



# Fixing Global Finance

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# Fixing Global Finance

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“Things that can’t go on forever, don’t”  
Herbert Stein

## Fixing Global Finance

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“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 16<sup>th</sup> 2008

# Fixing Global Finance

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“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

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- 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

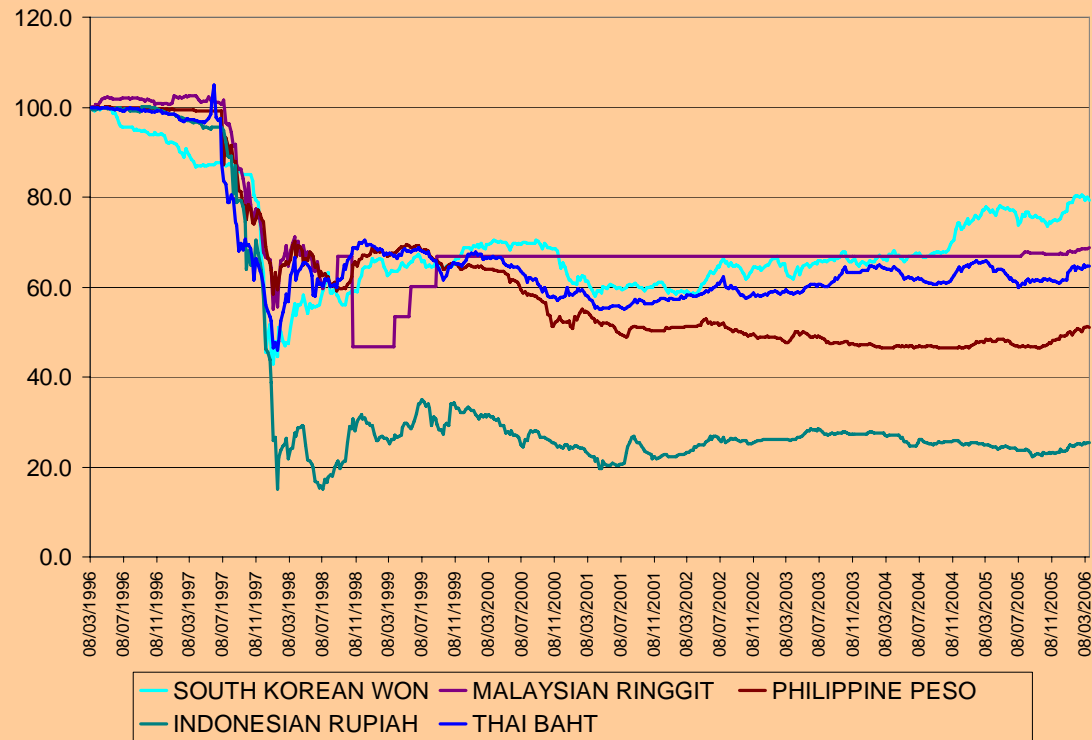
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- In the 1980s and 1990s, emerging market economies suffered a series of shattering foreign currency and banking crises
- These culminated in the Asian crises of 1997-98, the Russian and Brazilian crises of 1998-99 and the Argentine crisis
- A central 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

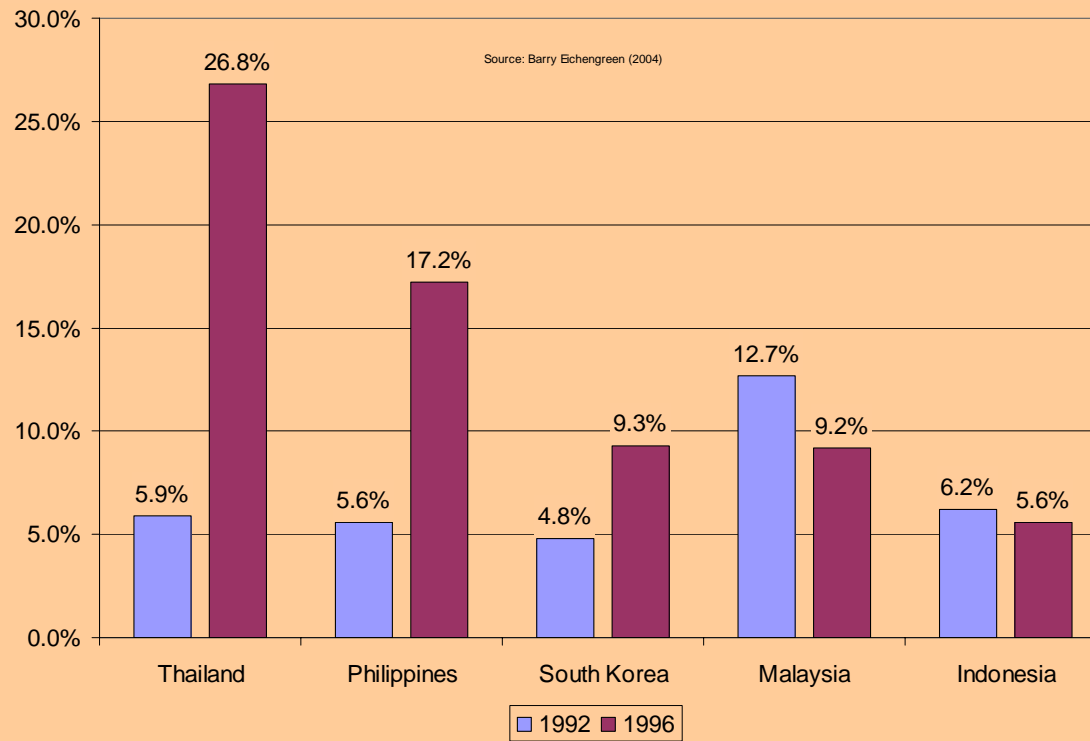
VALUE AGAINST THE US DOLLAR: EAST ASIA  
(January 1996 = 100)



# 1. Emerging market crises

## DANGER OF FOREIGN CURRENCY LIABILITIES

**FOREIGN CURRENCY LIABILITIES OF THE BANKING SYSTEM  
(per cent of GDP)**

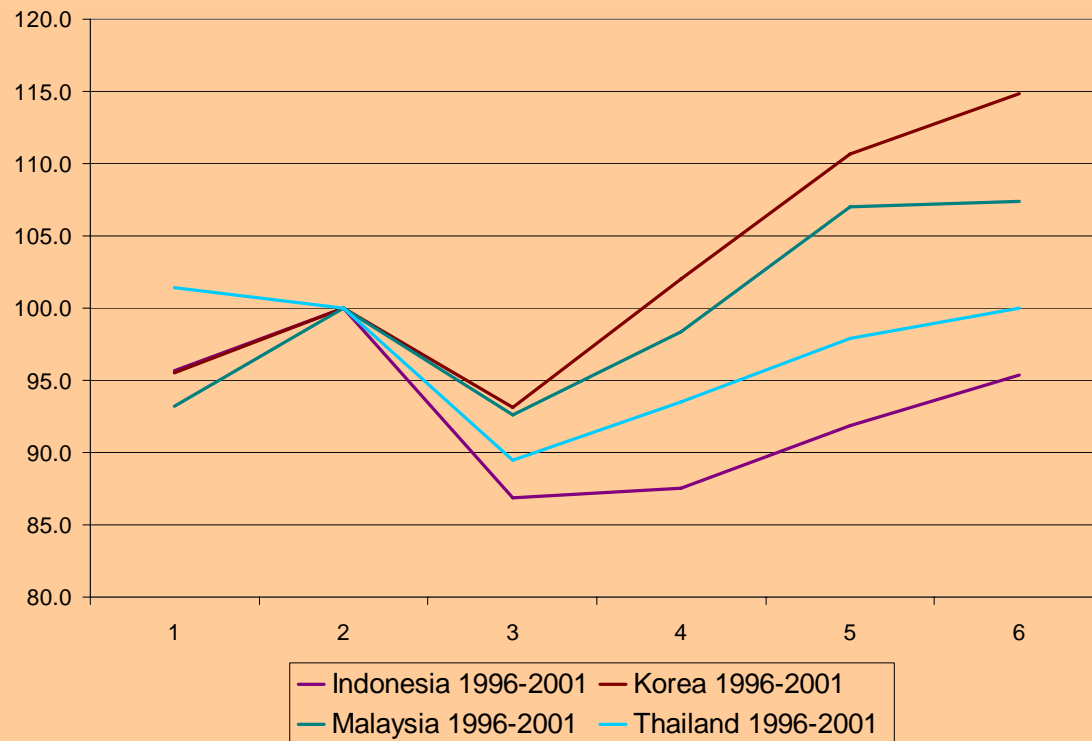




# 1. Emerging market crises

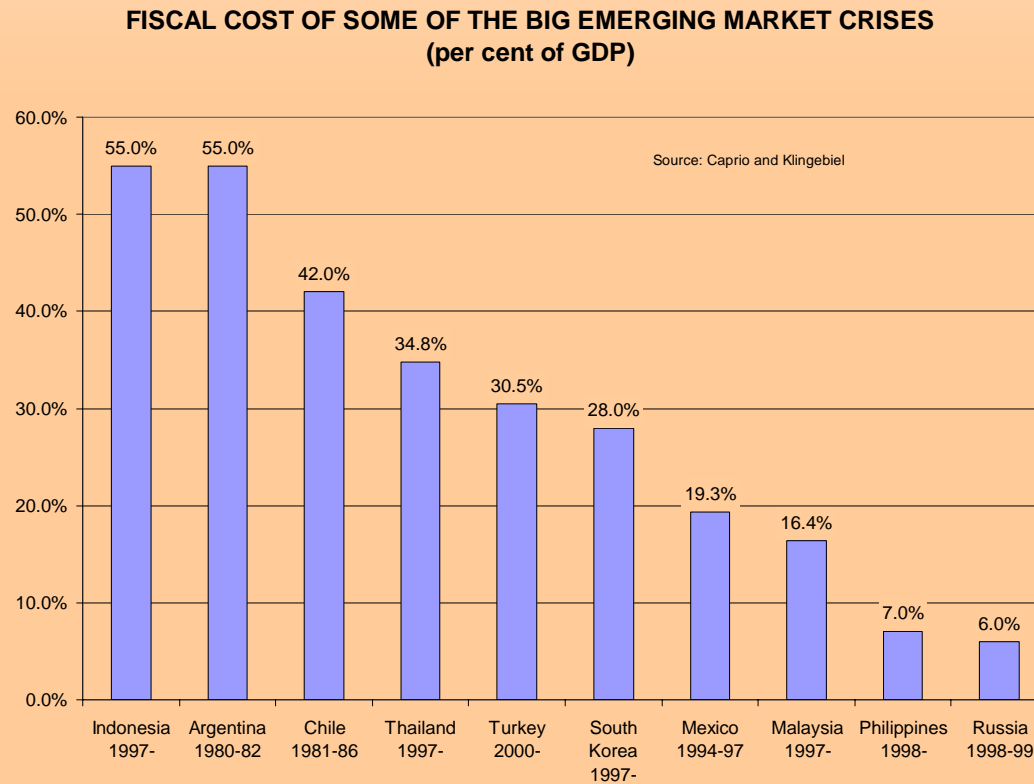
## CONSEQUENT ECONOMIC COLLAPSES

THE MACROECONOMIC CONSEQUENCES OF THE ASIAN CRISIS  
(GDP in the year before a crisis and four subsequent years)



# 1. Emerging market crises

## AND HUGE FISCAL LOSSES FOR BAIL-OUTS



## 2. Rise of emerging country surpluses

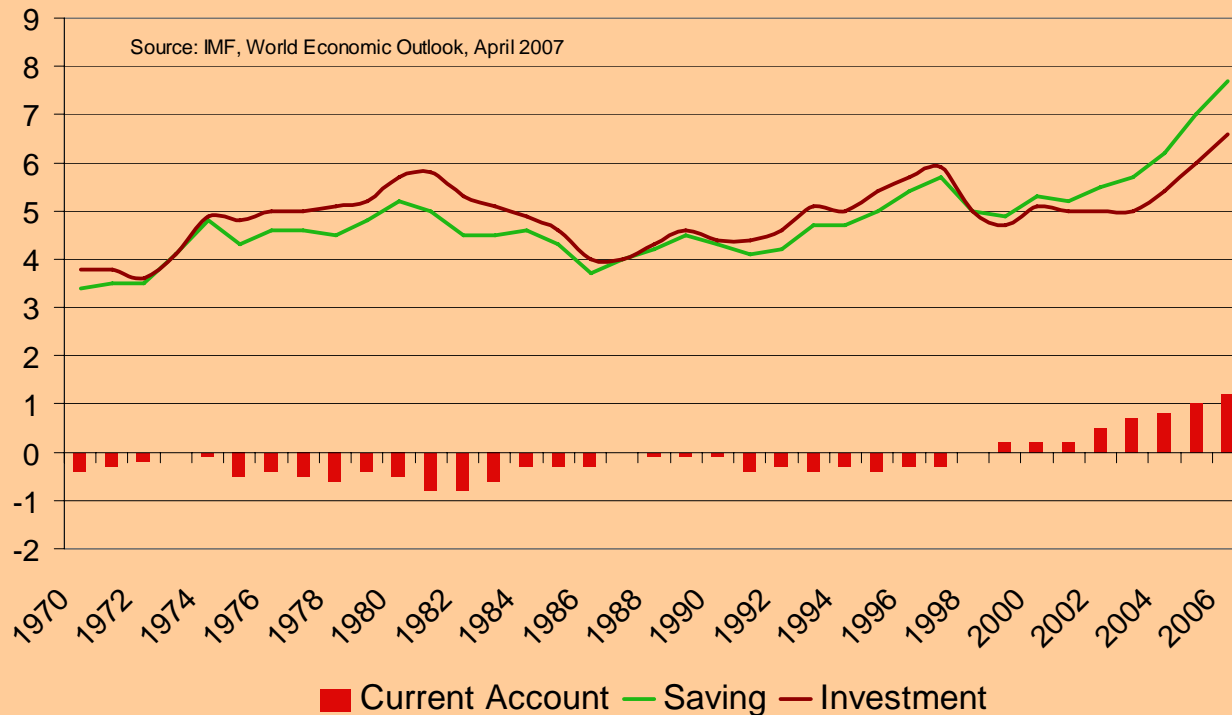
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- In the 2000s the emerging world moved into massive current account surplus
- This was part of the explanation for the “savings glut” and low global real interest rates pointed to, correctly, by Alan Greenspan and Ben Bernanke
- Behind the emerging 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)

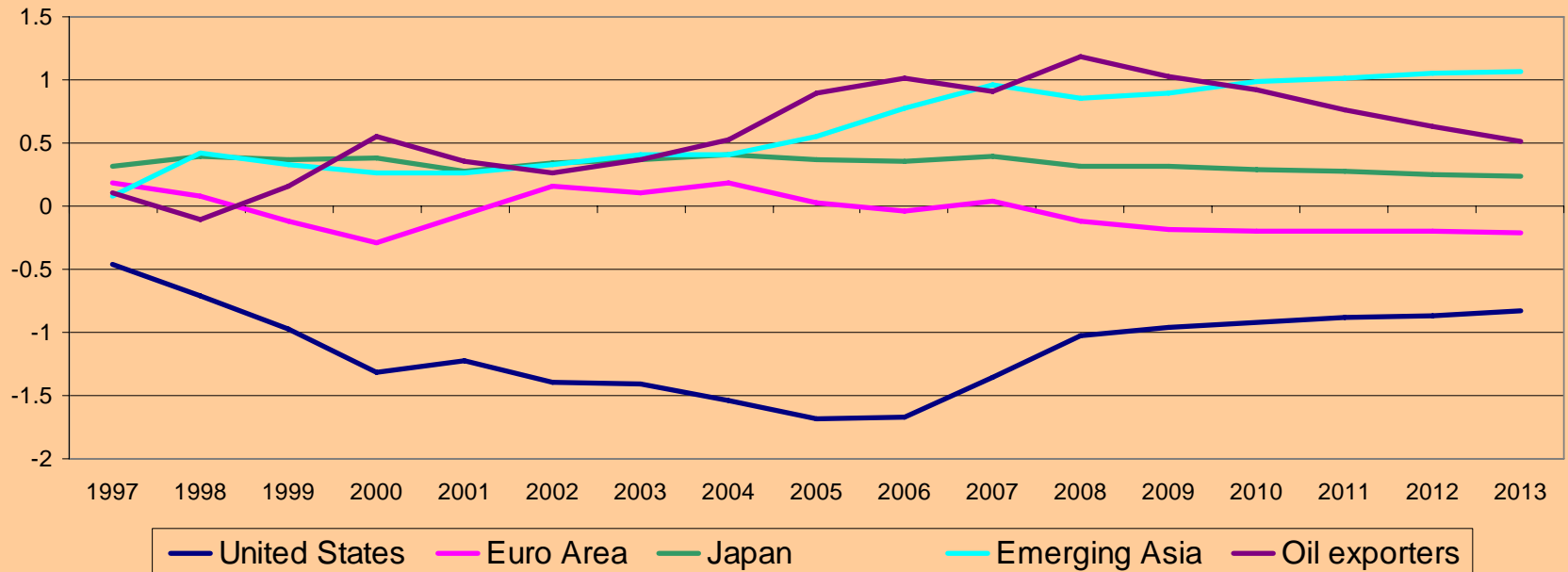


## 2. Rise of emerging country surpluses

### THE GREAT IMBALANCES

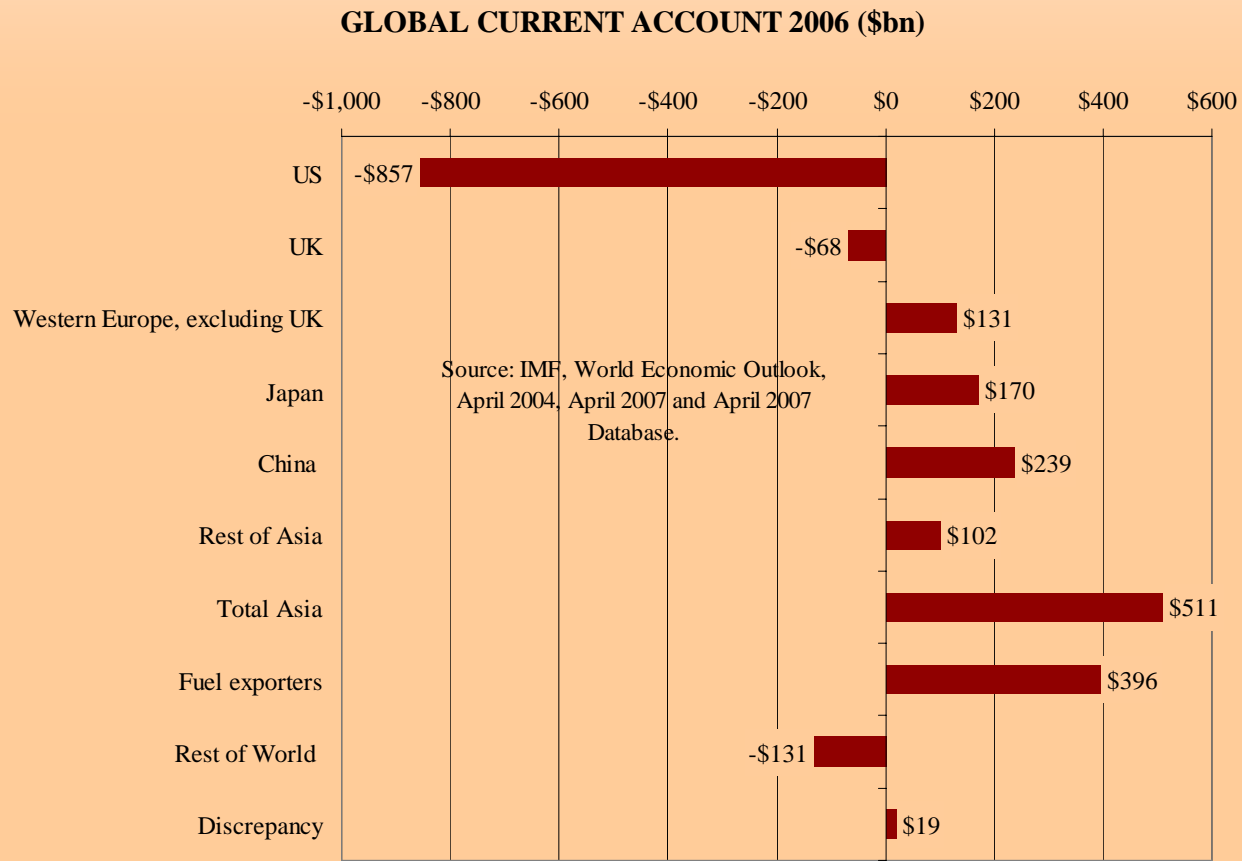
RISE AND FALL OF THE GLOBAL IMBALANCES  
(per cent of world GDP)

Source: IMF, World Economic Outlook April 2008



## 2. Rise of emerging country surpluses

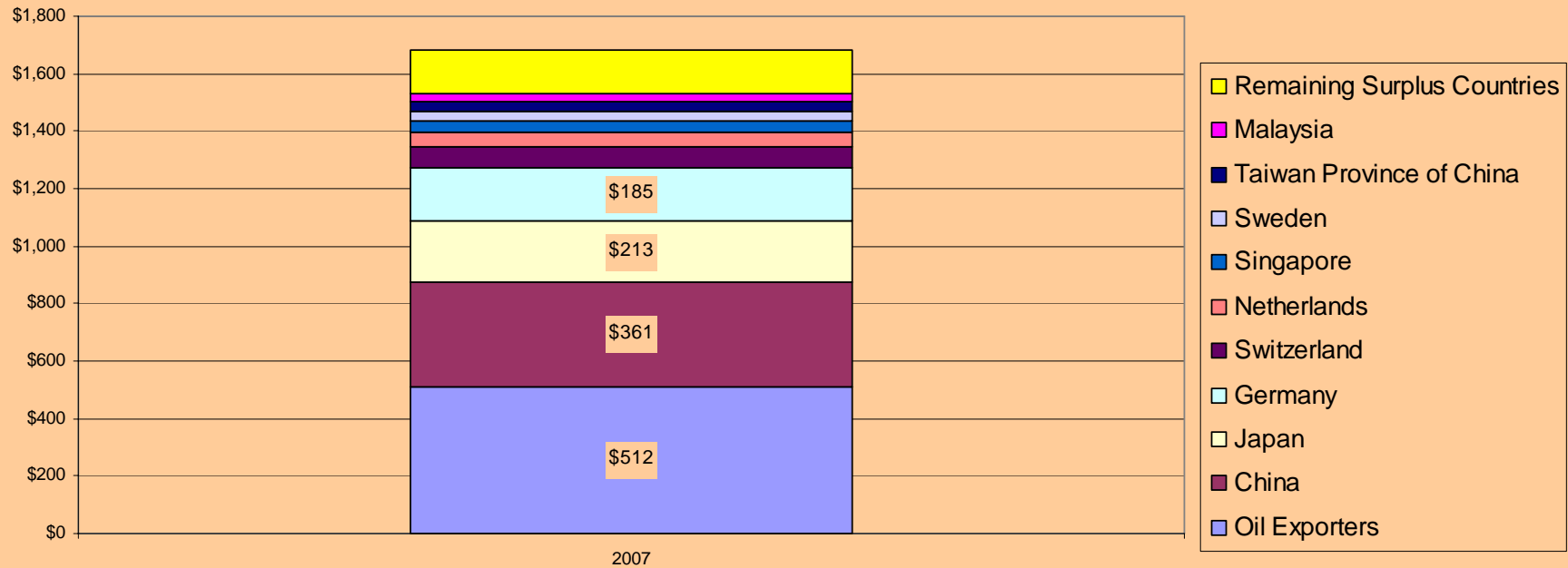
### US AS BORROWER OF LAST RESORT



## 2. Rise of emerging country surpluses

### GLOBAL SURPLUSES

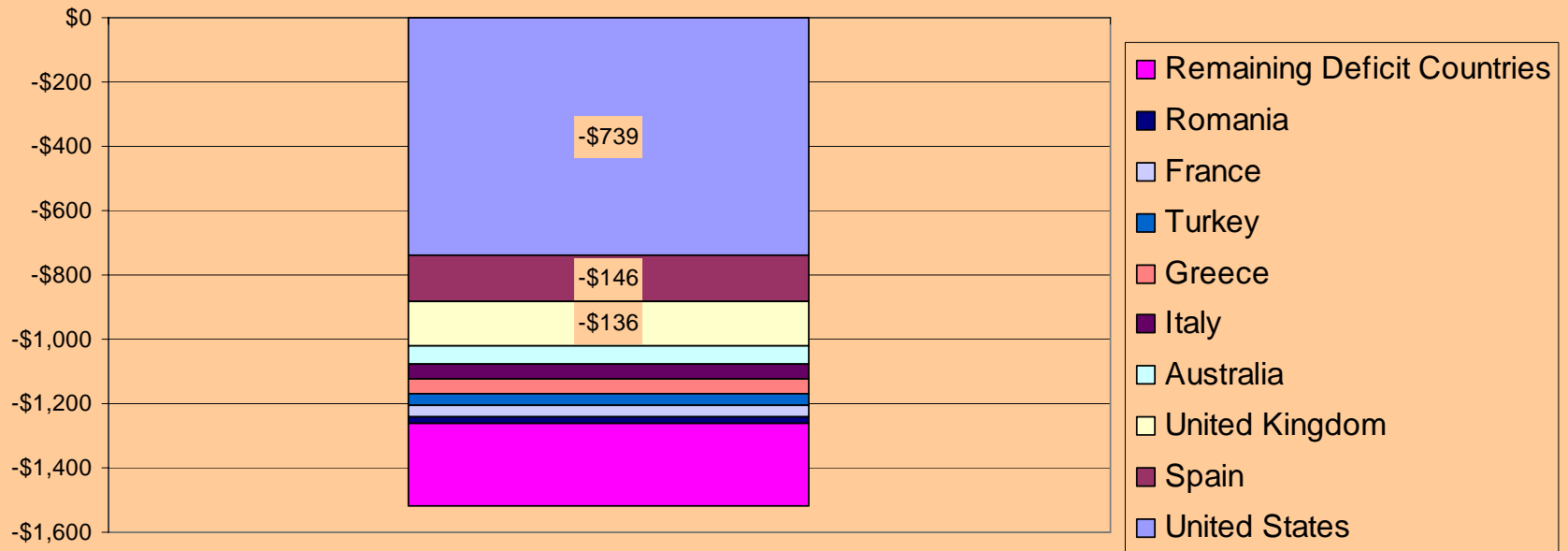
SURPLUS COUNTRIES 2007 (\$bn)



## 2. Rise of emerging country surpluses

### GLOBAL DEFICITS

DEFICIT COUNTRIES 2007 (\$bn)

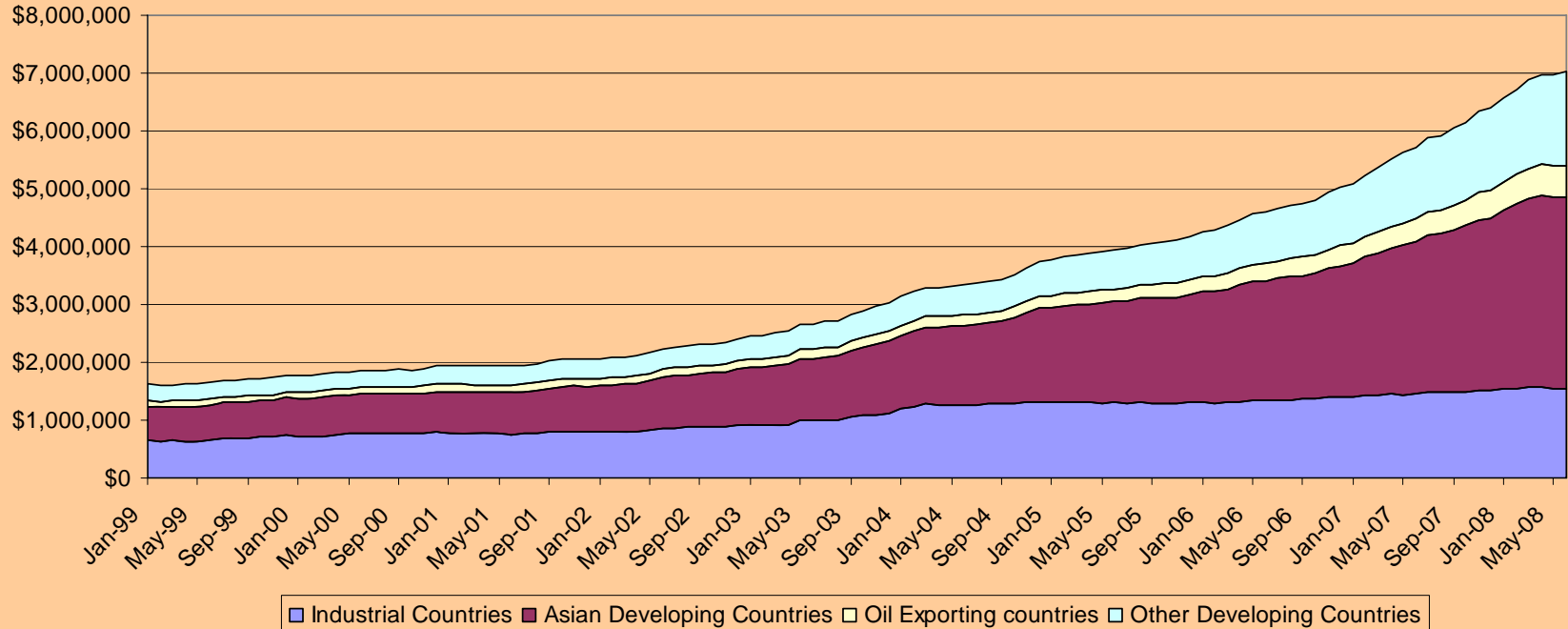




## 2. Rise of emerging country surpluses

### RISE OF FOREIGN CURRENCY RESERVES

GROWTH OF FOREIGN CURRENCY RESERVES (\$m)



### 3. US becomes borrower of last resort

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- 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

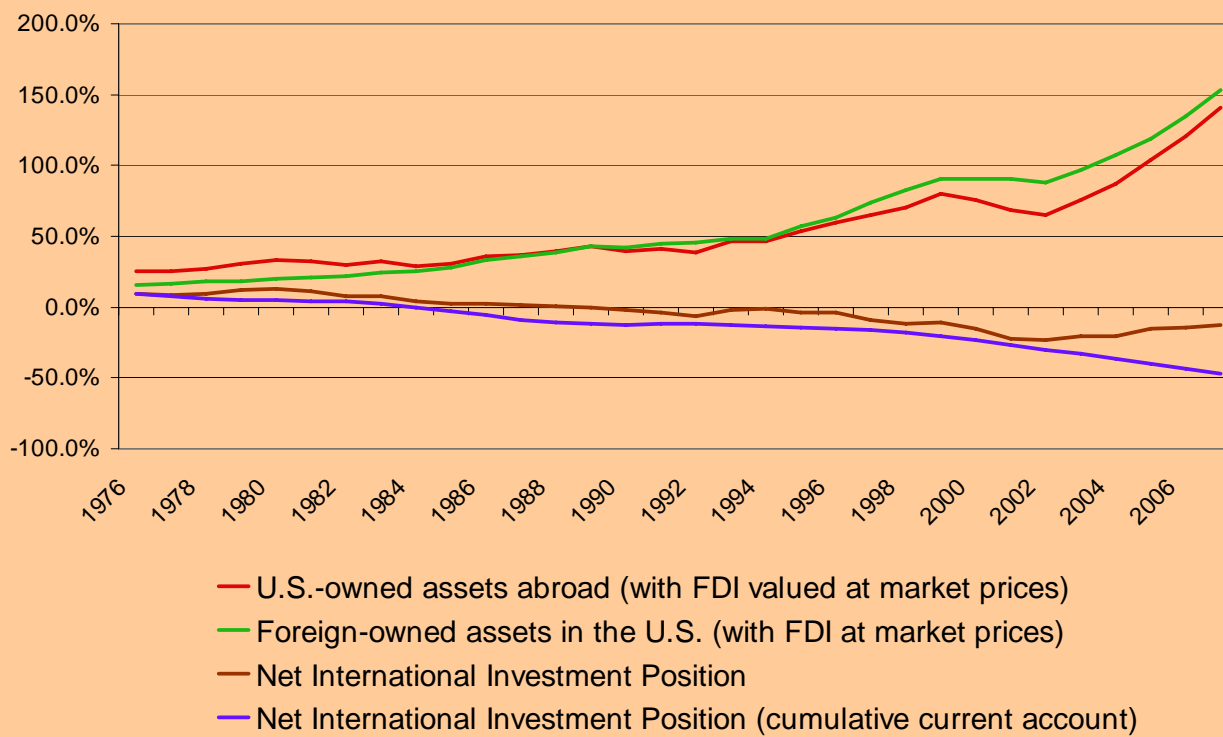
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- But the result was growing vulnerability of the US financial system to housing-related debt
- This was made worse by extremely poor regulation – indeed active encouragement of very bad lending
- It was the internal, not the external deficits, that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

### 3. US becomes borrower of last resort

## US “CHEATS” ITS CREDITORS

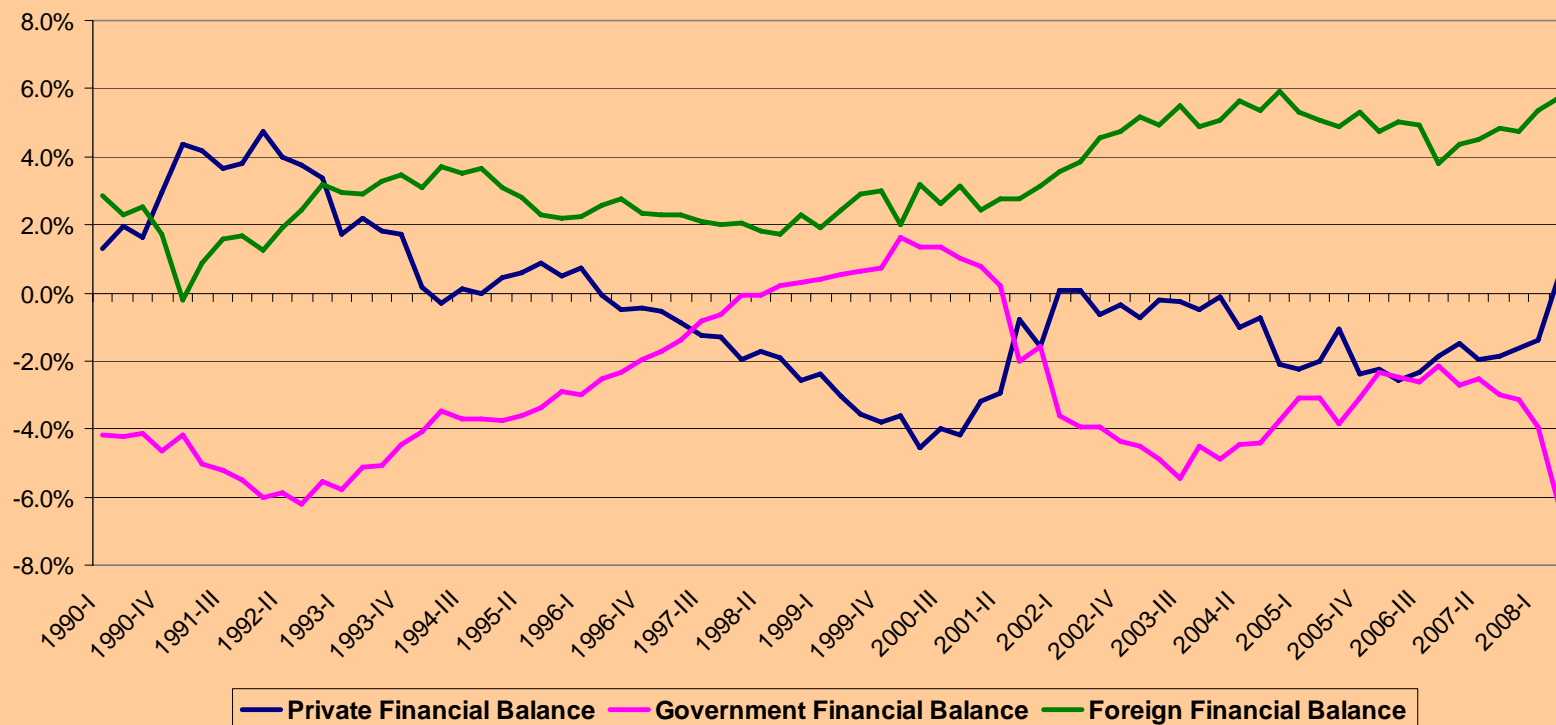
US NET INTERNATIONAL INVESTMENT POSITION  
(as per cent of GDP)



### 3. US becomes borrower of last resort

## US DOMESTIC IMBALANCES

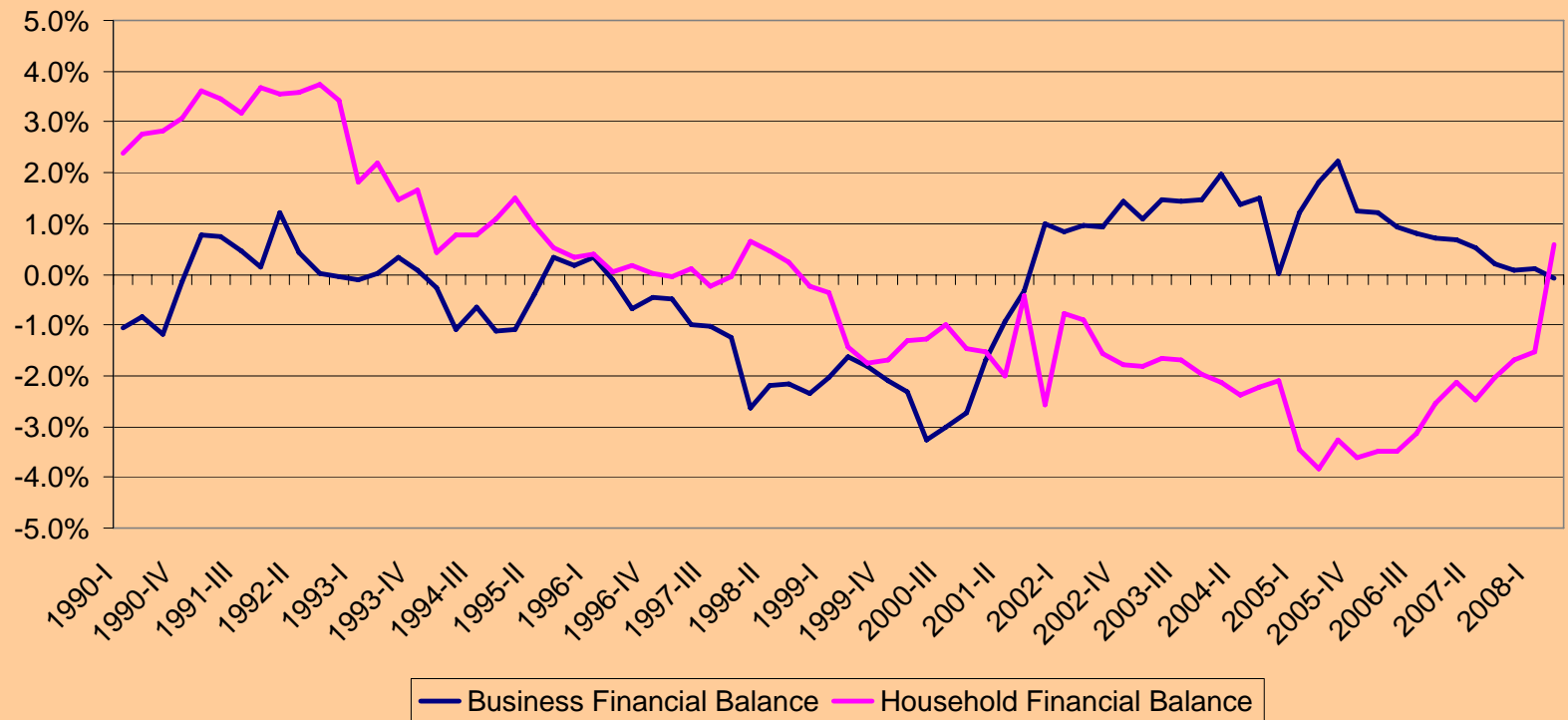
**FINANCIAL BALANCES IN THE US ECONOMY, SINCE 1990**  
(per cent of GDP)



### 3. US becomes borrower of last resort

## HOUSEHOLDS SPENT; COMPANIES DID NOT

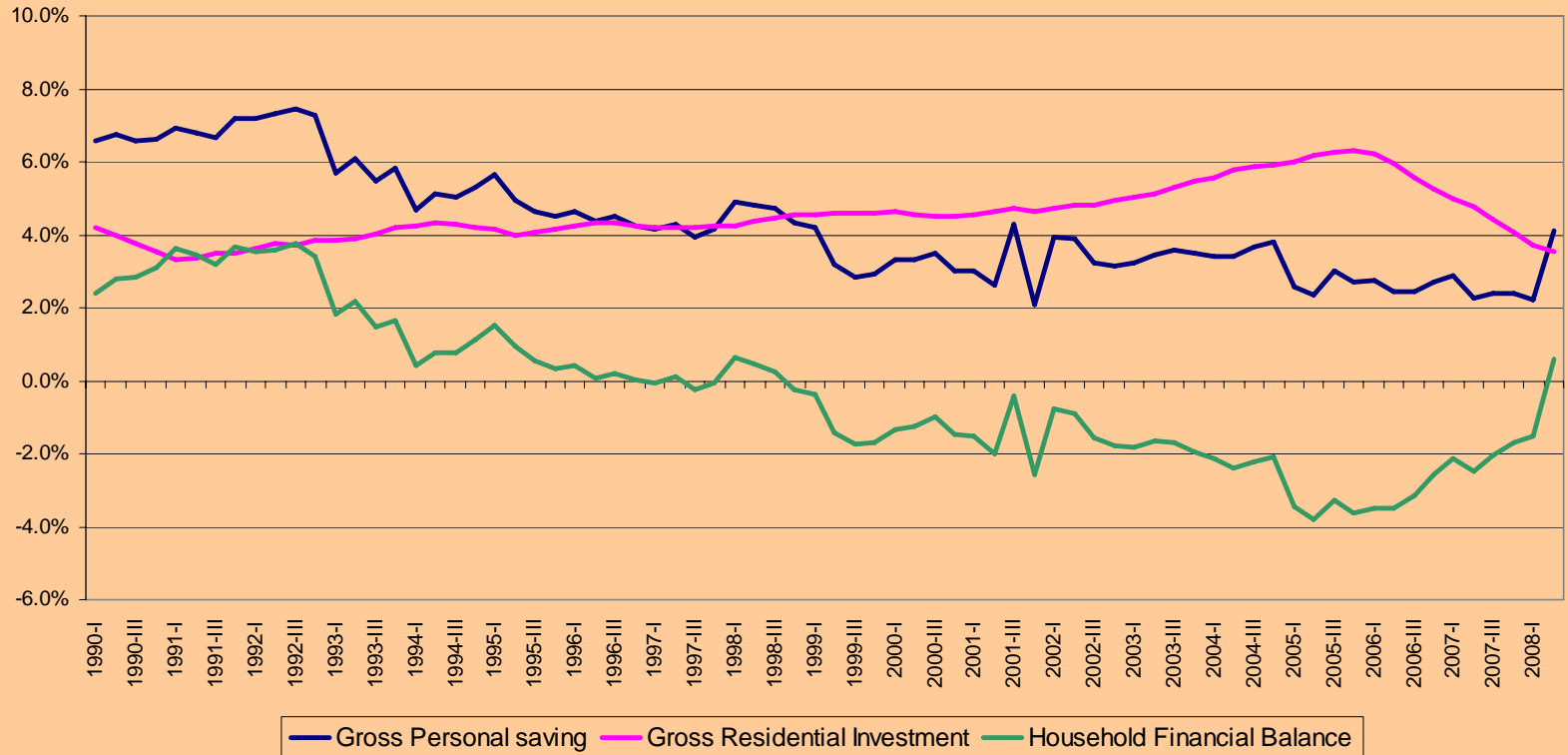
**US HOUSEHOLD AND BUSINESS FINANCIAL BALANCES**  
(as per cent of GDP)



# 3. US becomes borrower of last resort

## GREAT HOUSEHOLD SPENDING BOOM

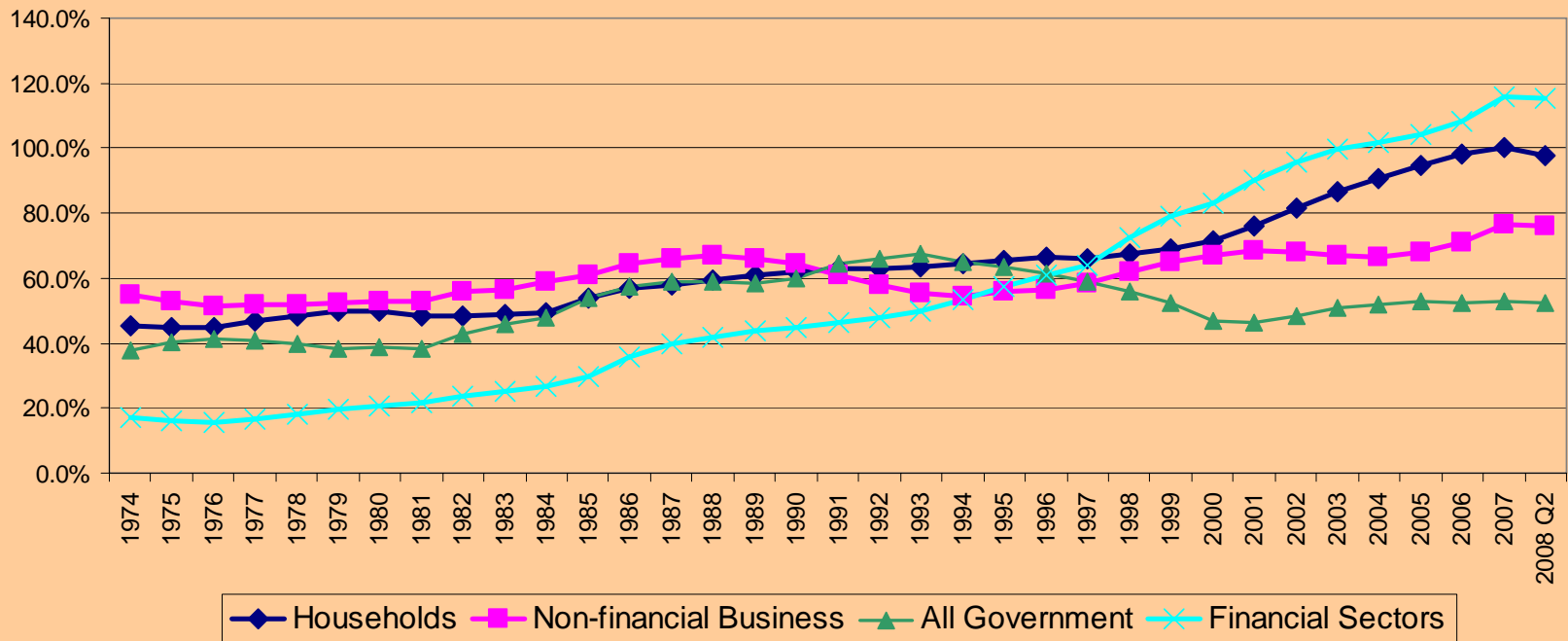
PERSONAL SAVINGS AND INVESTMENT  
(as per cent of GDP)



# 3. US becomes borrower of last resort

## AND MASSIVELY INCREASED OVERALL DEBT

SECTORAL RATIOS OF US DEBT TO GDP

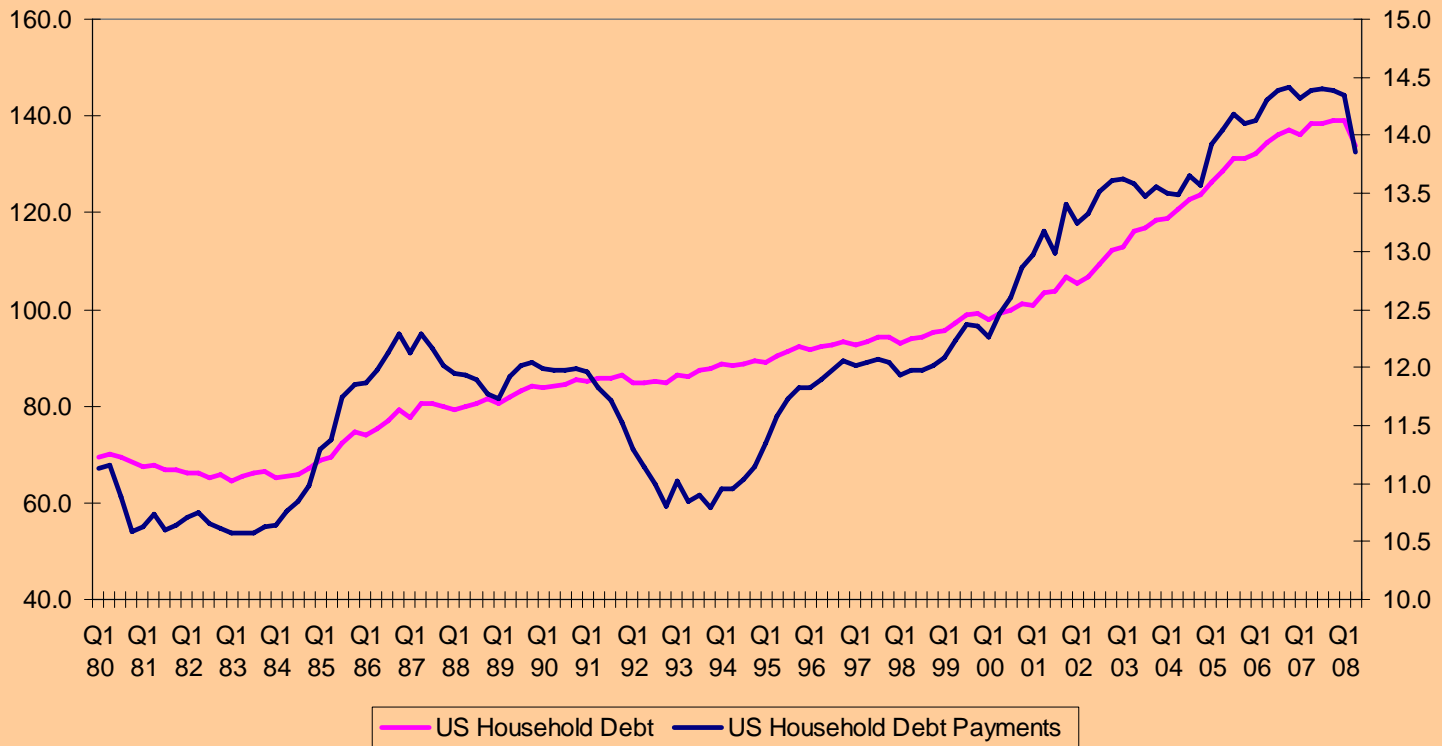




# 3. US becomes borrower of last resort

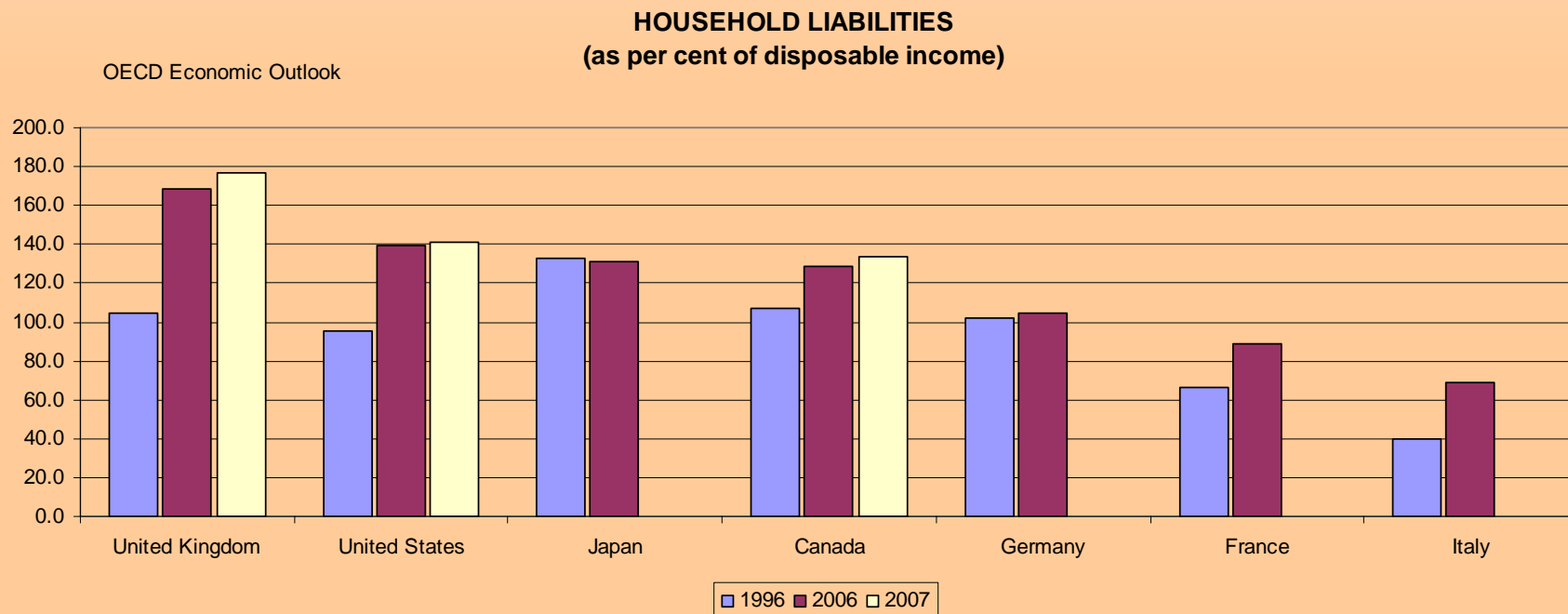
## AND MASSIVELY INCREASED HOUSEHOLD DEBT

HOUSEHOLD DEBT AND DEBT SERVICE  
(as per cent of disposable incomes)



### 3. US becomes borrower of last resort

## AND MASSIVELY INCREASED HOUSEHOLD DEBT



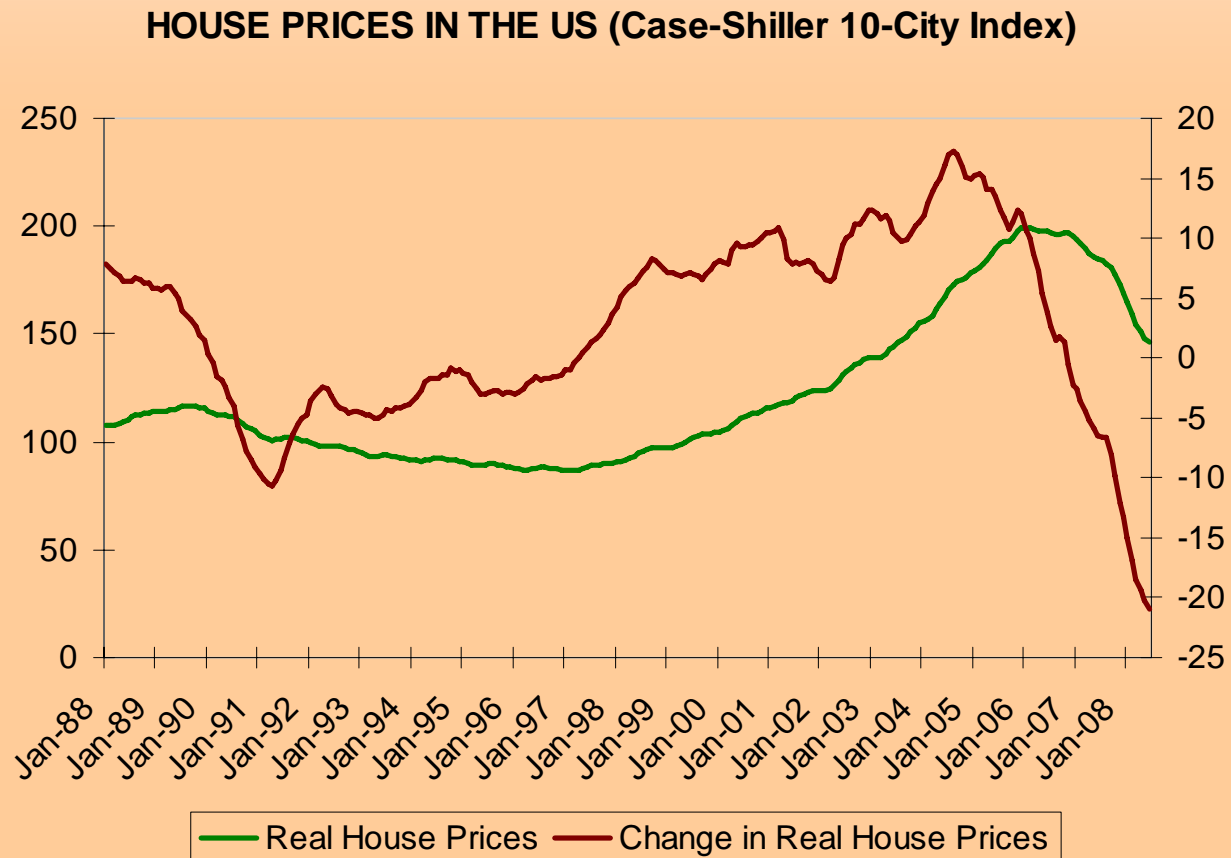
## 4. Implications of the “subprime crisis”

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- 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”

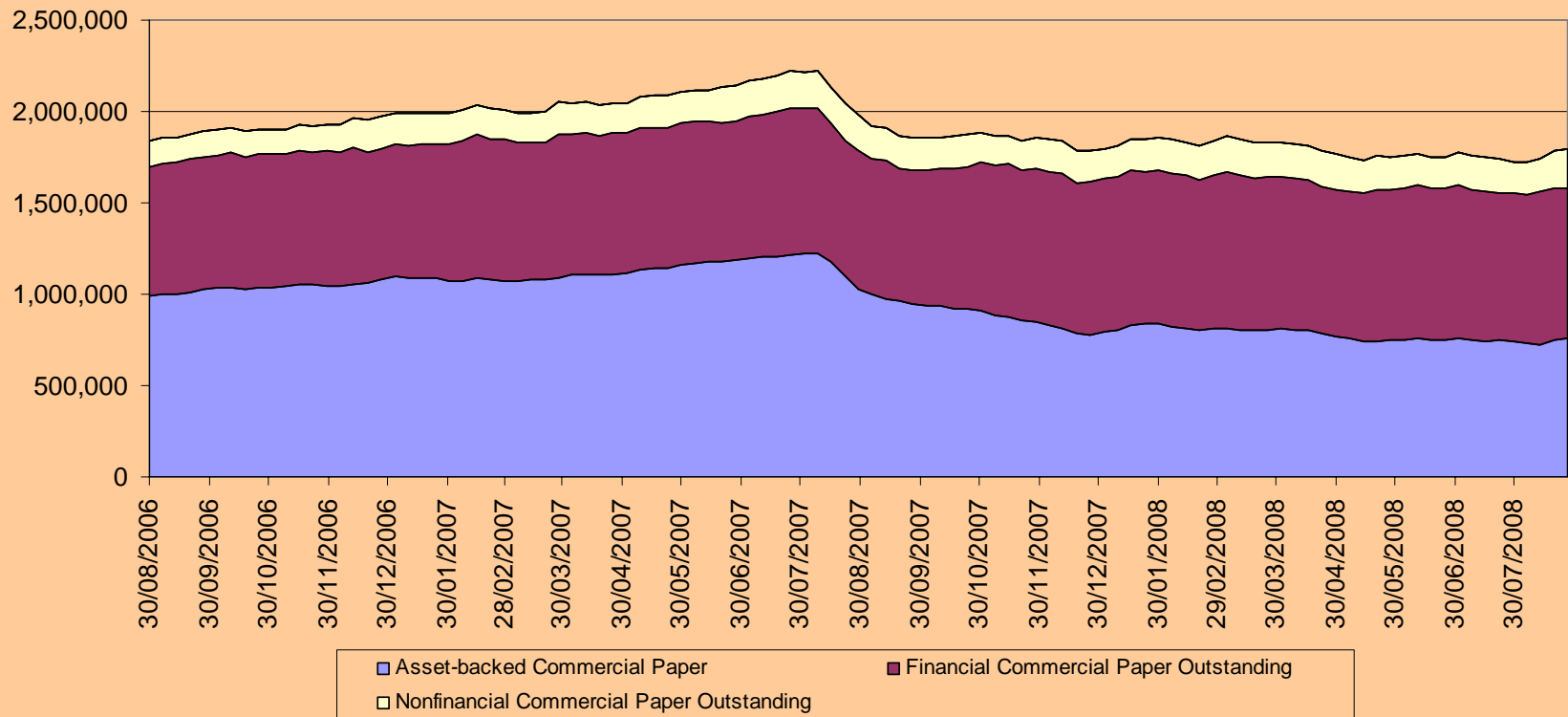
### BURST HOUSING BUBBLE



# 4. Implications of the “subprime crisis”

## CREDIT SHOCK IN THE US

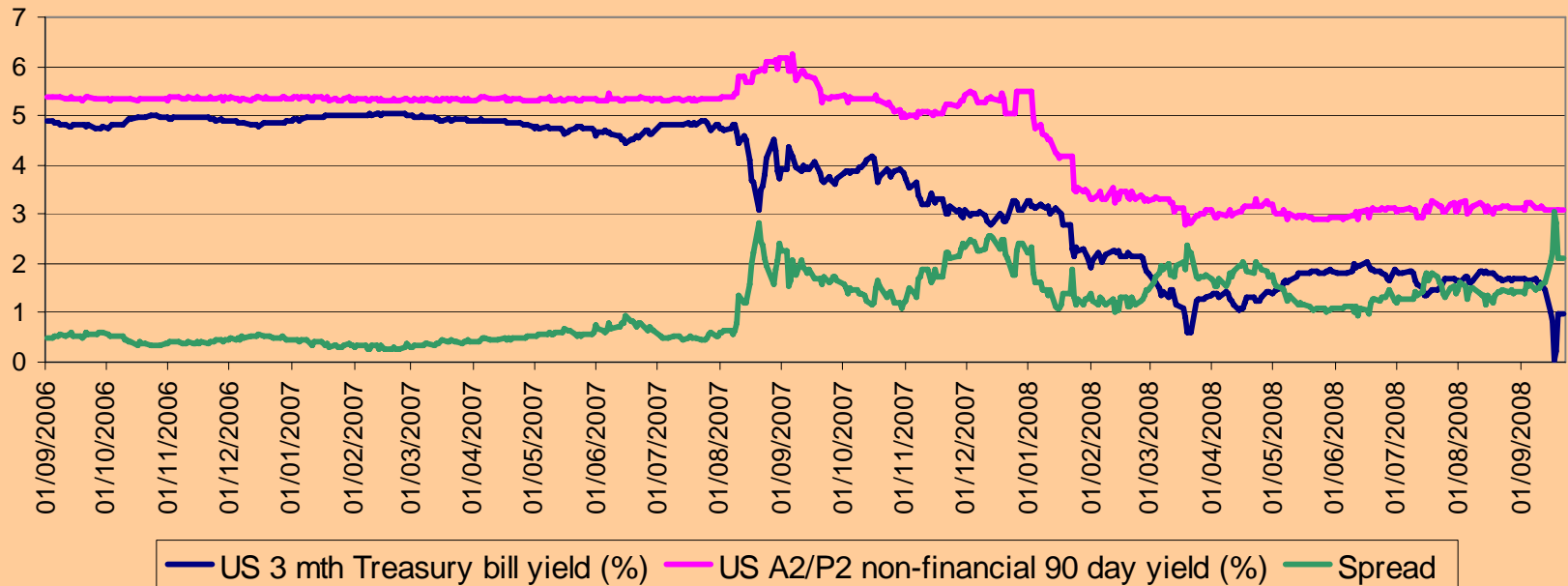
DISAPPEARANCE OF THE COMMERCIAL PAPER MARKET



# 4. Implications of the “subprime crisis”

## CREDIT SHOCK IN THE US

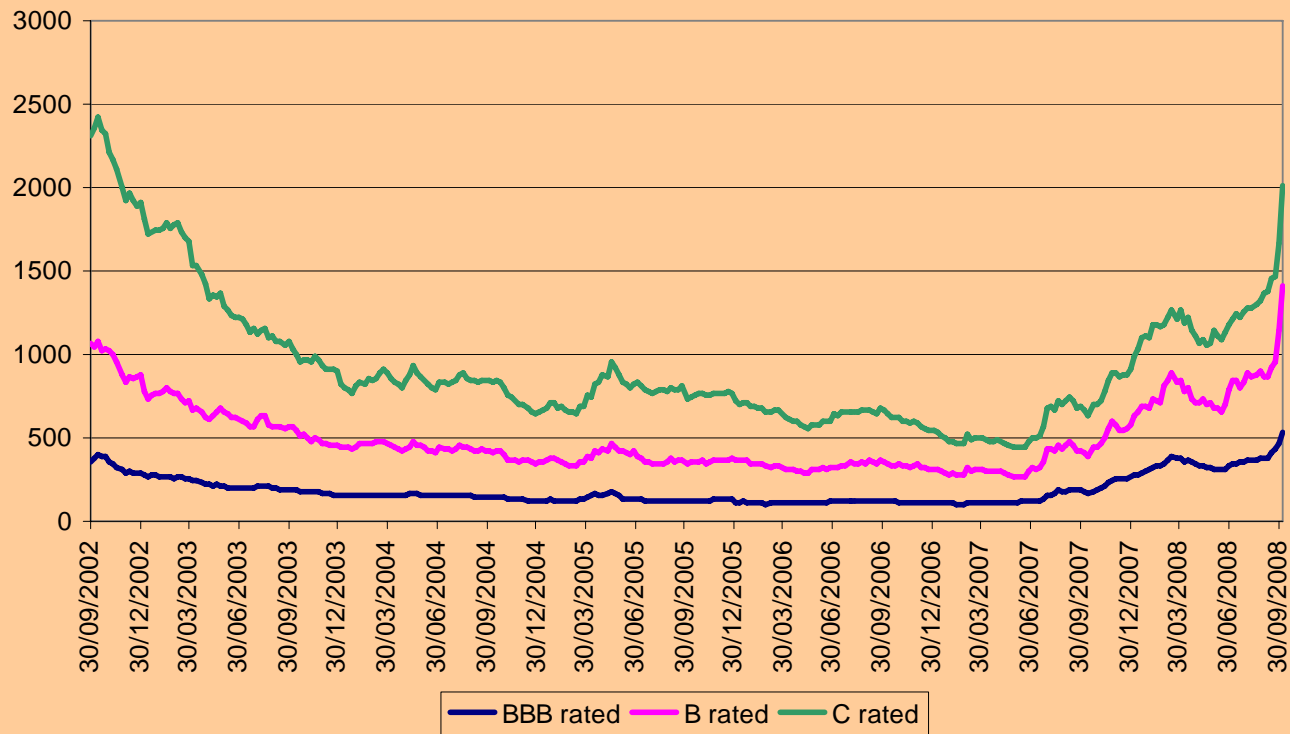
SPREADS BETWEEN TREASURY BILL AND COMMERCIAL PAPER RATES IN THE US  
(percentage points)



# 4. Implications of the “subprime crisis”

## RISE OF RISK PERCEPTIONS

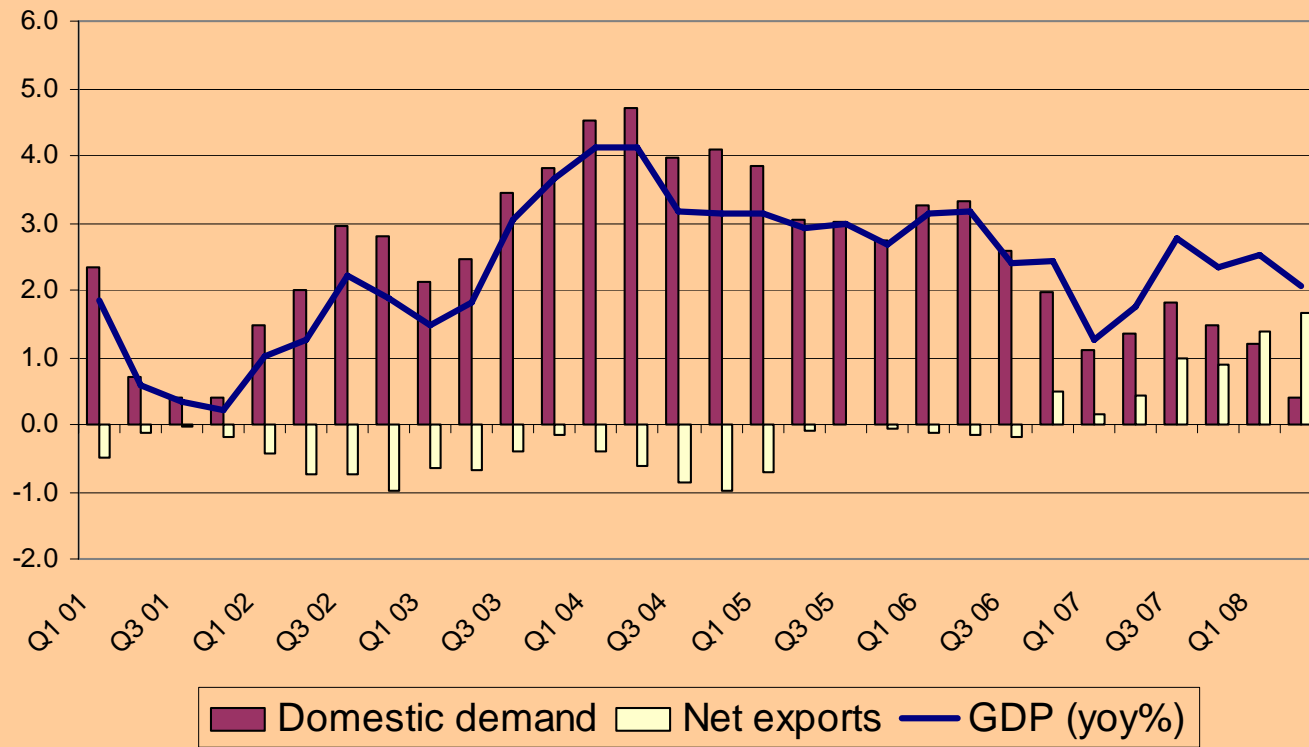
**RISK SPREADS ON US CORPORATE BONDS  
(percentage points over Treasuries)**



# 4. Implications of the “subprime crisis”

## US EXPORT-LED GROWTH

### DEMAND DRIVERS OF US GROWTH





## 4. Implications of the “subprime crisis”

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- 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

FALLING REAL EXCHANGE RATE FOR THE US



## 5. Need for adjustment in emerging economies

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- 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

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- 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

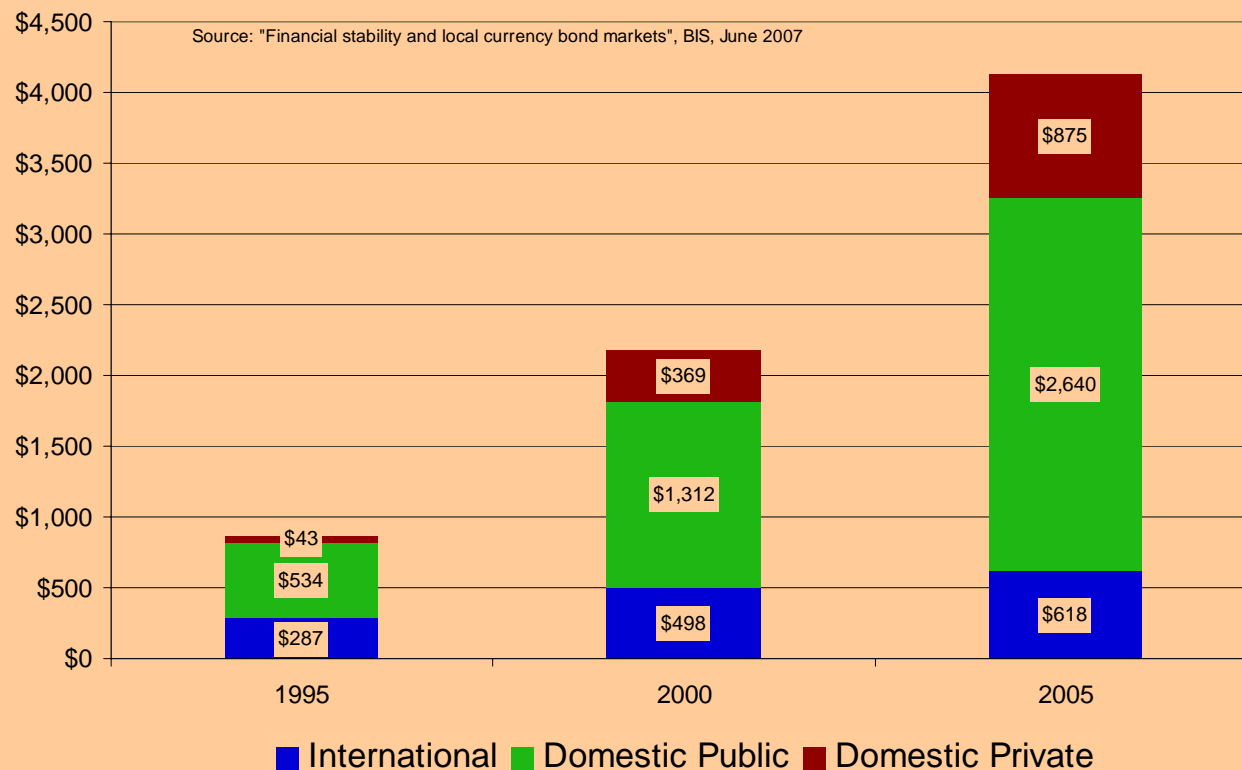
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- Of course, the development of local currency finance also depends on:
  - A sustainable fiscal position
  - A sound currency
  - A well-regulated financial system
  - Openness to foreign investors
- Without these qualities local currency finance 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

#### EMERGING MARKET BONDS OUTSTANDING (\$bn)



## 7. Conclusion

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- 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

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