Global Imbalances Policies, Structure, Finance and Ideas

ICRIER

Delhi, September 13, 2011

Reasons for the global imbalances of the last decade: Three questions

- misguided policies? (e.g. the Fed easy interest rate policy after 2000, the Chinese x-rate policy, build up of reserves in emerging economies)

or

- structural trends? (e.g. concentration of income in the US and its consequences on domestic consumption, corporate profits in China, Japan)

or

- financial sector inability to assess and manage risk? (particularly in the US and UK)

A Detour
Turbulences in the 1990s

- Mexico, 1995
- Thailand, 1997
- Indonesia, 1997
- Korea, 1997
- Russia, 1998
- Turkey, 2001-02
- Brazil, 1999, and 2002
- Argentina, 2001-2002

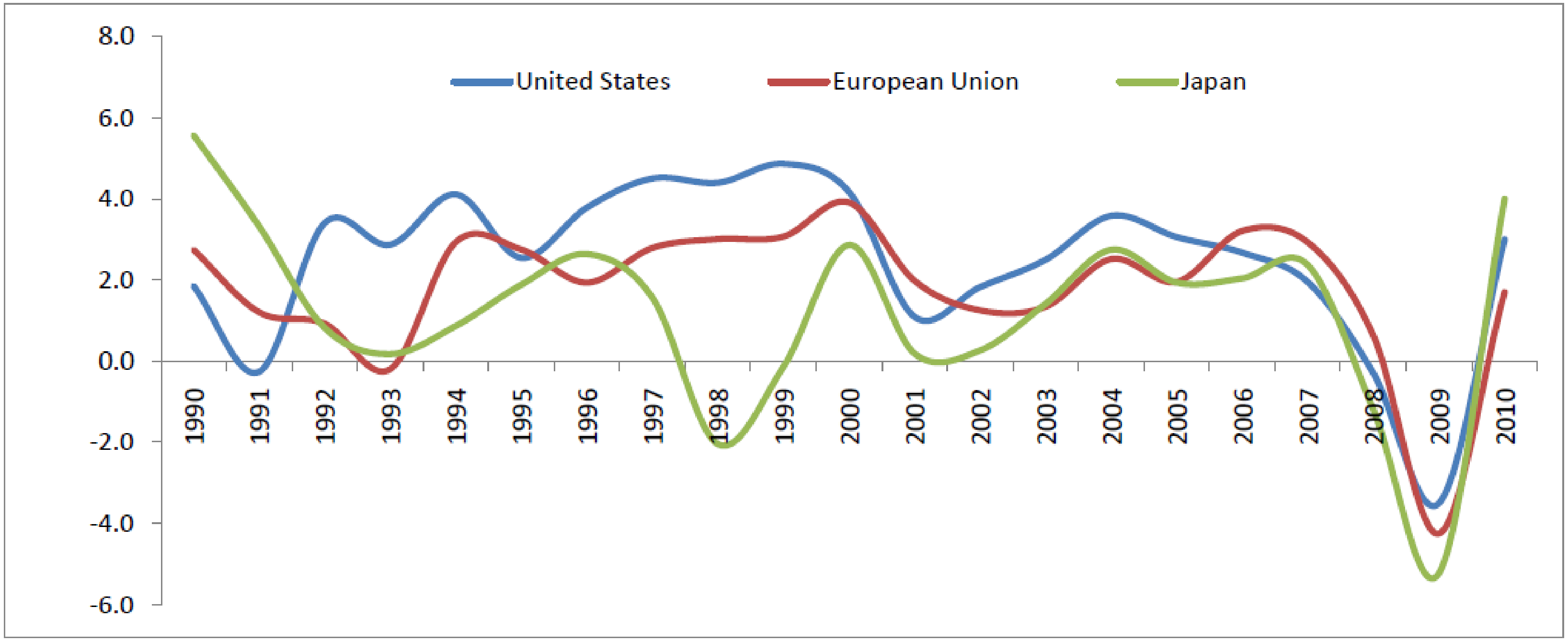
Lessons from the Crises in the 1990s

- **Bad idea to**: fight inflation with x-rate appreciation, not to take corrective action against large external imbalances, believe that the financial sector will be able to manage risks, assume that open capital accounts have only benefits, assume that fiscal adjustment can correct external imbalances.

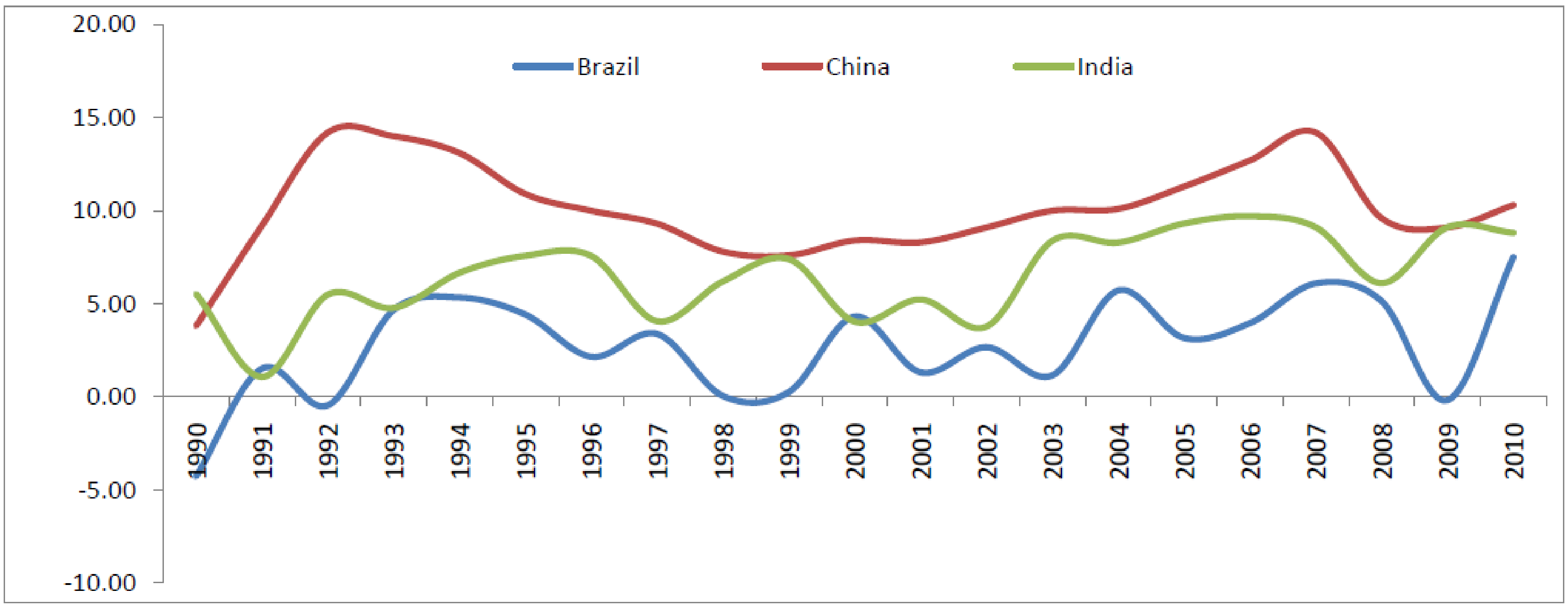
- **Lessons**: build up reserves, maintain competitive x-rates, address inflation through structural measures, and monetary and fiscal policies, IMF abandoned insistence on Article VIII, banks (and even international financial institutions)will not necessarily correctly assess the downside of structural policies. Private capital flows come easy, and leave easy. Private debts can become public.

- **Most Important:** the financial sector does not assess risk well, specially macro risks.

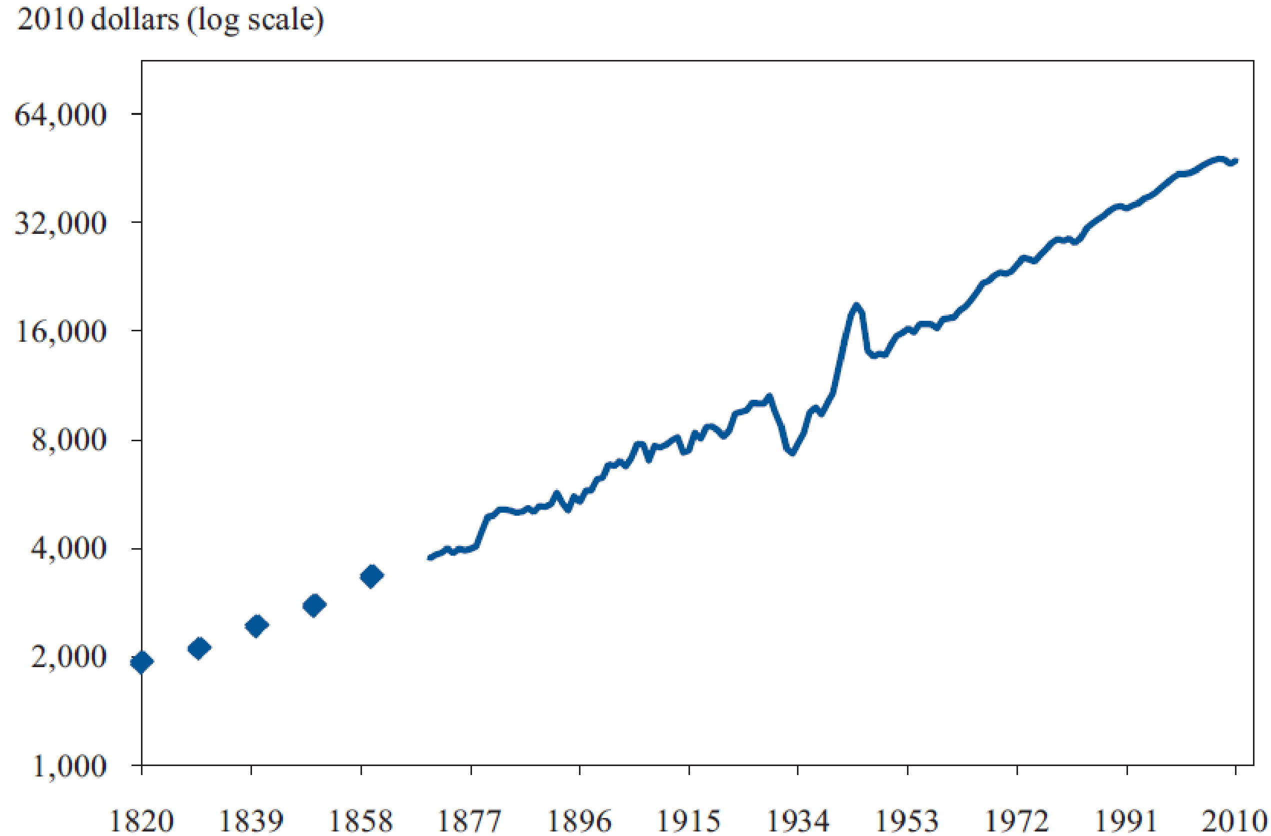
Growth Rates in Advanced Economies (2.5, 1.8, 1.2)



Growth in Main Emerging Markets (2.7, 10.1, 6.6)



Progress in U.S. Real Income Per Person Since 1820



Sources: Maddison (2008); Bureau of Economic Analysis, National Income and Product Accounts.

Good Imbalances

- 3 examples:

--Japan: aging faster than in other countries

--India: large investment needs to catch up with the rest of the world

--US: deeper and more liquid financial markets than in the rest of the world (questionable and questioned)

Japan: Population Projections

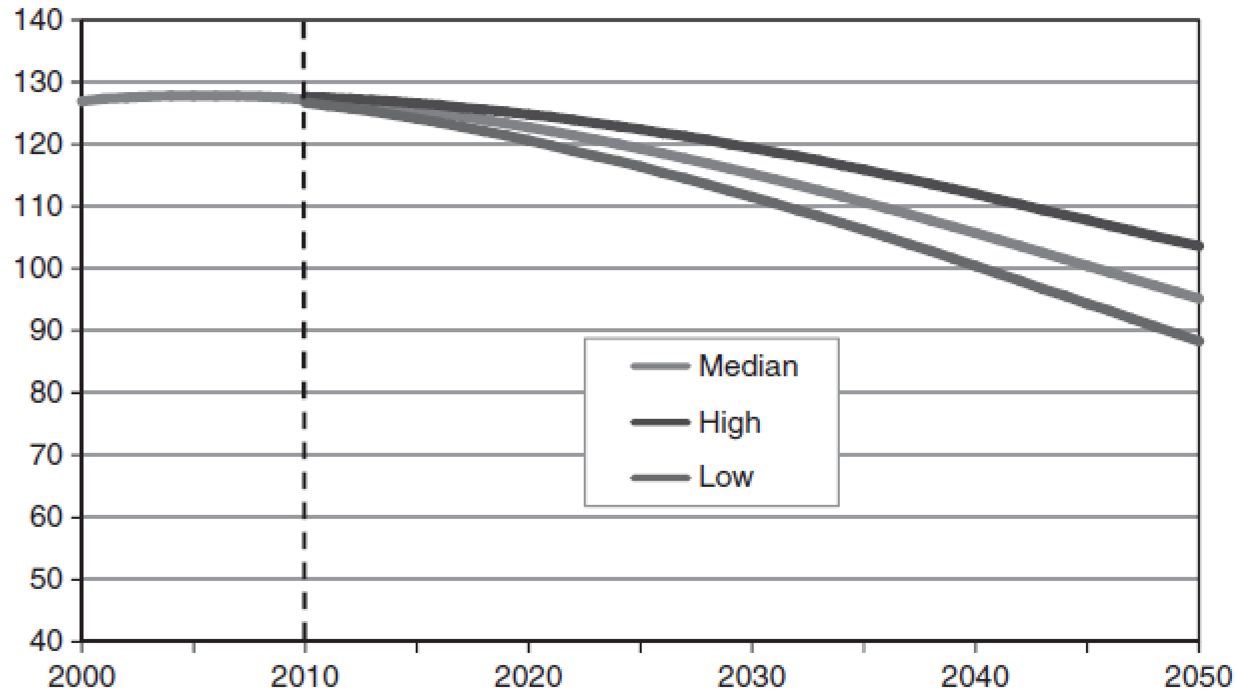


Figure 1: Population projections (million of people). *Source*: National Institute of population and social security research, http://www.ipss.go.jp/pp-newest/e/ppfj02/t_1_e.html (5 October 2010)

Bad Imbalances

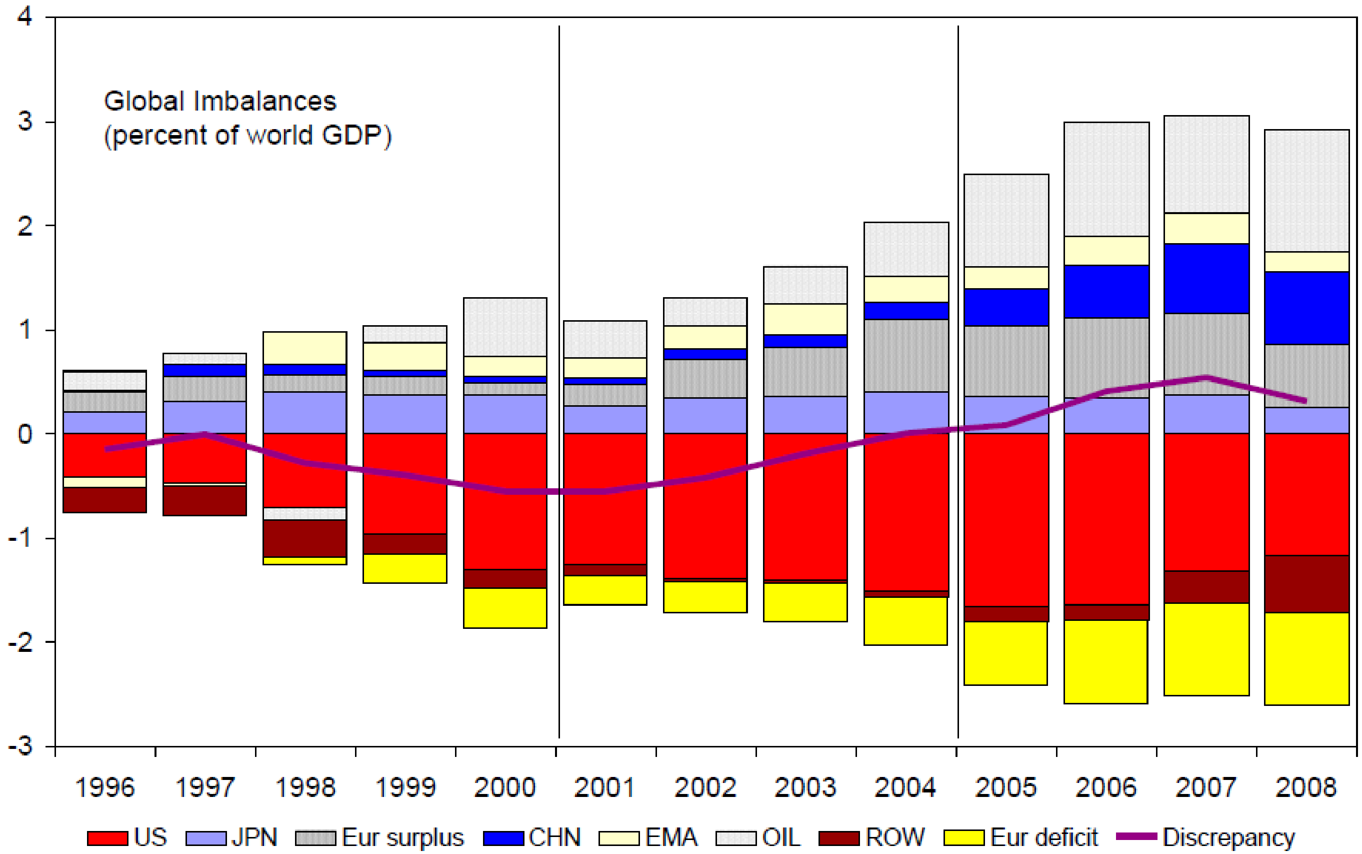
- 3 examples:

-- China: insufficient domestic consumption

--Argentina and Brazil in the 1990s: excessive consumption and currency appreciation

--East Asian countries pre-1997 crisis: same

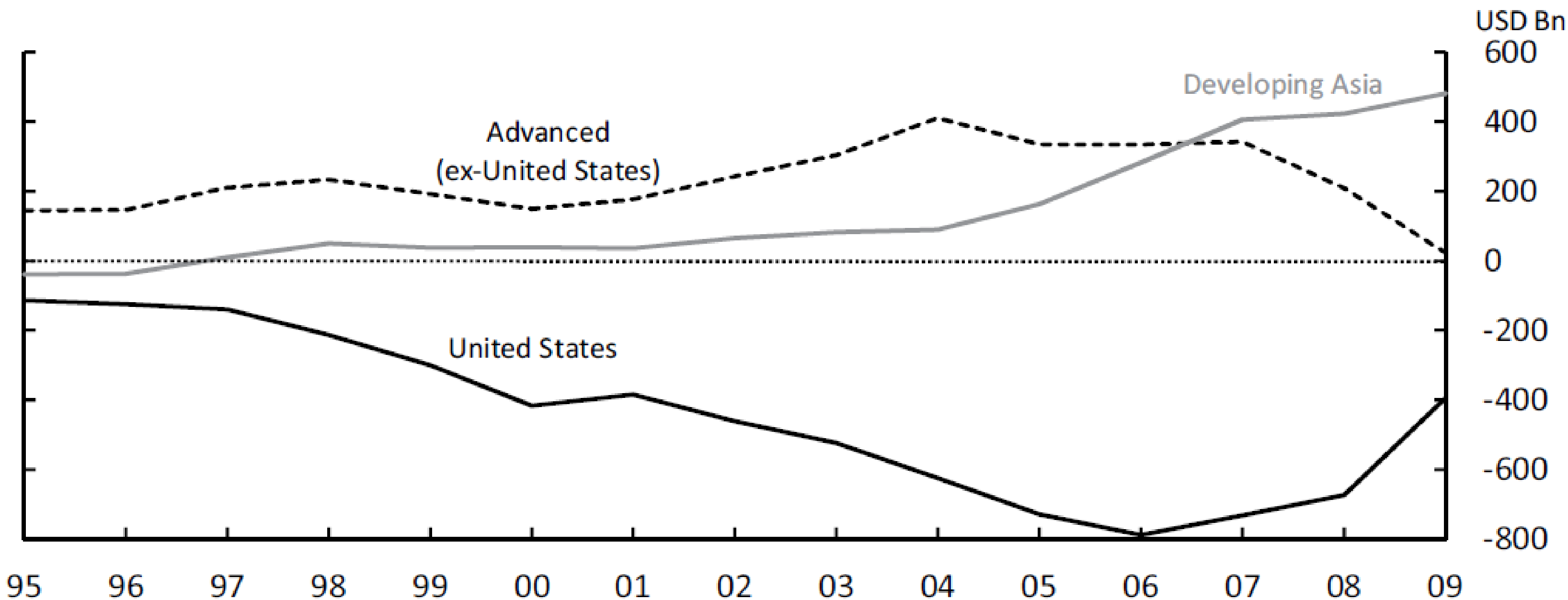
Global Imbalances: 1996-2008



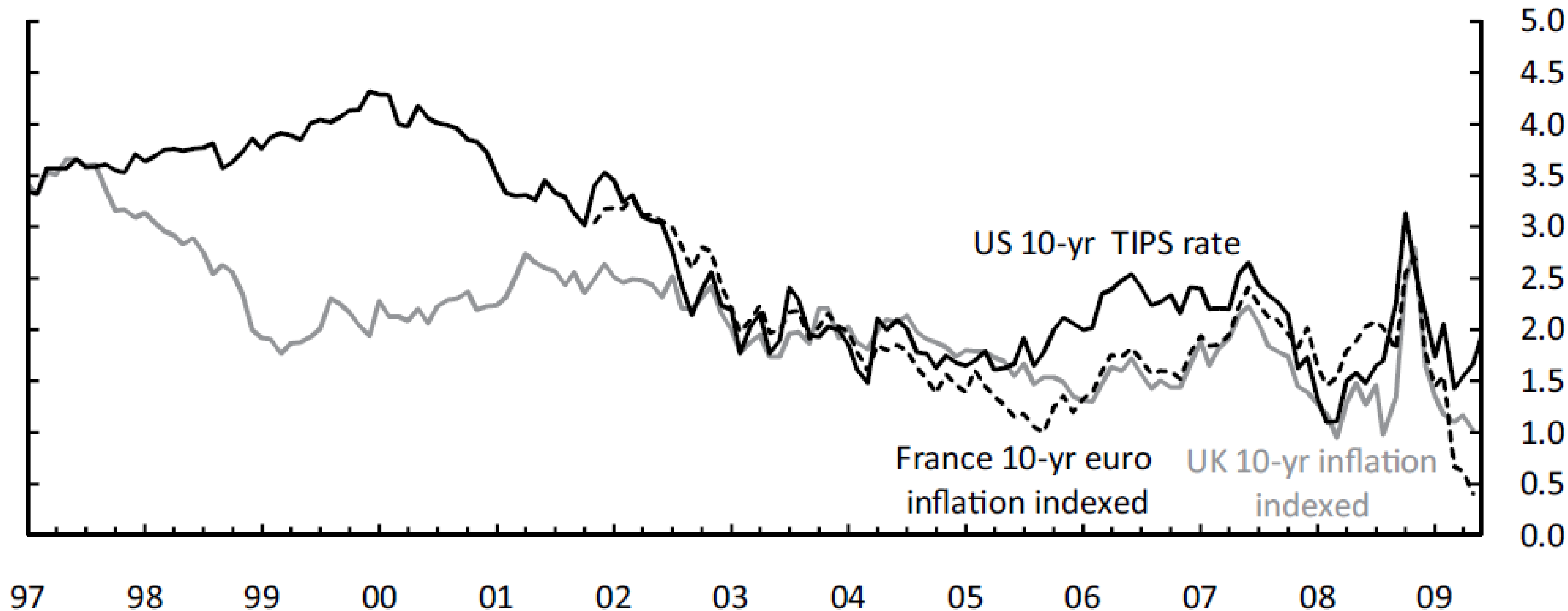
Note: Current account balances (in percent of world GDP). Source: World Economic Outlook, January 2010

Global Imbalances, 1995–2009

Current Account Surplus

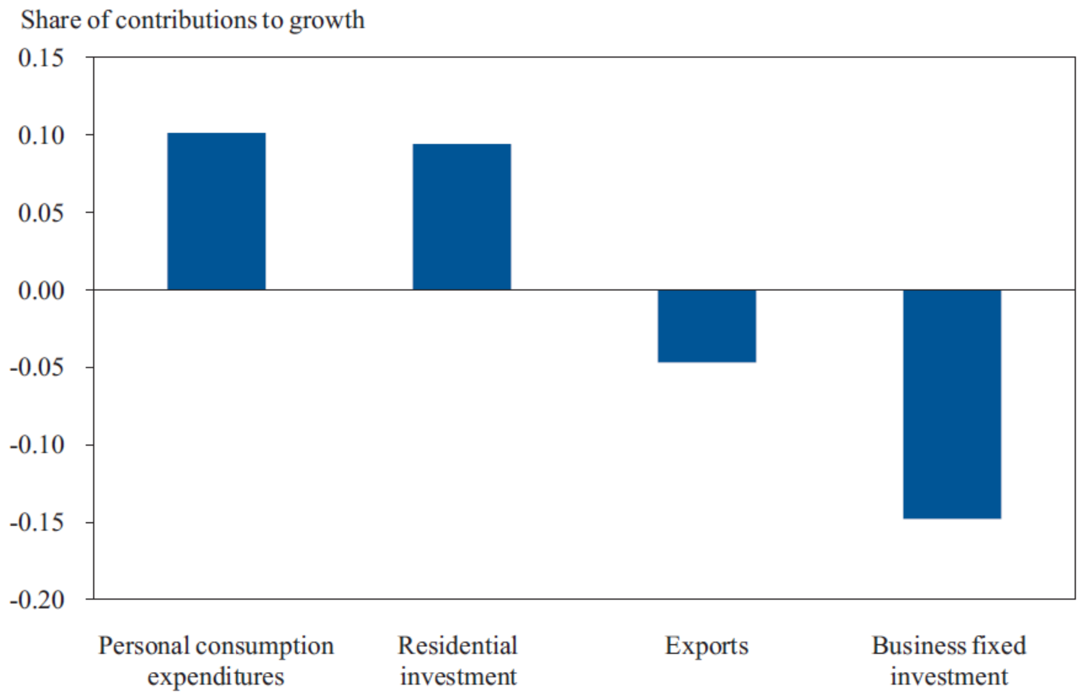


Long Term Interest Rates



Recent Expansion in the US

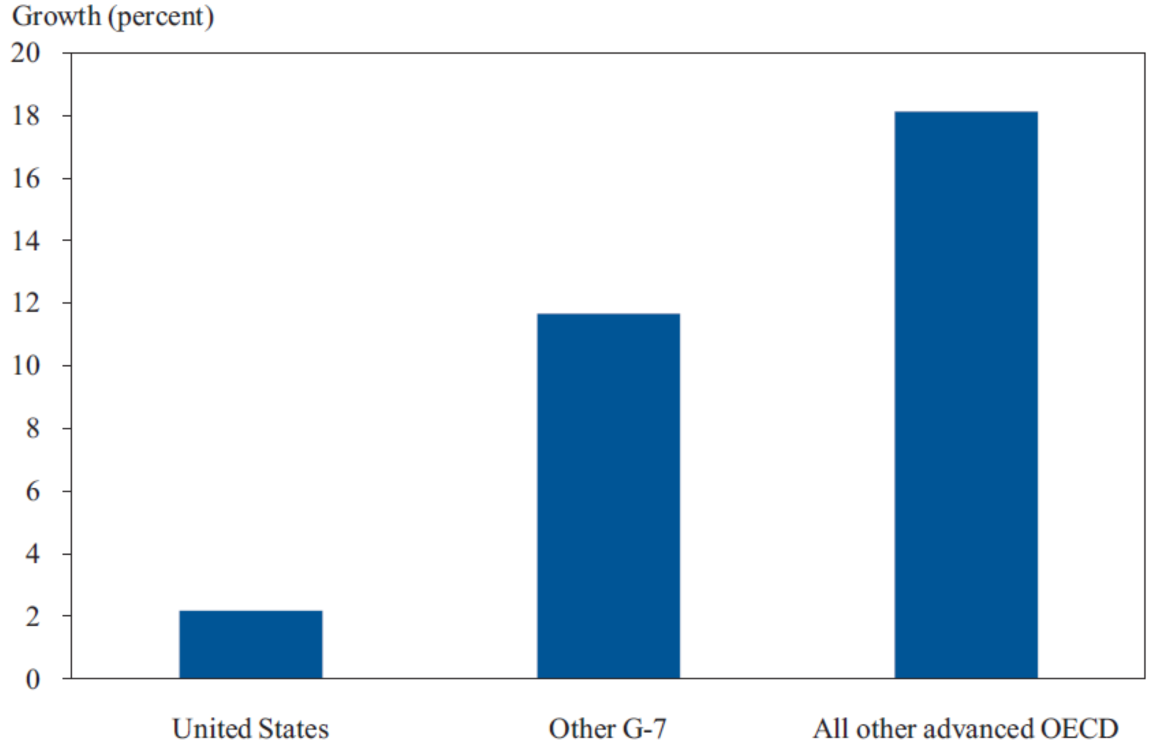
Figure 1-1
Unsustainable Expansion: Recent Boom vs. Past Booms



Note: The figure shows the share of contribution to GDP growth from 2001:Q1 to 2005:Q4 minus the share of contribution to growth from 1953:Q2 to 2001:Q1.
Source: Bureau of Economic Analysis, National Income and Product Accounts.

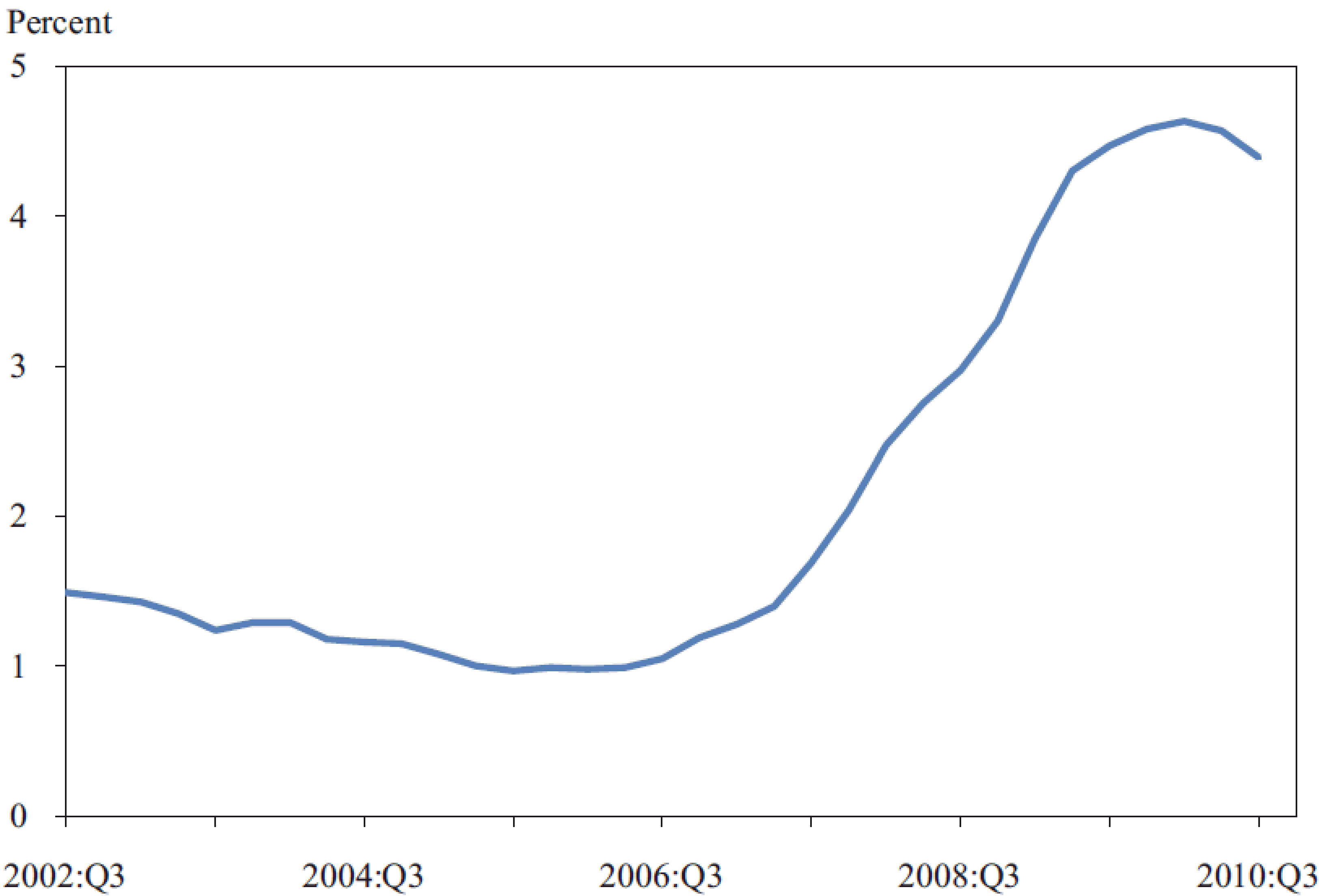
US Investment Growth

U.S. Investment Growth Lagged Other Major Economies, 2000–2005



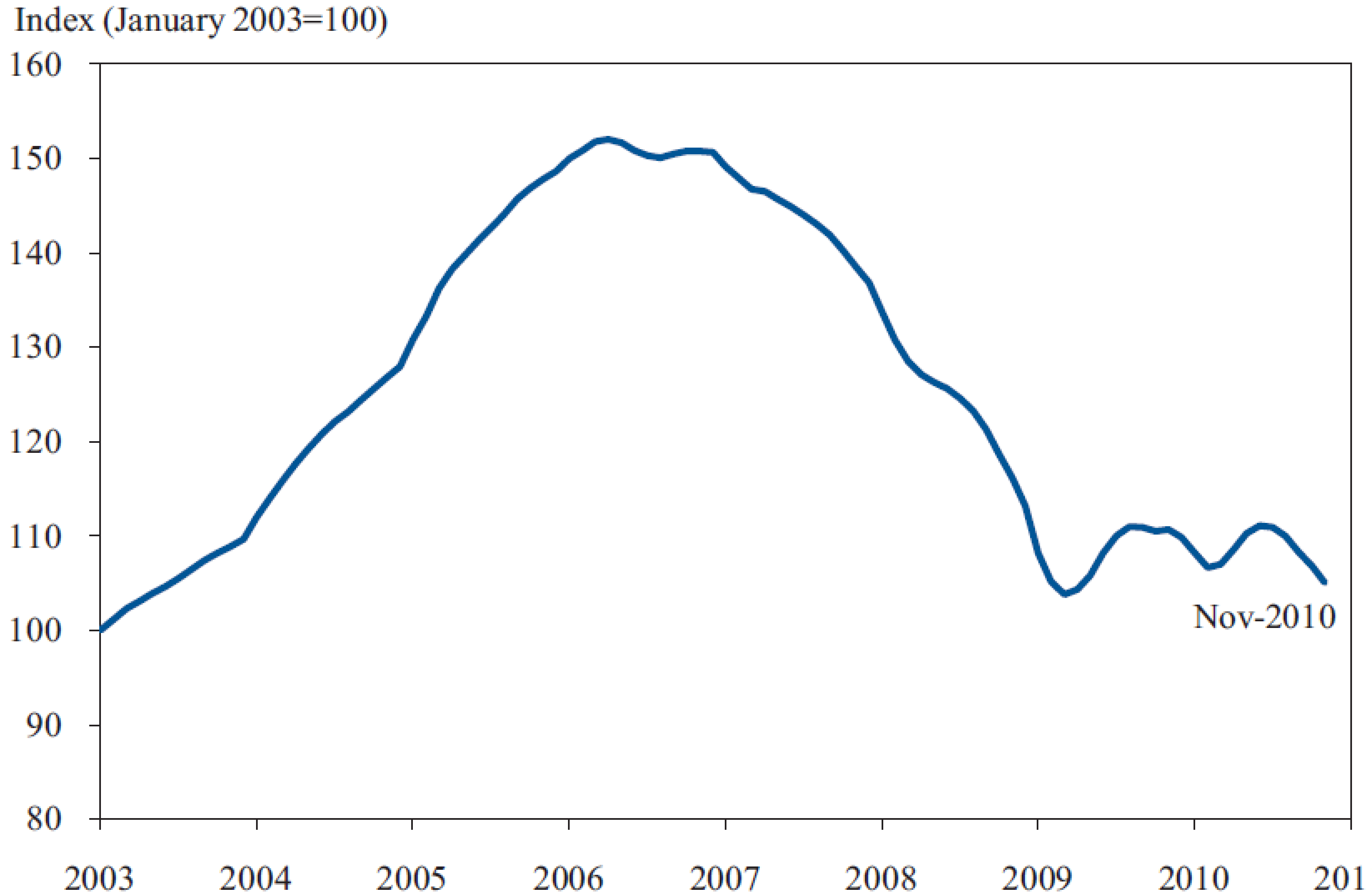
Note: Cumulative growth in real gross private nonresidential fixed capital formation, 2000–2005.
Sources: OECD Economic Outlook no. 88, Annex Table 6; CEA calculations.

Share of Mortgages in Foreclosure



Source: Mortgage Bankers Association, National Delinquency Survey.

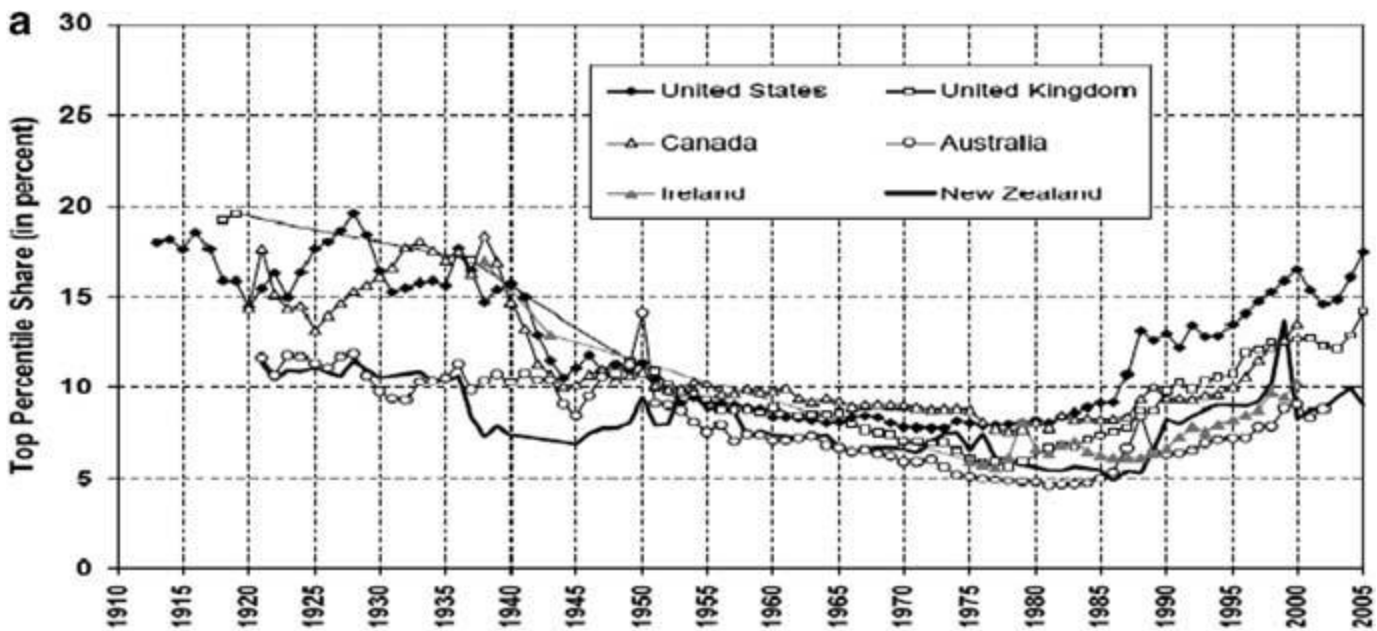
House Prices



Sources: First American CoreLogic National House Price Index including distressed sales; CEA calculations.

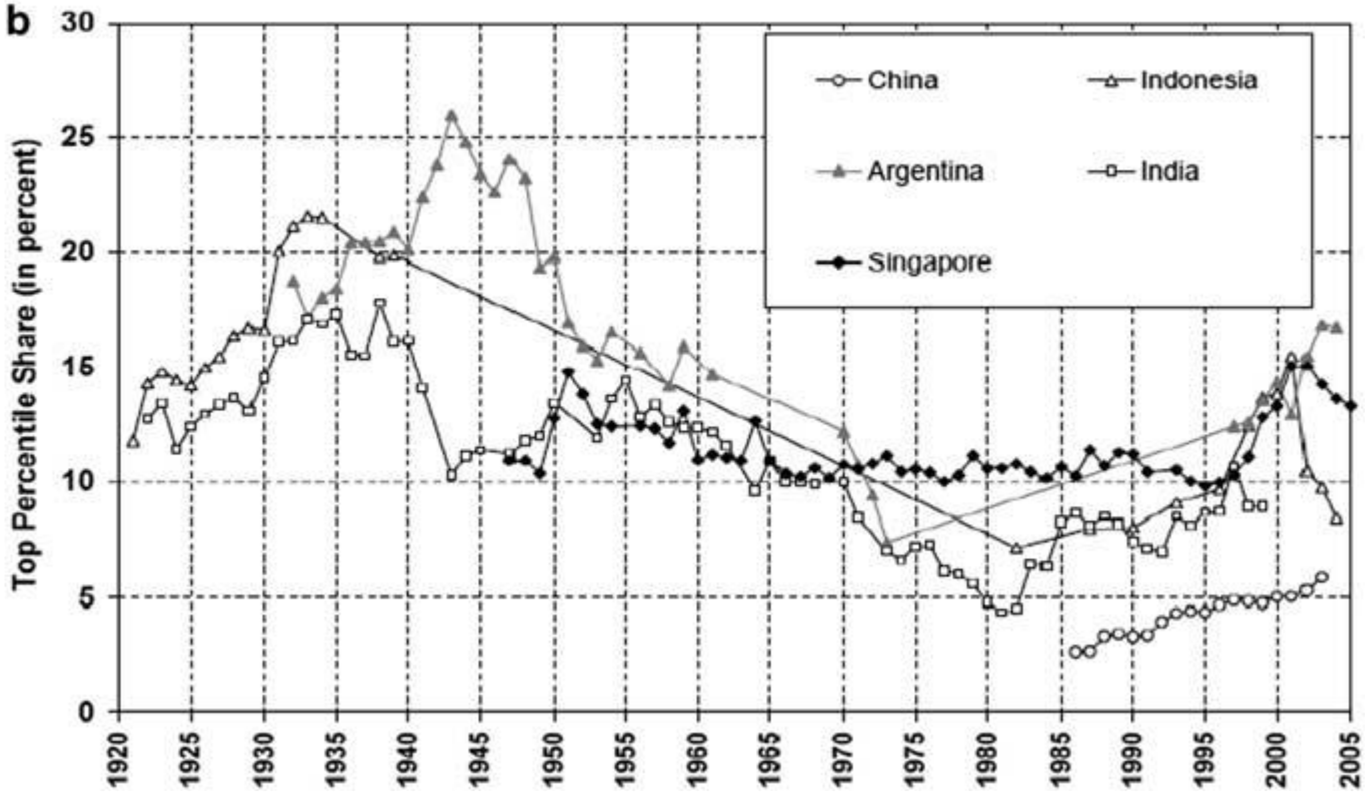
Income Distribution in Advanced Economies

(share of GDP accruing to the top 1% of the population)



Income Distribution in Emerging Economies

(share of GDP accruing to the top 1% population)



Income Distribution in Emerging Economies

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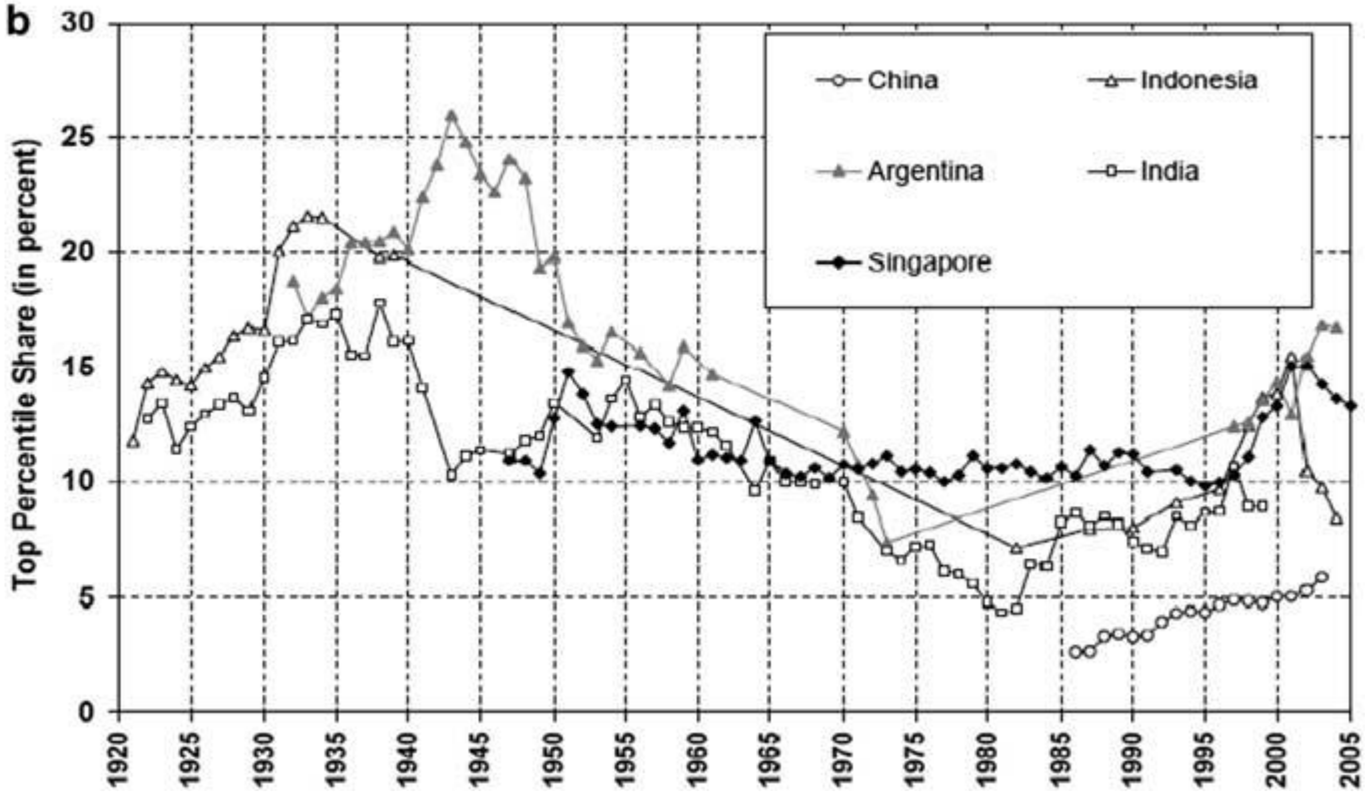
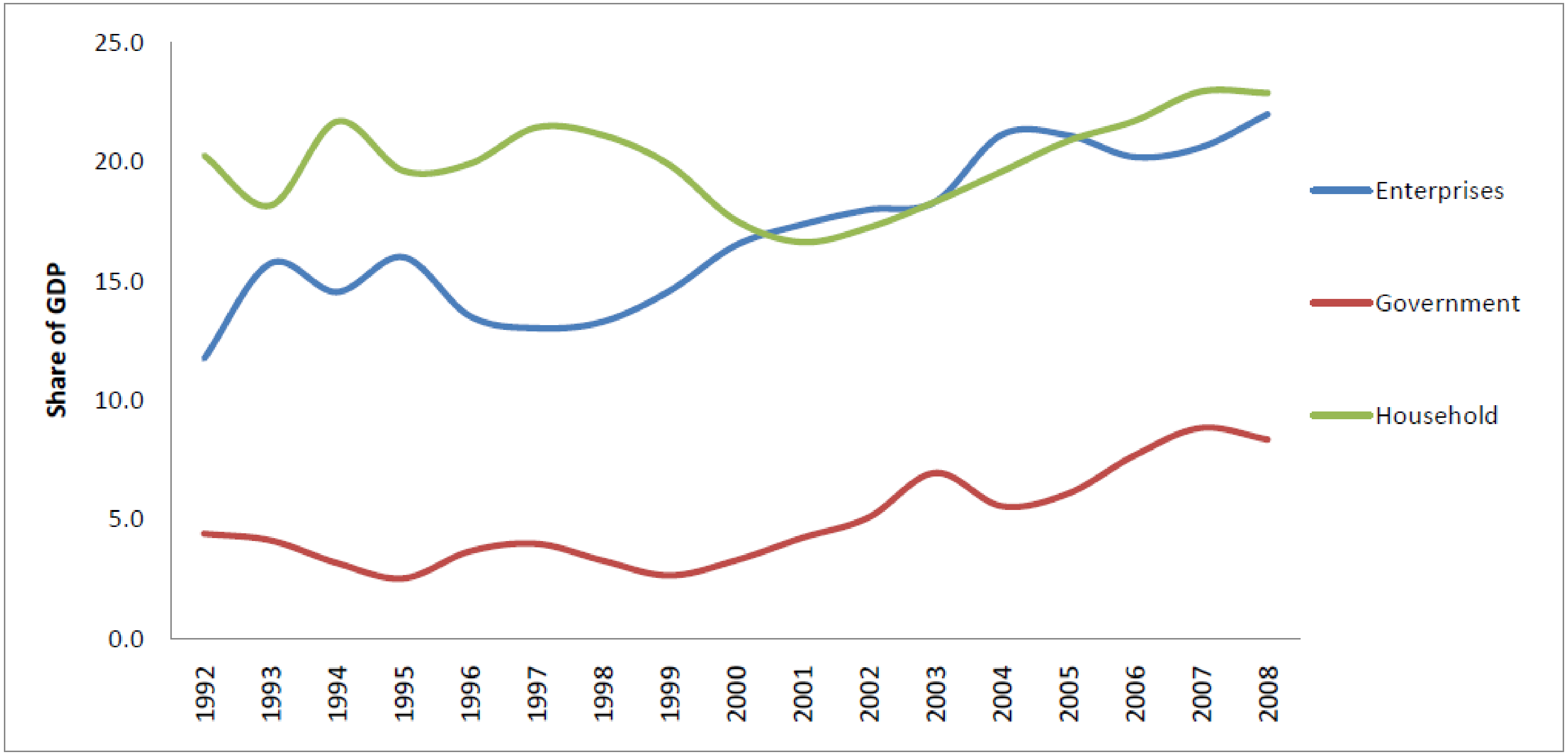
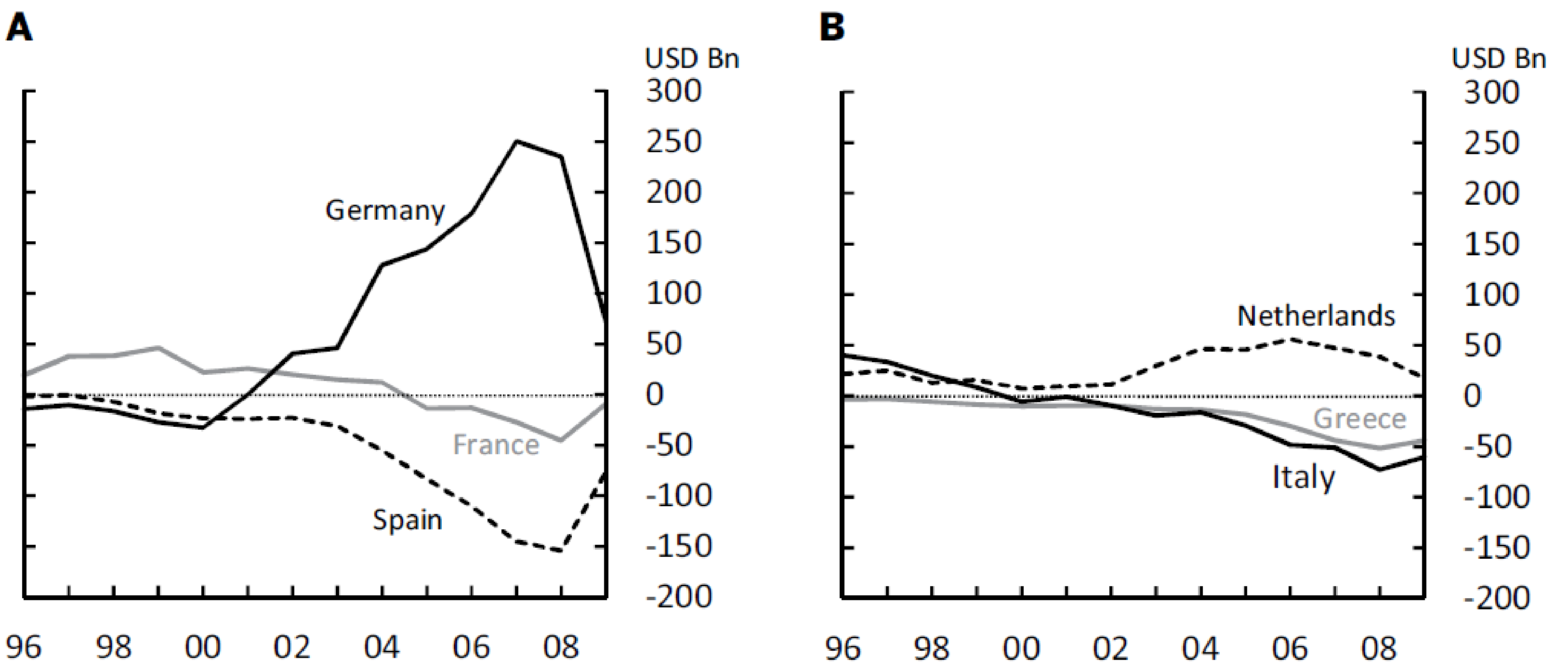


China’s Saving Rate



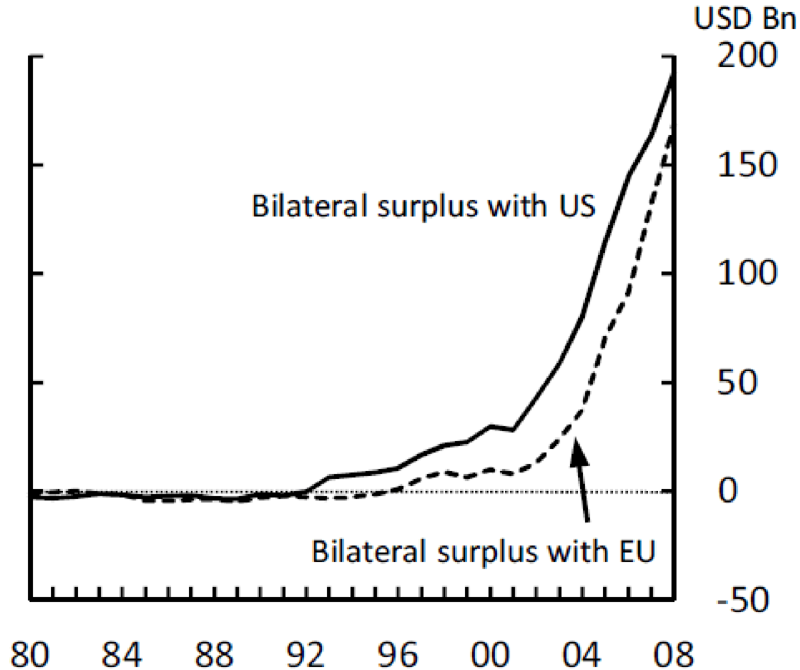
Selected Euro Zones Current Accounts



China’s Current Account

FIGURE 9

China’s Trade Surpluses with United States and European Union



Source: IMF, *Direction of Trade Statistics*

Five Challenges in Financial Regulation Large and Complex Financial Institutions

- They (a) exacerbate systemic risk (b) distort competition and (c) lower public trust due to the privatization of gains and socialization of losses

- The ability of sovereign governments to supervise Large Complex Financial Institutions is increasingly limited.

- First they are large in absolute terms. The 25 largest banks in the world account for $45 trillion in assets in 2008, only $6.8 trillion in 1990. That would be equivalent to 73% of global GDP and 42.7% of total global banking assets

- Second, they are very large relative to individual countries. In 1990, none of the top 25 banks had total assets larger than the respective national GDP. Today, there are 7.

Five Challenges in Financial Regulation Large and Complex Financial Institutions

- Third, the concentration is increasing. In 2007, the OECD reported that the top 3 banks on average accounted for 69% of total commercial bank assets within OECD member countries. The top 5-10 banks typically account for 50-80% of total financial business, particularly financial derivative business. Global banks dominate most of emerging market corporate and investment banking business.
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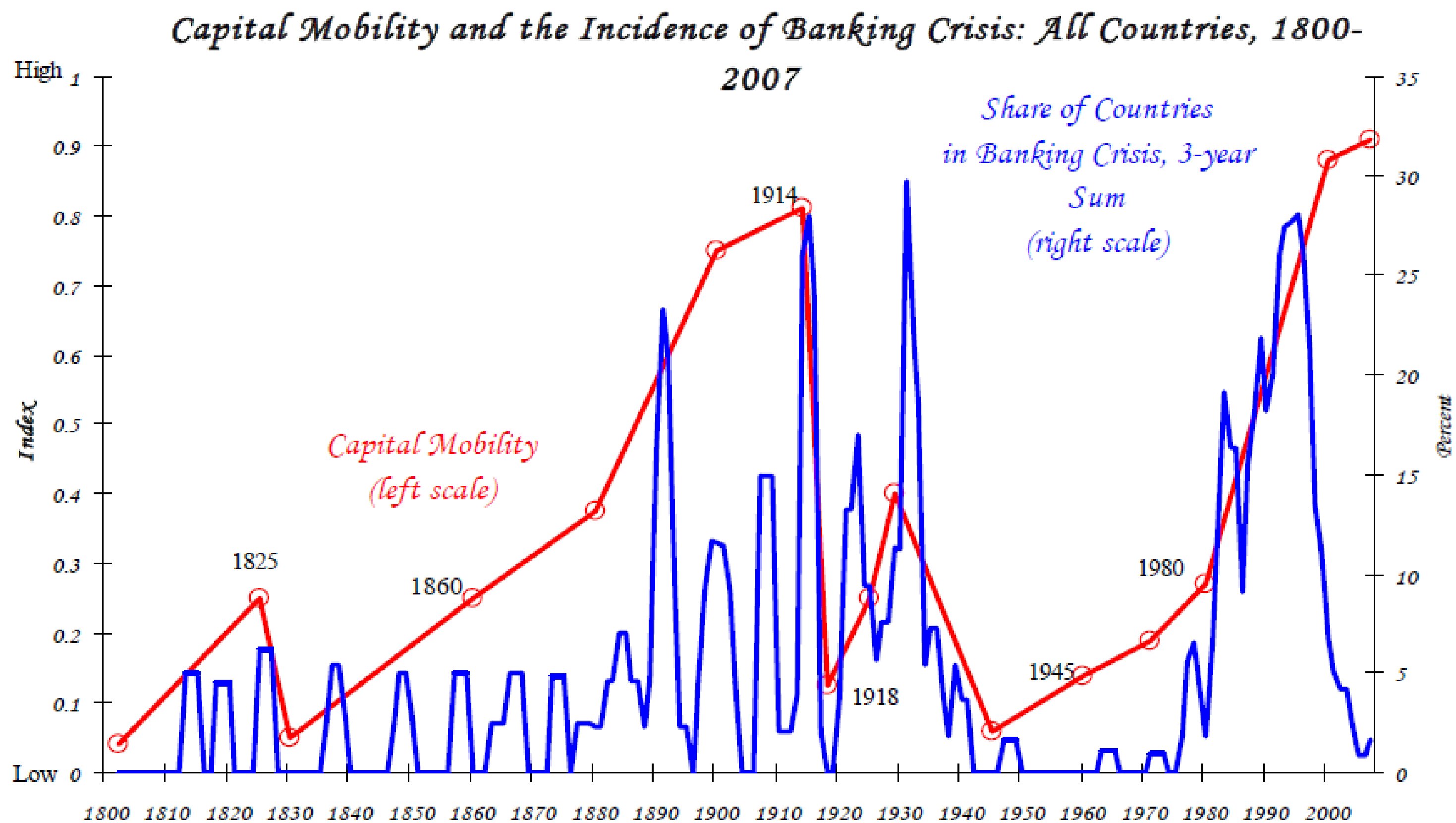
- Fourth, the total size of financial assets (stock market capitalization, debt market outstanding and bank assets, but excluding derivatives) has grown much faster than the real sector from 108% of GDP in 1980 to over 400% by 2009 (555% in the case of EU). Adding the value of financial derivatives: $615 trillion i.e.10.6 times global GDP at end 2009.

- Fifth, they are highly complex and non-transparent, with subsidiaries all over the world

Finance: One of Key Network Industries

- Four special sectors: transport, energy, telecommunications, and finance
- In Input Output terms they would be in every column
- The value of a network is exponentially related to the number of users, so that each financial institution tries to grow larger and larger vertically and horizontally.
- Examples: credit cards (3 dominant players), credit rating agencies (3) accounting services (4), airline networks (3) and Web services (3)
- If there were no further cross-border restraints, the forces of network concentration may result in only four or five global players in finance that are larger and more powerful than any single nation.

A Two Centuries Perspective on Capital Mobility and Banking Crises



Sources: Bordo et al. (2001), Caprio et al. (2005), Kaminsky and Reinhart (1999), Obstfeld and Taylor (2004), and these authors.

How to Manage Finance

- A uniform global tax on financial transactions or on size—a Tobin tax.
- The second is to impose personal sanctions on individuals within management for egregious behaviour, so that there is personal accountability when the institution breaks the rules.
- Thirdly, active anti-trust action.
- Fourthly, there should be more forensic end-to-end examinations of group activities and with their counterparties to have a better understanding of how institutions and the market lose control over the quality of derivative products and processes.
- Last but not least: Glass Steagall Act, partnership, capitalization.

A Peak at the Future

- US imbalances continue to be large
- China’s current account has declined (9.1 percent of GDP in 2008, 5.2 in 2009, 5.1 in 2010, 3.6 in 2011)
- But China’s saving rates will continue to be a problem
- National regulatory systems still await major reforms