Wolfson revisited [1]

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In December 2011, the Adam Smith Institute asked one of its Senior Fellows, Miles Saltiel, to form a team to compete for the Wolfson Prize for an essay on the best course for the Eurozone if members decide to drop out. He assembled a crew of City professionals and economists, who pored through the law-books, worked up the sums and took the counsel of an international group of seasoned veterans.

It turns out that our entry took a different approach from the shortlisted five, with a pronounced focus on making existing institutions work. One of the finalists has been generous enough to express his surprise not to find himself up against it.

Please click here to see the entry[3], setting out our analysis and proposals in full. It is offered as a contribution to the debate promoted by the prize, which we see as playing a positive part in adding to public understanding and the formation of professional opinion. Below the fold, we reproduce the one thousand word non-technical summary:

If Member States leave the Economic and Monetary Union, what is the best way for the economic process to be managed to provide the soundest foundation for the future growth and prosperity of the current membership?

We may not have reached a Berlin Wall moment but, if a Eurozone member secedes, policy-makers will be imprudent to continue to rely on theories of ?optimal currency areas?; likewise the econometrics supporting them. Neither would withstand the evidence of policy failure. We take it that there are no magic bullets: Germany will not ride to the rescue, as much for lack of means as lack of will. Future Eurozone membership will be the result of a tussle between leaders? political will (and capacity) and market judgment (if not sentiment).

To answer the Wolfson questions squarely, we offer serviceable proposals to manage adjustment and minimise turmoil. We take a piecemeal approach, going with the grain unless doing so threatens systemic risk. Our approach to economic welfare is similarly piecemeal: we decline an overarching attempt to theorise or forecast on a continental, let alone global, scale. Rather, we put forth proposals to deal with situations as they might arise, together with illustrative calculations.

We have analysed the legal position, the ambiguity of which presents a seceding State with the opportunity to take a strong line in negotiations. Here also our proposals go with the grain. We adhere to legal precedents wherever possible; we enlist the IMF as lead facilitator, making use of their long- standing expertise in the field and subscribing to their well-established processes; we also enlist the ECB as local facilitator, as the body best qualified to lead the EFSF or its successor, assemble other EU institutions, and act as an interlocutor with members. We invoke a standstill at the moment of redenomination to stabilise the immediate situation. We propose a treaty process as best meeting the need for comprehensive resolution. We suggest the use of proven templates for exchange instruments and introduce specific monetary, fiscal, and regulatory forbearance policies to ease adjustment.

Our proposals break new ground where they decline the Paris Club process, so as to cater for EU decision- making institutions. We envisage the ECB waiving claims for official creditor status, to the extent of a haircut and willingness to accept a lower coupon for exchange instruments. Failing leadership and adequate fiscal and monetary easing by the ECB, we propose the formation of ?Resolution Funds?. These intergovernmental groups of European and other states would function as ad hoc bank-like bodies, supporting fiscal and monetary easing, facilitating microeconomic reform, and if economics permit, acting as agent to issue exchange instruments supported by defeasance or collateral. We also envisage regulatory forbearance: from the BIS on recognising exchange instruments at par for tier 1 capital for Basel III requirements; from the IASB on the ECB?s treatment of delinquent assets, should haircuts fail fully to reflect impairment; and from jurisdictions governing bond agreements to suppress premature litigation threatening good order.

Our proposals contemplate arrangements to place assets from a seceding State in trust for collateralising exchange instruments, if third-party underwriting or defeasement fails; to alter IMF quotas to incentivise the participation of global capital-surplus States; and to invoke the seniority of treaty law to legitimate secession and the ensuing settlements, as well as to address obstacles posed by capital market instruments to an orderly resolution.

We do not shirk the calculations which lie at the heart of any solution, while mindful of the defects in our own. In particular, macroeconomic modelling is imperfect, with output only as good as the assumptions going in; and specific defects by way of the risk of roseate outcomes stemming from self-righting algorithms and inattention to the banking sector. In our essay we present:

- Estimates for bank contagion;
- Estimates for fiscal and monetary easing, as well as for burden-sharing for different classes of obligors, together with facilitating microeconomic reform for weak seceding states;
- Illustrative budgets for recovery for weak seceding states and balance sheets for the recovery institutions we propose; and
- Model runs for five economic scenarios: an example of a weak seceding State, Greece; and an example of a strong seceding State, the Netherlands. We then address the Eurozone as a whole, where we consider policy continuation, EMU dissolution, and fiscal union; notably, our runs suggest that the first of these is the worst case.

Our piecemeal solution adds up to a comprehensive answer to the Wolfson Prize questions and a pragmatic solution to secession from the Eurozone. We offer it in a spirit of contributing to a debate between contestants for the Wolfson Prize, which we see as playing a positive part in adding to public understanding and the formation of professional opinion.
