GENERAL DISCUSSION

Global Imbalances and the Financial Crisis: Products of Common Causes

Chair: Rakesh Mohan

Mr. Mohan: Thank you very much Maury, Ricardo, and Jacob, for very absorbing presentations. Mike Dooley?

Mr. Dooley: Thank you. Instead of making my standard comment at this point, that you've got the wrong crisis, the same point Ricardo made very well, let me try to do something else and that is put two things together. If Mike Mussa is right and this is going to be a V-shaped recovery, then we're going to have a current account deficit for the U.S. in the neighborhood of 4 or 5 percent of GDP by the end of next year. That's inevitable unless there's a big relative price change. Andrew Sheng said that the emerging markets are already under pressure from capital inflows. A week ago, the Central Bank of Brazil bought 5 billion dollars in one day to prevent appreciation of its currency. My point is that, unless we have the crisis that Maury and Ken have been predicting for a long time, by the end of 2010 we're going to be in exactly the same situation we were before the current crisis. If that puts an unbearable burden on the U.S. financial system to intermediate those net flows and, much more importantly, the gross flows associated with that, then the only feasible policy response we have between now and then is reregulation and supervision. We're not going to change international imbalances between now and the end of 2010. As Chairman Bernanke suggested this morning, if these international capital flows put an unbearable burden on the U.S. financial market, then we can predict with pretty high probability that exactly the same issues are going to arise in a very short period of time. So, to conclude, we better do something fast to make sure the system can handle these capital flows.

Mr. Mohan: Taka? If everyone can make it very brief, I think we will be able to get more questions in because we have very little time.

Mr. Ito: My prior is that global imbalances and the housing bubble and bust have very little connection. And my prior comes from the Japanese experience: Japan had huge surpluses in the 1980s and still got the bubble and bust. So,

bubble and bust could happen any place; it has little to do with current account surpluses or deficits. I think the connection some people push is that, because China was willing to recycle the surpluses into the U.S., the U.S. interest rate didn't rise as it might have otherwise. But how much would the interest rate have needed to rise to stop the bubble and bust? During the bubble in Japan 20 years ago—and also in the U.S. more recently—housing prices were rising 20 percent, 30 percent a year and raising the interest rate by two percentage points, like John Taylor would have preferred, wouldn't have stopped it. So, I'd be interested in hearing your thoughts on this.

Mr. Kashyap: I think we're all asking the same question in slightly different ways. The paper concludes, appropriately in my view, that central banks ought to take current account balances into account in the formulation of monetary policy, particularly when the regulators are not on the ball. So, how do you take the next step and neither argue that we should mechanically add the current account as a third argument in the Taylor rule, nor go to the other extreme and say that central bankers ought to take all the data into account when formulating policy? Can we be more precise about how the conduct of monetary policy needs to change?.

Mr. Eichengreen: This is a question for Ricardo. Financial institutions created these very complex securities with a lot of leverage, and then they kept them off their balance sheets. So, where is the logic that this stuff should have stayed on the balance sheets, and if it has to do with the incentives that Jacob was talking about, why do we want the government insuring whatever it is that permits that to happen?

Mr. Mohan: Michael Mussa and Joshua will be the last questions.

Mr. Mussa: As an international macroeconomist, I have to admit international imbalances must have played some role in the crisis, and in particular, in the excessive buildup in the residential investment sector in the U.S. But my main question is, is this similar to other circumstances where we've seen sizable capital inflows? And there is an extraordinarily dramatic difference and it appears, conveniently, on the final page of the Obstfeld and Rogoff paper. At the height of the crisis, the dollar's exchange rate spiked upward. In previous crises for emerging market countries, the exchange rate spiked downward. There was an absolute total difference of reaction of the foreign exchange market because people all around the world still had supreme confidence in the U.S. dollar and U.S. Treasury obligations as the safe asset of the system. The question that we need to ask is, the U.S. had a budget deficit of 1 percent of GDP in 2007, having

reduced the debt-to-GDP ratio in the 1990s. Now it looks like we're going to be seeing persistent deficits through the next decade, at least, pushing that debt-to-GDP ratio up in the neighborhood of 100 percent. If we had another crisis, would the authorities have the same flexibility to substitute official credit for private credit and to expect that the dollar would remain strong, perhaps even appreciate, rather than crash? Or would we have spent the credibility that was essential to stabilize the situation a year ago because of the large-scale persistent buildup of government debt?

Mr. Mohan: Last question, Joshua Aizenman.

Mr. Aizenman: Mike Dooley made the point that ideally we would like to impose better regulations to prevent more financial crises like we've seen in recent years. But Mike Mussa told us that it's apparently an impossible mission to predict such crises. I agree that there should have been much better regulation. But if Mike Mussa is correct and it's impossible to predict crises, maybe there will be a second or third bust. Maury Obstfeld is correct then that we should worry about global imbalances. So I agree with what Mike Dooley said, but I don't see any obvious demand of the average voter to push for a lot more regulation. That leads back to Maury's main point: maybe we are stuck in a third-best situation.

Mr. Mohan: Thank you. I have to add my question, which is a very simple one. According to the data that you showed, you can see that something really changed around 2003–04 in terms of the increasing magnitude of global imbalances. Now Chinese exchange rate policy has been roughly the same over the past 10 years, though in fact, it became a little less rigid in 2004. So, what happened in 2003–04 that changed everything? Who wants to go first? Reverse order, Jacob, so that Maury can have the last word?

Mr. Frenkel: I will just make one point, which is that external imbalances will always be with us, reflecting differences between income and spending across countries. When do these imbalances matter in a fundamental sense? They matter when the accumulation of imbalances creates additional obstacles that normally would not have existed. For example, concern about the right level of China's exchange rate has become a political issue rather than remaining a purely technical economic issue. And why is this the case? Because of the magnitude of the stocks of assets and liabilities that have built up with ongoing external imbalances over time. Let me give you another example. There has been a proposal coming from China about reviving the use of the SDR (special drawing rights). There are many good reasons to think about the SDR, but when the idea

comes from China I cannot resist a cynical interpretation that they feel stuck with very large dollar reserves that they cannot unload. They know the dollar is likely to decline if they unload their dollars all at once. If they go to the market to do it gradually, it would take too long. So wouldn't it be nice to have a mechanism with which to engage in a big swap with the IMF? I give you the dollars, you give me the SDRs, and everyone will live happily thereafter. Well, it might be nice, but it cannot be the rationale for reform of the international monetary system. What I'm saying is that the accumulation of large external imbalances may create unintended consequences that aggravate the situation beyond what normal current account balances would create.

Mr. Mohan: Ricardo?

Mr. Caballero: Let me address Anil's point. I think that we learned from this crisis very clearly that triple-A tranches of CDOs are much more dangerous than triple-A's from single named bonds and they have to be treated differently, especially if they're on the balance sheets of banks. Of course, insurance arrangements can help offset some of the risk of holding these kinds of instruments. Now, let me go back to a point that Jacob made, that people do make mistakes. I'm writing the Mundell-Fleming lecture and the title is "Sudden Financial Arrest" and I draw an analogy between what physicians do and what we economists do. Physicians also advise people to lower cholesterol, do exercise, and all these kinds of things, but they also have big defibrillators because they know some people will eat cheeseburgers and have heart attacks. So, the problem here is that some banks and important financial managers will make mistakes that will cause a crisis. You want to protect the rest of the system and that's the reason you need insurance against these kinds of things.

Mr. Mohan: Thank you. Maury, you have the last word.

Mr. Obstfeld: I can't possibly respond to all the points that were made in finite time, though I particularly want to thank my discussants, Ricardo and Jacob. I'll try to touch on a couple of the points that were raised from the floor in terms of focusing on Ricardo's discussion, which was more critical of the paper. One point we make in the paper is that the current account deficit of the United States reflected factors that were ultimately linked to the crisis. We're not saying the current account deficit caused the crisis. That's definitely not what we're saying. Of course, in economics nothing is indisputable, but when policymakers see a large current account deficit, particularly a large increase in a current account deficit, they should worry. There are some cases in which it's benign. Norway's development of North Sea oil in the 1970s was benign. But in many

situations large current account deficits are an indicator of trouble. It doesn't mean, to come back to Taka's point, that you need a current account deficit to get into trouble. You can get into trouble with a surplus, so it's neither necessary nor sufficient, but it is one of the things that one should worry about. One should ask, why is the current account deficit so big? Is it a benign phenomenon or are there things we should be worried about? And in the U.S. economy, there were things to worry about. The monetary policy makers, if you read the FOMC minutes and European central banks' discussions, were worried about those things. They did not react aggressively to those weaknesses, but if they had done so, we might have had a milder crisis or no crisis. The other role of the current account deficit, I believe, was in making it easier for policymakers to do nothing. Without the ability to run deficits there would have been greater inflationary pressures and greater pressure on interest rates. Again, would these have been sufficient to prick the housing bubble or to cause a vigorous enough response? We can't really know, but I think in terms of looking at the qualitative responses, the current account deficit, the ability to borrow, particularly with China's and other Asian countries' willingness to lend, was a facilitating factor.

Now, as far as the response of the dollar goes, that's a really interesting question. Unlike what many or most commentators envisioned, it turned out to be a global crisis, not a U.S.-specific crisis and, in fact, there was a sudden stop in capital flows. People stopped buying private U.S. assets. The U.S. was able to finance itself by selling foreign assets; so unlike in the case of an emerging market economy that has been borrowing but not lending, there were lots of available modes of finance which don't require foreigners to actually lend. The U.S., as Mike pointed out, did appear as a safe haven in this situation, and we do question in the paper whether this credibility of the dollar will continue. An interesting factor which is related to the points Ricardo was making about the demand for safe assets is that one of the main drivers of the demand for the triple-A rated tranches of CDOs was banks, primarily in Europe, that were looking to economize on required capital by holding triple-A rated securities; it was regulatory arbitrage. And when the credit markets froze, these banks, having large holdings of dollar assets, needed dollar financing, which I believe had an effect on the dollar, beyond the safe haven effect in the crisis period, creating this counterintuitive movement. Part of it, of course, is the safe haven effect.

Ricardo's point about currency and maturity mismatch is very interesting; the U.S. external portfolio does exhibit a huge risk mismatch, as the U.S. tends to borrow in safe assets while lending in risky assets. We tell emerging market

economies not to incur debt, especially not short-term debt, attract foreign direct investment, and get portfolio equity investment; but the U.S. ignores this advice. It is basically recycling safe short-term borrowing and some long-term borrowing into equities, and that's part of what's been responsible for the current account deficit not making the kind of dent you would think in the U.S. external position until last year. Equity markets have been buoyant. When equity markets are buoyant, the U.S. does well. The other factor that helps the U.S. in this regard is that the U.S. can borrow in dollars. So, when the dollar depreciates unexpectedly the U.S. net external position improves because the U.S. tends to hold foreign currencies. It's long in foreign currencies, in part, through its foreign equity holdings. So, this has been a very favorable circumstance and forecasting that that will continue in the face of the crisis experience and what it's done to the perception of our financial institutions and especially to our fiscal position is very risky.

Mike Dooley is completely right to worry about a renewed crisis. We're hearing some of the same language about interest rates that we heard in 2003, accommodation will be maintained for an extended period. We see bubble-like factors in East Asia, and it's very unclear what will happen in the future. As Mike asked, in the next crisis, will the dollar maintain its customary safe haven status? I think it's anyone's guess.

Mr. Mohan: Thank you, very much. I would like to first thank the current panel, Maury Obstfeld, Ricardo Caballero, and Jacob Frenkel. And to end this session I'd really like to thank all the authors and the discussants, for very absorbing papers and discussions as well as the audience for all their comments. We really had a very, very interesting morning. Of course, as you can see from this particular discussion, there is a lot that remains to chew over and discuss. The only thing I would say is that the return to some normality in financial markets should not make people forget the actual huge monetary losses the world has sustained because of this crisis. I think that really should give us thought in terms of the repair job that remains. We really can't be complacent. The final point I would make is, particularly since this conference has to do with Asia, there are lessons from Asia in the current crisis, since financial markets and banks in the region were able to remain relatively safe despite the huge downturn. What is it that they did after the 1997 crisis which enabled their financial sectors to withstand the crisis that is taking place now? Finally, I would like to thank the San Francisco Fed for inviting all of us here.