GLOBALISATION AND DEVELOPMENT AFTER THE FINANCIAL CRISIS
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What does it mean?
What does it mean?

“Simply stated, the bright new financial system – for all its talented participants, for all its rich rewards – failed the test of the market place.” Paul Volcker, April 8th 2008
What does it mean?

“Things that can’t go on forever, don’t” Herbert Stein
What does it mean?

• I am going to ask two big questions:
  – First, what happened in this crisis?
  – Second, what does it mean for the future?
1. What happened in this crisis?

- What we have seen is a “developing country” financial crisis, but at the core of the world economy. Why?
  1. Undue belief in the “great moderation”;
  2. Accommodative monetary policy aimed at targeting inflation;
  3. Emergence of global imbalances and extraordinary reserve accumulations in the late 1990s and early 2000s;
  4. Low real and nominal interest rates and a “reach for yield”;
  5. Innovation in the financial sector, to provide notionally safe, high-yielding assets; and
  6. Failures of commission (risk-weighted capital ratios and reliance on ratings) and omission (deregulation of securities and housing markets) in financial regulation.

- Success breeds excess and excess breeds collapse.
1. What happened in this crisis?

THE RISE OF THE IMBALANCES

GLOBAL CURRENT ACCOUNT BALANCES
(per cent of World Output)

Source: IMF WEO
1. What happened in this crisis?

CHINA RISES TO THE TOP OF THE SURPLUS LIST

CURRENT ACCOUNTS OF WORLD’S THREE LARGEST SURPLUS COUNTRIES ($bn)

Source: IMF WEO

Guardian Body
1. What happened in this crisis?

THE GREAT RESERVE ACCUMULATION

GLOBAL FOREIGN CURRENCY RESERVES ($m)

Source: IMF
1. What happened in this crisis?

US PLUNGES IN DEFICIT

US FINANCIAL BALANCES FROM 1990
(per cent of GDP)

Source: US NIPA
1. What happened in this crisis?

FINANCIAL SECTOR DEBT EXPLOSION

SECTORAL RATIOS OF US DEBT TO GDP

Source: Federal Reserve Flow of Funds
1. What happened in this crisis?

- The economic collapse has been large.
- The rescue has worked.
- Yet huge problems remain.
- And fiscal and monetary firepower is largely used up in the high-income countries.
1. What happened in this crisis?

HOW PRIVATE DEFICITS COLLAPSED

CHANGE IN FINANCIAL BALANCES 2006-09
(as per cent of GDP)

Source: IMF
1. What happened in this crisis?

RETURNING CONFIDENCE

SPREADS OF US CORPORATE BONDS OVER TREASURIES

Source: Thomson Datastream
1. What happened in this crisis?

**FISCAL FIREPOWER USED**

**GENERAL GOVERNMENT DEFICITS**
(as per cent of GDP)

Source: IMF

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<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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<tr>
<td>Sweden</td>
<td>-3.4</td>
<td>-2.9</td>
<td>-2.5</td>
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<tr>
<td>Germany</td>
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<td>Greece</td>
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<td>France</td>
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<td>Japan</td>
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<td>United Kingdom</td>
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</tbody>
</table>
1. What happened in this crisis?

**FISCAL FIREPOWER USED UP**

**GENERAL GOVERNMENT NET DEBT**
(over GDP)

Source: IMF
1. What happened in this crisis?

WEAK RECOVERIES IN DEVELOPED COUNTRIES

CONSENSUS FORECASTS FOR 2010
(per cent growth)

Source: Consensus Forecasts
1. What happened in this crisis?

STRONG ASIAN RECOVERIES

CONSENSUS FORECASTS FOR 2010
(per cent growth)

Source: Consensus Forecasts
1. What happened in this crisis?

ASIA’S CATCH UP CONTINUES

GROWTH OF SELECTED ECONOMIES
(at purchasing power parity)

Source: IMF
1. What happened in this crisis?

- The crisis has been “resolved”, by socialising the risk.
- It has also been managed by aggressive monetary and fiscal policies.
- What is needed now is a strong private-sector led recovery.
- Has enough been done to achieve this in the high-income countries, given their weak financial systems, private-sector debt overhangs, falling housing prices and need for higher savings in important economies?
- Answer: no.
1. What happened in this crisis?

- Big economic risks over the next five years:
  - Failure to restart credit expansion and crippled growth of the private sector in advanced countries;
  - Dollar and fiscal crises at the core of the world economy;
  - Surge in commodity prices, a collapse in profitability and a jump in inflation;
  - More bad lending and yet another credit crisis; and
  - Outbreak of global protection and the end of the “second globalisation”.
2. What does this crisis mean?

- For capitalism?
- For globalisation?
- For development?
- For the global balance of power?
- For India?
2. What does this crisis mean? Capitalism

• The crisis certainly does not mean that market economics is dead.

• But it does remind us that crises are a part of capitalism.
  – Financial fragility remains an abiding feature of decentralised market economies.
  – More specifically, the monetary and regulatory regimes adopted by high-income countries failed.

• Lessons have to be learned.

• Here are two.
2. What does this crisis mean? Capitalism

• First lesson – Make the financial system more robust.
• Here the options are:
  – Fixing the current system; or
  – Transforming the system.
• Under fixing the current system, the options are:
  – More capital, particularly for the biggest banks;
  – A resolution regime for banks; and
  – Movement of trading onto exchanges.
2. What does this crisis mean? Capitalism

- Under transforming the current system, the options are:
  - A new division between commercial and investment banking; or
  - Narrow banking; or
  - Narrow banking, plus an end to credit-creating intermediation.

- At present, the effort being made is to fix the current system.

- Will this work? I doubt it.
2. What does this crisis mean? Capitalism

• Second lesson - inflation targeting is not enough:
  – Yes, it is hard to identify bubbles, but ignoring them is potentially catastrophic, particularly when large credit expansions go along with them;
  – These generate intense fragility in the economy;
  – Central banks should “lean against the wind”;
  – They also need “macro-prudential tools”, to deal with bubbles; and, finally,
  – Fiscal policy needs to be extremely aggressive, in the context of asset price bubbles.
2. What does this crisis mean? Globalisation

- The crisis also brings lessons for the survival of the “second globalisation”.
- First lesson – we still cannot handle large global imbalances:
  - Emerging and developing countries have, in aggregate, become net capital exporters;
  - This was partly to reduce risk, by accumulating reserve assets, and partly to promote export-led growth;
  - Those policies of emerging countries were a response to crises;
  - Advanced countries have proved unable to absorb these inflows;
2. What does this crisis mean? Globalisation

– Stable growth probably requires some combination of smaller surpluses and better insurance mechanisms for countries suffering “sudden stops” in capital inflow, via International Monetary Fund or similar arrangements

• Second lesson – the export-oriented mercantilist strategy has hit the buffers:
  – The demand to offset growing export surpluses of continental-sized countries does not exist;
  – The big danger is of a protectionist backlash in deficit countries, especially the US;
  – If unemployment does not fall soon, these dangers are very great.
2. What does this crisis mean? Development

- The crisis also has positive and negative lessons for development.
- First lesson – countries with sizeable reserves and the ability to expand domestic demand have survived well. This is notably true for China and India.
- Second lesson – capital flows remain unstable. But some capital flows are much more unstable than others. Direct investment is recovering quickly.
- Third lesson – high trade ratios can be a benefit even in a global crisis. The explanation is that, at the margin, trade is then less vital.
2. What does this crisis mean? Development

COMMERCIAL BANK LOANS UNSTABLE AGAIN

EXTERNAL FINANCING OF EMERGING ECONOMIES ($bn)

Source: IIF

- Direct Equity
- Portfolio Equity
- Commercial Banks
- Nonbanks

2008 2009e 2010f 2011f
2. What does this crisis mean? Development

EXTERNAL FINANCE OF EMERGING ECONOMIES ($bn)

Source: IIF
2. What does this crisis mean? Development

RISING OPENNESS OF BOTH GIANTS

Source: IMF and OECD

OPENNESS TO TRADE
(per cent of GDP)

India
China
2. What does this crisis mean? Power

- The failure of the western financial system and the global recession have undermined western credibility and prestige.
- Meanwhile, China and India have come into their own.
- The rise of the G20 and eclipse of the G7 is proof of this shift.
2. What does this crisis mean? Power

GROUP OF SEVEN FALLING

SHARES OF G7 COUNTRIES IN WORLD GDP
(at PPP)

Source: IMF WEO
2. What does this crisis mean? Power

CHINA AND INDIA RISING

SHARES OF "BRIC" COUNTRIES IN WORLD GDP
(at PPP)

Source: IMF WEO
2. What does this crisis mean? India

• So what are the conclusion that India needs to draw from this crisis for its development and its engagement with the world economy?

• I would suggest the following ten lessons:
  – Lesson one: what India has been doing has worked. It should do more of it!
  – Lesson two: sustaining an open world economy may prove hard. India should do what it can to help.
  – Lesson three: openness to trade has not caused excessive vulnerability to global instability, notwithstanding the critics.
2. What does this crisis mean? India

– Lesson four: global capital markets are indeed unstable, particularly short-term credit flows and, above all, bank credit. It is right for a developing country to protect itself against this instability.

– Lesson five: for this reason, large holdings of foreign currency reserves have proved sensible. But China’s $2.5tn is excessive!

– Lesson six: it is wise to curb India’s vulnerability to “sudden stops” in capital inflows, especially credit inflows, by limiting inflows of such capital.
2. What does this crisis mean? India

– Lesson seven: it is wise to prevent large domestic asset and credit bubbles.

– Lesson eight: India will need fiscal room for manoeuvre. For this reason, the debt ratio needs to be lowered as soon as possible.

– Lesson nine: India needs to focus on developing its domestic economy. Many reforms are needed here.

– Lesson ten: Expect the unexpected. Flexibility is essential, in both the economy and policy-making.