

The Shifts and the Shocks

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Nottingham

The Shifts and the Shocks

- Why this matters
- What happened
- What is to be done

1. Why this matters

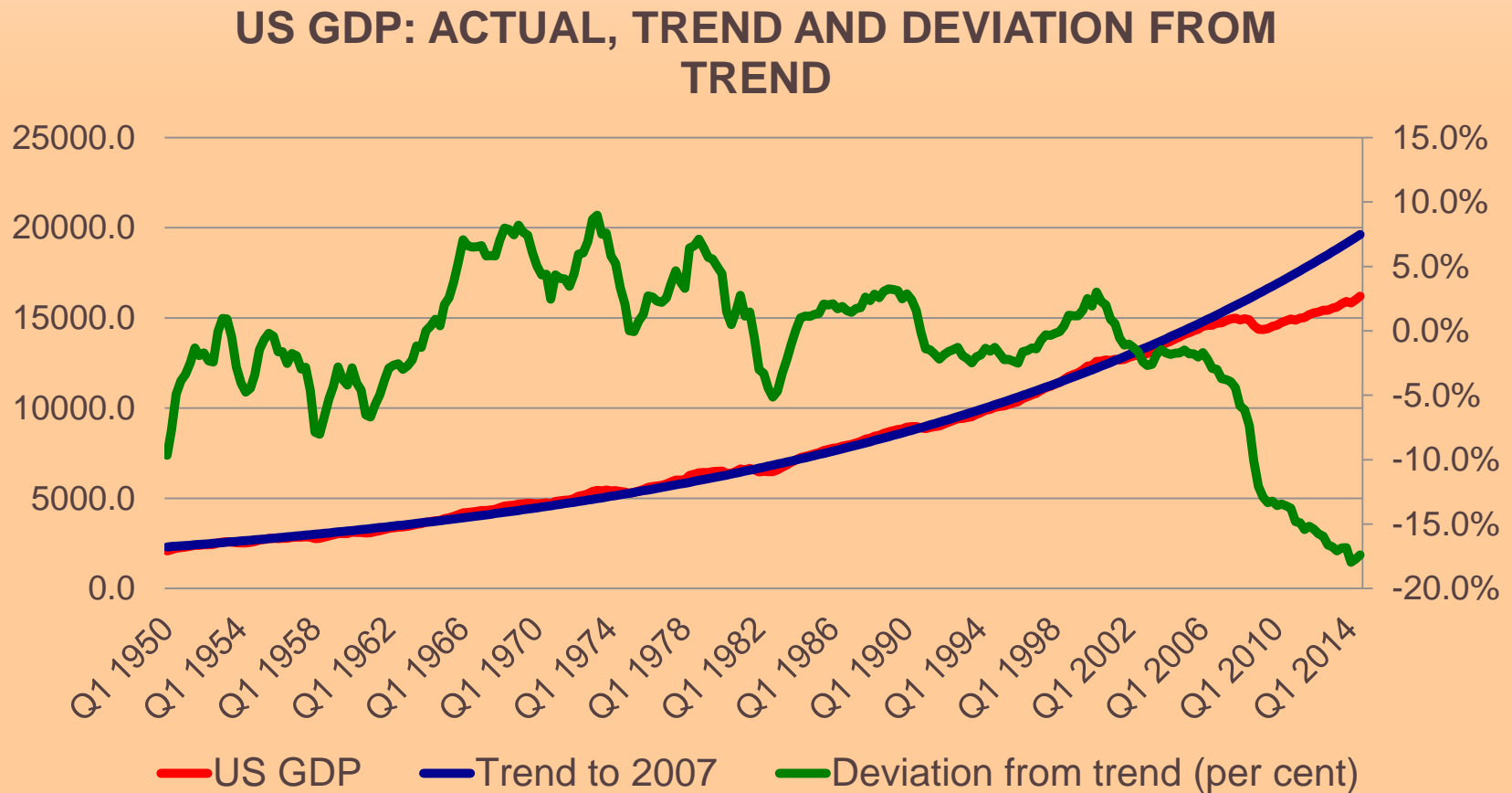
- The crisis and its aftermath was a failure of institutions, but also of understanding.
- The “old orthodoxy”:
 - Inflation targeting and financial deregulation;
 - Would generate stable prosperity.
- It didn't. This then is a second big shock to macroeconomics since World War II.
- It was not a simple failure of forecasting.

1. Why this matters

- One cannot forecast earthquakes. But geologists understand the probabilities reasonably well.
- Economists did not have a comparable understanding of the chances of a crisis.
- Because they ruled them out by assumption. They did not understand that “stability destabilises”, in Minsky’s phrase.
- It was a failure of imagination.

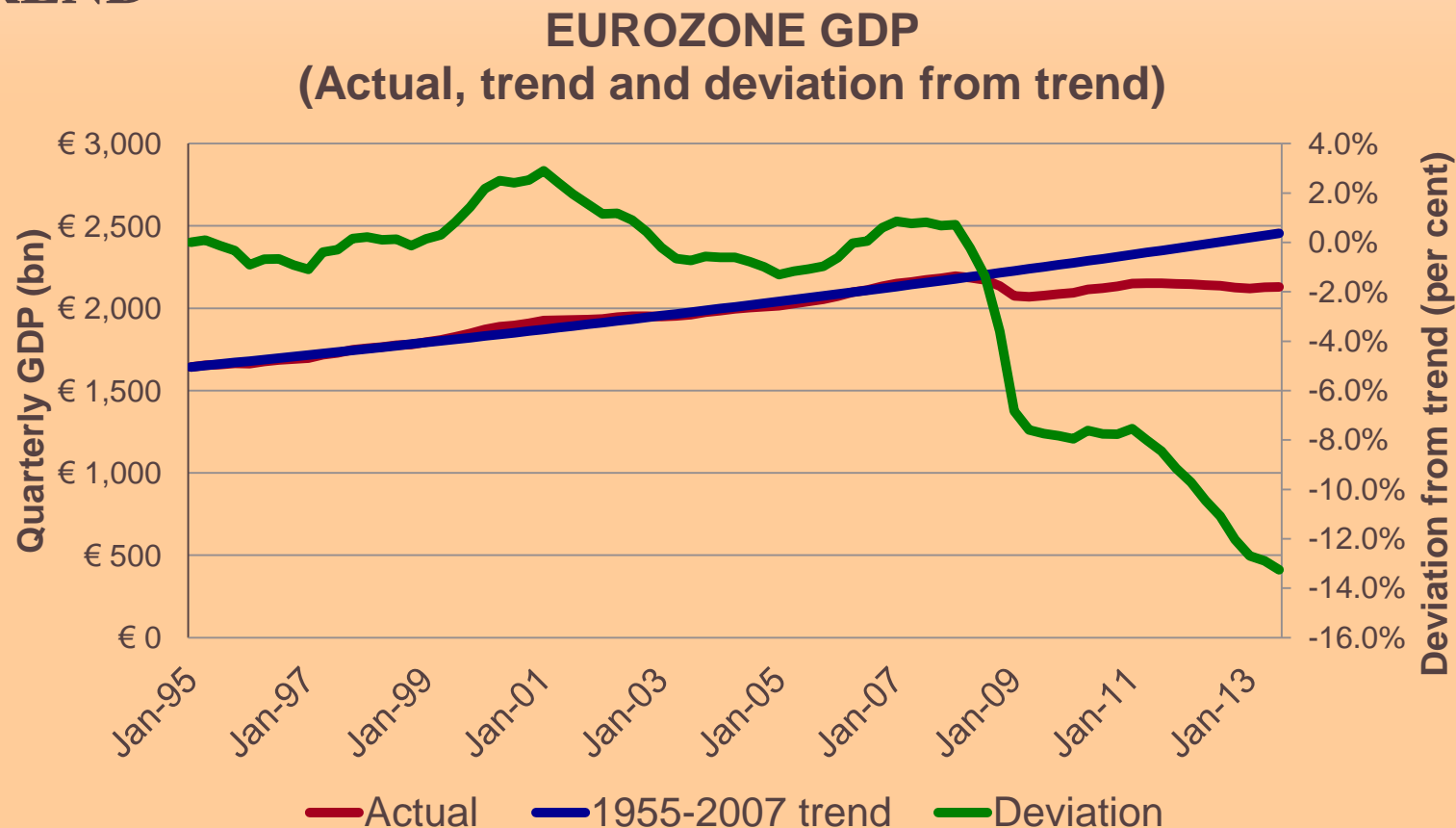
1. Why this matters

IN THE US IT IS NOW LOOKING LIKE A NEW ERA



1. Why this matters

OUTPUT IS VASTLY BELOW THE PRE-CRISIS TREND



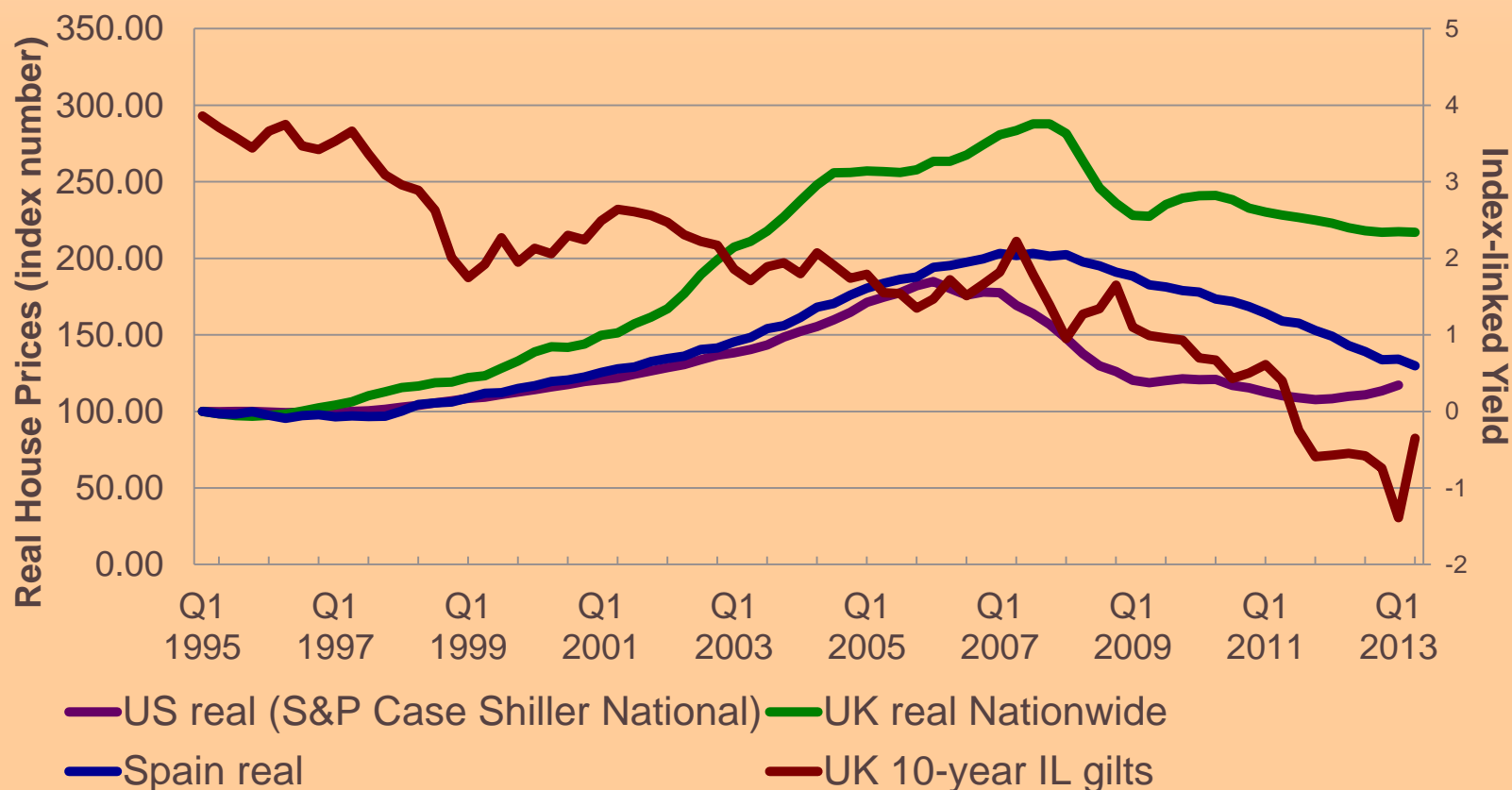
2. What happened

- There were two interwoven causes: macroeconomic shifts and financial shocks.
- These are intimately interconnected.
 - Macroeconomic trigger:
 - The “savings glut” (driven by external and internal changes), a fall in global real interest rates and global imbalances;
 - Financial consequences:
 - Financial innovation and liberalisation, credit creation and endogenous fragility.

2. What happened

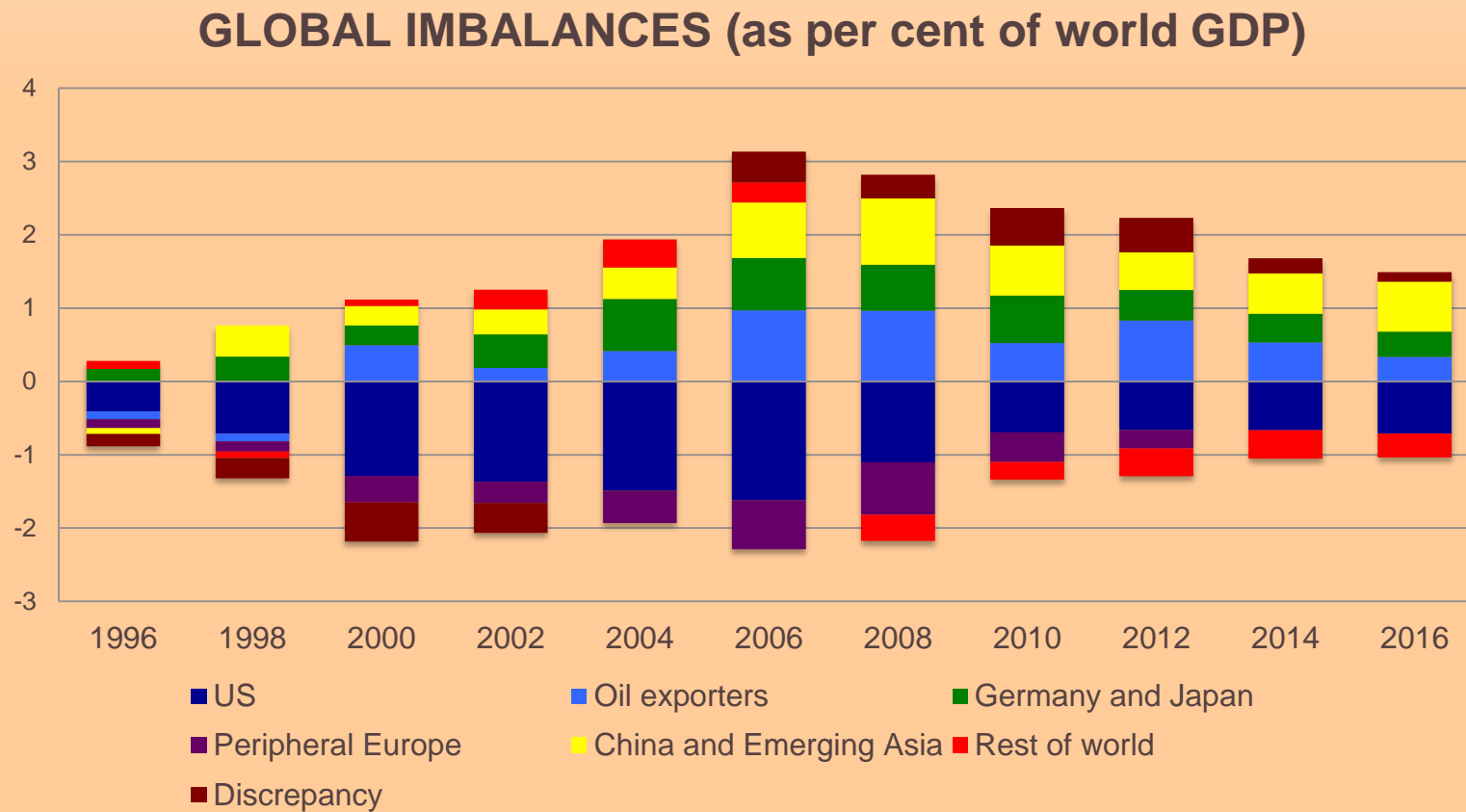
SLIDE INTO DEPRESSION RATES OF INTEREST

REAL HOUSE PRICES AND REAL INDEX-LINKED YIELDS



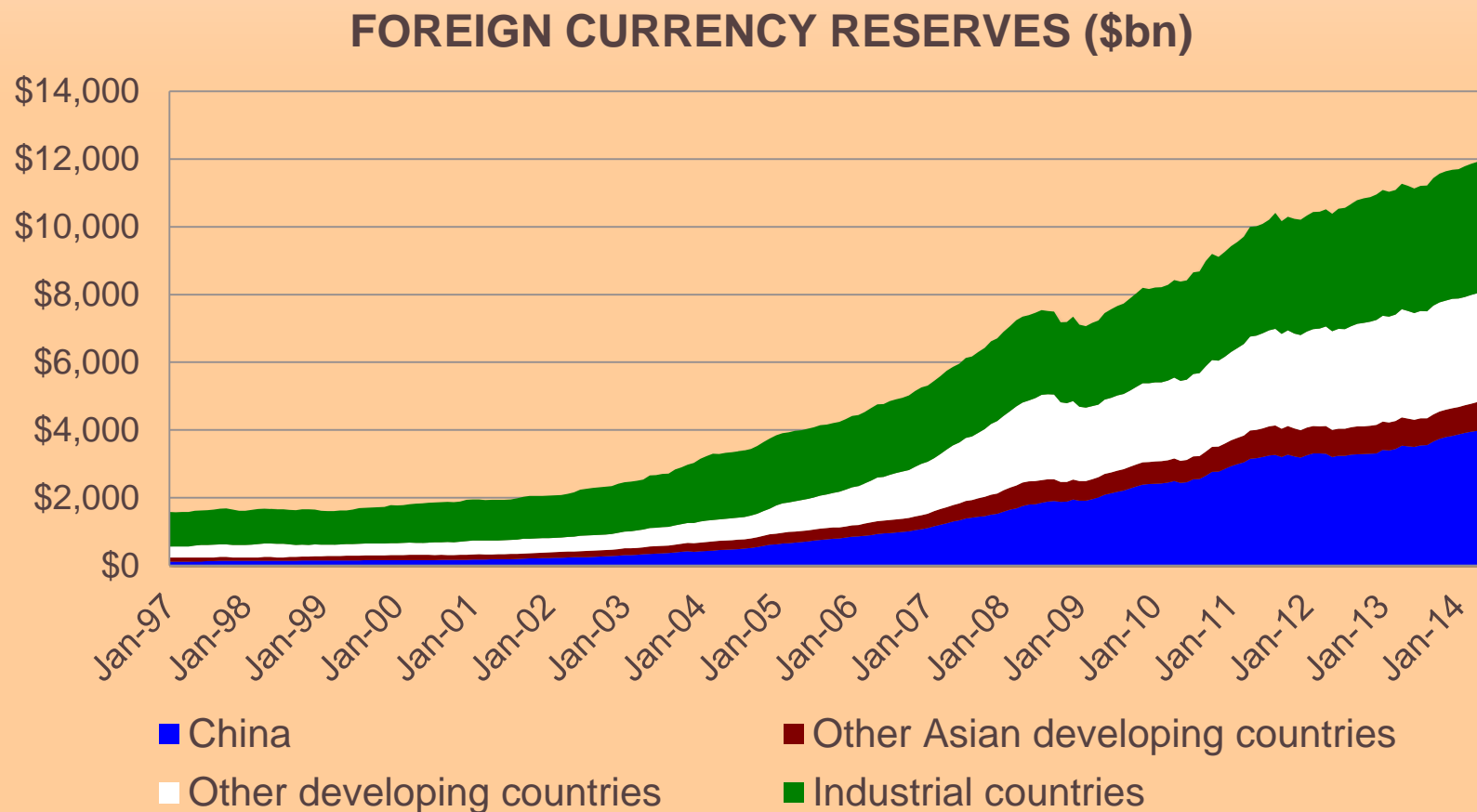
2. What happened

WHERE EXCESS SAVINGS CAME FROM



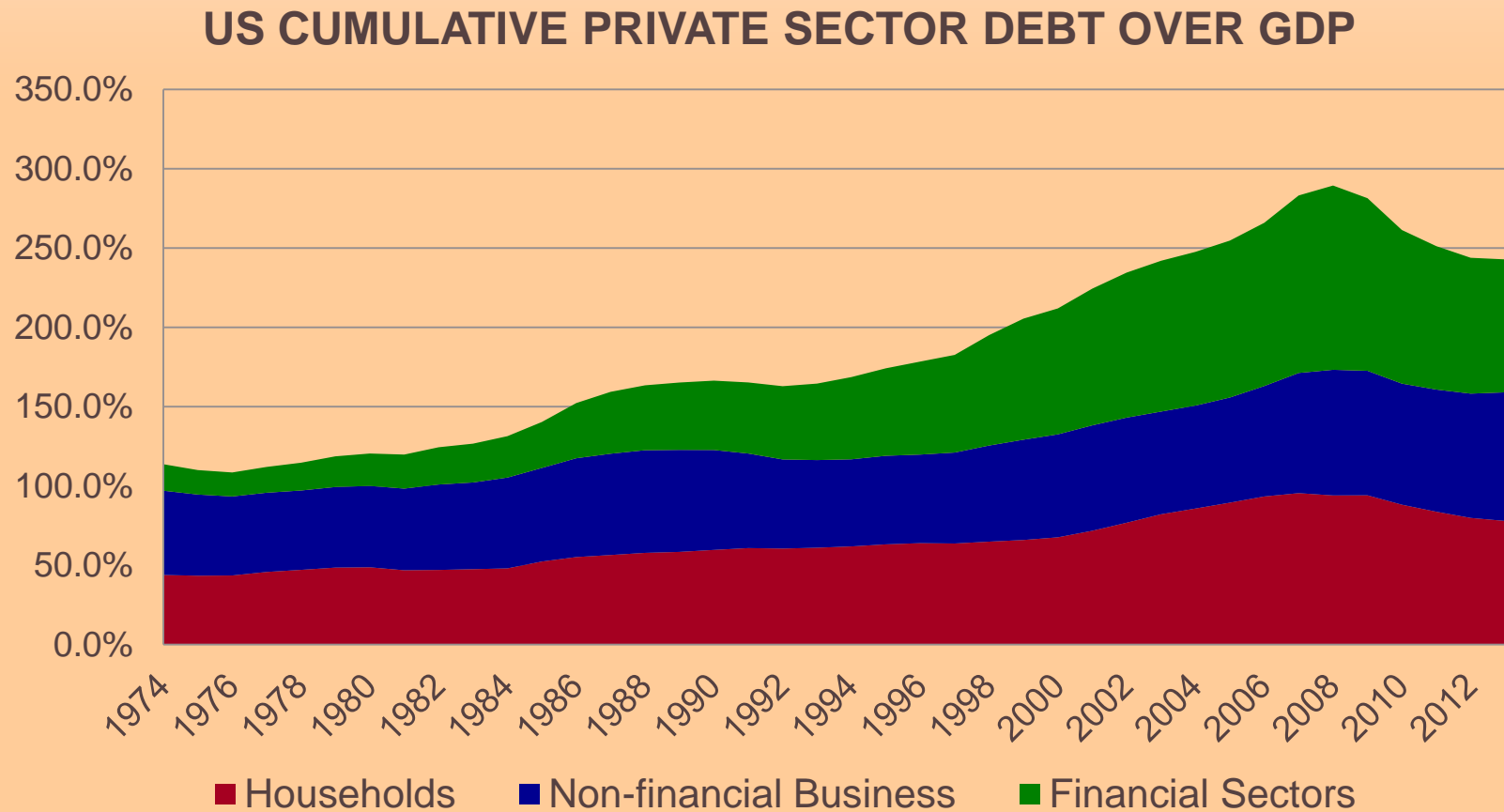
2. What happened

THE ROLE OF GOVERNMENTS



2. What happened

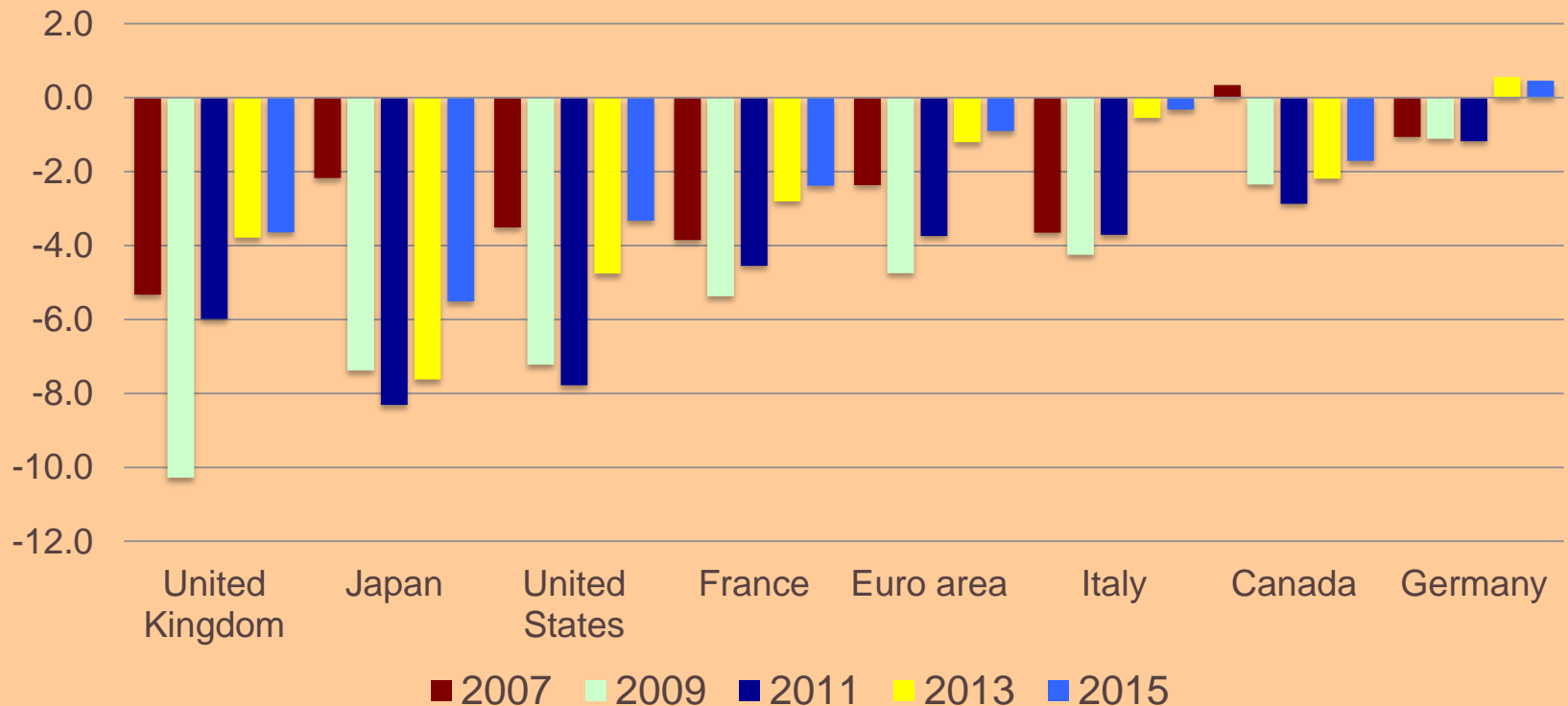
THE TRAP OF LEVERAGE



2. What happened

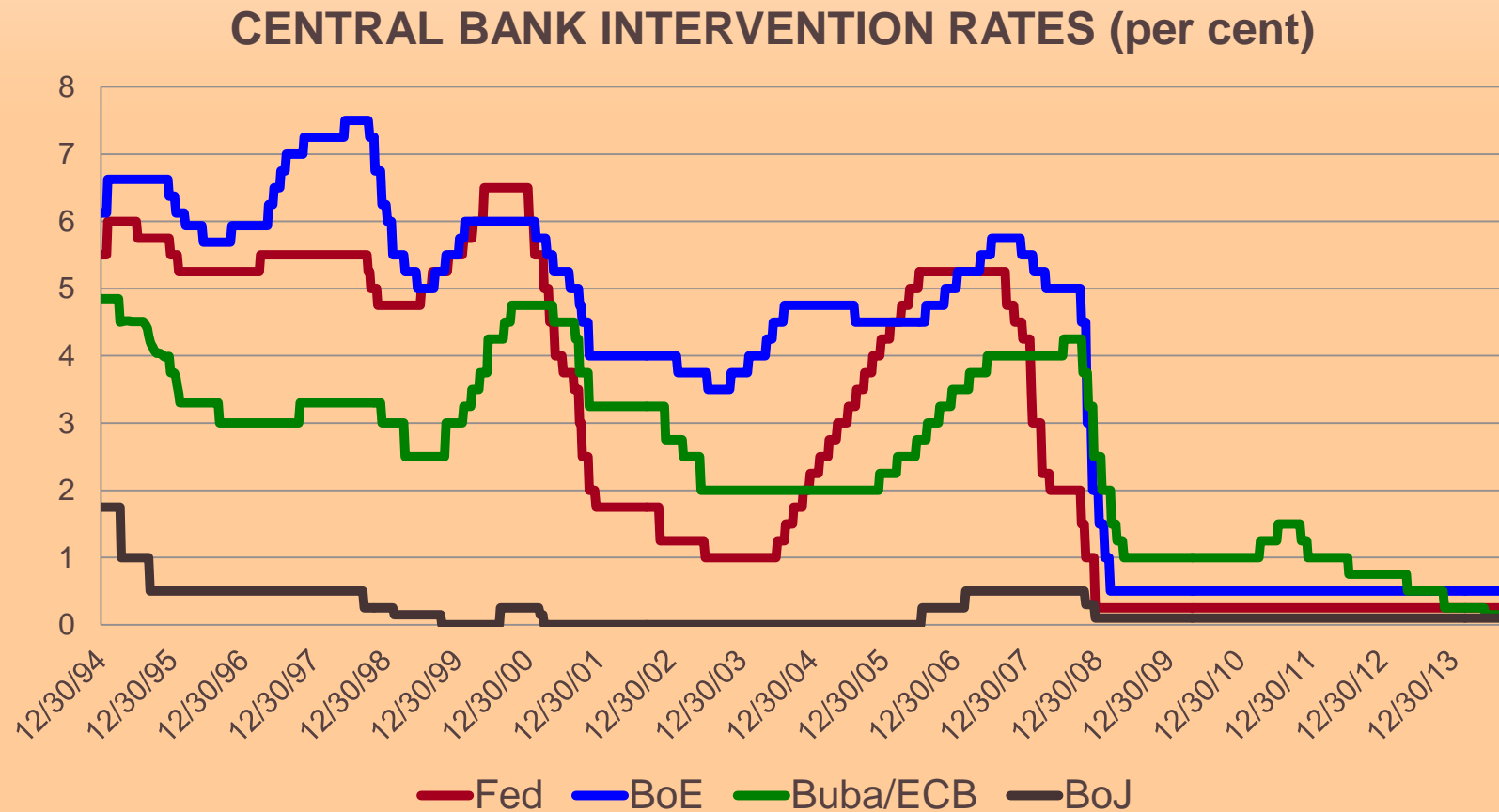
THE MOVE INTO FISCAL AUSTERITY

CYCLICALLY-ADJUSTED FISCAL DEFICIT
(as per cent of potential GDP) (Source: IMF)



2. What happened

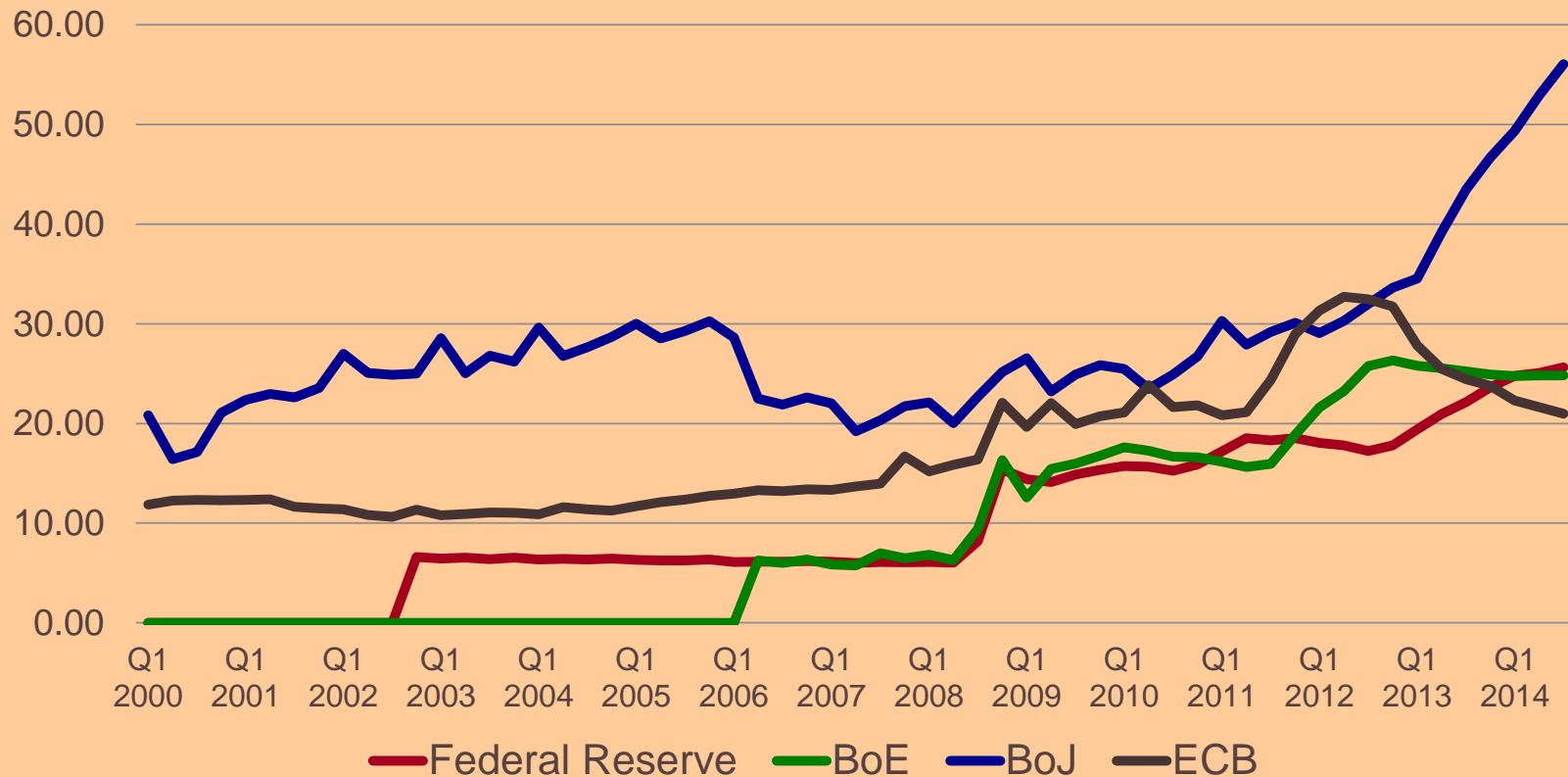
RATES AS LOW AS THEY WILL GO



2. What happened

CENTRAL BANK BALANCE-SHEET EXPANSION

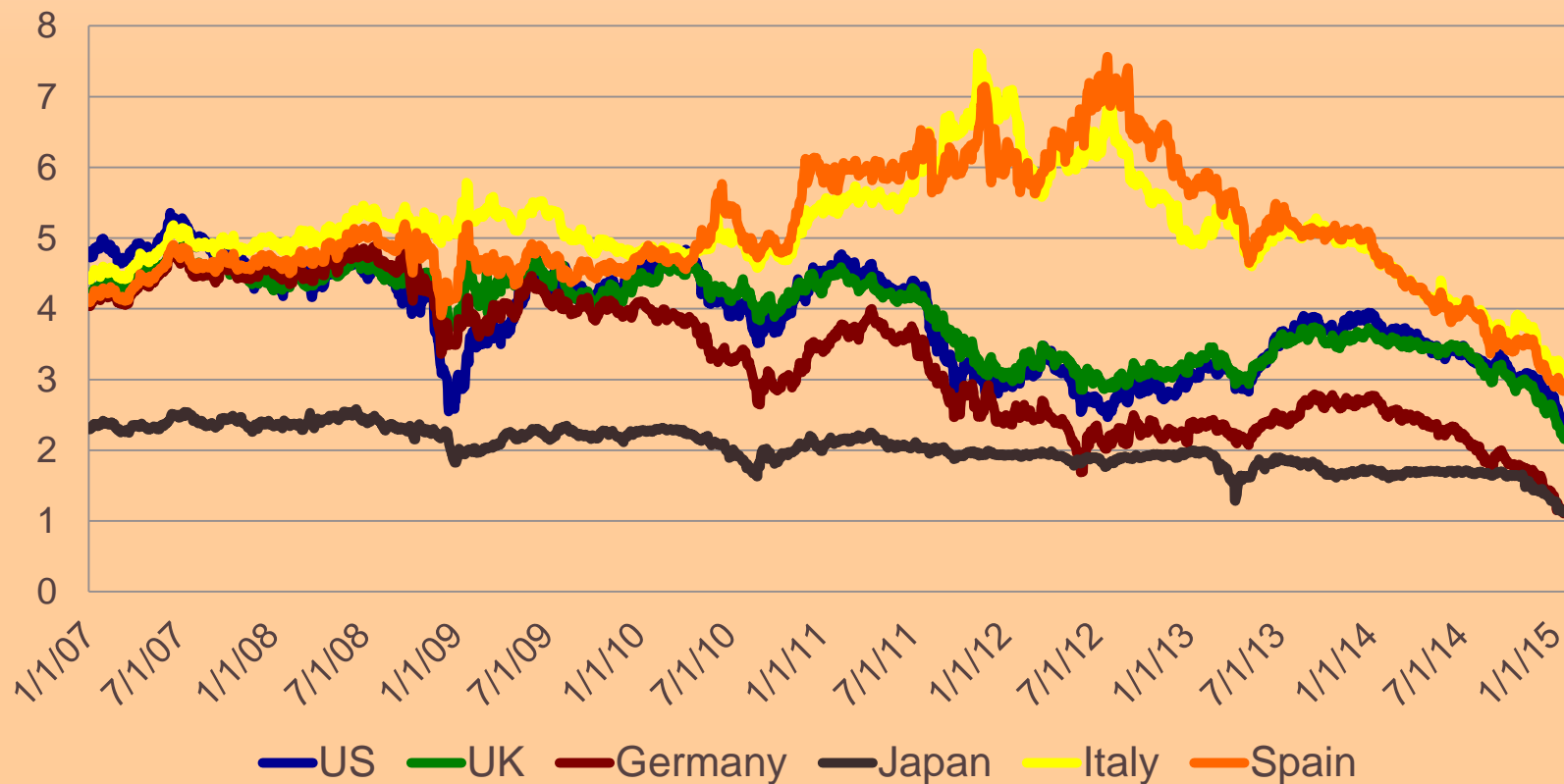
CENTRAL BANK ASSETS OVER GDP



2. What happened

EUROZONE BECOMES JAPAN

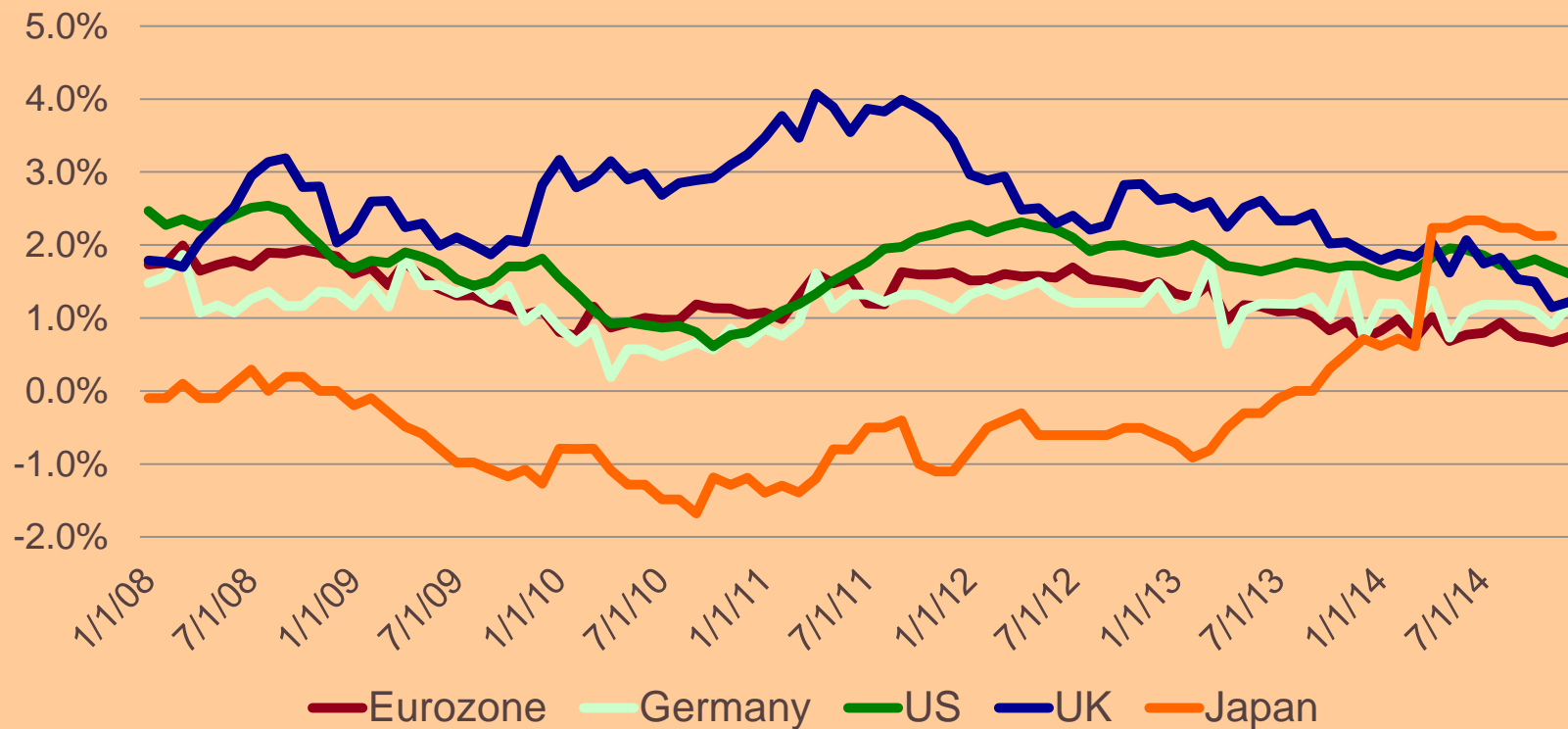
YIELDS ON 30-YEAR GOVERNMENT BONDS



2. What happened

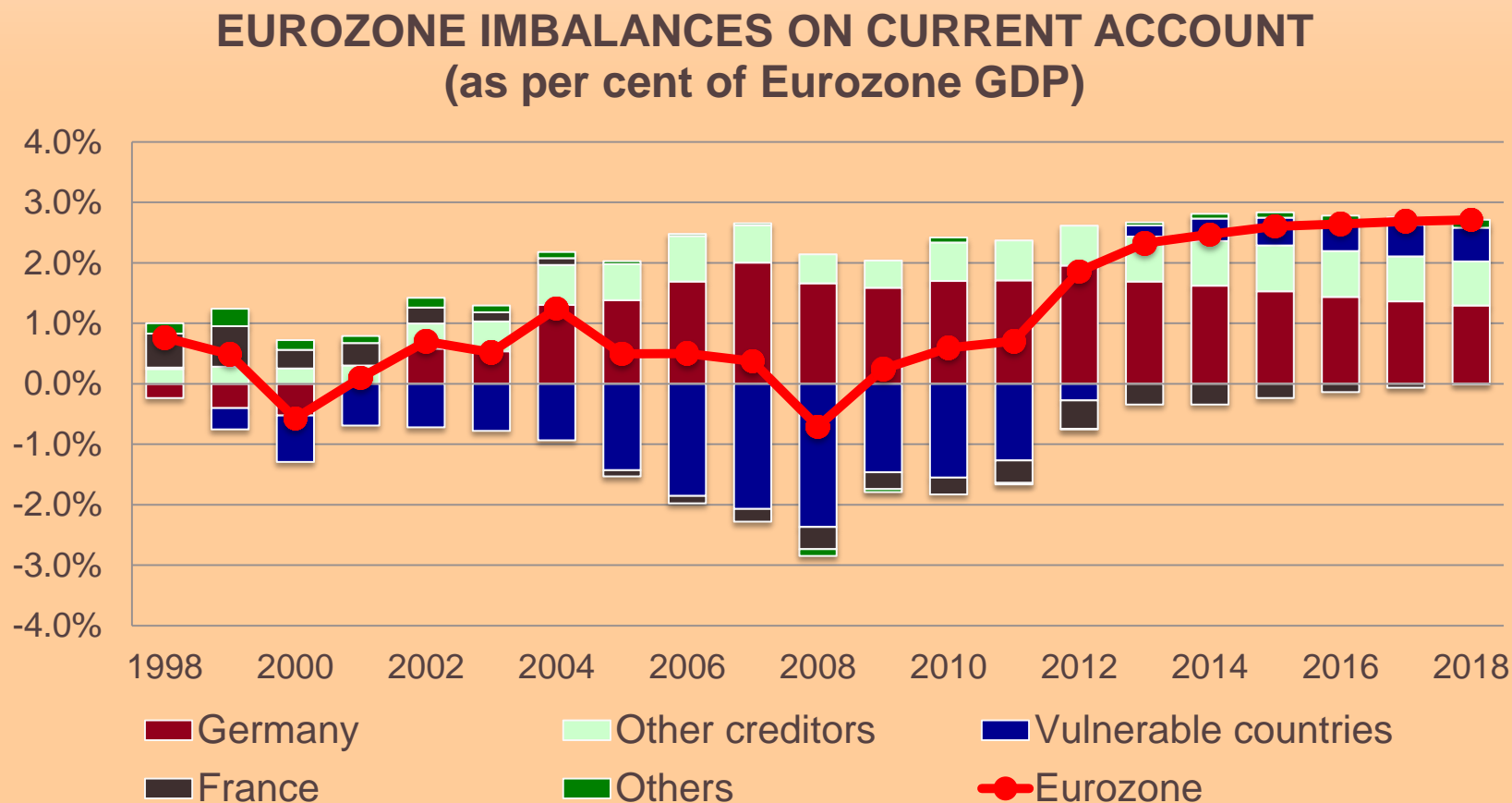
EUROZONE BECOMES JAPAN

CORE CONSUMER PRICE INFLATION
(excluding energy, food, alcohol and tobacco)



2. What happened

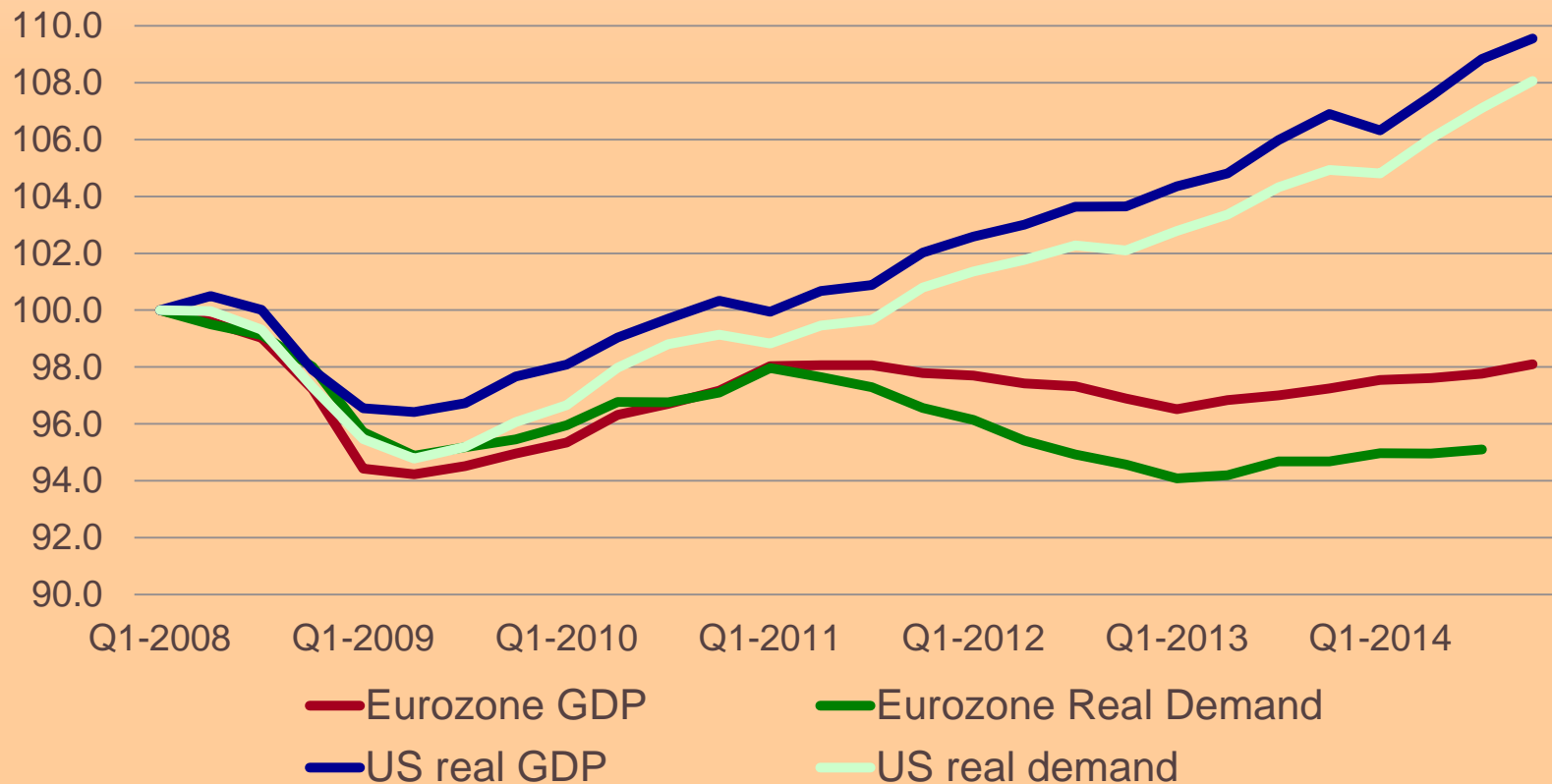
IMBALANCES AND REBALANCING



2. What happened

EUROZONE BECOMES JAPAN

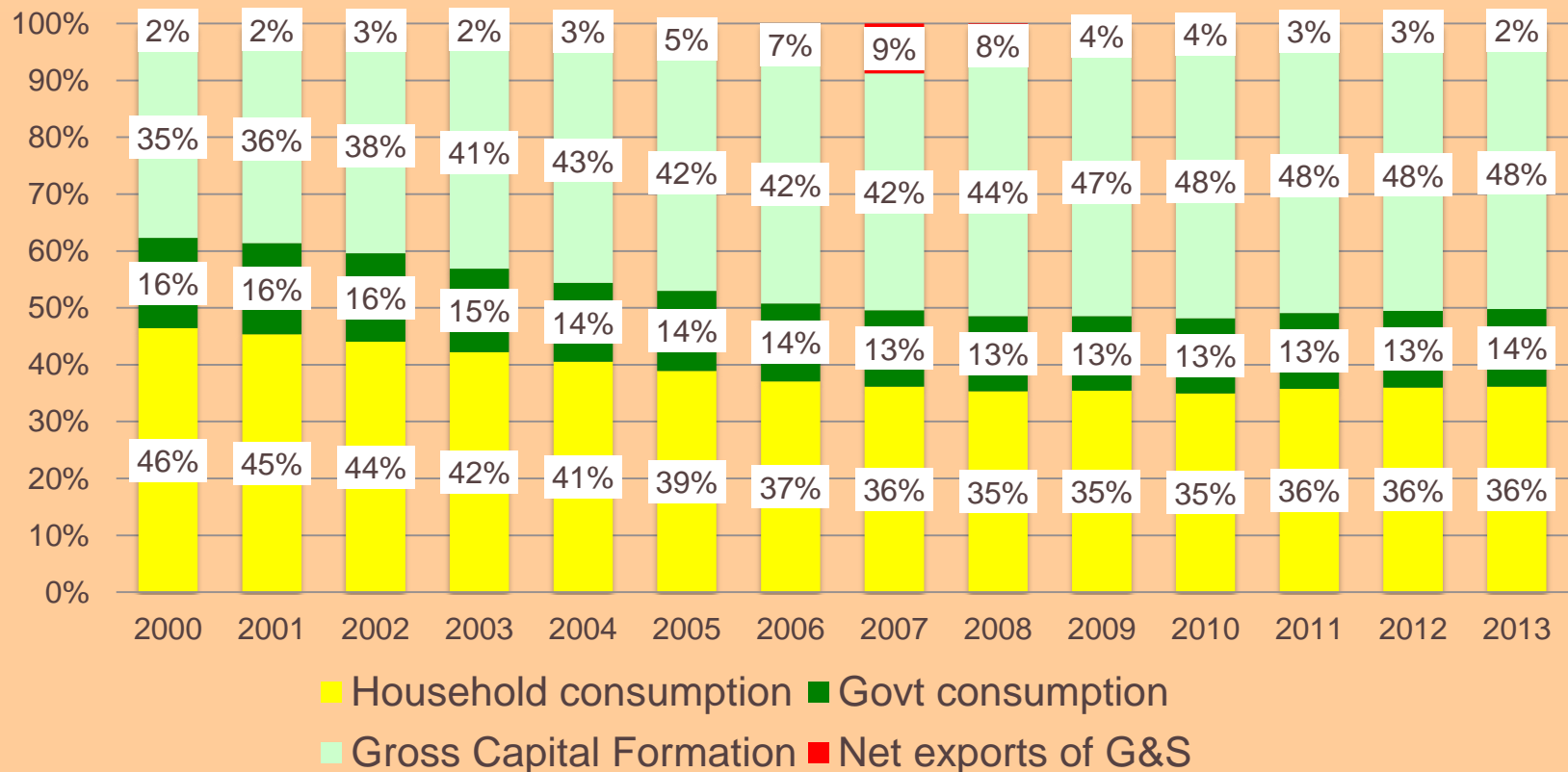
REAL GDP AND REAL DEMAND



2. What happened

THE UNBALANCED ECONOMY

SHARES OF EXPENDITURE IN CHINA'S GDP (per cent)



2. What happened

- What explains the “secular stagnation”?
 - Pre-crisis trends were to a degree unsustainable;
 - The crisis bequeathed a big debt overhang;
 - The crisis damaged credit and so the economy; and
 - Policy-makers adopted bad post-crisis policies, especially in the eurozone with too little fiscal support.
- Behind what has happened appears to be a “law of the conservation of bubbles”
 - The world economy only works well if there is a big bubble somewhere.
 - Why?

3. What is to be done

- Challenges: Restoring growth; stabilising finance; and rebalancing the world economy.
- Restoring Growth:
 - Stronger demand:
 - Ideally, via higher public investment;
 - Better co-operation between monetary and fiscal policy; and even
 - “Helicopter money”.

3. What is to be done

- Debt restructuring:
 - More capital in banks; and then
 - Debt write-offs and write-downs.
- Encouraging supply:
 - Structural reform for growth;
 - Financial reform for growth; and
 - Tax reform for growth.

3. What is to be done

- Stronger demand in the eurozone:
 - The “greater Germany” strategy is failing;
 - Eurozone needs to be an “adjustment union”;
 - Inflation in Germany should be 4 per cent; and
 - Debt restructuring is particularly important in the eurozone
- None of this is going to be easy:
 - Flow problem: if the eurozone and Japan choose external imbalance (beggar-my-neighbour policies) then other countries must accept external imbalances.

3. What is to be done

- Stabilising finance:
 - Much more capital in banks;
 - Radical deleveraging of economies with elimination of favourable treatment of debt;
 - Equity-sharing contracts; and
 - Experiments with 100 per cent reserve banking and state-created money.

3. What is to be done

- Global rebalancing:
 - Better insurance for developing country deficits;
 - More cross-border equity flows; and
 - Global monetary reform.

4. Conclusion

- This has been a major disaster, by any standards.
- It was caused by the interaction between macroeconomic forces and financial fragility.
- We need to make the global macro-economy better balanced.
- And finance far less fragile.