

GENERAL DISCUSSION
The Shifts and the Shocks:
Emerging Economies in an Age of Financial Crises

Mr. Wolf: I'm happy to take questions. I cannot imagine that I haven't enraged most people here.

Mr. Eichengreen: So Martin, that's a very complex narrative. You can't be accused of offering a monocausal explanation of the crisis. However, it did seem that you attached priority in your explanation to the mysterious decline in real interest rates around the turn of the century that set on foot housing booms and the associated financial excesses. That suggests that you really think the fundamental causes of the crisis were first China and the big inflows from China to the advanced economies. And number two, the euro, which was responsible for the decline in real rates in the European periphery. Without China and without the euro, does it follow we would not have had a crisis of this magnitude?

Mr. Wolf: I think that what was going on in the western nonfinancial corporate sector was also an important and interesting part of the story. It seems to me there were a number of forces coming together that were leading to the savings glut, investment at the global level, and the associated shift in real interest rates. But I do think that an important aspect of the monetary response, and therefore what I think affected the financial sector's role in this, was the way monetary policy evolved in the developed world and what it was trying to cope with. It does seem to me that the evolution of the current accounts, the savings surpluses, what Carmen Reinhart said about reserve accumulations, and the nature of the portfolio preferences of these countries had an important effect on the monetary policy response and on the financial sector consequences. Now, my view at the moment is that it is interesting to consider what would have happened if all our economies had been closed and we had simply liberalized their domestic financial systems. Would that have been enough on its own to have had these consequences? We can't run this counterfactual, so I think the answer is, we don't know. But I find it rather difficult to believe that would have been enough to create this degree of excess. Some of it would have happened anyway. I'm sorry I can't produce a simple monocausal explanation because I don't really think there is one.

Ms. Reinhart: You rightly point out that in the era of the Great Moderation these kinds of financial crises were unthinkable in the advanced economies. These things were supposed to only happen in emerging markets. And emerging markets often dealt with debt overhangs and debt restructuring. Could you comment on your view of restructuring issues in the periphery and debt restructuring in general?

Mr. Wolf: I think the observation is correct that developed countries have generally found restructuring of debt unthinkable. There's been quite a lot of restructuring of private debt in the United States. And in Europe, there's generally not even been much of that. My belief is that substantial amounts of debt restructuring in the public and private sectors in Europe including the United Kingdom are nearly certain to occur. The only question is when. Up to now, the assumption had been that, because we were able to operate zero interest rate policy, we can finance our governments relatively easily. That obviously didn't apply to the periphery. But it applied to the core. We hoped that we could get back reasonable nominal GDP growth sooner than we have—clearly we didn't expect still to be here, instead the assumption was that we would be able to grow our way out of this. The right relationship between nominal GDP and nominal interest rates would allow that to happen, because the assumption was that we would have sufficient control over both sets of variables. But it's now clear that in the periphery of Europe that isn't working and won't work, and the current policies clearly won't work. So debt restructuring seems to me pretty well inevitable. It is perfectly possible that we will end up in, say, the United Kingdom, having to do very substantial mortgage restructuring. And that depends largely on how well the economy grows and what happens to house prices and employment. But in the periphery of Europe—in Italy, Spain, and so forth, given their growth projection—given the likely growth rates and interest rates, I can't see any way they can get out of debt restructuring. I regard that as a necessary condition for a return to growth. It's not a sufficient one, because their economies remain deeply uncompetitive. And they're operating in a currency union, which has absolutely no demand for growth and which is falling into deflation. Therefore there seems to me no satisfactory way out of this, so debt restructuring is a necessary condition for getting back to growth. But it's a very long way from sufficient.