Fixing Global Finance

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Fixing Global Finance

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

“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

• Background to the global imbalances
• External and domestic US imbalances
• Challenges of global adjustment ahead
• Paths to a stable world economy
1. Background to the global imbalances

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

US AS BORROWER OF LAST RESORT

GLOBAL CURRENT ACCOUNT 2006 ($bn)


- US: -$857
- UK: -$68
- Western Europe, excluding UK: $131
- Japan: $170
- China: $239
- Rest of Asia: $102
- Total Asia: $511
- Fuel exporters: $396
- Rest of World: -$131
- Discrepancy: $19

Discrepancy: $19
1. Background to the global imbalances

UNBALANCED WORLD ECONOMY

CURRENT ACCOUNT BALANCES (as per cent of GDP)

1. Background to the global imbalances

EMERGING ECONOMIES SHIFT INTO SURPLUS

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

Source: IMF, World Economic Outlook, April 2007

EMERGING ECONOMIES SHIFT INTO SURPLUS

Current Account
Saving
Investment
1. Background to the global imbalances

- For the emerging countries the emergence of current account surpluses has brought big benefits
- In particular, it has reduced risks and lowered risk premia
- This has permitted faster and more stable growth, particularly in Asia
1. Background to the global imbalances

DISAPPEARING EMERGING ECONOMY RISK

REDUCTION IN EMERGING MARKET RISK SPREADS
(percentage points over US Treasuries)

Source: Datastream
1. Background to the global imbalances

IMF GOES OUT OF BUSINESS

IMF CREDIT OUTSTANDING ($bn)

Source: International Monetary Fund

Note: as of 31st October
1. Background to the global imbalances

DEVELOPING COUNTRY GROWTH SURGE

GROWTH OF THE WORLD ECONOMY
(at PPP exchange rates)

Source: IMF, World Economic Outlook, October 2007, Database
2. External and domestic US imbalances

• The emergence of the US as the global borrower of last resort brought stability to the world

• But it was temporary, alas

• It created two risks:
  – External – exploding external debt
  – Internal – credit bubble and internal debt

• It appears that the latter bit first.
2. External and domestic US imbalances

US AS A HAPPY DEBTOR

US NET INTERNATIONAL INVESTMENT POSITION
(as a share of GDP)

Source: BEA and my calculations

U.S.-owned assets abroad (with FDI valued at market prices)
Foreign-owned assets in the U.S. (with FDI at market prices)
Net International Investment Position
Net International Investment Position (cumulative current account)
2. External and domestic US imbalances

US DOMESTIC IMBALANCES

FINANCIAL BALANCES IN THE US ECONOMY (per cent of GDP)

Source: BEA
2. External and domestic US imbalances

HOUSEHOLDS SPENT; COMPANIES DID NOT

US PRIVATE SECTOR FINANCIAL BALANCES
(per cent of GDP)

Source: BEA
2. External and domestic US imbalances

RISING HOUSEHOLD DEBT AND DEBT SERVICE

HOUSEHOLD DEBT AND DEBT SERVICE
(as per cent of disposable incomes)
2. External and domestic US imbalances

BURST HOUSING BUBBLE

REAL HOUSE PRICES
(Case-Shiller 10-City)

HOUSE PRICES IN REAL TERMS

COMPOSITE-10

RATE OF CHANGE OF HOUSE PRICES

Jan-87 Jan-88 Jan-89 Jan-90 Jan-91 Jan-92 Jan-93 Jan-94 Jan-95 Jan-96 Jan-97 Jan-98 Jan-99 Jan-00 Jan-01 Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07

0 20 40 60 80 100 120 140 160 180 200

-15 -10 -5 0 5 10 15 20

Composite-10 annual per cent change
2. External and domestic US imbalances

CREDIT SHOCK IN THE US

SPREAD BETWEEN COMMERCIAL PAPER AND TREASURY BILL RATES

US COMM PAPER A2/P2 NONFIN 90 DAY  US TREASURY BILL 2ND MARKET 3 MONTH  SPREAD
2. External and domestic US imbalances

MISSED SLOWDOWN

CONSENSUS FORECASTS OF GROWTH FOR 2008

Source: Consensus Forecasts

USA 2008  UK 2008  Japan 2008  Eurozone 2008
2. External and domestic US imbalances

FALLING DOLLAR

US REAL EXCHANGE RATE (JP Morgan)
2. External and domestic US imbalances

**SHRINKING CURRENT ACCOUNT DEFICIT**

**CURRENT ACCOUNT BALANCE (per cent of GDP)**

Source: BEA
2. External and domestic US imbalances

- US domestic excesses are being unwound
- Similar things are likely to happen in other credit-boom countries: UK, Spain, eastern Europe
- External balances are being corrected
- Because the US has borrowed in its own currency, the adjustment will be manageable
- But the epoch when the US was borrower of last resort is now at an end
- So now what?
3. Challenges of adjustment ahead

- If the world economy is now to grow in a stable manner, the current account surpluses of other countries must shrink or deficits increase.
- The former would be far more desirable.
- Ideally, this should happen with an expansion in demand, relative to supply, and so rising domestic absorption.
- Where might this happen?
3. Challenges of adjustment ahead

**CURRENT ACCOUNT BALANCES FOR 2006 (bn) (IMF)**

<table>
<thead>
<tr>
<th>Region</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>All high-income countries</td>
<td>-$545</td>
</tr>
<tr>
<td>US</td>
<td>-$857</td>
</tr>
<tr>
<td>Other Anglosphere</td>
<td>-$109</td>
</tr>
<tr>
<td>Canada</td>
<td>$21</td>
</tr>
<tr>
<td>New Zealand</td>
<td>-$9</td>
</tr>
<tr>
<td>Australia</td>
<td>-$41</td>
</tr>
<tr>
<td>UK</td>
<td>-$80</td>
</tr>
<tr>
<td>Western Europe (excluding UK)</td>
<td>$162</td>
</tr>
<tr>
<td>Eurozone</td>
<td>$8</td>
</tr>
<tr>
<td>Japan</td>
<td>$171</td>
</tr>
<tr>
<td>Newly-Industrialised Asian economies</td>
<td>$87</td>
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<tr>
<td>Singapore</td>
<td>$36</td>
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<tr>
<td>Taiwan</td>
<td>$25</td>
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<tr>
<td>Hong Kong</td>
<td>$19</td>
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<tr>
<td>Korea</td>
<td>$6</td>
</tr>
</tbody>
</table>
3. Challenges of adjustment ahead

### CURRENT ACCOUNT BALANCES FOR 2006 ($bn) (IMF)

<table>
<thead>
<tr>
<th>Region</th>
<th>2006</th>
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<tbody>
<tr>
<td>Emerging market and developing countries</td>
<td>$544</td>
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<tr>
<td>Africa</td>
<td>$20</td>
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<tr>
<td>Sub-Saharan</td>
<td>-$9</td>
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<tr>
<td>Central and Eastern Europe</td>
<td>-$89</td>
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<tr>
<td>CIS</td>
<td>$99</td>
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<tr>
<td>Russia</td>
<td>$96</td>
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<tr>
<td>Excluding Russia</td>
<td>$3</td>
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<tr>
<td>Developing Asia</td>
<td>$253</td>
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<tr>
<td>China</td>
<td>$239</td>
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<tr>
<td>India</td>
<td>-$19</td>
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<tr>
<td>Excluding China and India</td>
<td>$34</td>
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<tr>
<td>Middle East</td>
<td>$212</td>
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<tr>
<td>Western Hemisphere</td>
<td>$49</td>
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<tr>
<td>Brazil</td>
<td>$14</td>
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<tr>
<td>Mexico</td>
<td>-$2</td>
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<tr>
<td>Fuel exporters</td>
<td>$396</td>
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<tr>
<td>Nonfuel</td>
<td>$149</td>
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<tr>
<td>Primary producers</td>
<td>$10</td>
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</table>
3. Challenges of adjustment ahead

• Where might the surpluses shrink?
  – Japan and Germany stick out. But they are unlikely to shift quickly, because of their structurally weak demand
  – For the oil exporters it depends on the future of the oil price, which is already very high. If it falls, their surpluses are likely to fall, too
  – China seems to be a very good candidate, however

• So how might needed adjustments happen?
3. Challenges of adjustment ahead

OIL BOOM – AND BUST?

NOMINAL AND REAL PRICE OF OIL

- Nominal price ($ per barrel)
- Real, deflated by US CPI
- Real, deflated by Ind countries unit value of exports
4. Paths to a stable world economy

• There are good reasons for the emerging economies to alter their policies:
  – Reserves are quite large enough, by any standards
  – It is hard to sterilise the monetary impact of huge reserve accumulations
  – Real returns on the assets they own are low and will certainly be negative when currencies adjust
  – Subsidising exports through an undervalued exchange rate and unhedged lending in foreign currencies is expensive
  – And so insurance has become excessively expensive
4. Paths to a stable world economy

THE GREAT CURRENCY RESERVE BOOM

EXPLOSIVE GROWTH OF FOREIGN CURRENCY RESERVES ($m)

Source: IMF
4. Paths to a stable world economy

• The big decision-maker is China
  – It is prepared to buy an acquiescent US, but nobody knows on what scale (including, I think, the Chinese)
  – It does not know how far to let the currency appreciate
  – And it is not sure what the best exchange-rate regime would be

• Adjustment is now surely necessary
4. Paths to a stable world economy

**CHINA’S EXPLOSIVE CURRENT ACCOUNT**

<table>
<thead>
<tr>
<th>Year</th>
<th>CA Balance</th>
<th>Net FDI</th>
<th>Other Capital Inflows</th>
<th>Reserves Accumulation</th>
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<tbody>
<tr>
<td>1996</td>
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<td>2007</td>
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Source: IMF and World Bank
4. Paths to a stable world economy

WHO DOES THE SAVING IN CHINA

COMPOSITION OF SAVINGS

(per cent of GDP)

Source: World Bank
4. Paths to a stable world economy

THE PEGGED EXCHANGE RATE

Remnimbi against the Dollar

$0.250
$0.200
$0.150
$0.100
$0.050
$0.000

02/01/1990 02/01/1991 02/01/1992 02/01/1993 02/01/1994 02/01/1995 02/01/1996 02/01/1997 02/01/1998 02/01/1999 02/01/2000 02/01/2001 02/01/2002 02/01/2003 02/01/2004 02/01/2005 02/01/2006 02/01/2007 02/01/2008
4. Paths to a stable world economy

HOW CHINA STERILISES RESERVES

Sterilisation of Foreign Currency Intervention
(growth rate, year-on-year, per cent)

Source: UBS
4. Paths to a stable world economy

THE FIXED CHINESE REAL EXCHANGE RATE

TRADE-WEIGHTED REAL EXCHANGE RATE

Source: JP Morgan
4. Paths to a stable world economy

- The big issue, however, is how to persuade emerging countries that running current account deficits is safe.
- Large reserves are part of the answer. The IMF is now too small to be relevant: its total resources are roughly a 20th of global foreign currency reserves.
- The other is a shift to domestic currency finance, because it was currency mismatches that made previous financial crises in emerging economies so dangerous. Get a domestic currency market that local citizens trust. Then foreigners will join in.
- This shift is now happening.
4. Paths to a stable world economy

RISE OF DOMESTIC CURRENCY FINANCING

EMERGING MARKET BONDS OUTSTANDING ($bn)

Source: "Financial stability and local currency bond markets", BIS, June 2007

International | Domestic Public | Domestic Private

1995: $43 | $534 | $287
2000: $369 | $1,312 | $498
2005: $875 | $2,640 | $618
4. Paths to a stable world economy

• My conclusions are:
  – Very large current account deficits almost always end up in crises
  – These crises are worse if the finance is in foreign currency
  – The US does not have this problem. So it will be able to spend itself out of trouble, but its external deficit will shrink
  – But the world economy will now need to be better balanced
  – That means lower surpluses/bigger deficits in emerging economies, particularly China
  – The question is how this can happen more safely
4. Paths to a stable world economy

– This is partly a matter of domestic currency finance
– It is also a matter of having the right sort of regulatory framework
– That is now a very big issue – one I will leave to my next Oxonia lecture