

COMMENTARY

**Global Imbalances and the Financial Crisis:
Products of Common Causes**

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As you indicated, this paper has two discussants, and I'm the last one. So, when I saw what Maury presented and what Ricardo said about the paper, I thought, what should I say? So, I decided to start by going farther back to the topic of imbalances.

First I noticed that today is the 22nd anniversary of "Black Monday," October 19, 1987, when global financial markets plunged. If you recall what happened then and confused cause and effect, we might have said that the lesson from 1987 is that the U.S. Secretary of the Treasury, James Baker, should never have flown to Germany to scream at the German Finance Minister, Gerhard Stoltenberg, to tell him that Germany should lower its interest rates in order to reduce its current account surplus because this projected a lack of coordination among global policymakers. This is a very interesting interpretation, but for the external imbalances that were prevailing then it does not really go to the foundations of the issue.

This paper gives a choice about the possible causes of the financial crisis. Was it the imbalances? Was it because of regulatory failings? Was it greed? Was it due to domestic policies? I would say it's all of the above. You can look at it in whatever way you want. After all, exports minus imports is savings minus investment as well as expenditures minus income. You can look at the causes of the financial crisis in whatever way you want and then dissect it the way you want. It's not so much an issue of what is correct and what is wrong, but rather what is useful and what is less useful in understanding the cause of the crisis.

I think that the best way to think about the crisis is to focus on the extent to which the imbalances made the global economy more vulnerable to shocks. We have all studied why when there are shocks countries try to smooth consumption over time by running external imbalances. So why do we worry about imbalances? Well, we worry about them if the system is vulnerable and if there are shocks things may go bad. Therefore we need to ask, what could go bad, what did go bad, and that's what this paper does.

I think that one of the key points is a truism: Trees do not grow to the sky. Or as Herb Stein said, if things are not sustainable, they will stop. The point is

not the truism itself, but rather, when things do not grow to the sky and when the unsustainability stops, how does it stop? Does it end in a crash? What are the spillovers? Do we know how to absorb the corrections and the like?

For this, I have a friend. He comes from the planet Mars, and he visits planet Earth from time to time. When he visited us this year, he saw that everyone was talking about external imbalances. He wanted to know where the imbalances are located, and I said the U.S. has a \$370 billion deficit, while Asia, primarily China, has a \$579 billion surplus. So he said, that's an interesting phenomenon. Let me try to understand, where do these imbalances come from and what's the vulnerability? And then, he remembered that the last time he visited here back in 2006, there were also imbalances and they were even larger. In 2006 the U.S. deficit was about \$800 billion, well above the \$370 billion deficit it has now. Correspondingly, China had a significantly higher surplus. At that time, the oil-producing countries and Russia also had significant surpluses, while Europe's current account was balanced. Then he asked, why are you screaming about external imbalances today? You should have screamed in 2006. And I told him, yes, my friend, but the fact that the imbalances were not sustainable in 2006 had a spillover effect, and that's what we see today in the current crisis.

Did we experience an adjustment, a correction, or a crash? From this picture, you might not be able to know fully, but some people told him, this will teach us a lesson. And he remembered that the last time he visited Earth, he went to the guillotine and saw the condemned guy go to the electric chair saying to himself, this will teach me a lesson. Well, even though it was a little bit too late for the condemned guy my friend said to him, will you learn, will you remember?

And then, my friend remembered that when he went to Wall Street in the past, they told him that there are two types of investors, those with short memories and those with no memories. He said, how can I be sure that all of these reforms will ensure that we are not going to be there again? He realized that all of these stories about greed are true, but we cannot expect regulation to change greed. The role of regulation is to ensure that the system with all its human nature traits will not be a dangerous system; don't look for a moralistic, ethical approach, but rather look at the incentives and be sure that things work well. In fact, as you compare the reality today in late 2009 to last year, my friend sees that credit spreads are shrinking, risk capital is starting to come back, the system is a bit more transparent, and there is discussion about better accountability and accounting. And he says, be careful. Remember that this discussion was much more vocal when the G-20 countries met in London earlier this year, but somehow the appetite to make these changes is diminishing because the

statistics show there has been some improvement. So, first of all, go faster and make sure that you don't celebrate the improvement too much and too prematurely. Did we see this movie again, or have we seen it before? Because remember, my Martian friend was also at the meeting between Stoltenberg and Baker in 1987.

The so-called policy coordination framework that was developed in the 1980s did not work too well, yet we are talking about it again now. The key difference between the system of the past and the system of the present is that we are in a fast-forward mode, with markets globalizing and interacting more rapidly. Interaction can come from trade, it can come from capital markets, it can come from banking, it can come from a variety of channels. And today, the financial system is just a road on which one travels much faster than in the past, and therefore the cost of a mistake is much higher.

But then my friend said, they taught me in grammar school on Mars—by the way, on Mars there is early economic education—that S minus I is equal to the current account surplus. So, what are the fundamentals? And he says, oh my goodness, we have a huge dispersion in savings in the world. China is saving more than 50 percent of its GDP, while the U.S. is saving less than 10 percent. Obviously almost any equation will predict that in this framework, China will have a surplus and the U.S. will have a deficit if they were the only two countries in the world. But remember, he told me, they are not the only two countries, so you can't analyze bilateral deficits and surpluses in a multicountry world. Then he asked, so why did you send your Secretary of the Treasury to China to ask them to appreciate their currency? I said, because this may improve the X minus M . He said, yes, but don't forget it is the same thing as S minus I ; why would anyone save less if you allow the currency to appreciate? Can't you find a better policy framework that will reduce the incentive to save, that will induce them to pay dividends and reduce the corporate retained earnings, that will encourage them to develop their social security system, pension system, and secondary financial markets so that individuals and companies will not need to self-insure so much but will instead use the market, et cetera? So, the question is, why are they afraid to appreciate? And the answer is because they are worried about employment and they depend on exports; therefore they really don't want to create a slowdown. If that's the case, why don't you push for more structural reforms so the change in the exchange rate will not have such devastating real effects?

This is the dialog that is going on between the economist and those who read the headlines of the popular press. But where this discussion becomes potentially dangerous, if not lethal, is when you ask, who holds reserves in the

world? Then you notice that today China is holding \$2.27 billion of reserves, twice as much as the second largest holder, Japan, and a very significant part of that has accumulated in the last few years. In fact, the flow, the accumulation of reserves during the past four years in China has been 10 times as much as it was in Japan.

If that's the case, then we understand why we must engage China. But what does it mean in terms of U.S. borrowing from foreign countries officially? Who abroad holds U.S. Treasury bills? Well, 25 percent or so of all outstanding Treasury bills held abroad are in China and Japan and, as we said, most of it in China was accumulated very recently. This sounds like a vulnerability.

The other vulnerabilities are that, if you look at financial markets and the size of the derivatives market in the U.S., the magnitudes are so big that you wonder how to deal with it. The Bank for International Settlements has been promoting that statistic about the size of the derivatives market for a long time. A popular solution, which I think is the right one to start with, is to make them trade in exchanges.

What about the banking system? When we see that in most regions of the world we have had write-downs and credit losses, that's the dark column, and we have had capital raised, that's the lighter column. In Europe, banks have raised more capital than write-downs. Asia, again the same. But in the U.S., capital losses and write-downs have exceeded the capital raised.

So, my Martian friend says, does that mean that banks need more capital? And the answer is yes, especially in the U.S., where systemically important institutions probably will need to have more capital. Thus requiring more capital is a key part of the kind of regulatory reform we are engaging in. But this gives the impression that, if only you come up with the right regulations, everything will be fine. Then you say not all financial institutions have been damaged to the same extent over the past couple of years. We had low interest rates that increased the appetite for risk, yet some financial institutions had better risk management and risk monitoring than others. So, we had better make sure that there is more capital, but by the same token that there is far better risk management.

And what about the very large financial institutions? Well, we are talking a lot about exit strategies for the Fed, and we have heard the Fed explain its strategy very well. We have talked a lot about exit strategies for the Treasury, but the fiscal exit strategy is not articulated very well. In addition, there is another exit strategy that needs to be discussed, which is an exit strategy from the paradigm of too-big-to-fail. This is where we find moral hazard and everything

else that ties the hands of policymakers. And that's why I think the notion of a resolution mechanism for large companies that go bad is a very important one. By the same token, maybe some of these companies should not be so large, especially if they move away from their core businesses and competencies. So I would say that, while the regulatory stuff is very important, it's not a panacea. It has to be done right, especially if you want to continue with globalization and not be afraid of external imbalances that can destroy everything. If you understand the background, then you had better make sure you don't create the framework for a devastating regulatory arbitrage albatross. And in order to not create such a framework, policy harmonization should involve harmonization of regulatory frameworks in an interconnected world.

In the old days 22 years ago, when Andrew Crockett, Morris Goldstein, and I were working on policy coordination for the G-5 countries which later became the G-7, the notion was to coordinate global fiscal policies through the "tango principle": you go forwards, they go backwards—it was a complete illusion, it never worked, it will never work. So, it is really a matter of policy cooperation, policy harmonization of the regulatory framework, not of policy actions.

We do have a world today in which the major countries run large fiscal deficits. So, we have huge and growing fiscal deficits around the world. And we say that this is a good thing because it's supposed to stimulate economic recovery. But it hasn't stimulated so well yet. So you ask yourself, why doesn't it do what it was supposed to by the simple spending multiplier?

To me one of the reasons is that there is no clear articulation of how you get out of this box of growing stocks of government debt. How do you exit? It is clear to me that if you say that you are going to have a very large deficit—although everyone knows that trees do not grow to the sky—but you don't say whether it will be resolved by higher taxes on capital, higher taxes on labor, or more protectionism, it paralyzes economic performance. So, I think that one does not need to say, let's withdraw the stimulus today, in order to articulate how you will withdraw it when you do. And frankly, if you articulate it very well, I don't think you will need another stimulus package. But at the end of the day, we see now that debt is increasing to levels that we have rarely seen, and it's that way all over the world.

So you ask yourself, what happens in a world in which public debt is so big but there are no signs of how you can get out of it? Who is being crowded out? And then you realize that basically, we had a problem that started from excess leverage—excess leverage of households, excess leverage of banks, excess leverage of firms—and then suddenly something happened. Trees stopped growing

to the sky, and people needed to deleverage. So, what do you do in order for this deleveraging to be not so painful? You decide to let leverage rise in the public sector, to offset the implications of deleveraging in the private sector.

So, there is a presumption that public sector leverage is going to be better than private sector leverage. I think that we need to make this point clear and, if that's the case, you must demonstrate when public sector leverage is better than private sector leverage. If you explain it well, I think that it will end up, indeed, being better.