Panel 1

Globalization and the Crisis

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Hans-Werner Sinn has asked me to consider the connections between globalization and the crisis. He did so, I suspect, because I am an international economist and there are international economics who will claim that globalization is at the root of recent events. I hate to disappoint, but the roots of the crisis, in my view, lie elsewhere.

Fundamentally I see the crisis as the result of flawed regulation and perverse incentives in financial markets. Regulators bought into the arguments of the regulated that financial institutions could safely operate with a thinner capital cushion. They accepted the premise that capital adequacy could be gauged on the basis of the banks' internal models and, where these were absent, ratings of securities provided by commercial credit rating agencies, notwithstanding the incentives for the proprietors of the former to tweak their models to minimize estimated risks and capital requirements and the tendency for the latter, as investment advisors as well as issuers of ratings, to fall prey to conflicts of interest. The regime that resulted was capital poor and dangerously procyclical. Regulators neglected liquidity, assuming away problems in wholesale money markets. Banks were allowed to hide risks in conduits and structured investment vehicles and window dress their balance sheets. Agency problems flourished at each stage of the originate-and-distribute process. Mortgage brokers had no fiduciary responsibility to homeowners. Banks not keeping a participation in the complex derivative securities they originated felt no responsibility to investors. The structure of compensation encouraged bank executives to roll the dice, disregarding the implications of their actions for the survival of the firm. And the regulators averted their eyes. If you want my summary of the crisis, there you have it, in one paragraph.

Of course, this summary goes only an inch below the surface. The deeper question is how these indefensible circumstances were allowed to arise. Here I would cite a powerful ideology of deregulation stretching back to at least the Reagan-Thatcher years. I would cite excessive confidence in quantitative methods of risk management, Value at Risk, and of asset pricing, the Black-Sholes model. I am not acquitting the academy, in other words; we too fell prey to a powerful collective psychology. I would cite the intensification of competition, with the Glass-Steagall restrictions starting to crumble even before passage of the Gramm-Bliley-Leach Act in 1999, encouraging banks to take on additional leverage in their desperation to maintain normal returns. Finally, I would cite the conscious policy of the Bush Administration to starve the regulators of human and financial resources. It is hard to understand the pre-crisis behavior of the Securities and Exchange Commission any other way. There's my summary of the deeper causes of the crisis, again in one paragraph.

What about globalization, which is what I was in fact asked to talk about? There are two connections. The oblique connection is between globalization and the competitive pressure that encouraged excessive risk taking. Financial institutions stretched for risk and gambled for survival as their profit margins were squeezed by growing competition. The intensification of competitive pressure reflected the increasing ability of commercial and investment banks to infringe on one another's turf. It reflected the growing overlap between banks and markets resulting from the dual processes of securitization and disintermediation. But another source of pressure was international competition, as finance was globalized, and in Europe in particular as the single market led to increasing in cross-border competition. It is no coincidence that previously sleepy Landesbanken were so heavily invested in toxic securities. I regard this as an indirect but important consequence of financial globalization.

The subsidiary connection is between global imbalances and the asset bubble. As I have said, the match that ignited the fire lay elsewhere, in lax regulation and perverse incentives in financial markets. But global imbalances poured fuel on the blames, leading to a once-every-hundred-year firestorm. With significant amounts of foreign capital (official capital in particular) flowing toward the United States, long-term interest rates were lower than otherwise. This, of course, is Mr. Greenspan's own explanation for his now notorious bond market 'conundrum'. The low level of long-rates encouraged households to assume additional mortgage debt. It encouraged portfolio managers to stretch for yield. It encouraged additional risk taking by fund managers who found it increasingly difficult to meet historical benchmarks.

The question is how much difference the capital flows associated with global imbalances made for the course of the crisis. I regard them as secondary factors – which is not to dismiss them but only to put them in their place. Empirical studies put the impact of foreign inflows on US treasury yields in 2004–2006 at 50 to 90 basis points (Warnock and Warnock 2009; Craine and Martin 2009). The incentives created by this fall in long rates no doubt encouraged the excesses that culminated in the crisis. Still, I would ask: how different would the crisis have been had US long rates been 50 or 70 or even 90 basis points higher? Not that different, I would submit. Agency and regulatory problems in financial markets, in conjunction with what would have still been a relatively permissive credit-market environment, would still have produced a major bubble and then significant dislocations when it burst.

What do I expect now in terms of regulatory reform? I expect a drawn-out process. In the United States, we have now passed the Frank-Dodd financial-reform bill, and President Obama has signed it. But it now falls to the Securities and Exchange Commission and other agencies to draft the regulations required to apply the law. The Basel Committee on Banking Supervision has issued a proposal for countercyclical capital buffers, but without indicating how countercyclical or how big. The Basel Committee has indicated that capital requirements will be supplemented with a simple leverage ratio, but it hasn't specified the ratio in question.

The difficulties of reaching agreement and coordinating regulation across countries suggest that there may be pressure to make finance a more national affair. Cross-border financial institutions will be tolerated only where the risks they create can be safely managed. And they can be managed only where there is agreement on the risks requiring regulatory cooperation. In practice, however, national officials continue to disagree about the nature of the problem. European officials see hedge funds and private equity firms as significant threats to financial stability and recommend clamping down on their operations. US and UK officials disagree. The EU can go ahead and apply strict regulation to hedge funds and private equity firms, but the latter will then simply have an incentive to relocate in the United States. EU officials have indicated in this case that they will adopt regulations limiting the ability of European residents to invest in foreign-headquartered hedge funds and private equity firms. This is as good – or bad, depending on your view – an example of the dynamics of financial de-globalization as one can imagine.

And even where there is agreement, there are problems. There is consensus in both the United States and Europe, for instance, on the need for an orderly resolution mechanism as a third way, besides uncontrolled bankruptcy and bailouts, for dealing with troubled banks, bank holding companies, and nonbank financial firms. But many of our big banks, bank holding companies and nonbank financial firms are international, even global, in scope. The best efforts of the Basel Committee's Cross-Border Bank Resolution Group notwithstanding, there has been little progress in creating a global resolution mechanism.

If regulators are serious about creating an orderly resolution mechanism as an alternative to uncontrolled bankruptcy and bailouts, they have no choice for the time being but to do so at the national level. The geographical domain of big financial organizations will therefore have to be made to more closely coincide with the domain of the respective resolution authorities. I would note that the Cross-Border Bank Resolution Group recommends making large financial entities less complex and interconnected. By implication it is pointing to the need to make them less international.

Finally monetary policy and global imbalances: I suspect that the immediate future will resemble the immediate past to a greater extent than many observers stipulate. To paraphrase a familiar quip about the weather, everyone says that monetary policy should be reconceptualized to better deal with the risks posed by asset bubbles, but no one does anything about it. We have yet to move beyond statements of principle. Specifically, there is no agreement on whether central bankers can in fact identify bubbles, how they should do so, on the circumstances under which they should lean against them, and on exactly how hard they should lean. Absent answers to these questions, I suspect that talk about adjusting monetary policy in response to asset market conditions will remain just that, talk.

Global imbalances will be smaller than they were at their pre-crisis peak, because US investment rates will be lower and because foreign finance for the US current account will be less freely forthcoming. But they are not going away. Surplus countries like China and Germany need to raise their consumption, while the United States needs to raise its saving in order to make further progress in rebalancing the world economy. This, and not the exchange rate, should be the focus of the rebalancing debate: what can be done to accelerate the rate of growth in consumption in China and Germany, and what can be done to accelerate the rise in saving in the United States. Chinese households, when they consume more, consume disproportionately Chinese stuff. US households, when the consume less, consume disproportionately less US stuff. So the price of Chinese stuff will have to rise relative to the price of US stuff. This is just another way of saying that the real exchange rate will have to adjust. It will have to adjust either through inflation in China and deflation in the United States, or else through a change in the nominal exchange rate. Personally, I prefer achieving the requisite change in the real exchange rate by allowing the nominal exchange rate to adjust.

This way of putting things has three implications. (There is a fourth implication, for the internal dynamics of the euro area, but I will resist the temptation to go there.) First, adjustment of the exchange rate goes together with the adjustment of spending levels: it is not the catalyst for them. But even if it is not the catalyst, exchange rate adjustment is needed to clear markets in general equilibrium.

Second, adjustment of the exchange rate will be slow and gradual rather than abrupt and discontinuous because the evolution of US and Chinese spending patterns will be slow and gradual rather than abrupt and discontinuous. It will take time for Chinese households to change their habits. It will take time for the Chinese government to build the social safety net that those households require to feel comfortable with lower levels of precautionary saving. It will take time to strengthen the governance of big state enterprises so that they pay out more of their earnings in wages, fringe benefits and dividends. And it will take time, like it or not, to narrow the gaping budget deficits that are now the main cause of low national savings rates in the United States, household savings rates already having risen.

Finally, because these adjustments will take time, the elimination of global imbalances will take time. They will be with us for years to come. In the short run, they are likely to widen out again as US investment recovers. That's bad news. The good news, such as it is, is that global imbalances were not the prime mover in the recent crisis.

Thank you very much.

References

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Panel

The European Editor of *The Economist,* **John Peet,** chaired the first panel and expressed praise for the organisers for the timing of the conference: after the Icelandic volcano had settled down and shortly before the British general elections, and only days after the Greek crisis had come to a head.

Martin Zeil, Bavarian State Minister of Economic Affairs, Infrastructure, Transport and Technology, pointed to the need for precise instruments for European fiscal policy with rules of the game that apply equally to all members and effective control systems in the eurozone. With regard to the criticism aimed at the German business model, he observed that the problem is not Germany's competitiveness but the loss of competitiveness in other European countries. Germany for its part must strengthen its domestic economy with structural reforms on the supply side that lead to sustainable growth from which all euro zone members would profit. Zeil also argued that there is no alternative to globalisation: protectionism is an illusion, not a solution. "Open markets are the life line of Europe, Germany and Bavaria".

For **Lady Barbara Judge** of the UK Energy Authority the role of globalisation in the financial crisis was more subtle than normally assumed. "It wasn't just that you could buy Californian mortgages in Germany but it was that everybody was watching it". Everybody watched the lines in front of Northern Rock on television that helped build virtual lines of depositors that wanted their money back. This kind of globalisation turned the financial crisis into a pandemic; the dramatic effect of the media contributed to turning a local banking crisis into a global crisis. The global supply chain then exacerbated the banking crisis, turning it into an economic crisis. Fortunately there was no repeat of the Great Depression because the international community acted immediately, decisively and in a coordinated way, putting in place significant fiscal and monetary stimulus and restoring confidence quickly and effectively. "The recession was painful but not killing". Globalisation lifted millions out of poverty over the past 30 years and its advance cannot be stopped. What the financial crisis shows is that we were ill-prepared to manage our global economy; "putting in place the necessary mechanisms to run the global economy is not going to be easy" but there is no other option. We need regulation that is global and we must avoid a situation where regulatory arbitrage prevails.

Martin Blessing, Chairman of the Board of Managing Directors of Commerzbank, pointed out that globalisation and the free movement of capital did not cause the financial crisis but helped it spread around the globe. Financial markets must remain international, but better regulations are needed in line with the 4 points made earlier by President Horst Köhler. He was not in agreement, however, with a tax on international financial transactions as this is far too complex. "We need to think of other instruments that are easier to implement". On the euro crisis, Blessing stressed that Europe needs to move towards a more politically and fiscally integrated system. The euro was created as a force for economic and political integration. "Without political integration Europe will become more and more unimportant globally".

Theo Waigl, the German finance minister during the negotiations for the Stability Pact and the single currency, observed that globalisation is an irreversible process. The risk of contagion is higher, to be sure, but the 'smoothing mechanisms' are also stronger. The lessons to be learned from the crisis are that freedom needs order, i.e. financial regulation. We also need a 'convincing consolidation strategy' to follow on the effective but very expensive action to respond to the crisis. Can this work? It did in the Clinton administration, which focused on consolidation, bringing about a budget surplus and new jobs. With regard to the euro, Waigl stressed that the euro is now stronger than originally anticipated. Inflation is under control, the ECB is performing well. And Germany has benefited from this. With regard to Greece there was no choice but to put it under budget control, and fortunately the experts of the IMF are also involved. For states with excessive deficits, the temporary withdrawal of voting privileges would be a better disciplinary instrument than monetary fines.

In the discussion **Brian Carney** of *The Wall Street Journal* asked what the legal ramifications of going against the no-bail-out clause of the Maastricht Treaty are. Barry Eichegreen replied, "legal niceties notwithstanding" we have to deal with the facts that are there, and the courts will certainly see the need to have dealt constructively with the Greek problem. Theo Waigl asserted that although the euro countries are not obligated to assume the debts of others of its members, they are not prevented from helping these countries – 'under strict conditions'. This stance would also stand in the courts, he was convinced.

What is needed more than fiscal integration, according to Hans-Werner Sinn, is debt control. Martin Blessing replied that the present debt-control mechanisms in the euro area have not been effective. Stricter controls would of course infringe on national sovereignty and this may be necessary for further integration. Without the mechanisms to enforce fiscal discipline, he fears that the euro will not work. Martin Zeil pointed out that Germany contributed to weakening the Maastricht rules itself and this "has now caught up with us". **Axel Weber** emphasised that the stability-oriented policy in the euro area has been working well for 10 years. The problem is the implementation. "We focused too much on the deficit and not on the debt. We failed to consolidate in good times". The lesson for the future is to use the recovery to tighten budgets and to move to sustainable budgetary positions.

John Peet brought up the criticism of German policy expressed by French Minister Christine Lagarde that Germany is causing a problem for its partners by running a very large current-account surplus, forcing others in the euro zone to run current-account deficits. Theo Waigl stressed that Germany, faced with the huge costs of unification, chose a moderate wage policy and it cannot be faulted for this. Germany can indeed improve its investment structure, especially with regard to research and education, but calling for higher wages to increase purchasing power is not very good advice. Martin Zeil pointed out that Germany cannot accept measures that would weaken its competitiveness on international markets. Axel Weber added that the high savings rate in Germany is motivated by its citizen's precautionary attitudes with regard to future security. In the United States, with its higher population growth rates, ordinary people tend to invest more in the stock market.