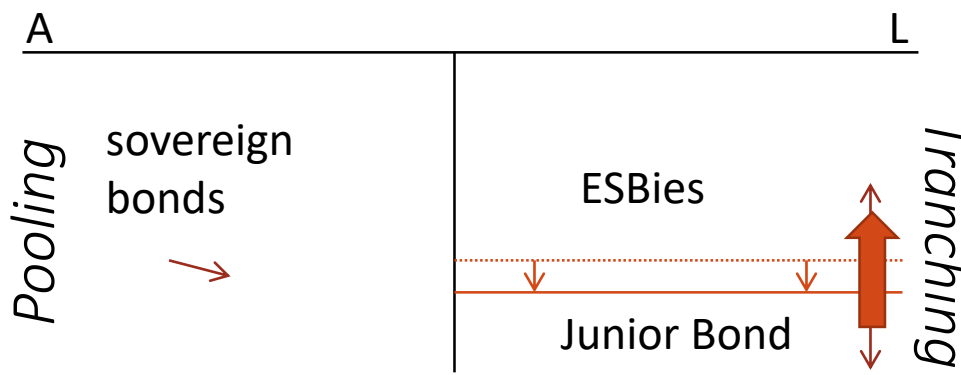


No Joint liability
No Eurobond!

- Euro-nomics Group (2011)

ESBies/SBBS: 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)

Overall European stability framework

Spread	Friction	Instrument	
Flight to safety Diabolic loop	Safety risk premium	ESBies	Self-stabilizing (autonomous)
Liquidity problem due to (self-fulfilling) multiplicity	Default risk premium	ECB Lender of last resort	
Liquidity problem due to lack of commitment		ESM conditionality + ECB's OMT	Interventionistic
Solvency problem	Expected default	Restructuring	
Exit risk	Redenomination risk premium		

- Risk premium for endogenous (self-generated) risks are **socially wasteful**
 - Total risk can be reduced

Overall European stability framework

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■ Role in crisis

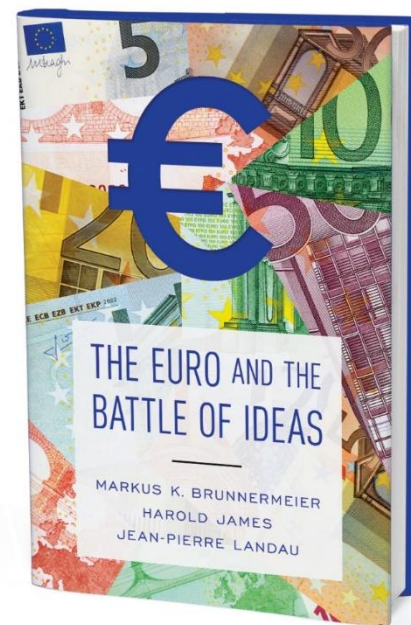
- Against debt restructuring

■ Recapitalization

- In US through fiscal authority TARP \$ 700 bn (various programs)
- In Europe through ECB € 65-165 bn
 - Dec. 2011 VLTRO – induce banks to acquire government bonds
 - Summer 2012 London Speech/OMT
 - Spring 2015 QE

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
- Italy’s, ECB’s philosophy, IMF perspective
- Proposals
 - European Safe Bond (ESBies)
 - Fire-walls & “Race away from the bottom”, ...



Modern Monetary Policy

- Contain **endogenous/self-generated risk**
 - E.g. redenomination/exit risk
 - Bottleneck approach (see “The I Theory of Money)
 - Youtube video:

<https://www.youtube.com/playlist?list=PLZwmltpoGuWlAlHwc0EI5ssbAuyx2ke4h>

