The Euro &
The Battle of Ideas

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Why ideas?

- **Interests** - incentives
- **Institutions**
- **Ideas** - ideologies
  - Interests are interpreted through the *lens of ideas* ≈ models
  - Different economic philosophies
Why France & Germany?

- Power shifts

“Rhine-divide”
Why France & Germany?

- **Power shifts**
  - 2010, May: EFSF, IMF
  - 2010, Oct: Deauville PSI

Intergovernmental - “Chefsache”

Paris       Berlin

“Rhine-divide”
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

- **Maastricht’s Ghost:** Monetary and fiscal stability
- **Maastricht’s Stepchild:** Financial stability
Is difference caste in stone? ... cultural?

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

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

- Historic breaks and reversals after World War II

"France"

from *laissez-faire* to *planisme*

"Germany"

from *cameralism* / state tradition to *Ordo-liberalism*
Ghost of Maastricht “Rhine Divide”

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

“French”

1. Discretion

2. Solidarity
   - Fiscal union

3. Liquidity

4. Keynesian Stimulus

“German”

“Rhine-divide”

Rules

Liability

No-bailout clause

Solvency

Austerity/Reform

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Ghost of Maastricht “Rhine Divide”

“French”
1. Discretion
   - Active management
   - Current crisis management

“German”
Rules
   - Autonomous - no “ad hocery”
   - Future crisis prevention
1. Discretion

- **Active** management
- **Current crisis** management
- Straitjacket commitment
- **Commit future** to fix current crisis

"German"

- **Rules**
  - **Autonomous** - no “ad hocery”
  - **Future crisis** prevention
- Safety/escape valves
Ghost of Maastricht “Rhine Divide”

“French”

1. Discretion
   - Active management
   - Current crisis management

Straitjacket commitment

- Commit future to fix current crisis
  - Commit not to default in order to keep current interest rate low

“German”

Rules

- Autonomous - no “ad hocery”
- Future crisis prevention

Safety/escape valves

- some debt restructuring (not official debt)
### Ghost of Maastricht “Rhine Divide”

<table>
<thead>
<tr>
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<th>“German”</th>
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Ghost of Maastricht “Rhine Divide”

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   - Active management
   - Current crisis management

Straitjacket commitment
   - Commit future to fix current crisis
     - Commit not to default in order to keep current interest rate low
     - Commit to currency peg/not to exit currency union in order to discourage currency attacks

Manage capital flows!

“German”

Rules
   - Autonomous - no “ad hocery”
   - Future crisis prevention

Safety/escape valves
   - some debt restructuring (not official debt)
Ghost of Maastricht “Rhine Divide”

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   - **Active** management
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**Manage capital flows!**

“German”

**Rules**
   - **Autonomous** - no “ad hocery”
   - **Future crisis** prevention

**Safety/escape valves**

- some debt restructuring (not official debt)
- floating exchange rate

**Free capital flow**
“French”

1. Discretion
   - Active management
   - Current crisis management

“Straitjacket commitment”
   - Commit future to fix current crisis
     - Commit not to default in order to keep current interest rate low
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“German”

Rules
   - Autonomous - no “ad hocery”
   - Future crisis prevention

Safety/escape valves

Some debt restructuring (not official debt)

Autonomous Monetary Policy

Trilemma

Fixed exchange rate

Free capital flow

International
Ghost of Maastricht “Rhine Divide”

“French”

1. Discretion
   Straitjacket Commitment
     - Active management

Problems

1. Time inconsistency
   (not ex-ante efficient)
2. Politics/Lobbying

“German”

Rules
Safety/escape valves

- Autonomous - no “ad hocery”

1. Unforeseen contingencies
Ghost of Maastricht “Rhine Divide”

1. Discretion

- Institutional Design (mechanism design)
  - Fiscal dominance
  - Monetary dominance
  - “Financial dominance”
    - Be strategically weak!
Ghost of Maastricht “Rhine Divide”

“French”

1. Discretion
2. Solidarity
   • Fiscal union
   • Illusion of default free bonds
   • Eurobonds with joint liability
     (sovereign debt is anyway default free)

“German”

Rules
Liability
   No-bailout clause/rule
   SDRM/insolvency procedure
   Avoid any joint liability (ESBies)
Ghost of Maastricht “Rhine Divide”

“French”
1. Discretion
2. Solidarity
3. Liquidity
   • multiple equilibria
     “big bazooka”

“German”

Rules
Liability
Solvency

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

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Draghi speech
Ghost of Maastricht “Rhine Divide”

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1. Discretion
2. Solidarity
3. Liquidity
   • multiple equilibria “big bazooka”
   • amplification/spirals
     ▪ E[NPV bailout]>0

“German”
Rules
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E[NPV]>0, at what discount rate?
“throw good money after bad”
Ghost of Maastricht “Rhine Divide”

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1. Discretion
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“German”
4. Keynesian Stimulus Demand
   - Output gap
   - Reforms in boom

   Austerity/Reform Supply
   unsustainable credit boom
   Reforms in crisis (political economy)
Overview

- Powershift

- Maastricht’s Ghost: Monetary and fiscal stability

- Maastricht’s Stepchild: Financial stability
Maastricht’s Stepchild: Financial Stability

- Why was financial sector ignored in early 1990s?
  - Large growth
  - Whole-sale funding
  - EU banks became global banks
  - 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
Contagion, Spillovers, Systemic Risk

“French”

1. Liquidity & Contagion
   • multiple equilibria
     “big bazooka”
   • amplification/spirals
     ▪ $E[\text{NPV bailout}] > 0$
     ▪ $E[\text{PV bailout} - \text{PV no bailout}] > 0$

“German”

Solvency

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

contagion/systemic risk
Contagion, Spillovers, Systemic Risk

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Solvency

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

contagion/systemic risk

Bail-out/LLR
- Countries
- Financial Sector

Bail-in
- Fire-walls

Cyprus
Two Diabolic (doom) loop

- Government-banking nexus (deadly embrace)
Gov. debt: safe versus contingent

“French view”
- Almost never default
  - Straitjacket commitment
- No risk weights
- Banks as hostage
  - Default would destroy banks and economy

“German view”
- Default in tail events
  - “Safety valve”
- Risk weights on risky s-debt
- Banks as insurance providers

“Rhine-divide”
Gov. debt: safe versus contingent

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→ Lower interest rate
  - chance to get out of crisis,
- Doubling up strategy, but ..
Two Challenges

- **Challenge 1:**
  Safe asset + sovereign debt restructuring *w/o diabolic loop*
  
  - French
  - IMF/Anglo-American/German

- **Challenge 2:**
  No asymmetrically supplied safe asset
  
  • German Bund

*How to square the circle?*
Solution: ESBies

- Across borders

- Across two European bonds

- Euronomics Group (2011)
  - www.euro-nomics.com
Conclusion

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

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

- **“Rhine Divide”**
  - **Ghost of Maastricht**
    - Rules vs. Discretion, Solidarity vs. Solidity/Liability,
    - Liquidity vs. Solvency, Stimulus vs. Reforms
  - **Stepchild of Maastricht**
    - Financial stability
    - Liquidity spiral, contagion, diabolic (doom) loop, ...
    - Disinflationary spiral

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