Sixten Korkman, 16.10.2012
ETLA Fiscal Policy Seminar

What sort of economic union is needed for the euro to survive?

Comment to Jean Pisani-Ferry

EMU and trinity

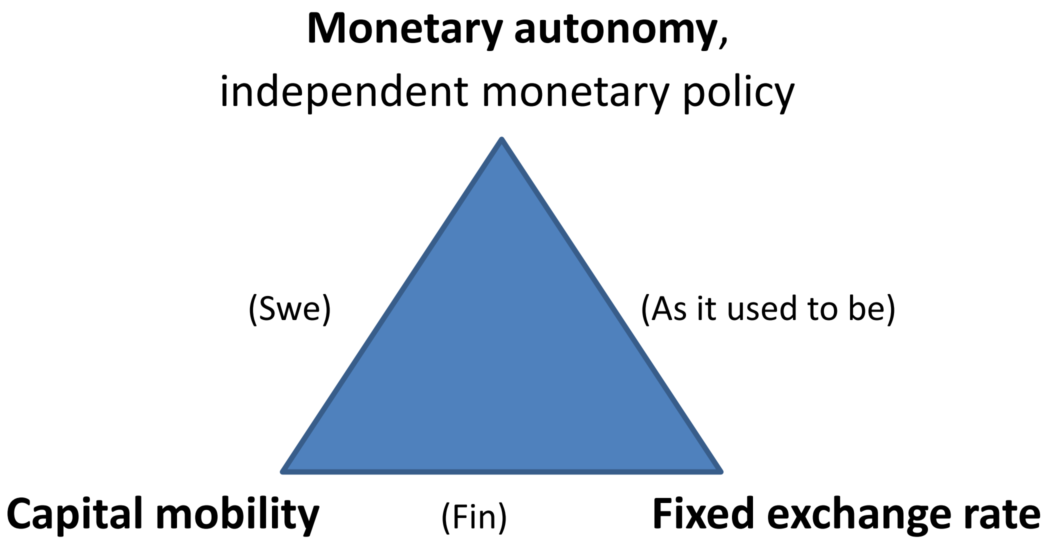
1. The old ”impossible trinity” (Mundell)

2. The new ”impossible trinity” (Bruegel)

3. Rodrik’s trilemma

4. Un (un)holy trinity for crisis management

1. The old impossible trinity (pick 2 out of 3)

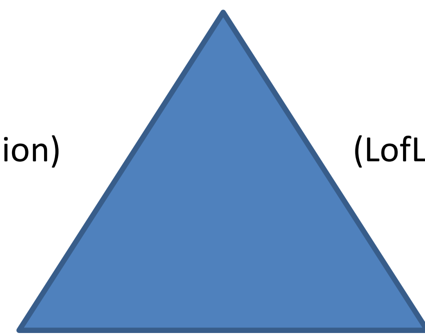


NB: Genuinly impossible trinity (as a matter of logic)

2. The new impossible trinity

No banking union

(fiscal union)



(LofLR for sovereigns)

No monetary financing of deficits

(banking union)

No cofinancing of deficits

NB: This trinity may be awkward but is not impossible (logically)

Questions

”Financial fragmentation is evidently a lethal threat to monetary union. It would make little sense for participating countries to abide by the disciplines of a common currency and not to be able to reap the benefits of a common financial market. Furthermore, fragmentation means that the same central bank policy rate translates into different loan rates, depending on the locations exclusively. This is not a situation that can last for long. Third, financial autarchy would entail a fundamental change in the balance between the costs and benefits of participating in the euro. For these reasons it emerged during the course of 2011-2012 that initiatives to repair the financial underpinnings of the euro were urgently needed.”

But can it be avoided? Given that

- setting up a banking union will take a lot of time,
- eurobonds are inaccceptable and would require a change of the treaty, and
- the ECB does not accept to be a lender of last resort (beyond OMT).

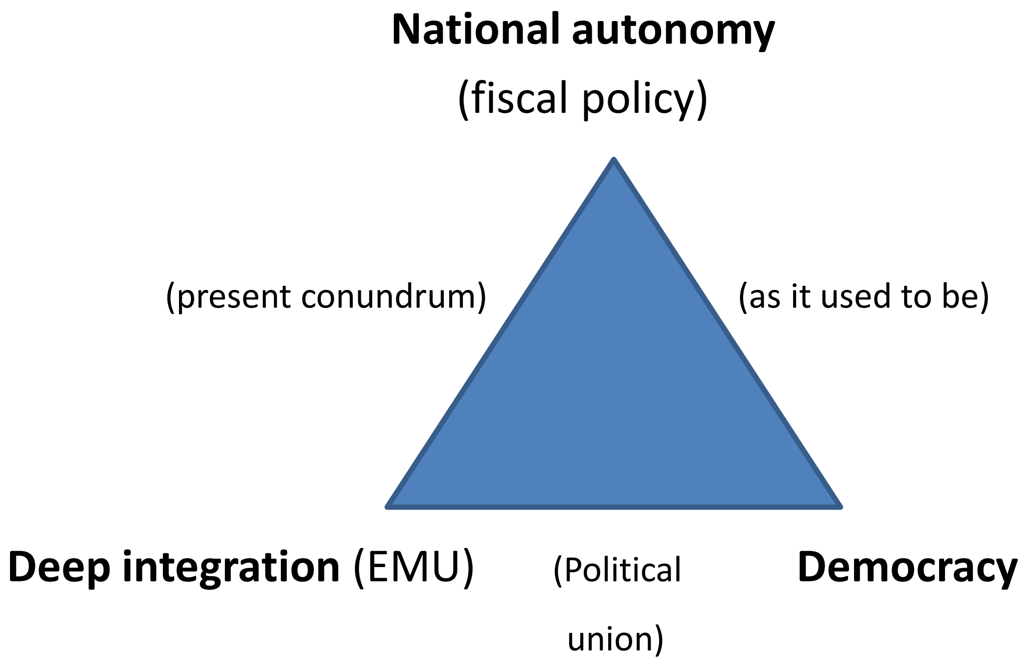
Is it so bad? Given that it

- gives an automatic feedback mechanism to policies (even if too much too late at times)
- imposes investor responsibility and reduces moral hazard (even if requiring authorities to act decisively ro limit contagion effects and restructure/recapitalize banks, which may aggravate problems in the short run but alleviate them later)

Anyway:

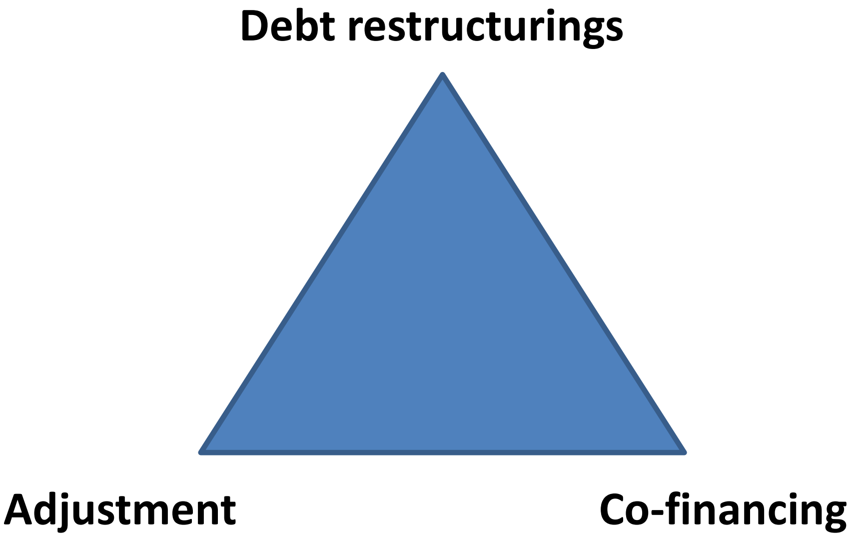
- monetary union will help to achieve price stability (in some countries)
- big firms can borrow abroad (and avoid location-specific interest rates)
- does a common financial market necessarily imply that there are no differences in risk premia on bonds/loans depending on, inter alia, the policies pursued by the government (which a banking union should help to achieve)?
- banks could (should?) hold a diversified portfolio of government bonds (and the ECB should ask for a basket of b bonds as collateral?)

3. Rodrik’s trilemma (adapted)



NB: generalized cofinancing risks undermining democratic legitimacy

4. (Un)holy trinity



NB: All three needed + appropriate balance: less adjustment, more financing (with conditionality) and more debt restructuring (e.g. Greek sovereign, Spanish banks)

What should we wish for?

- Better *rules* and better implementation

- *Muddling through*, aided by a judicious combination of debt restructuring (more), adjustment (less) and financing (more), supported forcefully by the ECB

- A renewed ECB *collateral policy* (based on a basket of bonds as collateral?)

- Work with a view to creating a *banking union* with strong powers of supervision and bank resolution and brutal implementation of investor responsibility (to limit the size of the fiscal backstop).