

The Shift and the Shocks:

Emerging economies in an age of financial crises

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“My view is that improvements in monetary policy, though certainly not the only factor, have probably been an important source of the Great Moderation. In particular, I am not convinced that the decline in macroeconomic volatility of the past two decades was primarily the result of good luck, as some have argued, though I am sure good luck had its part to play as well.” Ben Bernanke, Federal Reserve Board Governor, 2004.²

The past is a foreign country. In a celebrated speech on what economists hubristically called the “great moderation”, Mr Bernanke talked about what now seems a different planet - a world not of financial crisis and long-term economic malaise, but of outstanding stability and superlative monetary policy.³ This may seem exaggerated. But look at what then governor, now chairman, Bernanke, said: “improved monetary policy has likely made an important contribution not only to the reduced volatility of inflation (which is not particularly controversial) but to the reduced volatility of output as well.”⁴ This seems quaint.

The economics establishment failed. It failed to understand how the economy worked, at the macroeconomic level, because it failed to understand financial risk, and it failed to understand financial risk because it failed to understand how the economy worked at the macroeconomic level.

The work of economists who did understand these sources of fragility was ignored because it did not fit into an imaginary world of rational agents that the professors Pangloss had made up.⁵

In what follows, I intend to address four questions: where are we? How did we get here? What are the global implications? What are the implications for emerging economies?

Where are we?

Sometimes, indeed, I have to pinch myself. Since 2008, the high-income countries have been in a “contained depression”. What are the symptoms? They are the combination of exceptionally aggressive monetary policies with weak economies, high unemployment and low inflation. The Bank of Japan’s official intervention rate has been close to zero since 1995. The Federal Reserve’s rate has been near zero since October 2008. The Bank of England’s reached half a per cent in March 2009. The European Central Bank, the advanced economies’ most conservative central bank, has been at half a per cent since May of this year. But it reached 1 per cent four years earlier, then made a ridiculous effort to raise rates in 2011, and was driven back down to 1 per cent by December. Nobody but the ECB can imagine its monetary policies are not now too tight. Moreover, beyond nearly free money, these central banks have all engaged in huge expansions of their balance sheets. (See Chart 1.)

Nevertheless, of the six largest high-income economies, only the US and the German were larger in the second quarter of 2013 than they had been at their pre-crisis peak. More striking is how far economies had fallen below pre-crisis trends. In the second quarter of 2013, the eurozone economy was 13 per cent below its 1995-2007 trend, which was already far from dynamic, the US economy had fallen 14 per cent below its 1980-2007 trend and the UK had fallen 18 per cent, again below the 1980-2007 trend. (See Charts 2 and 3.)

A principal reason for this contrast between policy and effectiveness also seems clear: the credit machine broke. Measures of broad money have been stagnant and, to the extent that they have not been, that was because of quantitative easing. The evidence supports the view that, in the aftermath of a huge financial crisis, monetary policy is just not that effective. The zero lower bound bites. But willingness to use fiscal stimulus, which is the direct means of lowering excess desired savings, was, alas, limited. Politicians and publics suffered from “sticker shock” when they saw the huge fiscal deficits of 2009 and 2010 and chose austerity, instead, leaving the macroeconomic policy burden on the frail shoulders of central banks. (See Chart 4.)

How did we get here?

The crisis is, in my view, the result of the interaction of a global savings glut (as suggested by chairman Bernanke), with a fragile financial system. The link between the two was forged by inflation-targeting

monetary policy, especially in the US, but also inside the eurozone. When what some call the “Minsky moment” hit the financial system, the result was a huge financial crisis, a decision by states to back the entire financial system of the high-income countries and the aggressive monetary policies we have seen.

The Asian financial crisis coincided with a sharp fall in global real interest rates, which is indicated by evidence from indexed-linked governments bonds. The fall in UK indexed-linked bonds was from close to 4 per cent before mid-1997 to close to 2 per cent afterwards. This fall coincided with a beginning of house-price inflation in developed economies with elastic supply of credit. Causality is hard to prove. But it is hard to believe these are mere coincidences. (See Chart 5.)

In the aftermath of the Asian financial crisis, many emerging economies, including China, decided to pursue exchange rate, monetary and other policies that generated large current account surpluses. How far these surpluses were intended is unclear. But they were a natural reaction to the Asian crisis – “never again” became the motto - and a natural consequence of sterilized interventions in foreign exchange markets. But they were also supported by important structural shifts towards profits, particularly in China. These policies contributed to the emergence of large “global imbalances”. Three important capital exporting regions emerged: China and other emerging east Asian economies; the oil exporters; and some old

industrial countries, particularly Germany and Japan. At the same time, two important capital importing regions emerged: the US and peripheral (north, south and east) Europe. The latter, without exception, went into financial crisis in 2008-10. Was this yet another coincidence? I suggest not. (See Charts 6 and 7.)

An important feature of this world was that the fast-growing economies with, one must presume, the best opportunities, decided to lend huge quantities of capital to slow-growing economies with poor investment opportunities. The plausibility of the latter view is supported by another important fact: in the high-income economies, non-financial corporate sectors mostly ran financial surpluses: their retained earnings exceeded investment. This was partly because of the exceptional buoyancy of profits. It was also because of the weakness of corporate investment after the stock market bubble burst in 2000. Thus, the domestic counterparts of the capital flows into the high-income countries were, again almost without exception, fiscal and household financial deficits, the latter associated with rising real house prices and booms in residential construction.

Meanwhile, in an environment of depressed returns on safe assets, we saw the “reach for yield: the financial sector fabricated pseudo-triple-A, mortgage-backed assets in huge quantities: these were indeed “fool’s gold”, as my colleague, Gillian Tett, called it.⁶ The financial sector also leveraged itself up dramatically, in order to boost its return on equity (unadjusted for

risk) and pay its management and staff huge bonuses: in the UK, for example, the median leverage of the banking sector rose from 20 to one to 50 to one during the noughties, only to collapse, after the crisis was over. Furthermore, there was a huge expansion of the “shadow banking sector”, which increasingly took on the risks of a traditional banking sector, but without comparable oversight or insurance. Should someone steeped in the history of financial crises have been surprised? Not really. It was just a more imaginative and higher-technology version of previous excesses, supported by the illusion that our sophisticated modern financial sector understood so well how to manage risk that it needed essentially no capital at all.

The US Federal Reserve played a central role in all this. As a result of policies pursued elsewhere, the US external imbalance increased rapidly in the late 1990s and 2000s. This was (and remains) of no direct concern to the Federal Reserve. But it is, in itself, a disinflationary force, tending, other things being equal, towards underutilized capacity, rising unemployment and falling inflation. As an inflation-targeting central bank, the Fed’s job was to offset the external drag. It did that with its aggressive monetary policies of the early noughties. But how do the monetary policies work on the economy? The answer is that they work either through changes in asset prices or through changes in borrowing, or, more usually, both. In this case, it was both. It worked, above all, through house prices and the associated lending and borrowing. Moreover, as the supply of credit grew (created by

the financial system itself) it went out into the world looking for better returns than those available in the US. The UK was directly affected.

The European Central Bank accommodated a similar process inside the eurozone. Partly as a result, overheating in credit-elastic peripheral eurozone economies suffering from “interest-rate illusion” - the confusion of nominal with real rates natural in economies that had never enjoyed such low rates before - offset the extreme weakness of demand in the creditor countries particularly Germany. The eurozone average, which the ECB targeted, consisted of a part of the economy that was much too cold and a part that was much too hot, with capital flowing on an enormous scale from the former to the latter.

In brief, with house prices soaring and credit exploding, households and financial sector gross debt expanded rapidly, relative to GDP. (See Chart 8.) This combination of asset-price inflation with a huge rise in gross indebtedness was sufficient to stimulate additional spending by households, on consumption and residential investment. This then balanced economies that had huge current account deficits and so the world economy as a whole. But it did so only until the crisis hit. Thereupon the pumped-up demand collapsed, leaving policymakers the painful job of trying to pump it up again.

What are the global implications?

What we might call the “Advanced Countries Crisis” is merely the biggest, but far from the first, large financial crisis of the past four decades. It was preceded by the debt crisis of the developing countries in the 1980s, the Tequila crisis of the mid-1990s and the Asian financial crisis of 1997-98. Also important, in a host of other crises, was the one that hit Japan in the 1990s, which first brought the liquidity trap and the zero lower bound back to economists’ attention.

This history of devastating crises and particularly this last crisis, which took place in the world’s most sophisticated financial systems and most advanced economies, raises some very big questions. Here are five, with some brief and (I hope) provocative answers.

First, are such crises inescapable features of a liberal global economy and financial system?

The answer is: yes. The only question seems to be: how big and how often, with the horrible possibility that the less often they come, the bigger they will be. Stability breeds risk-taking, which then generates instability.

Second, was the notion that inflation-targeting would bring economic stability a feeble-minded delusion?

The answer is: yes, it was. The critics were correct. Stable inflation may be a necessary condition for financial and economic stability (though one can debate even that), but it is clearly not sufficient.

Third, what is the role of an unconstrained credit system in generating instability?

The answer is: fundamental. Financial crises are either fiscal or private. We know, more or less, what causes a fiscal crisis. Private crises are created by the ability of an elastic financial system to generate unlimited increases in credit, until solvency concerns bring the party to a halt. But the elasticity of credit itself postpones concerns about solvency, thereby guaranteeing bigger crises, in the end. This is why liquidity crises are ultimately solvency crises.

Fourth, will regulation allow us to enjoy the benefits of inflation targeting without risking huge financial crises?

The answer is: probably not. Macroprudential policy will frequently find itself fighting monetary policy. This tension is more or less inevitable since it is precisely when monetary policy is most expansionary that regulators are most likely to worry about financial sector misbehaviour. The least bad option is probably to force much higher capital ratios, permanently, with some semi-automatic countercyclical adjustments.

Finally, is it important that there is no global authority capable of mitigating the causes of crises and managing them when they hit?

Yes and no. It would have helped if the obvious “adding up” problems of policymaking in the noughties had been made still clearer. But the links between global macroeconomics and what was happening in the

financial sector were obscure and, to many, remain so. It is highly unlikely that if the International Monetary Fund, for example, had been far more powerful than it was, it would have been able to prevent the crisis.

Similarly, as the eurozone experience shows, the presence of a shared central bank does not prevent crises and may well worsen them.

What are the implications for emerging economies?

After the emerging economy crises of the 1980s and 1990s, the emerging economies sought to minimise the risks of crises. In general, their chosen solutions included:

- Conservative fiscal policies;
- Greater reliance on borrowing in domestic currencies;
- Inflation-targeting central banks;
- Floating or deliberately suppressed and so “undervalued” exchange rates; and
- Exchange controls.

By and large, these policies have worked. Emerging economies have proved far more resilient to shocks than they used to be. (See Charts 9 and 10.) This was proved dramatically true in 2009, except in central and eastern Europe, which had fallen into the trap of “easy borrowing”. This is partly because their policies were better. It is also because China proved able to respond to the crisis by expanding investment demand strongly.

Nevertheless, changes in policies in advanced economies, especially the US,

affect them all. That was true in 2008-09 and again over the summer of 2013, in the aftermath of discussion of “tapering” by the Federal Reserve. Indeed, it is quite striking how large a jolt that announcement of a possible reduction in the rate at which the Fed expanded its balance sheet turned out to give.

Would that be different if the renminbi became a global reserve currency? I cannot see any reason why it should unless one thinks China’s policies would be less domestically focused than those of the US, which seems entirely implausible. Would it be better for emerging economies to have a choice of reserve currencies? Possibly. But this might also exacerbate instability among the major currencies.

It would be different for emerging economies if the incidence and scale of shocks abated. I can see little reason to expect that. So the main global reform seems to be greater insurance, in place of the colossal investments in self-insurance we have seen over the past decade, or so. A much larger IMF would be one possibility. It would even be possible for emerging economies to pool their reserves, separately from the IMF, for this purpose. But that does not seem to be on the table.

Another and perhaps more plausible possibility would be a large-scale extension of swap lines from the core central banks, such as the Federal Reserve, to a growing number of approved central banks of emerging economies. This would be a carrot for reform in emerging

economies. It would also reduce the risks of “sudden stops” and so encourage net import of capital by emerging economies, which the advanced economies should definitely want. It could also be justified as a way for the central banks of the core countries to reduce the risks of instability that then affect their own economies. In the absence of better insurance, I believe emerging economies must control capital inflows – both net and gross.

Conclusion

I leave you with five conclusions.

First, the world economy is now in a very strange place. We should not forget how strange and disturbing it is.

Second, we should be devoting huge effort to understanding why we have ended up in the world of the zero lower bound and the liquidity trap.

Third, there is no reason to be confident we have eliminated the danger of doing this all over again.

Fourth, emerging economies have learned quite well how to cope with this. But that may be largely because they have avoided large net capital imports.

Finally, the way to encourage a better balanced and less crisis-prone world economy is partly via great insurance of emerging economies against liquidity risk. That should, in turn, encourage capital to flow the way it should, from countries with poor investment opportunities to countries with

good ones. Using the world's surplus capital to build houses in rich countries that nobody needs is silly. Let's not do anything like this again.

¹ Chief Economics Commentator, *Financial Times*, London.

² Ben Bernanke, "The Great Moderation", 20 February 2004, <http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm>.

³ James H. Stock and Mark W. Watson coined the term "great moderation" in "Has the Business Cycle Changed and Why?" in Mark Gertler and Kenneth Rogoff eds, *NBER Macroeconomic Annual 20012*, Volume 17 (Cambridge, Mass: MIT Press, 2003), <http://www.nber.org/chapters/c11075.pdf>.

⁴ Ben Bernanke, *Loc. Cit.*

⁵ Foremost among the economists whose views were widely ignored were the late Hyman Minsky and Charles Kindleberger. See, for example, Hyman P. Minsky, *Stabilizing an Unstable Economy* (New Haven, Connecticut: Yale University Press, 1986) and Charles P. Kindleberger and Robert Z. Aliber, *Manias, Panics and Crashes: a History of Financial Crises, 6th edition* (London: Palgrave Macmillan, 2011).

⁶ Gillian Tett, *Fool's Gold: How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Castastrophe* (London: Abacus, 2009).