Kiel Policy Brief

The Kiel Policy Package to Address the Crisis in the Euro Area

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The European Union at the crossroads

Thirteen years after its foundation, the European Monetary Union (EMU) is facing the greatest challenge of its history thus far. High unemployment in a number of member countries, the need for substantial consolidation of the budgets of numerous governments, and distressed banks are symptoms of economic misalignments and economic policy failure that threaten not only economic prosperity in Europe, but the European project as a whole. A series of interrelated fiscal and financial crises in the euro area have provoked a series of extraordinary policy measures. Some of these measures have undermined the fiscal sovereignty of affected countries, and they have circumvented market mechanisms. As social cohesion is called into question in various debtor countries, there is a danger that policy makers cannot or will not solve the existing problems in a way consistent with both monetary stability and the current political integration.

In the absence of a comprehensive European financial policy regime, the Eurosystem's ability to maintain both price stability and financial stability is threatening to become undermined (see Box 1). Possible outcomes include the chaotic dissolution of the EMU, with unpredictable economic and social consequences. The purpose of this Policy Brief is to outline a set of mechanisms to ensure economic, financial, social and political stability.

Economic policy to bridge short- and long-term considerations

It is important to both set the stage for an economic order that will ensure long-run economic sustainability together with short run support for countries in crisis. Only when both are achieved simultaneously is there a chance to create a win-win situation for both creditor and debtor countries and thereby achieve broad-based agreement on how to overcome the crisis and establish a stable institutional framework for long-term prosperity. This Policy Brief articulates the principles of such a program, encompassing the required combination of short-and long-term measures. These principles may be summarized as follows:

- Responsibility for mistakes that have led to the current crisis lies with all EMU member countries, just as all member countries stand to benefit from swiftly overcoming the crisis. A certain degree of temporary redistribution among countries is in the interests of all parties involved, provided that policymakers are able to build an institutional framework ensuring sustainable policies in the future.

- Sustainable government finances and a stable currency are necessary conditions for economic prosperity and social peace. Therefore we aim for an economic system that becomes more resistant to crises by establishing credible rules, designed primarily to achieve financial market stability and fiscal responsibility.

The integration of temporary and permanent measures is a distinctive feature of our policy package. In particular, our design reflects the fact that the effects of some instruments need time to unfold and that some temporary measures would not be appropriate for the long term. In specifying our short-term policy proposals, we require policymakers always to keep their long-term objectives in mind. Stopgap measures to contain the crisis can therefore only be taken if they are consistent with the aspired long-term solution.

Integrated solutions and a clear delegation of authority

The root causes of the European crisis can only be tackled by instruments of fiscal policy, financial market regulation policy and structural policies, since these are the areas where the crisis originated. Monetary policy should not be left with the challenge to tackle problems that are fundamentally non-monetary in nature. When appropriate measures in the other policy fields are taken, monetary policy can refocus on its original target, namely, to ensure price stability.

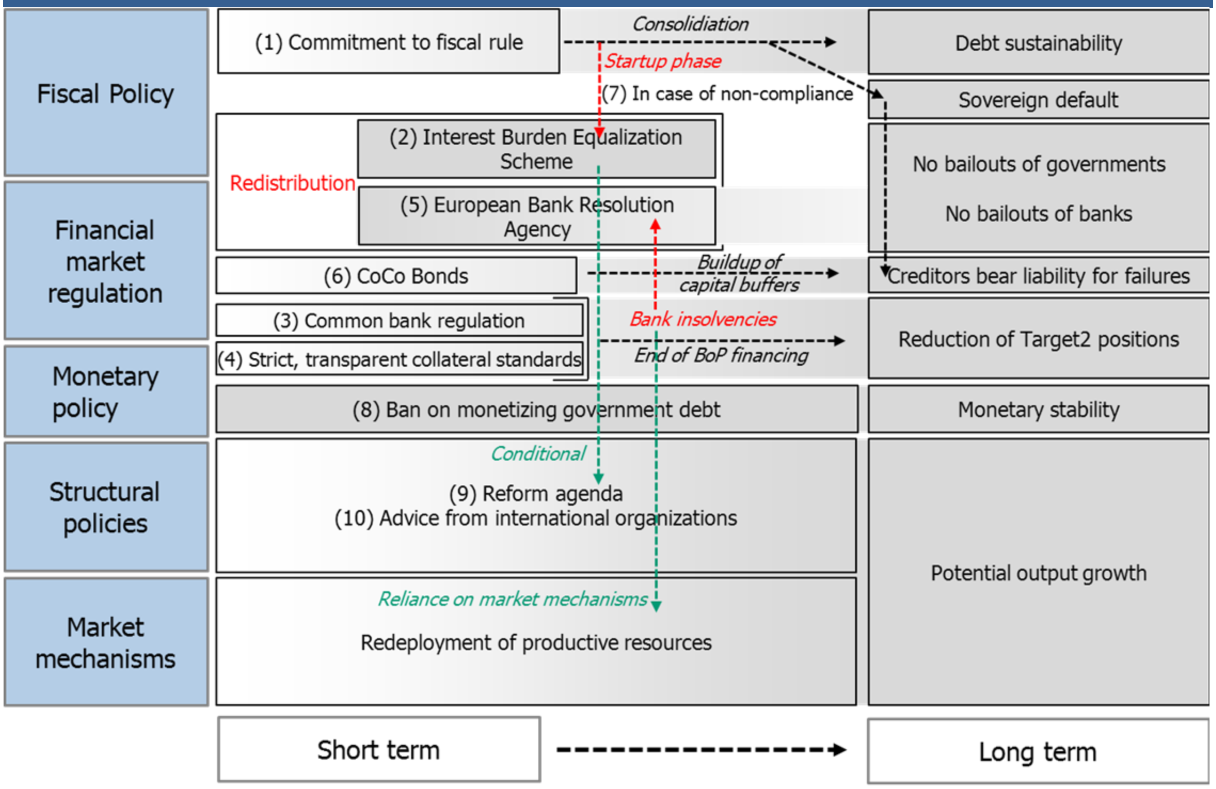
The relevant policy areas, underlying problems, and corresponding solution proposals are summarized in the following table:

Table 1:
Policy areas, problems, and solution proposals

Policy Area	Problem	Solution proposal
National Fiscal Policies	Lack of credibility of the fiscal criteria specified in the Maastricht Treaty and of the no-bailout clause. For several countries public debt is at a level where debt sustainability is called into question.	Preserve fiscal sovereignty; regain scope for countercyclical fiscal policy; keep debt at the national level (no mutualization of debt); assist solvent countries in achieving fiscal consolidation, by: • (1) Implementing national fiscal rules. • (2) Setting up a European fund for interest rate equalization available for solvent countries. • (7) Allowing for sovereign default as the ultimate consequence if national fiscal rule is chronically violated.
European Financial Market Order	European commercial banking markets are becoming increasingly segmented along national lines, and financial market stability is threatened by the “too big to fail” problem.	Deepen monetary integration and enforce the principle of liability, through: • (3) A common European system of bank regulation. • (5) A European Bank Resolution Agency which resolves failing banks without endangering the stability of the financial system. ESM funds will be focused exclusively on this purpose. • (6) Contingent Convertible Bonds for commercial banks´ future non-deposit financing operations.
European Monetary Policy	The European Central Bank's potential conflict of objectives concerning monetary stability and financial market stability, along with massive balance of payments financing through the Eurosystem.	Restoring monetary stability without distorting capital markets, through: • (4) Strict, uniform and transparent provisions regarding collateral used in refinancing operations. • (8) No monetization of public debt.
National Structural Policies	Unsustainable capital accumu-lation in particular sectors (distorted production structure). Supply side rigidities impeding necessary structural adjustment. Chronically high unemployment rates, especially among younger workers.	Facilitate redeployment of inputs toward new uses by: • (9a) Increasing labor market flexibility. • (9b) Increasing competition in goods markets. • (9c) Dismantling red tape for businesses. • (9d) Privatizing noncore state assets. • (10) Encouraging assistance from international organizations.

In what follows, we present the individual components of the Kiel Policy Package, relate them to the problems underlying the current crisis, and discuss the expected effect of implementing the entire package (see Exhibit 1). We advise policymakers to consider links among different components, since the success of one component affects the chance of success for the other components.

Exhibit 1:
Policy measures and effects over time



Shading indicates increasing or decreasing effect/importance over time, respectively.

Regaining sound public finances through national fiscal rules—Overcoming the confidence crisis in sovereign debt markets

The objective of a rule-based fiscal policy, which was introduced in the Stability and Growth Pact and has recently been reinforced through the European Fiscal Pact, is fundamentally appropriate. Restrictions on the government deficit are necessary in order to counteract the well-documented "deficit bias" of governments—borrowing in a downturn without achieving a corresponding surplus in the following boom, leading to excessive borrowing on average over the cycle. Reducing the large stock of existing debt requires a binding path for debt over the longer term. A rule imposed from outside, however, would not be accepted by voters in individual euro zone countries. Thus it is politically expedient that each government decides on its own national fiscal rule, reflecting its own preferences. Fiscal rules must be designed nationally, since long-term fiscal transfers that substantially exceed current flows are not politically acceptable, in reflection of the currently limited European solidarity and under-developed European identity. This implies that serious infringement of a member state's national fiscal sovereignty (fiscal sanctions) and substantial international transfers (fiscal union) will be difficult to achieve over the short to medium term.

A credible policy of fiscal consolidation is also important for the stability of the banking sector, as government bonds represent a substantial part of the assets of that sector. The sovereign debt crises in a number of euro area countries reflect concerns of investors that governments may ultimately not be able to service the debt as scheduled. The economic value of government securities falls with a rising probability of debt restructuring. To the extent that these securities are held by banks, their balance sheets are directly affected. Solving the sovereign debt crises is therefore at the heart of any solution to the crisis in the euro area. As there is no way to seize the assets of a sovereign state, as in the case of private debtors, it is imperative to restore confidence in the ability and willingness of debtor countries to service their debt. Importing confidence from abroad (for example through the mutualization of national debt) would not only be problematic for economic reasons (moral hazard), but is politically infeasible because of resistance in creditor countries. The debtor countries therefore need to re-establish confidence on their own through appropriate adjustments to their policies.

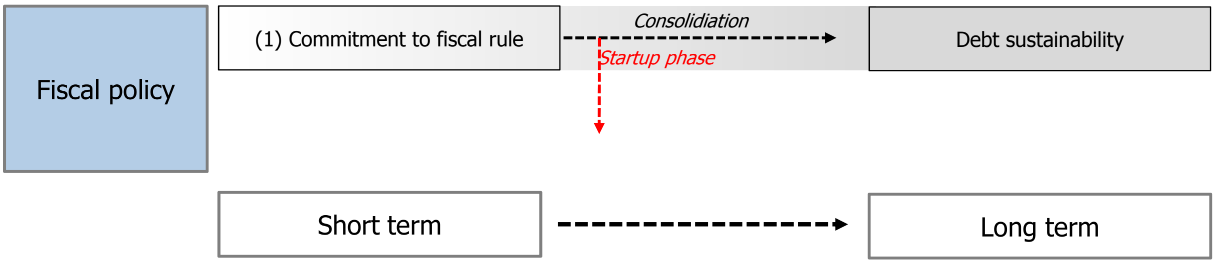
In order to ensure adequate fiscal consolidation while retaining national fiscal sovereignty, we propose that:

(1) Each country shall individually implement a binding national fiscal rule that guarantees the long-term sustainability of government debt, while leaving room for countercyclical fiscal policy.

This fiscal rule should adhere to the following principles:

a) *Design*: The rule must specify a target for the long-term maximum level of debt relative to GDP. This target is constrained by the Stability and Growth Pact, which stipulates that national debt must not exceed 60 percent of GDP. In addition, the rule has to define the speed at which the long-term level of debt is to be reached and to what extent fiscal policy is allowed to engage in countercyclical policies. With these three elements - *the long-term debt ratio, the convergence rate, and the degree of fiscal counter-cyclicality* - the rule defines a target for the government budget deficit or surplus, depending on the phase of the business cycle that the economy is in.

b) *Implementation*: The rule should be subject to a strict enforcement mechanism, enshrined in the country's constitution. Compliance with the rule has to be reviewed at the European level (i.e. external auditing). This requires a rigorous European auditing process, the data for which is to be made available by the national governments. The extent of countercyclical fiscal policies consistent with the specific rule should be determined by an independent expert council. The council would gauge the cyclical position (measured by the output gap or the deviation of output growth from potential, depending on the precise formulation of the rule) and derive the acceptable budget deficit or surplus, according to the three parameters specified by the fiscal rule. In order to ensure enforcement of the rule, automatic corrective fiscal policy measures (e.g. changes in VAT tax rates) should be legislated to be enacted by default, in case other measures to correct the fiscal stance are politically undertaken.



The fiscal rule would ensure that the public debt ratio reached its long-term target in a specified time frame, which would support confidence in bond markets. At the same time, national fiscal sovereignty remains intact, as the countries formulate their own rules and implement these rules through mechanisms embedded in their national legal systems. This allows countries to design their rules according to their national preferences. In particular, a well-designed rule allows for countercyclical fiscal policies and does not force highly indebted governments to engage in rapid fiscal retrenchments.

European Interest Burden Equalization Scheme in the transition to national consolidation programs

Government bond premiums in the crisis countries have risen over the course of the sovereign debt crisis, while refinancing costs for governments of countries perceived as safe havens have declined to historically low levels. The significantly higher cost of refinancing in the crisis countries weighs as an additional burden on government finances precisely at a time when government finances are already strained. Confidence of investors in an improvement of debt sustainability can however be expected to be weakest in the beginning of the consolidation process. Confidence is unlikely to improve sharply even if a fiscal rule were to be implemented, as it remains uncertain how tightly the rule will be enforced. Therefore, crisis countries, in spite of a commitment to fiscal consolidation, will presumably be confronted with substantially elevated risk premiums in the markets for their government bonds. In order to facilitate swift progress in fiscal adjustment we propose:

(2) The establishment of a European Interest Burden Equalization Scheme for a period of five years.

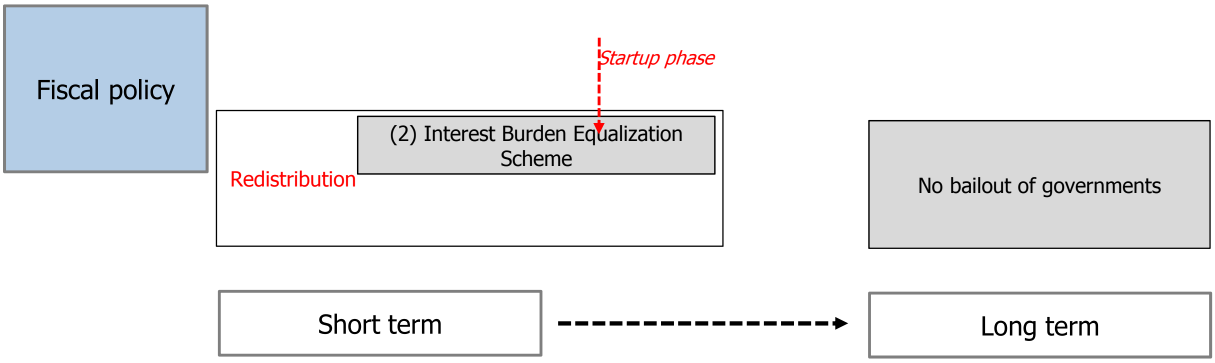
The average yield on government bonds for all euro area countries is the reference for the interest burden equalization scheme.[1] Countries that can finance themselves in the capital markets at better-than-average conditions relinquish part of their interest rate advantages to the benefit of the countries which have to pay higher interest rates. In order to qualify for payments from the interest burden equalization scheme, three conditions have to be fulfilled:

a) Countries must undergo a solvency test. Insolvent countries will not qualify for interest subsidies as a debt restructuring will sooner or later be inevitable.

b) A fiscal rule satisfying the conditions given by (1) must be implemented.

c) Countries applying for subsidies have to implement sufficient structural reforms for the purpose of raising potential output and debt sustainability.

The EU commission will evaluate whether a country fulfills these conditions.



With the interest burden equalization scheme, the Kiel Policy Package contains a temporary element of international redistribution which helps to smooth adjustment in the early phase of consolidation without mutualizing the underlying national government debts.

[1] Heinemann, F. (2012). FIRE for the Euro – A Strategy for Stabilizing Government Bond Markets. ZEW Policy Brief No. 1. July 2012.

Overcoming the national segmentation of banking—Preventing the Eurosystem from balance-of-payments financing

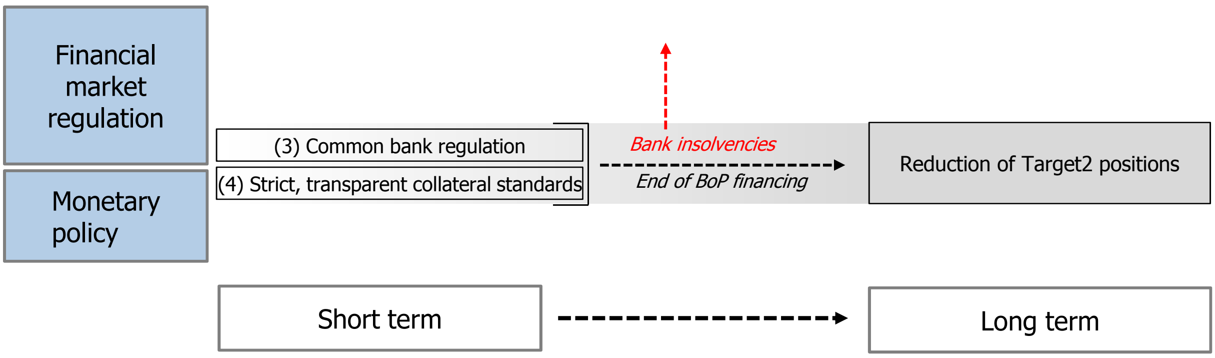
In order to contain the massive balance-of-payments financing through the Eurosystem, we propose the following two measures:

(3) Bank regulation and supervision must follow a unified set of standards in the whole currency area.

The setting and monitoring of banking standards will be assigned to a European body independent from the central bank, in order to avoid a conflict of objectives for the ECB. Banking supervision operations should remain with the established national authorities as they command the necessary country-specific knowledge. The work of the national authorities is, however, subject to oversight by the European body.

(4) The Eurosystem applies strict, uniform, and transparent standards to the collateral used in refinancing operations with commercial banks.

The risk management teams of each central bank of the Eurosystem shall keep the risk of non-payment at minimal levels. Uniform risk criteria guarantee that access to central bank money is governed by economic criteria and not by other considerations. Credibility and monitoring of the central banks is strengthened by comprehensive transparency regulations.



With the combination of measures (3) and (4) in place, all commercial banks have access to central bank money at the same conditions irrespective of the country involved. These measures would overcome the national segmentation of bank markets with respect to monetary policy and regulation policy. This is the precondition for ending the financing of balance of payments balances through the Eurosystem and thus the further accumulation of Target2 positions. The stock of low-quality securities acquired by the Eurosystem in recent years will successively be exchanged with securities of superior quality, and the problem of quality of the monetary base will diminish over time.[2]

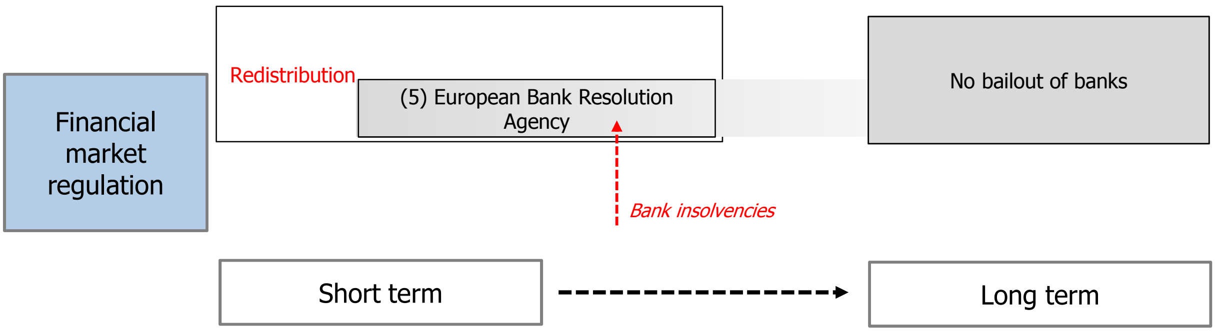
Allowing bank failures through an orderly resolution scheme

It is likely that some commercial banks may find it difficult to refinance their debts, due to the more restrictive access to central bank credit, and some of them may become insolvent. In a market economy, insolvencies eliminate businesses that do not create net value. This corrective mechanism is especially important in the case of banks, due to their crucial role in the allocation of capital throughout the rest of the economy. Bank insolvencies may in fact reduce the misallocation of capital in the longer run, but under the current policy regime, they can be highly disruptive in the short run if they occur at a system-wide level.

Bank insolvencies can be destabilizing if the failure (or the expectation of the failure) of one bank leads to runs on other banks, triggering a liquidity crisis. This can be addressed by the following measure:

(5) A European Bank Resolution Agency (EBRA) is established at the European level.

The EBRA resolves distressed banks and recapitalizes them if appropriate. Remaining ESM funds should be exclusively used for this purpose, and lenders would participate in the losses incurred by failing banks.



Commercial banks that failed in the market thus will not be rescued, but will be shrunk or closed down in a way which protects the financial system. The operations of the EBRA would typically involve international redistribution. Specifically, it is to be expected that funds needed for recapitalization of banks would be relatively higher in the crisis countries than in

[2] Kooths, S., und B. van Roye (2012). Euro Area: Single Currency – National Money Creation in the Euro Area. Kiel Working Paper 1787. Kiel Institute for the World Economy,Kiel.

the remainder of the euro area. Risks incurred by EBRA may lead to fiscal costs which have to be borne by taxpayers.

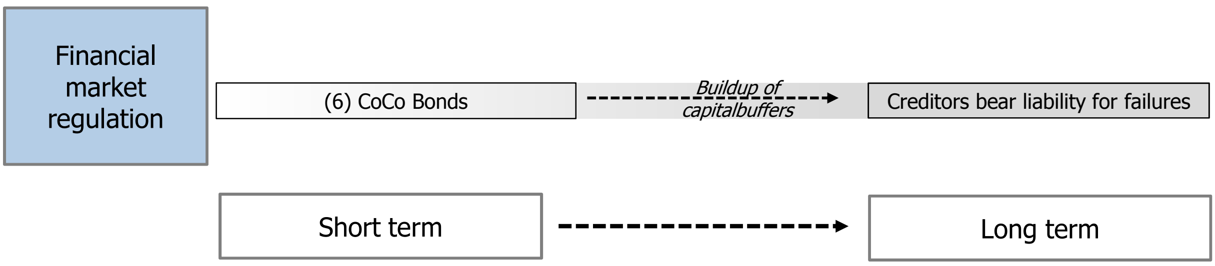
Concentrating public funds on bank recapitalization is superior compared with the way that the EFSF/ESM has been used so far, as the funds are better-targeted. Currently, the European rescue facilities protect all creditors from realizing losses. This comes, however, at a cost of potential moral hazard and also redistribution from taxpayers to bondholders. The EBRA proposal concentrates on fixing the situation in the banking sector and fully exploits the capacity of private investors to bear losses from bad investments.

Establishing the EBRA implies significant support for the crisis countries, as it reduces the danger of bank runs. At the same time, the EBRA reduces the likelihood that "zombie banks" distort the allocation of capital.[3] This part of the Kiel Policy Package is, however, not only an expression of pan-European solidarity but is also in the interest of potential donor countries, as they benefit from a more robust financial system. In addition, transfers would remain strictly targeted and temporary.

Strengthening the capacity of banks to absorb losses

To make sure that the recapitalization of banks through the EBRA remains an exceptional emergency measure, the capacity of the banking industry to absorb losses has to be increased substantially. To this end, we propose:

(6) Contingent Convertible Bonds (CoCo Bonds) which stipulate that bank debt is automatically converted into equity if the equity ratio falls below a certain threshold.



[3] „Zombie banks" are commercial banks which lack a feasible business model. They carry a portfolio of loans with a high risk of default. In order to prevent such risks from materialzing and the bank from becoming openly insolvent, the roll over these loans to debtors who otherwise would have to declare bankruptcy.

This provision is at the core of the proposed reform of bank regulation and re-establishes the principle of liability in the banking sector in a comprehensive way.[4] The convertibility clause would be obligatory for future external financing of commercial banks. Sight deposits from the non-financial sector (households and firms) would be excluded from this clause.

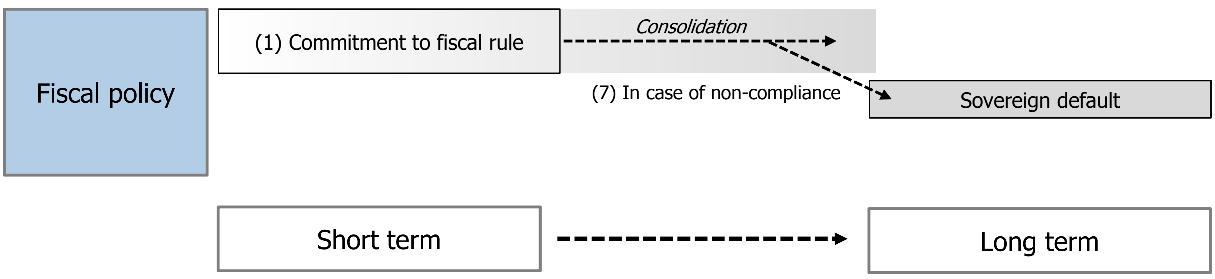
An obligatory CoCo clause would shift the burden of propping up ailing banks back from taxpayers to investors. As a result, appropriate risk management would not have to be imposed on the banks from outside. It would rather be in their own interest to keep from taking excessive risks. If a bank incurred higher risks, this would raise the probability that bank debentures would at some point be converted into equity, reducing the value of existing stocks. This gives the bank's shareholders an incentive to enforce prudent investment strategies by the bank's management.

The buildup of a sufficient buffer of CoCo bonds, however, will take time since new CoCo bonds will gradually replace existing bonds as they expire. Over time, the share of capital constituted by convertible bonds will gradually increase, and the potential need for external recapitalization will decline accordingly.

Debt sustainability vs. orderly sovereign default in the long term

In the case that the current crisis countries comply with their national fiscal rules, debt-to-GDP ratios will persistently fall, leading to improved debt sustainability and an increase in investor confidence. In the long term, gauging the credit standing of each and every member country remains completely up to the capital markets.

(7) If a country cannot convince investors of its debt sustainability in the longer term, it will have to come to a debt restructuring agreement with its creditors in an orderly process.



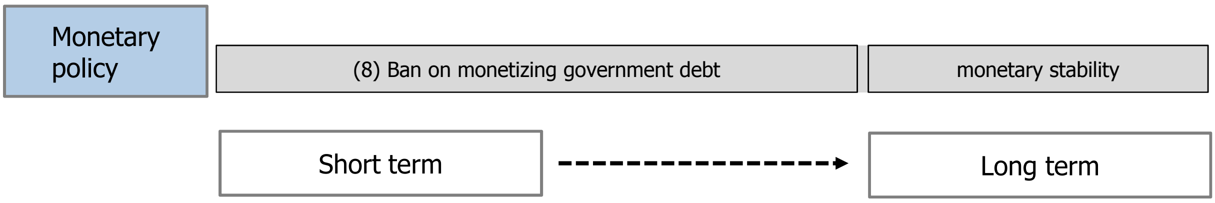
[4] Flannery, M. (2005). No Pain, no Gain? Effecting Market Discipline via "Reverse Convertible Debentures". In H.S. Scott (ed.), Capital Adequacy beyond Basel: Bankin, Securities, and Insurance. Oxford: Oxford University Press.

In the future, sovereign default could not endanger the stability of the financial system, since the capability of banks to absorb losses will be massively increased. With the stability of the whole financial system no longer at risk, the no-bailout clause would regain credibility.

Clear limits for monetary policy

The monetary mandate of the central bank is strengthened by the clear signal that neither in the long term nor in the short term will it finance governments through the printing press:

(8) The ban on monetizing government debt through the Eurosystem remains in place.



A credible guarantee that the ECB will not engage in government financing through the Eurosystem is a prerequisite for financial and monetary stability, and it will encourage governments to implement serious reforms along the lines of those contained in the Kiel Policy Package. At the same time, the implementation of such reforms will reduce pressures on the ECB to engage in government financing. The ECB could then focus on its main objective of price stability.

By creating a set of policy tools which is better equipped to deal with fiscal and financial problems, the Kiel Policy Package aims re-establishing confidence, as the expectations of private agents cannot be stabilized without confidence in the main pillars of the European monetary system.

A structural policy reform agenda to raise potential output

The current severe situation in the crisis countries is to a large extent rooted in structural problems. By prudently cutting down on regulations and reforming institutions that reduce flexibility, the government can tap the growth potential of the economy. Therefore we propose that:

(9) Crisis countries engage in structural reforms, most notably in the following areas: Increasing flexibility in the labor market, fostering competition in product markets, cutting red tape for businesses, privatizing noncore state assets.

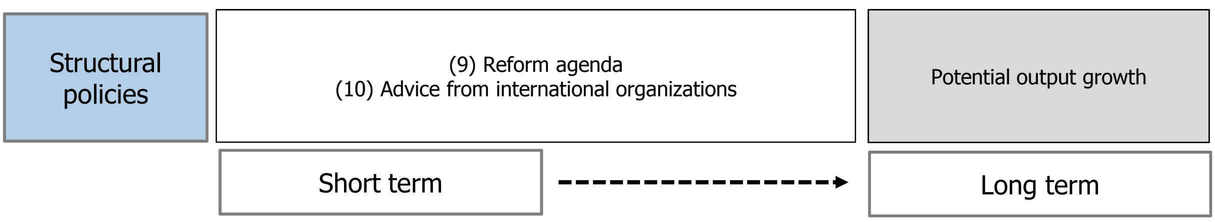
a) Especially in times of heightened structural change, labor market flexibility is important in order to move workers from less-productive to more-productive matches. Flexibility in the labor market can be improved by reducing protection against dismissal, reducing minimum wages where they work as a barrier to hiring, and introducing more decentralized wage bargaining. Allowing wages to reflect productivity differentials at the company level and at the regional level would help to increase output and possibly employment over the longer run. Labor market policy should focus on encouraging labor market participation and raising skill levels, particularly in such groups as the young and the long-term unemployed.

b) Policy can tap productivity potentials by enhancing competition in markets for goods and services. In the crisis countries, markets are regulated to different degrees in favor incumbents. Markets should generally be opened to new entrants. Opening up, to foreign competitors in particular, would help to raise productivity to international standards.

c) The government can support economic restructuring by reducing red tape for businesses, for example, by streamlining approval procedures. Another important element is to improve the predictability of legal decisions and the enforcement of legal claims in order to make their countries more attractive as a place to invest. In addition, cutting down on bureaucracy allows for reductions in government employment and expenditure without cutting essential public services or the quality of the education system.

d) There is generally also scope for reduction of the direct influence of the state on economic activity. Where the state acts as an entrepreneur, the privatization of noncore state assets can not only generate revenues, but also contribute to an increase in productivity for the total economy.

e) Should the country participate in the Interest Burden Equalization Scheme (2), the EU Commission shall prepare recommendations for structural reforms and shall monitor their implementation.



While structural reforms improve the outlook for longer-term levels of economic activity, they may lead to additional adjustment burdens in the short term, especially on the labor market. Even more important is the possibility that implementation may be jeopardized by the interventions of specific groups who have vested interests and stand to lose from the reforms. In this situation, conditioning emergency support (access to the Interest Burden Equalization Scheme) on reform measures can be helpful and even necessary. In the case that individual governments are not capable of swiftly implementing reforms due to political constraints, we suggest:

(10) At the request of the crisis countries, international organizations give advice on the implementation of reforms.

To the extent that domestic political considerations make it difficult to implement painful reforms, countries in crisis have in the past turned toward international organizations to provide advice and a certain degree of political cover.

Notwithstanding the need for economic policy adjustments, a sustainable improvement of the economic and social situation in the crisis countries requires a redeployment of inputs toward new uses. It is impossible to predict the form that this redeployment will take. Economic policy can only assist the necessary process of search and adjustment in the market economy, but cannot replace it.

Box:
The risk of overloading monetary policy

The European Monetary Union has been confronted with a series of interrelated balance-of-payments and banking crises for several years. These crises are characterized by extensive bank lending and the issuance of public and private debt obligations. A significant portion of these debts will not be repaid. Due to overoptimistic investments in the past (for example in the real estate sector), these debts (which are assets to the banking sector) are not backed by assets of equal or greater value. This holds especially true for consumer debt and debts incurred by governments which were then used to fund public consumption or transfer payments. In these cases no capital stock was built up as a source to pay future debt obligations. These bad loans, which are primarily held by commercial banks and put pressure on their balance sheets, also put at stake the financial stability of the whole EMU. Regulators have not adequately addressed these problems, and governments have lacked the political willingness to address these problems directly. In order to prevent a systemic crisis and to guarantee financial stability, the Eurosystem has stepped in with a series of extraordinary policy measures.

Financial stability is a crucial prerequisite for the proper functioning of a market economy. In the long run financial stability cannot be guaranteed through expansionary monetary policy measures. Continuously expanding the monetary base, in particular when these expansions are focused on rescue operations, would prolong misalignments in the financial sector. Furthermore, the central bank would run the risk of missing its primary target, i.e. guaranteeing price stability, when it is charged with other objectives at the same time. Permanently relying upon a short-term policy instrument does not lead to a long-term solution but instead runs a risk of creating new problems. The long-lasting balance-of-payments financing through the Eurosystem (i.e. Target2 imbalances) is just one example of this.

Relying upon monetary policy instruments to tackle non-monetary issues in the long run would result in a loss in credibility or independence of the monetary authority. A loss in credibility (or independence) would make it difficult for the monetary authority to achieve price stability, and that may provoke a move toward a more inflationary regime. It is difficult to say in advance when and how such a policy shift may occur. The longer that the current situation persists, the greater the risk of a policy shift becomes. In order to prevent such a scenario, there has to be a consensus among all euro area member countries about the future focus of the EMU on monetary stability. If this were not the case, then the monetary union would be fragile and unstable. “Rescue” efforts would not have their intended effect, and the potential risk and cost of dissolving the monetary union would increase over time.

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