The Euro &
The Battle of Ideas

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Why ideas?

- **Facts**
  - historians

- **Interests** - incentives
  - economists

vs

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

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

1. Discretion

2. Solidarity
   • Fiscal union

3. Liquidity

4. Keynesian Stimulus

“French”

“German”

Rhine-divide

Rules

Liability

No-bailout clause

Solvency

Austerity/Reform

Ideal types (Max Weber) White-black comparison to sharpen contrast
## Ghost of Maastricht “Rhine Divide”

<table>
<thead>
<tr>
<th>“French”</th>
<th>“German”</th>
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<tbody>
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<td>1. Discretion</td>
<td>Rules</td>
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<tr>
<td>▪ Active management</td>
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<td>▪ Future crisis prevention</td>
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Ghost of Maastricht “Rhine Divide”

“French”

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

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Safety/escape valves

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

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     - Commit to currency peg/not to exit currency union in order to discourage currency attacks

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Rules
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   - Future crisis prevention

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

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Rules

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

Safety/escape valves

- Manage capital flows!

some debt restructuring (not official debt)
1. Discretion
   - Active management
   - Current crisis management

Straitjacket commitment
   - Commit future to fix current crisis
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Manage capital flows!

“French”

“German”

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

Safety/escape valves
   - some debt restructuring (not official debt)
   - floating exchange rate

Free capital flow
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

- Commit not to default
- Commit to currency peg/not to exit
- Commit to currency peg/not to exit

Ghost of Maastricht “Rhine Divide”
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[NPV] > 0, at what discount rate?
Ghost of Maastricht “Rhine Divide”

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- Rules
- Liability
- Solvency

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

Draghi speech

Graph:
- 10Y Bond Yield Spread (%)
- Months: May to Dec
- Countries: Greece, Portugal, Ireland, Spain, Italy

"big bazooka"
Ghost of Maastricht “Rhine Divide”

“French”
1. Discretion
2. Solidarity
3. Liquidity
   - multiple equilibria
     - “big bazooka”
   - amplification/spirals
     - $E[NPV \text{ bailout}] > 0$

“German”

Rules
Liability
Solvency

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

\[ \text{Graph showing economic variables} \]

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Ghost of Maastricht “Rhine Divide”

- **“French”**
  1. Discretion
  2. Solidarity
  3. Liquidity

- **“German”**
  4. Keynesian Stimulus
     - Demand
     - Output gap
     - Reforms in boom
  5. 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

- 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
1. Liquidity & Contagion

- multiple equilibria
  - “big bazooka”

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

“French”

“German”

Solvency

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

contagion/systemic risk
1. Liquidity & Contagion

- multiple equilibria
  "big bazooka"
- amplification/spirals
  - $E[\text{NPV bailout}] > 0$
  - $E[\text{PV bailout} - \text{PV no bailout}] > 0$

Contagion/systemic risk

Bail-out/LLR
- Countries
- Financial Sector

"French"

"German"

Solvency

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

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”

Deauville
Gov. debt: safe versus contingent

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→ Lowers 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, Liquidity vs. Solvency
    - Solidarity vs. Solidity/Liability, Stimulus vs. Reforms
  - **Stepchild of Maastricht**
    - Liquidity spiral, contagion, diabolic (doom) loop, ...
    - Disinflationary spiral

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