The Euro &
The Battle of Ideas

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Harold James &

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Bundesbank-IAW Lecture

Tübingen, 4. July 2017

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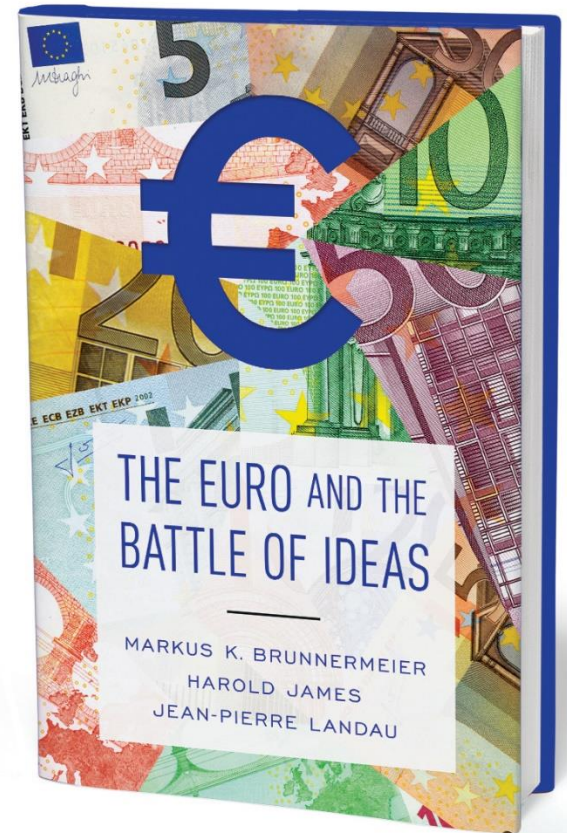
Ideas versus/and Interests

- Ideas   - ideologies matter!
  - Different economic philosophies

- Interests/incentives are interpreted throw 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

Rhine-Divide in Economic Philosophies

"French"   "German"

1. Discretion   Rules
   Straitjacket commitment   Safety/escape valves

Rhine-Divide in Economic Philosophies

"French"

"German"

1. Discretion
   Straitjacket commitment

   - No debt restructuring mech.

   Rules
   Safety/escape valves

   - PSI (Greece)

Deauville,
Oct. 2010

Rhine-Divide in Economic Philosophies
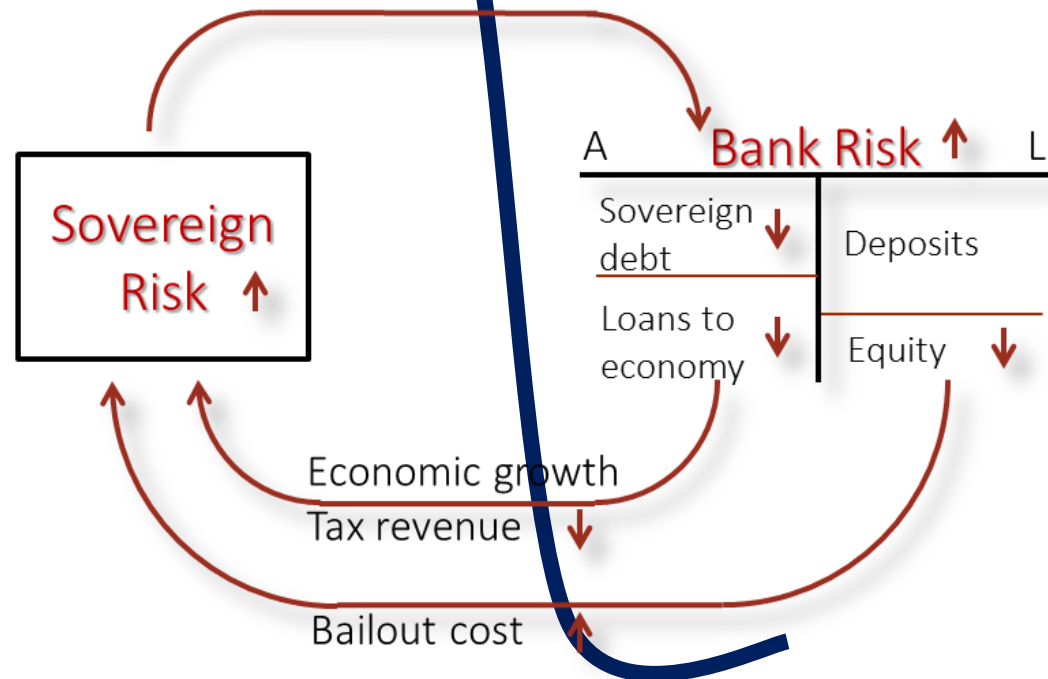
"French"

1. Discretion
Straitjacket commitment
- No debt restructuring mech.
  - Banks as hostage

"German"

Rules
Safety/escape valves
- PSI (Greece)
  - Banks as insurance providers

Rhine-Divide in Economic Philosophies

"French"

1. Discretion
   Straitjacket commitment

   • No debt restructuring mech.

     ■ Banks as hostage

"German"

Rules
Safety/escape valves

   • PSI (Greece)

     ▪ Banks as insurance providers

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Rhine-Divide in Economic Philosophies

"French"

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

"German"

Rules
Safety/escape valves
- PSI (Greece)
  - Banks as insurance providers
- Flexible exchange rate

Rhine-Divide in Economic Philosophies

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Safety/escape valves
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Autonomous
Monetary Policy

FRANCE GERMANY

Fixed ex-
change rate

Free
capital flow

Rhine-Divide in Economic Philosophies

"French"

"German"

1. Discretion
   Straitjacket commitment

   Rules
   Safety/escape valves

2. Solidarity
   - Fiscal union
   - Eurobond

   Liability
   - no transfer union, no-bailout
   - no joint liability!

Rhine-Divide in Economic Philosophies

"French"

"German"

1. Discretion
   Straitjacket commitment

   Rules
   Safety/escape valves

2. Solidarity

   Liability

3. Liquidity

   Solvency

   E[NPV]>0, at what discount rate?

   "throw good money after bad"

Rhine-Divide in Economic Philosophies

"French"

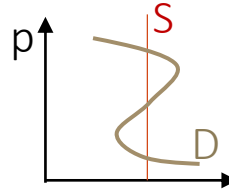"German"

1. Discretion
   Straitjacket commitment

   Rules
   Safety/escape valves

2. Solidarity

   Liability

3. Liquidity
   • <u>multiple equilibria</u>
   "big bazooka"

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

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Draghi speech,
Summer 2012
€ 0 spent on OMT

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Rhine-Divide in Economic Philosophies
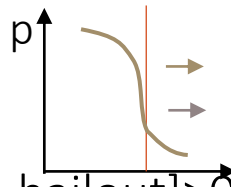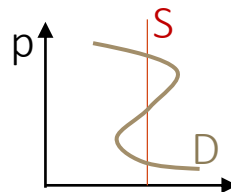
"French"

1. Discretion
   Straitjacket commitment

2. Solidarity

3. Liquidity
   - <u>multiple equilibria</u>
     "big bazooka"
   - <u>amplification/spirals</u>
     - E[NPV bailout]>0
     - E[PV bailout – PV no bailout]>0

contagion/systemic

"German"

Rules
Safety/escape valves

Liability

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

Cyprus,
Spring 2013
Bail-in become norm
for banks

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Rhine-Divide in Economic Philosophies

"French"

"German"

1. Discretion
   Straitjacket commitment

   Rules
   Safety/escape valves

2. Solidarity

   Liability

3. Liquidity

   Solvency

4. Keynesian Stimulus

   Austerity/Reform

Rhine-Divide in Economic Philosophies

"French"   "German"

1. Discretion   Rules
   Straitjacket commitment   Safety/escape valves

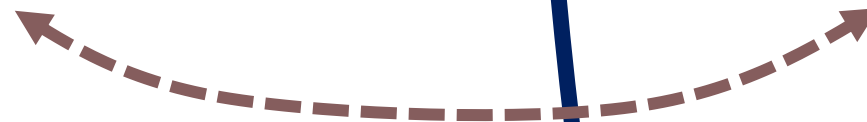2. Solidarity   Liability

3. Liquidity   Solvency

4. Keynesian Stimulus   Austerity/Reform

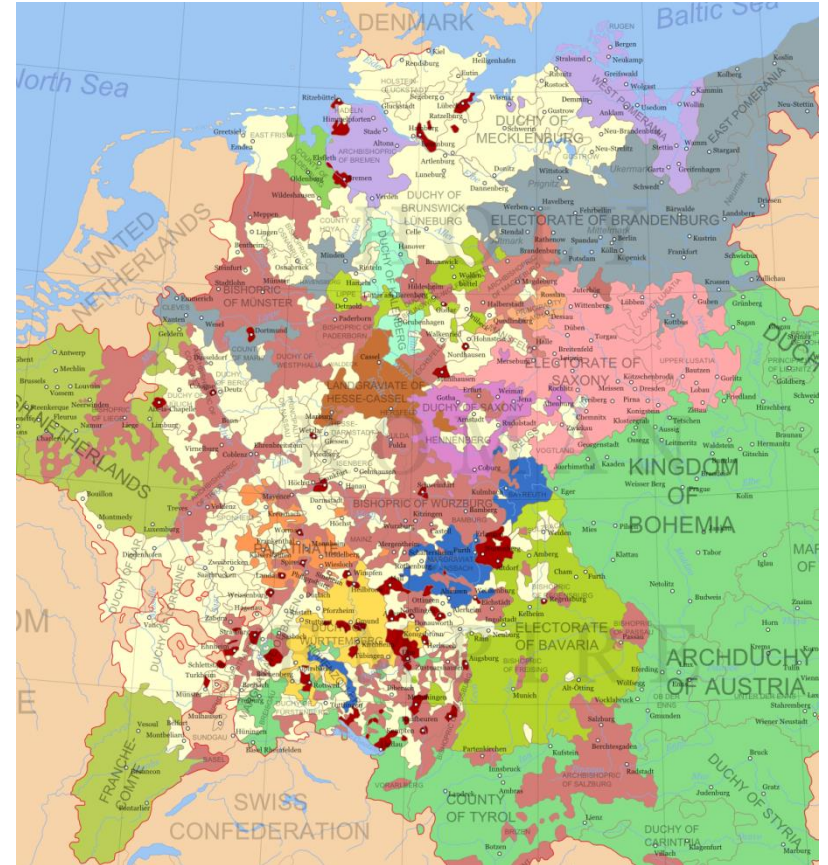switched sides   after WWII
Differences are not   caste in stone!

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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

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▌ … or fickle?

"France"   "Germany"

- Early 18th century
  Dirigisme/grand design

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

  Reversal

- After WW II
  to   planisme   to   Ordo-liberalism

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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
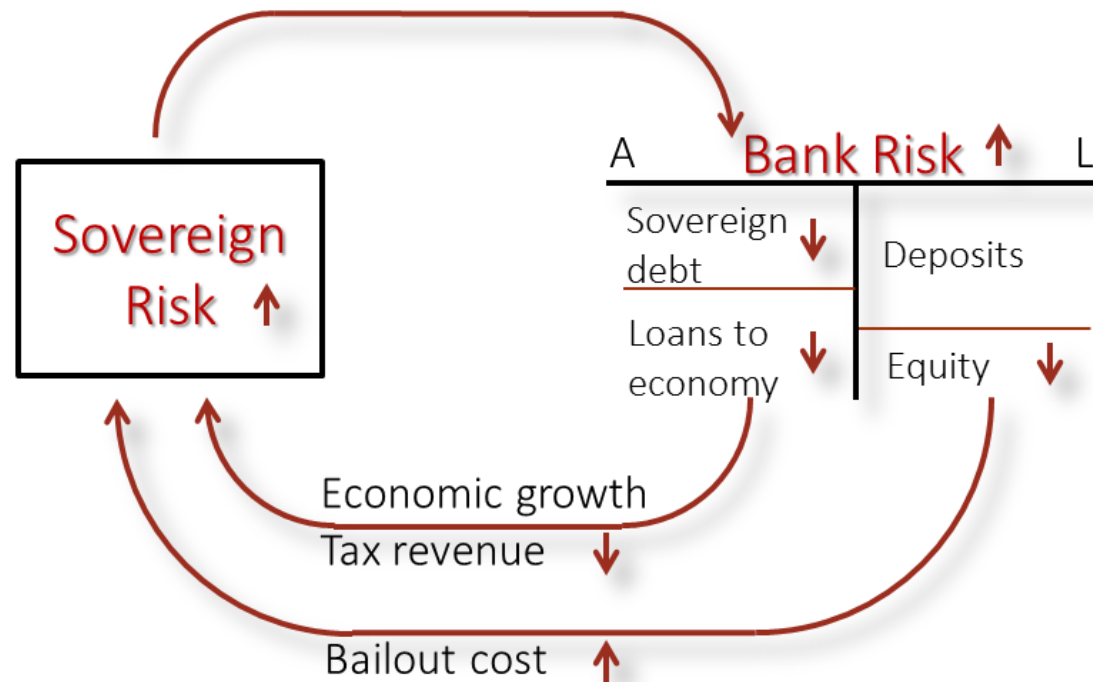
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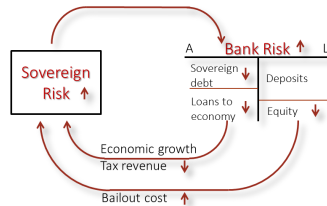
Maastricht's stepchild

1. Contagion, Spillover and Systemic Risk
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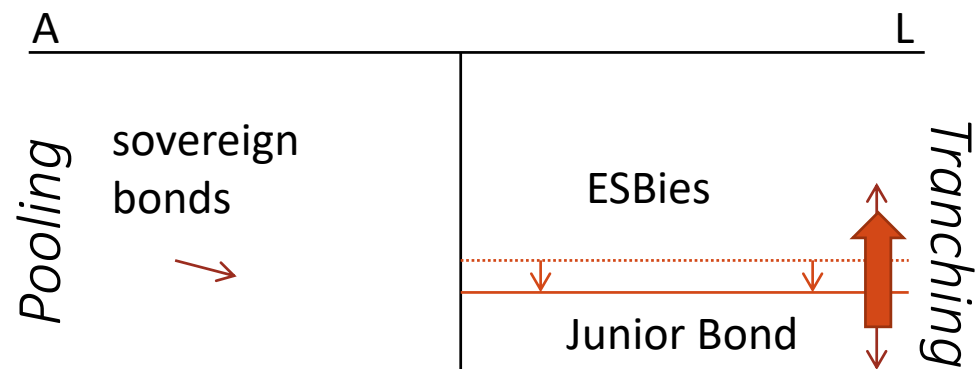

3. Cross-border
   Flight to safety   ⬅   no EA-wide safe asset

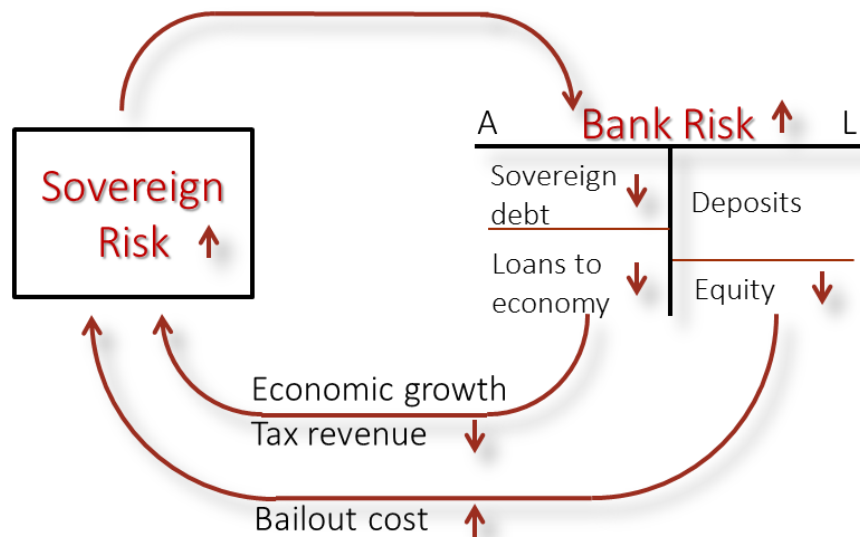# ESBies/SBBS: Safe Asset

Sovereign Bonds Backed Securities

A _____ L

Pooling

sovereign bonds

ESBies

Junior Bond

Tranching

No Joint liability
No Eurobond!

- Euro-nomics Group (2011)

ESBies/SBBS: Safe Asset

- ## Diabolic loop

  - Sovereign-Banking Nexus

  - Eliminated

Pooling

sovereign bonds

Tranching

ESBies

Junior Bond
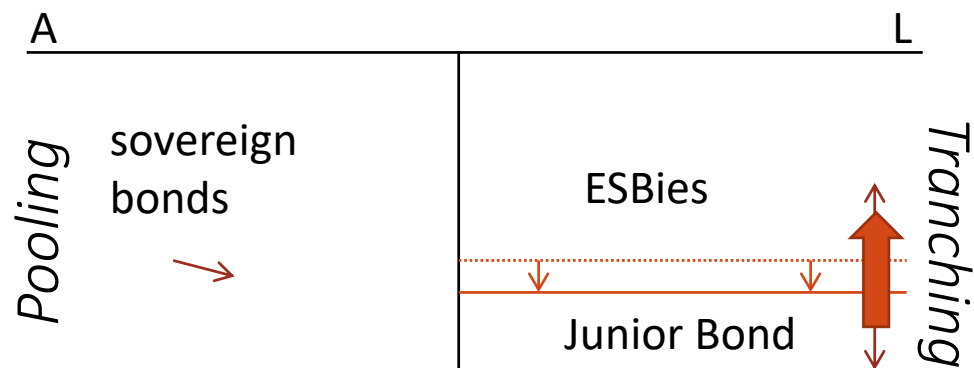
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ESBies/SBS: Safe Asset

- Diabolic loop
  - Sovereign-Banking Nexus
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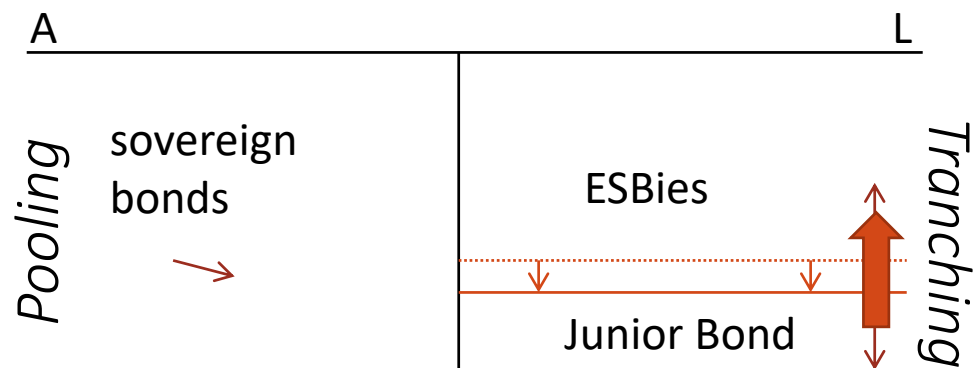- Flight to safety
  - Cross-border
  - Re-channeled across two European bonds

Pooling

sovereign bonds

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ESBies

Junior Bond

Tranching

No Joint liability
No Eurobond!

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Overall European stability framework

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

- ■ Risk premium for endogenous (self-generated) risks are socially wasteful
  - • Total risk can be reduces

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Overall European stability framework

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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

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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", …
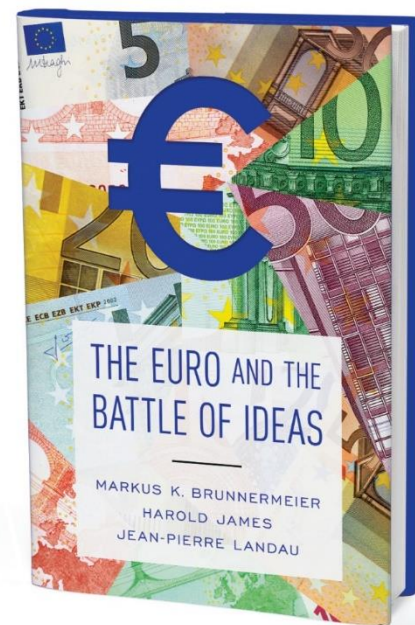
Modern Monetary Policy

▪ 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=PLZwmItpoGuWlAIHwc0FI5ssbAuyx2ke4h