

Unemployment and inflation in the euro area: why has demand management failed so badly?

By Willem H. Buiter⁹¹

Before getting to the main points I address in my presentation, I would like to comment on the speech made by the ECB's President, Mario Draghi, earlier in this session (Draghi (2015)). The title summarises the message well: "Structural reforms, inflation and monetary policy". President Draghi calls for structural reforms to be accelerated through both common/joint and country-specific policies and reforms that would strengthen euro area resilience (shock absorption capacity) and boost the growth rate of potential output. To boost resilience he makes the case for the elimination or reduction of labour and product market rigidities. To boost the growth of potential output, he calls for measures to increase trend labour supply and productivity growth.

I agree with most of the substantive recommendations for structural reform made by President Draghi. I have a problem, however, with central bankers making public statements about policies or reforms that definitely go well beyond their mandate and quite likely also beyond their competence.

1 The sound of silence

Central bankers are unelected, appointed public officials. They are given a mandate that is the product of a legitimate political process. In the case of the ECB, the primary objective is price stability and, without prejudice to the price stability objective, all things bright and beautiful. Of course, the true primary objective of any central bank is financial stability, and the ECB is no exception. The actual references in the Treaties to the true primary objective are de minimis. Protocol No 4, Article 3.3 reads: "In accordance with Article 127(5) of the Treaty on the Functioning of the European Union [TFEU], the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". The bold and sweeping actions taken by the ECB when the financial stability, and indeed the integrity of the euro area were at risk in the years since the start of the Great Financial Crisis in the second half of 2007 leave no doubt in my mind that, should there ever be a conflict between price stability and financial stability in the euro area, financial stability would be the winner.

The ECB has been given a high degree of political independence (Article 130 TFEU), operational independence, and some target independence, in the sense that the ECB's Governing Council sets the practical, numerical operationalisation of the price stability objective – unlike, for instance, in the United Kingdom, where the Chancellor sets the

⁹¹ Citigroup.

operational inflation target. In addition to designing and implementing monetary policy for the euro area, the ECB is, since November 2014, the dominant member of the Single Supervisory Mechanism (SSM) which, in addition to the ECB, has the national bank supervisory entities (national competent authorities or NCAs) as its members. The only chink in the armour of operational independence is the rather bizarre Article 219(2) TFEU, which allows the Council of the European Union (aka Council of (Finance) Ministers) to formulate "general orientations" for exchange rate policy. These orientations have to be "without prejudice" to the primary objective of price stability. Clearly, if the Council were to be able to give binding instructions about exchange rate management, the ECB would lose the substance of operational independence. Not surprisingly, finance ministers and ECB Executive Board members have divergent interpretations of the meaning of "general orientations".

The notion that central banks should focus exclusively on their mandates and not be active participants in wider public policy debates, let alone be active players in the negotiations and bargaining processes that produce the political compromises that will help shape the economic, social and political evolution of our societies is, I believe, sound. Alan Blinder described this need for modesty and restraint for central bankers as "sticking to their knitting". Both fiscal policy and structural reform have clear and often significant distributional consequences. They are, therefore, deeply political. As regards fiscal policy, this is so obvious it does not require elaboration. But structural reform too, including labour market liberalisation, opening up the professions, and opening up product markets to greater domestic or external competition, is not just about efficiency gains or the size of the pie, but about the distribution of the pie. What looks like an artificial barrier to entry to an economist is a source of rents to the protected worker, professional or firm. When central bankers take part in the often very partisan political debates on fiscal policy and structural reform, they compromise and undermine their independence.

Central banks and central bankers sticking to their knitting – the design and conduct of monetary policy and credit policy in the pursuit of macroeconomic stability and financial stability – has become the exception rather than the rule since many advanced economy central banks achieved a measure of operational independence, starting with the Reserve Bank of New Zealand in 1989. Indeed, quite a few central bankers devote more of their public utterances to issues like structural reform and fiscal sustainability that ought not to concern them, except in one narrow sense defined below, than to monetary policy and financial stability.

A straightforward brace of illustrations of the kind of "extra-territorial" or "extra-curricular" activities of central bankers that I consider to be inappropriate and a threat to the operational independence of central banks, even where this make sense – in the conduct of monetary policy, narrowly defined – can be found in the 17 October 2014 web edition of the Financial Times (FT). It carries two prominent headlines about central bankers. The first one says "Yellen bemoans rising US inequality". The subheading is "Boston speech highlights Fed chair's liberal sympathies". The speech does not deal with monetary policy or other aspects of central banking. It does not even discuss the impact of monetary policy on inequality or the implications of inequality for the conduct of monetary policy. The second headline reads "Bundesbank hits back at calls for stimulus". The subheading is "Weidmann says Germany needs to maintain a balanced budget". In the speech to which

the FT headline refers, Weidmann picks a public argument with the chief economist of the International Monetary Fund (IMF), Olivier Blanchard, about the benefits to the rest of the euro area from a German fiscal stimulus through an increase in German public investment (see Weidmann (2014)).

It does not matter whether the themes developed and statements made by these two distinguished central bankers are right or wrong, or whether we agree with them or not. Both are using – I would say mis-using – the high profile and visibility they possess as a result of their central bank positions to speak out, in their official capacities, on issues that are far from their mandates and (probably) from their domains of expertise and competence. As private individuals or as scholars, they are certainly entitled to their views on these and any other issues. But they cannot use the prominent pulpit provided by their official position to engage in overt political speech-making or other political activities. They ought to wait to speak out on non-central banking issues until they leave their official central bank positions. The central bank should not be used as a political bully pulpit.

There is a long history of central bankers going beyond their mandates and competence to lecture the world on deeply political issues. Former Fed Chairman Bernanke⁹² routinely lectured the US Congress and the White House on fiscal sustainability and appropriate fiscal stimulus measures. He played a prominent, high profile public role in gathering support for a fiscal stimulus package to counteract the US slowdown/recession from late 2007 through to 2009. On Thursday, 17 January 2008, for instance, in testimony to the House Budget Committee, he backed calls for a fiscal package to stimulate the economy, but stressed that such a plan should be “explicitly temporary”. He said “... any programme should be explicitly temporary, both to avoid unwanted stimulus beyond the near-term horizon and, importantly, to preclude an increase in the federal government’s structural budget deficit”.

He went on to say that the nation faced daunting long-run budget challenges associated with an ageing population, rising health-care costs and other factors, and that a fiscal programme that increased the structural budget deficit would only make confronting those challenges more difficult. Yet “... fiscal action could be helpful in principle, as fiscal and monetary stimulus together may provide broader support for the economy than monetary policy actions alone”.

Chairman Bernanke may or may not have been right about the usefulness of this kind of fiscal policy package at the time (for what it is worth, I believe he was largely right), but it is an indictment of the American political system that we have the head of the central bank telling members of Congress how they ought to conduct fiscal policy. Fiscal policy is not part of the Fed’s mandate. Nor is it part of the core competencies of the Chairman of the Federal Reserve Board to make fiscal policy recommendations for the US federal government. It is true that Bernanke acting ultra vires was likely the lesser of two evils: usurping the constitutional roles of Congress and the Executive versus permitting a re-run of the Great Depression. The point is that political institutional reforms are required in the United States (and elsewhere) to prevent a recurrence of this “rule by technocrats”.

⁹² Former chairman of the Board of Governors of the Federal Reserve System.

This was not the first time the (former) Chairman of the Fed strayed into controversial policy issues that were none of his and the Fed's business. He lectured, as Chairman of the Fed, on free trade, on aspects of globalisation that were not relevant to the conduct of monetary policy and on equality, equality of opportunity, educational achievement and teenage pregnancy (see Bernanke (2007a, 2007b and 2007c)).

The President of the ECB, Mario Draghi, like his predecessor Jean-Claude Trichet, is actively trying to influence and shape euro area policies in the areas of fiscal policy and structural reform, using a range of possible monetary policy interventions as sticks or carrots to get national governments and the European Commission to do what he considers to be "the right things". His recent address at the Jackson Hole Conference organised by the Federal Reserve Bank of Kansas City demonstrates the broad range of economic issues on which the President of the ECB feels comfortable to lecture, some might say badger, the political leadership of the euro area (Draghi (2014)). Regardless of the economic merits of Draghonomics, there is something worrying, from a constitutional/legal/political/legitimacy perspective, if unelected central bank technocrats become key movers and shakers in the design and implementation of reforms and policies in areas well beyond their mandate and competence. Indeed, when Italian Prime Minister Silvio Berlusconi resigned on 12 November 2011, it was widely reported that the ECB supported his replacement with Mario Monti. Some reports go further and allege that the President of the ECB played an active, albeit indirect, part in Berlusconi's resignation by restricting the ECB's buying of Italian sovereign debt during the days leading up to the announcement of his resignation. This certainly has a ring of plausibility, as on 29 September 2011 the then President of the ECB, Jean-Claude Trichet and the ECB President-in-waiting, Mario Draghi both signed a letter to Berlusconi that contained a detailed list of fiscal and structural reforms the Italian government ought to implement asap. The words "or else" were not part of this missive, but were clearly implied.

I don't wish to assign all or even most of the blame for this usurpation of parliamentary and executive power to the individual central bankers involved. In the case of the ECB, the blame for this intolerable situation lies mainly with the defective institutional design of Economic and Monetary Union (EMU) and the unwillingness and/or inability of the euro area political class to correct the manifold deficiencies of EMU and the European Treaties. The banking union is proceeding only slowly and incompletely: as a result, the failure to sever the two-way umbilical cords between national sovereigns and banks inside their national jurisdictions forced the ECB to take the lead role in the Greek sovereign debt and banking crises since the beginning of 2014. There is no sovereign debt restructuring mechanism; there is no European Monetary Fund with mutualised sources of funding from the Member State sovereigns capable of providing conditional liquidity to sovereigns on a scale sufficient to avoid the risk of fundamentally unnecessary sovereign debt restructuring or to mitigate the trauma associated with unavoidable sovereign debt restructuring; and there are no adequate mutualised "fiscal pots" to back up the Single Resolution Mechanism for systemically important banks or the Single Deposit Guarantee Scheme which may one day materialise. Finally, there has been a steady increase in the scale and scope of ECB/Eurosystem activities that are not subject to the normal profit and loss-sharing rules of activities undertaken as part of the implementation of the single monetary policy. This happened because of an unwillingness of euro area creditor sovereigns and/or those sovereigns with a high sovereign credit rating to assume greater

exposure to the debt of near-insolvent or high credit risk sovereigns through the monetary operations of the Eurosystem. The heads of the central banks of the creditor nations, acting in the pursuit of their narrow national agendas rather than serving the euro area-wide mandate, pushed through the latest (and thus far the largest) infringement of the profit and loss-sharing rule (the own-loss provision attached to up to €760 billion worth of purchases of public sector debt instruments). This represents a further big step on the road turning the Eurosystem from an operationally decentralised monetary union into a system of currency boards (see Buiter (2015)).

The ECB was and is stuck with the uncomfortable choice between letting the euro area collapse or taking on responsibilities and acting in ways that are well beyond its mandate. It is time to correct this situation. Elsewhere I have written extensively on this subject (see Buiter (1999, 2004, 2005, 2007, 2008a, 2008b, 2008c, 2012 and 2014)). Congressional paralysis in the days following the eruption of the Great Financial Crisis compelled the Fed to act, especially in the years 2007-09, in a quasi-fiscal manner on a scale and in ways that had never been seen before and that, in the views of many, went well beyond its mandate. The lack of transparency (shared with the ECB and many other central banks) surrounding the terms of its financial rescue operations and the identity of many of the beneficiaries led to a lawsuit by Bloomberg News against the Fed and The Clearing House Association LLC, which was won by Bloomberg in 2011 and compelled greater disclosure from the Fed. The ECB still provided no relevant information about most of its financial operations, even with a suitable lag to allow potentially turbulent markets to settle down and to ensure commercial confidentiality.

Since the Great Financial Crisis the US Congress has passed legislation, as part of the Dodd-Frank Act, that prevents the bailout by the Fed of individual struggling counterparties, although it left intact Fed powers to provide lender-of-last-resort assistance to groups of firms. Bipartisan proposals to further restrict the power of the Fed to lend and as lender of last resort are currently pending in the US Congress. I consider both the Dodd-Frank restrictions and the new proposed restrictions to be a threat to financial stability. It is not hard to see, however, how the astonishing expansion of the Fed's rescue operations during the Great Financial Crisis and its unwillingness to provide the information necessary to assess the scope and scale of the Fed's quasi-fiscal interventions, created the momentum for legislative initiatives to impair the Fed's ability to act as lender of last resort and market-maker of last resort in the future.

There are just two (related) legitimate reasons for a central banker to talk about fiscal policy or structural reform. The first is that this is part of an explanation of his/her view of the transmission mechanisms of fiscal policy and structural reform – the way in which they, directly or indirectly, affect the variables that are directly or indirectly relevant to the central bank's mandate. The second is to explain the central bank's reaction function: what the central bank's likely response will be to past, current or anticipated future fiscal policy measures and structural reforms. Under no circumstances should the central bank give advice on, recommend or warn against fiscal or structural reform policies.

One of the unfortunate consequences of central bank independence in the euro area has been widespread acceptance of the Teutonic view of central bank independence as being incompatible with coordination of monetary, fiscal and structural reform policies and with cooperation between the monetary, fiscal and structural reform authorities. This view is

illogical: only independent agents can cooperate and coordinate. Subordinates are told what to do. Regrettably, the Teutonic view – which can be summarised as the following guideline for central bankers: don't answer the phone when the ministry of finance calls – is the dominant view in the euro area. Sometimes the Teutonic view appears to be based on a fear of "capture" of a cooperative central bank by a predatory Treasury. Other times it appears to be based on a distorted version of the "commitment problem", i.e. that only an independent central bank can commit to a set of (possibly contingent) future actions while a cooperative central bank acts in a time-consistent but suboptimal manner.

If the central bank cannot act cooperatively with the other policy-makers in charge of fiscal policy and structural reforms, the only legitimate thing to do is for it to act as a Stackelberg follower in a policy game where the other players, the fiscal authority and the structural reform authority, are likely to possess the political legitimacy that the central bank lacks. The central bank does the best it can (preferably with credible commitment) taking as given the past, current and anticipated future actions or reaction functions of the fiscal authority and the structural reform authorities.

2 Unemployment in the euro area

The euro area suffers both from deficient aggregate demand and from fundamental supply side problems – in labour markets, product markets, in the professions and in financial markets. In many countries (France, Finland, Belgium and Austria are obvious examples), the share of public spending in GDP is so high that even the best-designed tax system inevitably ends up being highly distortionary. In addition, high marginal tax rates and, at the lower end of the income distribution, high marginal benefit withdrawal rates plus marginal tax rates damage incentives to work, save and invest. Hysteresis has probably also contributed to supply side weakness (see Blanchard et al. (2015)). Excess capacity depresses capital formation and future potential output. Persistent unemployment, especially long-term unemployment, adversely affects human capital – both the aptitude for work and the attitude towards work.

Of course, the presence of hysteresis in the labour market does not necessarily mean that demand stimulus is called for. If hysteresis is not due to the human capital destruction caused by (long-term) unemployment, but to the disenfranchisement of unemployed and inactive workers from effective participation in bargaining over wages and other conditions of work (the insider-outsider model discussed in this session by Galí (2015)), then a direct assault on the man-made barriers to effective competition from the outsiders can eliminate the problem. This could involve legislation weakening the power of unions, or limiting the capacity of employers and unionised workers (or even just employed workers) to negotiate terms and conditions of employment that are binding not just on those that negotiated the deal but also on all other workers and employers active in the industry or entering the industry in the future. In the Netherlands such collective bargaining agreements are called generally binding declarations (or AVVs). They are, of course, insider-outsider problem generators par excellence.

Deficient aggregate demand is the result of a number of factors. One is continued excessive leverage – in the public sector in the vast majority of euro area Member States,

in the banking sector almost everywhere and in a significant number of countries also in the household sector. Spain, Portugal and Ireland have excessive leverage in all major sectors. High leverage dampens domestic demand and reduces the interest-sensitivity of aggregate demand. The second factor is that the neutral real interest rate (the risk-free short-term real interest rate that would equate aggregate demand and supply at full employment) is likely negative, and the official (nominal) interest rate, the refi rate, is, at 0.05%, near the effective lower bound, although the Swedish example (a refi rate of -0.30%) suggests that there is room for some further reduction in the refi rate. In orderly financial markets, central bank balance sheet expansion, whether through outright asset purchases or through collateralised lending, repos, etc. is not very effective. It tends to affect the most liquid asset markets (government debt markets, the foreign exchange markets and the stock market) with little evidence of transmission to the real economy. Even changes in the exchange rate appear to have most of their impact on profits in exporting and import-competing industries with limited effects on volumes.

3

Why is euro area demand management failing?

In the euro area, demand stimulus through fiscal policy has been severely handicapped by the widespread acceptance of the Triad of Teutonic Fallacies. The first of these is that there are reckless and/or stupid borrowers/debtors but no reckless and/or stupid lenders/creditors. As we are talking about the same transactions, that position is rather difficult to defend. It is, however, firmly believed by many living north of the Rhine, and it gives the creditors a sense of moral superiority or even outrage that diminishes their cognitive capabilities. The second fallacy is that expansionary fiscal policy is contractionary. There are indeed models in which this is the case. Provided any fiscal deficit expansion resulting from a fiscal stimulus is monetised, however, this will never be the case in a world with excess capacity and inflation below target. The third fallacy is that any increase in the balance sheet of the central bank will inevitably get monetised and lead to an undesirable increase in the rate of inflation. The fact that this is analytical nonsense does not mean it is not an influential view.

The combination of Fallacies two and three makes it effectively impossible to have a targeted helicopter money drop, that is, a temporary fiscal stimulus, funded permanently by an increase in the stock of base money. To make the meaning of the central bank's contribution to a helicopter money drop clearer, the central bank could cancel, write off or forgive the sovereign debt it purchases as part of the helicopter money drop. Because the Treasury is the beneficial owner of the central bank, buying government debt and holding it permanently is equivalent to cancelling it – at any rate in a system where one central bank is beneficially owned by one Treasury. In the euro area, of course, there are 19 national central banks (NCBs) plus the ECB and there are nineteen beneficial owners – the national Treasuries of the euro area Member States – who (with a growing number of regrettable exceptions) share the profits and losses. With own-risk public debt purchases, we are back in the one-on-one case.

In the euro area, for a helicopter money drop to be most effective, the fiscal stimulus should be targeted at the countries with the largest negative output gaps and at those in need of an appreciation of their real exchange rates vis-à-vis the rest of the euro area.

Article 123 of the Treaty on the Functioning of the European Union makes it awkward even to engage in backdoor helicopter money of the kind that we are now seeing in the euro area: a relaxation of the fiscal austerity imposed either by former Troika programmes or by the European Commission, combined with a “quite separate” monetised purchase of sovereign debt as part of an asset purchase programme that is justified as being in the pursuit of price stability.

Effective supply-side reforms of real significance since 2007 have only been undertaken in Spain and even there much remains to be done. But the sad reality of the euro area’s inability to engage in deep structural reforms should not stop it from at least closing the output gap as soon as possible.

4

What is to be done?

To close the output gap, the euro area needs effective combined monetary and fiscal stimulus. Unfortunately, the deeply flawed original design of EMU has not been meaningfully revised since its inception, except as regards the creation of a (too) small sovereign liquidity and bank recapitalisation fund (the European Stability Mechanism (ESM)), some quite impressive, but still incomplete, steps towards banking union and a regrettable increase in the scope and scale of own-risk financial operations by NCBs. Without deep reforms, I believe the euro area will not survive – and does not deserve to.

5

Some modest first steps: ten commandments/suggestions

Clearly, many of the deficiencies of EMU could be rectified by a move towards proper fiscal federalism, with a sizeable, independent federal taxation, spending and borrowing capacity under the political control of a euro area parliament. Such a development is, however, not likely in the foreseeable future, and neither are other proposals for mutualisation of the outstanding public debt and/or of future public debt issuance. I will focus therefore on a less unrealistic proposal for a minimal fiscal union to support a viable monetary union.

For EMU to survive and prosper the reforms listed below are required. “Essential” means necessary for survival. “Highly desirable” means necessary for EMU to prosper. The first six reforms relate to the Eurosystem. One of these, number five, is fiscal in nature. The next three address further building blocks of the minimal fiscal Europe. The last one is regulatory.

1. (Essential) Abolish/revoke Article 123 TFEU. The ECB should always have the right to say “no” to a request for monetisation of a sovereign’s debt or deficit. It should not be denied the right to say “yes”. Helicopter money is an essential policy instrument at the effective lower bound and may be essential even away from the effective lower bound if aggregate demand is interest-insensitive.
2. (Highly desirable) Adopt a triple mandate: financial stability, employment and price stability.

3. (Highly desirable) Reduce the size of the Governing Council of the ECB to, say, seven members, five rotating NCB Presidents (or ECB Branch Managers, see reform number six below) and two Board members (the President and the Vice-President, say). The size of the ECB's Governing Council is too large to allow for meaningful discussion. Currently there are 19 NCB governors (the number of euro area Member States) sharing a total of 15 voting rights in rotation (a number that is capped) and six Board members, all of which vote. More radical reform is proposed below in number six.
4. (Highly desirable) End the consensus model of decision-making and move to a simple model, with the President having the casting vote. In a majoritarian decision-making model with seven voting, if four are in favour and three against, the wishes of the four are implemented, even if the President votes with the three. A consensus model implements the decision of the majority only if the losing minority is not too unhappy. In the euro area the losing minority that must be kept reasonably happy can be small indeed. For this to work, it is of course necessary that an actual vote be taken, something that has not been the case for interest rate decisions by the ECB Governing Council in the past.
5. (Essential) Introduce full profit and loss sharing for all operations undertaken by the ECB and the NCBs for implementing the single monetary and credit policy and in the pursuit of financial stability. Currently there are three kinds of transactions that are for the own risk of the NCB undertaking them: (i) lending operations under emergency liquidity assistance (ELA); (ii) lending operations under the de facto resurrected (in 2012) Tier-2 collateral system, where an NCB is responsible for any losses on collateral accepted (with the approval of the ECB) by that NCB but not generally accepted in the Eurosystem; and (iii) up to €760 billion worth of purchases of public debt under the PSPP (public sector purchase programme) component of the ECB's QE programme. Apart from the fact that these "own risk" features infringe the TFEU, it turns the Eurosystem from an operationally decentralised monetary union into a system of currency boards (see Buiter (2015)).

With limits on profit and loss sharing, individual NCBs can become insolvent even if the consolidated Eurosystem is solvent. Solvency here is defined as the capacity to always pay your bills. If a balance sheet version is required it should add to the conventional assets and liabilities the net present value (NPV) of future seigniorage as an asset. A central bank that has few foreign currency-denominated liabilities need never become insolvent, although defending its solvency may require uncomfortably high rates of inflation. The Eurosystem has small foreign-currency-denominated liabilities and has discretionary control of its current and future seigniorage. Not so for individual NCBs. Each NCB gets its ECB capital key-weighted share of the aggregate seigniorage profits (monetary income). The aggregate seigniorage is determined by the majority of the voting members of the ECB's Governing Council, currently 25 in number.

So without profit and loss sharing an individual NCB can become insolvent even if the system as a whole is solvent. The NCB closest to this situation is the Bank of Greece. Unless the insolvent NCB is either recapitalised by its sovereign (unlikely if the insolvency of the sovereign is the cause of the insolvency of the NCB) or, in breach of the no profit and loss sharing conventions, is bailed out ex post by the rest

of the Eurosystem, that NCB ceases to be an eligible counterparty for the rest of the Eurosystem through TARGET2. It would mean the effective exit from the euro area of the nation whose NCB finds itself in that predicament.

6. (Highly desirable) End the nonsense of (currently) 20 entities with legal personality in the Eurosystem – the ECB and the (currently) 19 NCBs. Abolish the NCBs and replace them with a number (say 12) of regional branches of the ECB. The ECB would have legal personality, not the branches. This would have the advantage of avoiding the current situation where NCB presidents too often vote in their national interests instead of serving the ECB's mandate. It would also ensure that there is full profit and loss sharing in the Eurosystem, as none of the branches would have any responsibilities other than the implementation of the single monetary, credit and financial stability policy.
7. (Essential) Establish an orderly sovereign debt restructuring mechanism (SDRM) alongside a serious conditional sovereign liquidity facility (a much larger ESM, with the bank recapitalisation role split off, and with a credit line to the ECB, jointly and severally guaranteed by the euro area sovereigns). There will be future sovereign debt restructurings in the euro area, and no-one wants to see a re-run of the Greek debacle, where the need for debt restructuring was first denied (by all three members of the Troika, including the IMF) and, when recognised at last, implemented only after the euro area Member States had effectively assumed (in breach of Article 125 TFEU) part of the sovereign debt of Greece held by private creditors.
8. (Essential) Complete banking union with a much larger mutualised fiscal backstop than the Single Resolution Fund currently envisaged. The banking recapitalisation facility of the ESM should be merged into this. The new fiscal backstop should have a credit line to the ECB, jointly and severally guaranteed by the euro area sovereigns.
9. (Highly desirable) Mutualise deposit insurance but reduce the upper limit on insured deposits to, say, €20,000 rather than the current €100,000 limit. This is meant to be social policy (the protection of widows and orphans) rather than financial stability policy, for which the Eurosystem is responsible as lender of last resort and market-maker of last resort.
10. (Essential). Strictly limit the exposure of all banks to all sovereign debt, including that of their own sovereign. Risk weighting of sovereign debt for capital adequacy purposes should be no different from risk weighting of commercial debt. Concentration or exposure limits should be the same for public counterparties as for private ones.

References

Bernanke, B.S. (2007a), *The Level and Distribution of Economic Well-Being*, remarks before the Greater Omaha Chamber of Commerce, Omaha, Nebraska, 6 February.

Bernanke, B.S. (2007b), **Recognizing Leadership**, speech given at the Princeton Prize in Race Relations Awards Program, Washington, D.C., 22 May.

Bernanke, B.S (2007c), **Education and Economic Competitiveness**, speech given at the US Chamber Education and Workforce Summit, Washington, D.C., 24 September.

Blanchard, O., Cerutti, E. and Summers, L.H. (2015), "Inflation and activity – two explorations and their monetary policy implications", paper presented at the *2015 ECB Forum on Central Banking, Session 1: Current perspectives on inflation and unemployment in the euro area and advanced economies*, Sintra, 22 May 2015.

Board of Governors of the Federal Reserve System (2010), "**American International Group (AIG), Maiden Lane II and III**", *Regulatory Reform*.

Buiter, W.H. (1999), "Alice in Euroland", *Journal of Common Market Studies*, Vol. 37, No 2, pp. 181-209.

Buiter, W.H. (2004), "Two naked emperors? Concerns about the Stability and Growth Pact and second thoughts about central bank independence", Institute for Fiscal Studies 2003 Annual Lecture, *Fiscal Studies*, Vol. 25, Issue 3, pp. 249-277, September.

Buiter, W.H. (2005), "**New developments in monetary economics: Two ghosts, two eccentricities, a fallacy, a mirage and a mythos**", Royal Economic Society 2004 Hahn Lecture, *The Economic Journal*, Vol. 115, No 502, pp. C1-C31, March.

Buiter, W.H. (2007), "**Clipping central bankers' wings**", *Central Banking Journal*, Vol. 43, Issue 2, pp. 28-32, November.

Buiter, W.H. (2008a), "**Central bankers should stick to their knitting**", *Willem Buiter's Maverecon Blog*, Financial Times, 28 January.

Buiter, W.H. (2008b), "**Central banks and financial crises**", paper presented at the Federal Reserve Bank of Kansas City's symposium on *Maintaining Stability in a Changing Financial System*, Jackson Hole, Wyoming, 21-23 August.

Buiter, W.H. (2008c), "Monetary economics and the political economy of central banking: Inflation targeting and central bank independence revisited", in Jorge Carrera, (ed.), *Monetary Policy Under Uncertainty; Proceedings of the 2007 Money and Banking Seminar*, Banco Central de la República Argentina, Buenos Aires, Argentina, pp. 218-243.

Buiter, W.H. (2012), "**The Role of Central Banks in Financial Stability: How has it changed?**" in *The Role of Central Banks in Financial Stability*, Evanoff, D., Holthausen, C., Kaufman, G. and Kremer, M. (eds.), *World Scientific Studies in International Economics*, Vol. 30.

Buiter, Willem H. (2014), "**Central Banks: Powerful, political and unaccountable?**", British Academy Keynes Lecture, *Journal of the British Academy*, Vol. 2, pp. 269-303, December.

Buiter, W.H. (2015), "**The Euro Area: Monetary Union or System of Currency Boards?**", *Global Economics View*, Citi Research, Economics, 19 March.

Draghi, M. (2014), “**Unemployment in the euro area**”, speech given at the Federal Reserve Bank of Kansas City’s symposium on *Re-evaluating Labour Market Dynamics*, Jackson Hole, Wyoming, 22 August.

Draghi, M. (2015), “**Structural reforms, inflation and monetary policy**”, introductory speech given at the *2015 ECB Forum on Central Banking*, Sintra, 22 May.

Galí, J. (2015), “Hysteresis and the European unemployment problem revisited”, paper presented at the *2015 ECB Forum on Central Banking, Session 1: Current perspectives on inflation and unemployment in the euro area and advanced economies*, Sintra, 22 May 2015.

Weidmann, J. (2014), “**Reforms for Recovery and Resilience**”, speech given at the *Bank of Latvia Economic Conference 2014*, 17 October.

Yellen, J.L. (2014), “**Perspectives on Inequality and Opportunity from the Survey of Consumer Finances**”, speech given at the *Conference on Economic Opportunity and Inequality*, Federal Reserve Bank of Boston, Boston, Massachusetts, 17 October.