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Cross-border equity ownership is key to eurozone risk-sharing

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According to the new "Brussels consensus", the only viable solution to lower the risk of balance of payments crises within EMU is by moving closer to fiscal union. There is little doubt that cross-country *ex ante* risk-sharing is required in a monetary union. But it would be ill-advised to rely on mutualisation mechanisms through fiscal transfers only, as opposed to market-based mechanisms. In large federations such as the US or Germany, the federal budget is neither the sole nor even the main channel of risk-sharing among states. Indeed, according to empirical studies, the largest absorber against state-specific shocks is cross-ownership of equity capital, far ahead of the federal tax-transfer system.

Advocating increased reliance on market-based risk sharing mechanisms could appear counterproductive since cross-border private financial flows have exacerbated the boom-bust in periphery economies. However, the eurozone has been suffering from "mal-integration": flows from the core to the periphery took quasi-exclusively the form of debt, mostly inter-bank loans or bonds, as opposed to direct and equity investment. Paradoxically, equity capital has been flowing "uphill": over the past 12 years, Germany has been a net importer of equity capital from the rest of the eurozone.

As a complement to banking union, it is thus key to promote a genuine and complete financial integration by enhancing cross-border capital ownership of banks and corporates. In theory, this process should take place spontaneously though market mechanisms. In peripheral economies, the fall in share prices combined with the ongoing downward adjustment in unit labour costs should create attractive investment opportunities for core country companies and investors. In practice however, this process is hindered by many obstacles both in the periphery and in the core. Therefore, more centralised solutions combining private and public funds are necessary, at least as catalysts in the initial stage of this process.

First, the European official sector could help in restructuring the foreign liabilities of peripheral countries by a sort of debt-to-equity conversion. So far, financial assistance to member states was provided through loans, thus adding to their debt burden. As a result, a substantial share of the periphery government debt is now held by the official sector. Exchanging debt for equity would be an alternative to Official Sector Involvement, providing immediate and substantial relief to periphery states while being more acceptable by core states than "voluntary" debt haircuts. This could be done by establishing an agency in charge of purchasing, restructuring and privatizing state-owned assets. Owing to stronger expertise, political independence and a longer time span (10-15 years, thus preventing "fire sales" and giving time to restructure assets), this agency would be much more effective than existing national privatization schemes, which have so far achieved disappointing results.

Second, a greater share of the structural German external surplus should be recycled through direct and equity investment in the rest of the eurozone. By lending its excess savings to the other EMU members, Germany had been able to accumulate record-high current account surpluses without facing the risk of exchange rate appreciation and currency losses on foreign asset holdings. But the debt crisis has brutally reminded that credit risk replaces exchange rate risk within a monetary union. As a result, German private capital outflows have reversed, while deposits at the Bundesbank have surged. In other words, German excess savings are now primarily intermediated by the Eurosystem. There is no doubt that this form of recycling is suboptimal, including for Germany. On the one hand, German savers accumulate domestic bank deposits earning zero nominal return. But on the other hand, as taxpayers they remain exposed to peripheral credit risk. Wolfgang Schaüble, Germany's finance minister, said recently: "We *want to show that we are not just the world's best savers*". Recent bilateral arrangements with peripheral countries might be seen as a first step in this direction but KfW, the German state bank, will primarily provide loans instead of capital to small business. A more ambitious idea would be to create a German long term investment vehicle funded by both private and government savings (or benefiting from a government guarantee), and designed to take equity stakes in periphery economies. The involvement of government money would be key to entice risk-averse German savers.

Such asset property transfers would face major political obstacles, especially in the periphery. But bear in mind that hurdles to fiscal union would be much higher.