

Flossbach von Storch
RESEARCH INSTITUTE



How can the Euro survive?

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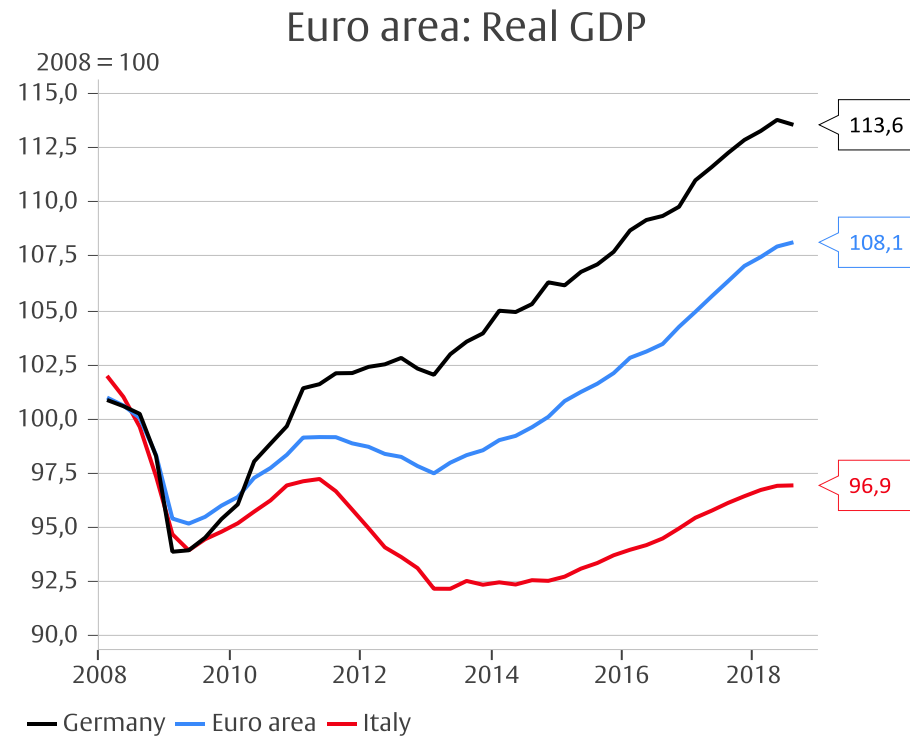
Frankfurt, 24 November 2018

The problem

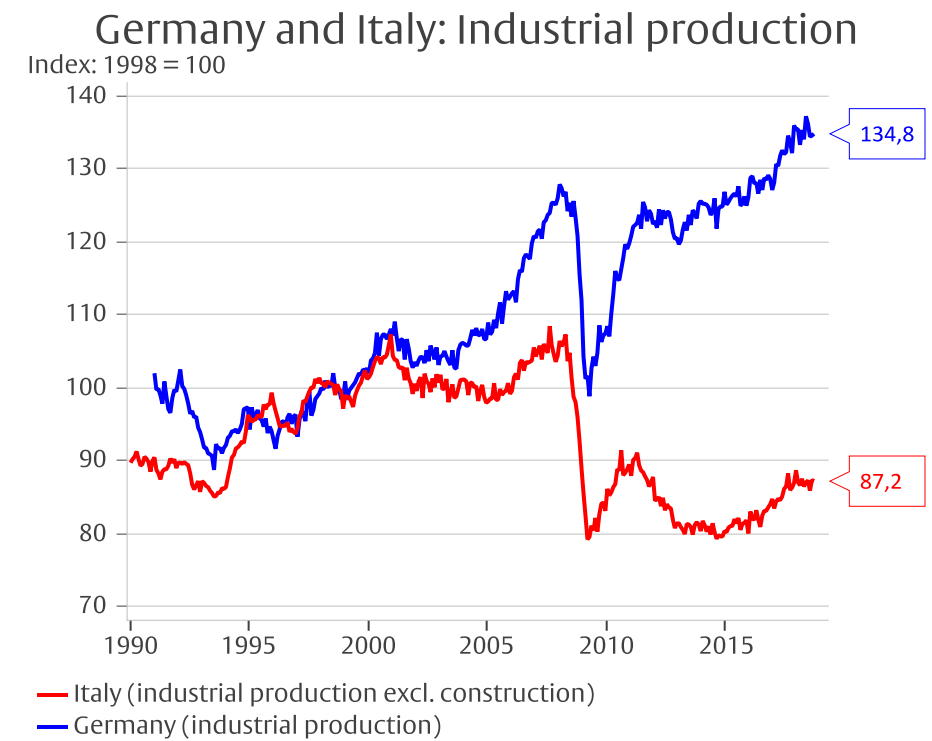


Real Divergence

Italy has not been able to adjust to the requirements of a single currency



Quelle: Macrobond



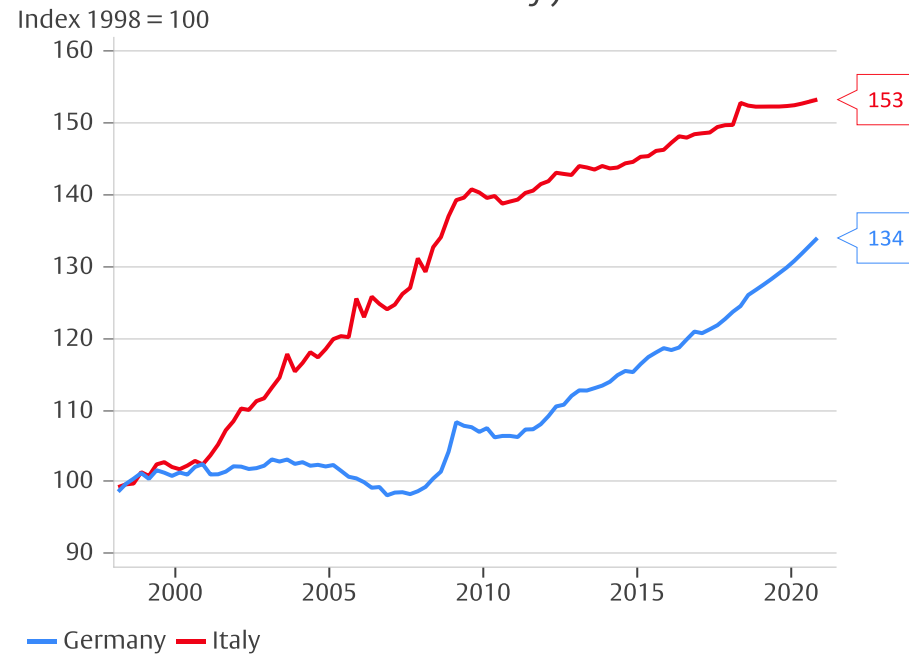
Quelle: Macrobond



Divergence in costs and prices

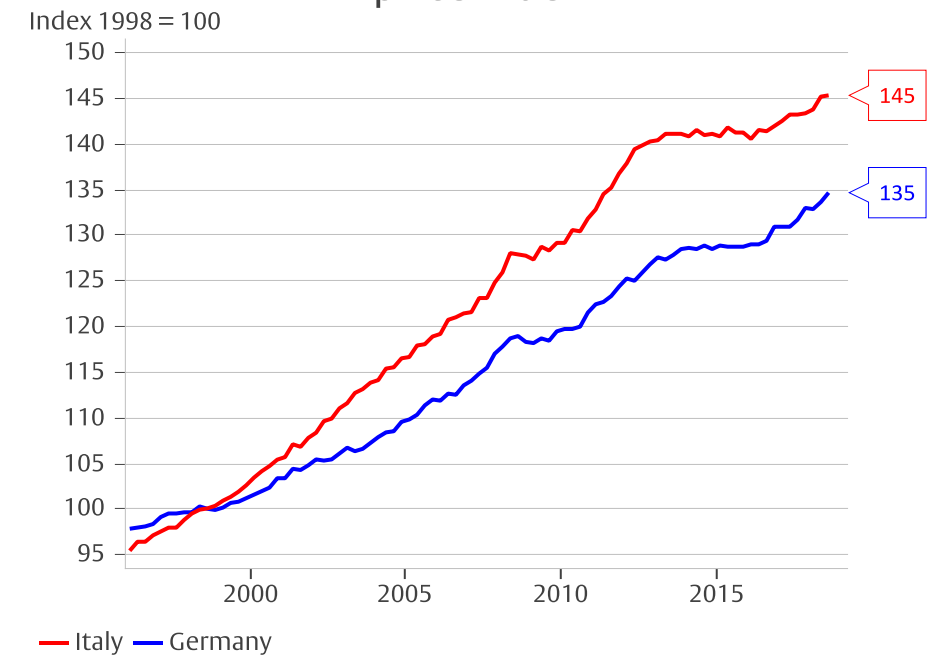
wage policy not euro compliant

Germany and Italy: Unit labour costs (total economy)



Quelle: Macrobond

Germany and Italy: Harmonized consumer price index



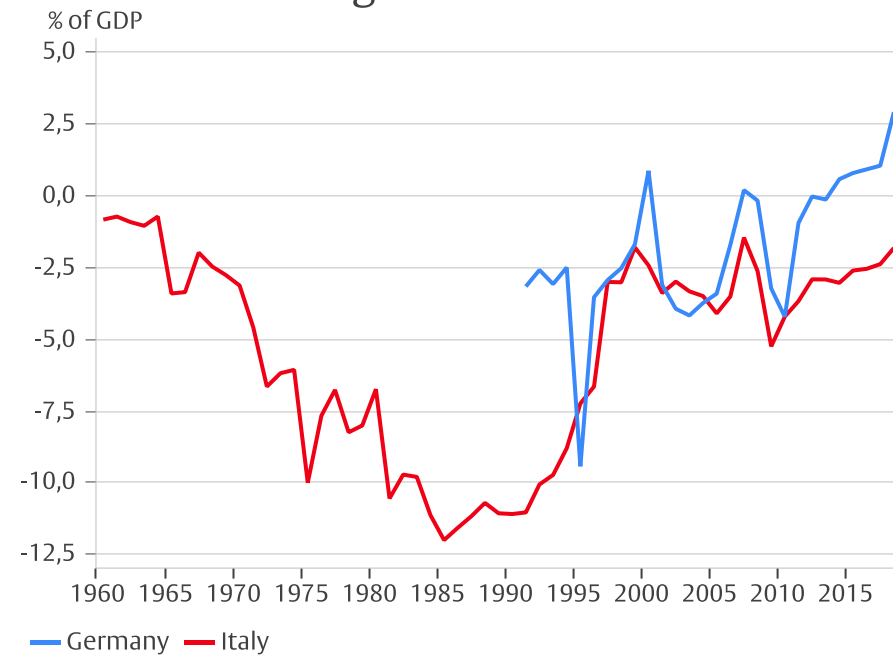
Quelle: Macrobond



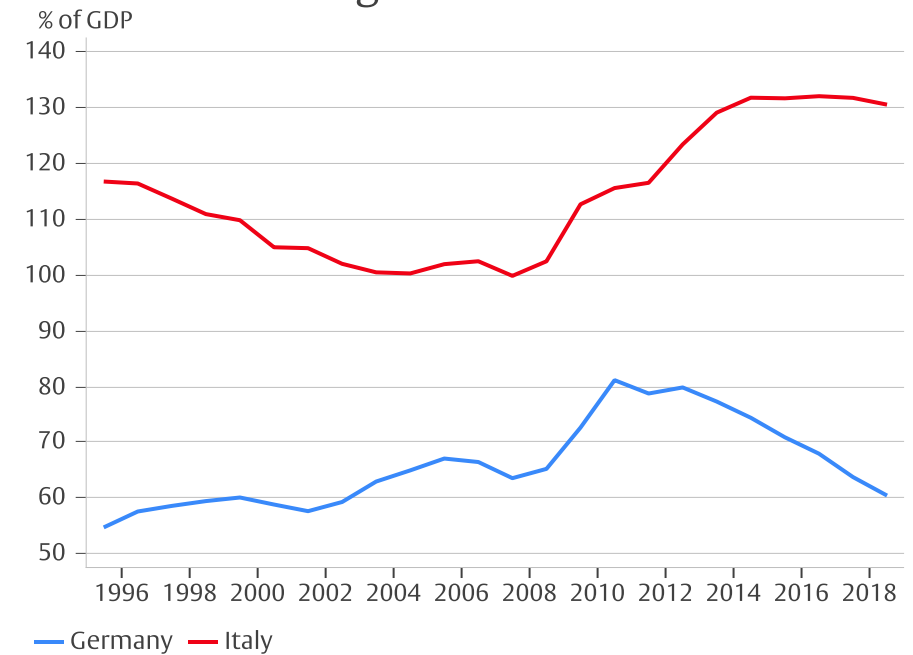
Divergence in government finances

Fiscal policy not euro compliant

Germany and Italy: Budget balance of general government

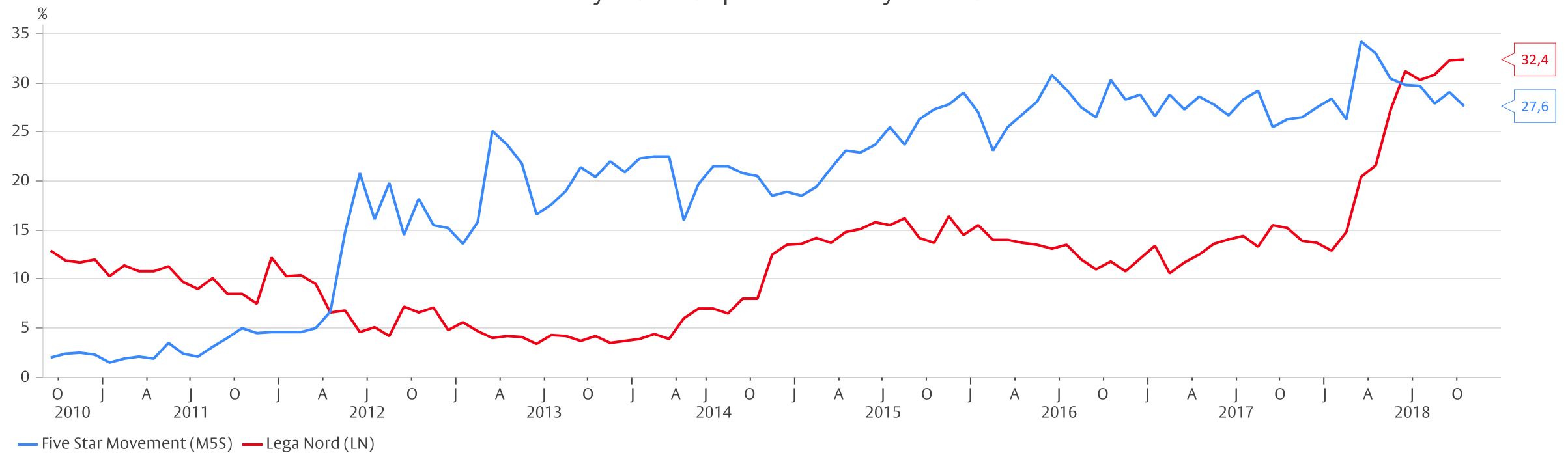


Germany and Italy: Gross debt of general government



The political reaction

Italy: Polls for parliamentary elections



Quelle: Macrobond

How the euro could blow up



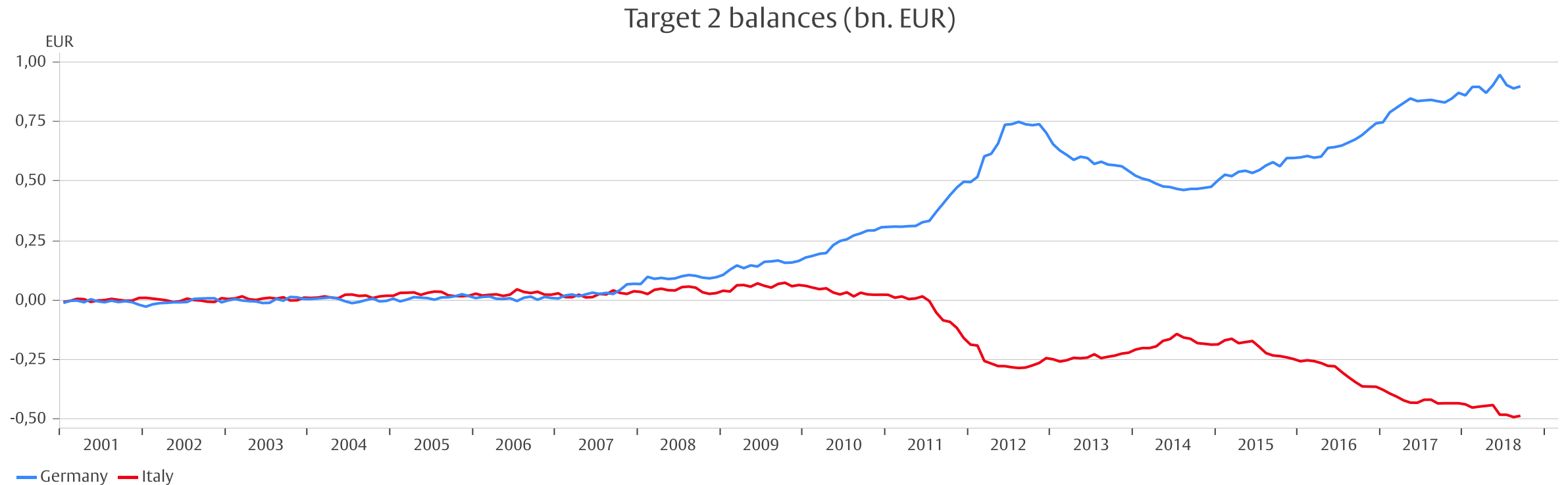
Monetary Union is a fairy tale

- Bank notes and coins are the only means of payment of equal quality in the entire euro area
- The value of deposit money depends on the quality of the credit portfolio of the issuing bank and the solvency of the government guaranteeing the bank
- Instead of monetary union we have a cash union



Balance of payments deficits are funded by the Eurosystem

Unlimited financing of balance of payments deficits at zero cost

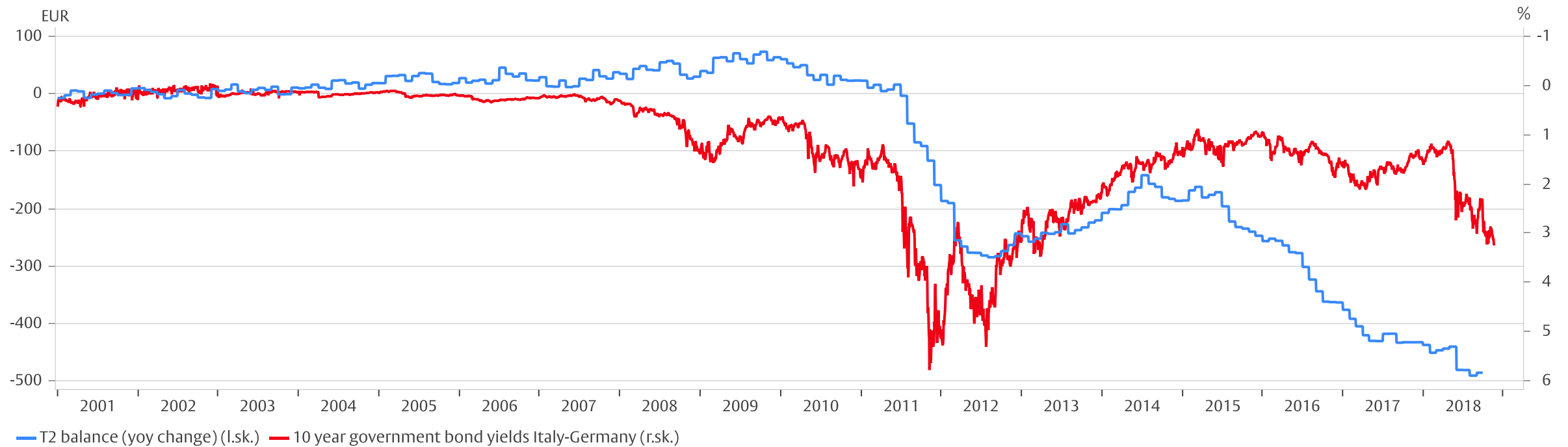


Quelle: Macrobond



Target balances reflect uncompensated risk differentials

Italy: Target2 balance (bn EUR) and yield spread (%)



Quelle: Macrobond



A bank run can break the euro

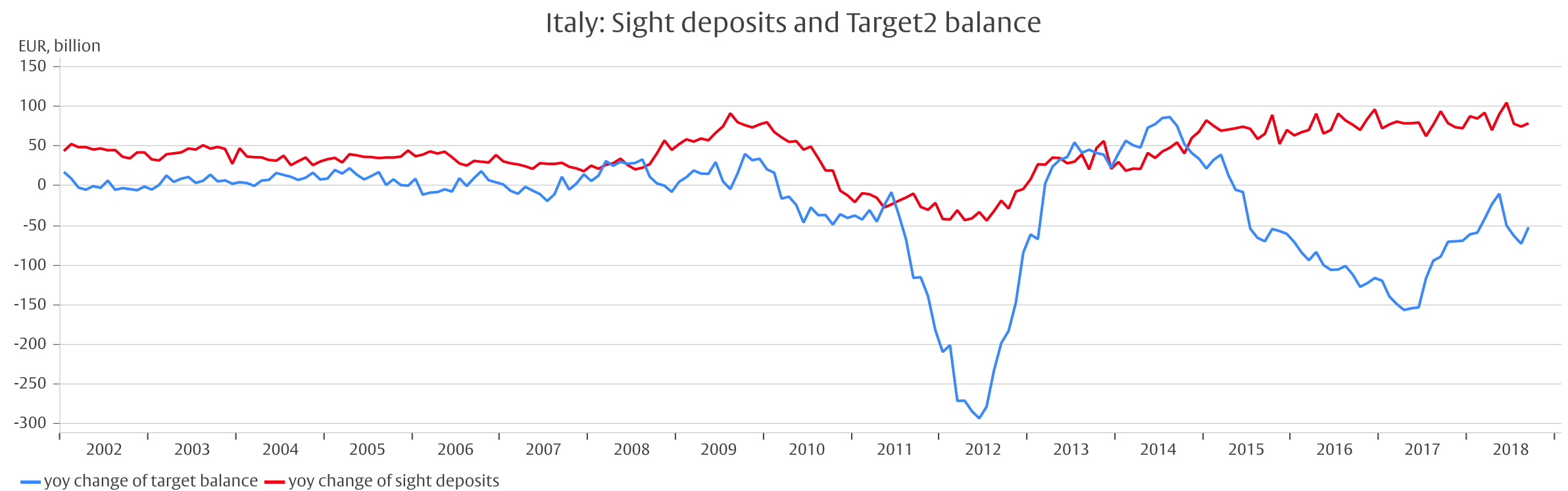
- Flight of deposit money needs to be funded with central bank money

Assets	Liabilities		Assets	Liabilities
100 K		→	100 K	100 E
10 R	110 E			

- If the central bank stops the supply of central bank money, deposit money can no longer be moved
- The ECB Council can stop ELA with a 2/3 majority
- In case of a run on Italian banks money transfers abroad and cash withdrawals are likely to be restricted



Italian bank customers still keep their nerves



Source: Macrobond



The fairy tale of safe deposits in Banking Union

- Prerequisite: „safe banks“
 - Equity backing of government bonds
 - Maximum credit limits
 - Equity ratio of 25% (Martin Hellwig)
- Consequence: Increase of credit costs
 - Assumption: Equity costs = 6%, debt costs = 2%
 - Consequence
 - $WACC = 0.25 \times 6\% + 0.75 \times 2\% = 3\%$
 - Credit costs = WACC 3% + operational costs 1% + riskpremium 1% = 5%
 - Italy: Interest burden of government = $130\% \times 5\% = 6.5\%$ of GDP (4% of GDP today)
- **Ergo: EDIS needs the backing of creditor country tax payers**



Monetary reform to save the euro



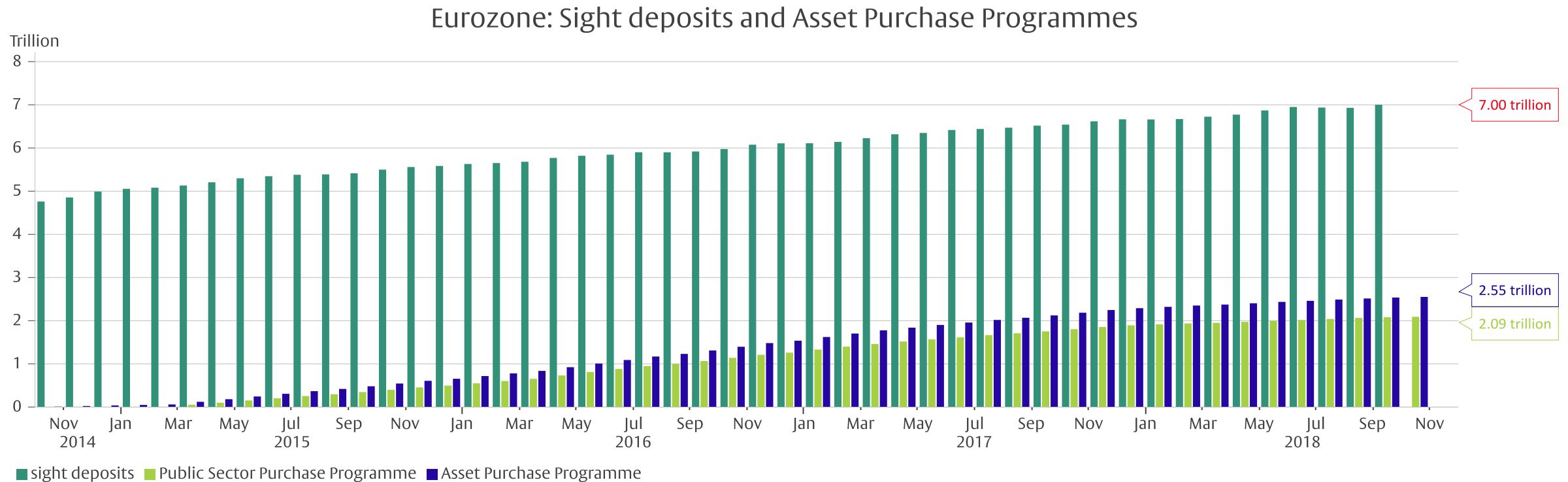
The safe deposit

- Safe deposit = Sight deposits backed to 100% with central bank reserves
- Credit money = private bank money
- Private bank money treated like other senior bank obligations (with variable exchange rate to all other money)
- Money competition



Coverage of sight deposits by ECB asset holdings

Expanded Asset and Public Sector Asset Purchase Programme (EAPP and PSPP) $\approx \frac{1}{3}$ of sight deposits



Source: Macrobond



Debt reduction through the safe deposit

Chicago-Plan as historical model

- Government debt: 9.7 trillion EUR (87% of GDP)
- Sight deposits: 7 trillion EUR (62% of GDP)
- Remaining government debt after 100% backing of sight deposits with government bonds: 2.7 trillion EUR (25% of GDP)



Public-private money competition



The world of tokens

- „Token“: Medium that can be traded via Blockchain / DLT
- Payment-token: Uncovered means of payment without other functionalities (e.g. Bitcoin)
- Utility-token: Medium that allows the user access to goods and services (e.g. „Nounou“ token for healthcare services in China).
- Securities-token: Claims on investment returns (e.g. Dividend-tokens)
- Asset-token: Claims on assets (precious metals, commodities, equities, real estate)



Tokens as a means of exchange and store of value

- Creation of a legal framework for property exchange
- Establishment of orderly market for tokens
- Public securities-tokens: Claims on returns from public infra-structure investments
- Public utility-tokens: Claims on the use of fee-based public services (administration, public health care, etc.)
- Public payment-token: Euro as common currency



The future of EMU

- „Liraisation“ of the euro leads to exit of hard currency countries
- Hardening of the euro leads to exit of soft currency countries
- „Transfer union“ leads to political break-up of EMU
(political centripetal force < economic centrifugal force)
- The Great Bargain: Debt reduction through the Safe Deposit in exchange for money competition



Outlook

- Status-quo orientation of politics
- Politics can only act in crises
- Success of crisis management is uncertain
- Probability of success is higher if crisis solutions have been discussed in advance



„Some things that have been utopian
in the morning are already sci-fi at
noon and reality in the evening“



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