FINANCIAL TIMES

Fixing Global Finance

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

OXONIA, The Oxford Institute for Economic Policy

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Fixing Global Finance

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

" Do we need an IMF? Is there a role for a multilateral institution in the management of the international monetary system? If so, what is it?" Mervyn King, governor of the Bank of England, February 20th 2006.

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

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

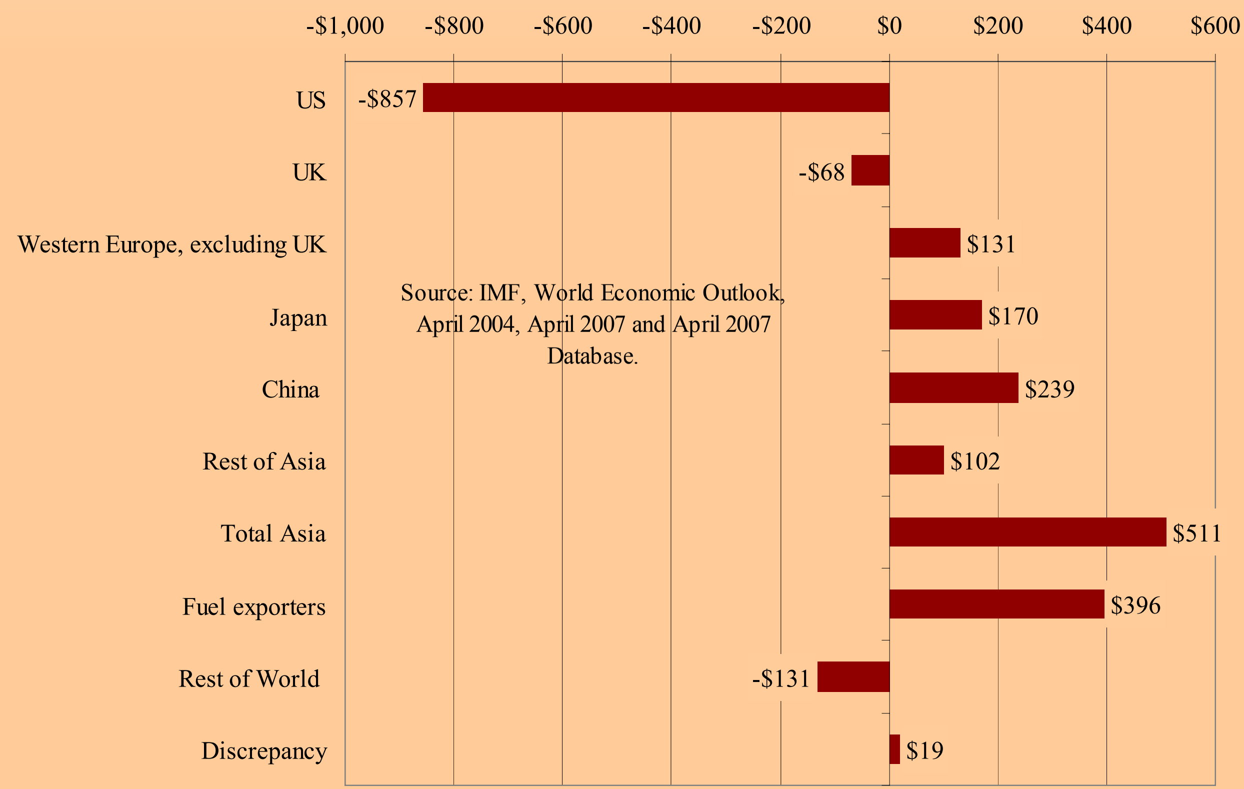
1. Background to the global imbalances

- 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)

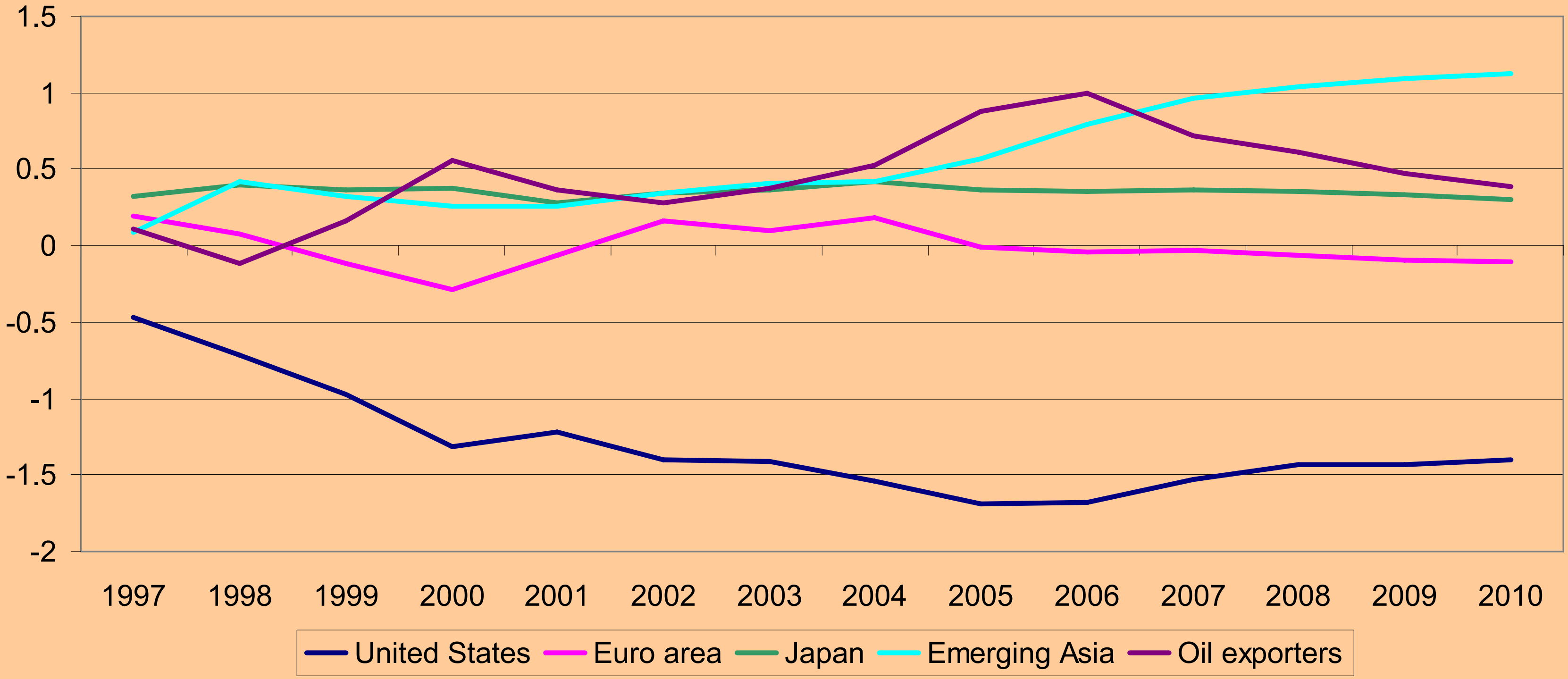


1. Background to the global imbalances

UNBALANCED WORLD ECONOMY

CURRENT ACCOUNT BALANCES (as per cent of GDP)

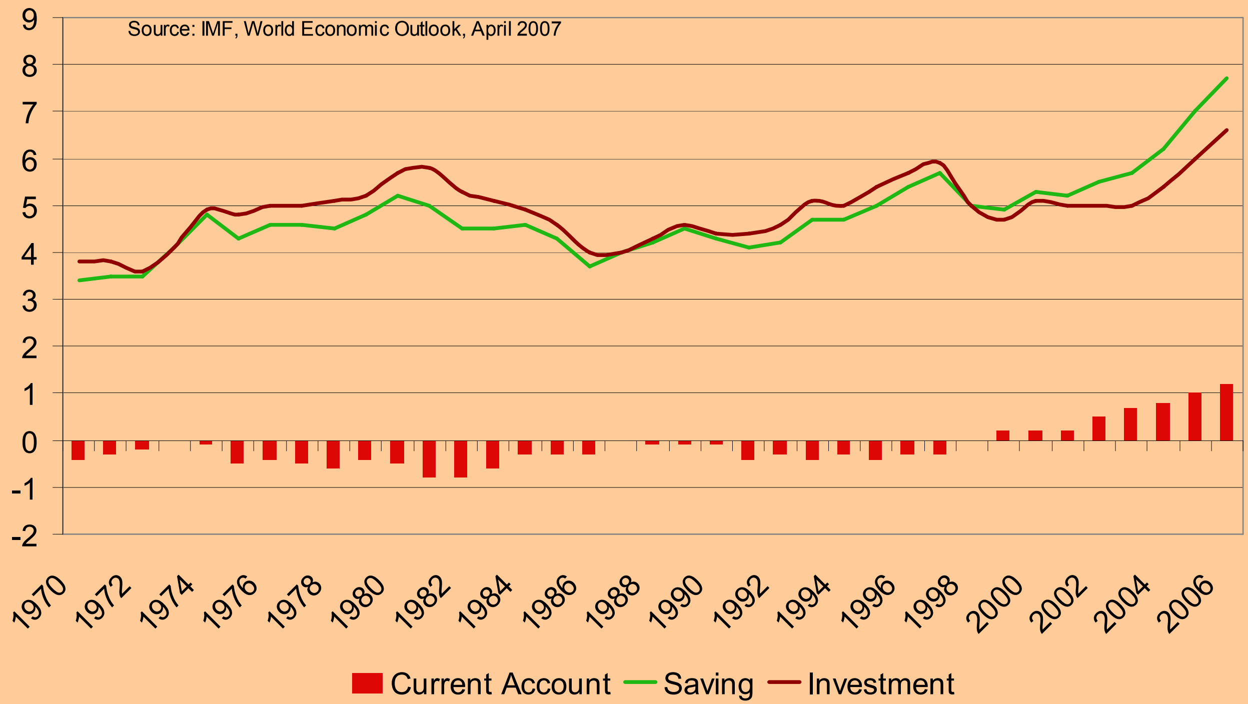
Source: IMF, *World Economic Outlook*, October 2007



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)



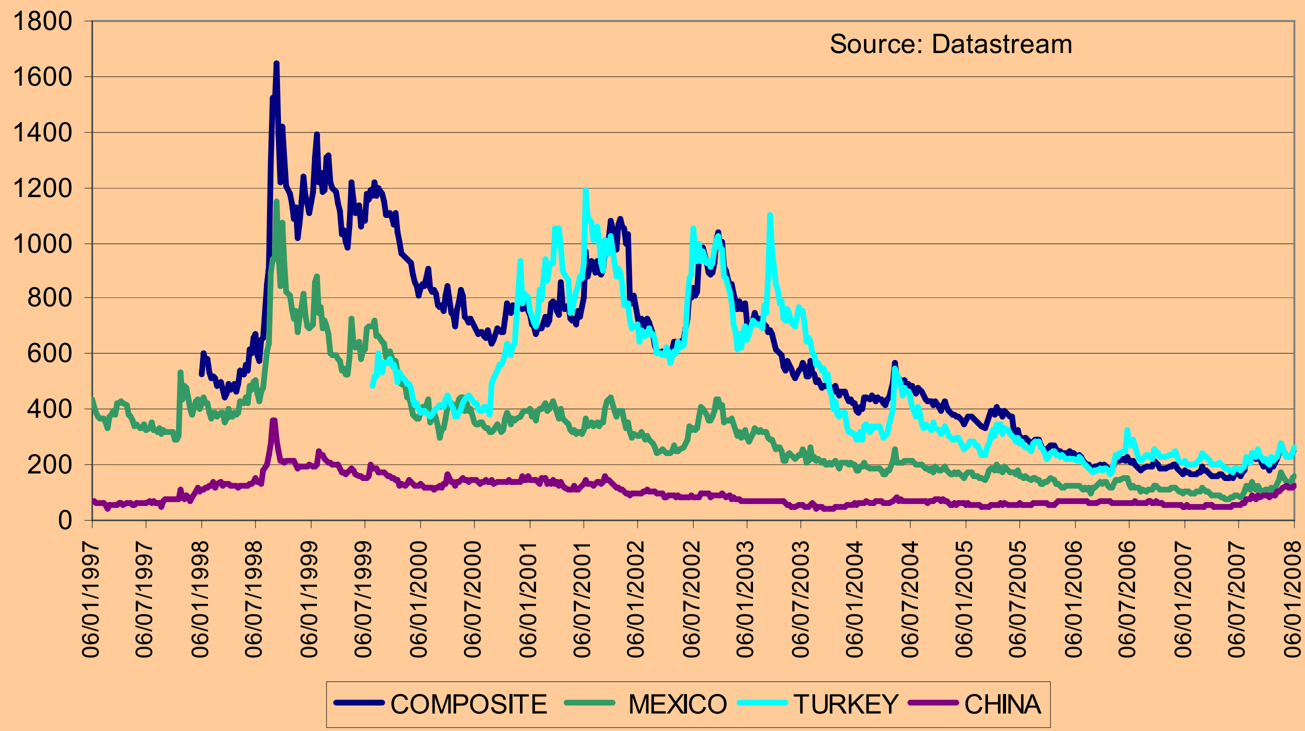
1. Background to the global imbalances

- 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

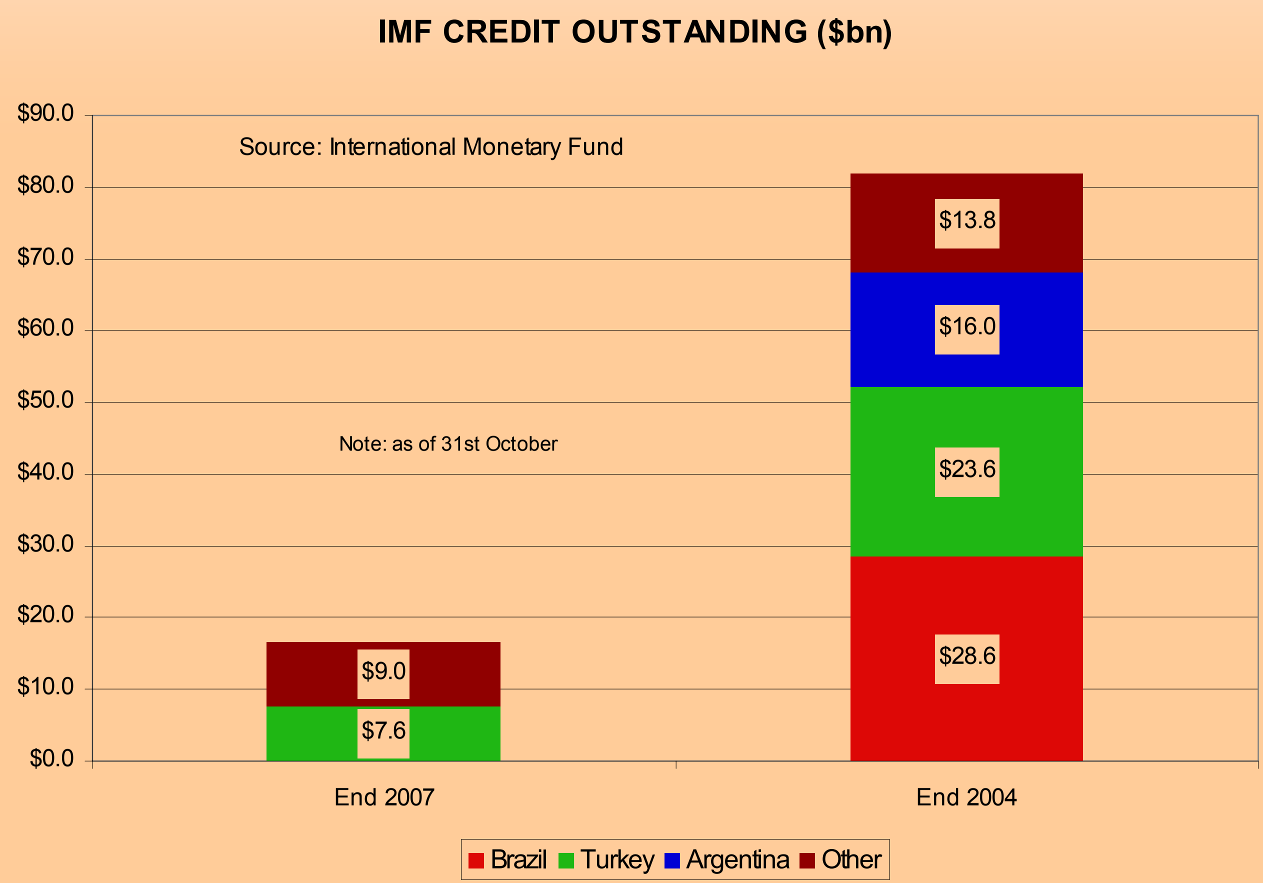
DISAPPEARING EMERGING ECONOMY RISK

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



1. Background to the global imbalances

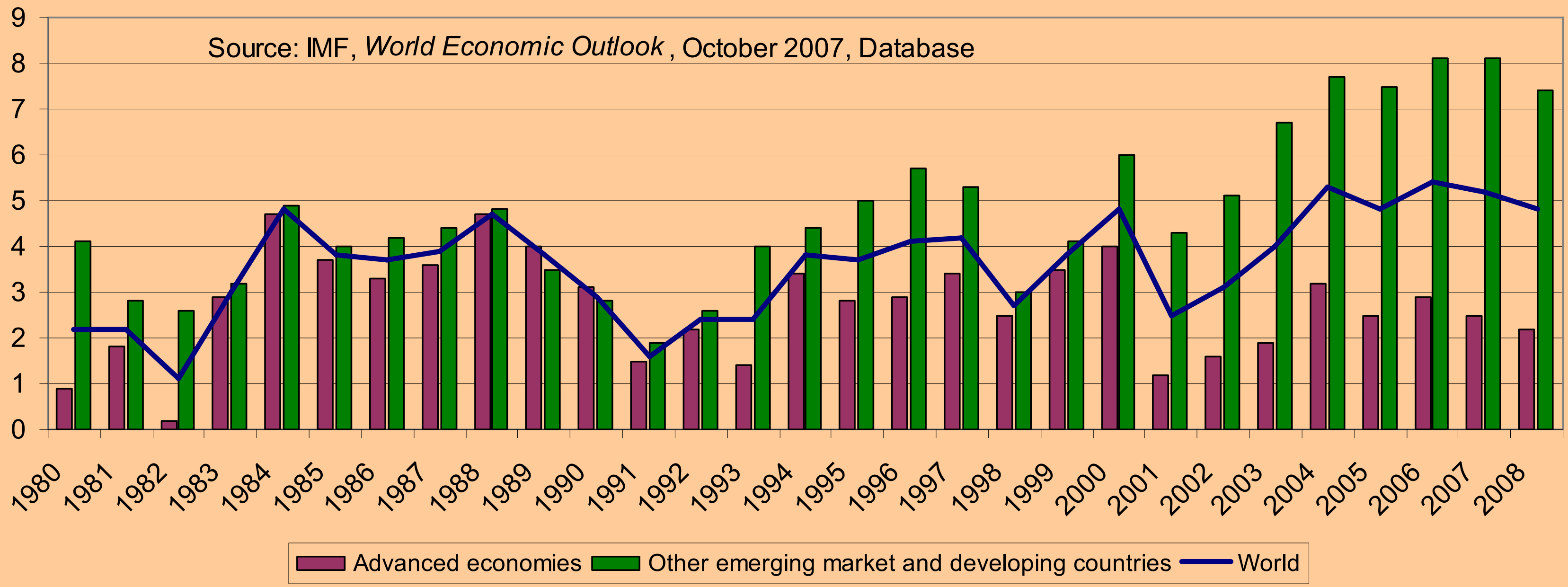
IMF GOES OUT OF BUSINESS



1. Background to the global imbalances

DEVELOPING COUNTRY GROWTH SURGE

GROWTH OF THE WORLD ECONOMY
(at PPP exchange rates)

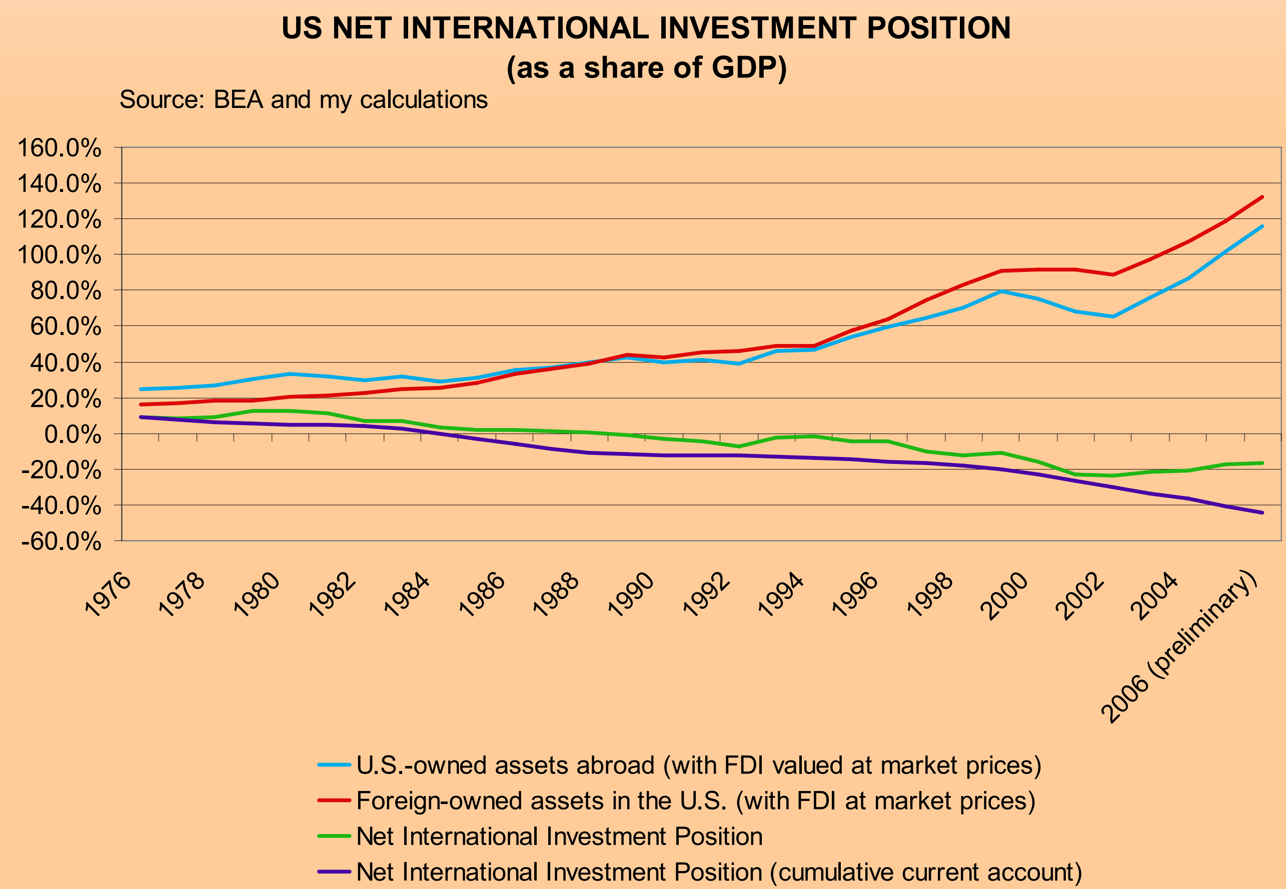


2. External and domestic US imbalances

- 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

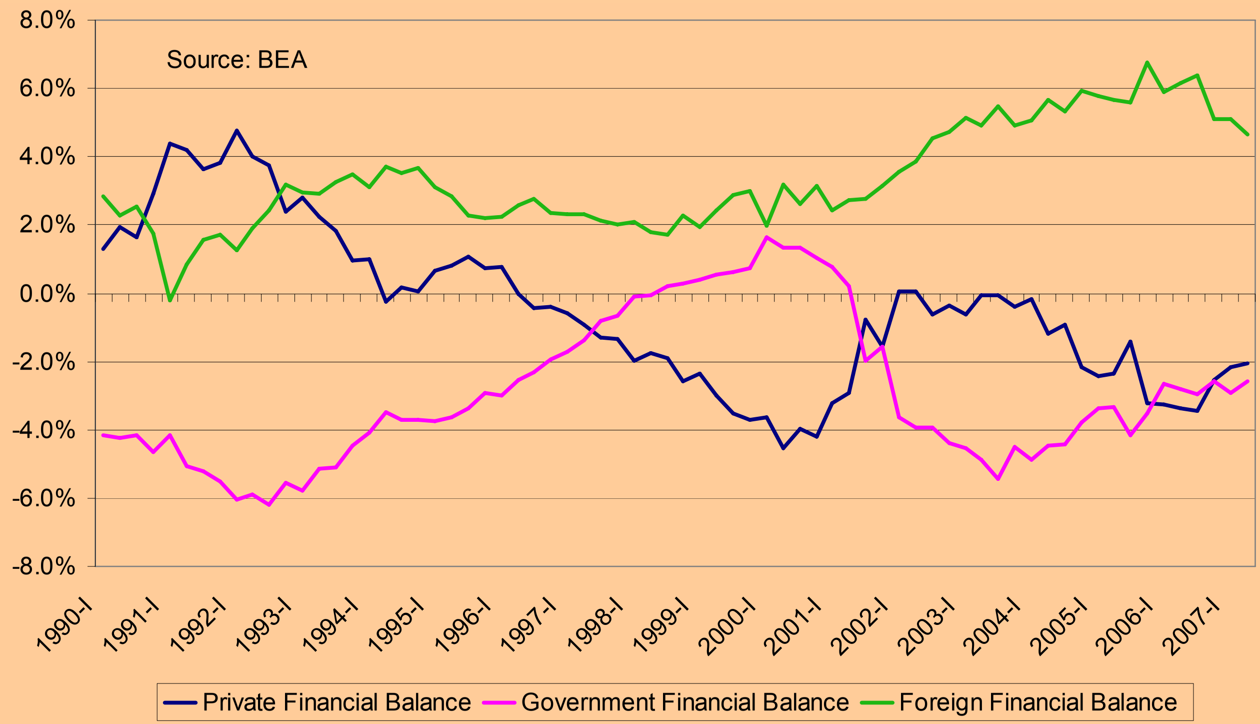
US AS A HAPPY DEBTOR



2. External and domestic US imbalances

US DOMESTIC IMBALANCES

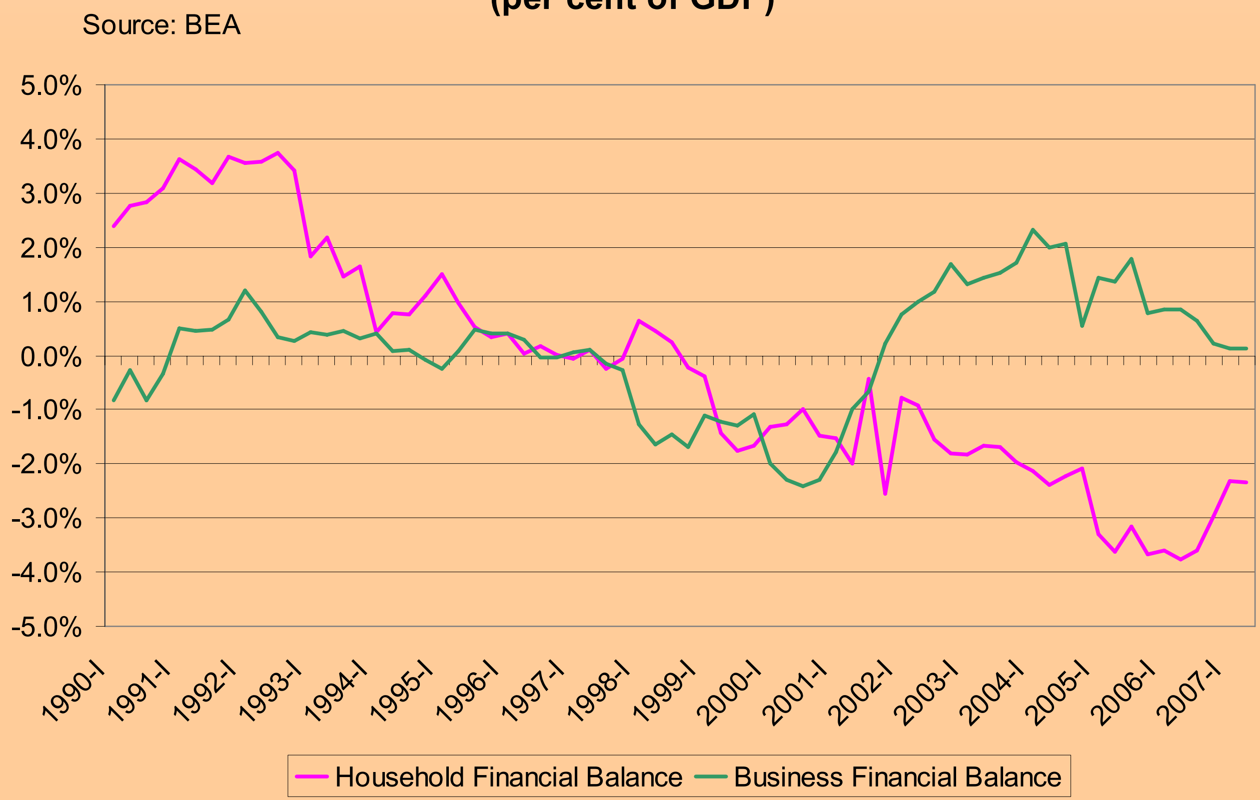
FINANCIAL BALANCES IN THE US ECONOMY (per cent of GDP)



2. External and domestic US imbalances

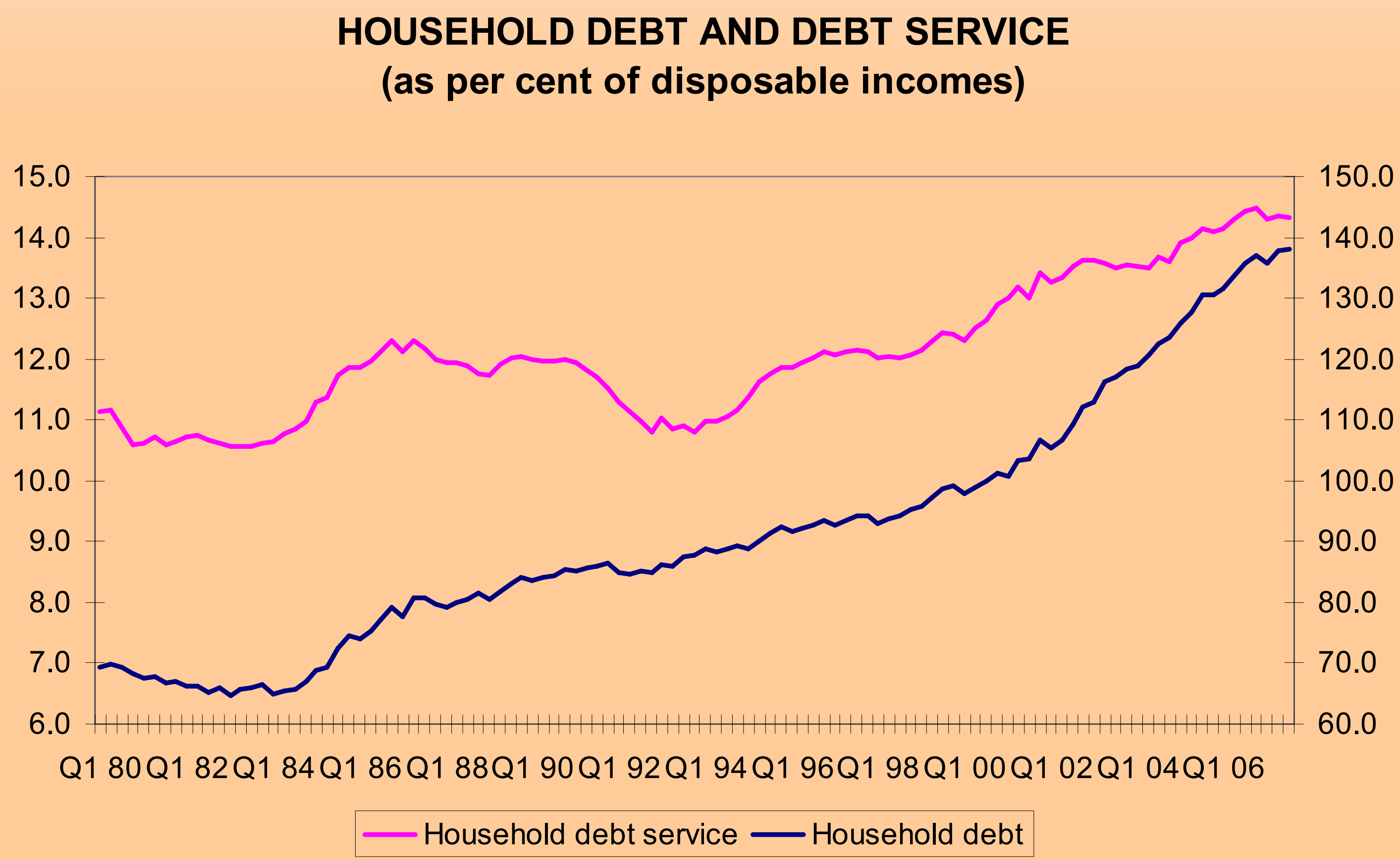
HOUSEHOLDS SPENT; COMPANIES DID NOT

US PRIVATE SECTOR FINANCIAL BALANCES (per cent of GDP)



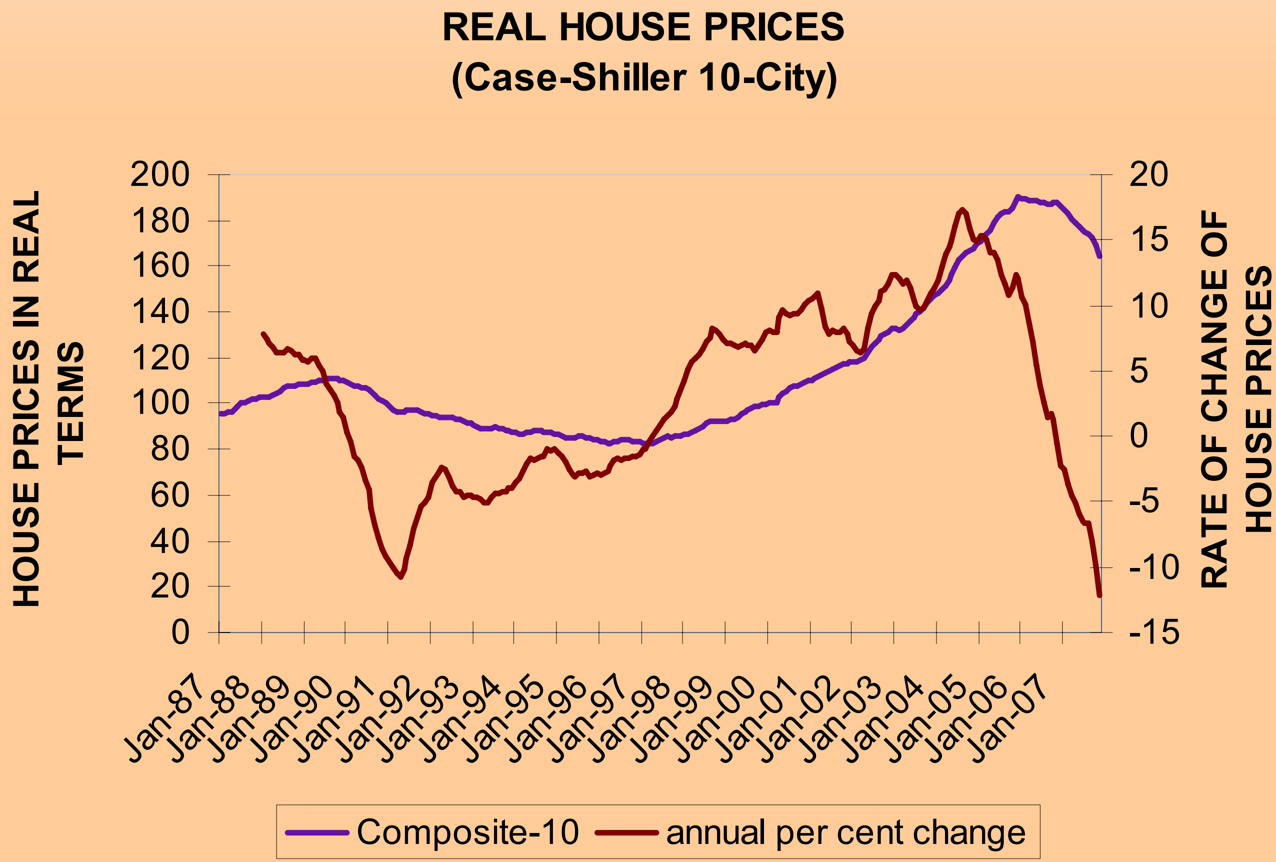
2. External and domestic US imbalances

RISING HOUSEHOLD DEBT AND DEBT SERVICE



2. External and domestic US imbalances

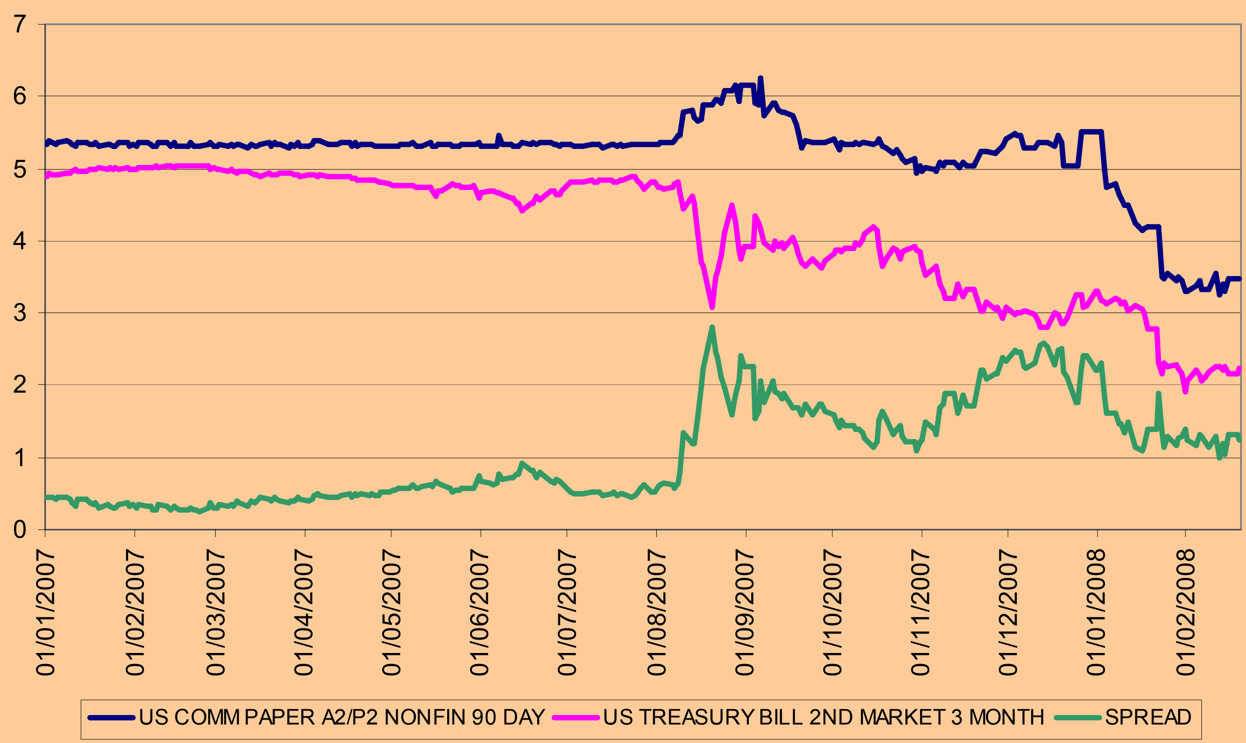
BURST HOUSING BUBBLE



2. External and domestic US imbalances

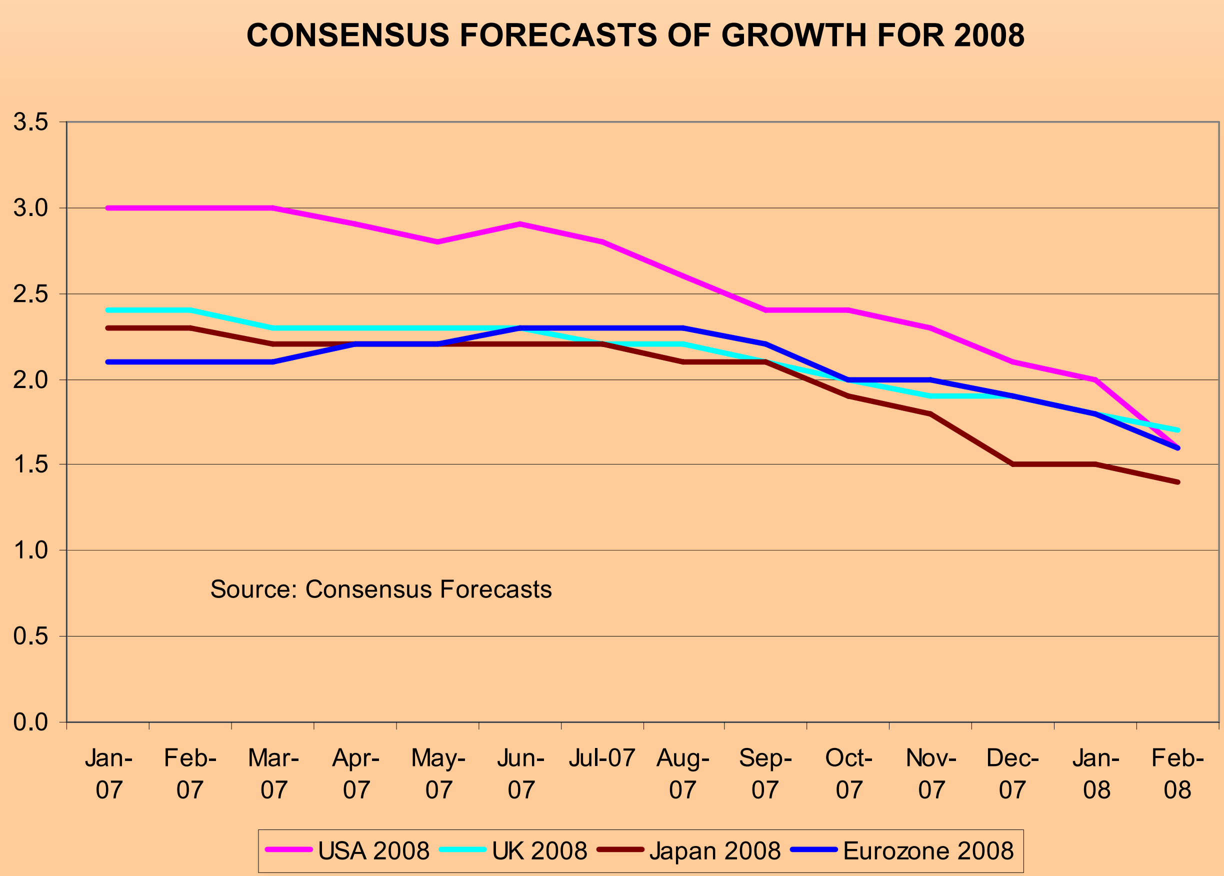
CREDIT SHOCK IN THE US

SPREAD BETWEEN COMMERCIAL PAPER AND TREASURY BILL RATES



2. External and domestic US imbalances

MISSED SLOWDOWN



2. External and domestic US imbalances

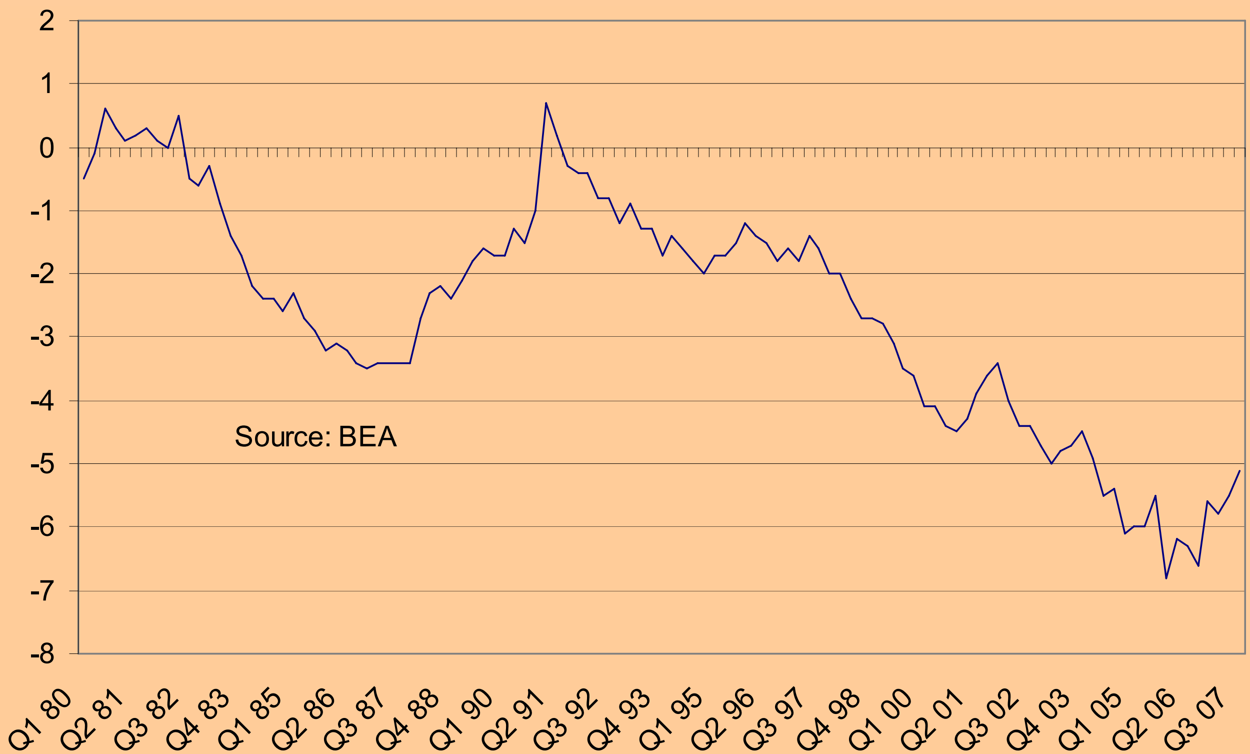
FALLING DOLLAR

US REAL EXCHANGE RATE (JP Morgan)

2. External and domestic US imbalances

SHRINKING CURRENT ACCOUNT DEFICIT

CURRENT ACCOUNT BALANCE (per cent of GDP)



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)

	2006
All high-income countries	-$545
US	-$857
Other Anglosphere	-$109
Canada	$21
New Zealand	-$9
Australia	-$41
UK	-$80
Western Europe (excluding UK)	$162
Eurozone	$8
Japan	$171
Newly-Industrialised Asian economies	$87
Singapore	$36
Taiwan	$25
Hong Kong	$19
Korea	$6

3. Challenges of adjustment ahead

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

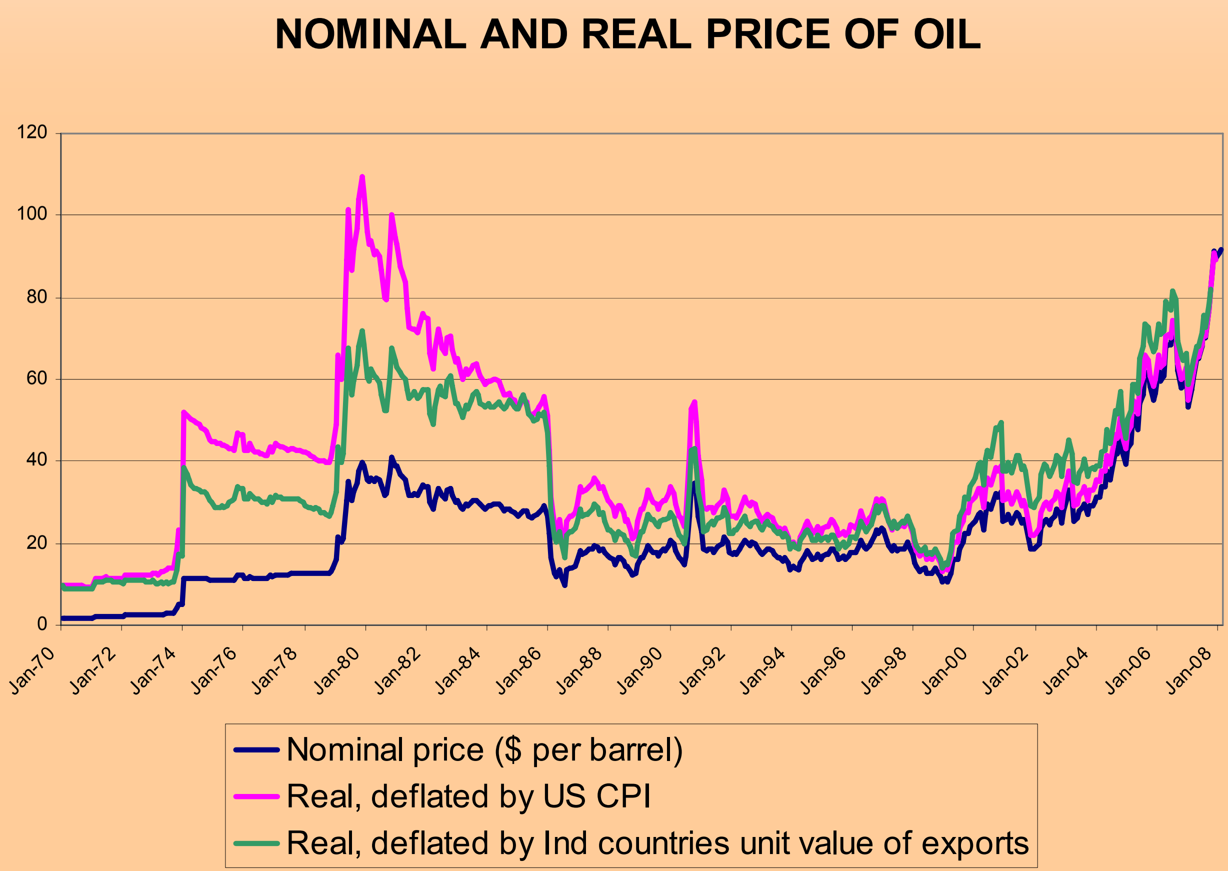
	2,006
Emerging market and developing countries	$544
Africa	$20
Sub-Sahara	-$9
Central and Eastern Europe	-$89
CIS	$99
Russia	$96
Excluding Russia	$3
Developing Asia	$253
China	$239
India	-$19
Excluding China and India	$34
Middle East	$212
Western Hemisphere	$49
Brazil	$14
Mexico	-$2
Fuel exporters	$396
Nonfuel	$149
Primary producers	$10

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?

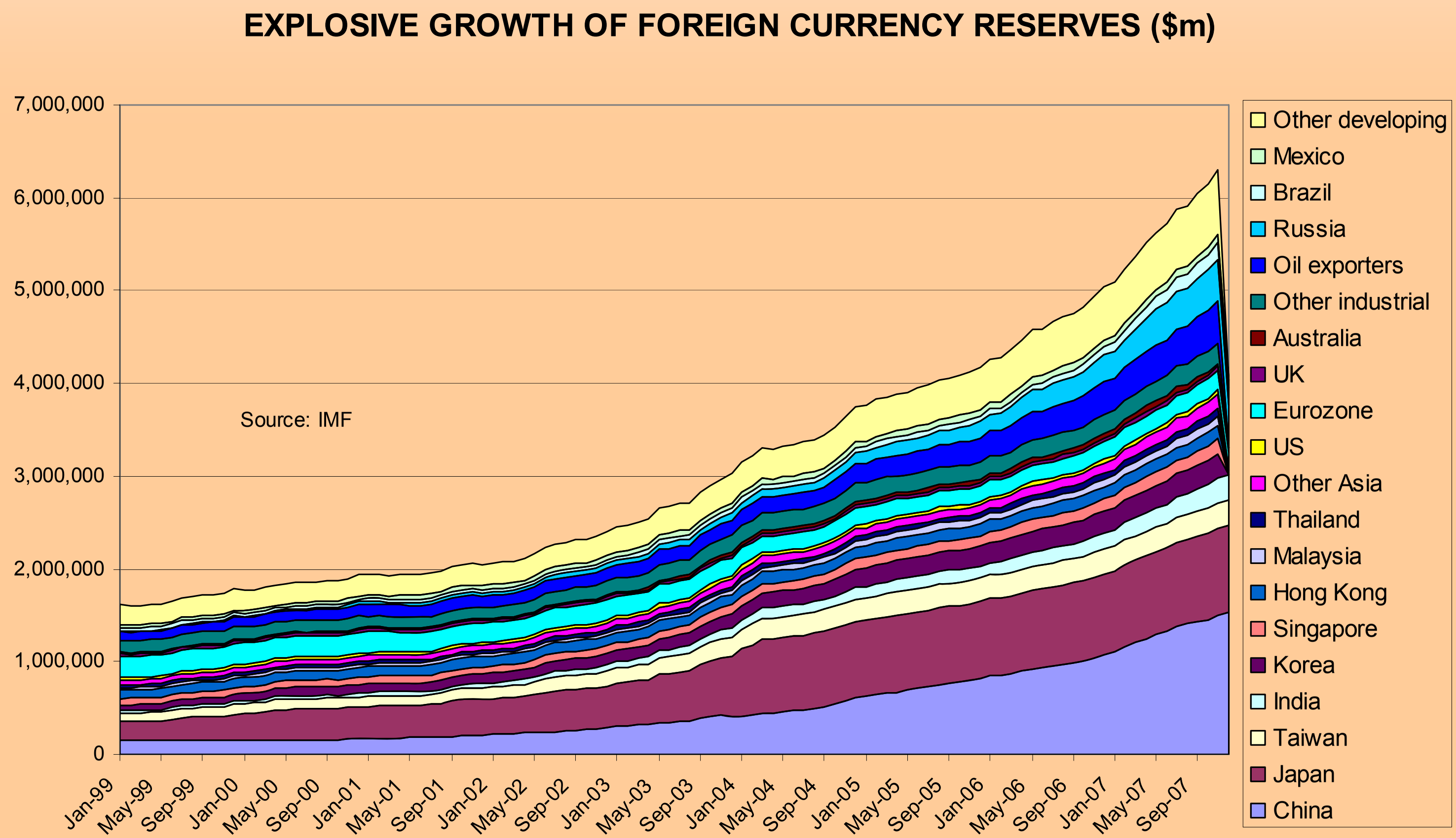


4. Paths to a stable world economy

- 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

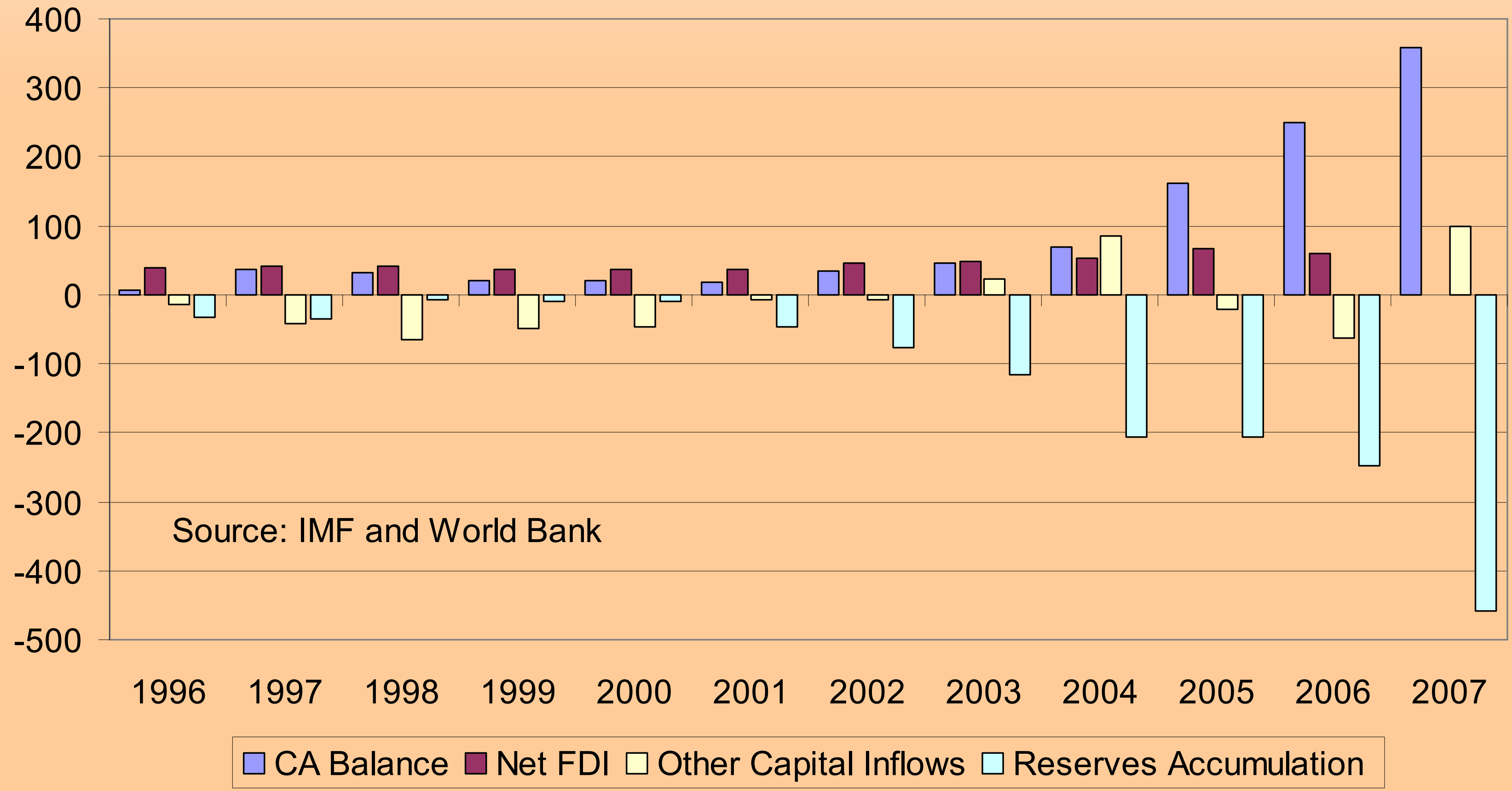


4. Paths to a stable world economy

- 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

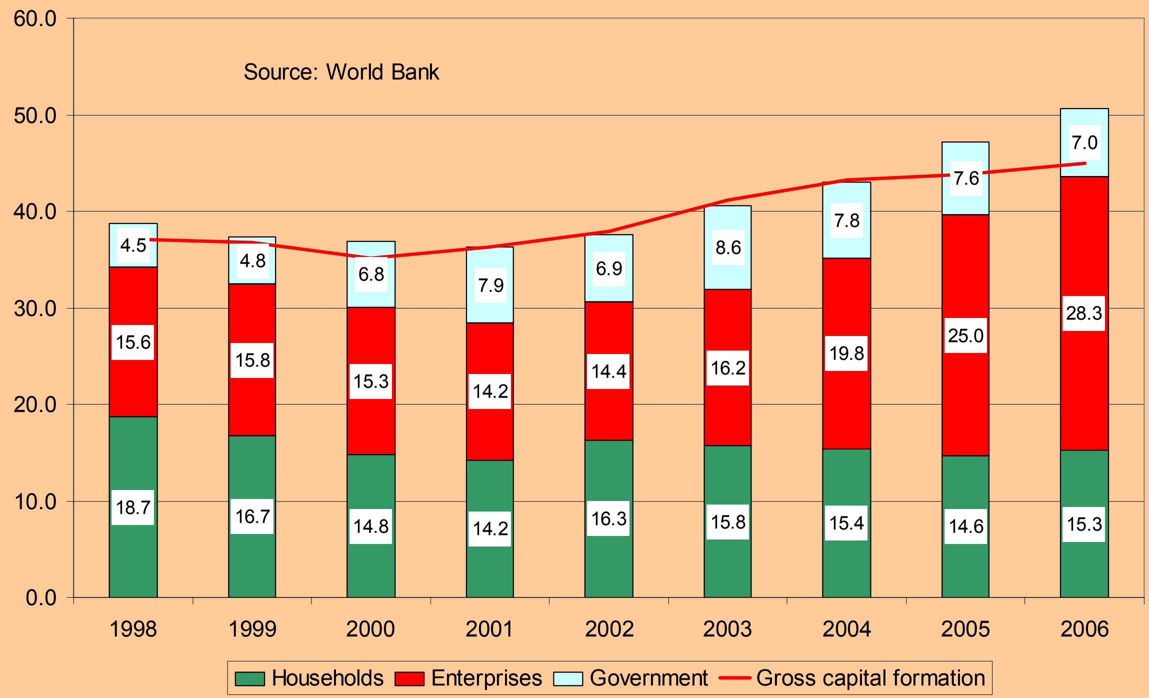
CHINA'S EXPLOSIVE CURRENT ACCOUNT



4. Paths to a stable world economy

WHO DOES THE SAVING IN CHINA

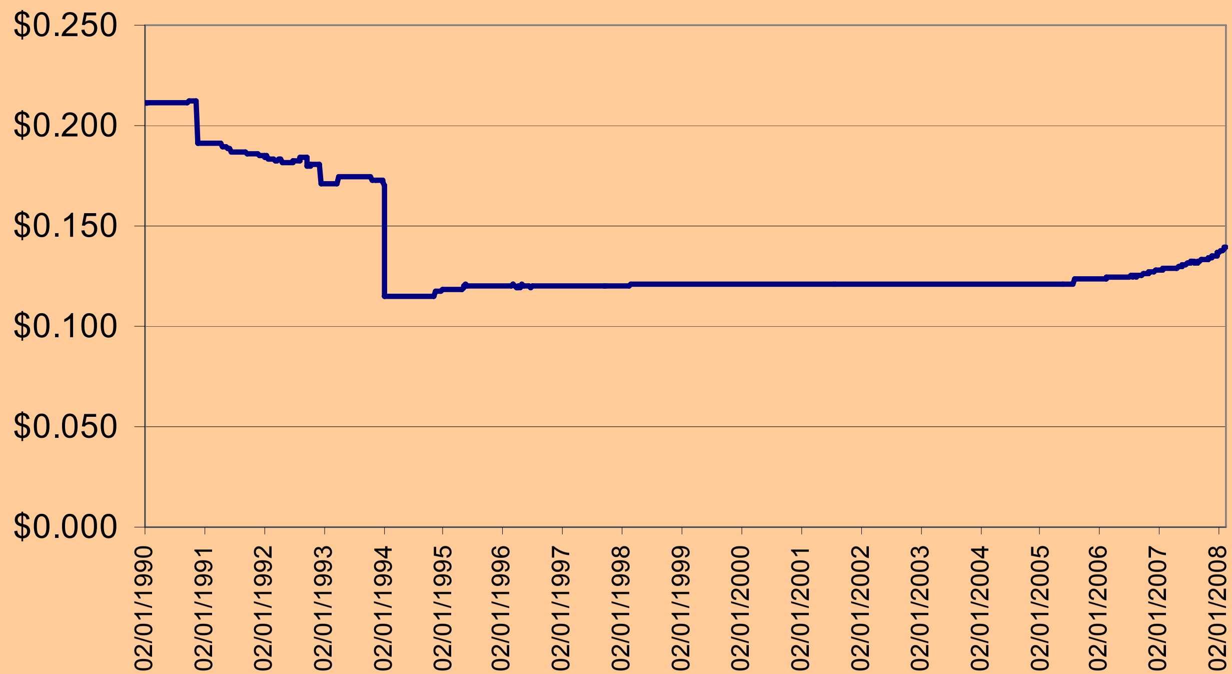
COMPOSITION OF SAVINGS
(per cent of GDP)



4. Paths to a stable world economy

THE PEGGED EXCHANGE RATE

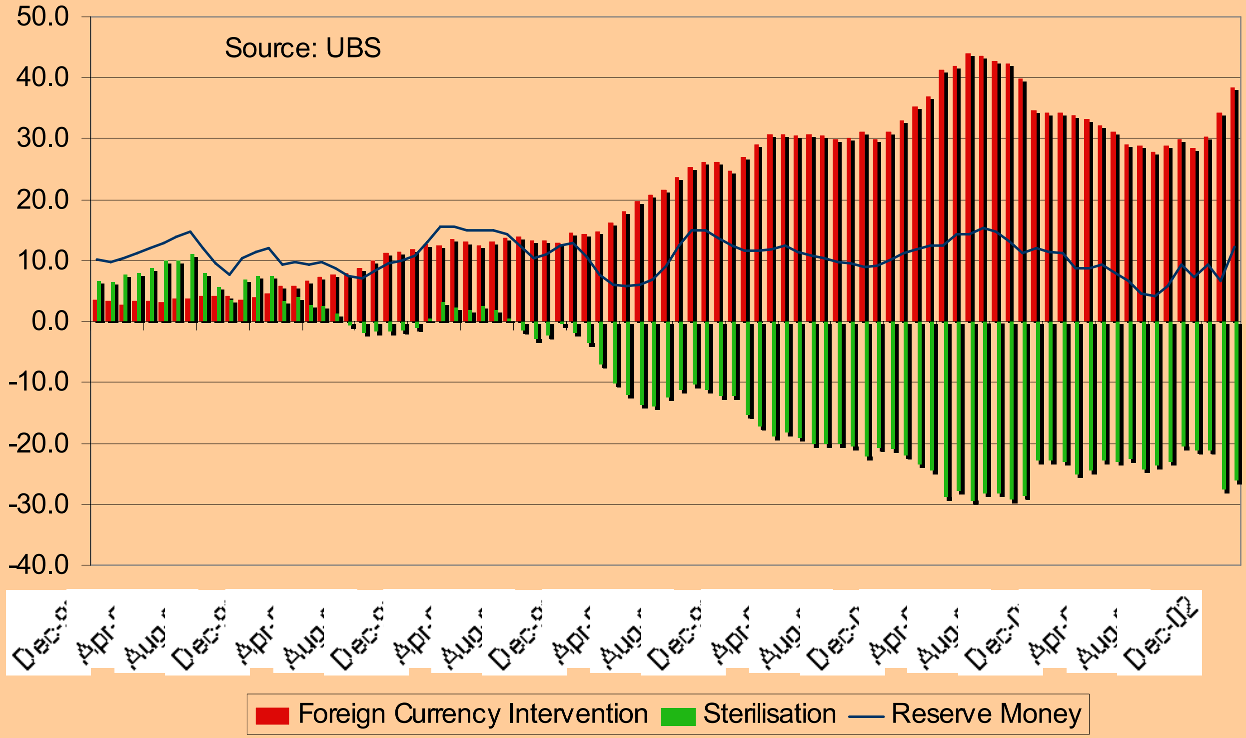
Remnimbi against the Dollar



4. Paths to a stable world economy

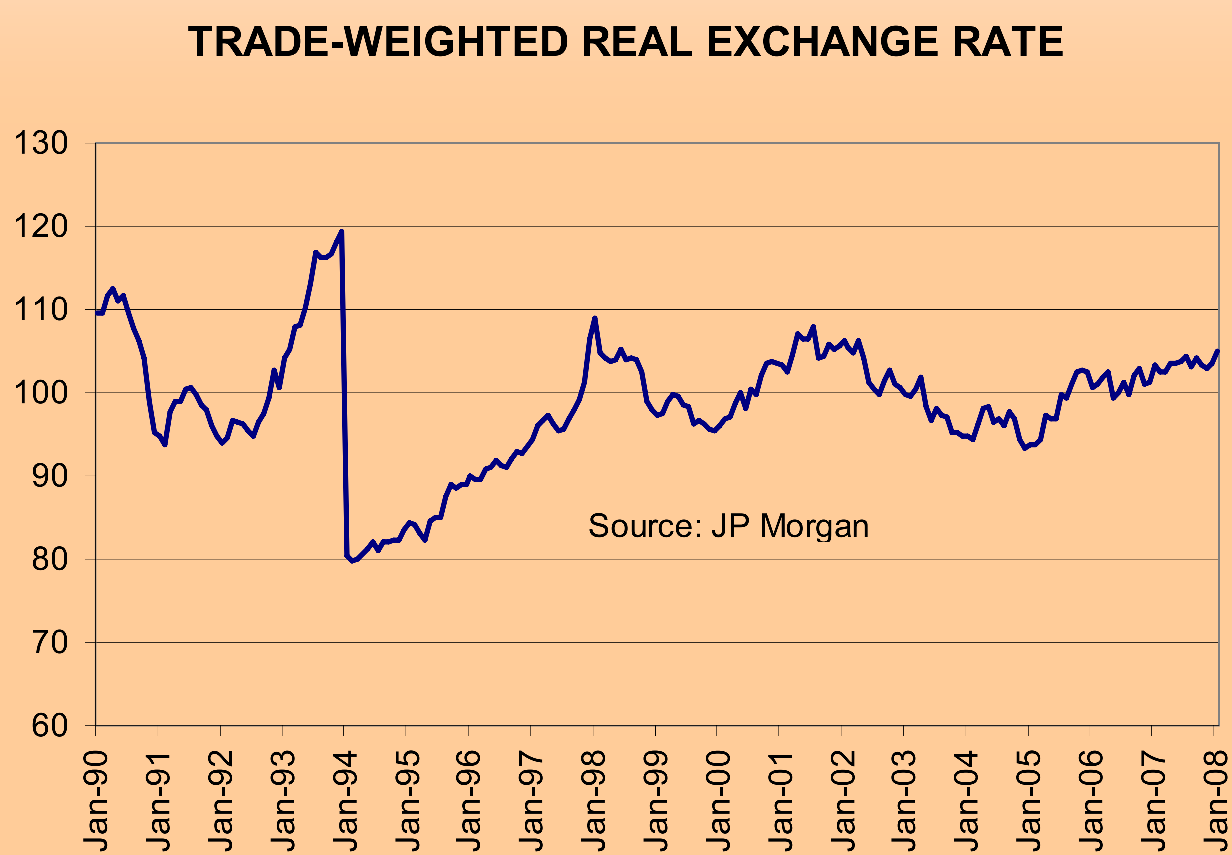
HOW CHINA STERILISES RESERVES

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



4. Paths to a stable world economy

THE FIXED CHINESE REAL EXCHANGE RATE

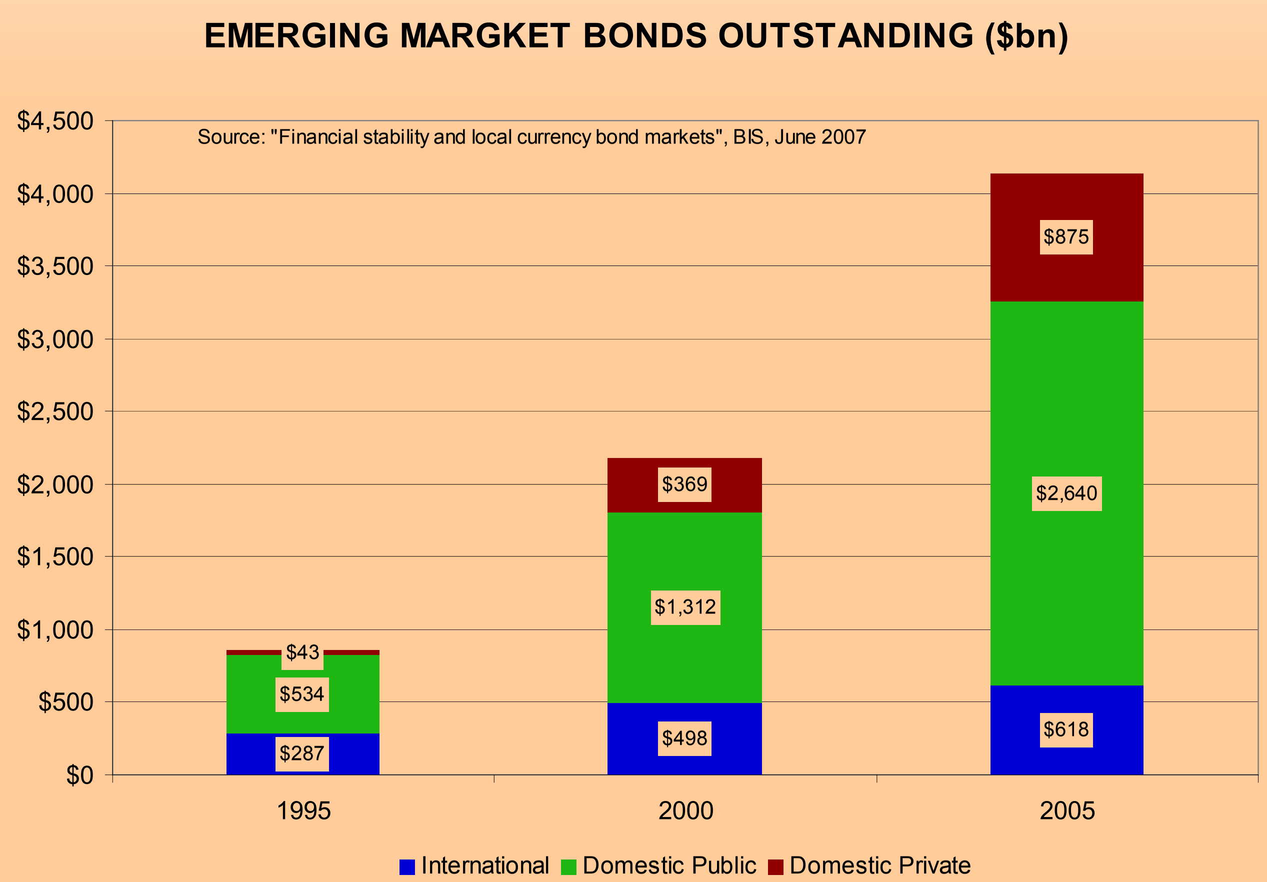


4. Paths to a stable world economy

- 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



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