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Risk, insurance and stabilization

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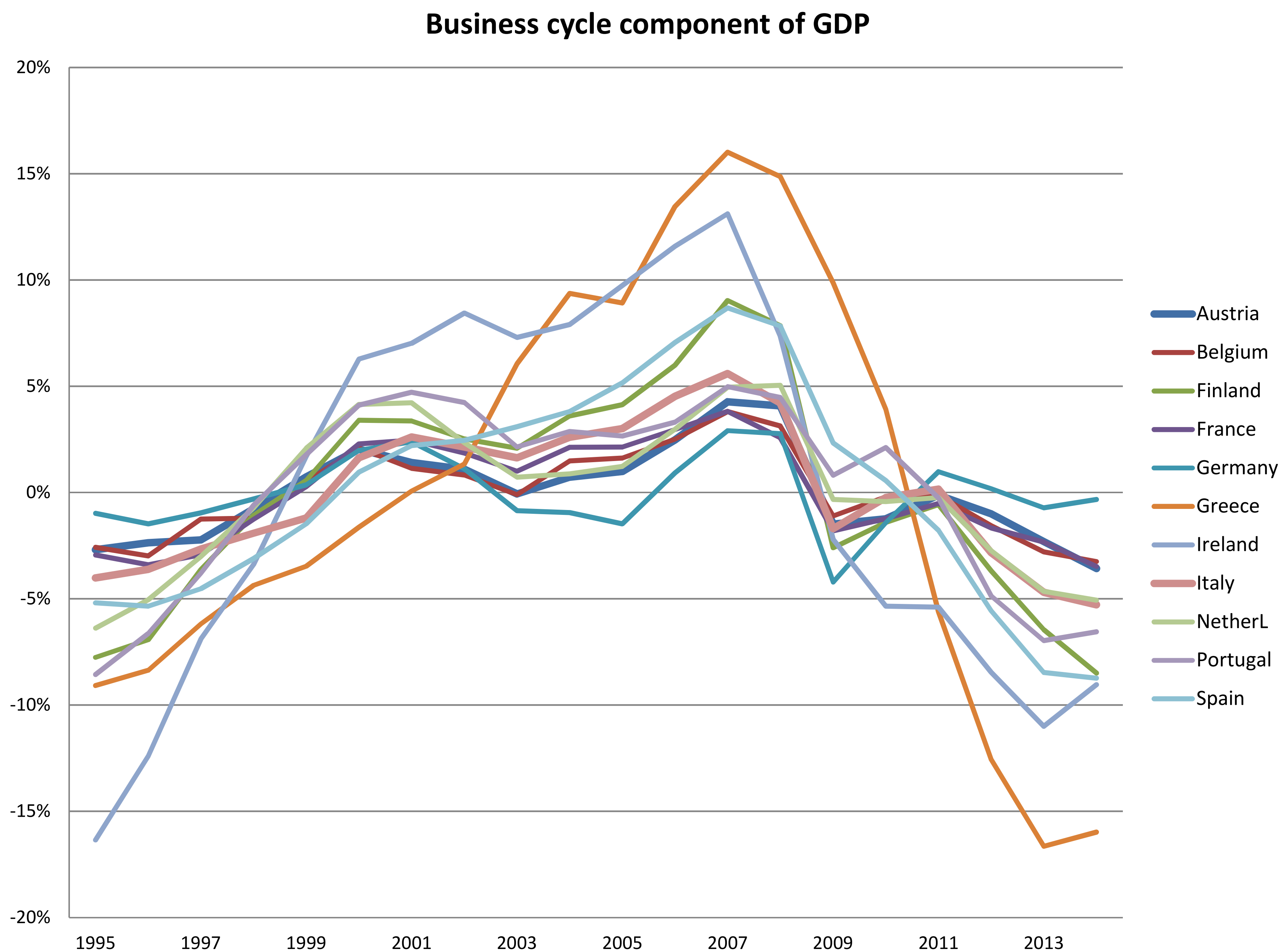

Business cycle component of GDP
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
NetherL
Portugal
Spain

Booms and busts in the Eurozone

- These were strongly synchronized in Eurozone
- Asymmetry was in the amplitude of the booms and busts
  - Some countries (Ireland, Greece, Spain) experiencing wild swings
  - While others (Germany, France, Netherlands, Belgium) experiencing mild swings

- Monetary union had great difficulties in dealing with the asymmetric occurrence of these boom-bust scenarios, for two reasons.
  - Build-up of large divergences in competitive positions and external imbalances during boom phase
  - Instability in government bond markets during downswing

Major risks: sudden stops

- Fragility of government bond markets in the absence of a backstop (central bank)
- Destabilizing capital flows during downturns
- **Tail risks**

Role of financial markets

- Financial markets do not provide insurance against tail risks
- They are very efficient in insuring against normally distributed risks
- When tail risks occur, financial markets panic and amplify the risks
- Capital markets union
  - might be good for efficiency
  - but will do nothing to deal with tail risks

Public insurance

- Tail risks can only be insured by governments
- Who are they in a monetary union?
  - National governments cannot do it because when subject to sudden stops they lose all capacity to insure
- The ECB:
  - Insures against liquidity risks (OMT)
  - It has attached stiff conditionality to its use, handicapping its use in the future
  - Credibility of ECB to use this in the future is weak

Recent proposals

- E.g. Common unemployment insurance
- Cannot deal with tail risks as it is too small
- BUT can be seen as first step towards budgetary union
- Budgetary union (including consolidation of national public debts) is the only mechanism that can deal with tail risk

- Insurance literature: very much influenced by modern macroeconomics (DSGE)
  – Shocks are exogenous
  – One cannot do anything about it
  – Only insurance can help to mitigate and spread the pain

- Reality is different
- Booms and busts are endemic in capitalism
- These are produced by endogenous movements in “animal spirits”
- Nothing to do with exogenous shocks
- Not only insurance matters
- But also stabilization

- The major conundrum of Eurozone:
  - Capacity of national governments to stabilize has very much been eroded
  - without creating capacity to create stabilization mechanism at the level of Eurozone
  - Only ECB has some capacity to do so
  - But this puts too much burden on the ECB
- To survive Eurozone will have to set up stabilization mechanisms