

Conference

"Together we can put an end to debt
and austerity problems in Europe"

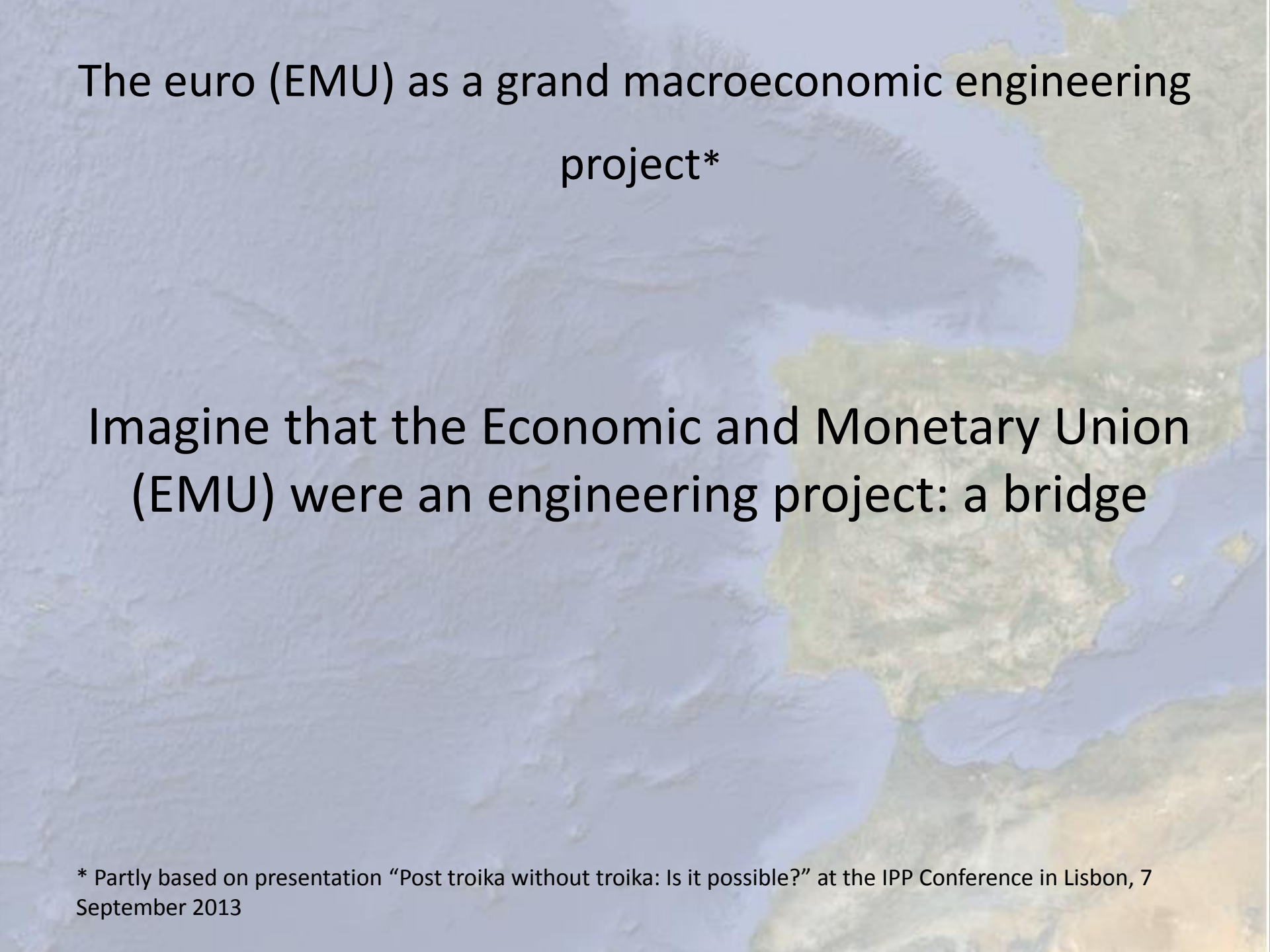
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Reengineering the €uro

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The euro (EMU) as a grand macroeconomic engineering project*

Imagine that the Economic and Monetary Union (EMU) were an engineering project: a bridge

* Partly based on presentation “Post troika without troika: Is it possible?” at the IPP Conference in Lisbon, 7 September 2013

Tacoma Narrows Bridge Collapse

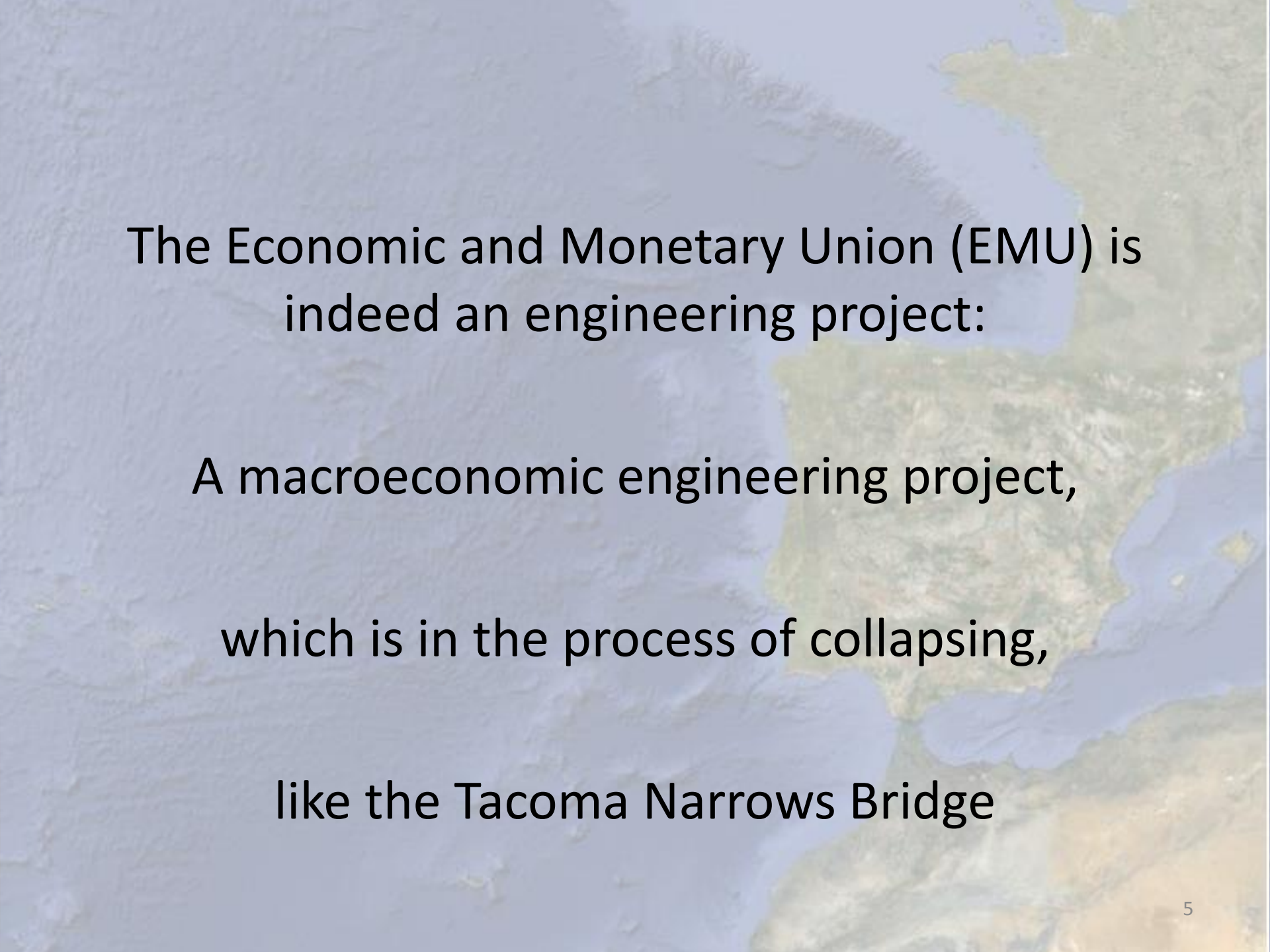
"Gallopin' Gertie"

Inauguration: 1.Jul.1940, Collapse: 7.Nov.1940



http://www.youtube.com/watch?feature=player_detailpage&v=j-zczJXSxnw

Wikipedia: "The event is presented as an example of elementary forced resonance with the wind providing an external periodic frequency that matched the bridge's natural structural frequency, though the actual cause of failure was aeroelastic flutter."




The Economic and Monetary Union (EMU) is indeed an engineering project:

A macroeconomic engineering project,

which is in the process of collapsing,

like the Tacoma Narrows Bridge



Diagnosis of the euro crisis

Characterization of the euro crisis

- Key economic policy parts of the the EMU (EU Treaty) are utopia:
 - An economic and monetary union without fiscal transfers
- Euro crisis is an intra-eurozone balance of payments and external debt crisis
- It is very large
 - The largest peacetime balance of payments and external debt crisis in World History
 - A few member countries have external debt levels that are more than twice the size of Argentina's in 2001
 - 13 EU members in the periphery have large levels of net external debt
- Its effects are asymmetric and concentrated geographically
 - Eurozone periphery hit particularly hard
 - Some Eurozone members derive some limited short-term benefits from the crisis

Origins of the euro crisis

- Large and systematic intra-eurozone external imbalances between member countries
 - These imbalances started building up in the run up to the euro launch but accumulated until 2010
 - Eurozone, as a whole had roughly balanced external accounts
- Imbalance accumulation enabled by deficiencies in the EMU architecture, notably in the design of the ECB monetary policy instruments and procedures
- Austerity strategy assumes euro crisis is fiscal crisis, caused by lax fiscal discipline
 - Misdiagnosis of nature of crisis
 - Misguided belief in the virtues of austerity

Levels of external debt are too high

Versailles Treaty imposed (external) debt reparations that were too high:

- “If we take the view that Germany must be kept impoverished and her children starved and crippled [...]. If we aim deliberately at the impoverishment of Central Europe, vengeance, I dare predict, will not limp”
- The European “population is accustomed to a relatively high standard of life, in which, even now, some sections of it anticipate improvement rather than deterioration. [...] (*Parts of this*) population secured for itself a livelihood before the war, without much margin of surplus, by means of a delicate and immensely complicated organisation [...]. By the destruction of this organisation [...] a part of this population is deprived of its means of livelihood. [...]
- The danger confronting us, therefore, is the rapid depression of the standard of life of the European populations to a point which will mean actual starvation for some [...]. Men will not always die quietly. For starvation, which brings to some lethargy and a helpless despair, drives other temperaments to the nervous instability of hysteria and to a mad despair. And these in their distress may overturn the remnants of organisation, and submerge civilisation itself in their attempts to satisfy desperately the overwhelming needs of the individual. **This is the danger against which all our resources and courage and idealism must now co-operate.**” (text italics, and formatting added)

* John Maynard Keynes, 1919, *The Economic Consequences of Peace*, London: Hartcourt

Possible responses to the crisis

- Present strategy: “Austerity Strategy” accompanied by extremely accommodative monetary policy and unconventional measures (e.g., quantitative easing)
 - Austerity Strategy is very expensive. EU creditor countries’ taxpayer funds loaned to GIIPS in excess of €1.2 trillion, already. They will never be fully repaid (Keynes, 1919)
- Various other plans put forward by small groups of mostly academics:
 - Debt mutualization
 - Debt restructuring
 - Fiscal transfers, etc...
- To be effective, all plans must:
 - Be a dimension comparable to the crisis, i.e. be very large
 - Involve explicit or implicit fiscal transfers, so as to reduce external debt levels
- Instead of spending time and wasting resources on trivia, with disastrous social and economic consequences, governing institutions of the EU should focus resources on designing a robust policy response to save the euro

Banking Union: Single Supervisory Mechanism

- Single supervisory mechanism represents an unprecedented concentration of power in the ECB
 - Banks control assets
 - ECB has information on all assets held by largest euro area banks
 - ECB is able to influence bank credit decisions
 - ECB yields great power over banks:
 - As supervisor
 - As central bank that is able to discretionarily cut off access to Eurosystem liquidity
 - Euro area banks have assets that represent 283% of GDP (€26.7 trillion), with most assets concentrated in the largest banks that fall under the supervision of the ECB
 - That's a lot of power (and firepower) under the control of the most independent central bank in the world, which lacks accountability
- It is very worrisome that the ECB has gained this additional power

Banking Union: Single Resolution Mechanism

- Caveat: The devil is in the detail and not enough is known about the single resolution mechanism
- Nonetheless, it is incomprehensible that the ultimate responsibility for the Single Resolution Mechanism seems to have been given to the ECB
- I do not believe this is compatible with the national constitutions
- Moreover, I believe that if ever the ECB comes to resolve a bank, ECB decisions may well be successfully challenged in a court of law
 - This would throw into confusion a procedure that, in purpose and by design, needs to be swift in achieving closure

Background: Special resolution procedure

- It is a type of “express chapter 11” for banks
 - Purpose is to quickly and swiftly restructure banks, ensuring that it is possible to resolve a bank on a Friday afternoon at the end of business, and have it open for business on Monday morning
 - Due process is “suspended”, or better said, a special resolution procedure can be interpreted an “opt-out clause” to due process in bank restructuring procedures
 - This exception occurs because the legislator recognizes banks’ special role and the public interest in a swift bank restructuring process
 - Follows very simple rules-of-thumb
 - Very simple priority/seniority rule for prioritizing creditors
 - It is typically implemented by a government agency outside of the normal court system (in the US case, the FDIC)
 - Stakeholders (and among these, creditors), have little to no legal recourse

One of the problems with the EU single resolution mechanism

- The ECB is the largest creditor of euro area banks
- Faces obvious conflict of interest in the case of a bank resolution
 - Single resolution mechanism likely puts ECB simultaneously as creditor and as restructuring/bankruptcy judge
 - Other creditors and stakeholders will most rightly feel defrauded by resolution process
- As a consequence, in my (admittedly economist's view), the EU's single resolution mechanism does not ensure "equal treatment and equal protection under the law"
 - Which are clauses likely found in euro area member countries' Constitutions
 - Thus, I hope that the intergovernmental treaty that will create the single resolution mechanism does not pass the scrutiny of member countries' Constitutional Courts



Thank you