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“Can the euro still be saved?”

Threats to monetary robustness of the euro area

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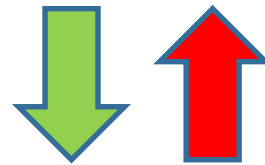
Monetary policy: Overloaded



Quelle: FAZ, 26th October 2011, p. 11

The core problem: Lack of monetary consensus

Consensus



Institutions

Stuck in the middle: The worst place to be

- Maastricht 2.0
 - » Rules
 - » No bail-out
 - » Fiscal discipline via capital markets
 - » Decentral macro stabilization by solvent member states
 - » No monetary government financing, hard currency
 - ⇒ **Diversity, competition**
- Fiscal union
 - » Discretion
 - » Mutualized debt
 - » Conditionality of fiscal support
 - » Macro stabilization on EMU level
 - » Monetary government financing, soft currency
 - ⇒ **Harmonization, deepening**

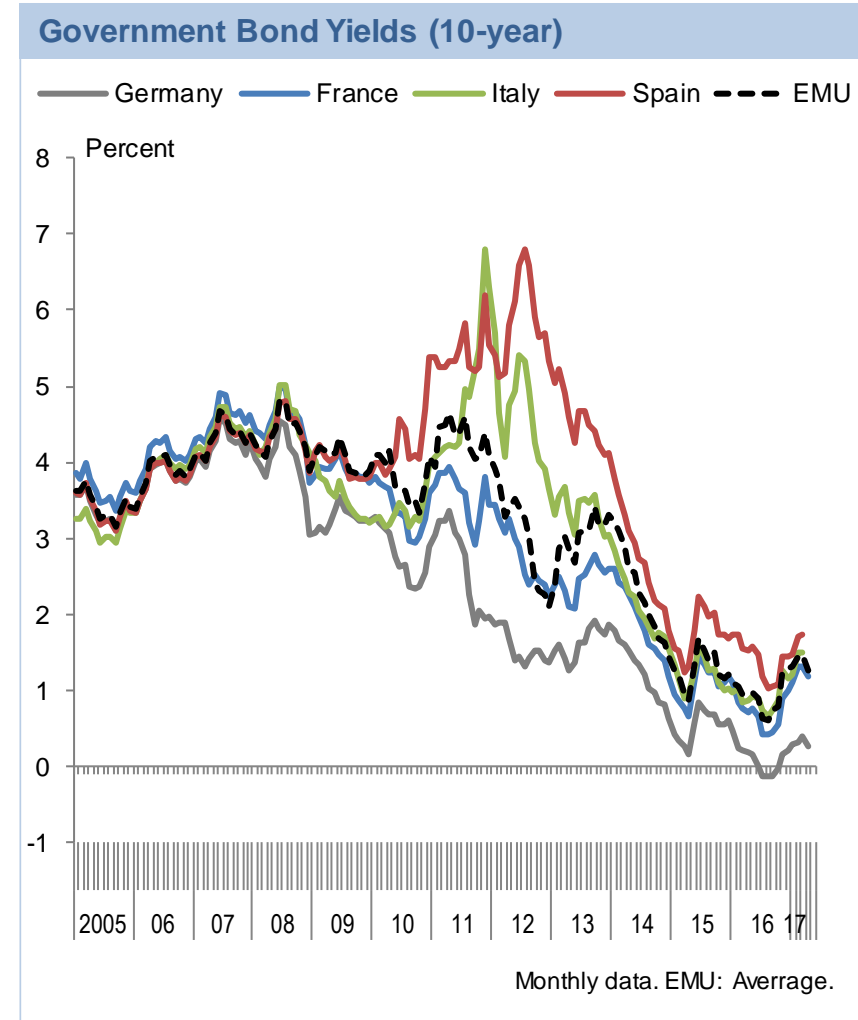
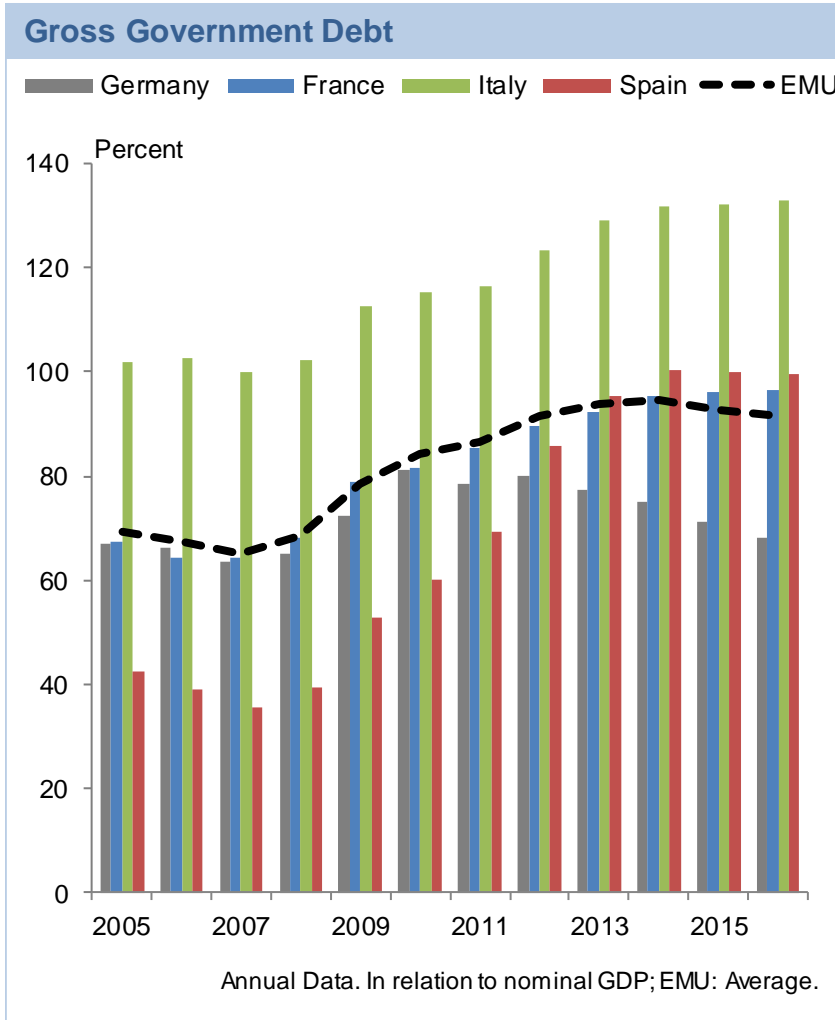
*Critical
rationalism*

*Rationalistic
constructivism*

The myth of conditionality (bail-out vs. structural reforms)

Key insight for successful reform processes:
Ownership matters.

Historically high public debt levels, historically low government financing cost



Data source: Eurostat, European Commission.

Buying time did not work

Low refinancing cost:
Consolidation and reform efforts wane.

Diagnostic failure: Predominance of macro-management thinking

- Shock absorption
- Risk sharing
- Mobilizing fiscal space
- ...

⇒ EMU-budget

- » Expenditure-side (EMU-specific collective goods)?
- » Cyclical vs. structural problems?

Interest rates ...

- ... just another instrument for macro-management?
 - ... or the key price relation within the market system?
 - » Time preference
 - » Coordinating savings and investment
 - » Component of all prices for goods and services (relative prices)
 - » Impact on capital/production structure
- ⇒ **„Capital gives money time to cause trouble.“ (Garrison)**

- **Idiosyncratic: Entrepreneurial ventures**
 - » Wrong expectations of one market participant
 - » Happens every day, no systemic risk
 - » Liquidation, reallocation of resources

- **Pervasive: Expansionary monetary policy**
 - » Systematically wrong expectations of all market participants
 - » Financial crisis (debt crisis = flip-side of heavy capital stock distortion)
 - Fragile financial system
 - Excess debt positions destabilize monetary system

Three options of coping with debt-crises

■ Public bail-outs

- » Shifts private debt to public sector
- » Private debt crisis \Rightarrow sovereign debt crisis
- » No solution for fiscally distressed countries

■ Inflating the debt away

- » Takes a long time, promotes zombification
- » Puts the currency at risk
- » Not targeted towards non-performing loans

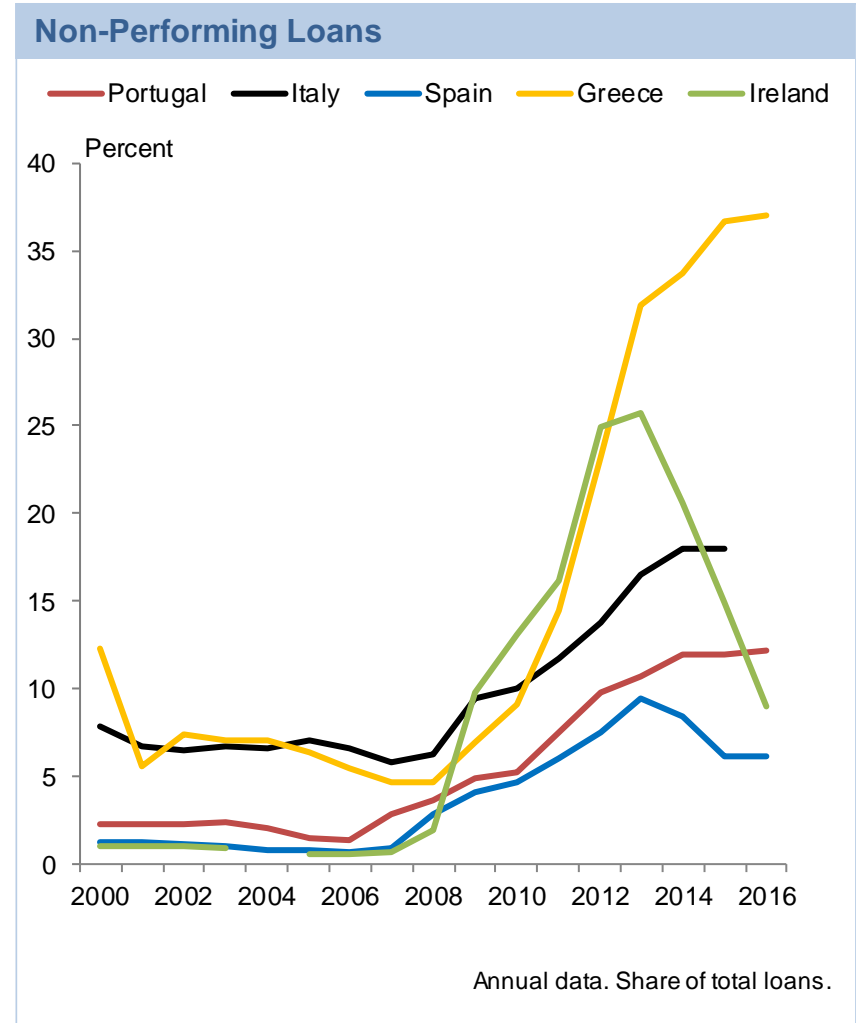
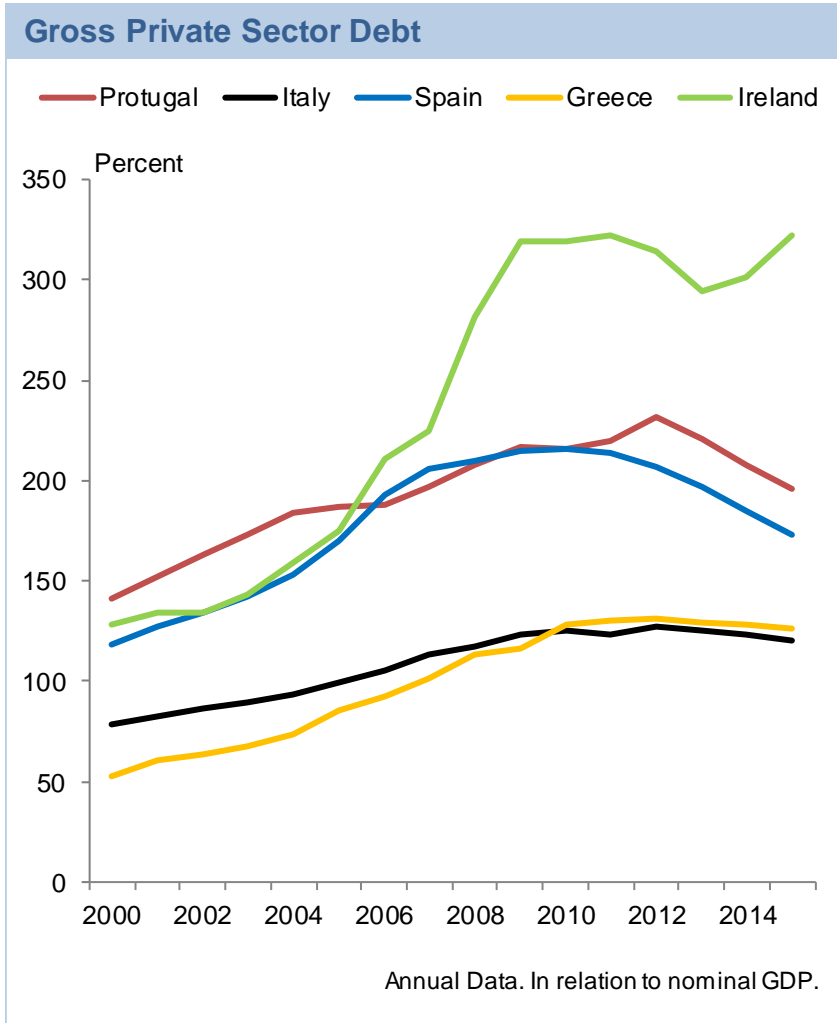
■ Liquidation

- » Tough (cold turkey) in the short-run ...
- » ... but targeted (and root cause oriented)
- » Puts capital at second (now first) best use

**Anti-capitalist
approach**
(harms principle of
accountability,
creates moral
hazard risks)

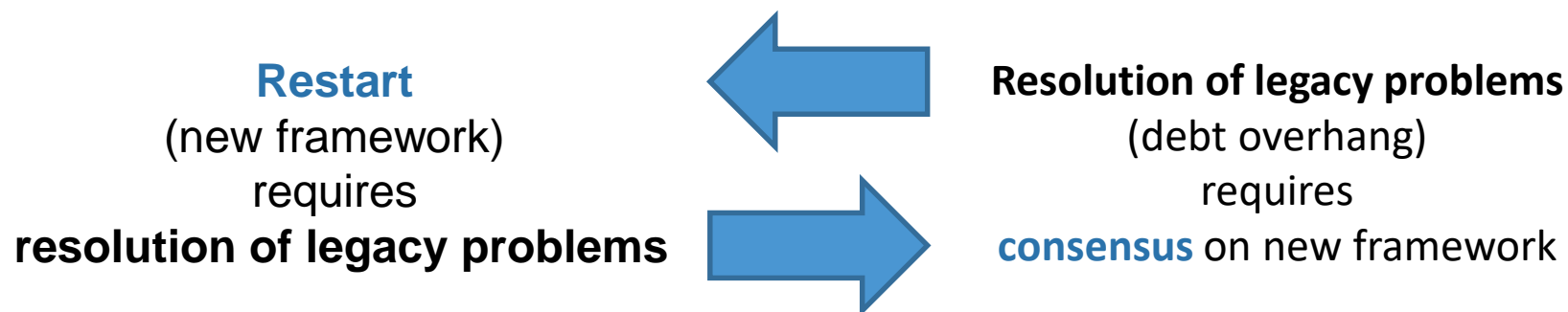
**Capitalist
approach**
(in line with free
market principles)

Flip-side of not liquidating (= “buying time”): High debt positions hamper credit channel



Data source: Bank for International Settlements, World Bank.

Hard to solve: The Legacy-restart-nexus



Radical monetary strategy: Regime change instead of policy renormalization

- Buying risks upfront instead of lowering risk free yields
 - » More private sector securities
 - » Distortion of risk premia and related cost of capital
 - Targeting non-performing assets
 - » Monetary bail-out
 - » Turning the Eurosystem into a bad bank
 - Helicopter money
 - » Bypassing the credit channel to inflate the debt-overhang away
 - » Transforms the Eurosystem into a pure fiat money system
- ⇒ **Hardly in line with ECB's mandate, radical consequences**
- ⇒ **Chicago plan 2.0 requires credible post-resolution design**

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