



**The shifts and the shocks:
lessons of the financial crisis**
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Birmingham

The shifts and the shocks

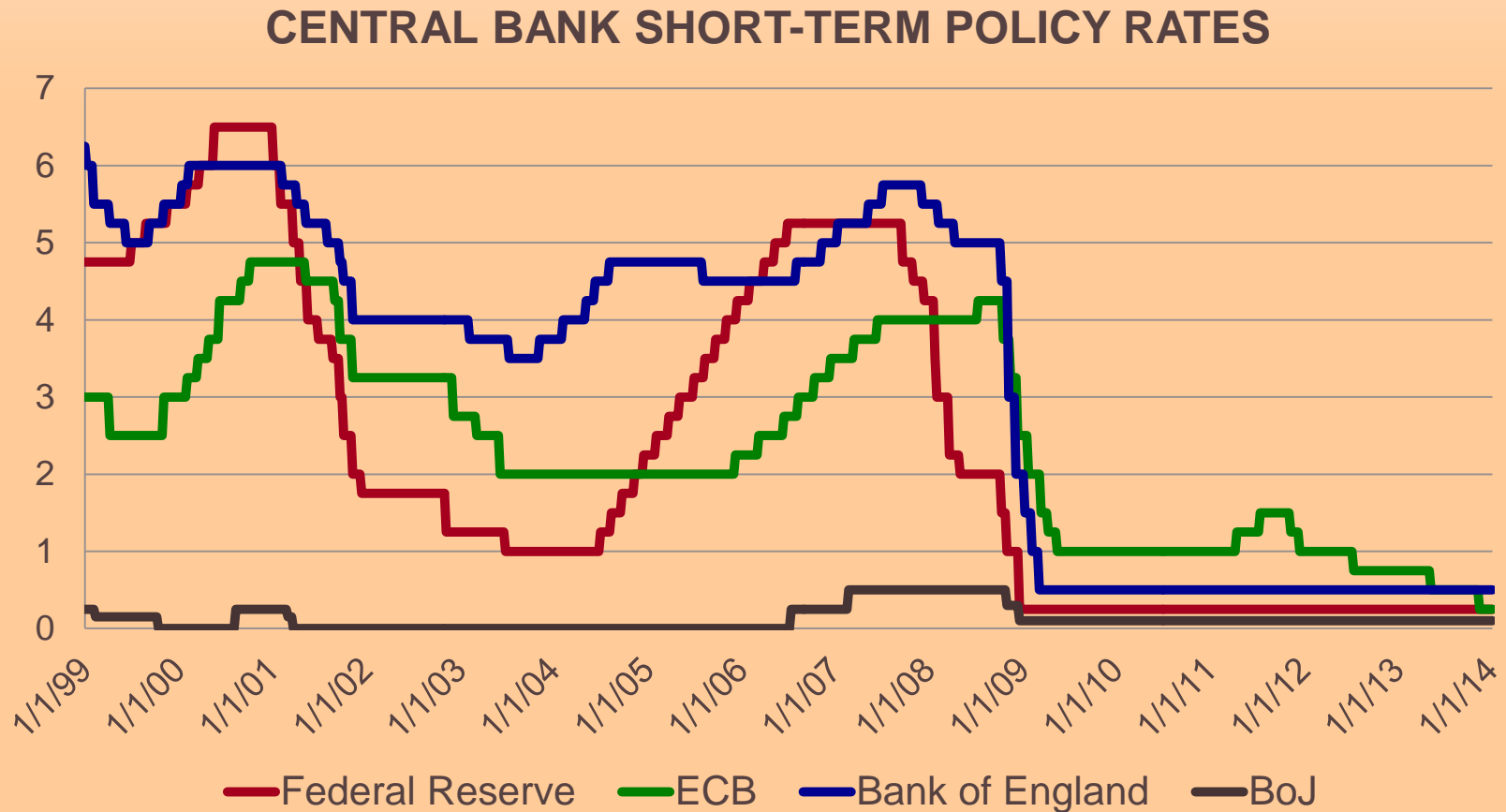
- In this lecture, I intend to address the following four issues:
 - Where we are.
 - How we got here.
 - What we should learn.

1. Where we are

- The high-income countries have *not* recovered.
- Output is far below trend.
- In most cases, output is even below the pre-crisis peak.
- This is the case even though we have had the most stimulative monetary policies in history.
- I call this a “contained depression”.

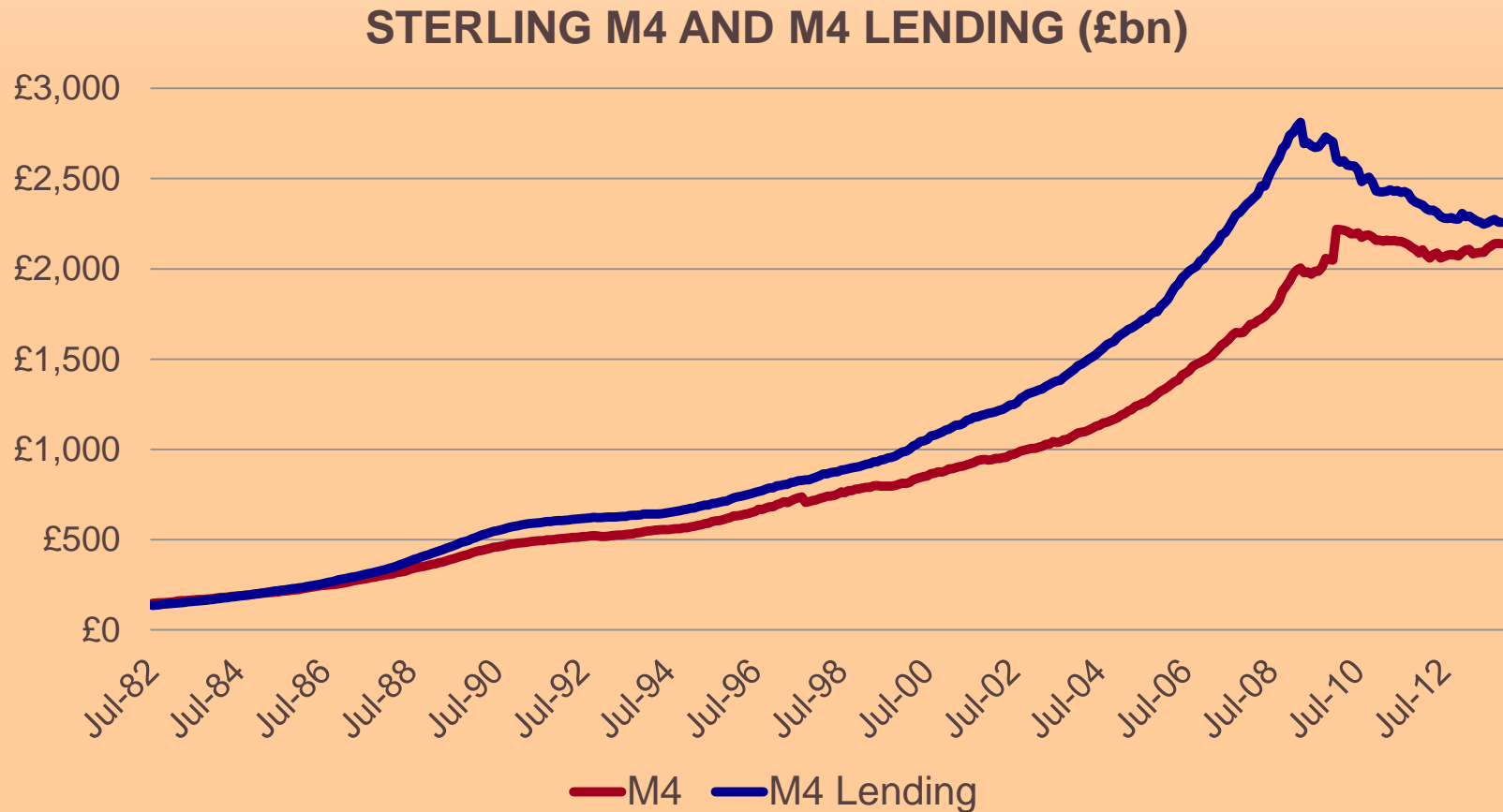
1. Where we are – monetary policy

A WORLD OF FREE MONEY



1. Where we are – credit

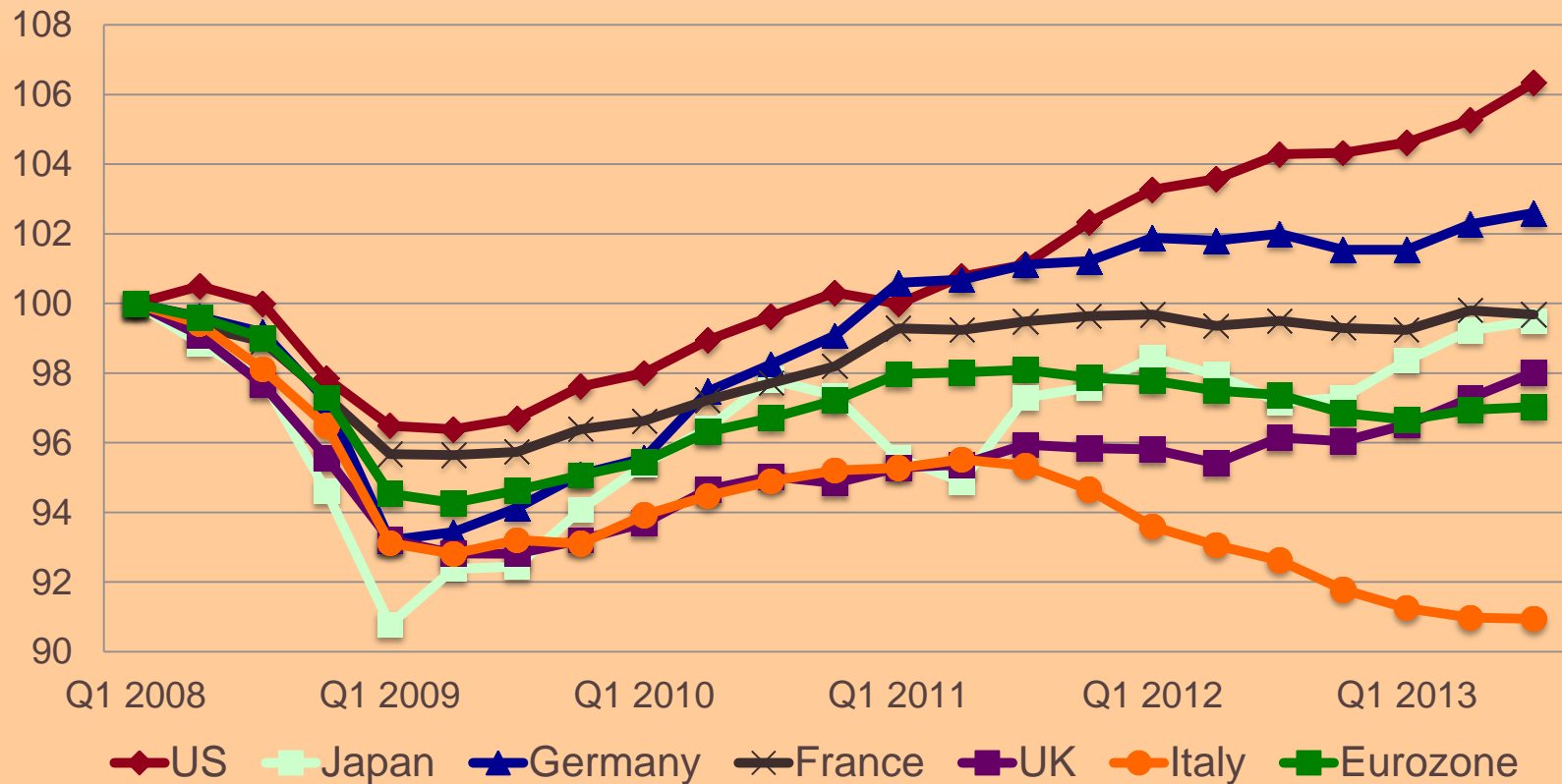
CREDIT ENGINE REVERSED



1. Where we are – the slump

THE LONG RECESSION

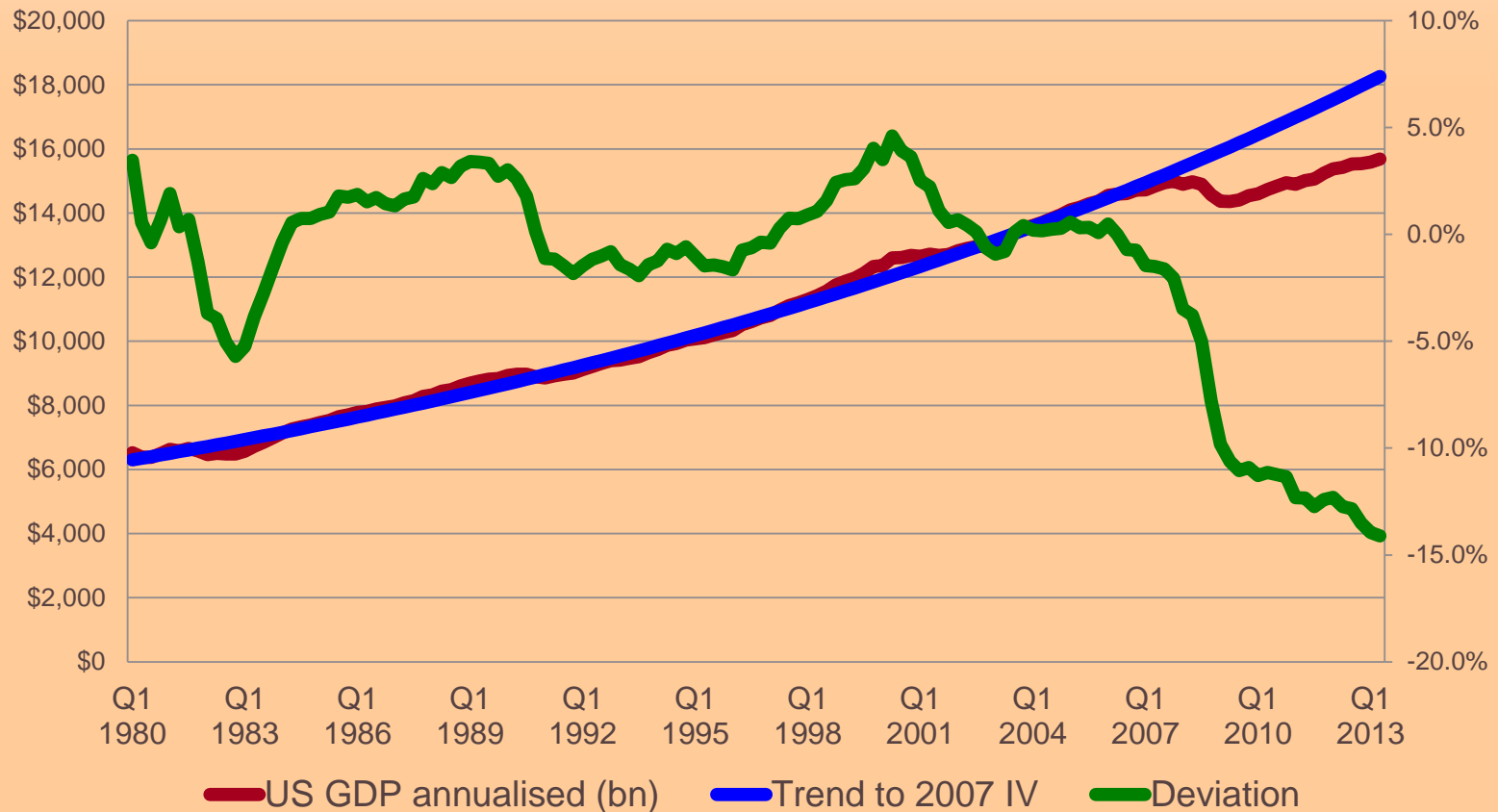
REAL GDP SINCE THE CRISIS



1. Where we are – the slump

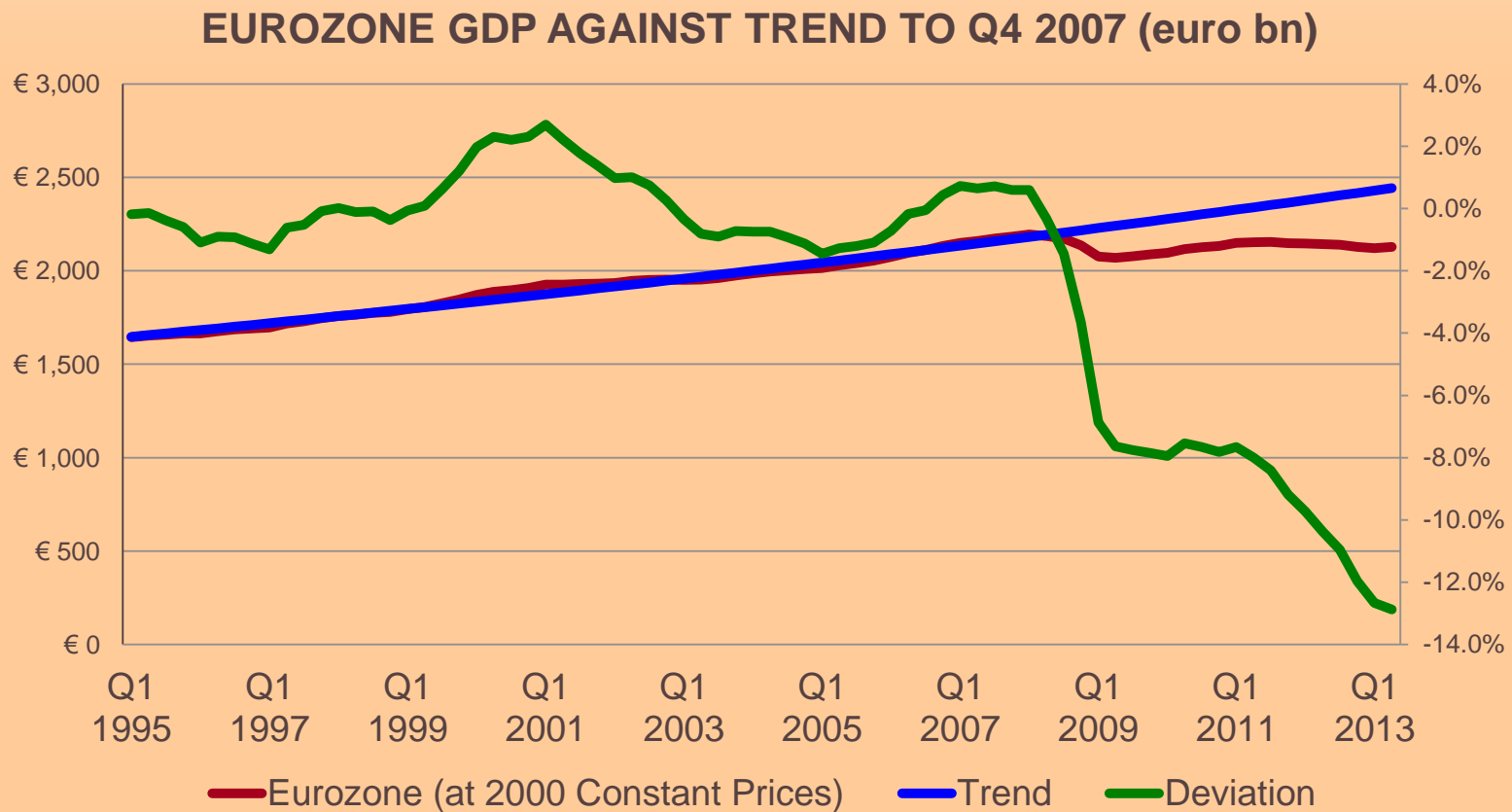
THE LONG SLUMP

US GDP AGAINST TREND TO 2007 IV (\$bn)



1. Where we are – the slump

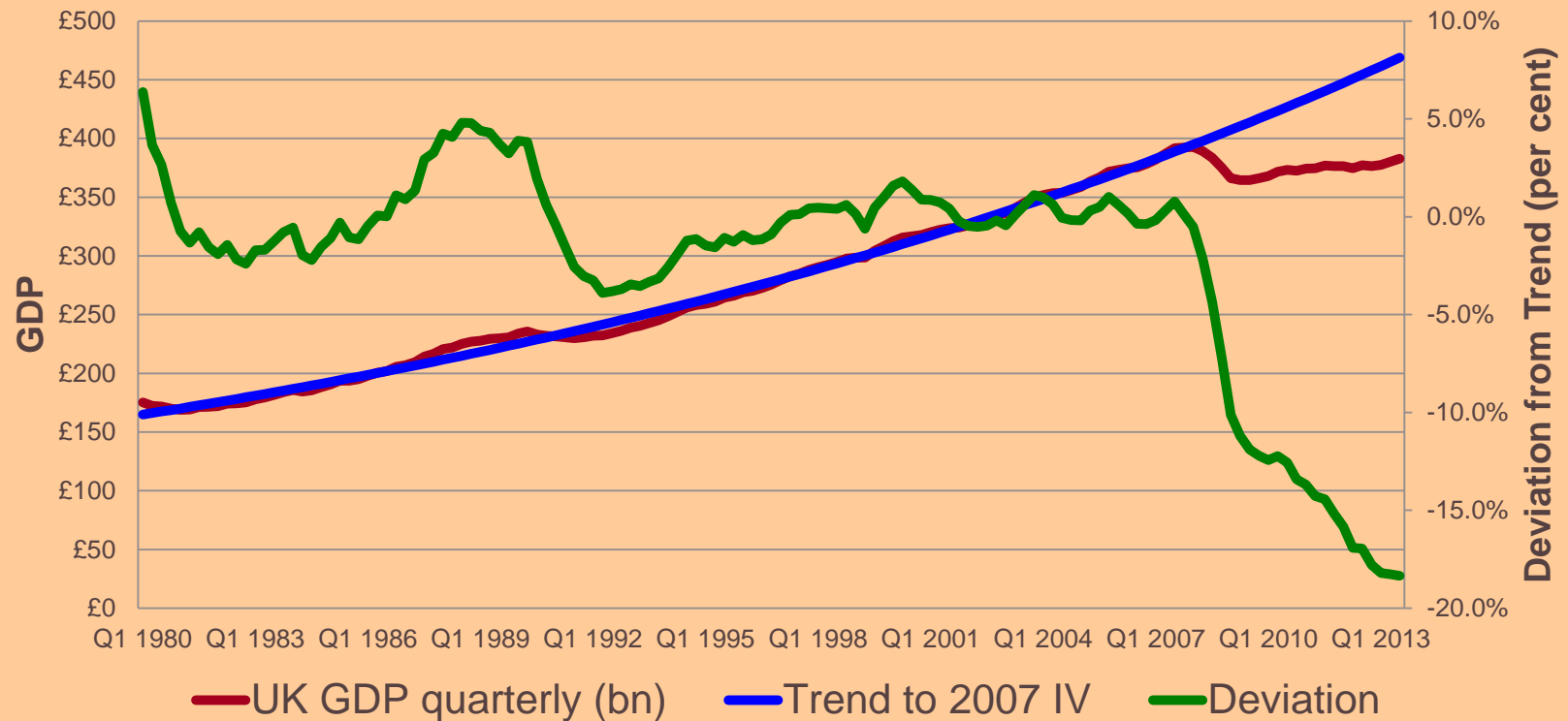
THE LONG SLUMP



1. Where we are – the slump

THE LONG SLUMP

UK CONSTANT PRICE GDP (£bn):
ACTUAL AGAINST TREND TO 2007 CONTINUED



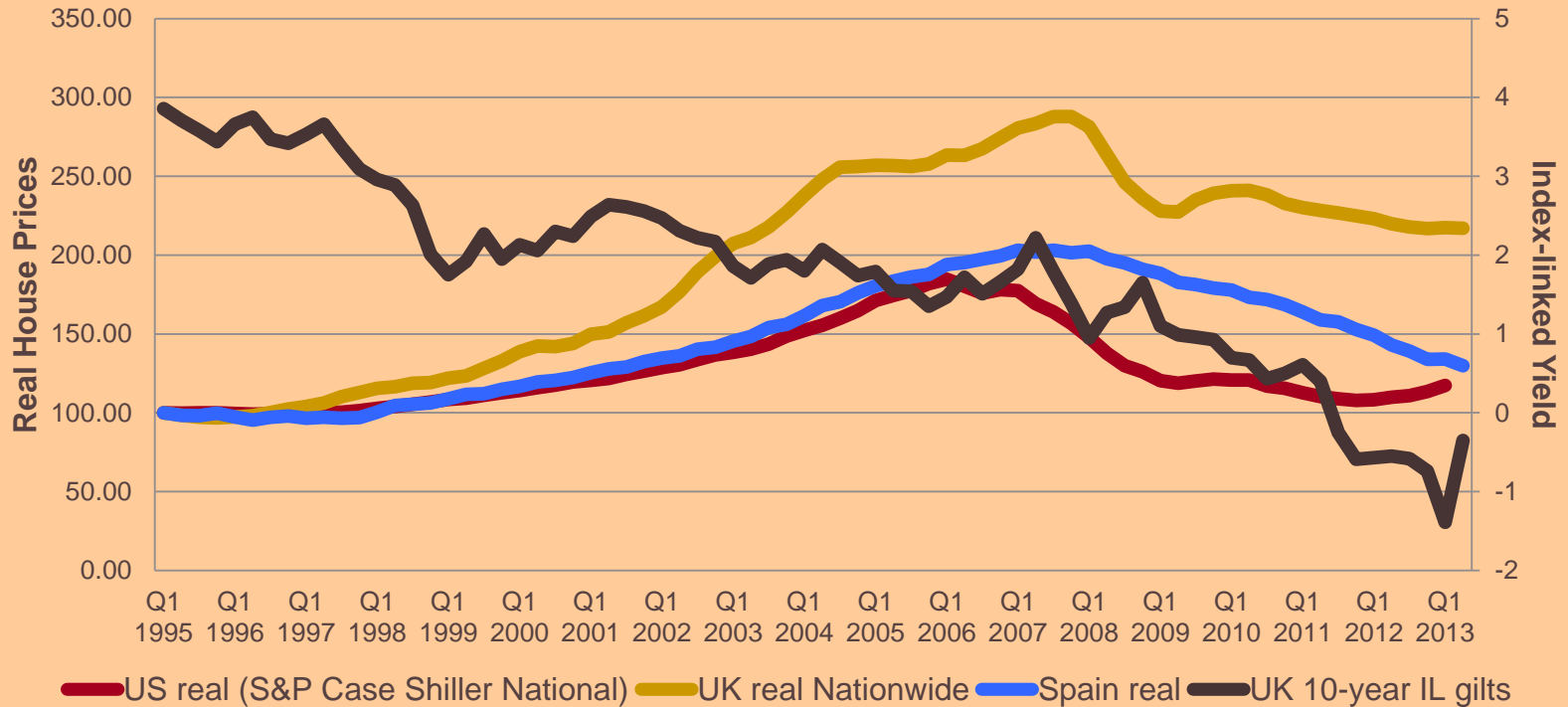
2. How we got here

- The crisis is the result of a complex interaction between two forces:
 - A global saving glut; and
 - A fragile financial system
- When the “Minsky moment” came in 2007-08, the results were:
 - A huge financial crisis;
 - State-backing of the core financial system; and
 - Hyper-aggressive monetary and fiscal policies.

2. How we got here – asset bubbles

BEGINNING AND END OF HOUSING BUBBLES

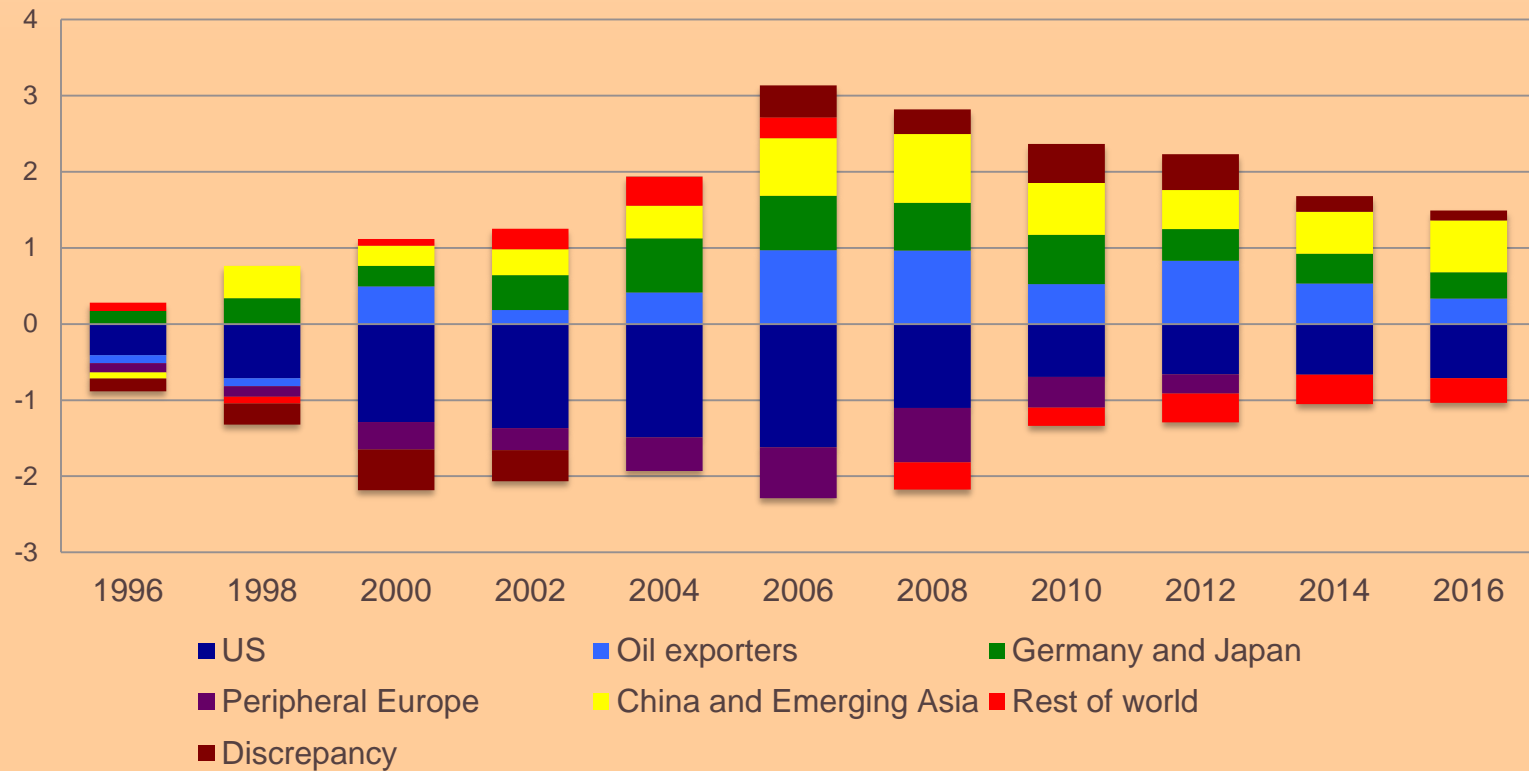
REAL HOUSE PRICES AND REAL INDEX-LINKED YIELDS



2. How we got here – global imbalances

WHERE EXCESS SAVINGS CAME FROM

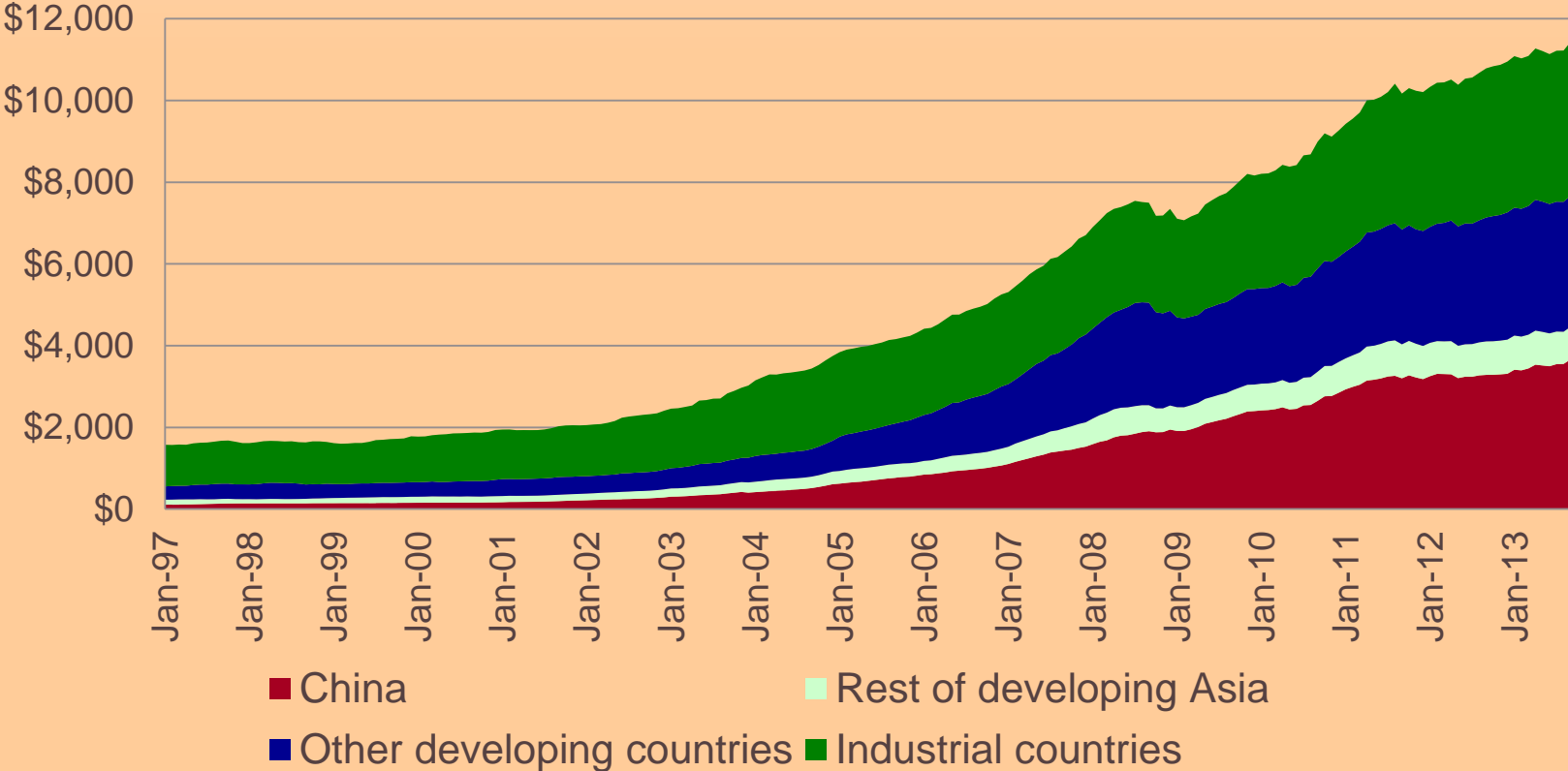
GLOBAL IMBALANCES (as per cent of world GDP)



2. How we got here – global reserves

THE ROLE OF GOVERNMENTS

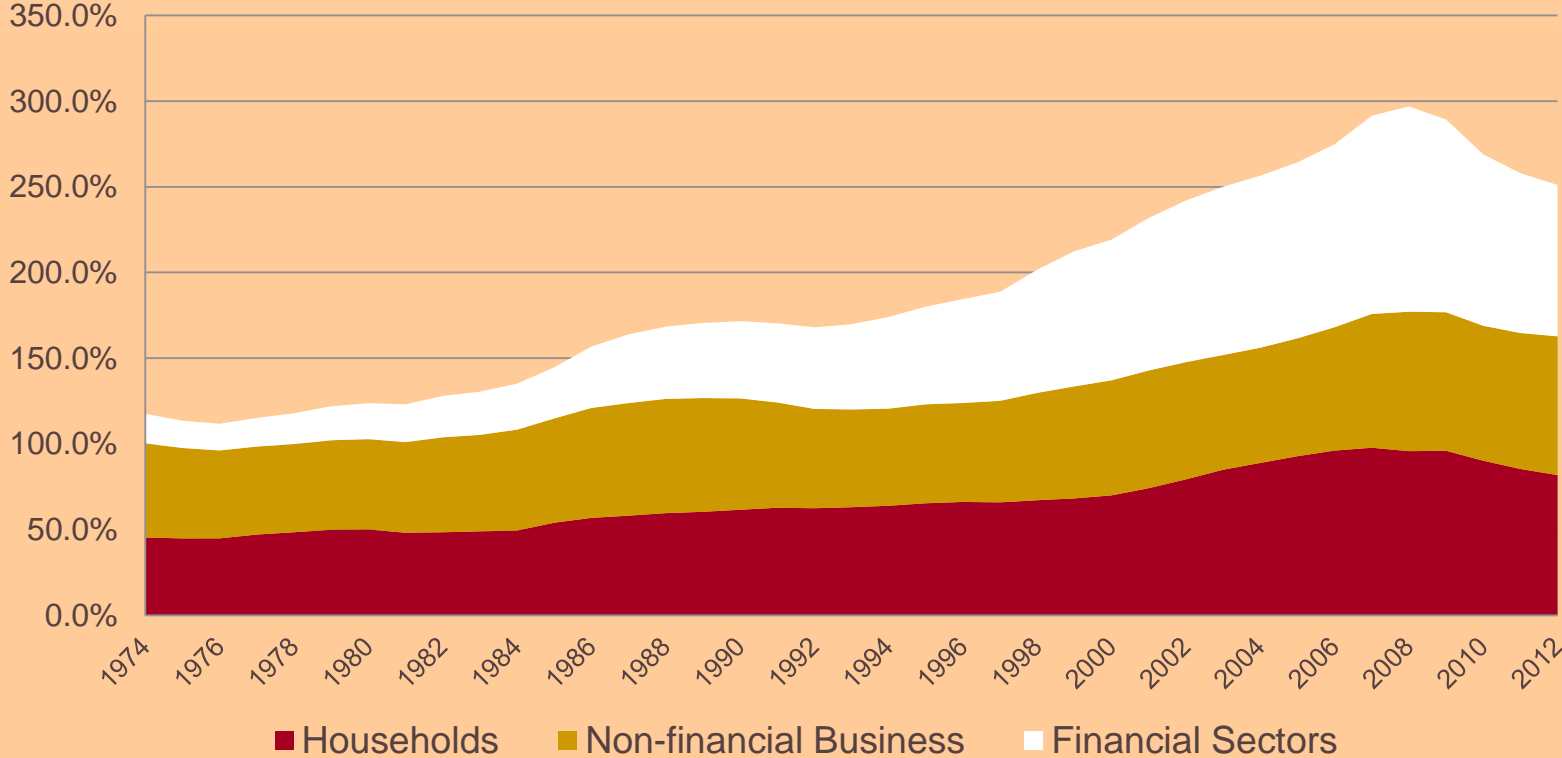
FOREIGN CURRENCY RESERVES (\$bn)



2. How we got here – debt

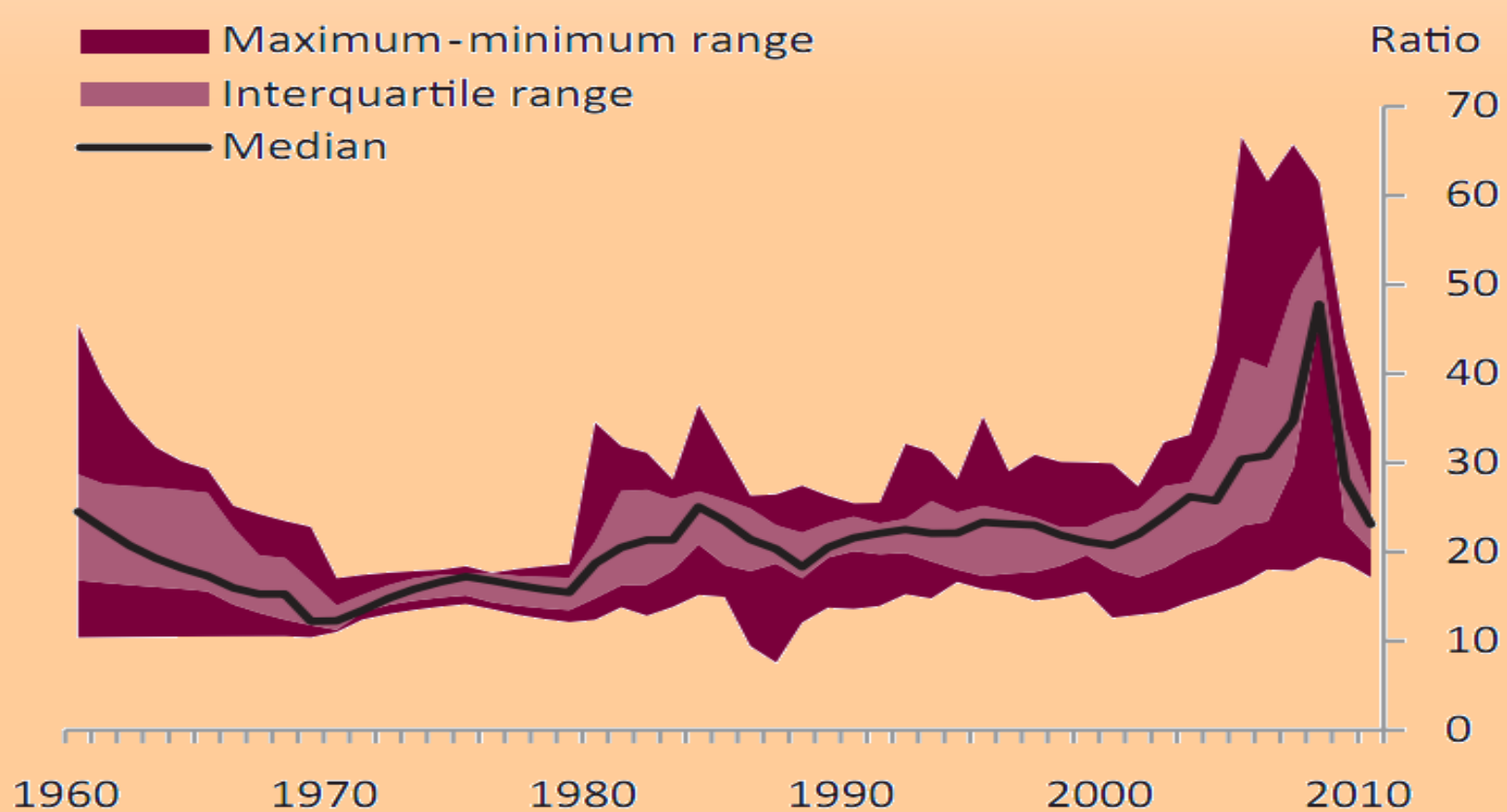
THE RISE OF THE LEVERAGED ECONOMY

US CUMULATIVE PRIVATE SECTOR DEBT OVER GDP



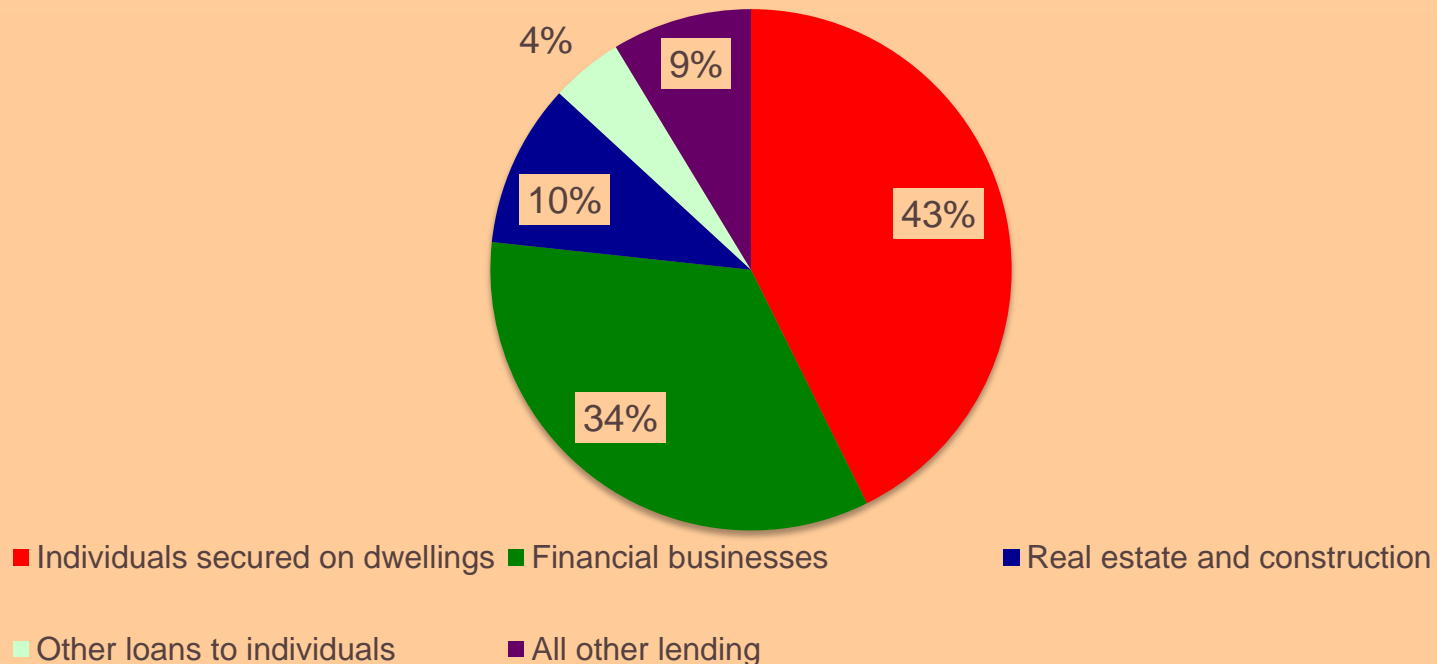
2. How we got here – financial leverage

LEVERAGE IN PRE-CRISIS UK BANKING



2. How we got here – financial leverage

LOANS FROM MONETARY FINANCIAL INSTITUTIONS TO UK RESIDENTS IN ALL CURRENCIES (August 2013, £m)



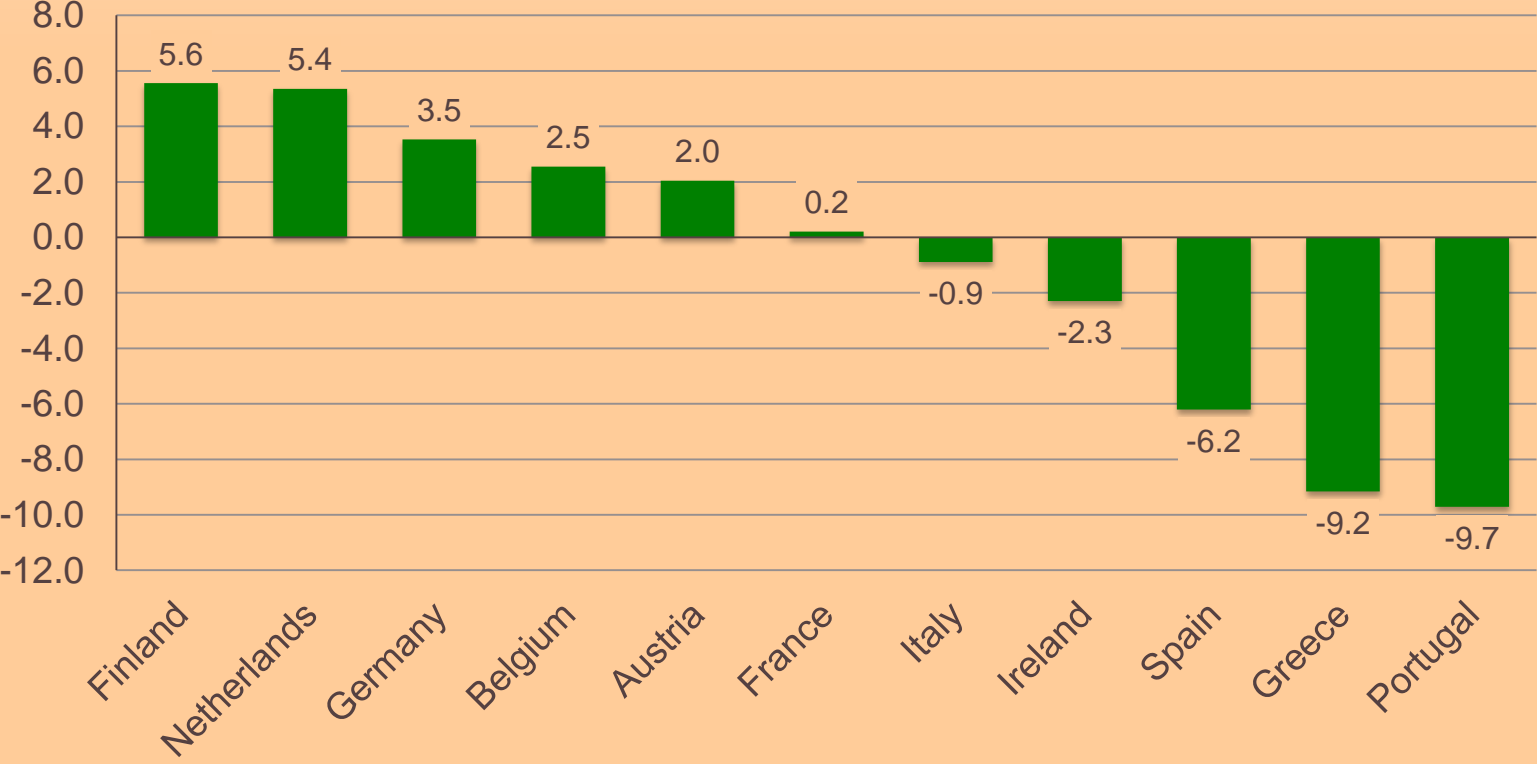
2. How we got here – eurozone

- The core of the eurozone financial crisis is *not* fiscal
- The fiscal crisis is more a symptom of the financial crisis than a cause of that crisis
- The crisis is largely the result of divergences accumulated in the years of excess: what made everything seem so good was in fact creating an acute long-term crisis
- External imbalances played a far bigger role than fiscal imbalances: it mattered less whether the private or public sectors were being financed than how big the external finance was

2. How we got here – eurozone imbalances

THE ROAD TO THE EUROZONE CRISES

AVERAGE CURRENT ACCOUNT BALANCES 2000-08



2. How we got here – eurozone debt

CRISIS-HIT COUNTRIES SUFFER



3. What we should learn

- First, the financial system is crisis prone:
 - We have allowed private institutions to serve a fundamental public function – the creation of money.
 - The result, in a fiat money system, in which bank reserves can be created without limit, is an explosive system.
 - The financial system is always part of the state. It is not fully private.
 - We need to make the financial system much more robust.
 - The three most important reforms are higher capital ratios and workable macro-prudential policies.

3. What we should learn

- Second, large current account imbalances (i.e. external imbalances) always suggest a crisis is on the way:
 - The concern over imbalances felt by Keynes at Bretton Woods remains valid.
 - But there is no mechanism to ensure global balance.
 - Indeed, the role of the dollar seems to make balance almost impossible to achieve.

3. What we should learn

- Third, we may be moving into secular stagnation in the high-income countries:
 - Weak demand in the private sector;
 - Slowing trend productivity growth;
 - Deteriorating demographics;
 - Debt overhangs; and
 - Financial repression.

3. What we should learn

- Fourth, management of the world economy has become more difficult as the economic and political weight of the West has declined.
 - We are in another period of difficult transition between hegemonic powers, as in the 1920s and 1930s.
 - The relationship between the US and China will be far more difficult than between the US and the UK.
 - China cannot be the hegemon of a global market economy.

3. What we should learn

- Fifth, the eurozone is a bad marriage, but divorce is very costly. Can it be made a good marriage?
- For that it needs:
 - Debt restructuring – debt overhangs are now large.
 - Financing – largely supplied by the European Central Bank
 - Adjustment – symmetrical adjustment of income and spending
 - Fundamental reform – a banking union and a minimum fiscal union.

4. Conclusion

- Here are my four main conclusions:
 - We are in a contained depression. It will not end until we have sustained growth at “normal” interest rates and without unsustainable debt build-ups. We are nowhere near that.
 - We got here because of the interaction of macroeconomic imbalances with a profoundly unstable financial system.
 - It is not clear what sort of “normal” the high-income countries can get back to. That will, in turn, determine how the post-crisis debt overhang is handled and where we end up.
 - We need to learn some big lessons about how to understand and handle our economies and financial systems, including not least in the eurozone.