

# **The Political Economy of Fiscal and Monetary Institutions**

## ***The Problem of Debt: The Game of Banks***

- government guarantees bank debts
- banks keep the winnings, tax payers keep the losses
- so banks want to gamble like crazy
- solution: bank regulation and supervision
- legal solution: specified amounts of deposits guaranteed, bail-in provisions on bonds, capital requirements (equity holders to take the losses), restrictions on the types of risky investments
- not a problem unique to the EU

## ***The Game of Banks: Who Won in Italy?***

### Banca Monte dei Paschi di Siena

2009 huge losses hidden by bank

2013 bailed out by Italian government

“the 16-member board of the Fondazione Monte dei Paschi di Siena, which owns a stake of almost 35% in the bank, is dominated by political appointees: eight are chosen by the city authorities and five by provincial authorities”

## ***The Game of Banks: Who Won in Spain?***

### Bankia

2012 bailout by Spanish government

“Bankia’s components – Caja Madrid, Bancaja from Valencia and smaller savings banks from the Canary Islands, Catalonia, Rioja and the towns of Avila and Segovia in central Spain – were typical of the cajas that accounted for half of Spain’s banking system by assets before the crisis began. They began as regional businesses and were in most cases closely connected to politicians in the areas where they operated, so that Caja Madrid and Bancaja were influenced and run by the Popular party now in government.”

## ***The Game of Banks: Who Won in France and Belgium?***

Dexia

bailed out in 2008

in 2008 hired former Prime Minister of Belgium as Chairman

bankrupt in 2011

## ***The End Game of Banks***

2008 Michael Woodford

economists have written thousands of papers about central bank independence from the government

when the problem is central bank independence from the banking sector

in the US bank supervisors have offices and work directly in the banks they supervise, their friends, people they eat lunch with are bank employees

the President of the NY Fed is expected to be chummy with the “banking community” who indeed are his board of directors

Goldman Sachs has spent years encouraging and subsidizing employees to take high government positions: the Treasury secretary who bailed out Goldman Sachs was a former head of the company

## ***Bank Regulation?***

- the point here is not a deep point
- shifting banking supervision and deposit insurance to the EU level is a good idea
- it might reduce the coziness between local politicians and local banks
- but it doesn't go to the heart of the problem – why is the banking lobby so effective and what can we do about it?
- a problem in political economy not macroeconomics

## ***The Game of Democracy***

- as part of the monetary union the EU as a collective guaranteed the debt of member states
- creates the same problem as guaranteeing bank debt
- Brazil had the same problem – provincial governments set spending and the Federal government was responsible for the resulting debts
- the US does it the opposite way: states are responsible for their own debts and do not get bailed out by the Federal government
- the EU recognized the problem and imposed limits on budget deficits



## ***The Game of Democracy: Who Won in Greece?***

primary surplus (from the ECB)

2014	0.352
2013	-8.344
2012	-3.670
2011	-2.962
2010	-5.253
2009	-10.270
2008	-4.978
2007	-2.156
2006	-1.63

as soon as the time to repay came the government that made the agreement was thrown out of office and replaced with a government that refused to repay

when the city of Detroit in the U.S. went bankrupt it didn't paralyze the political system in the U.S. for months on end – and nobody suggested that the solution was for Detroit to issue its own currency

## *The Political Problem of EU Institutions*

the voters and politicians of every member state view the EU as a menu of options

- free trade
- free movement of labor
- agricultural subsidies
- development funds
- member state contributions to the EU
- bank guarantees

each would like to be free to select from the menu of options

“we'll have free trade, no banking regulation, development funds, no contributions, our citizens can move freely, but other eu citizens are not welcome here, we want deposit insurance but can't be bothered to pass the enabling legislation...”

## ***The Contradictions of Schengen***

- border free movement for citizens but not non-citizens
- non-citizens have no rights in Schengen only in the host state
- but the EU has no control over citizenship which is decided entirely by the host state
- like the fiscal problem one day it doesn't matter until one day it does

## ***The Raw Power of the EU***

- no Army, no police, no tax collectors
- brought Greece to its knees by closing the banks
- not many people realized that the monetary union was a deal with the devil
- removed a democratically elected prime minister (Berlusconi) and replaced him with their own man (Mario Monti)
- also by threat of financial ruin
- to my knowledge (since the end of reconstruction in 1877) the Federal Government of the United States has never removed the Governor of a State and replaced him with their own choice

## ***The Political Institutions***

the EU isn't a state and nobody wants it to be  
people view themselves as “Italian, German, French” not as “European”  
voters generally like the current system and do not want stronger  
central authority

but the system is not stable

- members states discontent with their menu have referendums on whether to stay
- the recent parliamentary election was supposed to help
- European commission President is now elected through parliament

but Greece, immigration all dealt with the group of heads of state with the commission and parliament playing essentially no role

## *ADEMU*

- so you think I'm going to tell you the answers
- what I am going to say is that we don't have the tools
- so what we are doing is building the tools
- and at the end perhaps we will have some answers

## *The Project*

Rohan Dutta, Andrea Galeotti, Andrea Mattozzi, Salvatore Modica

- collusion
- social disruption

applications

- voting
- lobbying
- protests

## ***A Summary Question***

how does a system work with multiple sources of political power?

- voters vote in politicians
- who take bribes from lobbyists
- leading to political protests