Fixing Global Finance

Martin Wolf, Associate Editor & Chief Economics Commentator, *Financial Times*

Leverhulme Centre for Research on Globalisation and Economic Policy and School of Economics, Nottingham University

October 13th 2008

"Things that can't go on forever, don't"
Herbert Stein

Fixing Global Finance

"The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the second world war." Alan Greenspan, *Financial Times*, March 16th 2008

Fixing Global Finance

"Asia has become the source of finance, the source of savings. It now has the human capital to manage that well. Why doesn't it take the advantage of that opportunity to try and create financial markets that work better for the people of Asia?" Joseph Stiglitz.

Fixing Global Finance

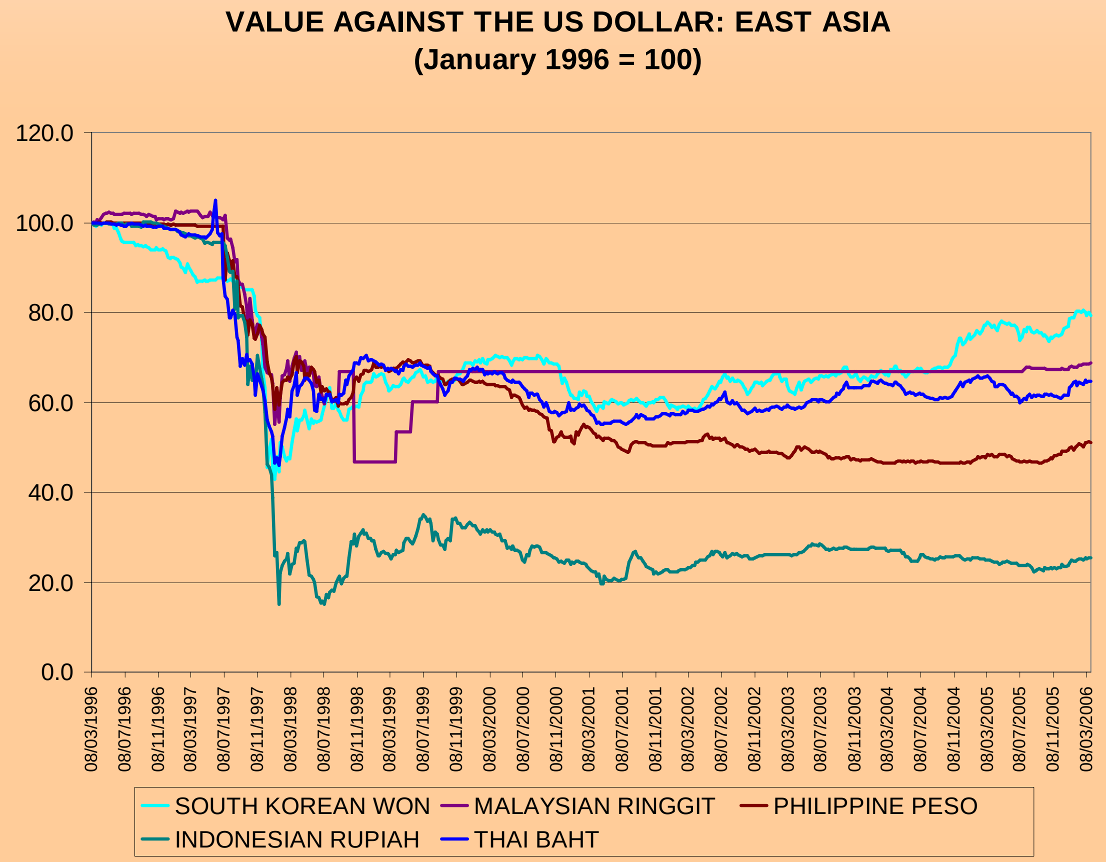
- Outline of the argument:
  1. The emerging market crises showed the danger of foreign currency borrowing
  2. Many emerging economies decided to self-insure and become creditor nations
  3. The US and a few other high-income countries became borrowers of last resort
  4. This created twin economic risks: external and internal
  5. The internal risks have proved dominant, but this saga is not over
  6. More emerging economies will now move into current account deficit
  7. This means we need a much stronger system of global finance

1. Emerging market crises

- In the 1980s and 1990s, emerging market economies suffered a series of shattering foreign currency and banking crises
- These culminated in the Asian crises of 1997-98, the Russian and Brazilian crises of 1998-99 and the Argentine crisis
- A central feature of many of these crises was current account deficits, financed by short-term foreign currency borrowing
- When the crises hit, the currencies collapsed and the currency mismatches created mass bankruptcies

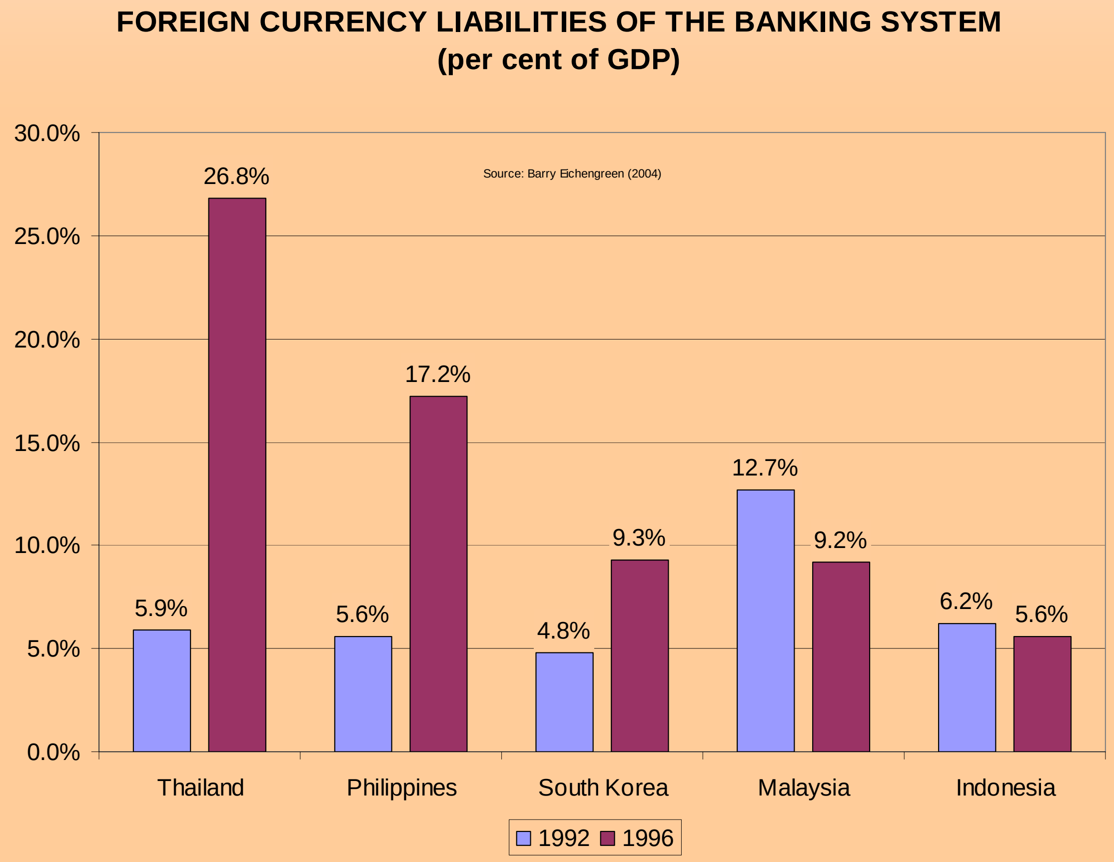
1. Emerging market crises

CURRENCY COLLAPSES IN THE CRISES



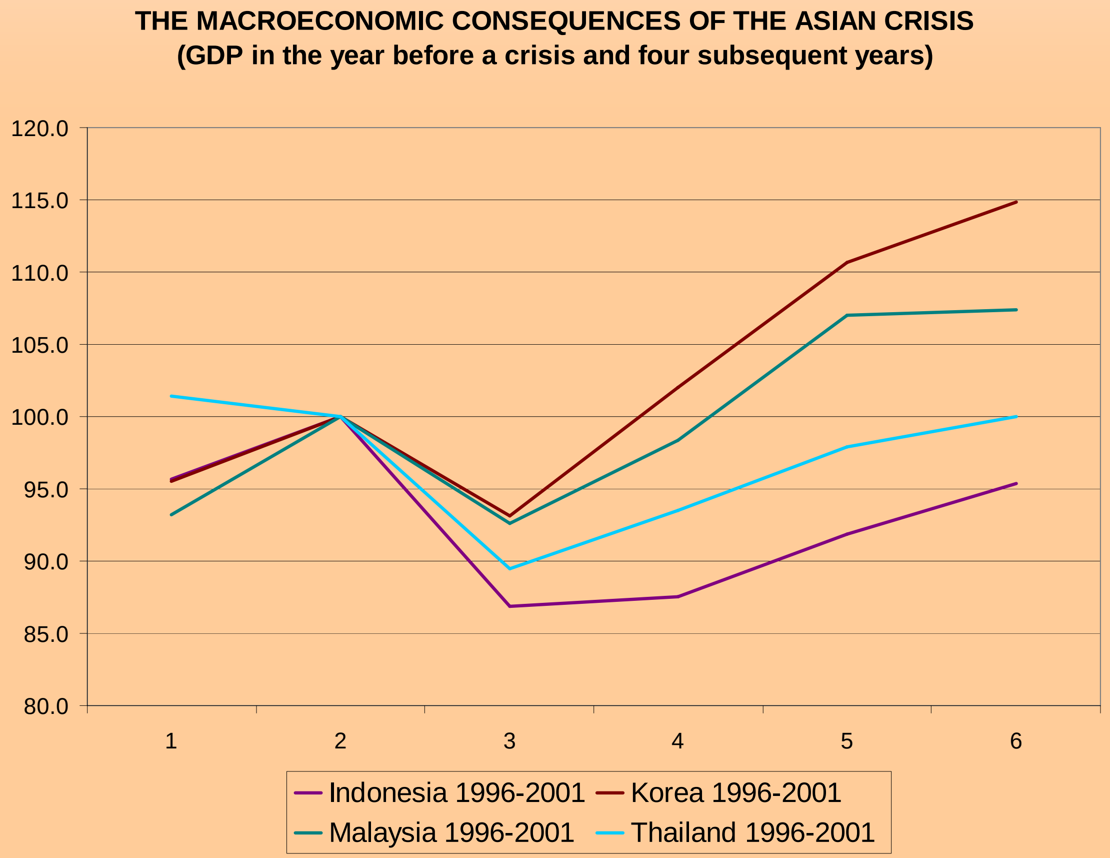
1. Emerging market crises

DANGER OF FOREIGN CURRENCY LIABILITIES



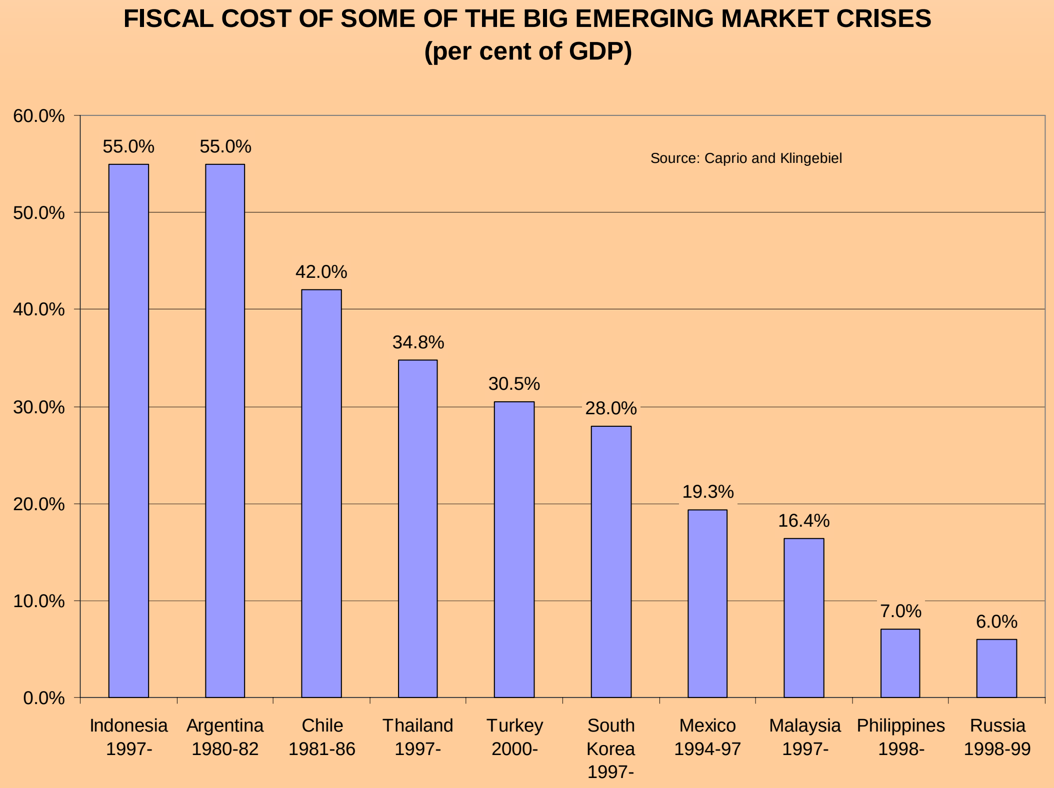
1. Emerging market crises

CONSEQUENT ECONOMIC COLLAPSES



1. Emerging market crises

AND HUGE FISCAL LOSSES FOR BAIL-OUTS



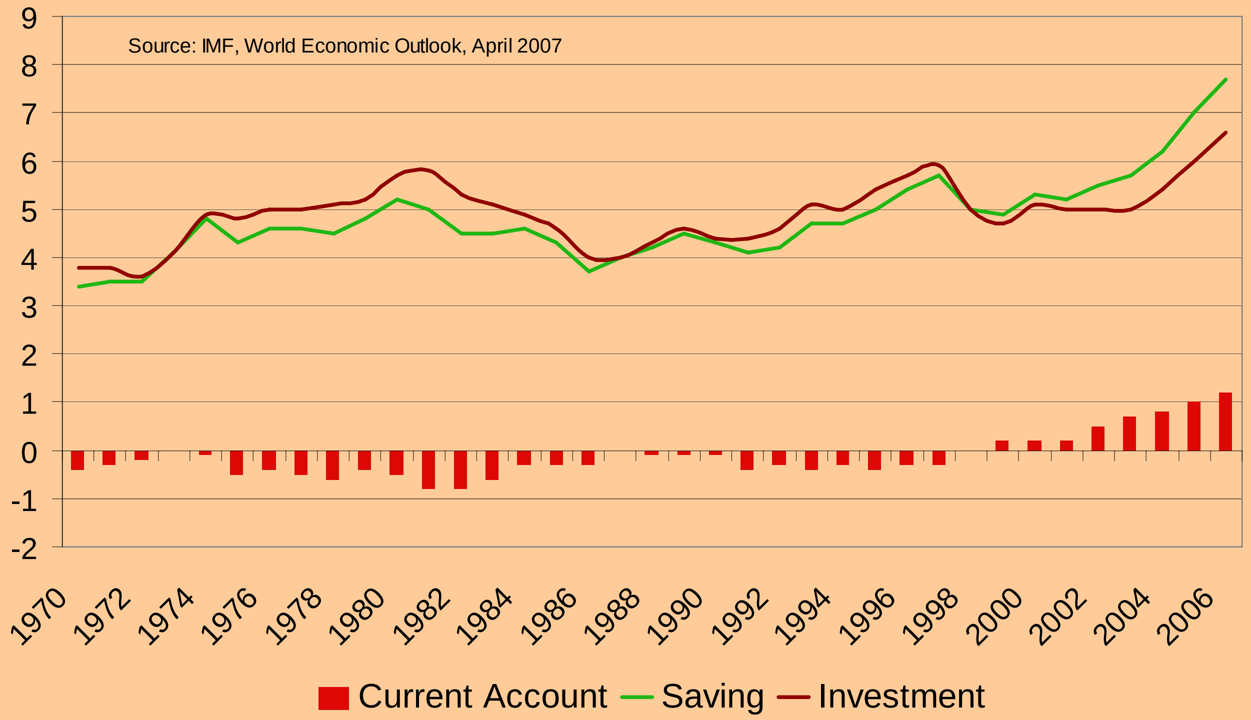
2. Rise of emerging country surpluses

- In the 2000s the emerging world moved into massive current account surplus
- This was part of the explanation for the “savings glut” and low global real interest rates pointed to, correctly, by Alan Greenspan and Ben Bernanke
- Behind the emerging savings glut were three forces:
  - Cut-backs of investment in countries affected by financial crises;
  - Emergence of vast Chinese surpluses; and
  - Emergence of the surpluses of oil exporting countries with high oil prices.

2. Rise of emerging country surpluses

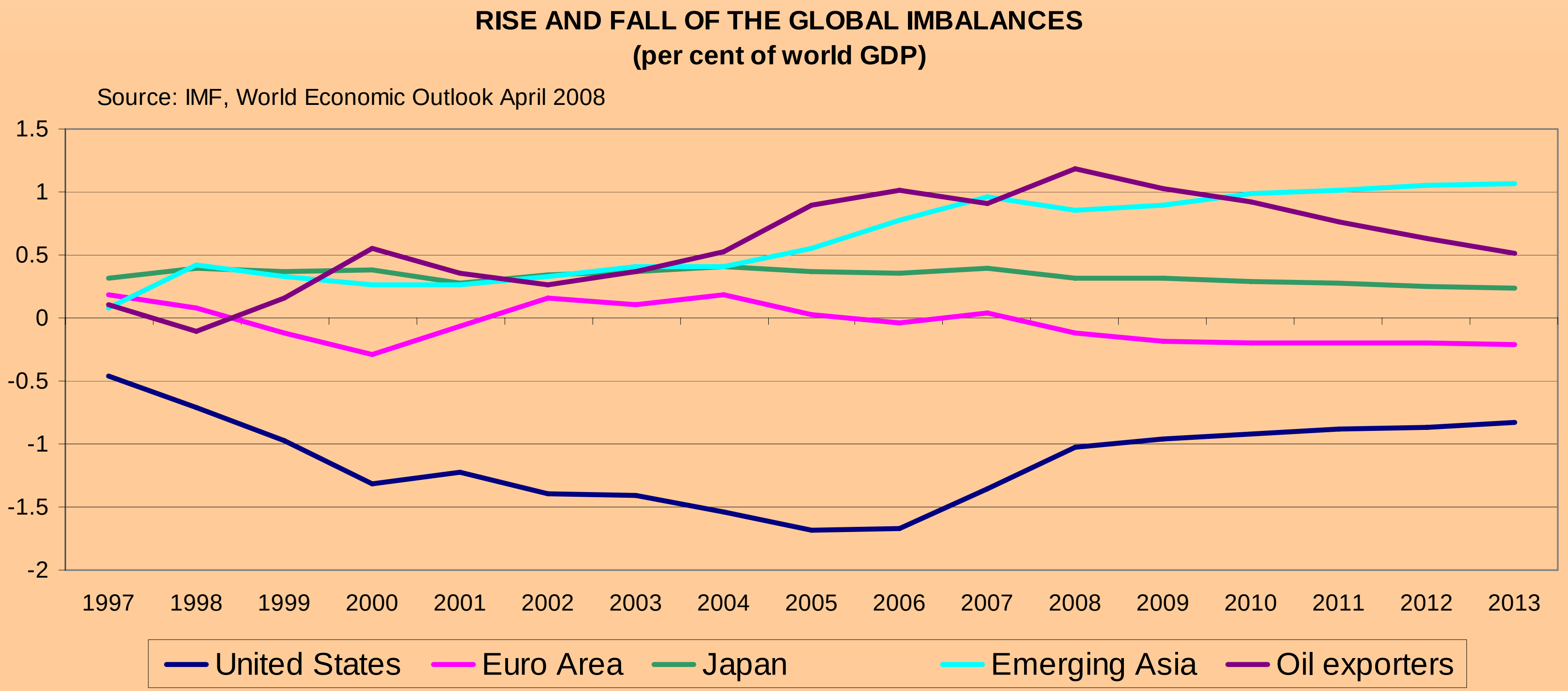
EMERGING ECONOMIES SHIFT INTO SURPLUS

SAVINGS, INVESTMENT AND CURRENT ACCOUNTS OF EMERGING MARKET AND OIL-PRODUCING COUNTRIES (per cent of GDP)



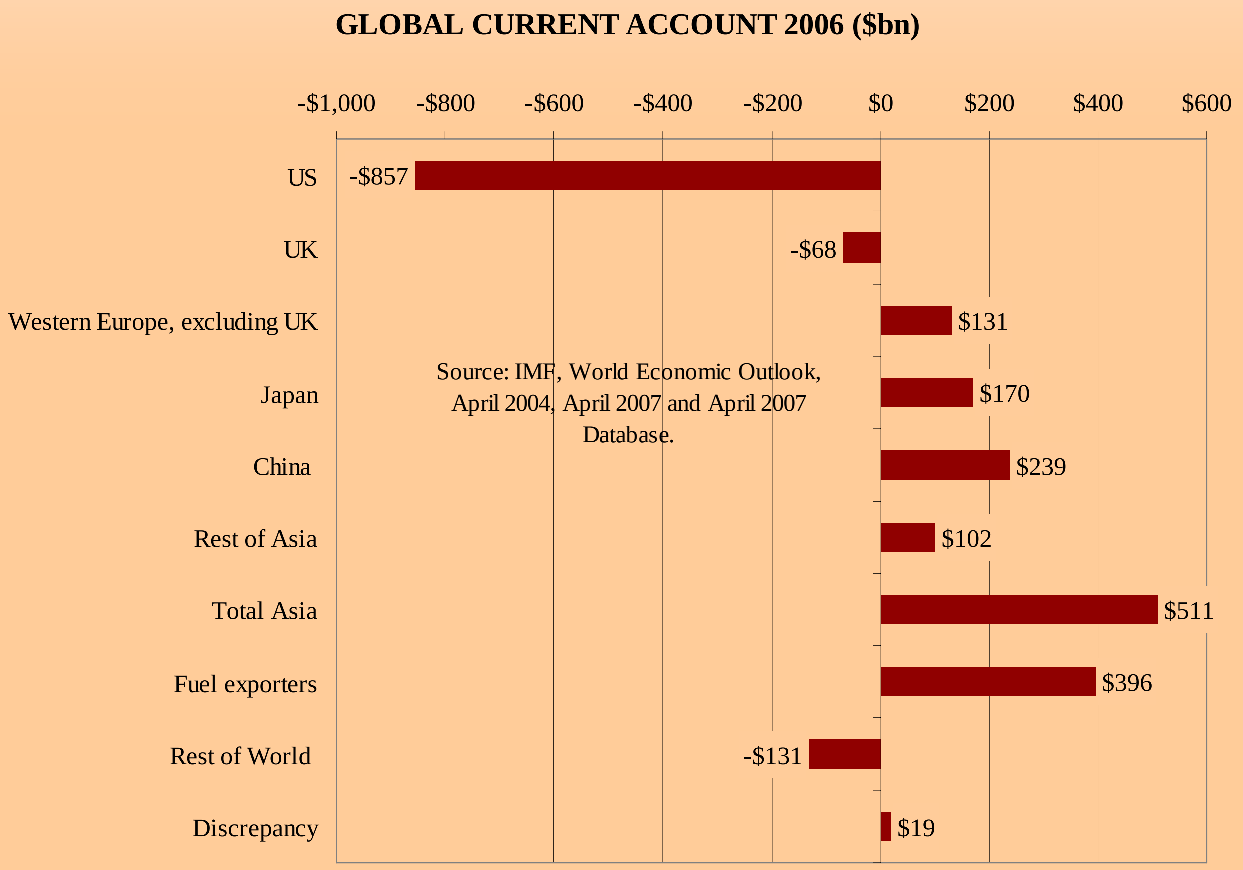
2. Rise of emerging country surpluses

THE GREAT IMBALANCES



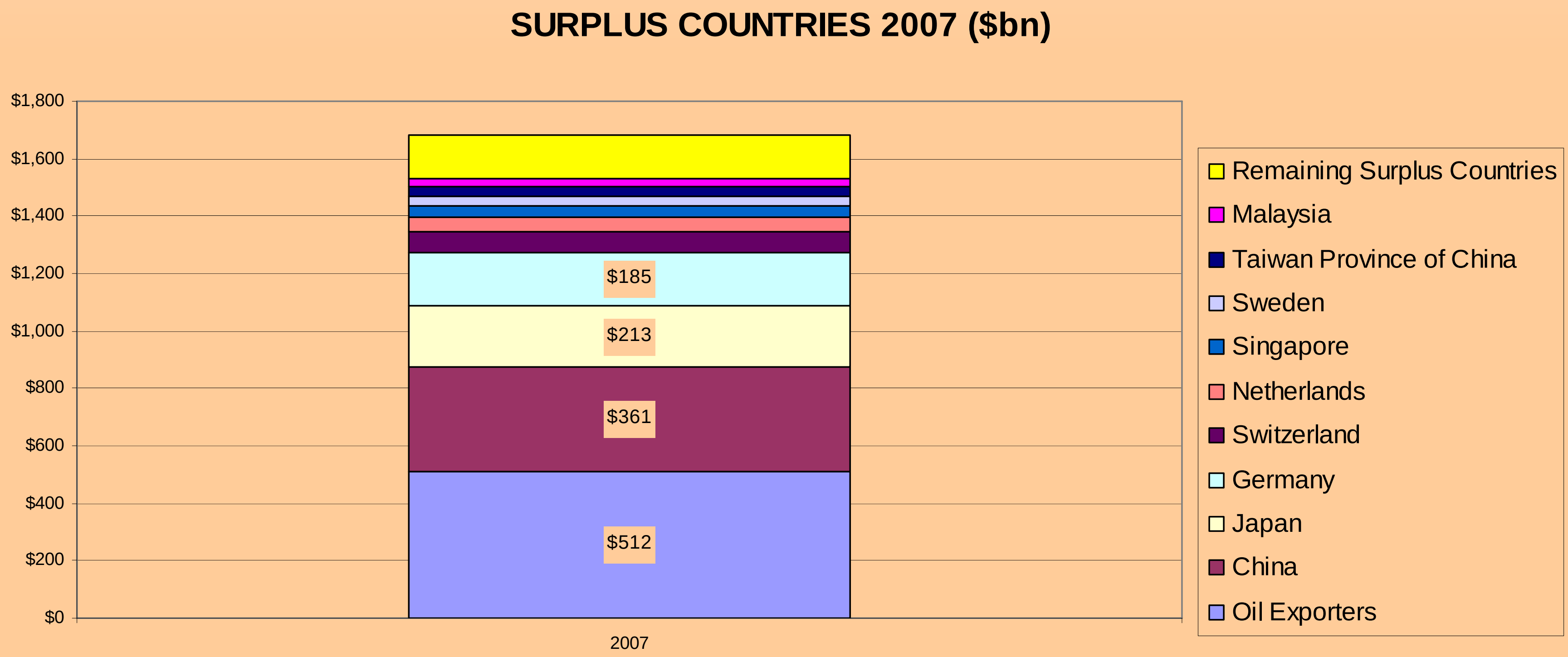
2. Rise of emerging country surpluses

US AS BORROWER OF LAST RESORT



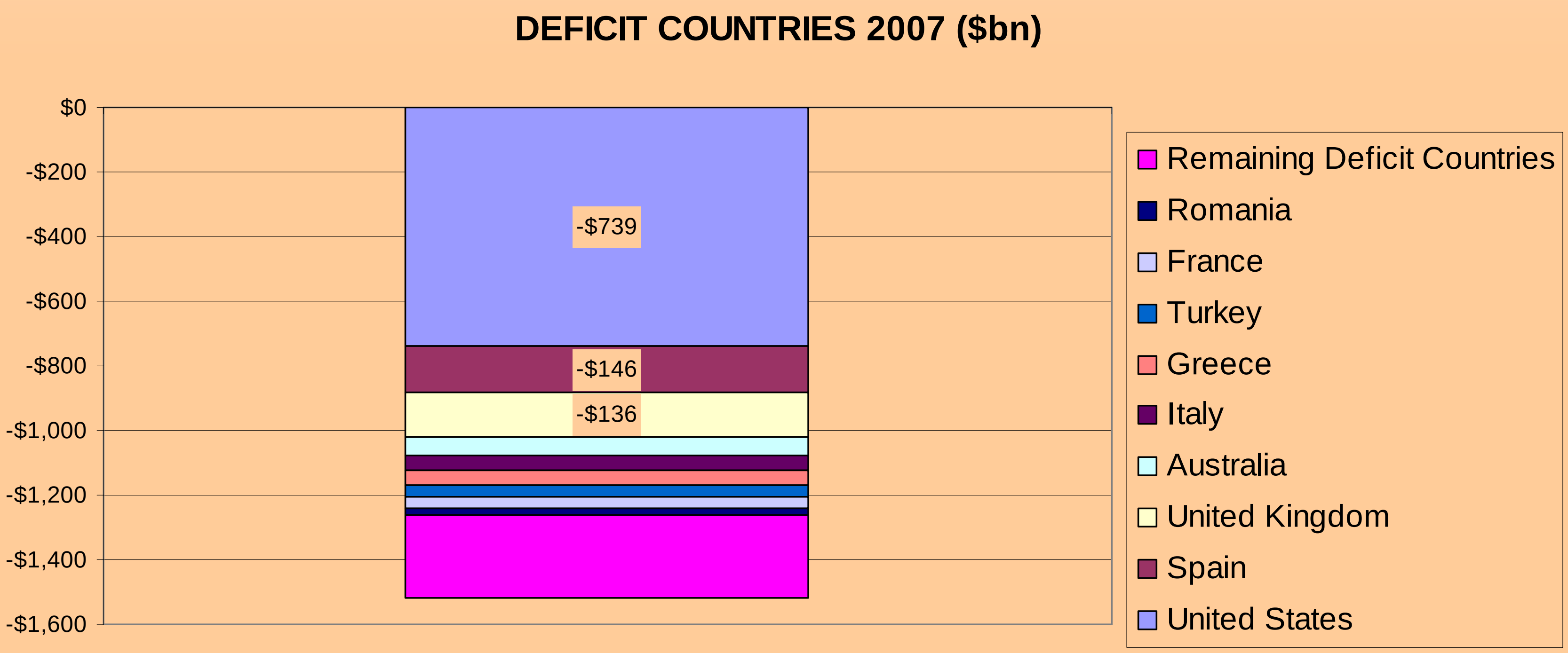
2. Rise of emerging country surpluses

GLOBAL SURPLUSES



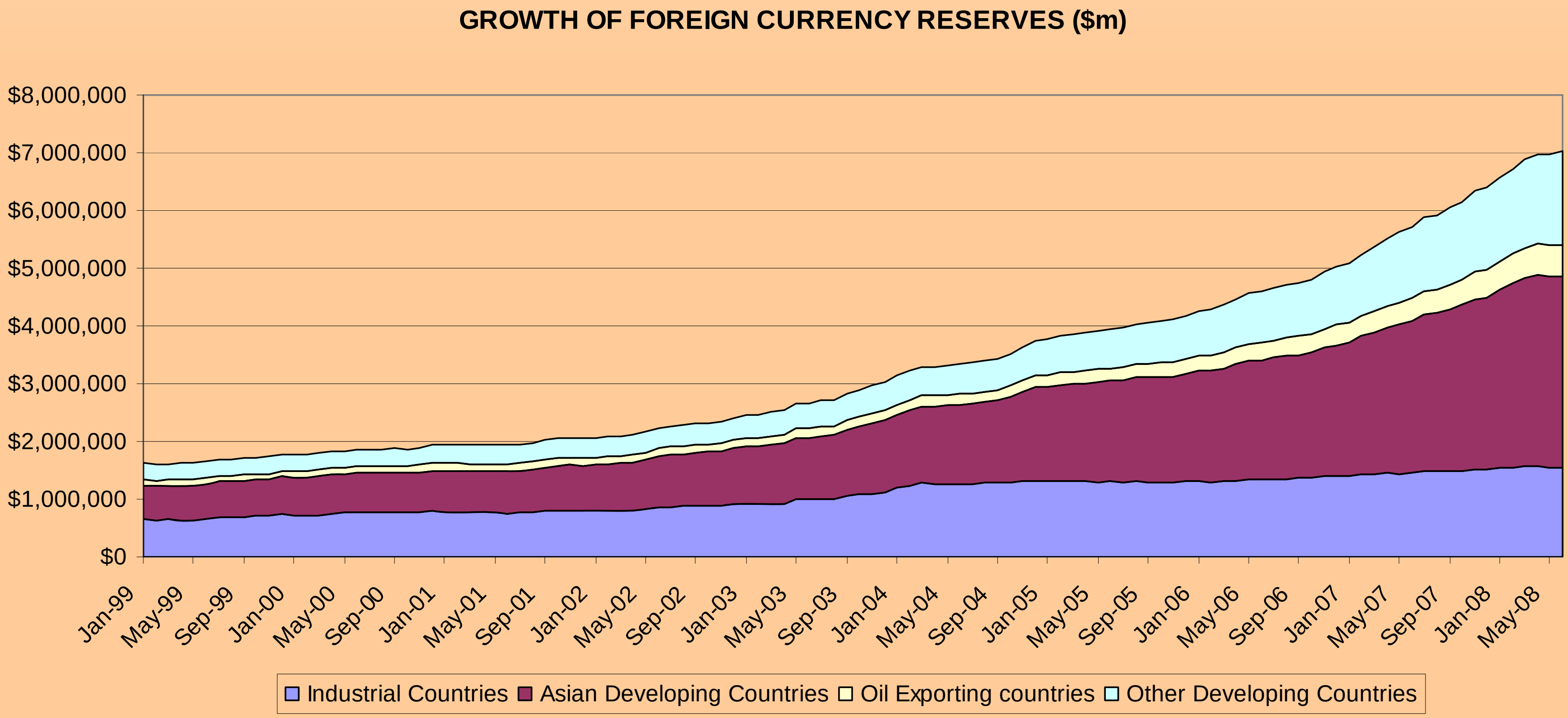
2. Rise of emerging country surpluses

GLOBAL DEFICITS



2. Rise of emerging country surpluses

RISE OF FOREIGN CURRENCY RESERVES



3. US becomes borrower of last resort

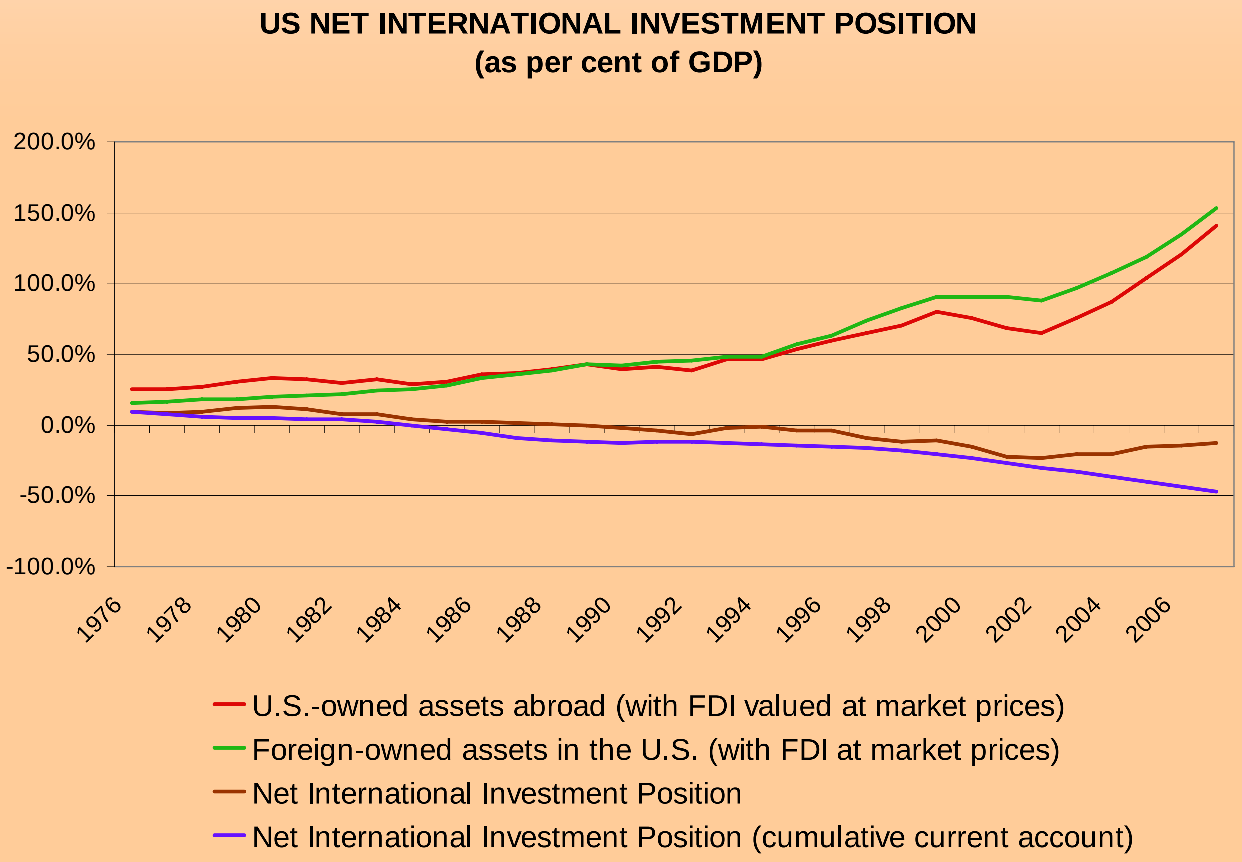
- US emerged as the principal borrower in the system
- This created external and internal financial deficits
- These were also promoted by the loose monetary policy, made partly in response to the savings glut
- The most important aspect of internal deficits was the huge financial deficits of US households
- These were sustained by the ability to borrow against rising housing wealth

3. US becomes borrower of last resort

- But the result was growing vulnerability of the US financial system to housing-related debt
- This was made worse by extremely poor regulation – indeed active encouragement of very bad lending
- It was the internal, not the external deficits, that proved the “killers”

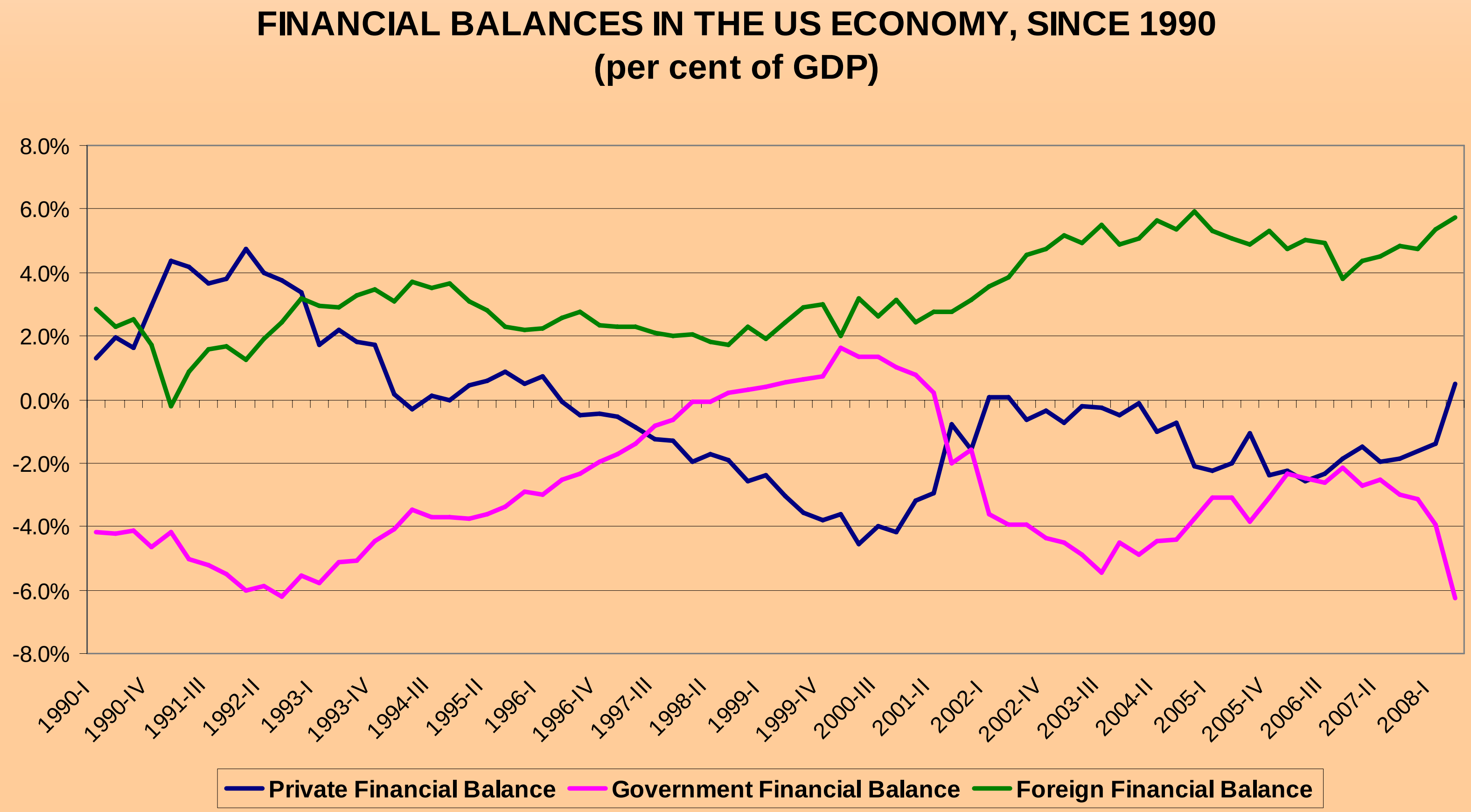
3. US becomes borrower of last resort

US “CHEATS” ITS CREDITORS



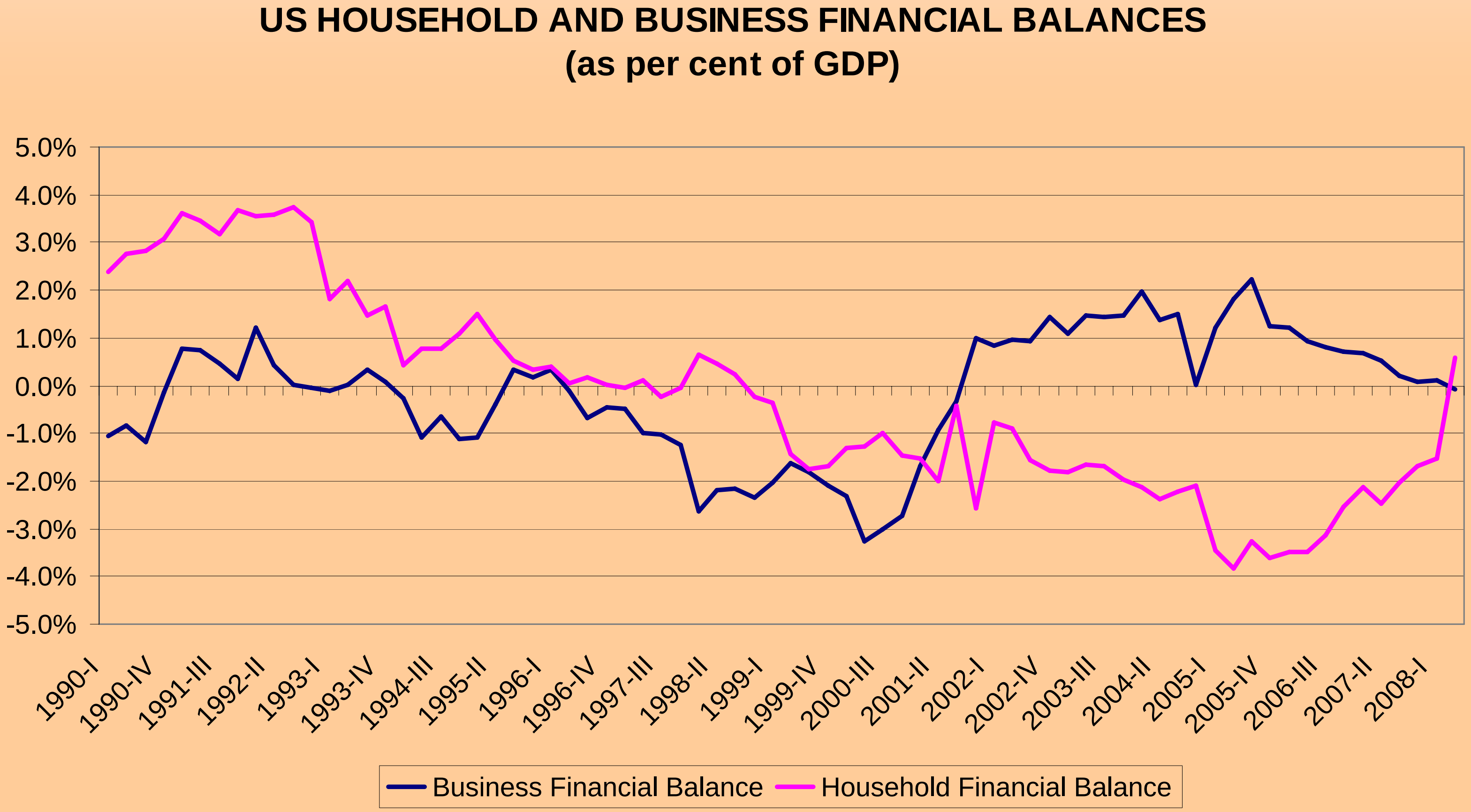
3. US becomes borrower of last resort

US DOMESTIC IMBALANCES



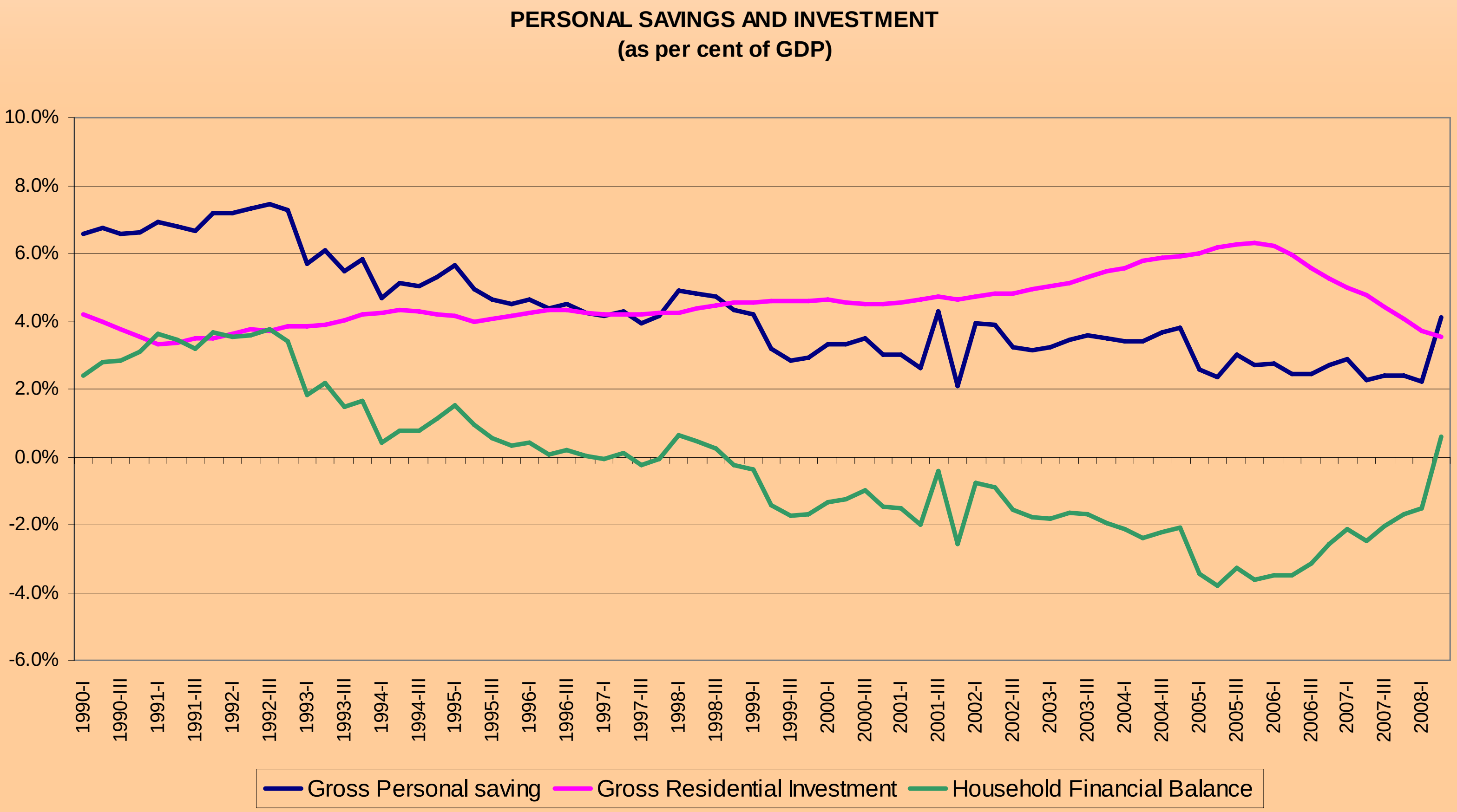
3. US becomes borrower of last resort

HOUSEHOLDS SPENT; COMPANIES DID NOT



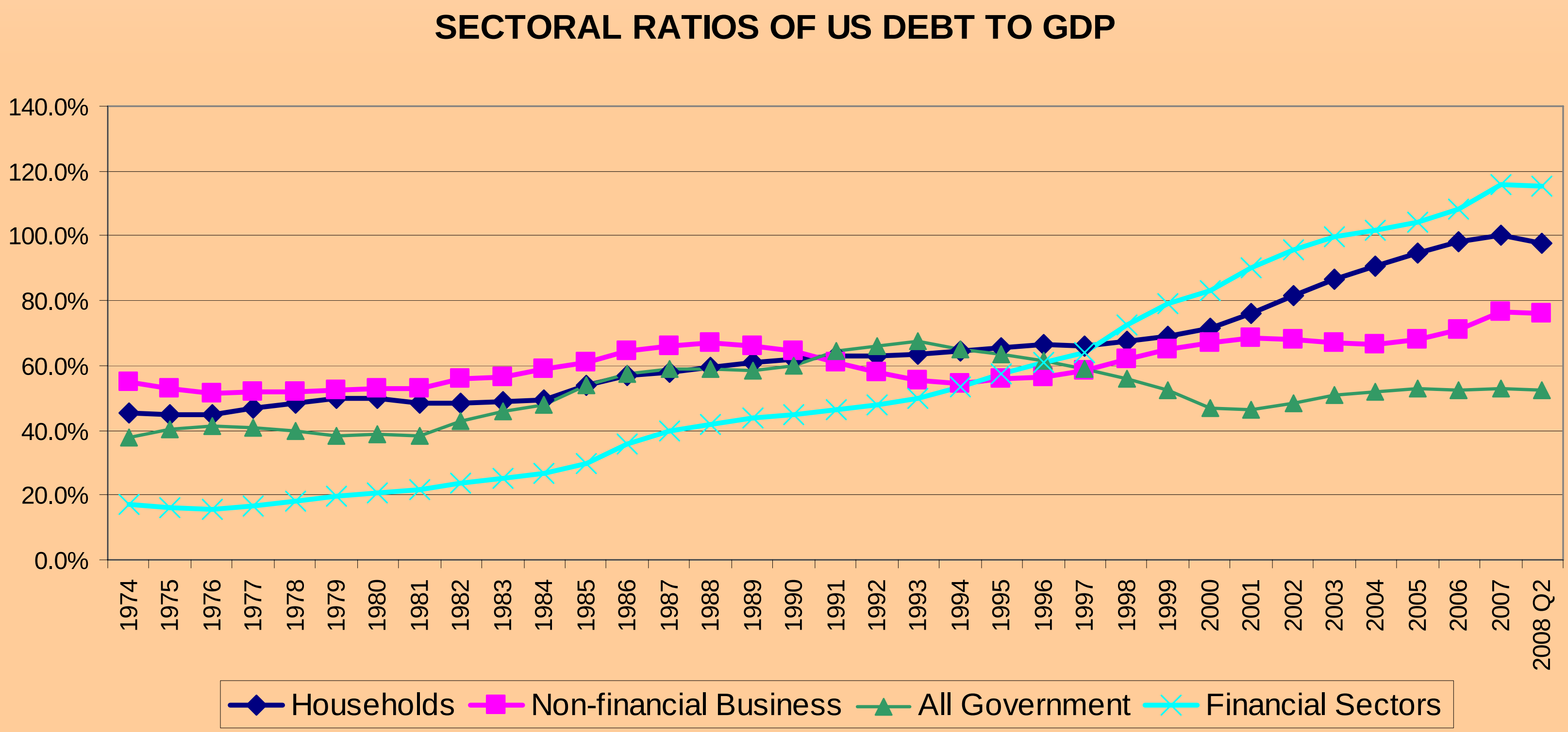
3. US becomes borrower of last resort

GREAT HOUSEHOLD SPENDING BOOM



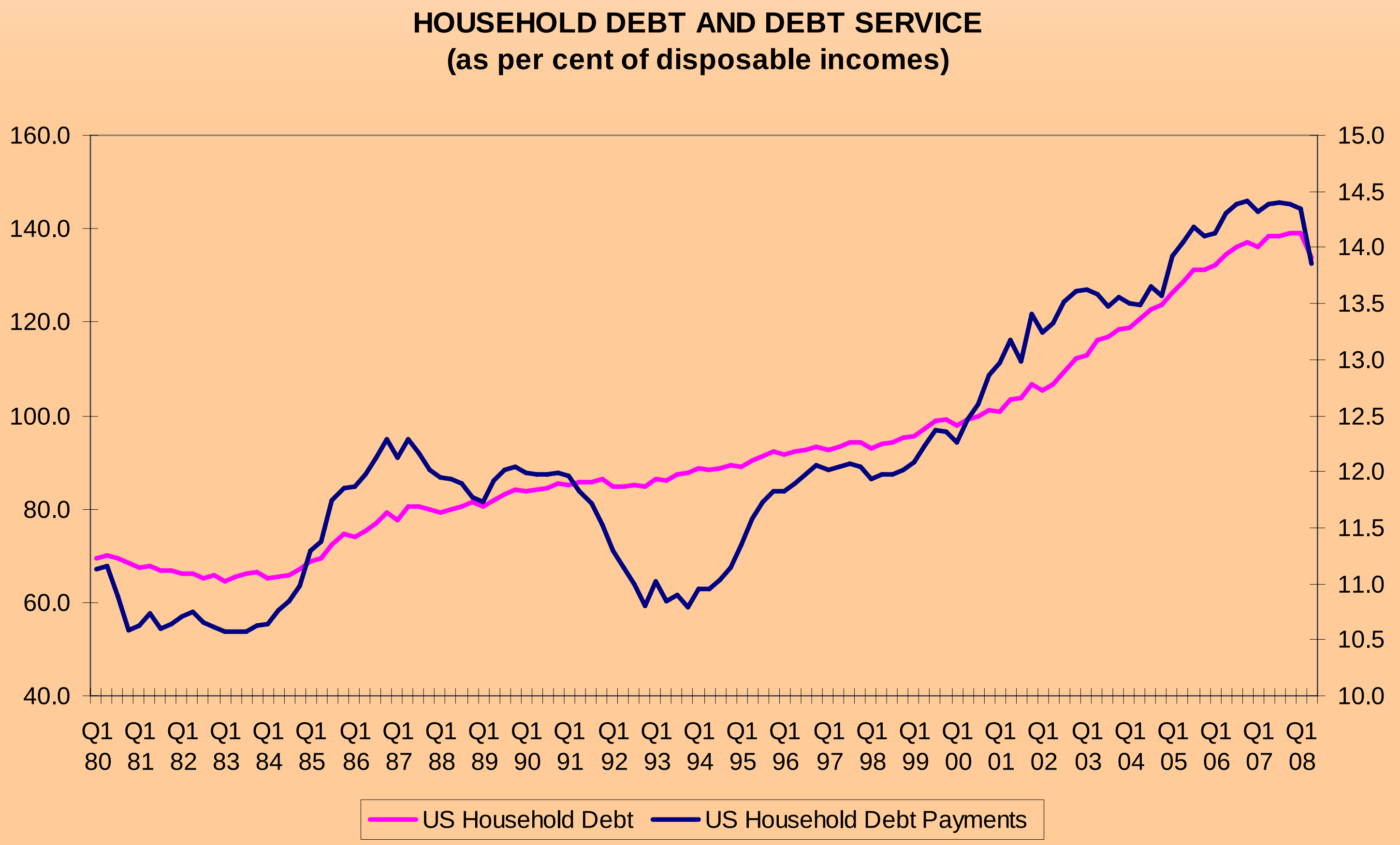
3. US becomes borrower of last resort

AND MASSIVELY INCREASED OVERALL DEBT



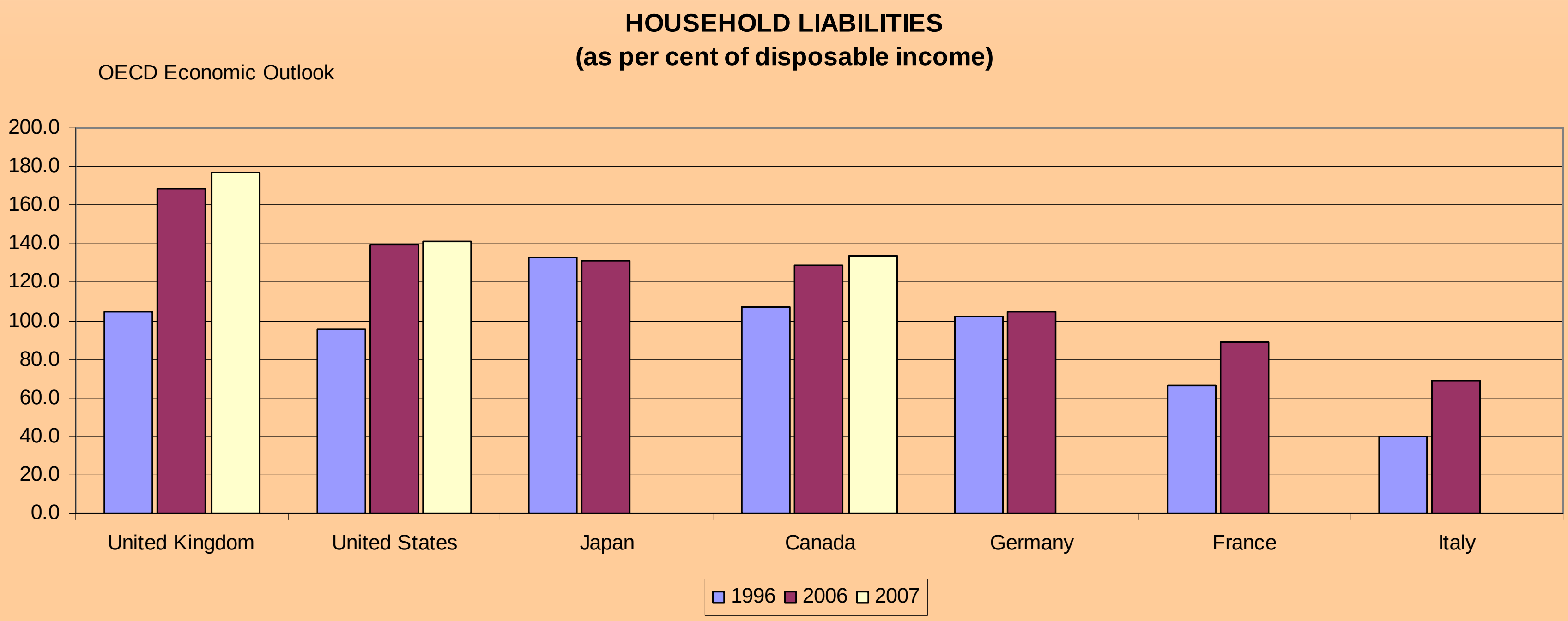
3. US becomes borrower of last resort

AND MASSIVELY INCREASED HOUSEHOLD DEBT



3. US becomes borrower of last resort

AND MASSIVELY INCREASED HOUSEHOLD DEBT



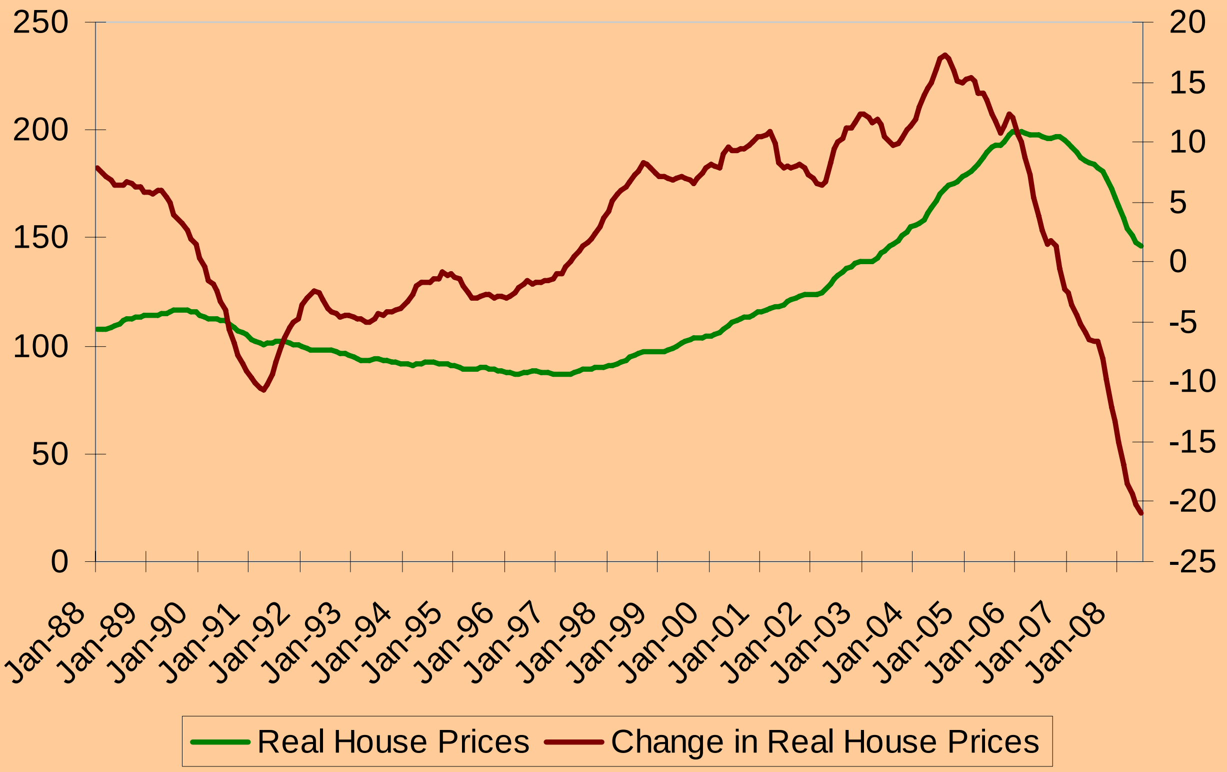
4. Implications of the "subprime crisis"

- This episode is now at an end, as:
  - US house prices fall;
  - housing-related debt deteriorates in quality; and
  - the financial system becomes de-capitalised
- So the US is moving into export-led growth

4. Implications of the “subprime crisis”

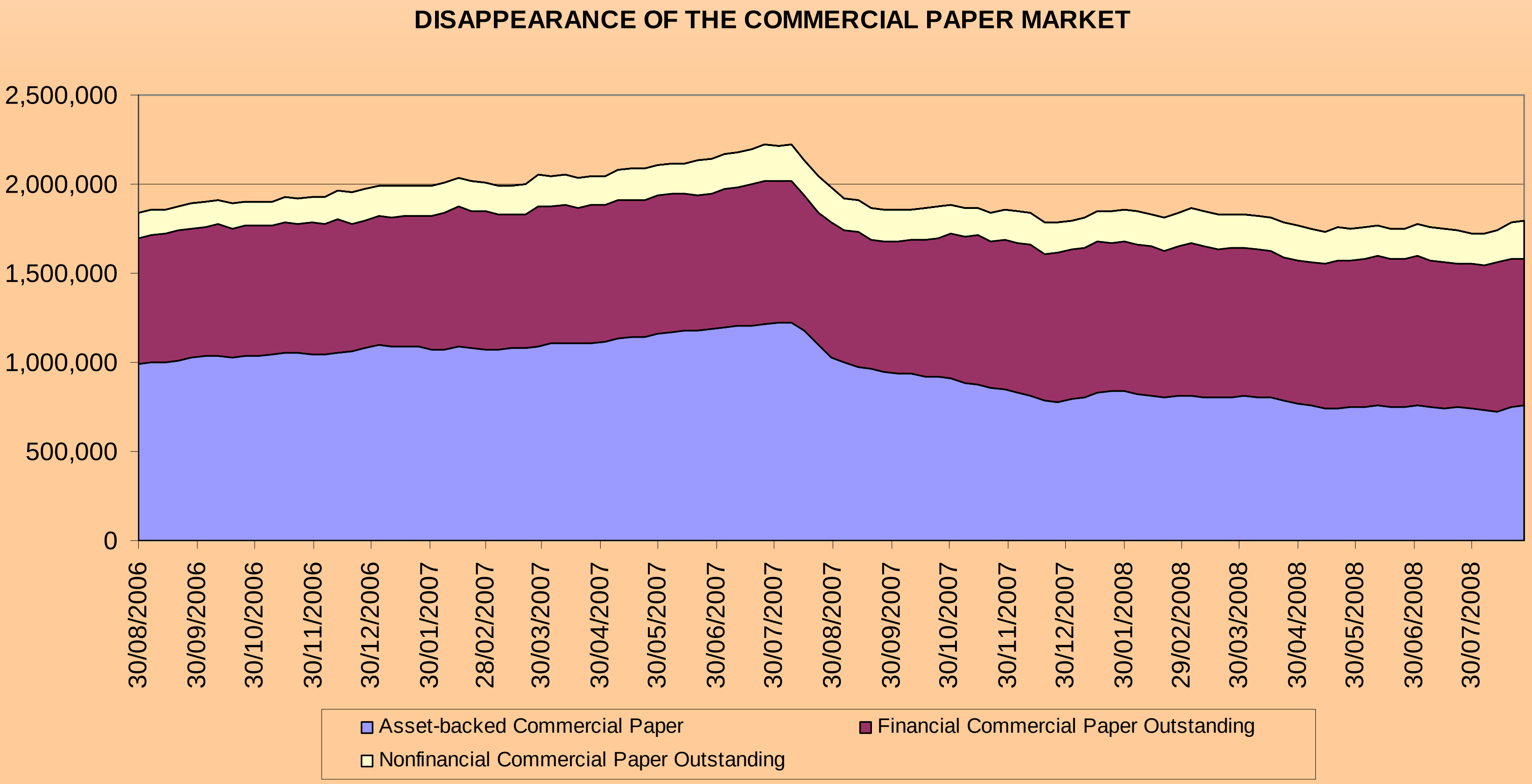
BURST HOUSING BUBBLE

HOUSE PRICES IN THE US (Case-Shiller 10-City Index)



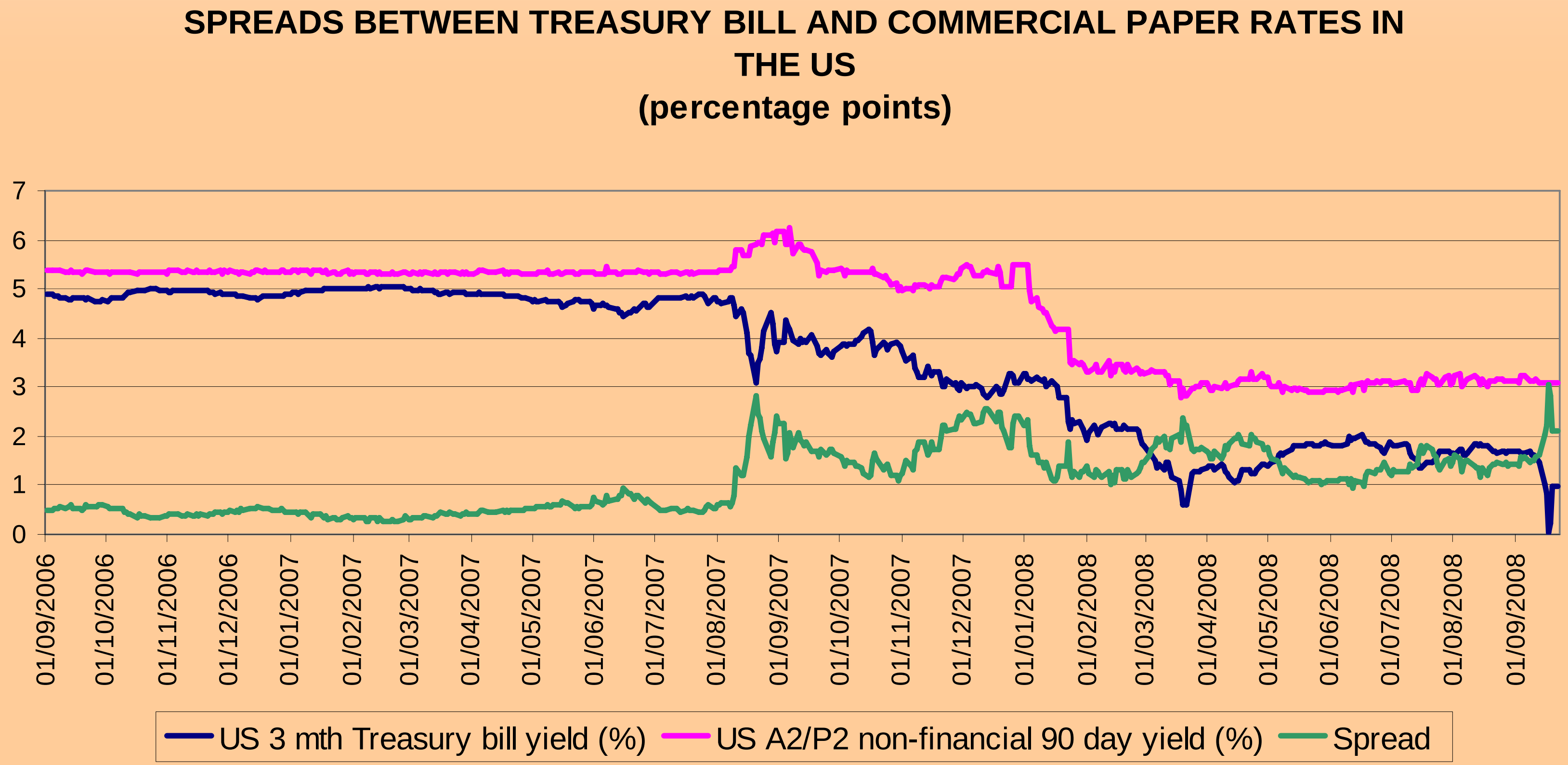
4. Implications of the “subprime crisis”

CREDIT SHOCK IN THE US



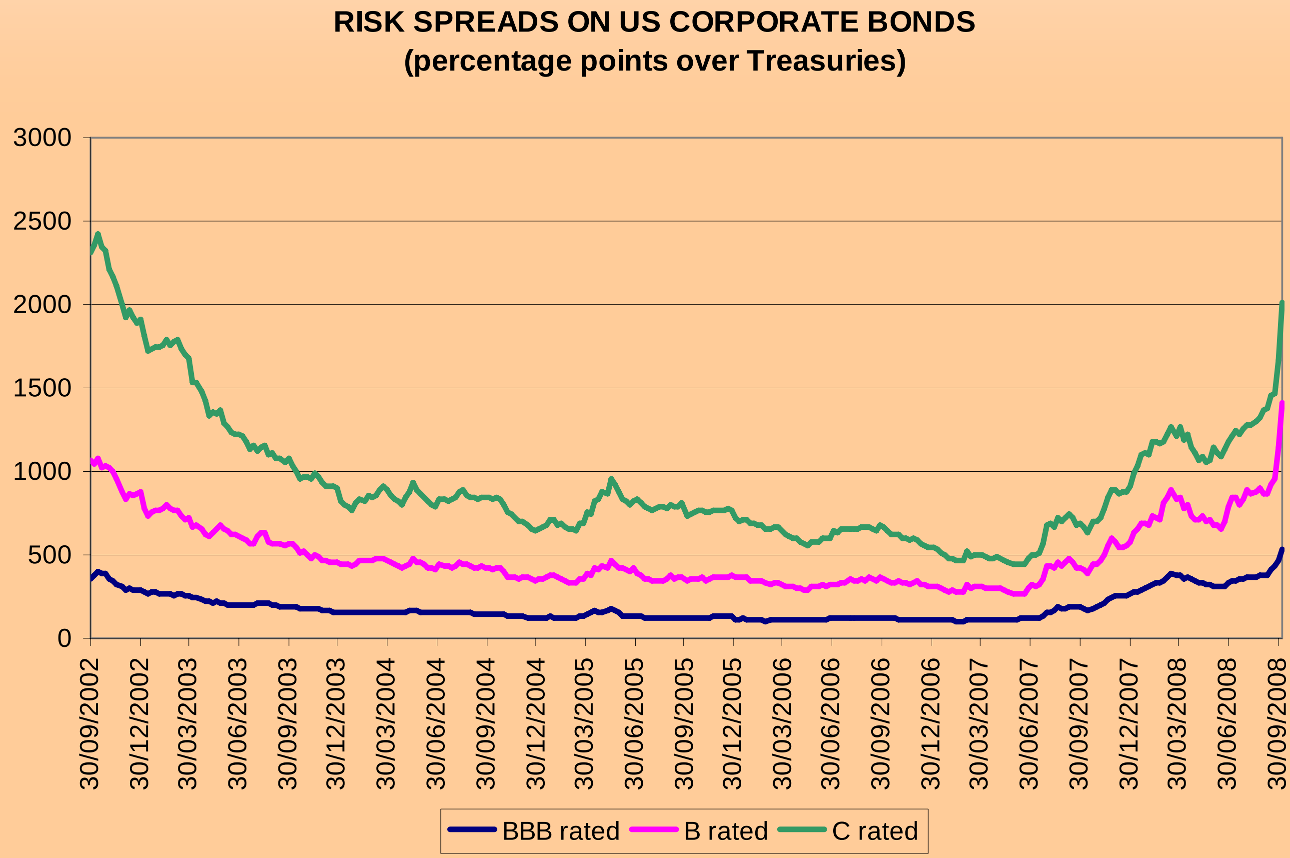
4. Implications of the “subprime crisis”

CREDIT SHOCK IN THE US



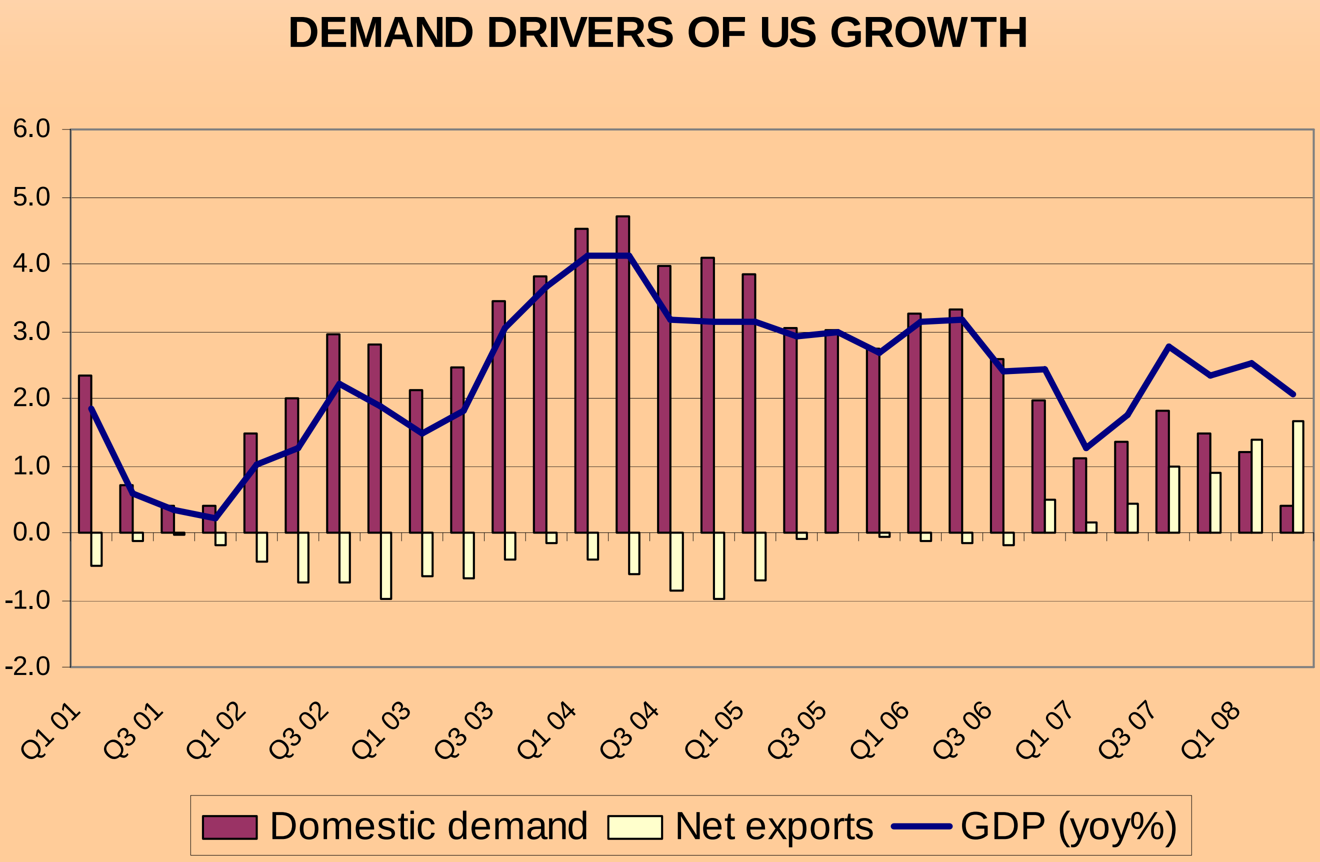
4. Implications of the “subprime crisis”

RISE OF RISK PERCEPTIONS



4. Implications of the “subprime crisis”

US EXPORT-LED GROWTH

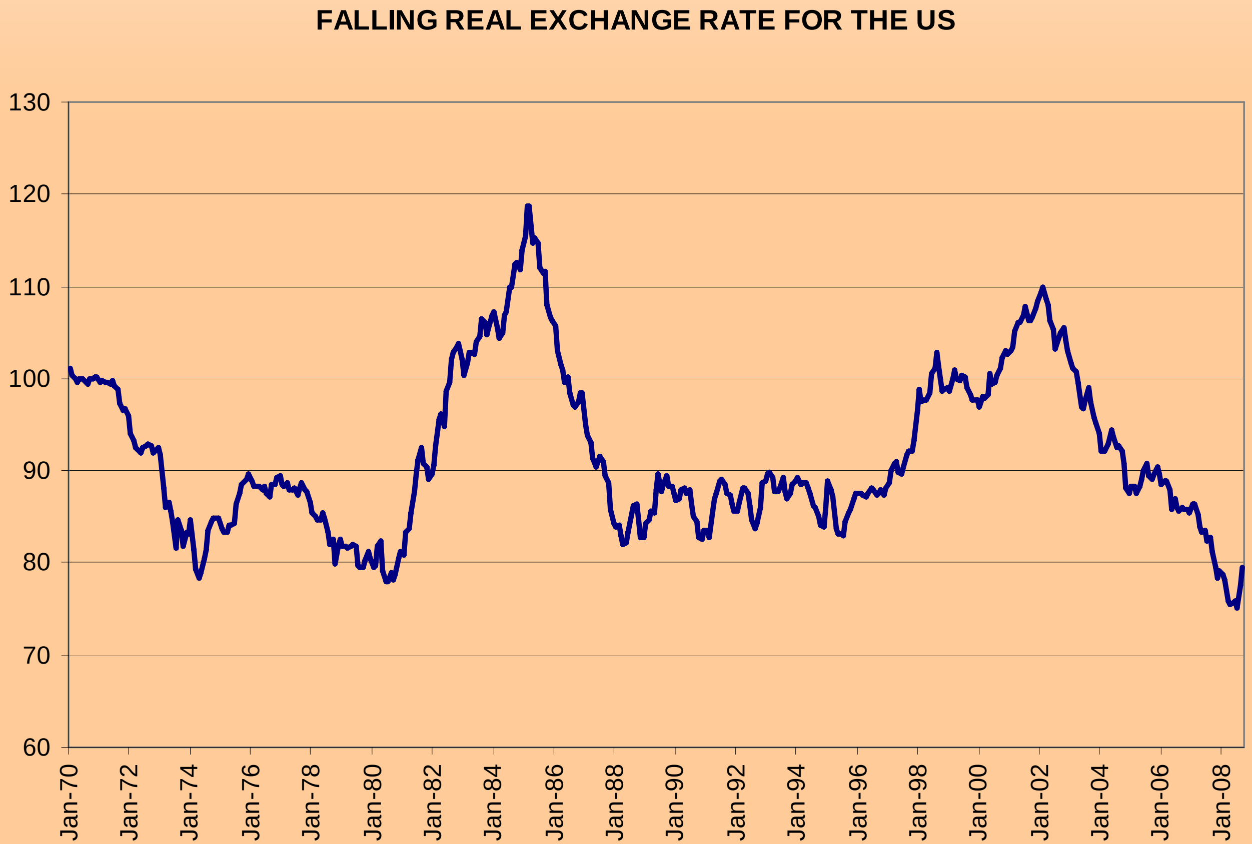


4. Implications of the “subprime crisis”

- At present the risk is almost entirely on the internal side, which the US can manage, because it borrows in its own currency
- But there is also a risk on the external side:
  - What if creditors decide they are losing too much?
  - What if there is a panic sale of dollars
- Then the US may only be able rescue the financial system by an inflationary default and possible collapse of the dollar standard
- So external vulnerability is also an issue

4. Implications of the “subprime crisis”

IT’S MANAGEABLE – SO FAR



5. Need for adjustment in emerging economies

- This big US adjustment is compatible with global growth only if other countries have smaller surpluses or bigger deficits
- Oil exporters have a good reason to run big surpluses, because they are shifting one asset into another, though the IMF does expect them to spend more
- But non-oil exporters also need to reduce current account surpluses or increase deficits
- This means they must spend more relative to incomes
- China is the most important single case

6. Role of reforms in global finance

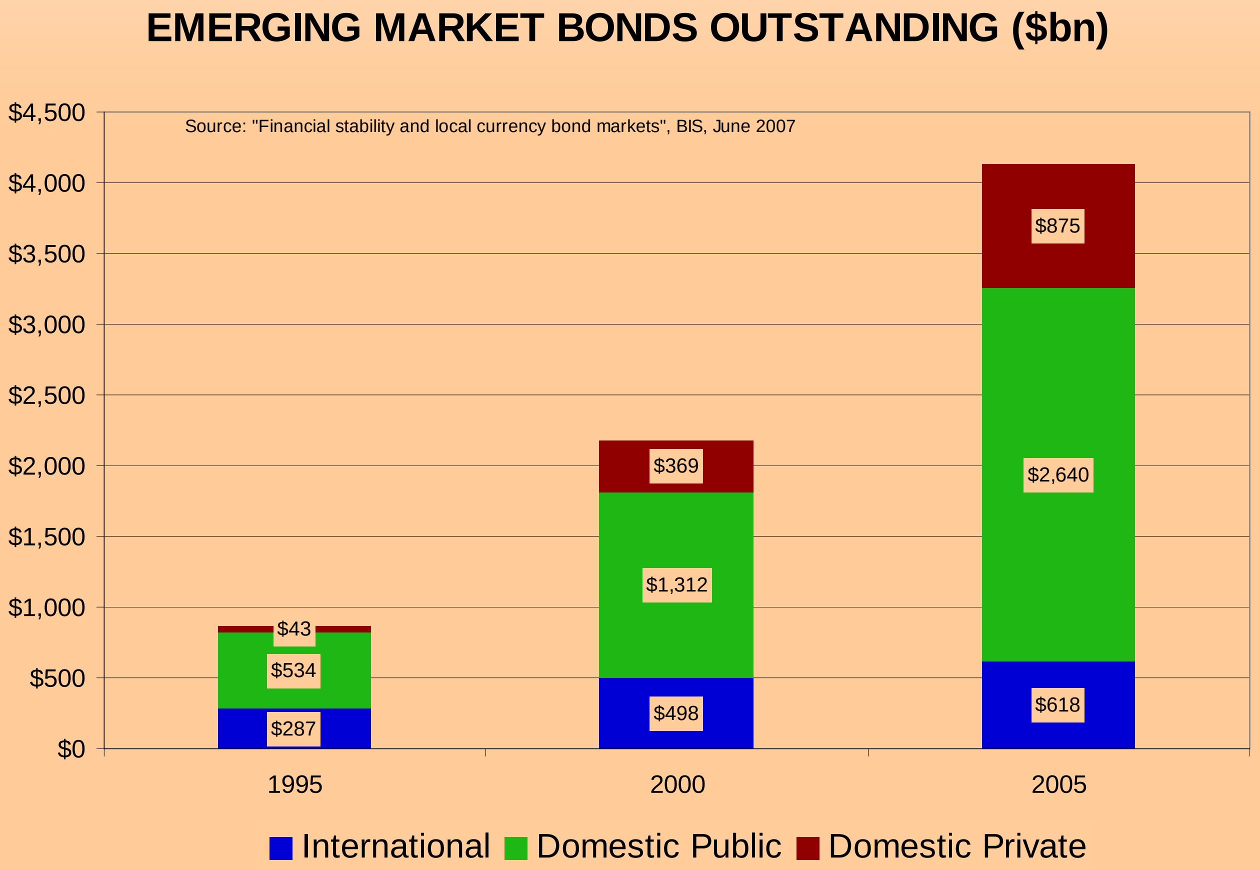
- So how are emerging countries to run current account deficits safely?
- The answer is that the external finance must itself be relatively stable
- There are three solutions:`
  - Equity investment (FDI and portfolio);
  - Local currency bonds; or
  - More collective insurance – e.g. via the IMF
- The development of local-currency bond markets shifts a potentially lethal risk onto foreign investors

6. Role of reforms in global finance

- Of course, the development of local currency finance also depends on:
  - A sustainable fiscal position
  - A sound currency
  - A well-regulated financial system
  - Openness to foreign investors
- Without these qualities local currency finance will fail, for both domestic residents and foreigners
- Countries that cannot generate such conditions need exchange controls

6. Role of reforms in global finance

RISE OF DOMESTIC CURRENCY FINANCING



7. Conclusion

- The financial crisis is far worse than I had expected
- Moreover, interestingly, it is far more related to internal, rather than external, imbalances
- This may not remain the case indefinitely, however
- The reduction in the internal imbalances depends on reducing the external imbalances, while maintaining global economic growth
- This depends on big changes in the rest of the world and reforms in the global financial system

7. Conclusion

- These changes include:
  - Much more local currency finance
  - Bigger collective insurance systems
  - More co-operative management of the system