



# Macroeconomics of the crisis

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## Road map

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- Global imbalances (GI) caused crisis
- *GI interacted with* greed, incentive problems, financial innovation, weak regulation
- Concerns going forward
- Policies: markets, imbalances, institutions
  - focus on regulatory reform misses GI
  - must develop domestic financial markets of emerging market (EM) countries
  - *provide credible insurance against sudden stops*
  - improve global governance: G20, IMF, FSF

See Dewatripont, Freixas and Portes, *Macroeconomic Stability and Financial Regulation: Issues for the G20*, CEPR, 2009



## Why did the 'crisis' of autumn 1998 have no real effects?

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- Leverage was actually higher then, and deleveraging was rapid
- But financial engineering hadn't yet developed the range of structured products that have proved so toxic
- Nor were they being held in 'off balance sheet' vehicles
- And there were *no global imbalances*

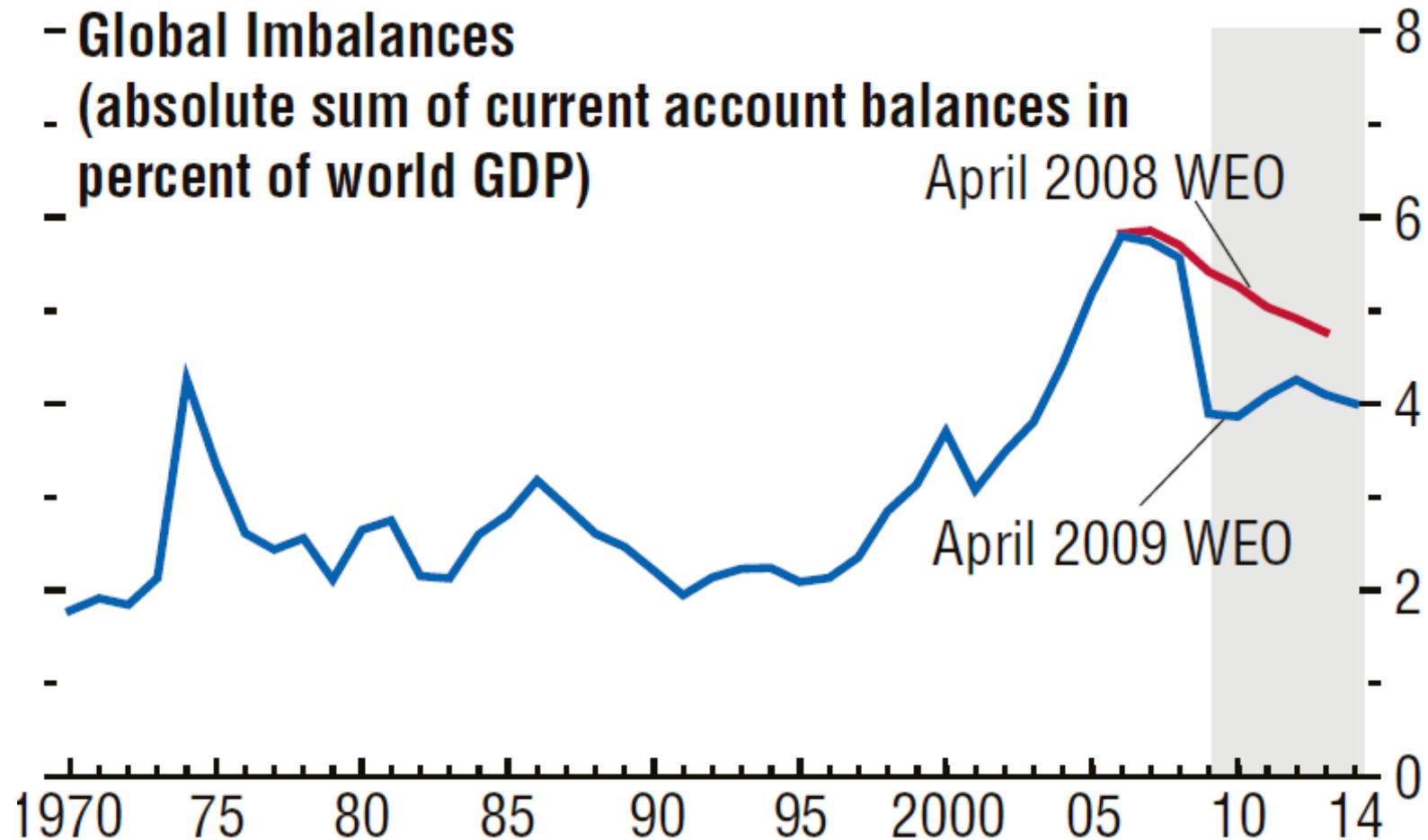


## GI: the issues

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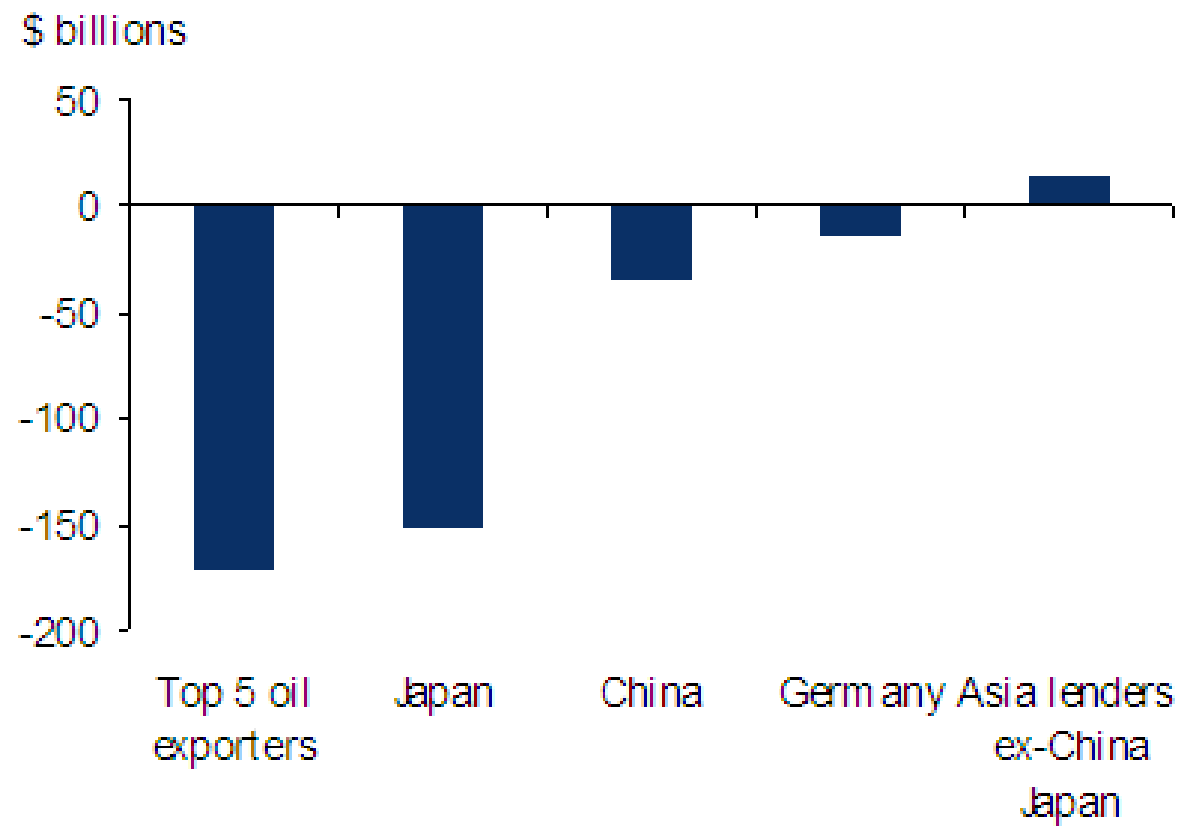
- Increased *dispersion* of CA over the past decade – counterparts are much bigger net and gross capital flows, *putting pressure on intermediation*
- And loose monetary policies together with reserve accumulation brought excessive global liquidity
- Capital flowing the ‘wrong way’ – from poor and EM countries to AC
- *Not* just a US-China story, nor advanced and EM countries: UK, southern and central Europe, Australia with large CA deficits; Germany, Japan, several Asian EM and commodity exporters with large CA surpluses

## IMF: Global imbalances down, but forecast to continue at 2004-05 level



Source: IMF, *WEO*, April 2009

## Some rebalancing: Expected fall in global lenders' external savings, 2008 vs 2009

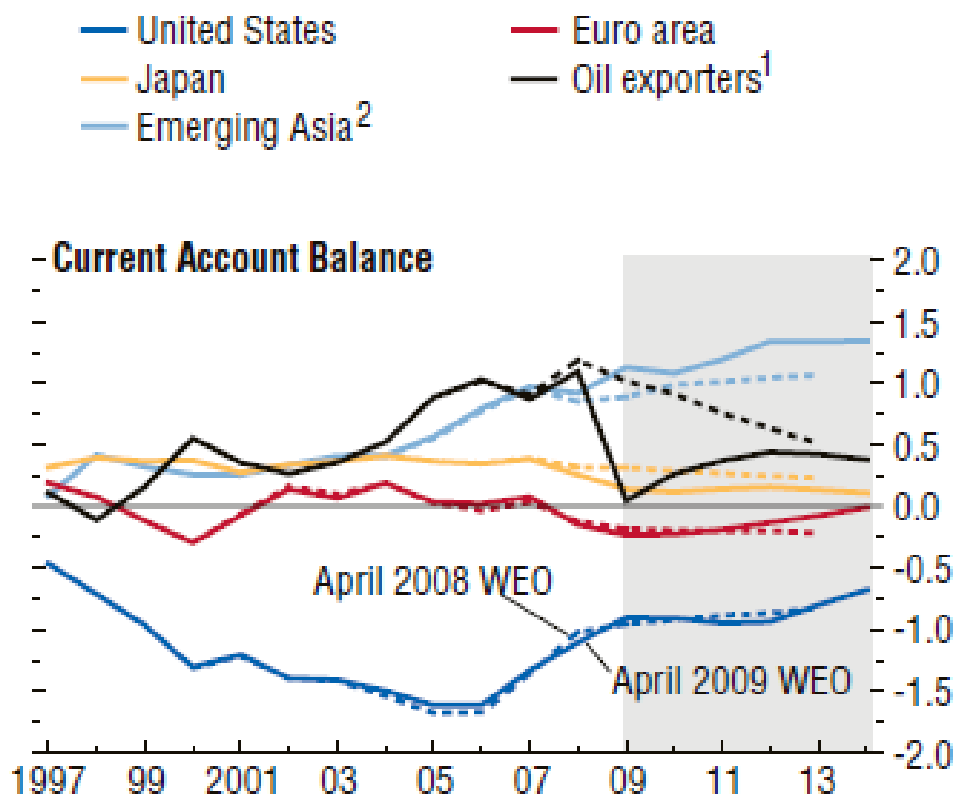


Source: Broda et al., 'The new global balance', VoxEU.org, 22 May 2009

# But emerging Asia current account surplus projected to rise! (Zhou Xiaochuan disagrees...)

## Current Account Balances and Net Foreign Assets

(Percent of global GDP)



Source: IMF, *WEO*, April 2009



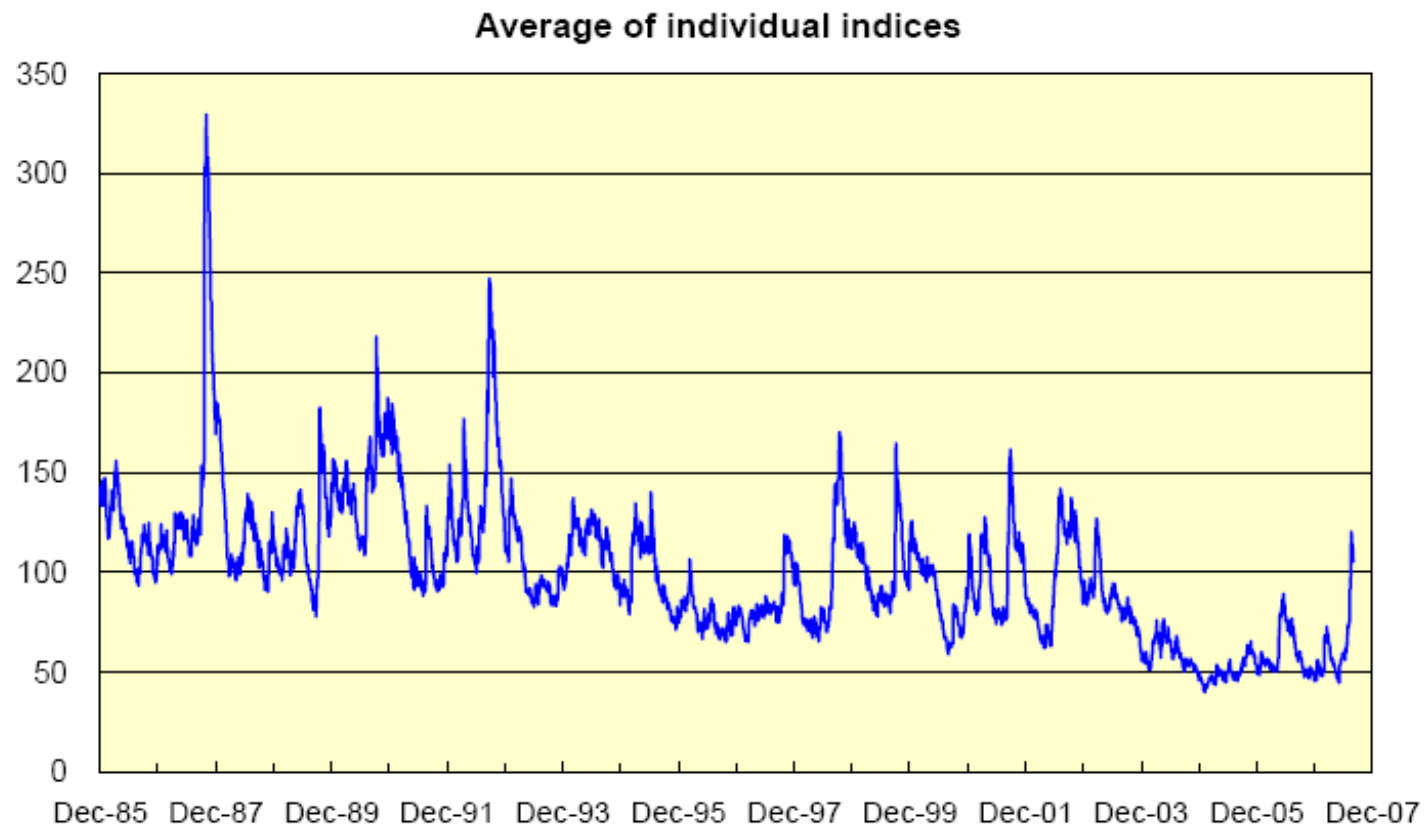
# The problems

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- *Not* (yet) the feared unravelling of imbalances, 'sudden stop' for US, abrupt dollar depreciation (Ferguson *et al.* 2007 and WEO April 2009 focus on this)
- But GI played significant role in fall of volatilities from 2004 to mid-2007 (financial market volatilities are a decreasing function of turnover and liquidity)
- Low volatilities, with low interest rates and low inflation, led to 'search for yield' and increase in leverage
- Search for yield created demand for financial 'innovation'

# 'Financial quiescence': volatility was exceptionally low for 4 years – across all asset classes and markets

**Figure 4.7** Global volatility indices (1)



Source: Ferguson, Hartmann, Panetta and Portes, *Global Financial Stability*, CEPR 2007



## So the underlying problem was not – and is not – the failure of regulation

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- The standard story leads to focus on regulatory reform...
- Stop subprime mortgages, high LTV ratios
- Curtail greed – caps on executive compensation, remedy incentive to stress short-term profits
- Regulate ratings agencies, hedge funds, private equity firms
- Improve macroprudential regulation, make it countercyclical
- Cap leverage
- Remedy deficiencies of originate-to-distribute model

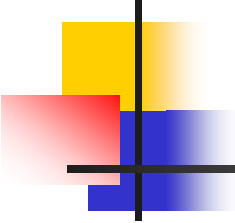
But 'financial excesses' are as old as financial markets.  
*And if underlying global imbalances remain, they will  
continue to threaten stability.*



## 'Bretton Woods II'

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- The facts: many EM had high savings rates, higher than their (also) high investment rates, so they ran large current account surpluses, and the resulting reserve growth financed large external deficits in the US and some European countries. They also pegged to USD.
- BW II interpretation: China used export-led growth strategy to absorb surplus labour, relied on exchange-rate undervaluation, had to invest surpluses in dollar-denominated assets ('vendor finance'). Other East Asian countries pegged to CNY. So US is 'world banker' with dollar as key currency, as in BW.



## BW II was not and is not a sustainable equilibrium

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- BW II misunderstands rationale for trade surpluses – EM countries (not just E Asians) built up precautionary reserves to deal with ‘sudden stops’
- Also too focused on China...
- ...with excessive emphasis on exchange-rate policy
- And maintains that what can't go on, will nevertheless go on



## A variant: 'Global asset shortage'

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- The story: excess global demand for collateralisable assets. Hence asset price bubbles (Caballero)
- Excess savings countries with undeveloped domestic financial markets must buy US securities (Rajan, Caballero *et al.*, Mendoza *et al.*) – US financial markets and assets uniquely attractive



## This story is harder to maintain since the crisis

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- In fact, surplus country savings went into *all* AC financial assets, with wide range of quality
- And flows to US didn't come primarily from private sector – official inflows at least as high, and they went into government and agency securities
- Now that a large category of 'collateralisable' assets has disappeared into the toxic waste bin, why isn't excess demand – hence bubble – even greater?
- No one now believes in exceptional quality of US financial markets...



## Both stories misleading

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- Both are *asymmetrical* – they assign the cause of global imbalances to the excess savings of East Asia, which impose a current account deficit on US
- And both ignore surpluses of fuel and commodity producers (Russia, Middle East, ...)
- The pattern was not benign: inflows didn't finance US investment, but rather consumption and government deficits. Nor did the process channel emerging market savings into EM investment projects – instead, a lot covered the US deficit, the rest went mainly through the US to advanced country markets.
- Both miss the key point: global imbalances impose *stresses on financial intermediation*



## Concerns looking forward

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- Large increase in AC net debt issuance could crowd out EM from capital markets – EM defaults?
- Can RoW do without US deficits? Must have rise in domestic demand in *surplus* countries, which requires they *accept fall, perhaps reversal of their CA surpluses*. This is *not* primarily an exchange rate issue.
- Will there be a dollar crisis after all?



## Policies: objectives

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- Limit *both* GI and financial fragility
- But there are powerful forces behind 'deglobalisation', which policy should resist
- Avoid reversing financial development and financial integration
- Avoid financial repression
- Get capital flowing from AC to EM and poor countries



## Policies: the markets

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- Limit borrowing and leverage of financial institutions – implications for GI
- Control currency mismatches (especially household sector borrowing in foreign currencies)
  - could require that advanced country financial institutions accept obligations only in the currency of the borrower (Krueger)
- Develop EM domestic (local currency) securities markets



## Policies: dealing with GI

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- Provide *credible insurance* to countries that forego further reserve accumulation
- more central bank swap lines
- 'reserve pooling'
- expand IMF resources, use flexible, fast-disbursing schemes with low conditionality – FCL the right instrument, Mexico and Poland showing the way
- Reduce focus on exchange rate adjustment



# Policies: the institutions

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- IMF needs legitimacy – major quota redistribution
- Either IMFC should run IMF or Executive Board structure and role must change
- But will EU, and in particular the UK, be willing to play?
- FSB should expand secretariat, take on capital markets functions from IMF
- G20 the right forum to avoid free riding
- Can't fix system without fundamental agreement to reduce GI – a 'deal' between reserve-accumulating countries and those running deficits



## Implications for trade

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- Financial deglobalisation and more financial regulation will restrict financing for CA deficits and for trade
- Surplus countries will have to switch to production for domestic consumption
- Does that require industrial policies that might be WTO-incompatible (Rodrik)?