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
Euro crisis “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
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 (autonomous)
Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment

“French”

“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)
Rhine-Divide in Economic Philosophies

"French"

1. Discretion

- Straitjacket commitment
  - No debt restructuring mechanism
    - Banks as hostage

"German"

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

1. Discretion
   Straitjacket commitment

   - No debt restructuring mech.
     - Banks as hostage

   “French”

   “German” Rules (autonomous)
   Safety/escape valves

   - PSI (Greece)
     - Banks as insurance providers

Sovereign Risk ↑

Bank Risk ↑

Economic growth

Tax revenue

Bailout cost

A

L

Sovereign debt

Deposits

Loans to economy

Equity
Rhine-Divide in Economic Philosophies

1. Discretion
   Straitjacket commitment
   • No debt restructuring mech.
     ▪ Banks as hostage
   • No EMU exit rules
   Currency peg

   “French”

   “German”
   Rules (autonomous)
   Safety/escape valves
   • PSI (Greece)
     ▪ Banks as insurance providers
   • Flexible exchange rate

Brunnermeier, James & Landau
Rhine-Divide in Economic Philosophies

“French”

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Currency peg

“German”

Rules (autonomous)

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• Flexible exchange rate

Currency peg

Autonomous Monetary Policy

Fixed exchange rate

Free capital flow
Rhine-Divide in Economic Philosophies

1. Discretion
   - Straitjacket commitment

2. Solidarity
   - Fiscal union
   - Eurobond

   “French”

   “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

1. Discretion
   - Straitjacket commitment

2. Solidarity

3. Liquidity
   - multiple equilibria
   - “big bazooka”

   "French"

   "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
     - $E[\text{NPV bailout}] > 0$
     - $E[\text{PV bailout} - \text{PV no bailout}] > 0$

   "throw good money after bad"

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

   Contagion/systemic

   Contagion/systemic

   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
2. Solidarity
3. Liquidity
4. Keynesian Stimulus

“German”
Rules
Safety/escape valves
Liability
Solvency
Austerity/Reform

switched sides
Differences are not caste in stone!

after WWII
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"

- Early 18\textsuperscript{th} century
  - Dirigisme/grand design

- 18/19\textsuperscript{th} century
  - from \textit{laissez-faire} to \textit{planisme}

"Germany"

- 18/19\textsuperscript{th} century
  - from \textit{cameralism}/state tradition to \textit{Ordo-liberalism}

- After WW II
  - to \textit{planisme}

\textbf{Reversal}
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
   \[\text{Bail-in}\]

2. Diabolic (Doom) Loop \[\text{Gov. bond is not a safe asset}\]
Maastricht’s stepchild

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

2. Diabolic (Doom) Loop
   \[ \text{Gov. bond is not a safe asset} \]

![Diagram showing the relationship between Sovereign Risk and Bank Risk, with economic growth, tax revenue, and bailout cost as factors.]

Notes:
- Contagion and spillover risks are critical in understanding systemic risk.
- The bailout process can lead to bail-in, changing the dynamics of financial stability.
- Government bonds are often viewed as safe assets, but their safety can be compromised in certain scenarios.
Maastricht’s stepchild

1. Contagion, Spillover and Systemic Risk
   - Bailout

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

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

Sovereign Bonds Backed Securities

Pooling

sovereign bonds

ESBies

Junior Bond

No Joint liability
No Eurobond!

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

- **Diabolic loop**
  - Sovereign-Banking Nexus

- **Eliminated**

  - ESBies
  - Junior Bond
  - Tranching

- No Joint liability
- No Eurobond!

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

- **Diabolic loop**
  - Sovereign-Banking Nexus

- **Flight to safety**
  - Cross-border

- **Eliminated**

- **Re-channeled across two European bonds**

No Joint liability
No Eurobond!

- Euro-nomics Group (2011)
### Overall European stability framework

<table>
<thead>
<tr>
<th>Spread</th>
<th>Friction</th>
<th>Instrument</th>
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</thead>
<tbody>
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<td>ESBies</td>
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<td>Liquidity problem due to (self-fulfilling) multiplicity</td>
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<td>ECB Lender of last resort</td>
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<td>ESM conditionality + ECB’s OMT</td>
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<td>Solvency problem</td>
<td>Expected default</td>
<td>Restructuring</td>
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- Risk premium for endogenous (self-generated) risks are **socially wasteful**
  - Total risk can be reduced
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ECB

- **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=PLZwmItpoGuWIAlHwc0Ei5ssbAuyx2ke4h