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"Can the euro still be saved?"

Threats to monetary robustness of the euro area

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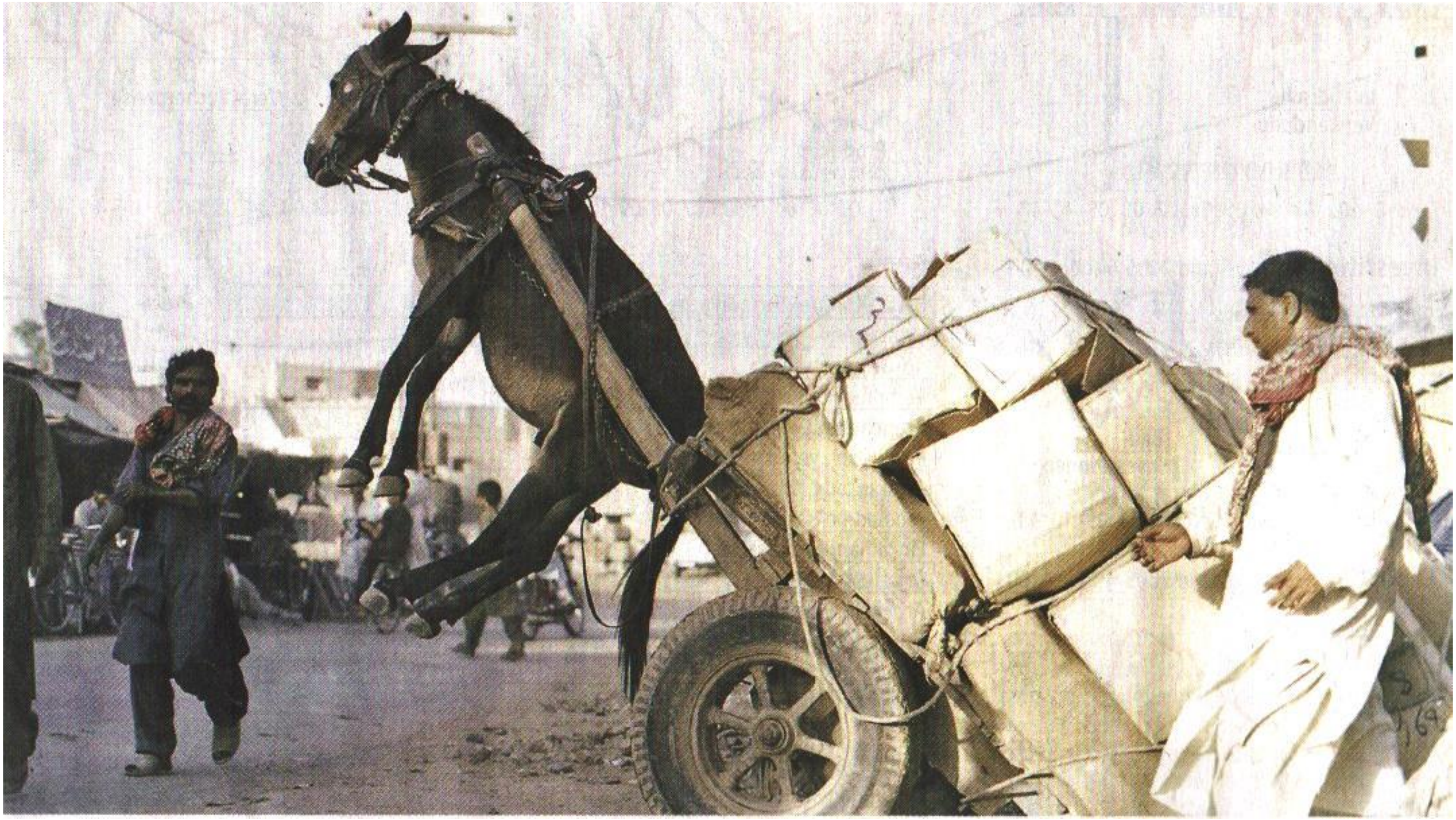
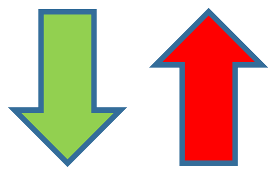
Monetary policy: Overloaded



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**

Critical rationalism

- Fiscal union
  - » Discretion
  - » Mutualized debt
  - » Conditionality of fiscal support
  - » Macro stabilization on EMU level
  - » Monetary government financing, soft currency
  - ⇨ **Harmonization, deepening**

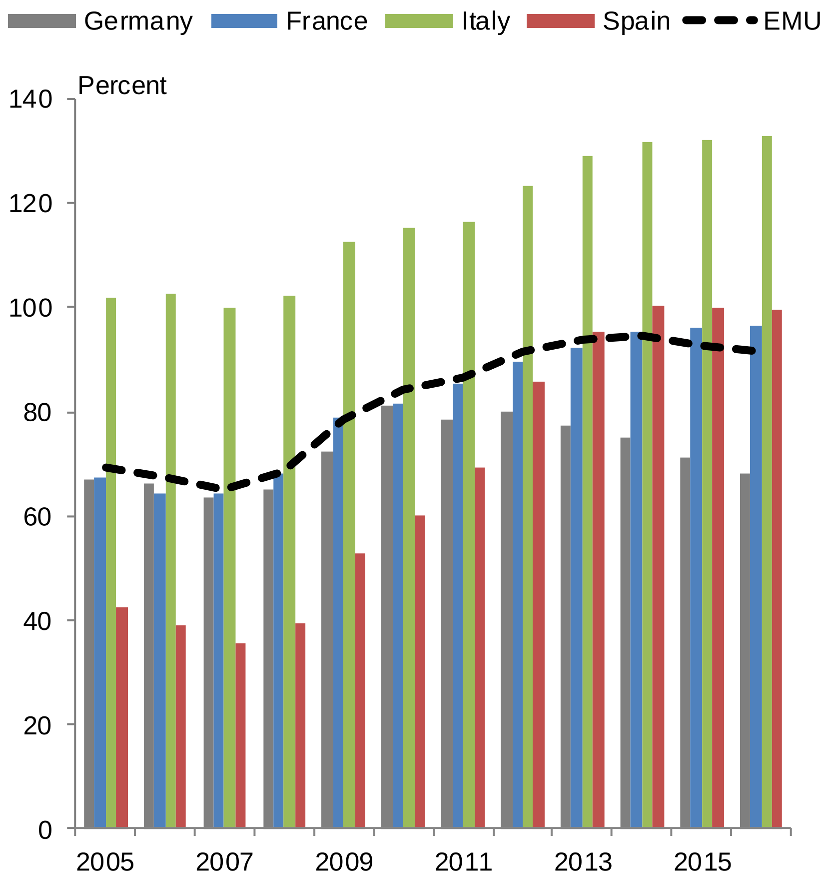
Rationalistic constructivism

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

Key insight for successful reform processes:
Ownership matters.

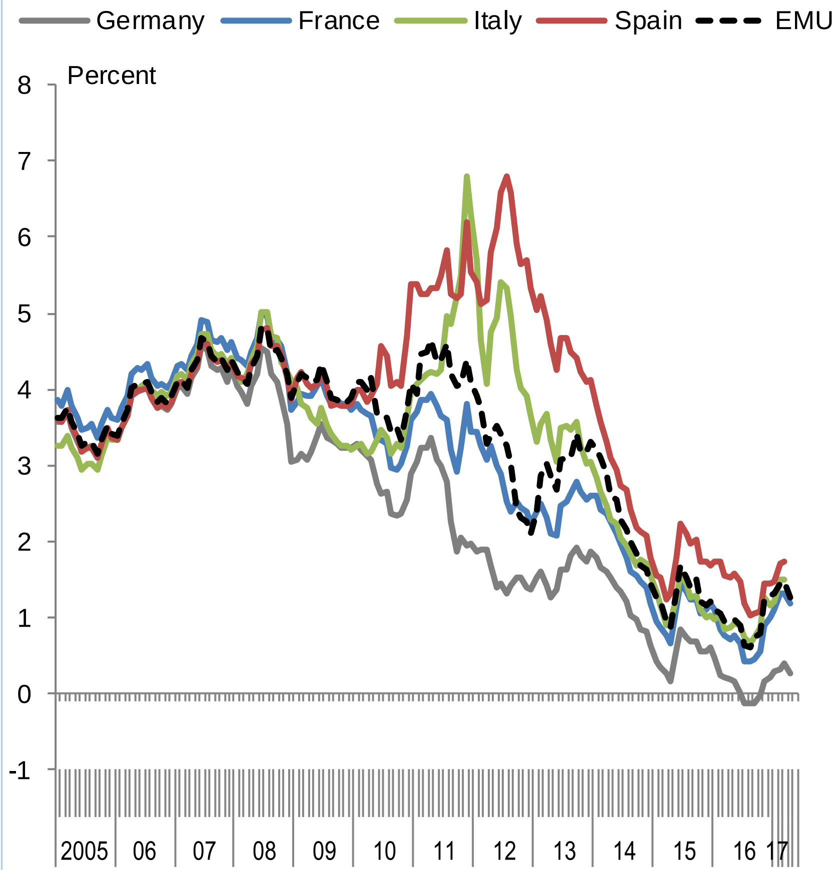
Historically high public debt levels, historically low government financing cost

Gross Government Debt



Annual Data. In relation to nominal GDP; EMU: Average.

Government Bond Yields (10-year)



Monthly data. EMU: Averrage.

Data source: Eurostat, European Commission.

Buying time did not work

Low refinancing cost:
Consolidation and reform efforts wane.

Diagnostic failure: Predominance of macro-managment thinking

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

⇨ EMU-budget

  » Expenditure-side (EMU-specific collective goods)?

  » Cyclical vs. structural problems?

Interest, capital, and production structures

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)**

Two types of mal-investments

- **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

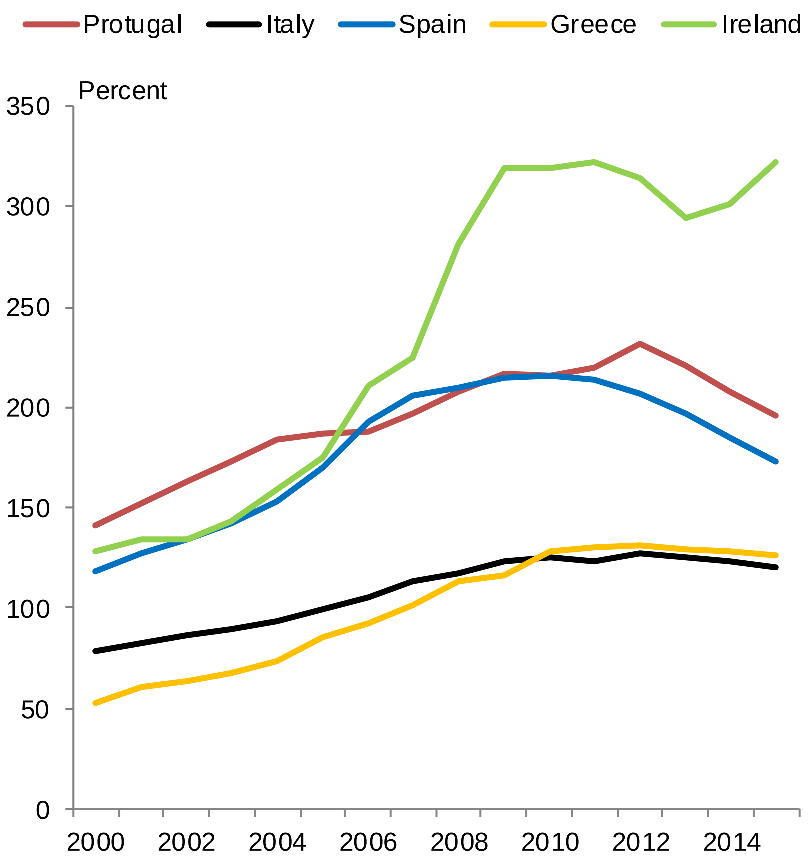
- **Public bail-outs**
  - Shifts private debt to public sector
  - Private debt crisis ⇨ sovereign debt crisis
  - No solution for fiscally distressed countries
- **Inflating the debt away**
  - Takes a long time, promotes zombification
  - Puts the currency at risk
  - Not targeted towards non-performing 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)

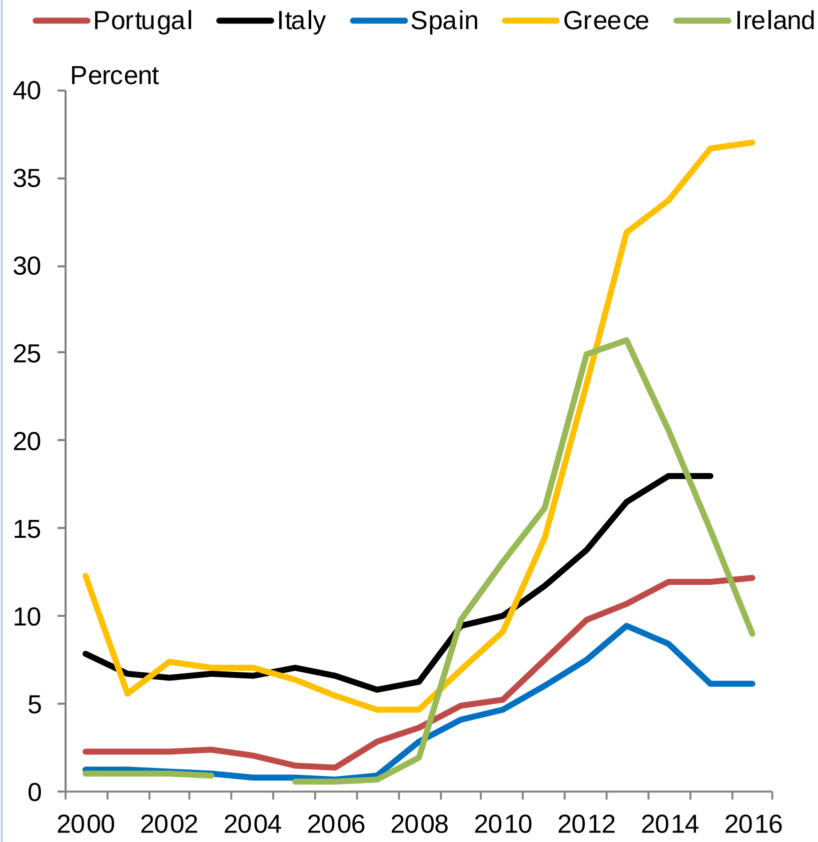
Flip-side of not liquidating (= “buying time”): High debt positions hamper credit channel

Gross Private Sector Debt



Annual Data. In relation to nominal GDP.

Non-Performing Loans



Annual data. Share of total loans.

Data source: Bank for International Settlements, World Bank.

Hard to solve:
The Legacy-restart-nexus

Restart
(new framework)
requires
resolution of legacy problems

Resolution of legacy problems
(debt overhang)
requires
consensus on new framework

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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