



Kiel Institute

for the World Economy

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Addressing the crisis: The Kiel Policy Package

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Joint work at the Kiel Institute

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Situation

- Trans-border banking crisis as reason for Europeanization of member states' problems
- Real-world capital stock crisis as crux of the banking crisis
 - Past investments enabled by financial claims whose yields cannot be earned in the real sector
 - Management of past losses (legacy problem) matters for future production possibilities
- Policy dilemma for monetary authorities
 - Monetary mandate vs. financial stability
 - Eurosystem left alone
 - In crisis-mode for more than 4 years
 - Massive national re-segmentation of banking markets
 - Symptom: Excessive BoP-financing (Target2 debate)
 - Monetary maneuvers are not the solution (on the contrary)

⇒ **Non-workable euro area policy framework**

Widening the angle

- Crisis as such is a symptom, not the problem
 - Reflects necessary correction of heavy distortions in the production sector/capital stock (part of the solution)
 - Searching the root of the problem at the beginning of the preceding upswing
 - ⇒ **Crisis: not a shock, but a response**
- Preventing bankruptcies per se can make the problem worse/prolong the crisis
 - Zombie-bank problem
 - Wrong incentives for future decisions
 - ⇒ **Short-term instruments must not contradict fundamentals of the policy framework**
- Multiplier-analysis assumes the capital stock deformation away (output-gap uncertainty)
- ⇒ **High risk of wrong short-termism**



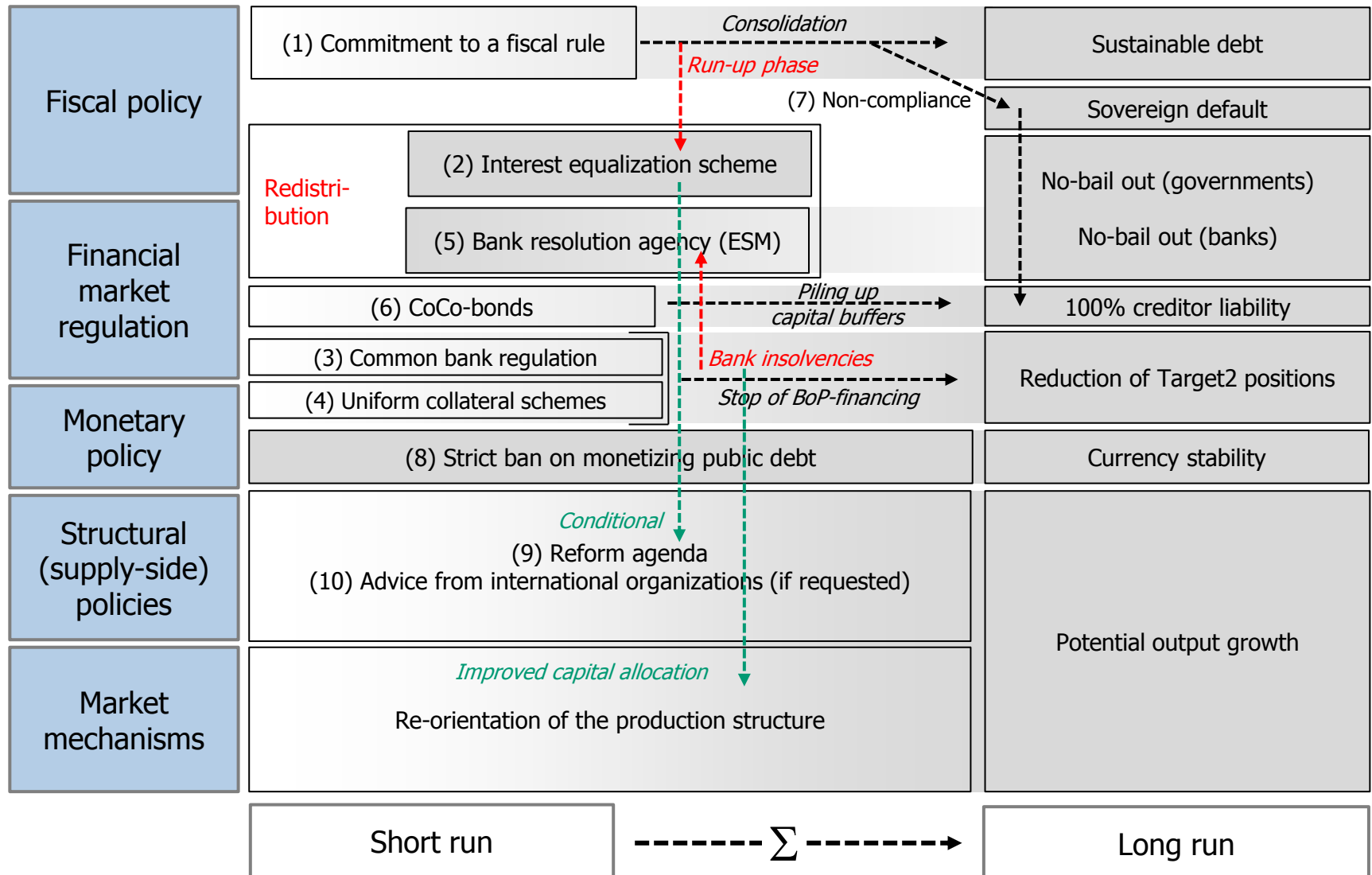
Key features of the Kiel proposal

- Package approach
 - Fiscal policy
 - Financial market regulation
 - Monetary policy
 - Structural (supply-side) policies
 - (Market mechanisms)

- Assignment of competencies and responsibilities
 - Policy fields
 - National vs. European level
 - Realistic solidarity and respect for fiscal sovereignty

- Time dimension
 - Path dependency (bridging long-run and short-run)
 - Starting from “now”
(accepting the situation as it is today incl. legacy problems)

The Kiel Policy Package



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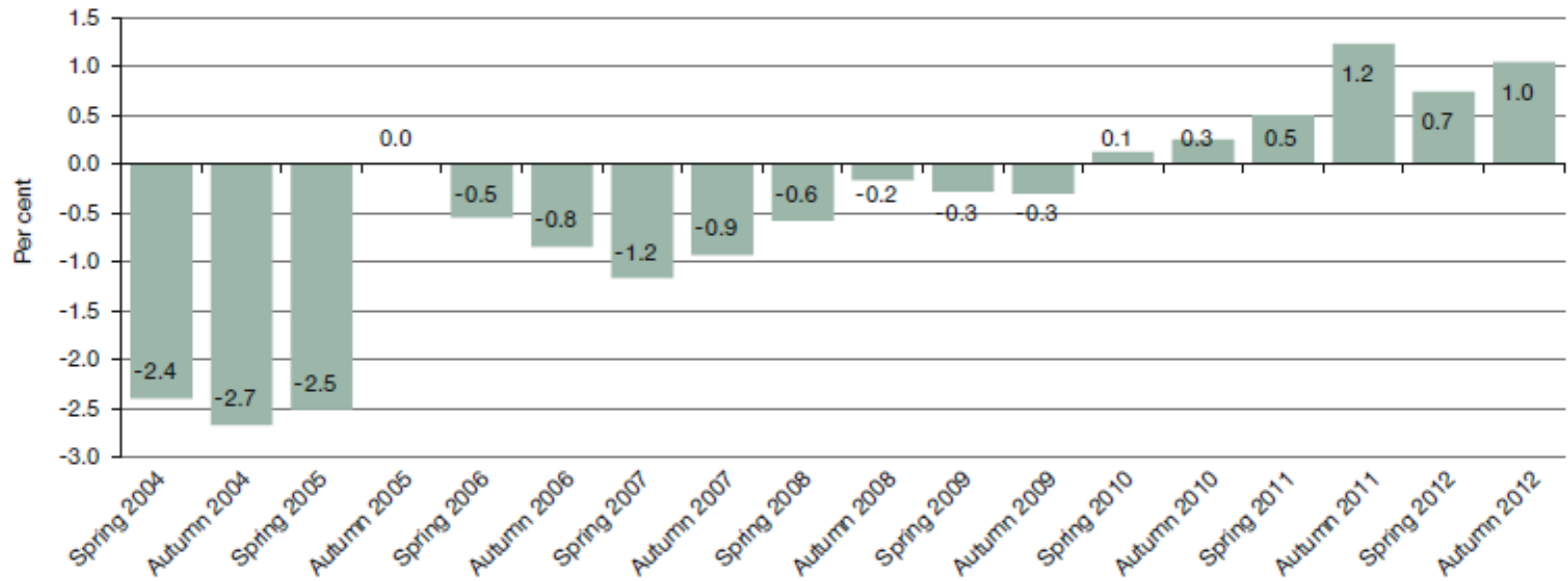


Appendix

- Output gap estimations
- Intra-EMU balance of payments financing

EC estimates of the 2005 output gap in Spain

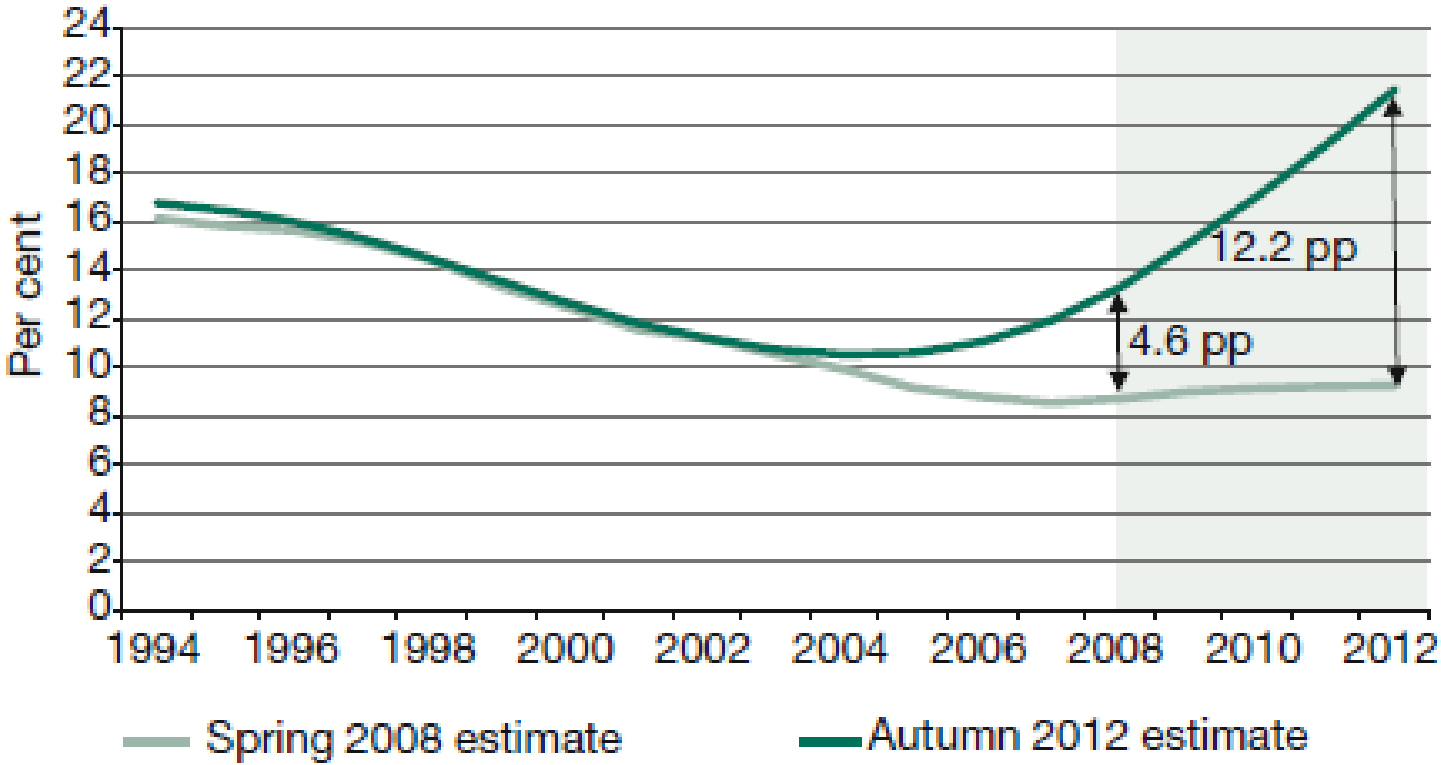
Source: E. Klär, Potential Economic Variables and Actual Economic Policies in Europe. Intereconomics, Vol. 48 (1), 2013



Source: European Commission.

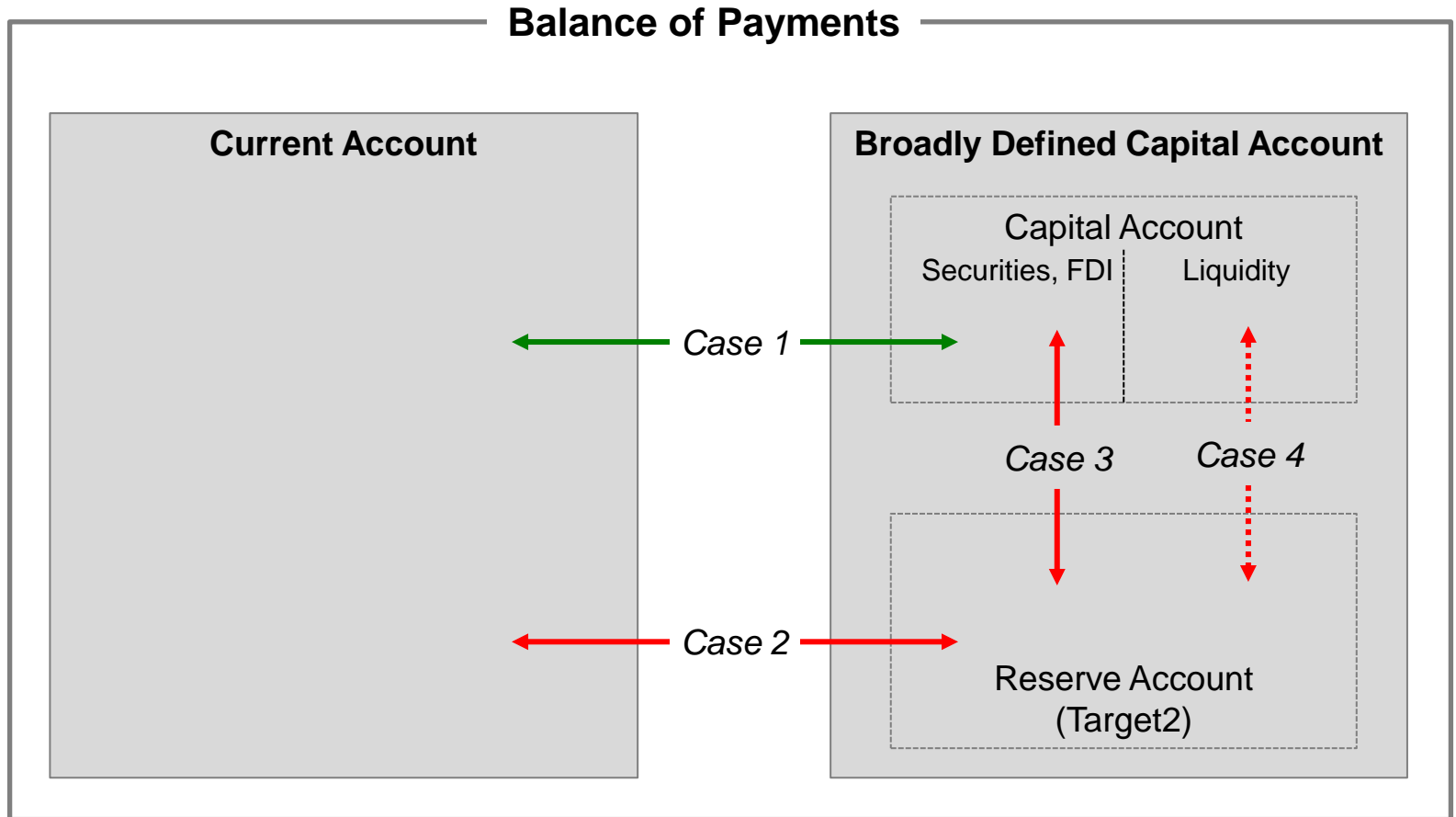
EC NAIRU estimates for Spain

Source: E. Klär, Potential Economic Variables and Actual Economic Policies in Europe. Intereconomics, Vol. 48 (1), 2013

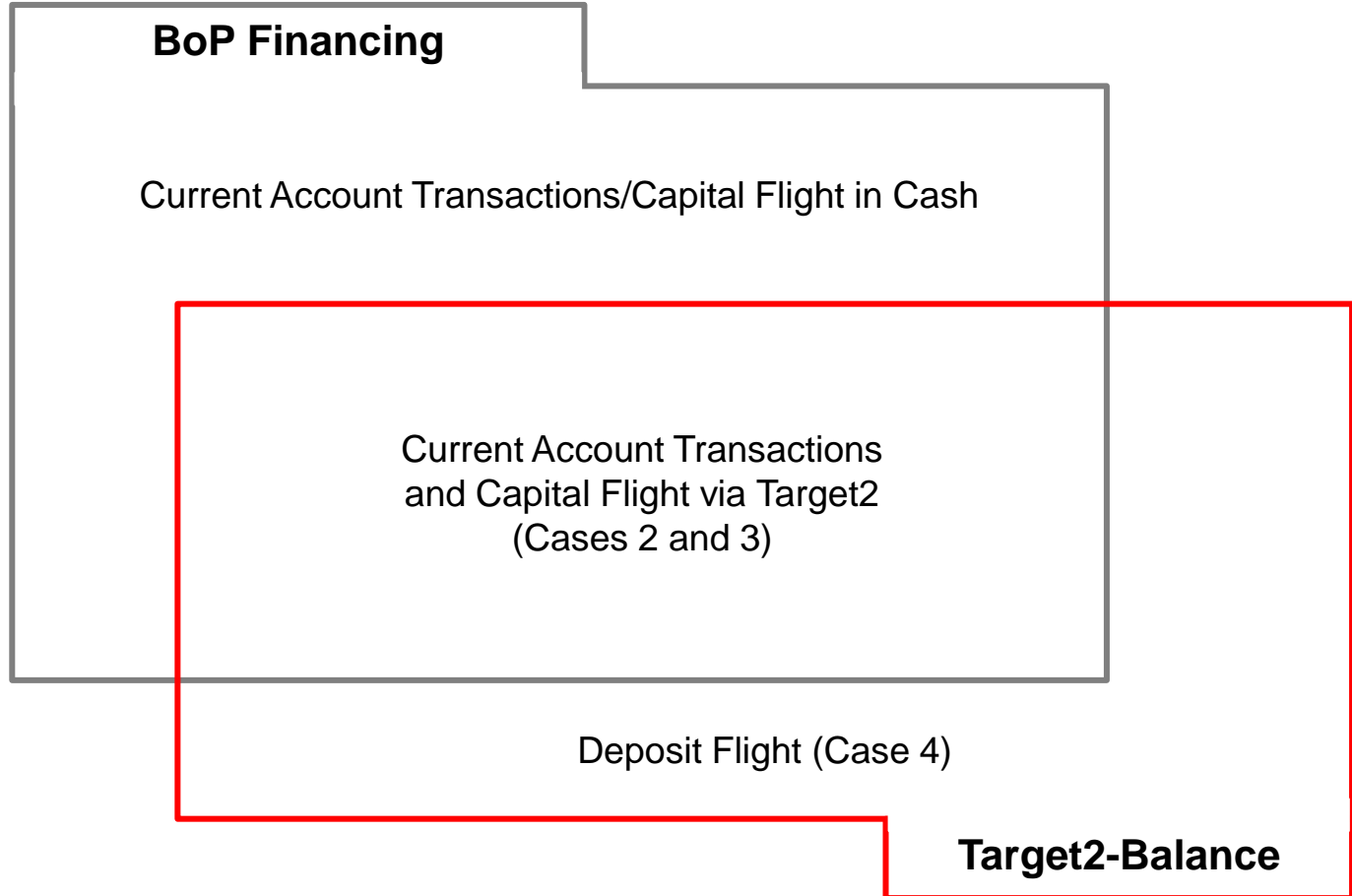


Source: European Commission.

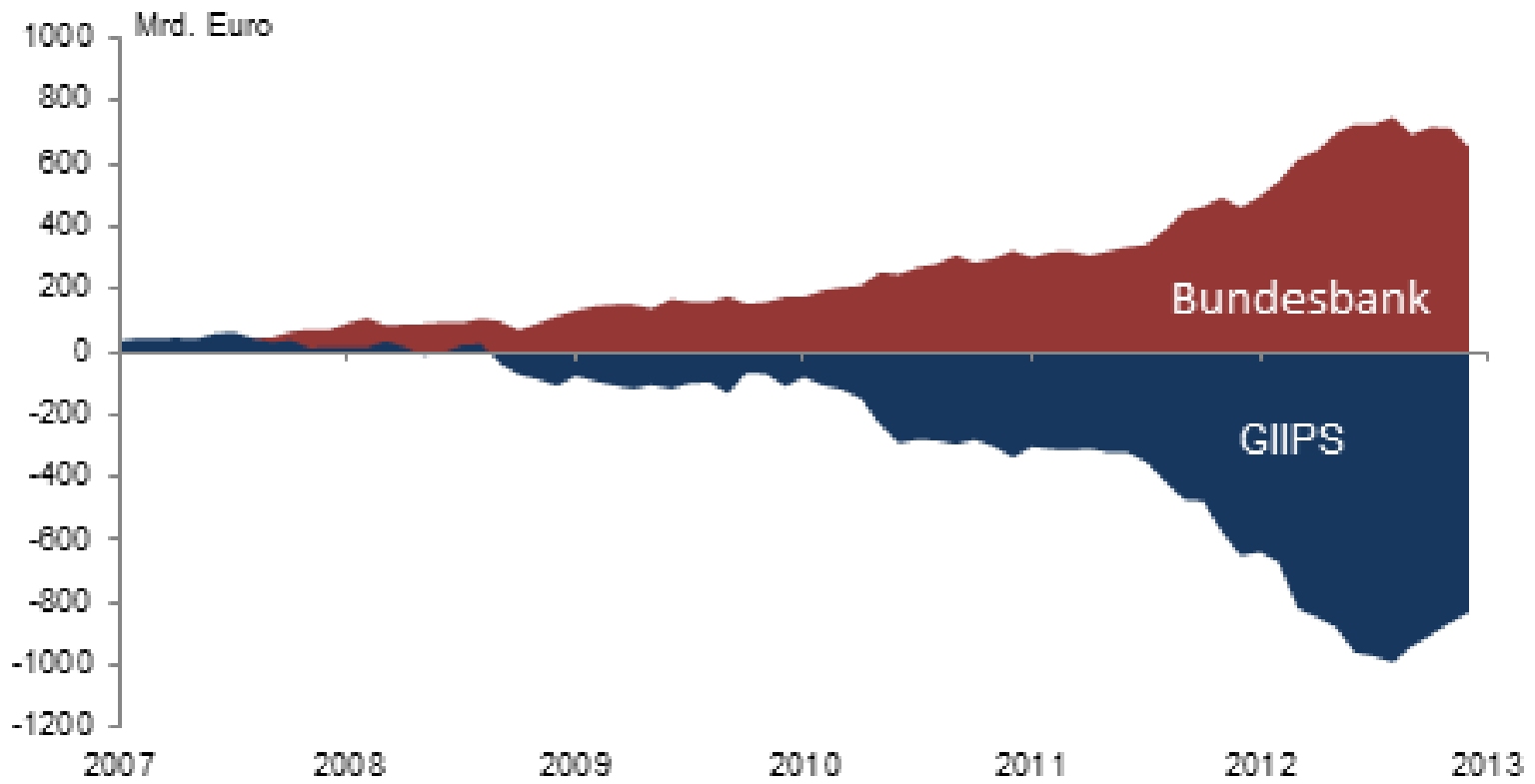
Balance-of-Payments-financing via the Eurosystem



BoP Financing and Target2-Balances



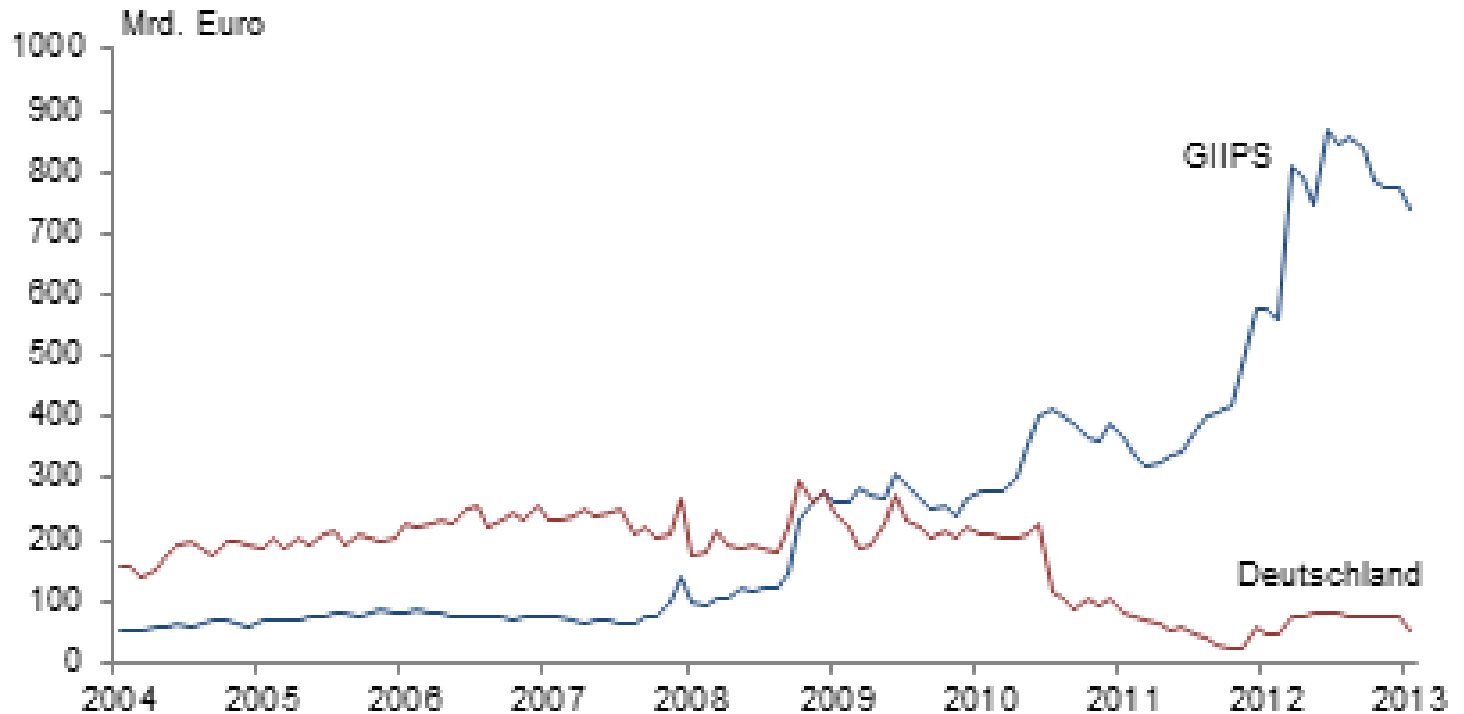
Target2 claims



Monatsdaten; GIIPS: Notenbanken von Griechenland, Irland, Italien, Portugal, Spanien.

Quelle: ifo Institut.

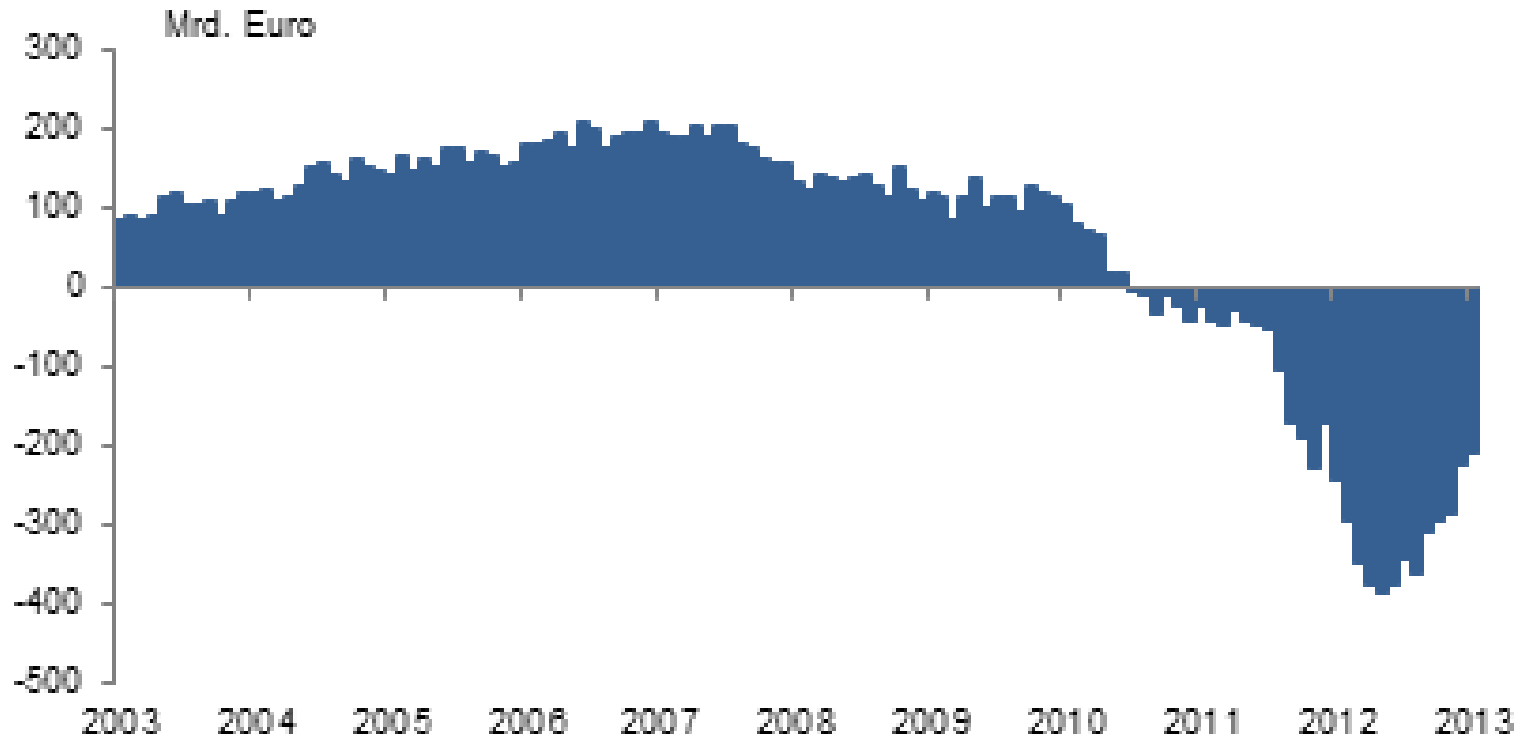
Refinancing operations of the Eurosystem



Monatsdaten, GIIPS: Griechenland, Irland, Italien, Spanien und Portugal.

Quelle: Nationale Zentralbanken; Deutsche Bundesbank, *Monatsbericht*.

Bundesbank's net claims against MFI



Monatsdaten, Differenz aus Forderungen und Verbindlichkeiten aus geldpolitischen Operationen.

Quelle: Deutsche Bundesbank, Monatsbericht.

Summary of the intra-EMU BoP-problem

- Target2 dynamics
 - Flip-side of excessive credit creation in crisis countries
 - Rules of the game (currency union) are suspended (circulation of fixed quantity of money)

- BoP-financing via the Eurosystem erodes the Euro Area
 - Centrifugal forces become stronger from month to month (asymmetric impact on exit costs)
 - Ongoing deterioration of money quality

⇒ *If something cannot go on forever, it will stop.*

Herbert Stein