NEW HORIZONS IN GLOBAL MARKETS *NEW UNDERSTANDINGS, NEW RISKS*

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Prague

30 November 2006

NEW UNDERSTANDINGS, NEW RISKS

- CHANGING GLOBAL LANDSCAPE
  - NEW GLOBAL MACRO-ECONOMICS
- NEW CHALLENGES TO INVESTORS
  - NEW MICRO-ECONOMICS

GLOBAL IMBALANCES

- Recent focus of IMF (September meetings)
- Massive:
  - U.S. borrows almost $3 billion a day
  - Huge bilateral trade deficit with China
- New global economic order
  - Most countries have learned to discipline themselves (fiscal and monetary discipline)
  - Eroding confidence in the dollar—no longer good store of value
  - Countries no longer thinking of dollar as backing to country, currency, but wealth
  - With diversification as principle of wealth management
  - *Change* itself will have consequences, as portfolios get rebalanced

Keeping Blame Game in Perspective

- China's surplus is small relative to U.S. trade deficit (and probably overstated)
- The elimination of China's surplus would probably leave U.S. deficit relatively unchanged
  - Deficit (= capital inflows) = difference between domestic investment and domestic savings
  - Changing exchange rate is likely to have minor affect on either
    - Could actually increase investment

Reducing China's surplus could worsen global instability

- U.S. deficit unchanged, as U.S. buys textiles from Bangladesh and Cambodia rather than China
- But China is engaged in vendor finance, lends "surplus" back to U.S.
- Bangladesh and Cambodia less likely to do that
  - More likely to spend money at home
  - Or to put money in strong currency
- U.S. may face problem financing deficit
  - Will be financed
  - But adjustments may be "painful"—large changes in asset prices

But is Bush to blame?

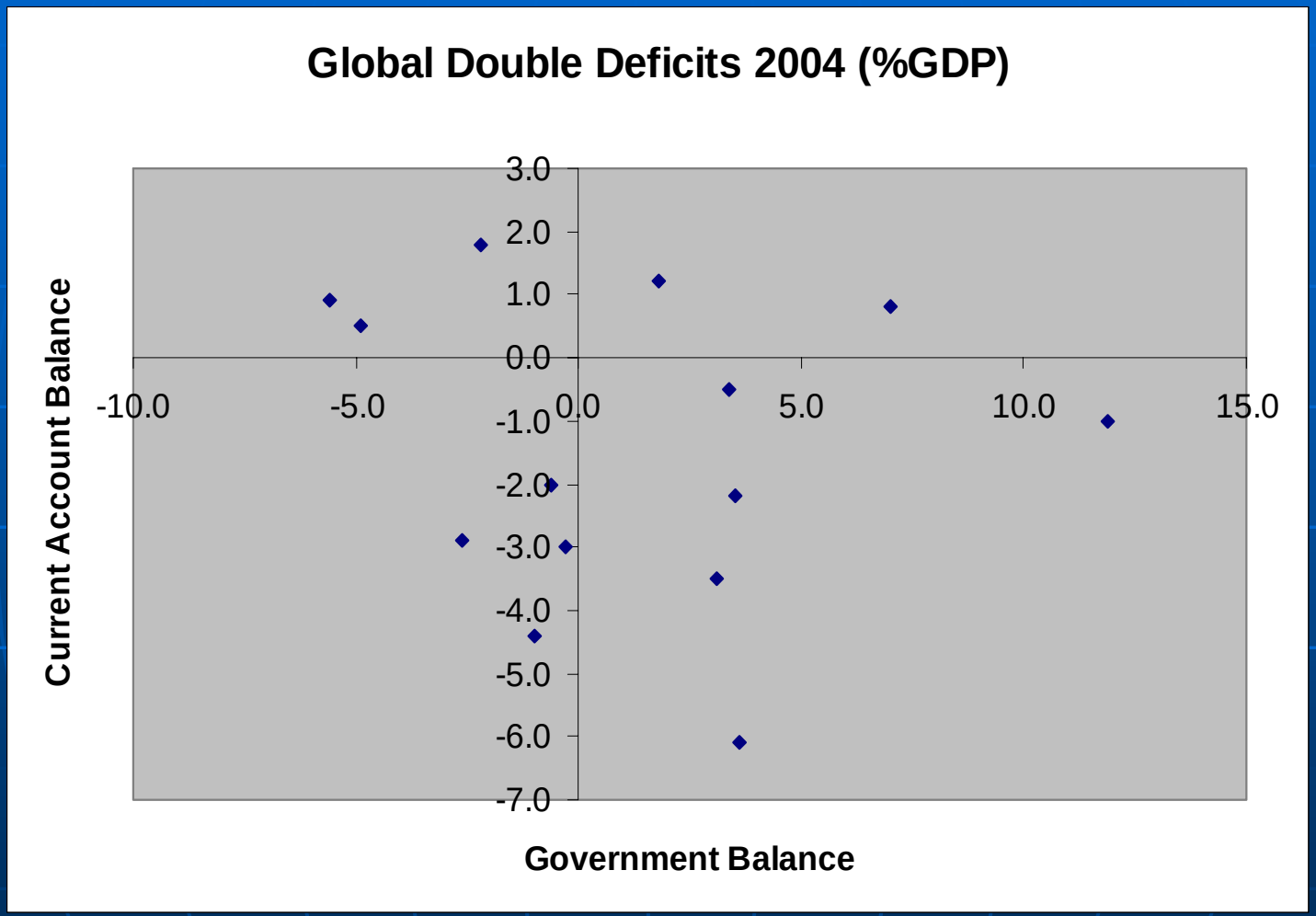
- Standard argument—twin deficits
  - Fiscal deficit leads to trade deficits
  - In partial equilibrium setting, relationship is clear
    - TD = CF = Investment – Domestic Savings
    - *Ceteris Paribus*, an increase in the government deficit reduces domestic savings, and exacerbates the trade deficit (TD)/Capital inflows (CF)
      - Of course, in Barro-Ricardo world, public borrowing is offset by increased private savings
      - But even if there is *some* effect, not large enough
    - More to the point: we are not in a *ceteris paribus world*

The data

- Time series
  - U.S. has been steadily increasing Trade Deficit, regardless of what happens to fiscal deficit
    - In 90s, investment increased
    - From a balance sheet perspective, it makes a big difference—borrowing to finance an asset rather than a consumption binge
- Cross section
  - No relationship across countries

Global Double Deficits 2004

Country	Current Account (%GDP)	Gov. Balance (%GDP)
Australia	-5.6	0.9
Austria	-0.6	-2.0
Belgium	3.4	-0.5
Britain	-2.6	-2.9
Canada	1.8	1.2
Denmark	-2.2	1.8
France	-0.3	-3.0
Germany	3.1	-3.5
Italy	-1.0	-4.4
Japan	3.6	-6.1
Netherlands	3.5	-2.2
Spain	-4.9	0.5
Sweden	7.0	0.8
Switzerland	11.9	-1.0

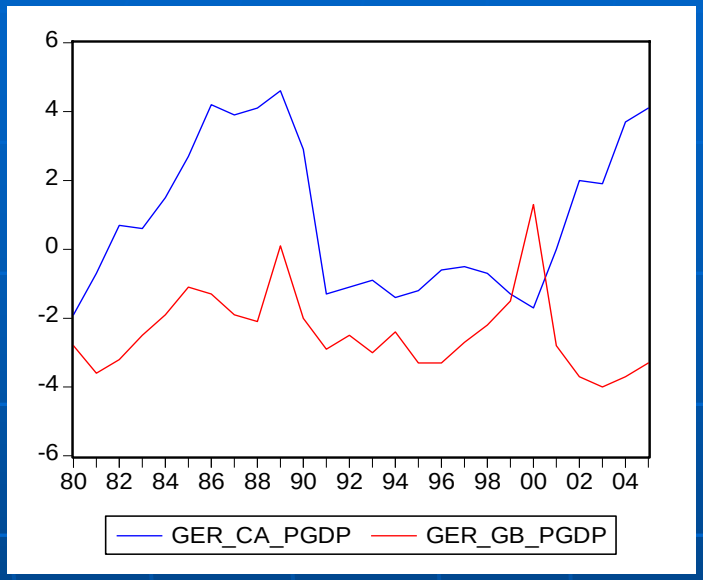

Global Double Deficits 2004 (%GDP)
Current Account Balance
Government Balance
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
-6.0
-7.0
-10.0
-5.0
0.0
5.0
10.0
15.0

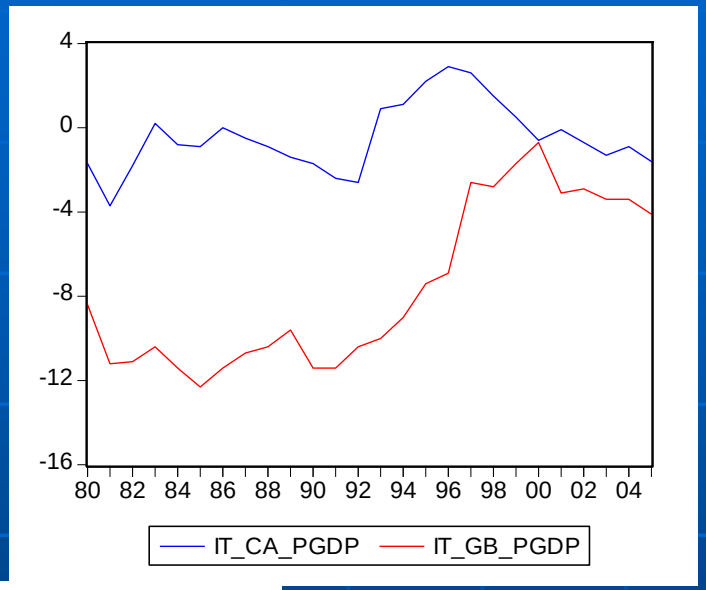
No Systematic Relationship

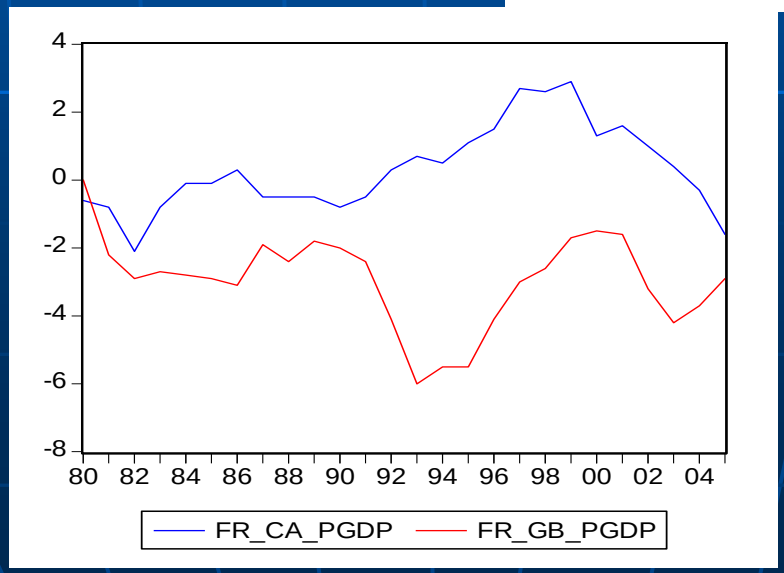
- With the exception of Canada, the data shows no systematic relationship between the Current Account Balance and the Government Balance

- In the case of Canada, the Current Account Balance appears to cause the Government Balance, but not vice versa

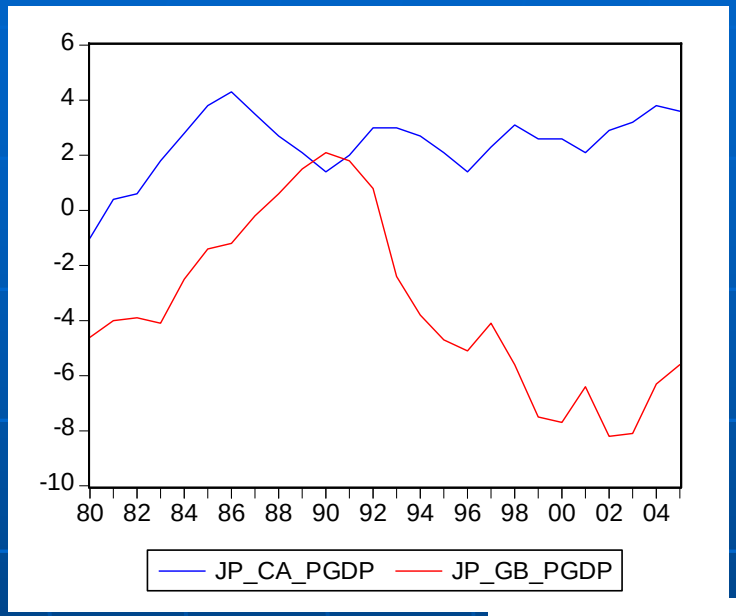
Germany, France, Italy

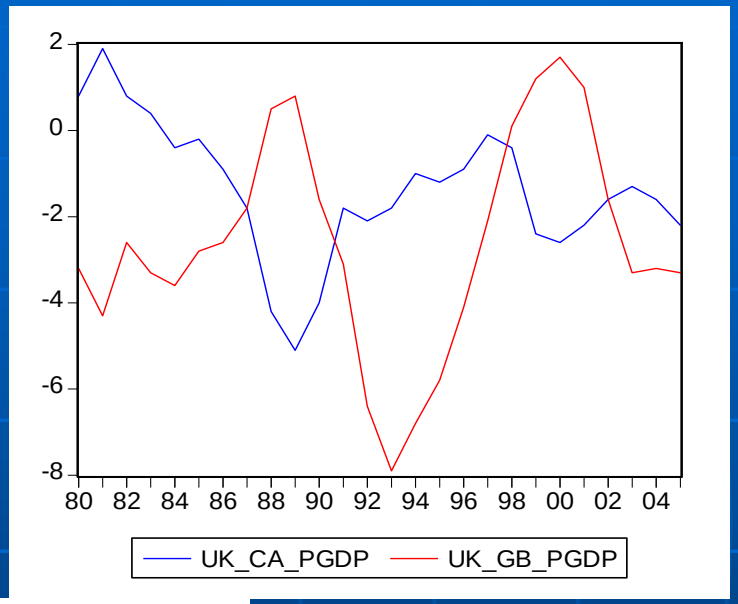


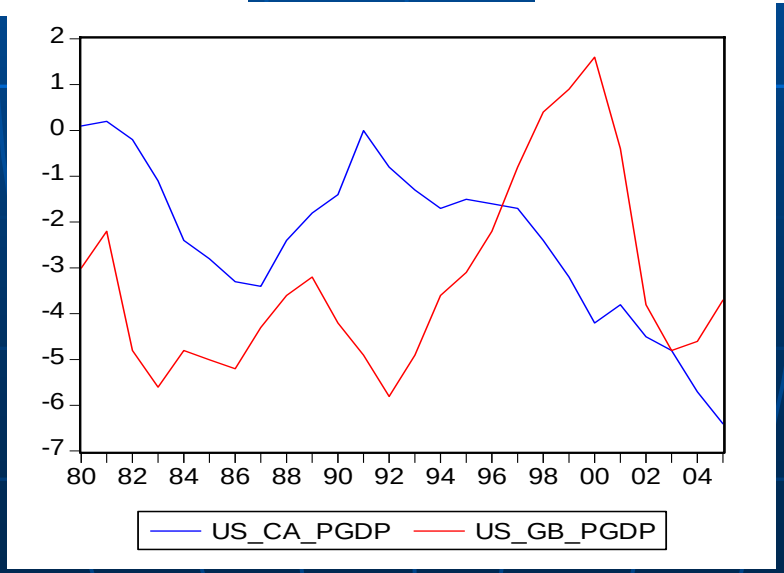




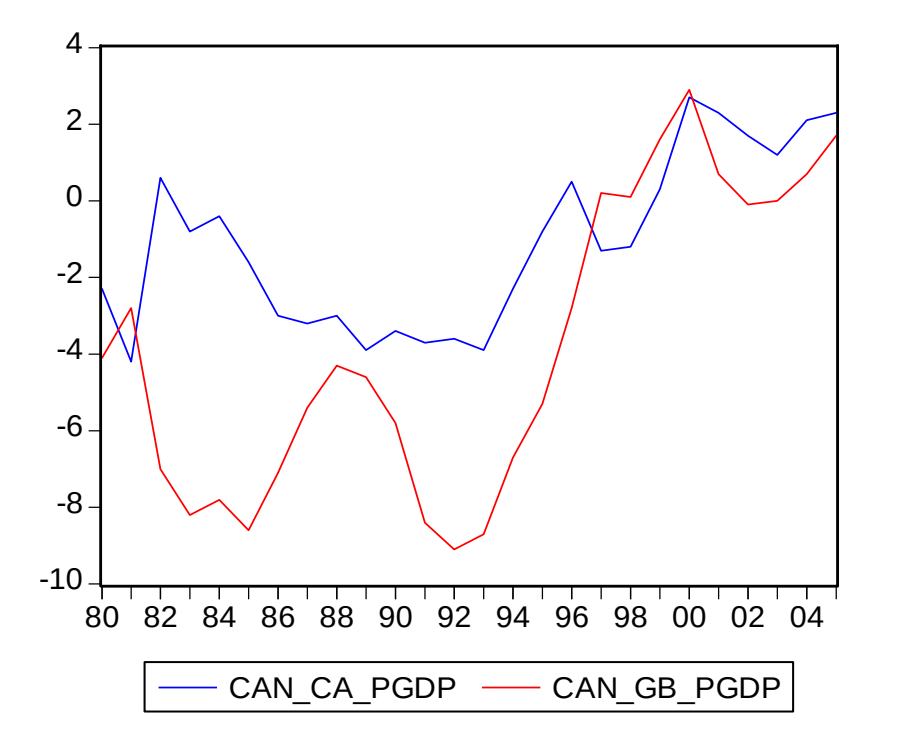
Japan, US, and UK







Canada displays apparent causality



An alternative View

- Fiscal deficits are endogenous
  - What is required to maintain the economy at full employment
  - Capital inflows are *exogenous*
    - Foreigners want to hold T bills in reserves
    - Exchange rates and other asset prices adjust to make sure this is possible
  - But since Trade deficit = CF, that means trade deficit is exogenous
    - Negative effect on aggregate demand
    - Government must offset this, either through monetary or fiscal policy
    - It is in this sense that trade deficit *causes* fiscal deficit
    - In the 90s, irrational investor boom meant government deficit was not needed—but that is an exception

Implications

- It is the dollar reserve system that is at the root of the problem
  - UK had a similar problem when sterling was reserve currency
- The U.S.—and world—would be better off shifting to a global reserve currency
  - Current system is inherently unsustainable
  - As IOU's accumulate, confidence in dollar erodes
  - If confidence erodes, Central Banks may move out of dollar, dollar weakens, reinforcing problem
  - Is there a tipping point? Are we near there?
  - The dollar reserve system is fraying

Further problems

- Insufficiency of global demand
  - Purchasing power “buried” in ground
  - In past, deficiency was made up by loose monetary and fiscal policies
    - But countries who provided this global service were punished
  - U.S. has become consumer of last resort
    - Prides itself on providing this global service
    - But something is wrong with a global financial system which requires the richest country of the world to spend beyond its means to maintain global prosperity

Further problems

- Inequities
  - Developing countries are lending U.S. trillions of dollars at low interest rate
    - Consequence most clear at micro-level, with standard prescription—keep dollar reserves equal to short term dollar denominated debt
      - Firm in poor country borrows $100 million from U.S. bank at 20% interest
      - Country has to put $100 million in reserves—$100 million T bills implies lending to US
      - Net flow zero *except* interest received 5%, interest paid 20%
    - Form of foreign aid by poor countries to U.S.
      - Magnitude greater than U.S. aid to developing country

Global reserve currency

- Issued in amount commensurate with reserve accumulation
  - Offsetting negative effect on aggregate demand
  - Would thus not be inflationary, would avoid deflationary bias of current system
- Would enhance global stability
  - Inherent in any single country being reserve currency
  - But provide an additional degree of flexibility
    - Countries could run a small trade deficit without having a problem
    - Net reserves would still be increasing

- Basic trade identity: sum of surpluses = sum of deficits
  - If some countries insist on having a surplus, some others must have deficit
  - Hot potato of deficits: as one country eliminates its deficit, it appears somewhere else in the system
  - US has become deficit of last resort
    - Apparent in statistic
    - But is this sustainable?

Implication

Surplus countries are as much part of systemic problem as deficit countries

- Keynes emphasized negative effect on global aggregate demand
- Should “tax” surplus countries—reduce their allocations of global reserve currency
- Using proceeds for financing global public goods and development

Reform is an adaptation to current situation of an idea originally developed by Keynes

- Keynes was worried by adverse effect of being reserve currency on U.K.
- Though idea was not adopted, Britain’s problems were resolved as it pushed the problem on the U.S.—U.S. became the reserve currency

- There are two actual precursors—IMF SDR's and Chang Mai Initiative
  - SDR's episodic, and U.s. has vetoed last expansion
  - Proposal can be thought of as a globalization and refinement of Chang Mai initiative
  - A Europe/Asia joint endeavor would be a way of introducing it
  - U.S. will resist, since it thinks it gains from low interest loans
  - But it loses from high instability
  - And amounts of loans will in any case be decreasing
- Ideas are developed in greater length in
  - J. E. Stiglitz, *Making Globalization Work, especially Chapter 9*
  - Bruce Greenwald and J. E. Stiglitz, "A Modest Proposal for the Reform of the Global Financial System," presented at AEA meetings, January, 2006.

From general theory to the here and now….

- Theory simply says situation not sustainable, does not say when problems will become overwhelming
  - Some think that because we have not had a crisis for several years, crises are a thing of the past
  - But why should that be so? Crises have marked capitalism from the beginning
    - Irrational optimism and pessimism
    - Bubble always break
    - Not always self-evident that it is bubble until it breaks
      - Always stories of “new era”—new economy at end of 90s

Two views

- Financial innovations mean that we can manage risks better
- Financial innovations mean that we can undertake more risks easier
  - Lull in crises a result of low interest rates, low risk premium
    - Argentina special because problems were anticipated
  - Surprising in a world marked with such high risk
  - Including risk of an increase in risk premium
  - Is this a case of another bubble?
  - Lesson of Asia crisis: many people who thought that they were “protected” were not
  - Even if there is “excess” liquidity, why should it be maintained?
    - China trying to decrease savings
    - Shift out of dollar reserves
    - Tightening monetary policies in many Central Banks
      - Could get worse with another large oil price shock
      - Especially with so many Central Banks focusing on inflation targeting

Increasing Risk

- Worsening balance sheets
  - Consumption sustained by people taking money out of housing
  - Even with stable housing prices, cannot be sustained
  - But growth requires that it increase
  - Large inventory of housing
  - Possibility of higher medium/long term interest rates
  - Suggests likelihood of declining housing prices
  - Already happening
  - Implying a consumption crunch
    - Will evolve more slowly

Can something else offset effects?

- Firms are in a good position—but are not likely to increase investment as consumption falls
- Exports could increase—but global growth is projected to slow
- May be hard for government to offset
  - Given large and persistent deficits and worsening balance sheet
  - Especially with democrats elected to restore fiscal sanity
    - But timing is crucial
    - Problems similar to 93
    - But Clinton managed fine tuning
    - Helped by special circumstances of banks' balance sheets

From global risk to individual risk

- Risk is diversifiable but cannot be eliminated
- Fundamental flaws in standard rational actor model:
  - Individuals only go through their life once; cannot "learn" whether they are saving too little or too much
  - Rapidly changing world means that they can learn little from parents, others in previous generation
- Information asymmetries and forms of myopia may further expand the area of inefficiency/limited risk diversification
- Behavioural Finance has shown an array of reasons why single investors often make imperfect choices

Implications

- Many individuals may be affected by financial downturns
- Individuals need help in understanding the consequences of their decisions
  - But individuals can often be easily preyed upon
  - Ample evidence that this often happens
- Regulators but also Asset Managers and Distributors have important responsibilities. “Solutions” (second best and often imperfect) exist and can and should be pursued
  - Important area for basic research
  - Important area for policy analysis