



Kiel Institute

for the World Economy

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Working Group on Longer-Term Prospects and Structural Change

The monetary side of the Euro area crisis: Single currency, national money creation

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Situation

- Trans-border banking crisis is 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
 - Accepting losses of the past, but handling legacy-problems „with care“ (not neutral for future production)
- Policy dilemma for monetary authorities
 - Monetary mandate vs. financial stability
 - Eurosystem in crisis-mode for more than 4 years

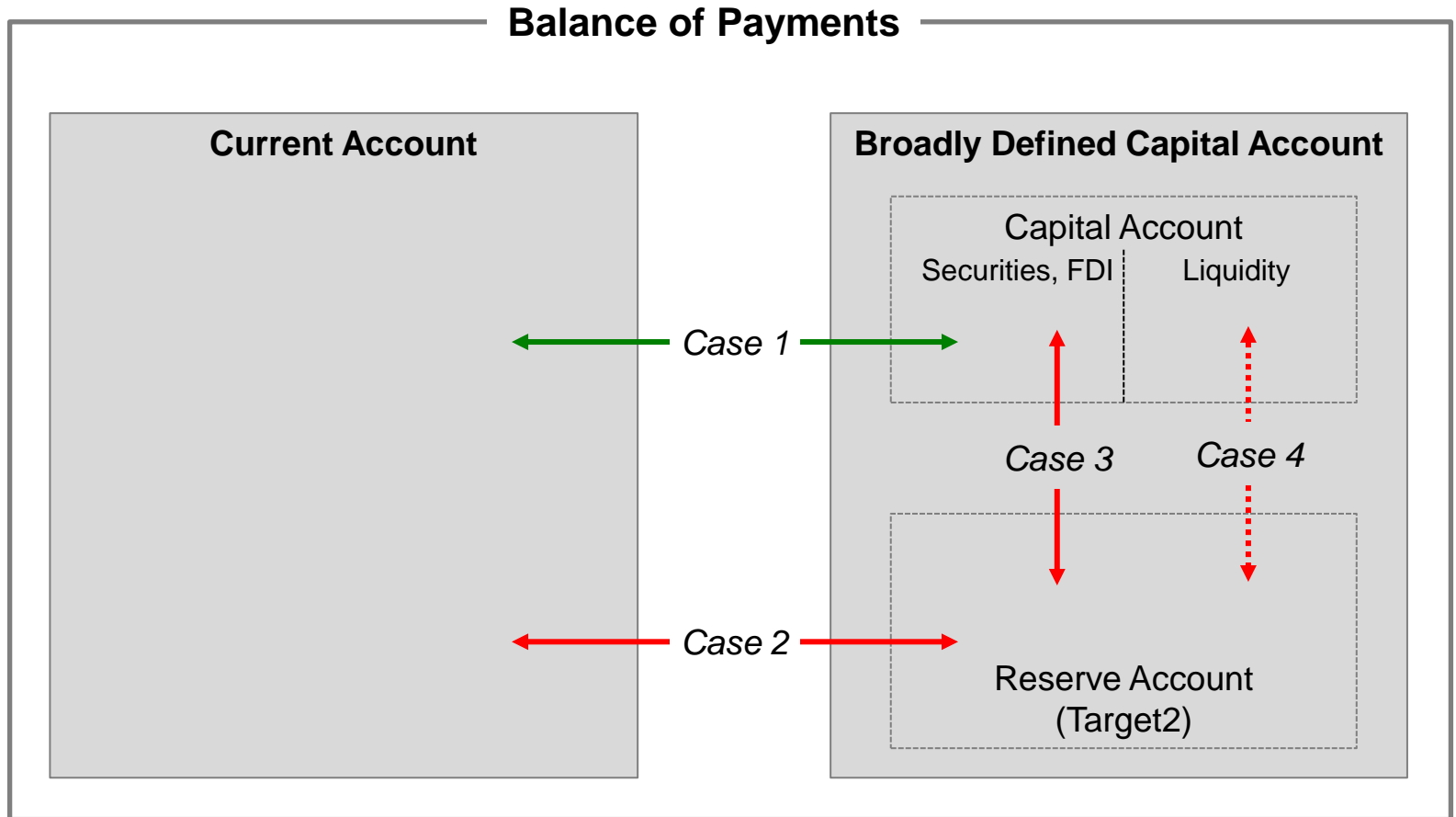


Widening the angle

- Crisis as such is not the problem (but part of the solution)
 - Necessary to correct heavy distortions in the production sector/capital stock
 - Searching the root of the problem at the beginning of the preceding upswing

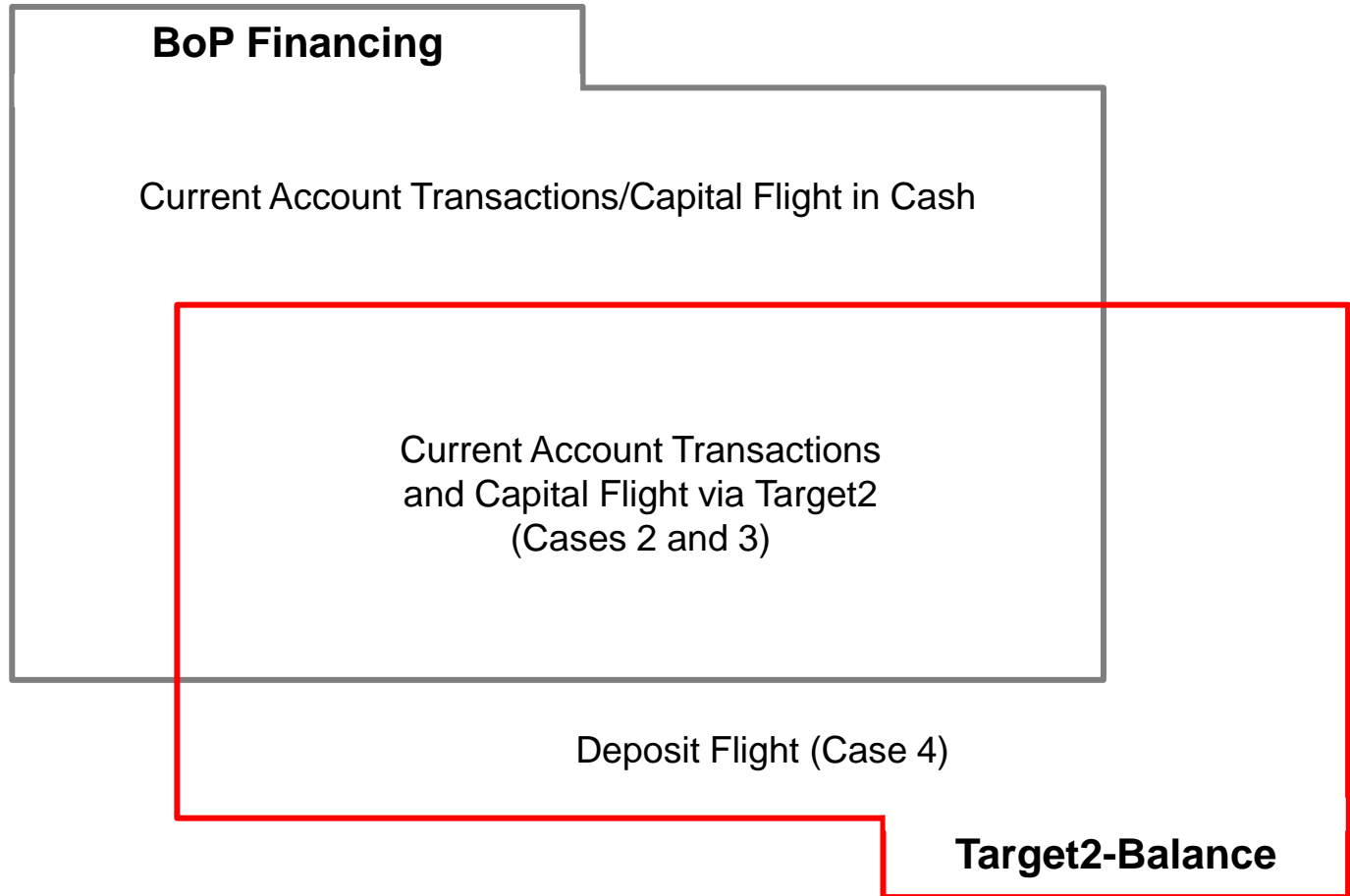
⇒ **Crisis is not a shock, but a response**
 - Preventing bankruptcies per se can make the problem worse/prolong the crisis (Zombie-bank problem)
 - Multiplier-analysis assumes the capital stock deformation away (output-gap uncertainty)
- ⇒ **High risk of wrong short-terminism**

Balance-of-Payments-financing via the Eurosystem



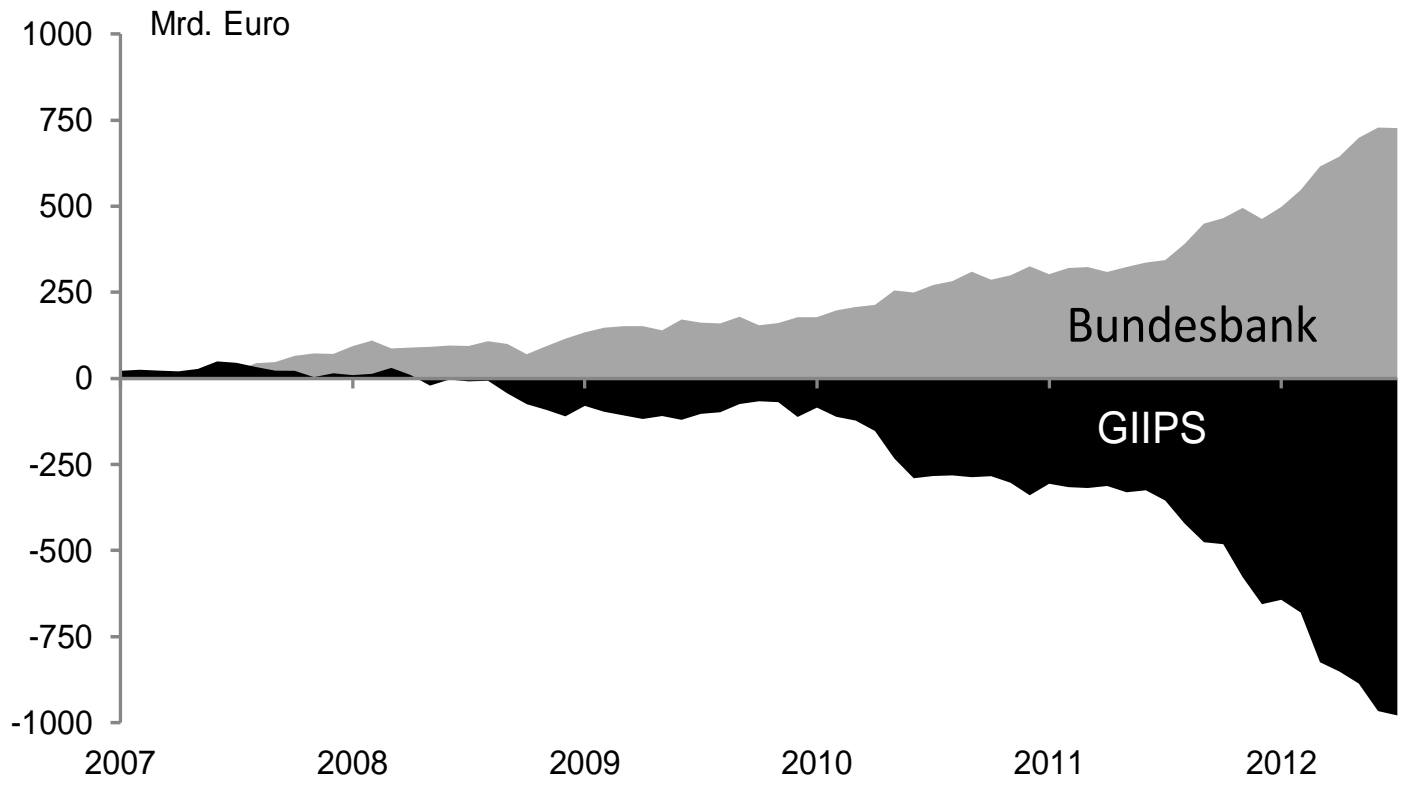


BoP Financing and Target2-Balances





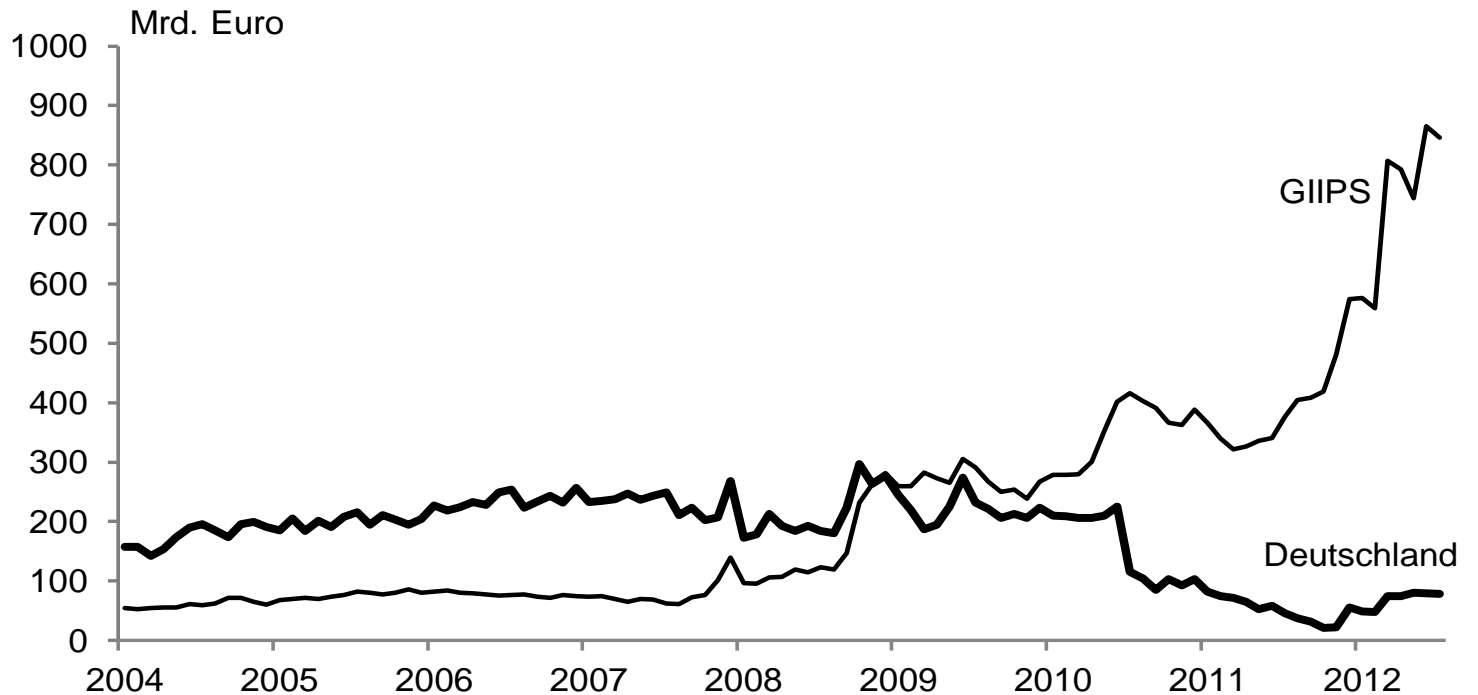
Target2 claims



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

Quelle: Universität Osnabrück, *Euro Crisis Monitor*.

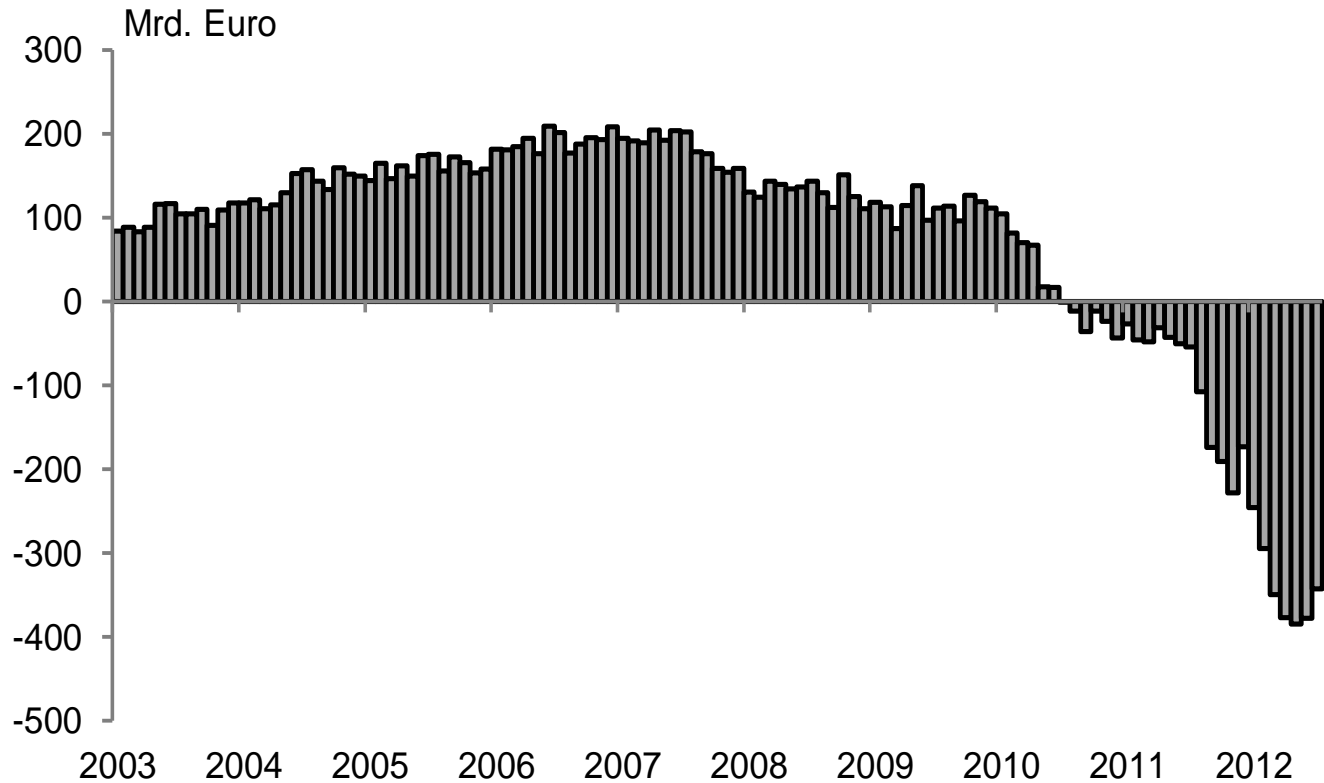
Refinancing operations of the Eurosystem



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

- 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

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



Therapy

- Insolvency/capital stock problems must not be addressed by monetary interventions
 - Fiscal policies: addressing legacy problems (bank recapitalization, sovereign debt)
 - Regulatory framework: overcoming national segmentation of banking markets, enforcing liability principle ("too-big-to-fail" problem) via CoCo-Bonds
 - Structural policies (easing structural change)

- Uniformly restrictive collateral eligibility criteria in all member states may stop the BoP-financing process and gradually resolve the Target2 stock problem

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