



# **GLOBALISATION AND DEVELOPMENT AFTER THE FINANCIAL CRISIS**

**Martin Wolf, Chief Economics  
Commentator, *Financial Times***

Launch of Festschrift in honour of Montek Ahluwalia

Delhi, India

9<sup>th</sup> February 2010

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 8<sup>th</sup> 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?

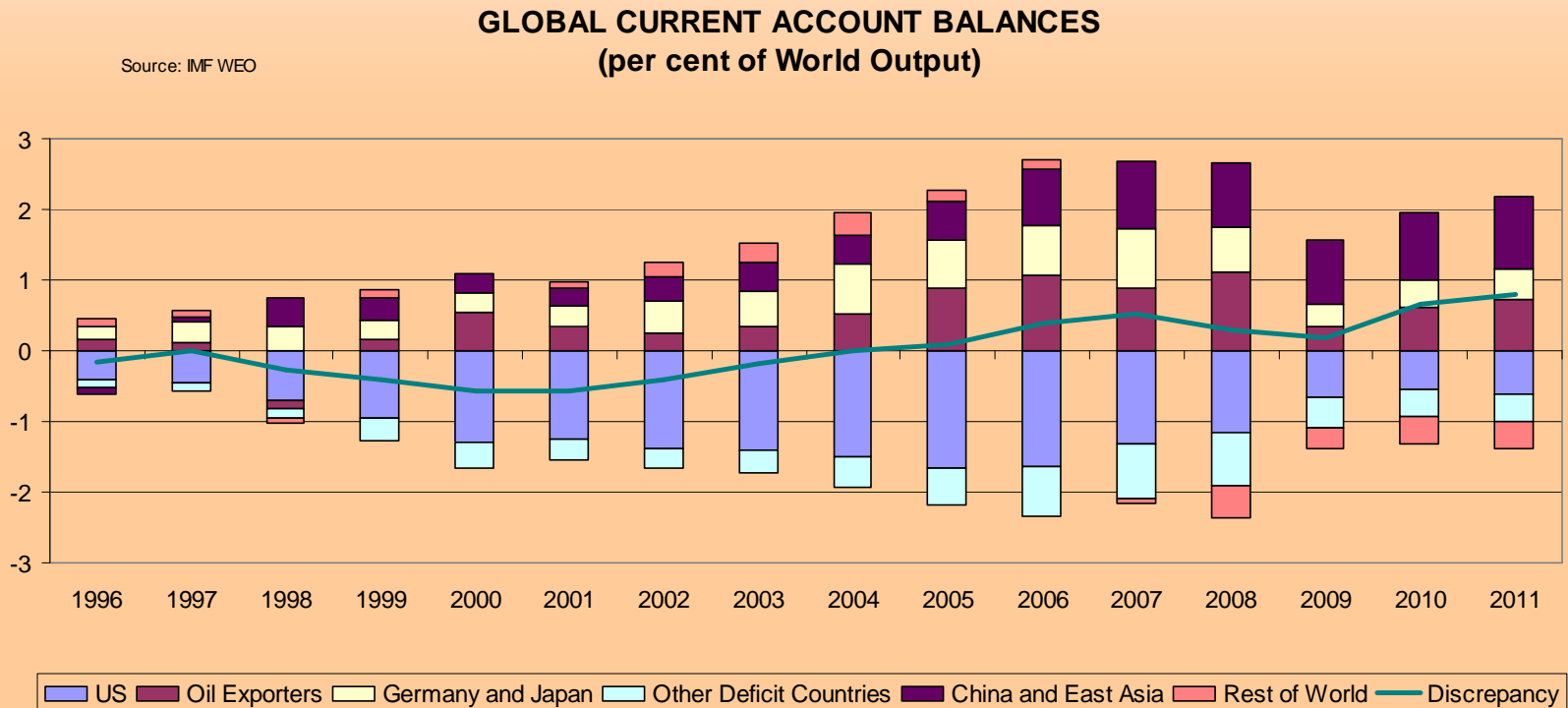
# 1. What happened in this crisis?

---

- 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

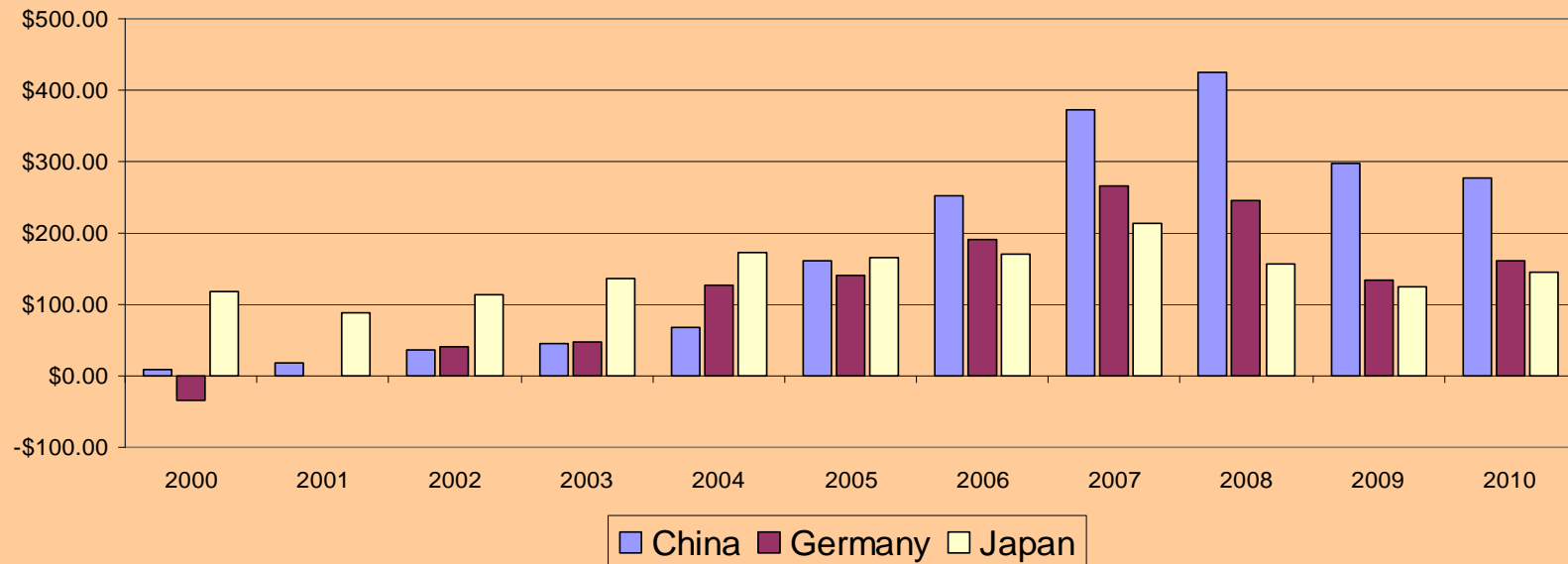


# 1. What happened in this crisis?

## CHINA RISES TO THE TOP OF THE SURPLUS LIST

### CURRENT ACCOUNTS OF WORLD'S THREE LARGEST SURPLUS COUNTRIES (\$bn)

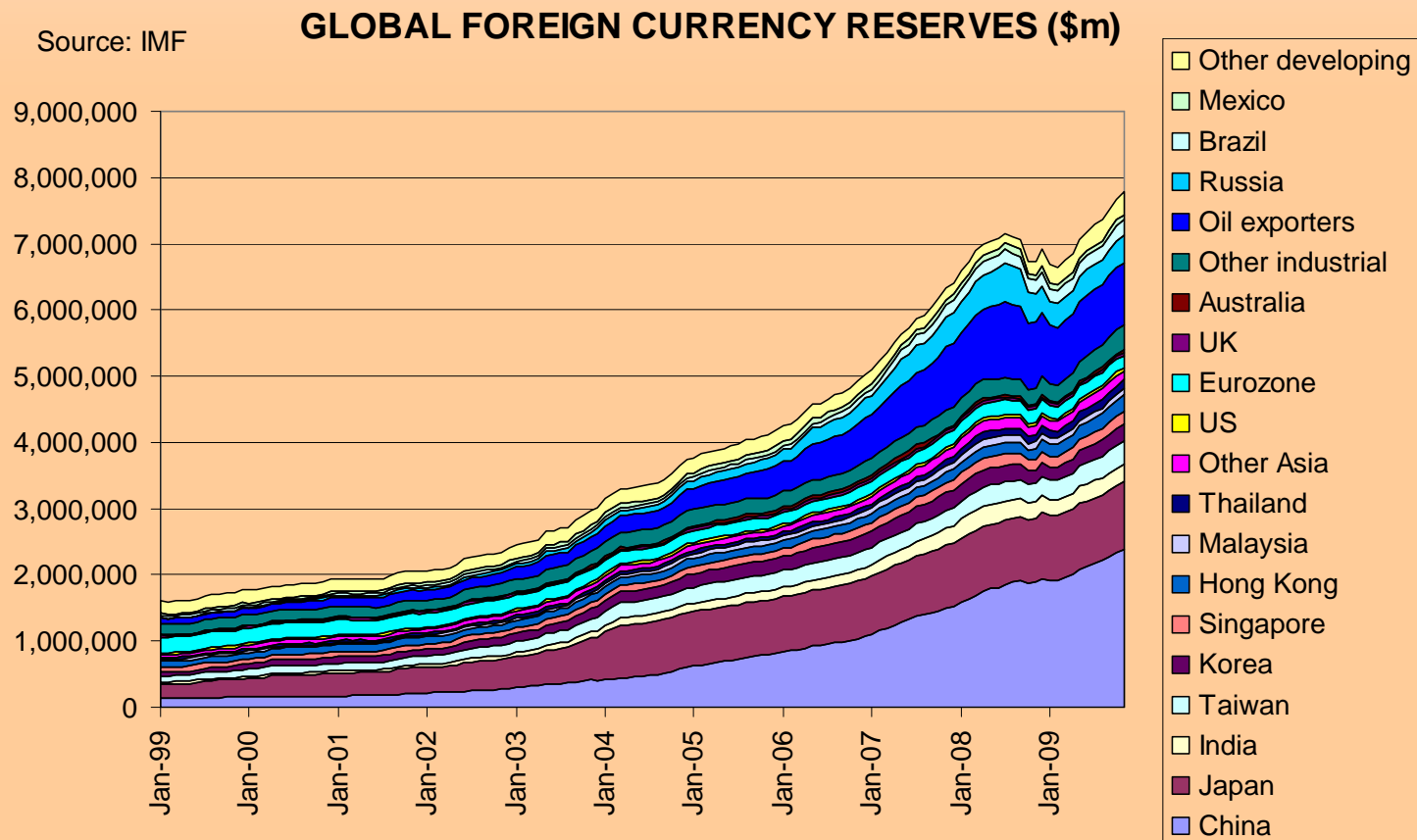
Source: IMF WEO





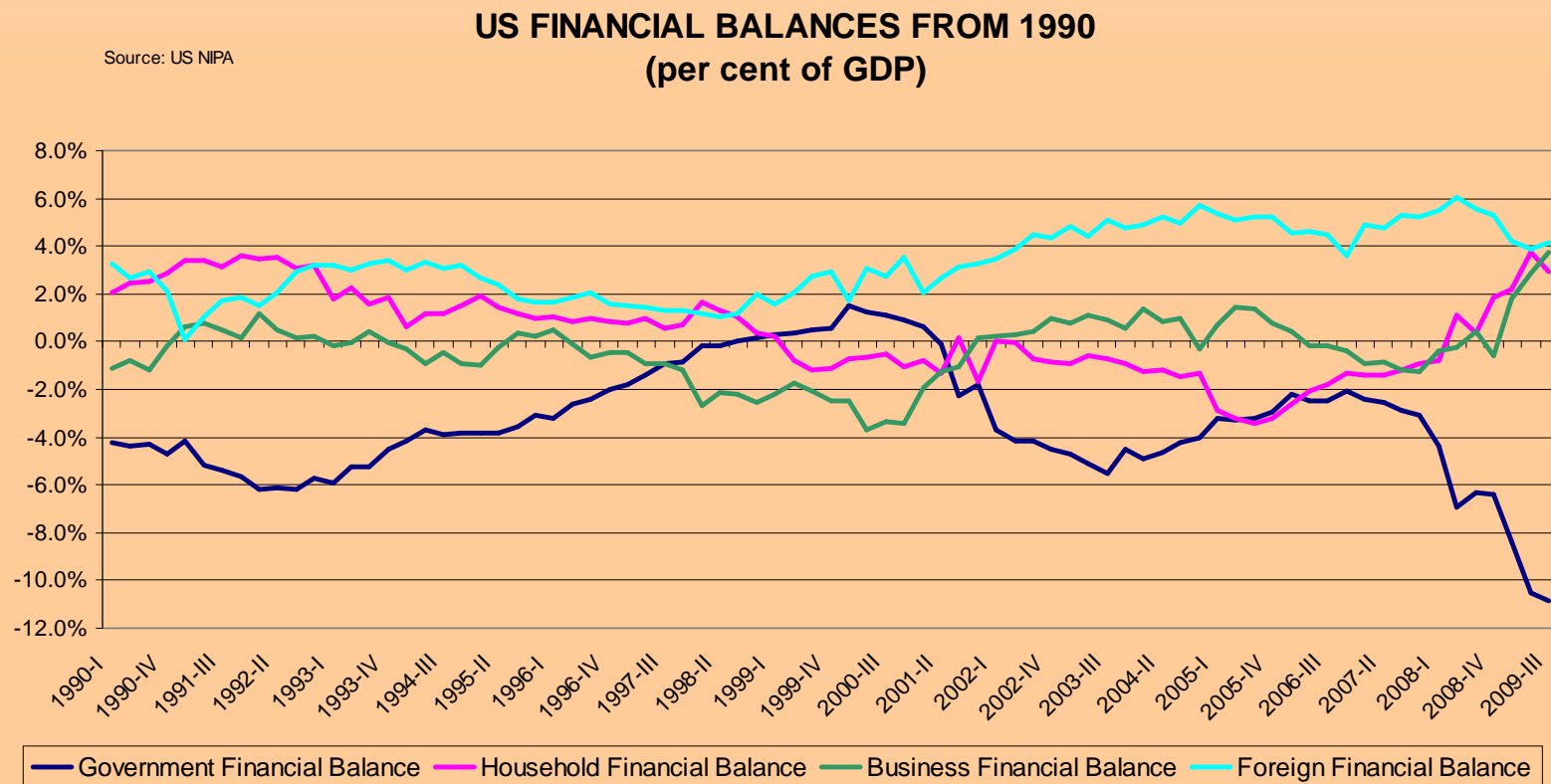
# 1. What happened in this crisis?

## THE GREAT RESERVE ACCUMULATION



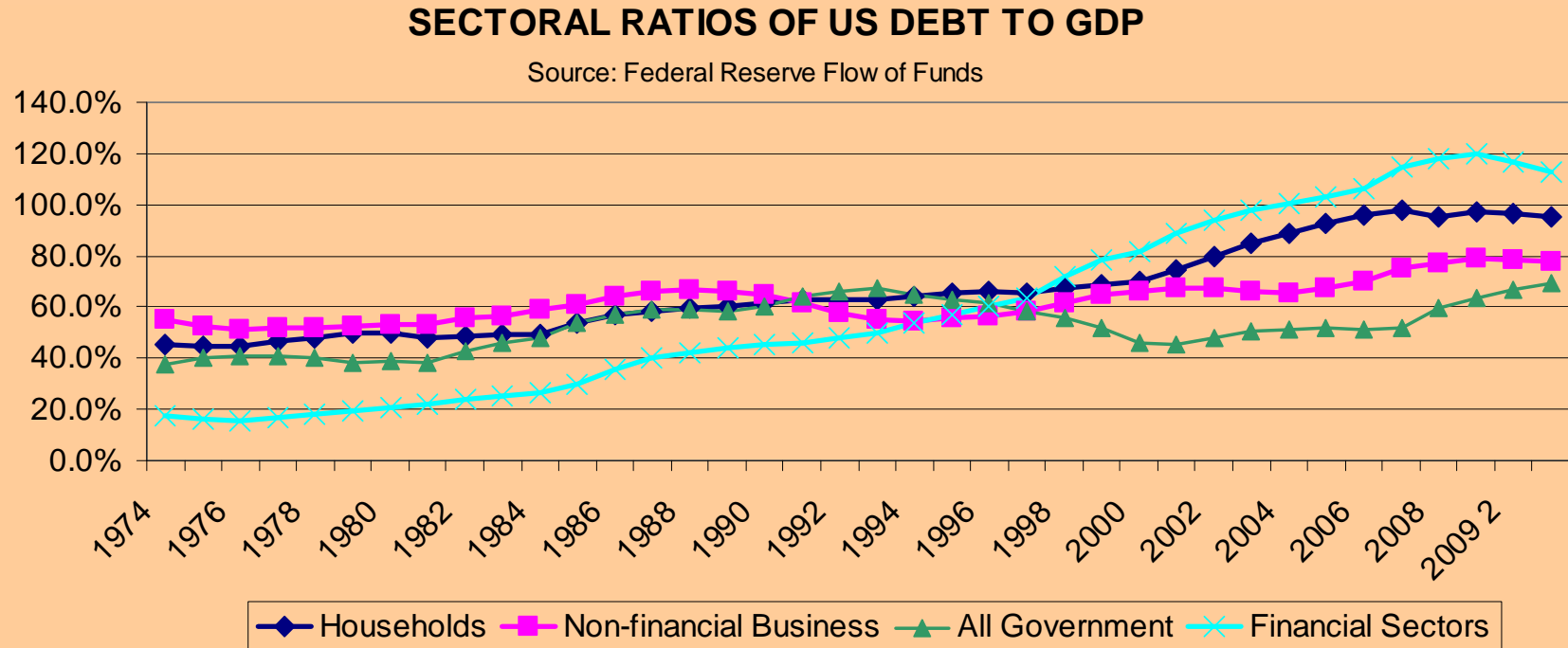
# 1. What happened in this crisis?

## US PLUNGES IN DEFICIT



# 1. What happened in this crisis?

## FINANCIAL SECTOR DEBT EXPLOSION



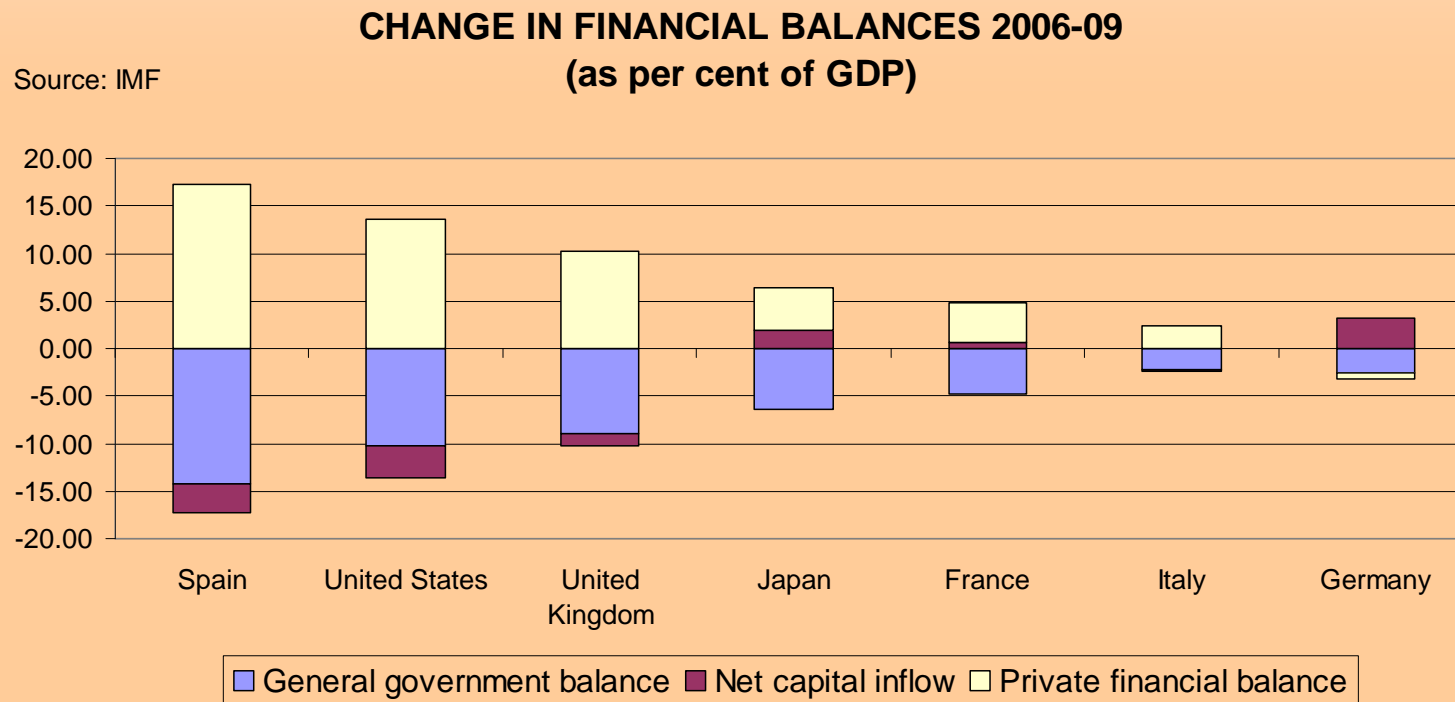
# 1. What happened in this crisis?

---

- 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

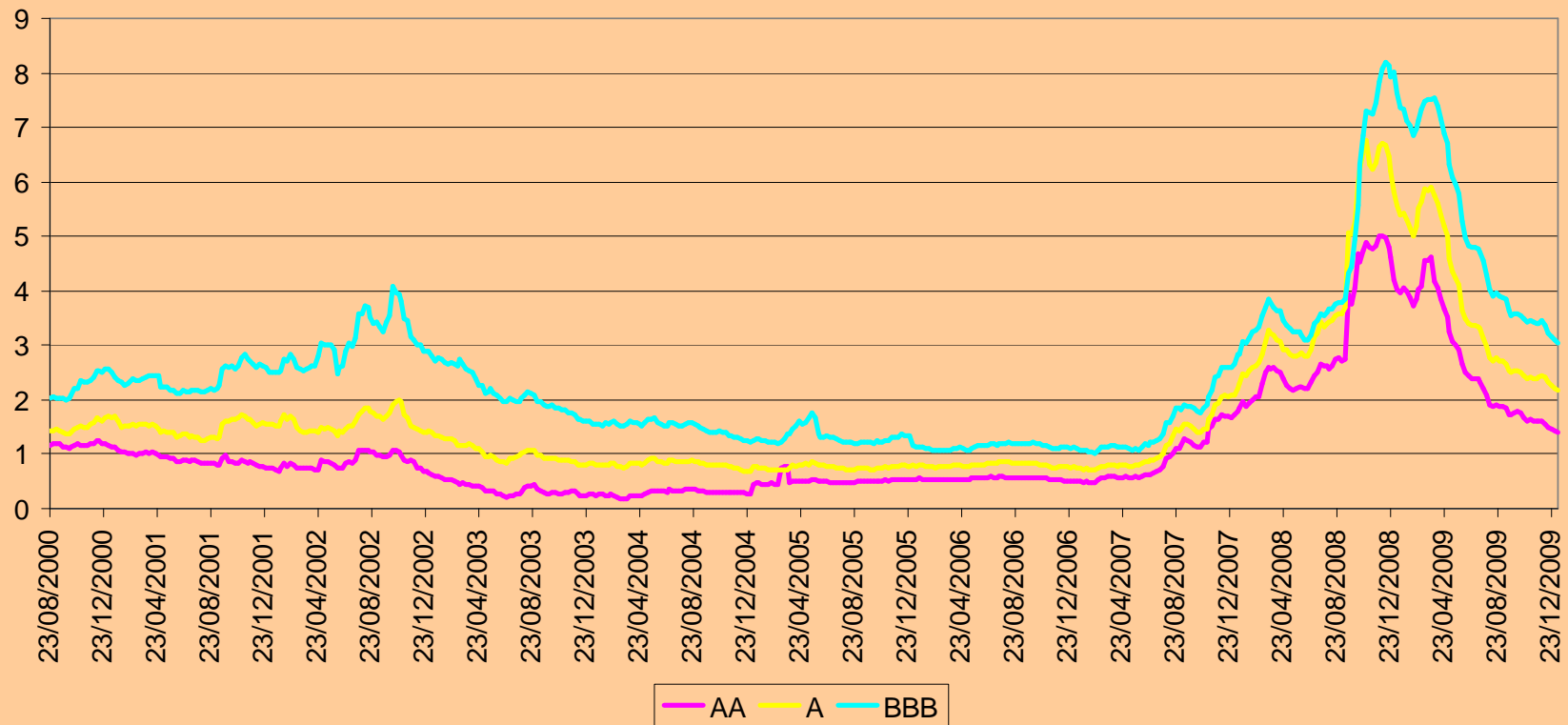


# 1. What happened in this crisis?

## RETURNING CONFIDENCE

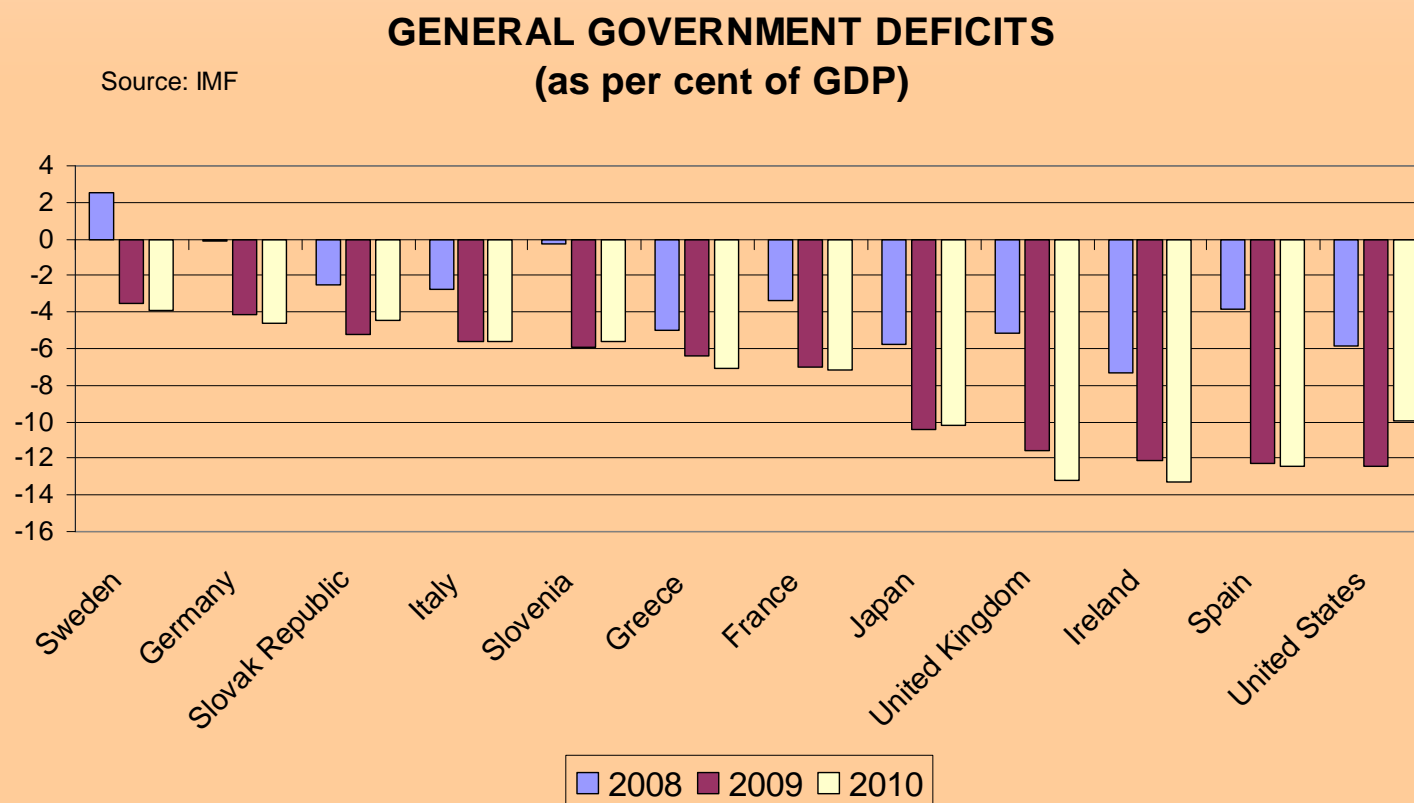
### SPREADS OF US CORPORATE BONDS OVER TREASURIES

Source: Thomson Datastream



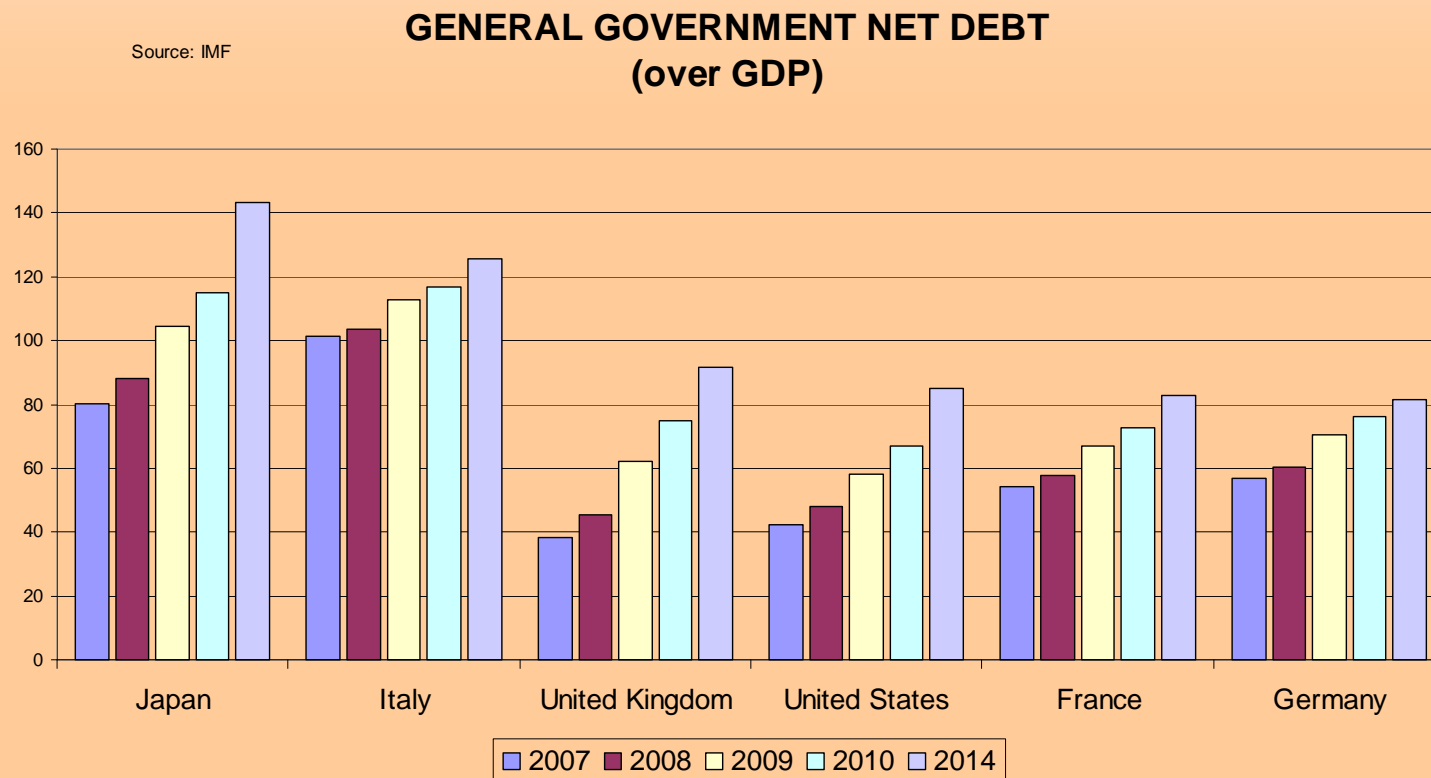
# 1. What happened in this crisis?

## FISCAL FIREPOWER USED



# 1. What happened in this crisis?

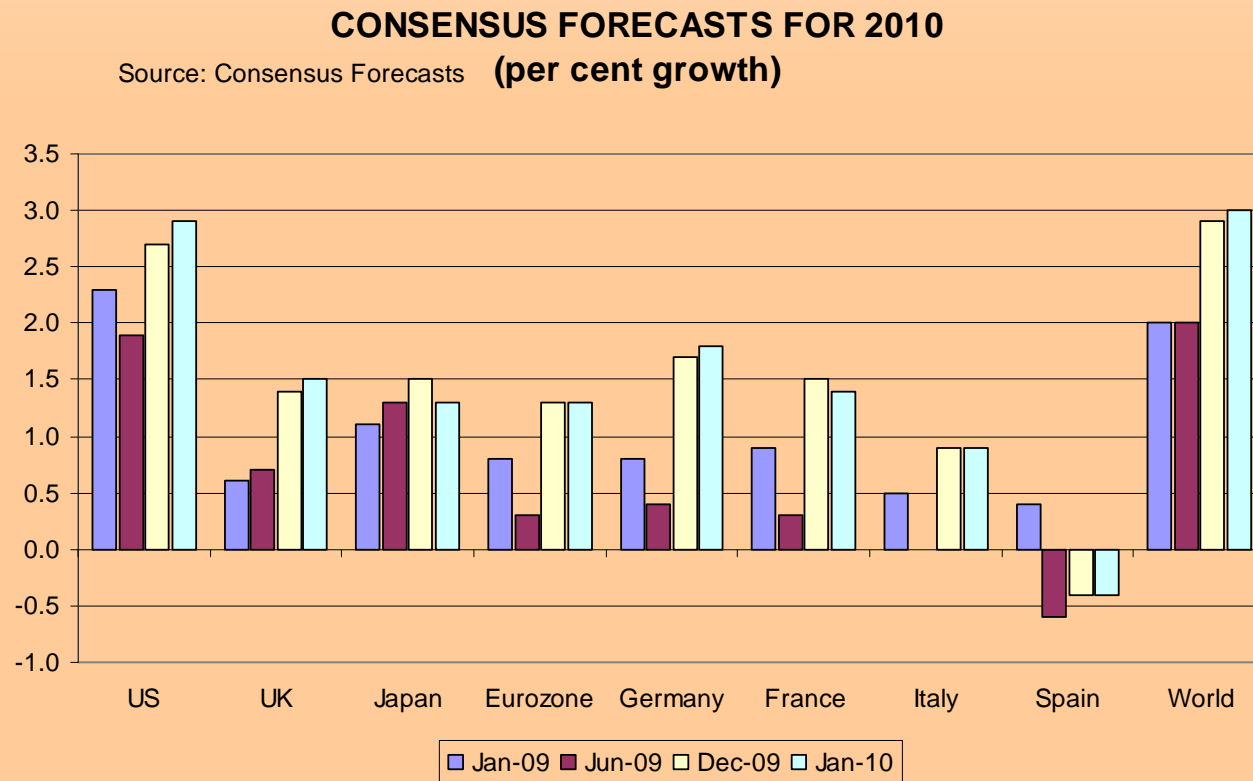
## FISCAL FIREPOWER USED UP





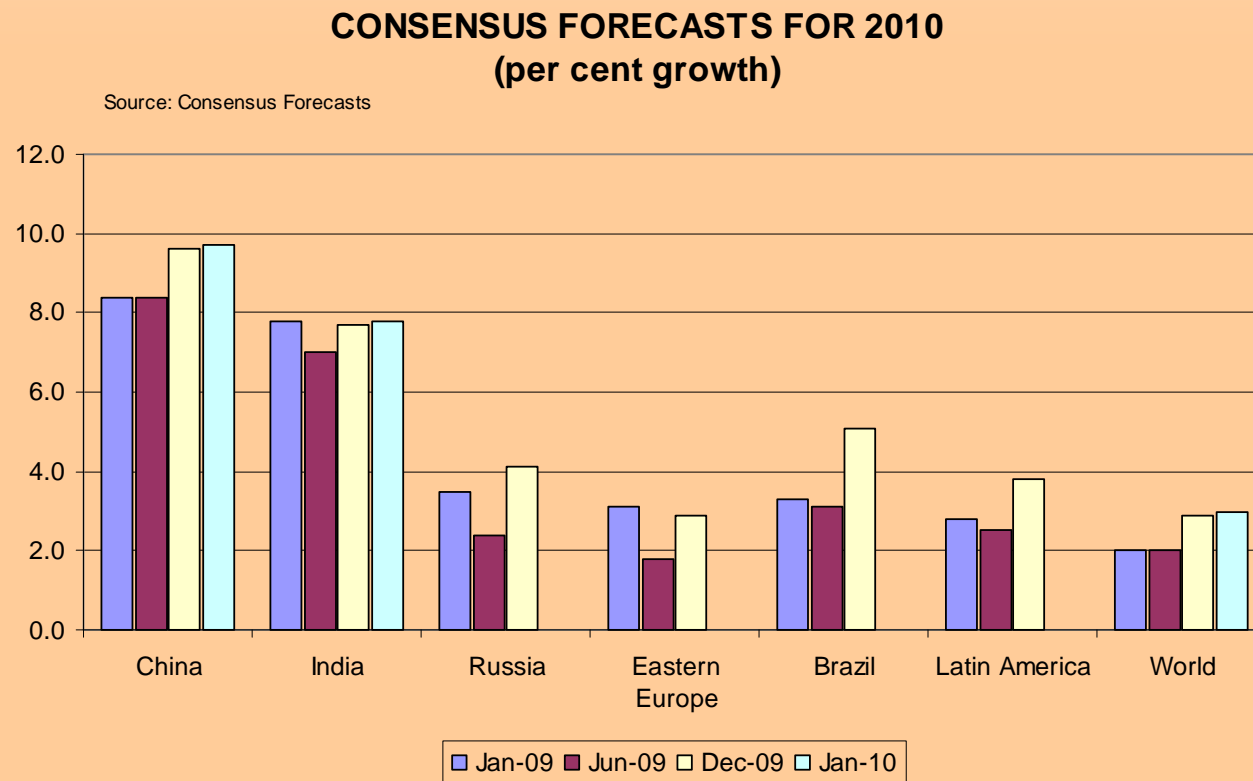
# 1. What happened in this crisis?

## WEAK RECOVERIES IN DEVELOPED COUNTRIES



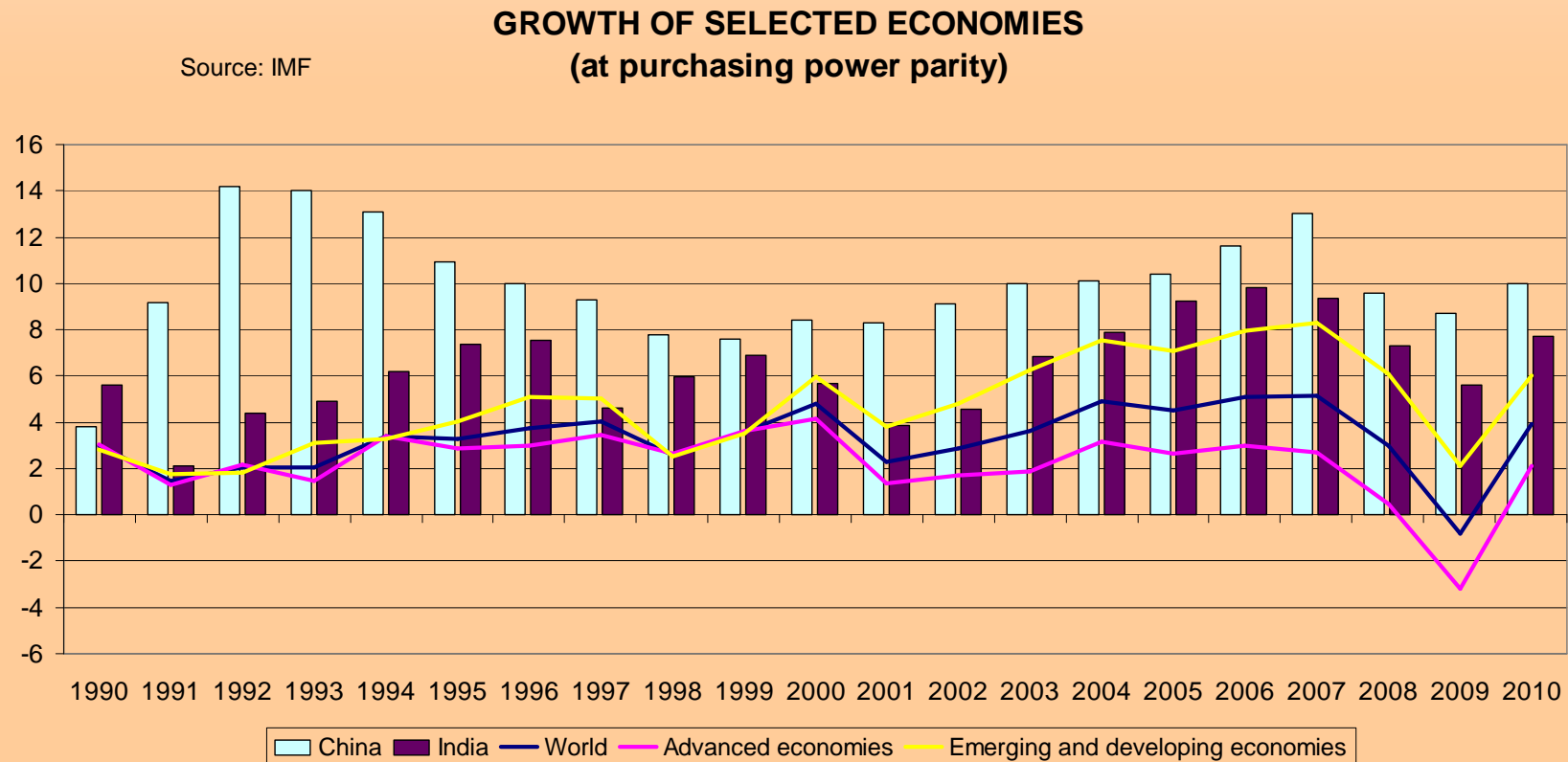
# 1. What happened in this crisis?

## STRONG ASIAN RECOVERIES



# 1. What happened in this crisis?

## ASIA'S CATCH UP CONTINUES



# 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.

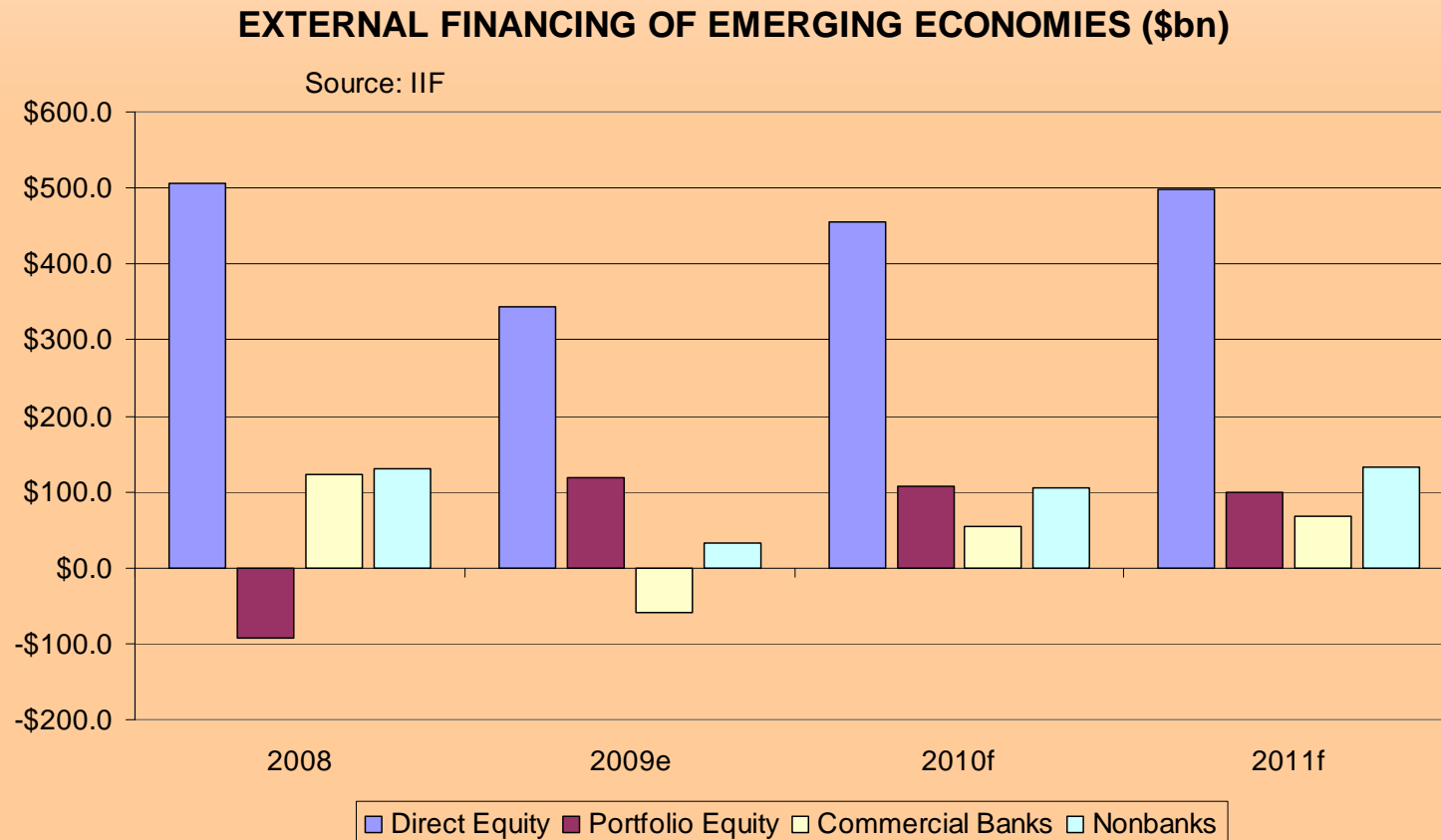
## 2. What does this crisis mean? Development

---

- 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.

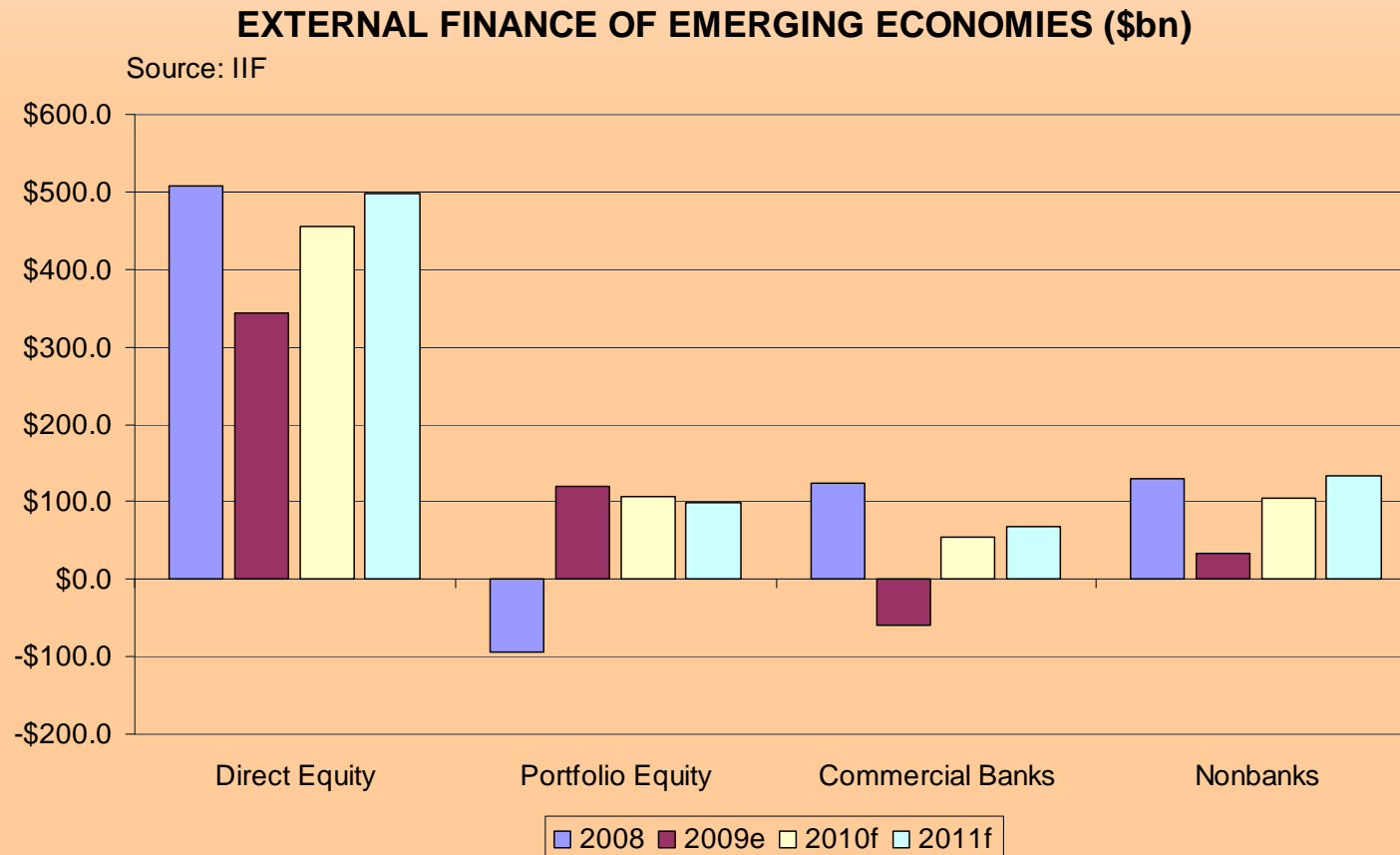
## 2. What does this crisis mean? Development

### COMMERCIAL BANK LOANS UNSTABLE AGAIN



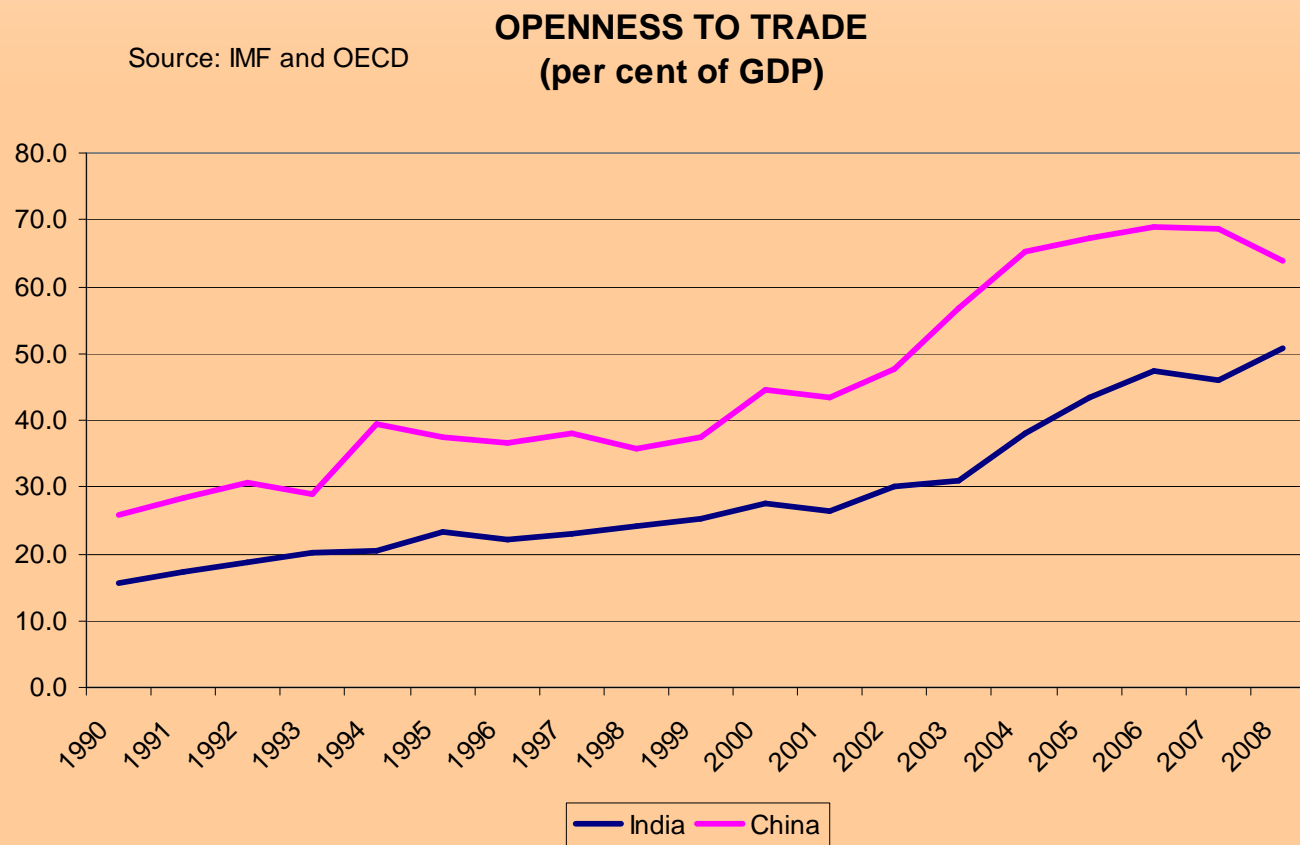
## 2. What does this crisis mean? Development

### COMMERCIAL BANKS LOANS UNSTABLE AGAIN



## 2. What does this crisis mean? Development

### RISING OPENNESS OF BOTH GIANTS





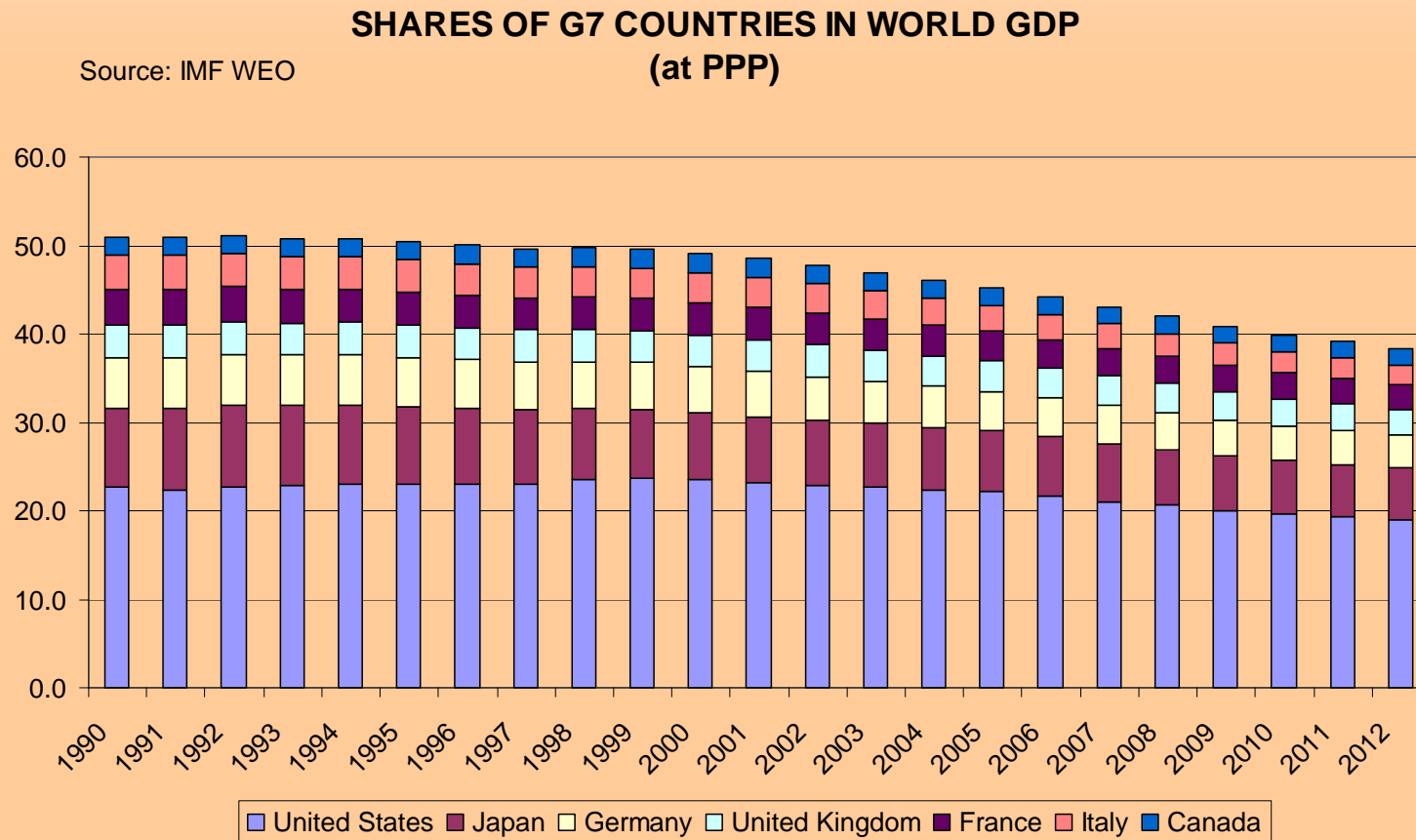
## 2. What does this crisis mean? Power

---

- 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.

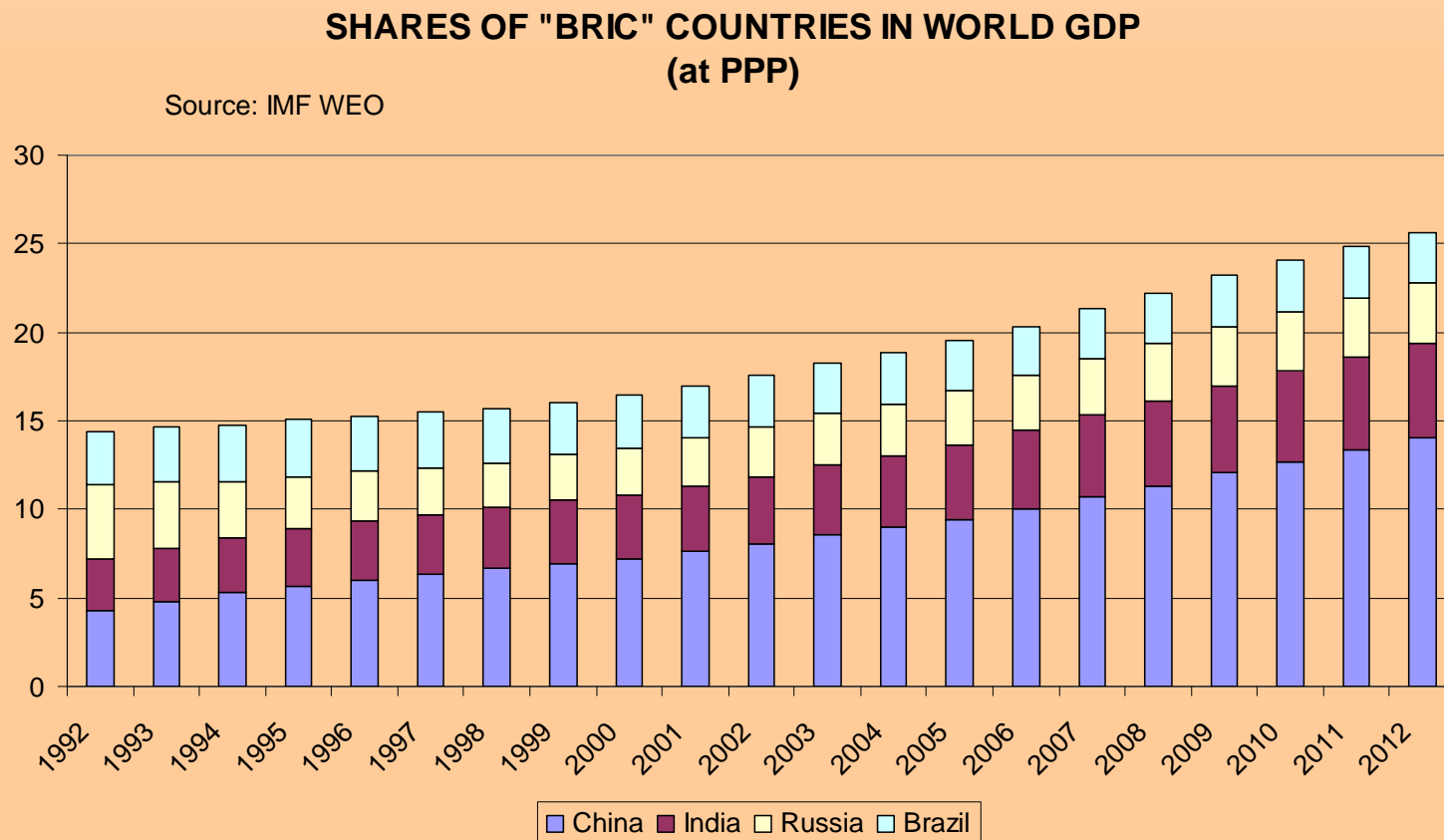
## 2. What does this crisis mean? Power

### GROUP OF SEVEN FALLING



## 2. What does this crisis mean? Power

### CHINA AND INDIA RISING



## 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 \$2.5trn 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.