«The euro and the Battle of Ideas» by *Markus Brunnermeier* (jointly with H. James, JP Landau)

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Comments

Massimo Bordignon

EFB & Catholic University of Milan

The book

- Interesting, but also strange book.
- Partly, a lively, detailed and almost **journalistic account** of the debate and the different steps that before/after the crisis led European governments and institutions to take the euro area where it is now.
- Partly, a **deep** (but accessible to no specialists) **economic analysis** of the consequences of Maastricht compromise on economic, fiscal, and financial development of the euro area.
- Partly, a **historical essay** on the development of economic ideas, and how main events and institutional development affected those same ideas.

The book

- Euro area developments seen as the result of conflict/compromise of two different “ideal types”:
- The **German view** (rules rather than discretion, long term stability rather than short term flexibility, open markets and free capital mobility, structural reforms, terror of moral hazard and transfer union)
- The **French view** (pretty much the opposite, much more reliance on the government’s ability and **moral obligation** to intervene to manage the economy, even in the short run, rules are there to be overcome)
- Other actors’ view (Italy, US-UK, IMF, ECB, etc.) also discussed, but **marginal characters** in the drama.

The book

- The book first discusses **where these two views come from**, how major **historical events** (second war world, Nazi regimes), **institutional** (federalism, unitary state) and **economic** structures (large companies and banks versus medium size and local banks) **shaped** and changed them;
- Then show how their interactions led (or not led, delayed, papered out..) to **compromises** at the **critical junctions** of Euro foundation (Maastricht) and crisis (Greece, PSI, Cyprus, BCE);
- And finally try to **assess the validity** of these compromises.

The book

- The first **objective** is to explain the French view to German (elite) and vice-versa;
- The second is to propose an **optimal balance** (whenever possible) between these two views, on the basis of economic theory and available empirical evidence;
- Fiscal policy, monetary policy, macro-prudential policies (..GDP bonds, federal unemployment funds, European banks charter, ESBies..), insurance of tail risk..
- Main policy indication: *European safe bonds (*ESBies) or how to overcome the **diabolic loop** between banks and sovereigns through sovereign bond backed securities and tranching.

General assessment

- Very much **sympathetic** with the general objective. Solutions to the euro area problems can only come from compromises, and understanding each other is the first step to re-establishing trust and finding solutions.
- Indeed, my **debates** at the College of Europe in Bruges try to do the same..
- Lot of arguments convincing, pretty reasonable. I very much **appreciate** the part on financial stability (a crash course in modern banking finance and the euro financial crisis).

General assessment

- Perhaps the **book overstress the role of the French view** (recently German view **prevailed**). Because of their weak economy, French politicians too much afraid of losing special relationship with Germany to risk a serious conflict. France never went under a speculative attack.
- I have some **serious concerns** about the chapter on Italy (Italy as an example of transfer union? 12% of GDP transferred to the South? Private wages in the South half than in the North?) but Italy is marginal in the story.
- Here some **specific comments** and a **look** to the future.

Specific points (1)

- Book discusses many **institutional junctures** as game changer in the economic philosophy of a country (e.g. Nazi regime as generating distrust in Germany versus central government).
- But it is surprisingly silent about a main event (**German re-unification**) that several authors see as fundamental in shaping German view.
- As a result of the unification, **massive transfers** have been introduced from the richer Western landers/people to the poor Eastern ones. Fears of a second Mezzogiorno remain (Sinn, 1995). Unification **reduced** the taste for redistribution.

Specific points (2)

- The book stress on financial responsibility in the German view would lead the unwary to believe that **institutions** in Germany are free of moral hazard problems.
- Quite the opposite. Germany is a well known **case study** of problems of soft-budget constraints (moral hazard) in **intergovernmental relationships** (Rodden, 2005, Bordignon et al, 2015). (Constitutional rulings, lack of autonomous financing for landers, undefined bankruptcy rules for municipalities..)
- Several landers in many cases have been **bailed out** ex ante (extra transfers) or ex post (debts) by the federal gov.

Specific points (2)

- Indeed. The **debt brake,** the "father" of fiscal compact, (and several other reforms on German fiscal structure) in 2009 perhaps reflects **more the effort to control Landers** than total expenditure as such (Janeba, 2015).
- Book mentions federalism as a component of German view, but not these specific examples.
- Sure there are long term elements shaping German view. But perhaps this view has been **more affected** by recent contingent events (unification, some landers' irresponsible fiscal behaviour..) than the book concedes.
- Views can change..

Specific points (3)

- Narratives matter in reinforcing established views.
- Because of language problems, media markets are totally segmented in Europa. Each market presented an **alternative** and generally **biased** version of the Euro crisis (Italy vs German newspapers), emphasising the difference in views.
- In turn, national media, forming public opinion, conditioned national leaders (whatever their true views are).
- This was specially problematic because the crisis changed economic governance in the EU (why?), promoting the **intergovernmental method**.

Specific points (3)

- The euro crisis could maybe have been **avoided**, or its effects **reduced**, if the same decisions were taken earlier.
- But national leaders, only accountable to national opinion and national media, took a lot of time **to reach a compromise** and sell it to their electorate (the “too little, too late” syndrome).
- Problem is still there and will resurface with the next crisis.
- We need an **institutional solution** that (i) allows to improve economic governance of euro area and reaches more timely decisions; (ii) promotes more interaction in national media markets.

Specific points (4)

- Germany is a **reluctant hegemonic**. Nothing to do with the German view per se, but perhaps with its recent history. Germany does not want to appear to rule.
- It is **hegemonic** because of its population size and economic importance, but it is **reluctant** to take responsibility for this (does not **internalize spill-over effects** of its choices).
- For instance. Since early 2000, Germany kept wage growth below productivity growth to regain competiveness (not obvious that was the result of Shroeder's reforms, started before; Bastasin, 2013).
- Matters of national preferences. If Luxembourg had done the same, nobody would have cared.

Specific points (4)

- But because of German size, this produced **large spill-over effects** on other Euro countries. With no devaluation possibility, they also had to cut wages.
- Similarly. Germany is now **over performing** on fiscal grounds; reducing expenditure and deficits faster than its MTO. But in a zero interest environment this is producing large negative spill-overs on others (EU Commission, 2016).
- It seems impossible to explain Germans that their decisions, fiscal or otherwise affect others. (Why is this our problem?).

Specific points (4)

- But they do and the long term consequences might be bad for the area and Germany itself.
- For instance, now (almost) all euro countries run a trade surplus and the Euro area has an overall current surplus of 3,3% of GDP. This is creating conflicts in international relations (Trump docet).
- Thus, again the **institutional solution**. Either we find a better way to coordinate national policies (forcing big countries to internalize spill-overs) or we move more decisions at the European level, also introducing a **fiscal capacity** (with the paradoxical effect that Germany would be however the larger contributor).

Specific points (5)

- The *European safe bonds* : nice idea, now even backed by the Commission.
- In the long run, ESBies will overcome the “diabolic loop”, make easier to run monetary policy, avoid disruptive capital flights and allow to complete the banking union.
- In turn, the banking union is also the only solution to re-establish some form of **market discipline** and eliminate **moral hazard**. A euro country (Italy?) **could default** on its debt without being forced to exit the euro, and therefore inducing smaller contagious effects on the other countries.

Specific points (5)

- But what happens in the **transition period**?
- If the safe bonds were introduced and accompanied by **regulatory support**, what would be the consequences on the current value of periphery public bonds?
- To introduce safe bonds, need to buy a large tranche of periphery bonds (60% of GDP in the proposal) which **push up demand** for these assets; but with safe bonds, less need to hold periphery bonds that **reduces their demand**. At what price the debt would be sold?
- Worried, because several periphery countries **on the brink**; debt on GDP is stabilized or reducing, but a sharp increase in interest rates could jeopardize the process.

The future

- What happens now?
- Many simultaneous crises on the **negative** side (Brexit, fiscal crisis, defence, refugees, populism, Trump, Putin, etc.) and Macron’s election on the **positive** one, are now creating the potential for a **great bargain**.
- Germany giving up obsession for fiscal stability, and allowing for an European fiscal capacity and more fiscal expansion, in exchange of shared responsibility on defence, security, border controls and immigration.
- Many proposals are on the grounds, including from the EU Commission.

The future

- But realistically, what can one expect from this bargain? Would it strengthen even further **the intergovernmental method** (a re-edition of the Sarkozy-Merkel directory) or open the way to a more **federal** solution? What should the new euro minister do and to whom should he made accountable?
- In the bargain, would there be a role for **intertemporal exchange proposals** (such as Wyplocz PADRE or Corsetti et al, 2015, Tabellini 2017) to take into account the legacy of high debt in some countries?
- Which is the **optimal timing**? Should we fix the euro area first (Giavazzi & Benassy, 2017)? But can we really fix the euro area without new institutions at the Euro level?