

Eurozone crisis and risk-sharing

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Eurozone crisis and risk-sharing

- The unique hybrid
- Learning lessons
- Meeting challenges
- Conclusion

1. The unique hybrid

- The eurozone is a unique hybrid structure
- It is not the gold standard, since it has a central bank to manage liquidity risk for banks and governments (albeit controversially).
- It is not a federal union, since it lacks almost all fiscal insurance mechanisms
- These features are unlikely to change in any fundamental way in the foreseeable future

1. The unique hybrid

- This makes it extraordinarily important that the financial sector is able to provide insurance against risk
- This is true, above all, where cross-border lending is concerned, because other forms of insurance, particularly fiscal, are lacking
- This is made even truer by the large structural net capital exports of Germany and a few other northern members

2. Learning lessons

- It is helpful to view the crisis and its aftermath as a failure of attempted financial integration
- In the run-up to the crisis, capital flowed freely and interest rates converged.
- But this financed unproductive booms in peripheral countries.
- These created an illusion of overall economic health.

2. Learning lessons

- Then the crisis broke:
 - Risk-spreads exploded;
 - Capital flows stopped;
 - Peripheral economies went into crisis; and
 - The eurozone went into a deflationary depression;
- The eurozone has not yet emerged from this slump, despite aggressive European Central Bank action.

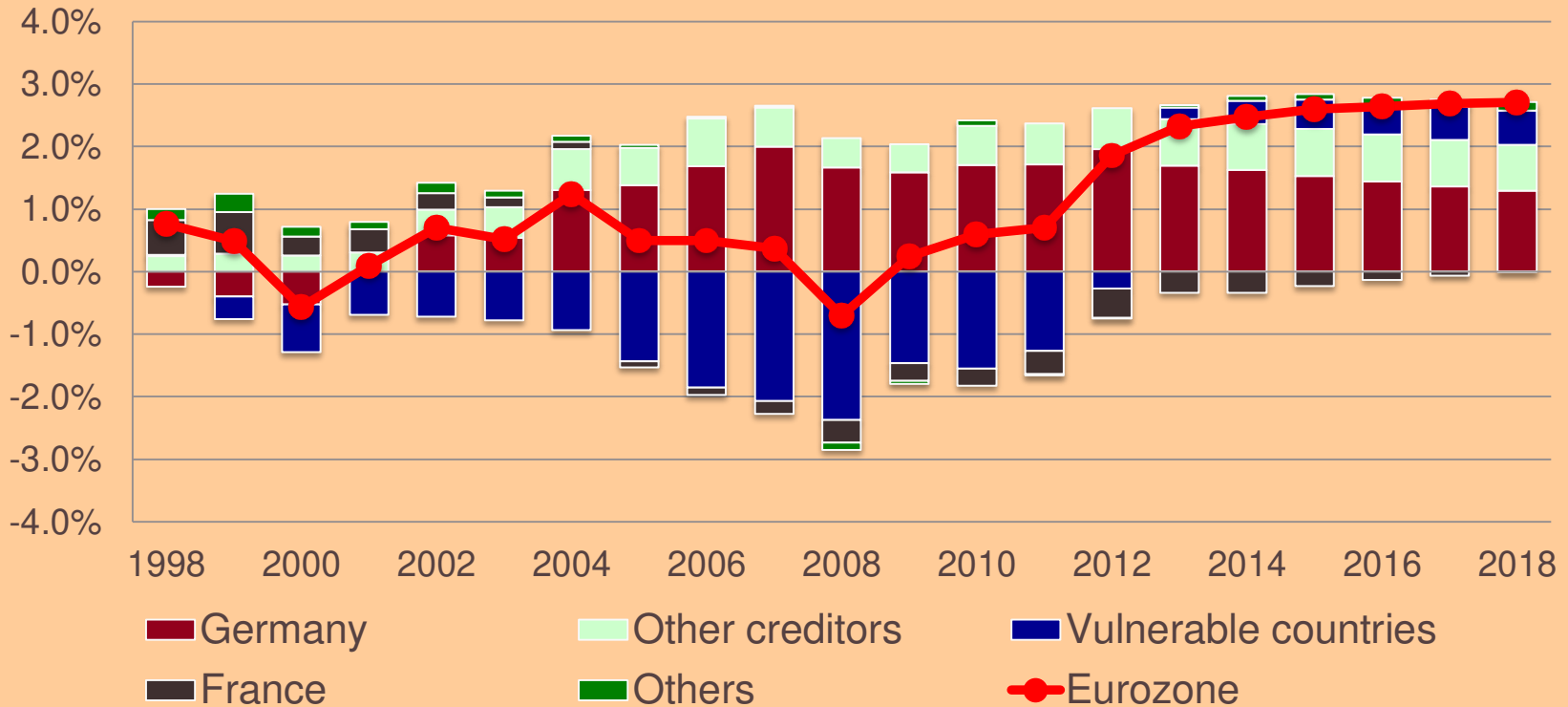
2. Learning lessons

- The eurozone then is a special case of my overall view of the crisis
- This is that macroeconomic shifts dovetail with increased financial fragility:
 - Macroeconomic triggers - savings gluts, falls in real interest rates; imbalances; and *endogenous* monetary policy; and
 - Financial trigger - credit creation, innovation, liberalisation, the Minsky cycle (“stability destabilises”) and so *endogenous* fragility.

2. Learning lessons

IMBALANCES AND REBALANCING

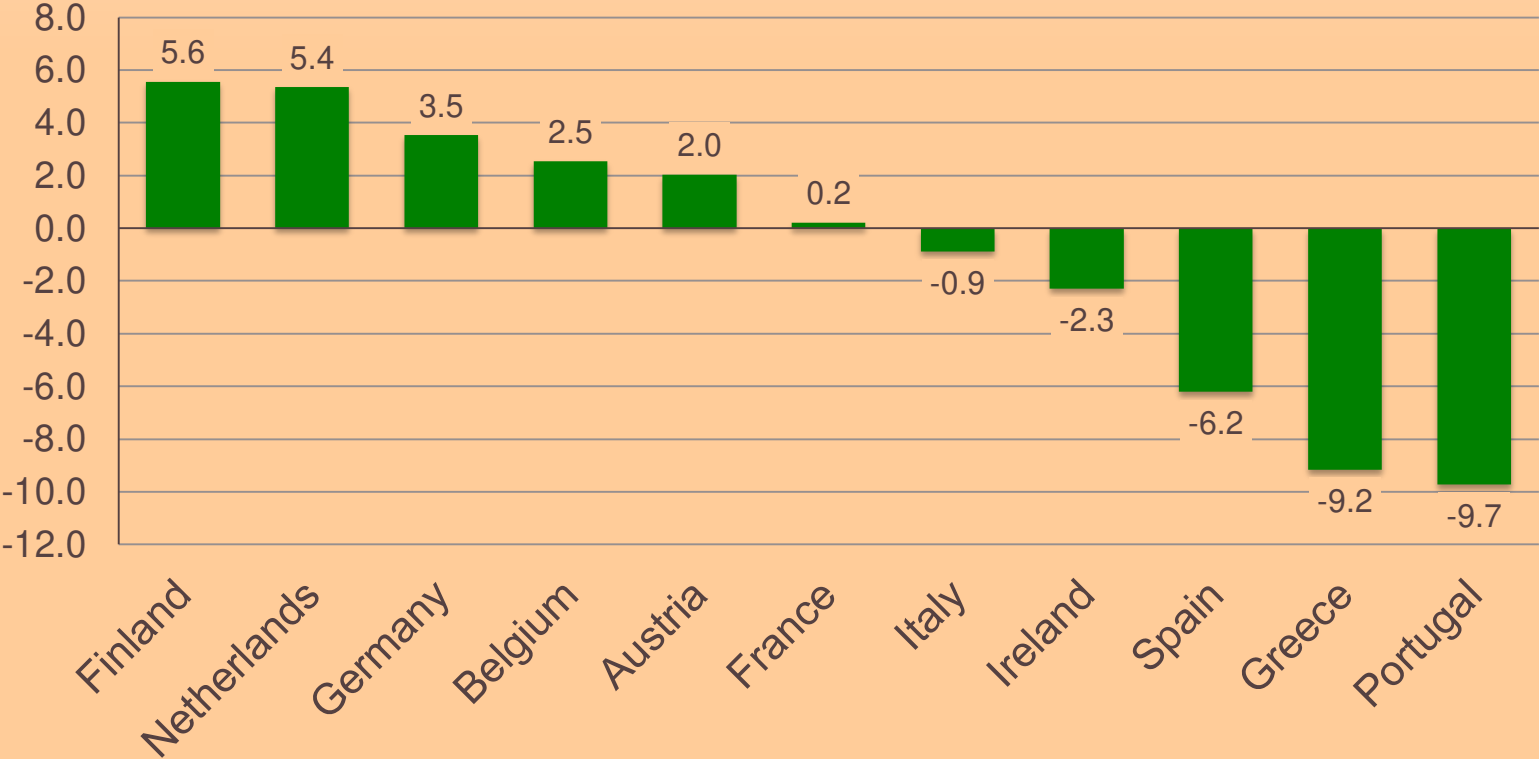
**EUROZONE IMBALANCES ON CURRENT ACCOUNT
(as per cent of Eurozone GDP)**



2. Learning lessons

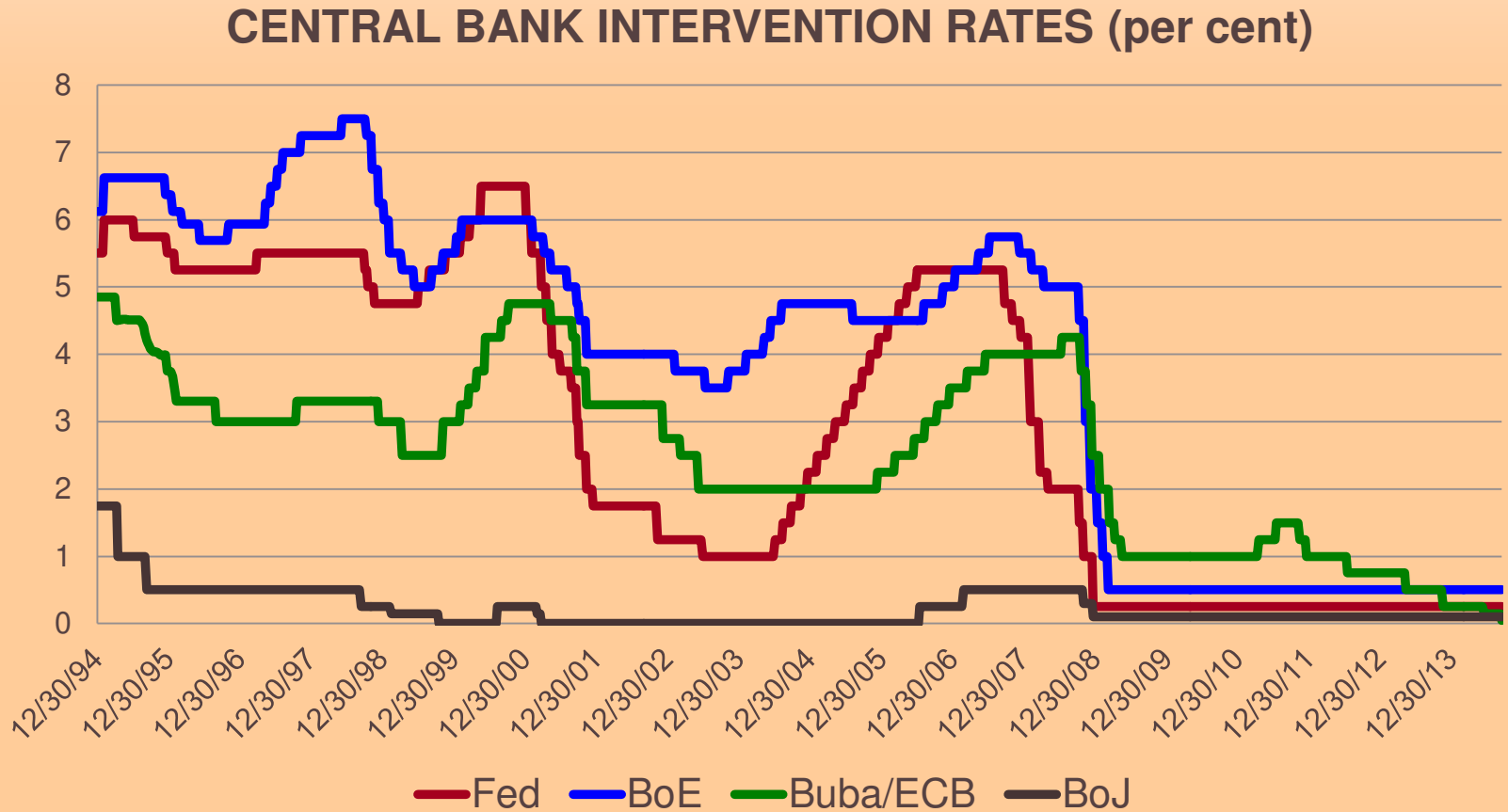
THE ROAD TO THE EUROZONE CRISES

AVERAGE CURRENT ACCOUNT BALANCES 2000-08



2. Learning lessons

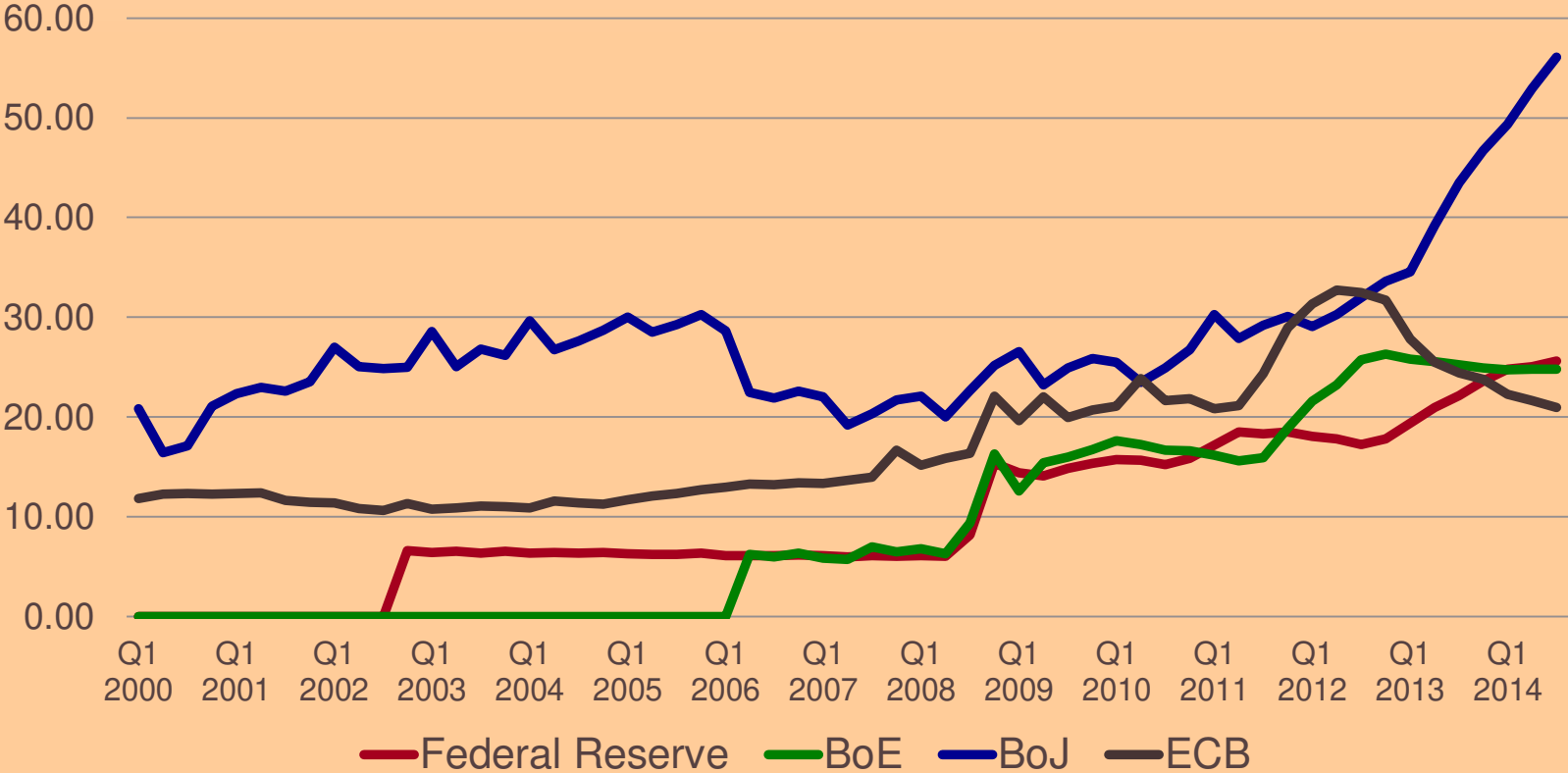
THE RELUCTANT ECB



2. Learning lessons

THE RELUCTANT ECB, ONCE AGAIN

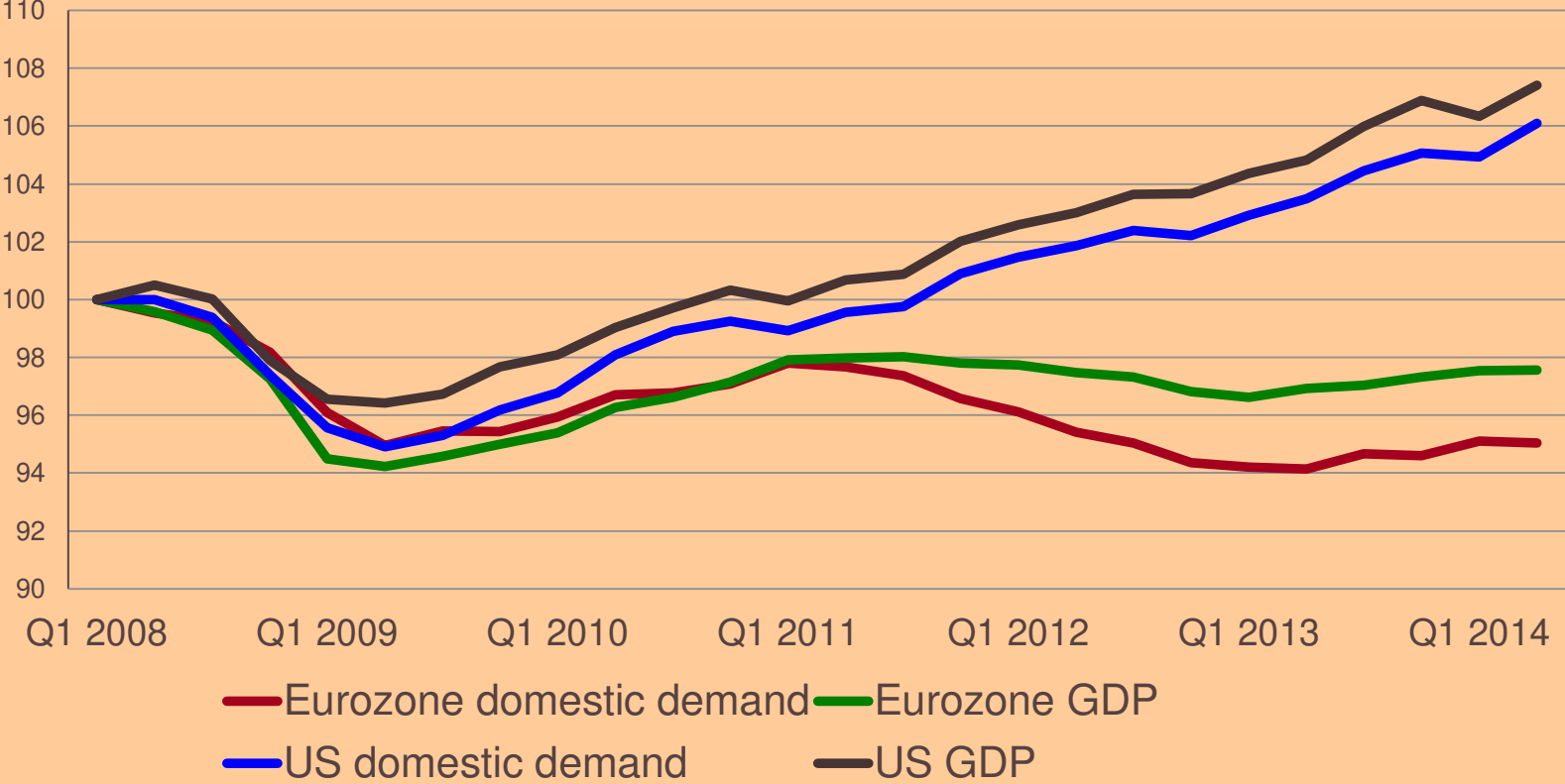
CENTRAL BANK ASSETS OVER GDP



2. Learning lessons

COLLAPSE IN POST-CRISIS DEMAND

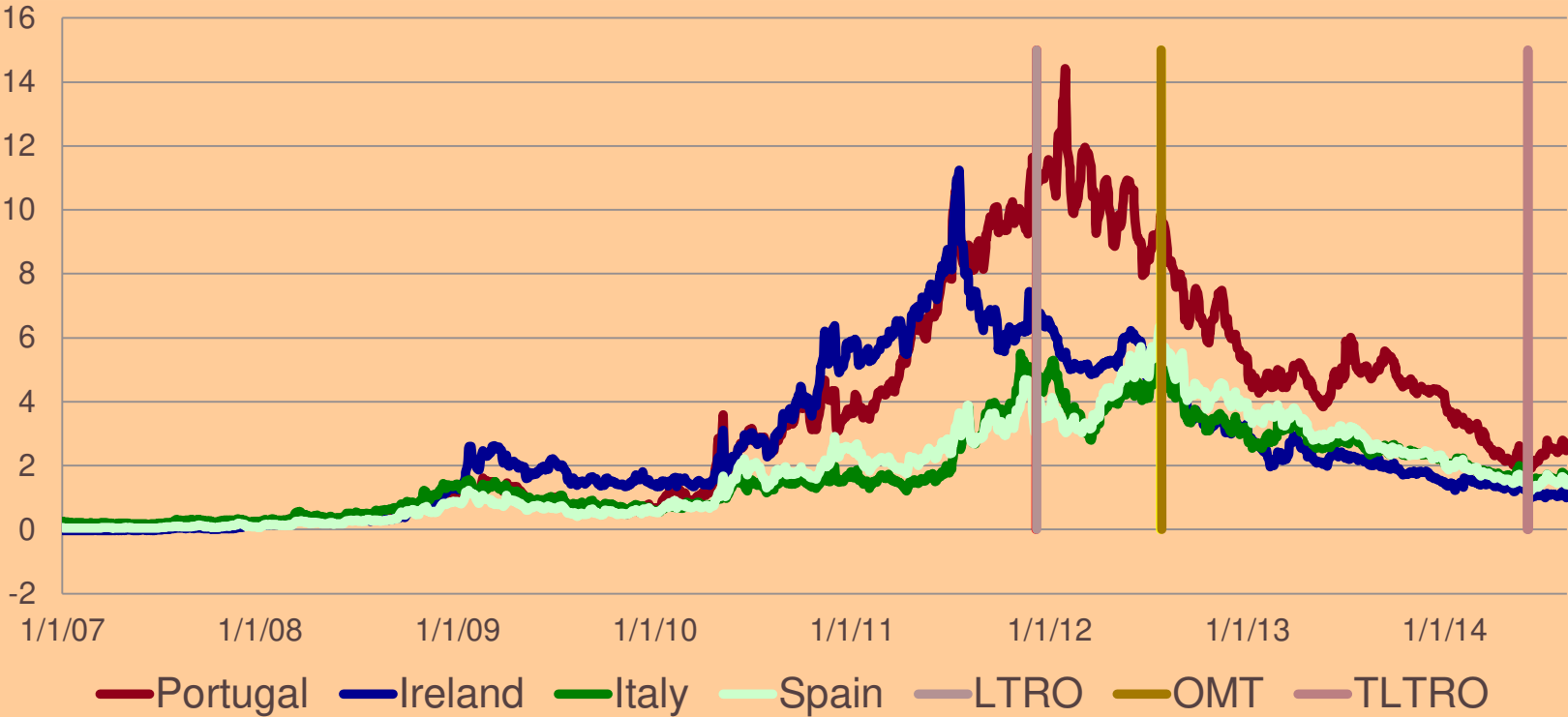
GDP AND DEMAND IN THE CRISIS



2. Learning lessons

THE EUROZONE LEHMANS

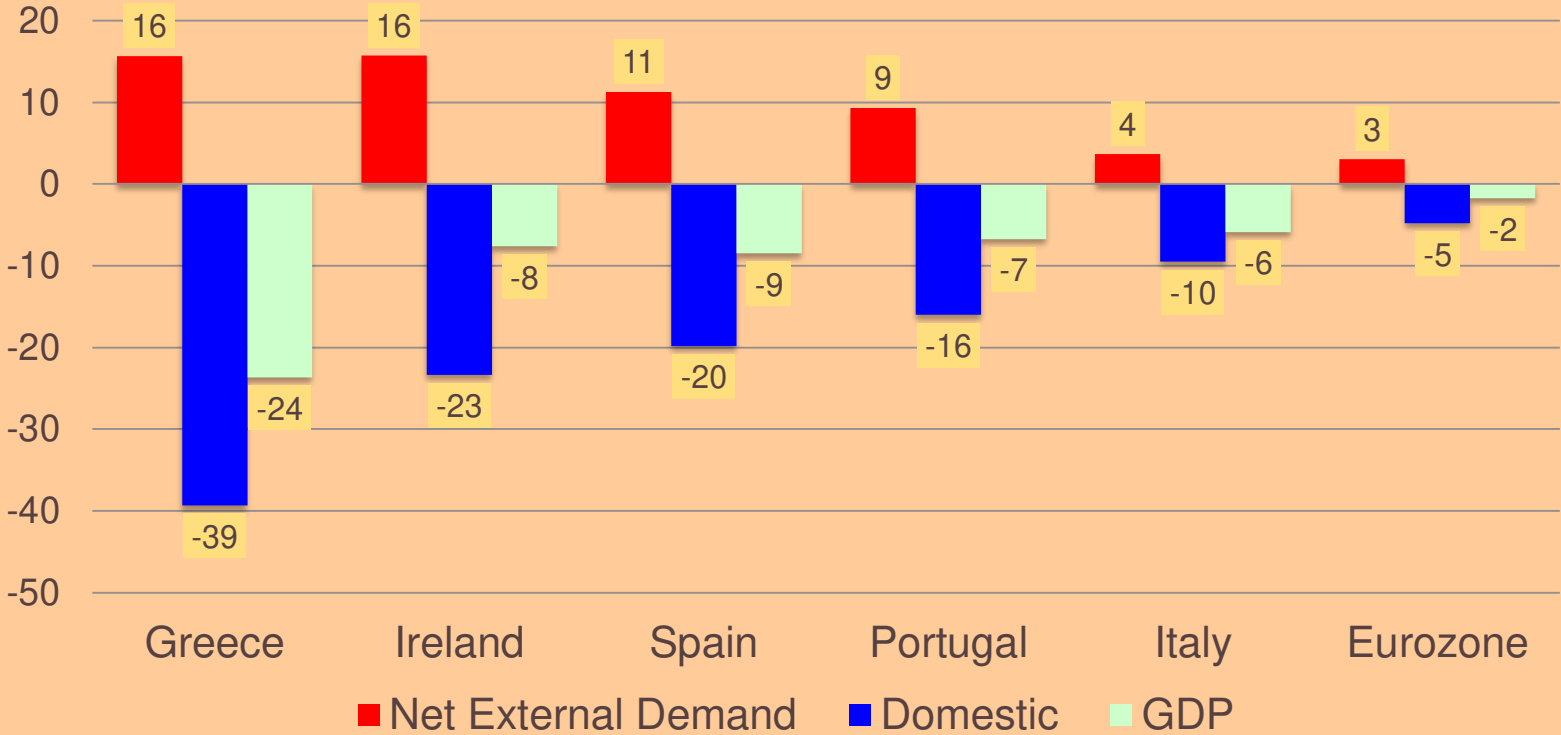
SPREADS ON TEN-YEAR GOVERNMENT BONDS OVER BUNDS (percentage points)



2. Learning lessons

ADJUSTMENT IN THE CRISIS

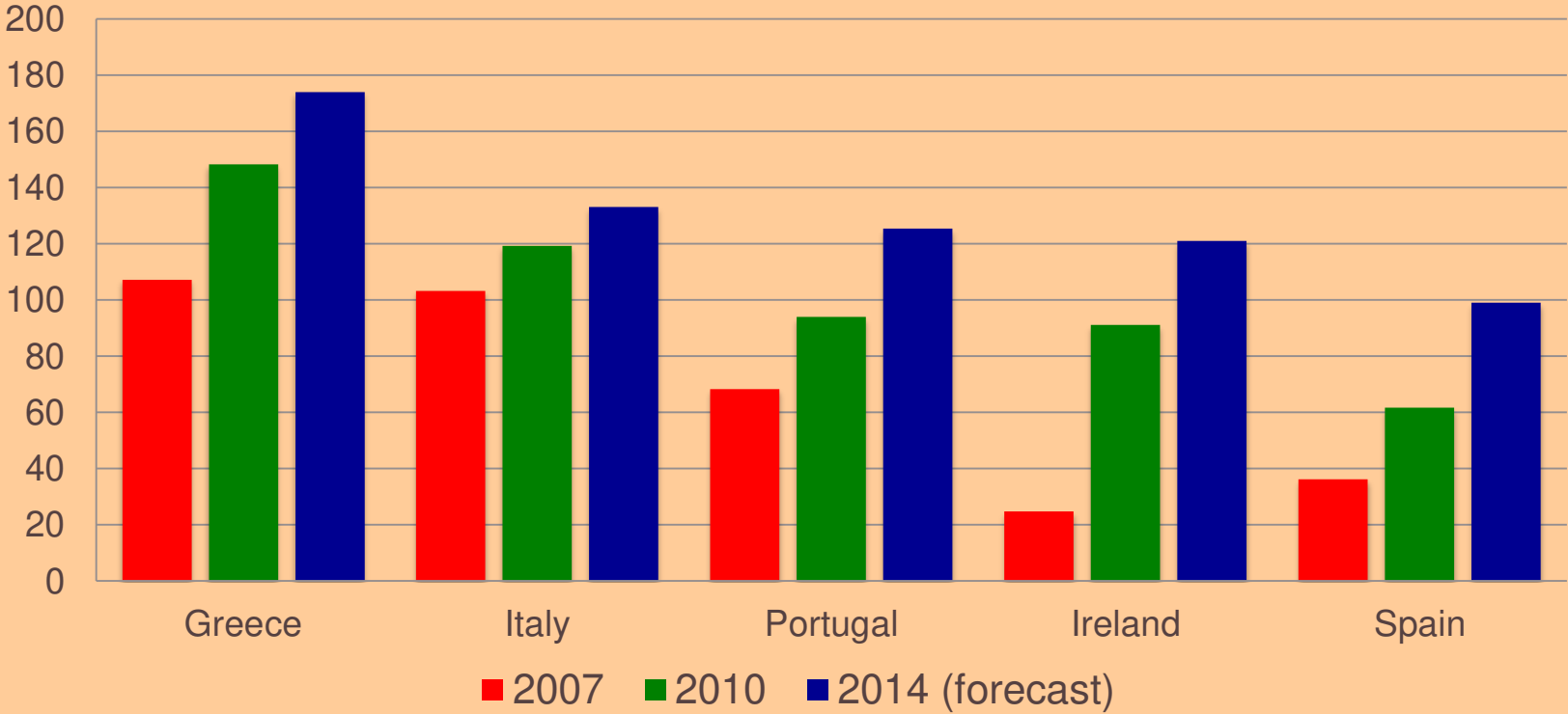
CONTRIBUTIONS TO CHANGES IN GDP 2007-13
(per cent)



2. Learning lessons

AND A BIG DEBT OVERHANG

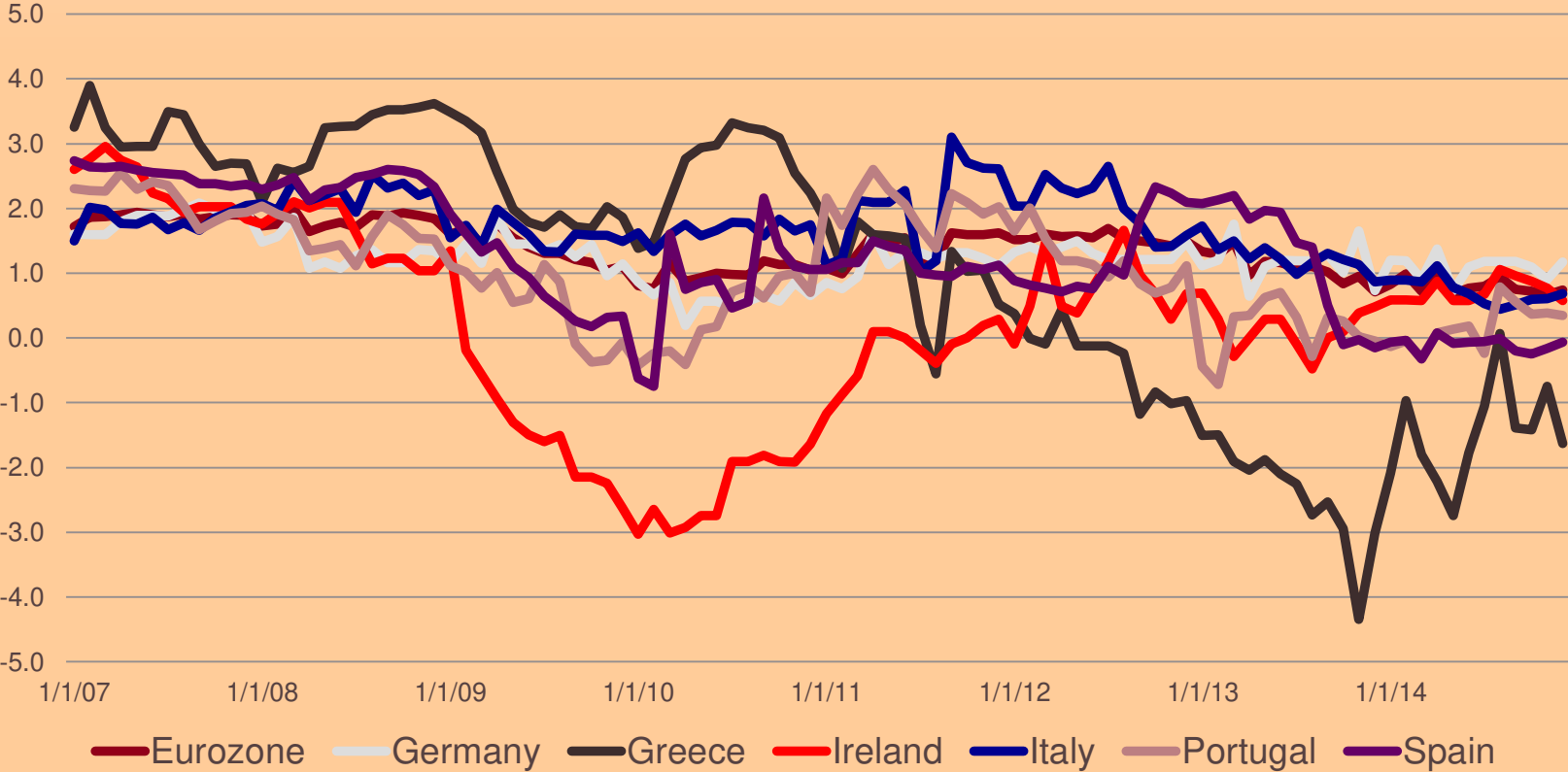
GROSS PUBLIC DEBT OVER GDP (PER CENT)
Source: IMF



2. Learning lessons

EUROZONE IS BECOMING DEFLATIONARY

CORE INFLATION



3. Meeting challenges

- What are the lessons of both the huge crisis and the failure to emerge fully seven years later, despite increasingly supportive monetary policies?
- There are two obvious ones:
 - The eurozone has been unable to generate sufficient demand to absorb potential output without huge financial bubbles; and
 - The eurozone also lacks adequate risk-insurance mechanisms to deal with “sudden stops” in cross-border capital flows.

3. Meeting challenges

- The solution to the demand problem:
 - Becoming a greater Germany with a huge external current account surplus, *but* the eurozone is surely too big for that to be feasible;
 - Using fiscal policy, *but* the fiscal compact rules that out;
 - Relying on monetary policy, *but* that may require new credit bubbles; and
 - Relying on spontaneous private demand, *but* even if that could happen, it is likely to cause the re-emergence of internal current-account imbalances and huge net cross-border capital inflows.

3. Meeting challenges

- What happens if none of these things happen:
 - A zero-sum, failed beggar-my-neighbour adjustment process;
 - Prolonged structural slumps;
 - Forced debt write-offs; and
 - Political crises.

3. Meeting challenges

- A solution to the risk-sharing problem is crucial, if the eurozone is to become less crisis-prone:
 - Fiscal mechanisms are largely unavailable;
 - So the answer has to be financial;
 - This means that finance must be less prone to runs and have built-in risk-sharing;
 - Short-term cross-border bank lending is prone to runs - a clear lesson of financial crisis in emerging economies;
 - Long-term debt contracts are better, but are also sources of fragility, because they are not *state-contingent*;

3. Meeting challenges

- What is needed inside the eurozone is more:
 - Equity, including foreign-direct investment;
 - Quasi-equity contracts automatically indexed to states of the world (such as nominal GDP-linked bonds, house-price indexed bonds and so forth).
- So cross-border bank lending should be reduced;
- Alternatively, the equity buffers in bank lending need to be increased above current levels
- Furthermore, bank lending and conventional bonds need to be replaced/complemented by state-contingent, risk-sharing contracts.

4. Conclusion

- Reform of policy needs to resolve the special problems of the eurozone as a hybrid economic structure;
- That hybrid has shown itself unable to cope well with financial crises and negative shocks to demand;
- The shortfall in demand remains chronic;
- But so is the lack of true risk-bearing and, above all, risk-sharing characteristics of cross-border finance.