Making Globalization Work: Global Financial Markets in an Era of Turbulence

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Global Financial Integration

- The world has become increasingly integrated
  - Implying that there is more interdependence
- Problems in one part of the global economic system have ramifications for the entire system
  - Implying that there is more need for global collective action

Need for Global Collective Action

- But we have neither the institutions, nor the mindsets, with which to do this effectively and democratically
  - There is greater need for institutions, like the IMF, to regulate the global international financial markets
  - But confidence in these institutions has never been lower
    - Failed to do anything about global imbalances
    - Failed to do anything about inadequate regulations
      - Flawed proposal to strengthen bank regulation

Global Imbalances

- Massive U.S. borrowing from abroad
  - $850 billion in 2006 alone
  - U.S. blames China (undervalued yuan)
  - But even if China revalued its currency and completely eliminated its trade surplus, and even if China's surplus translated dollar-for-dollar into a reduction of the U.S. trade deficit, the U.S. trade deficit would still be massive, reduced to "only" $720 billion
  - More likely scenario is that the deficit would be little changed, as U.S. buys textiles from Bangladesh and other countries
    - US simply trying to shift blame
- Genuine worry is potential disorderly unwinding

Inadequate Regulations

- Inadequate regulations in U.S.
- But foreign regulators trusted U.S.
- U.S. allowed to export its toxic financial products abroad
- Causing weakness in foreign financial systems
  - Mitigating domestic impact of bad behavior and bad policies

Flawed Proposal to Strengthen Bank Regulation

- Basel II relies on risk management systems of major banks and risk assessments of rating agencies
  - Both have been shown to be highly flawed
  - Both seemed to have believed in financial alchemy
  - Securitization converted low-grade loans into AAA rated financial products

Failures

- Failure to understand correlated risks
  - And how banks, using similar models, can give rise to correlated risks
  - Failure to understand systemic risk has systemic consequences
    - Including risks facing market insurers
- Failure to understand fat-tailed distributions
  - With “once in a hundred years” events occurring every decade!

Failures

- Failure to understand the economics of securitization
  - Understood advantages of diversification
  - Failed to understand problems of information asymmetries associated with securitization
    - Including possibilities of “bad actors”, i.e., distorted appraisals
  - Failed to understand problems of re-negotiation
  - Contrast with “old model” where banks originated loans, kept them, and re-negotiated if necessary
- Problems had been pointed out earlier
  - And some were seen in earlier crises

A Closer Look at the Current Problem

- Three distinct but related problems:
  - The freezing of credit markets
  - The sub-prime mortgage crisis
  - The impending recession
- Each teaching lessons about economics
  - Even well-functioning market economies have problems
  - Monetary and regulatory authorities in U.S. made major mistakes
- Each interacting to exacerbate problem

The Sub-Prime Mortgage Crisis

- Loans were made to people who couldn’t afford them
  - With negative amortization
  - And “reset provisions”
- Pyramid scheme — borrowers were told not to worry, home prices would continue to rise, they could refinance (with large transaction costs)
  - The more you borrowed, the more you “made”

Foul Play

- Lobbyists worked hard to prevent legislation intended to restrict predatory lending
- New bankruptcy legislation gave lenders confidence that they could squeeze borrowers
- Over-valuation of residential real estate

Bad Advice and Complicity of Regulators

- Fed encouraged people to take out variable rate mortgages *just as interest rates reached all time lows*
- Part of strategy to keep the economy going
  - Especially important in light of high oil prices
  - And drag on economy from the Iraq War
- Encouraged reckless lending
  - Said that it would lead to more home ownership
  - Real result is just the opposite – more foreclosures
  - Should have recognized that there was something wrong gong on
    - Some mortgages were made with no money down
    - With borrowers able to walk away, like giving away money
    - But normally, banks do not give away money

What were They Thinking?

- Unprecedented increase in housing prices
- Obviously was not sustainable
  - Especially as median real income in the U.S. was declining
- What was going on?
  - Products were so complicated that neither originators nor borrowers nor regulators could adequately measure the risk
    - Clearly not designing products to meet specific risks
    - Lack of transparency may have been biggest culprit
  - Regulatory arbitrage
  - Accounting “management” — à la Enron? (off/on balance sheet arbitrage)

The Problem is Huge

- More than 2 million anticipated foreclosures
  - Many will lose their entire life savings
- Foreclosures will lead to falling home prices
  - Large real adjustment needed
  - Vicious circle
  - May well extend beyond sub-prime mortgages
  - Problem is not just lack of liquidity, many individuals cannot afford housing
- Unless something is done, there will be huge dislocations, as people downsize, house prices get reappraised with large transactions costs, and everybody loses

No Easy Solution

- Which probably means no real solution
- The result: *Impending Recession*
  - Growing consensus among economists that there will be a substantial gap between actual and potential GDP
    - Even a 2% shortfall for one year means a loss of a quarter of a trillion dollars

Underlying Macroeconomic Problem

- *The US economy has been fueled by unsustainable consumption for the past five years:*
  - Zero or negative savings for the last two years
  - Based on "optimism" from rising home prices
    - And persistence of low interest rates
  - Financed through home equity withdrawals in the hundreds of billions of dollars
  - Much of it from sub-prime borrowers

A Cover-Up?

- High level of liquidity, regulatory laxness required to offset earlier policy mistakes
  - Iraq War led to rising oil prices
    - Rising oil prices meant that hundreds of billions of dollars were being spent to buy oil rather than to buy American made goods
    - Iraq expenditures did not stimulate economy in the way that other expenditures might have
  - 2001-2003 tax cuts were not designed to stimulate the economy, and did so only to a limited extent
- Question: Why did the economy seem as strong as it did?
  - Answer: America was living on borrowed money and borrowed time
- There had to be a day of reckoning
- That day has now arrived...

The Game is Over

- Households will not want or be able to continue taking out more money from their homes
  - Housing prices down 7% from peak
  - New regulations
    - Closing the barn door after the cows are out
    - May have adverse short-run effects (the standard trade-off)
  - Securitization game which started it all is also over
    - Increased scrutiny on valuations
    - Increased scrutiny on rating agencies
    - Increased scrutiny on CDO’s and other instruments
- If savings returns to “normal” rate of 4 to 6%, it will create a major drag on aggregate demand
  - If adjustment is quick, downturn may be deep
  - If adjustment is slow, downturn may be prolonged

What will Replace Consumption?

- Probably not investment
- Net exports have so far played an important role
  - But unlikely to be sufficient
  - And will have global ramifications
- Can government action save the day?
  - Given lags, it may already be too late

Can Monetary Policy do the Trick?

- Probably not — Keynes' view: pushing on a string
  - Will lenders be willing to lend, and households be willing to borrow, to continue unsustainable consumption?
    - Probably not
    - And this would just be postponing the day of reckoning
      - Making eventual adjustments even more difficult
      - In politics, timing is everything
- Long-term interest rates may even increase as inflationary expectations mount
  - They didn't rise as short term rates rose ("conundrum")
  - This is just the reverse

Fiscal Stimulus?

- Any stimulus should be timely and targeted to maximize impact (especially important given high level of U.S. deficit) and address long-term problems
- Most effective excluded from package
  - Unemployment insurance
    - America probably has worst unemployment insurance system of advanced industrial countries
  - Assistance to states and localities
    - Tax revenues about to plummet
    - Forcing them to cut back on spending
    - Leading to deepened downturn

Other Features of Stimulus

- Tax rebates
  - May be less effective than normal: uncertainty may lead many to use refunds to pay credit card bills, etc.
  - Exacerbates fundamental problem — *excessive consumption*
- Business incentives
  - Mostly for investment that would have occurred anyway
  - Very low bang for the buck

What Else Should Have Been Done?

- Marginal investment tax credit — strong incentives for *additional* investment
- Infrastructure investment
  - America’s infrastructure is in bad shape
    - Not a single one of the top ten global airports is in U.S.
    - Not enough public transportation
    - Other green investments necessary to achieve global warming targets
- R & D
    - Public R & D has high return on investment
    - Underlies America’s economic strength
    - Cutbacks in recent years
- Strategies that stimulate in the short-run while providing basis for long-run growth

Sovereign Wealth Funds

- Not a surprise that they had to rescue America’s premier financial institutions
  - Large redistribution of global (liquid) wealth
- America has not been saving
  - America has become consumer of last resort, living beyond its means
- High oil prices have created huge reserves of liquid funds in the Middle East
- Mismanagement of 1997-98 crisis has led developing countries to say “never again” will they allow loss of economic sovereignty
- To prevent history from repeating, they have accumulated massive reserves

Worries about Sovereign Wealth Funds

- Partially reflect old-fashioned protectionist sentiment
- Partially reflect worries about inadequacy of our regulatory structures
  - Both competition (can a firm be so large that its actions become "relevant"?)
  - And regulations concerning conduct
  - Though most of the potential problems could arise with any form of private ownership, whether foreign or domestic

G-8 Solutions Not Well Thought Out

- Transparency
  - Fashion of the day
  - Cure-all for all problems
  - Part of long-standing strategy of diverting attention (used in 1997-98 crisis)
- But what *information* would *guarantee* that they behave "well"?
- So long as there are unregulated, secret hedge funds, they could always buy ownership through these hedge funds

Making Globalization Work

- Failure of IMF not a surprise
- U.S. major source of global imbalances
- Inadequate regulation in U.S. having global consequences
- But U.S. has veto power at the IMF
  - IMF not likely to be aggressive in criticizing U.S.
  - Contributes to undermining credibility of IMF

Other Institutions Also Not Working

- G-8 most important informal institution
- Major issues:
  - Global imbalances
    - Blame China, but China is not there
  - Sovereign Wealth Funds
    - But sovereign funds are not there
  - Global warming
    - Blame developing countries
    - But developing countries are not there
- Not good enough just to invite them to lunch
  - Without consulting on agenda or communiqué
  - Especially when communiqué is issued before lunch

Need Better Cooperation in Global Financial Markets

- Macroeconomic cooperation
- Cooperation on regulation
- But voices of developing countries have to be heard
  - Reform institutions
  - Reform governance
- Will need some more fundamental reforms

Fundamental Reforms

- After 1997-98 global financial crisis, discussion of fundamental reform in global financial architecture
  - Nothing came of it
  - Consistent with suspicions at time that U.S. did not want any change
- What kinds of policies exacerbate "contagion," contribute to "automatic destabilizers"?
  - Many of IMF and banking regulatory policies may contribute to instability

Fundamental Reforms

- Developing countries still bear brunt of interest and exchange rate risk
  - International institutions should bear larger share of risk
- No mechanism for restructuring sovereign debt
- Global reserve system

Global Reserve System

- Dollar-based system is fraying
  - US has been consumer of last resort
  - US has been debtor of last resort
- Contributes to instability and cannot work in the long-run
  - As dollar debts accumulate, confidence in dollar erodes
- Inequitable
  - Developing countries lending U.S. huge amounts of money at low interest rates
  - Net transfer to U.S. is greater than foreign aid U.S. gives to developing countries
- Dual (dollar/euro) reserve system may be even more unstable

- We CAN make globalization work
- Or at least work much better
- Both for the developing and the developed world