Global Market Disruptions – Will Global Imbalances Unwind?

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From June 12 to 14, 2008, the Oesterreichische Nationalbank (OeNB) hosted a roundtable discussion on global imbalances at Weißenbach/Attersee co-organized by the European Affairs and International Financial Organizations Division of the OeNB and the Reinventing Bretton Woods Committee (RBWC).

The participants, consisting above all of public sector representatives (especially central bankers), market participants and academics, engaged in a lively discussion and a fruitful exchange of information.

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Summary of the Roundtable Discussion "Global Market Disruptions – Will Global Imbalances Unwind?"

In his opening remarks, *Josef Christl* (Executive Director of the OeNB) addressed today's formidable challenges: high oil and commodity prices and the concomitant high inflation rates and a slowdown in economic growth. The financial market turbulence and global imbalances likewise pose daunting problems, in particular for central banks. Christl expressed his appreciation for the high-level participation and encouraged all contributors to lead an open discussion.

Session 1 "The Repricing of Risks: Origins, Remedies and Outcome" centered on the costs and implications of the financial market turmoil that had commenced in summer 2007.

According to *Anthony Santomero* (Senior Adviser, McKinsey), global losses attributable to the financial crisis have so far run up to around USD 800 billion or 5.9% of the U.S. GDP. Banks account for USD 550 billion and other financial institutions for USD 250 billion. These figures are based on a scenario which assumes only a mild and temporary crisis-induced recession in the U.S.A. Two other McKinsey scenarios peg the losses at USD 625 billion and USD 1,280 billion.

As banks have recapitalized by USD 232 billion to date, they still need about USD 300 billion. Recapitalization is becoming increasingly difficult, however, and will to a considerable extent stem from retained earnings in the future. Banks' remaining recapitalization needs equal three years of profits. To weather the crisis, banks will have to clean up their balance sheets. This is the only way to restore investor confidence and stabilize the liquidity situation in the markets, especially in the credit market. To revitalize asset securitization it will take straightforward and transparent financial instruments with high-quality underlying assets.

Christoph Avenarius (Director, Credit Suisse) noted that the Federal Reserve System had assumed the role of ultimate prime broker in combating the financial crisis. The turbulence made evident the weaknesses of the existing framework. Value-at-risk models, for instance, work only in liquid markets, and it is problematic that banks all use the same risk models. The Fed stabilized the U.S. markets at a dangerously high price level. Sovereign wealth funds

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(SWFs) might benefit in the medium term as they could purchase assets at relatively low prices.

Tryggvi Herbertsson (President, Askar Capital) shed light on developments in Iceland and expressed his doubt about the effectiveness of monetary policy in small open economies with large globally active banking systems. A restrictive monetary policy is immediately undermined by carry trades, which moreover increase the vulnerability of these economies to the repricing of risk. Under such circumstances, fiscal policy is made to bear the main burden of stabilizing the economy with Keynesian demand management. Iceland, however, also has the option of adopting the euro in the medium to long term.

In the subsequent discussion, the insufficiently regulated U.S. mortgage market was identified as one of the causes of the market turmoil. The rescue plan put forth by U.S. Treasury Secretary Henry Paulson was viewed with skepticism. Only a sweeping reform, which would equal a considerable political feat, would ensure a truly effective institutional and regulatory framework. It was also pointed out that the risks to the Fed's balance sheet had increased significantly due to the liquidity support it had provided. More than 50% of the assets held by the Fed were in the meantime considered to be risk laden.

European banks have likewise suffered disproportionately high losses from their U.S. investments. The magnitude of these losses depends heavily on the U.S. economy, with a severe recession set to drastically increase the damage.

Session 2 was titled "Unwinding of Global Imbalances – Orderly or Disorderly Adjustment?"

According to *Kristin Forbes* (Professor, MIT), the unwinding of global imbalances has hitherto been carried out in an orderly fashion. It is, however, uncertain whether the required net capital flows into the U.S.A. are sustainable. In 2008, the U.S.A. would need gross capital inflows of USD 1,800 billion to USD 2,700 billion (current account deficit: USD 627 billion, capital outflows: USD 1,200 billion to USD 2,000 billion). There is substantial risk that foreign investors' willingness to provide net financing to the U.S.A. will decline in the medium term. In this context, Forbes named the following determining factors: (a) the recent history of low returns for foreigners investing in the U.S.A., (b) many countries continue to develop and strengthen their financial markets, (c) the turmoil in U.S. financial markets since 2007, (d) hostility to foreign investment in the U.S.A. perceived in some sectors, (e) the danger of excessive regulation of U.S. financial markets in response to the crisis; such a reregulation might be an overreaction and poorly thought out.

Menzie Chinn (Professor, University of Wisconsin) talked about prospects for U.S. adjustment and the U.S. dollar. He argued that the decrease in the U.S. current account deficit over the past few quarters was traceable chiefly to the sluggish U.S. economy. Forecasts from Taylor Rule fundamentals indicated that the U.S. dollar would continue to depreciate against the euro in the adjustment process. It remains to be seen whether the U.S. dollar can retain its hegemony as primary reserve currency in the medium to long term. While a shift from the U.S. dollar to the euro is a low probability event according to Chinn, it may nevertheless not be ruled out completely.

Sophia Drossos (Executive Director, Morgan Stanley) explained why the framework conditions for an orderly unwinding of global imbalances had deteriorated noticeably since the second half of 2007. Further adjustment and the costs involved will be determined by capital flows into the U.S.A. by public sector investors (central banks, sovereign wealth funds). The increase in U.S. asset prices has been driven largely by the vast sums invested in the U.S.A. Furthermore, Drossos doubted that Asian economies would be able to continue to grow so dynamically if the advanced industrialized countries faced an economic downturn. The U.S. dollar's downward slide is bound to end since the ensuing costs to the U.S.A. exceed the benefits, especially as a weak dollar also means that U.S. assets will become less attractive to foreign investors.

The U.S. dollar's weakness of the past months dominated the discussion that followed. It was pointed out that foreign retail investors' sinking willingness to hold U.S. assets might explain part of the depreciation of the U.S. dollar, which, via valuation effects, had led to a decrease in the U.S. net debt. Whether the U.S. dollar will have to depreciate further against the euro for the U.S. current account deficit to shrink to a sustainable level will depend not least on the speed at which Asian currencies will appreciate against the U.S. dollar and the euro in the future.

In the second part of Session 2, *Miranda Xafa* (Alternate Executive Director, IMF) showed that the weakness of the U.S. dollar was attributable to domestic factors, referring to developments in the U.S. real estate and credit markets as well as the marked decline in U.S. dollar interest rates. As U.S. households are holding fewer assets and saving more, the U.S. current account deficit will contract further.

Michael Dooley (Managing Director, Cabezon Capital) expressed the opinion that Bretton Woods II (i.e. the U.S. dollar exchange rate peg of many emerging market economies) represented a stable system in the medium, perhaps also longer, term. Some of these economies, e.g. Brazil, naturally "graduate" from the system at some point and switch to more flexible exchange rate regimes, but then other developing countries are set to join Bretton Woods II. China and India represent the core of these countries pegged to the U.S. dollar and are bound to remain at the center of the system in the foreseeable future because they will continue to pursue an export-driven growth strategy based on undervalued exchange rates. In a nutshell, Bretton Woods II remains firmly in place according to Dooley and is set to evolve further.

Arnab Das (Managing Director, Dresdner Kleinwort) contended that the global economy was undergoing a disorderly nonadjustment and that the question was how stable this imbalance was. When the rise in asset prices had started to abate, investors in U.S. assets turned to commodity markets. Investors thus amplified the price increases of many commodities, which resulted in a price bubble. The fundamental macroeconomic issue of the past few years – too much liquidity in the global financial system – still exists and will give rise to other price bubbles.

The subsequent discussion again zeroed in on the U.S. dollar. The U.S. currency was said to come under enormous pressure should U.S. residents lose their willingness to hold U.S. dollars at the given interest and exchange rates. Global inflationary pressures and the monetary policy response were another hotly debated issue. It was criticized that many central banks had reacted too late to the ongoing rise in inflation. Countries with a U.S. dollar peg temporarily tolerated increased inflation in hopes of reaping the benefits of the peg, namely stability, in the longer run. Many countries, e.g. the Gulf states, lack an alternative monetary anchor in the short to medium term. The surpluses of the oil exporting countries (and thus the deficits of other countries) are bound to contract once people realize that the higher oil price is here to stay and the oil exporting countries step up consumption. As to Bretton Woods II, it is necessary to introduce restrictions on capital movement in the light of the export-driven growth strategy Asian countries pursue by maintaining undervalued exchange rates. Such capital controls would become less and less sustainable on the back of a successful catching-up process. The euro could play a greater role in this system; after all, with the U.S. dollar and gold, Bretton Woods also had had two anchors.

Session 3 revolved around the issue "The World in the Emerging Market Mirror: New Suppliers of Financial Stability," putting the spotlight on several country accounts.

The chair of this session, *Ousmène Mandeng* (Head of Public Sector Investment Advisory, Ashmore Group), remarked at the very outset that the emerging markets, while representing one-third of the international economy, accounted for half of global economic growth. He thus concluded his statement with the recommendation: Sell U.S. dollars and buy emerging market currencies.

Cristian Popa (Deputy Governor, Banca Națională a României) briefly described the current economic situation in Romania, where a dynamic catching-up process goes hand in hand with great imbalances. There are signs of consolidation efforts, which should be supported with stability-oriented policies. Monetary policy bears the brunt of the adjustment effort in Romania, but its effectiveness is limited. In addition, the sustained rapid increase in real wages raises some concern at the Romanian central bank. Popa expects the economy to slow down but does not see a hard landing on the horizon. At the current juncture, Romania plans to introduce the euro in the year 2014.

Mehmet Yörükoglu (Deputy Governor of the Turkish central bank, Türkiye Cumhuriyet Merkez Bankasi), provided an overview of worldwide inflation developments and monetary policies in emerging market and advanced economies. According to Yörükoglu, price increases of food, commodities and energy impact much more strongly on inflation in the emerging economies than in the industrialized countries, as these product groups are more significant in the consumer price baskets of the former and developing economies. Monetary policy in the emerging economies will thus have to decouple from that of the advanced countries. In emerging and developing economies, this will lead to tighter monetary policy, exchange rate appreciation and higher inflation targets.

Paulo Vieira da Cunha (former Deputy Governor, Banco Central do Brasil) provided an overview of the remarkable stabilization and catching-up process of the Brazilian economy, where a leftist administration applied a mainstream macro policy and set off a virtuous circle. At the same time, he criticized the shift to big government (transfer economy) and fiscal policy, which he called procyclical. It is hard to dampen the excess demand triggered by booming commodity prices, even though inflationary developments and the current account deficit call for a tighter macro policy.

Lawrence Brainard (Chief Economist, Trusted Sources) stressed the difficulties faced by China: more than USD 1,700 billion in international reserves, inflows of speculative capital to the tune of USD 46 billion per month. As an interest rate raise would only reinforce capital inflows, China cannot avail itself of this option for cooling the overheated economy. For this reason, it will attempt to combat inflation by means of administrative measures and a currency revaluation. China's transition to post-Bretton Woods II will likely prove disorderly and entail instability.

The consensus in the discussion that followed was that the current state of the global economy provides a litmus test for the inflation targeting strategies pursued in some emerging economies. Opinions differed as to whether today's inflationary pressures call for an upward revision of the – in some cases quite ambitious – inflation targets. The argument was put forth that repeated breaches of the targets could impede the credibility of central banks; yet, central banks would risk losing face by (prematurely) changing inflation targets in the first place. Perhaps inflation targeting strategies will suffer the same fate as monetary targeting strategies. Inflationary developments in China were deemed to be precarious since under the current conditions the government and the central bank lacked instruments to curb inflation.

Session 4 was dedicated to the "Prospects for the International Financial Architecture: Merits and Demerits of the Current International Monetary System."

Richard Portes (Professor, London Business School and CEPR) claimed that there was no international monetary system, but rather a non-system. Owing to capital account liberalization, low transaction costs and new players, such as hedge funds, capital flows have increased substantially, by far exceeding trade flows.

The number of financial crises has likewise risen, and so have the efficiency of capital allocation and the options for financing current account imbalances and the possibility of parallel financial market development. This deepening of international financial integration promotes the development of national financial markets.

The hegemony of the U.S. dollar in the international monetary system is increasingly being eroded. It remains to be seen whether the ascent of the euro will lead to greater instability (hegemonic stability theory). Before 1914, the pound sterling did not play as dominant a role as the U.S. dollar after World War II, given its rivalry with the French franc and the Deutsche mark.

The weakness of the IMF, which has yet to reinvent itself, and the lack of both a lender of last resort and an international bankruptcy court have taken their toll on the international monetary system. Furthermore, there is room for improvement in how the large central banks, i.e. the Federal Reserve Board, the Eurosystem and the Bank of England, cooperate; as liquidity pools are international, suboptimal cooperation proves problematic.

According to *Alexander Swoboda* (Professor, University of Geneva), the economic developments of the past few years, i.e. a sound macro background (Goldilocks economy and the Great Moderation), unexplainably low bond yields ("Greenspan conundrum"), a flat yield curve, quasi-reliable interest rate cuts in times of stock market downturns ("Greenspan put"), global imbalances and overspending by U.S. consumers, have led to a situation of abundant liquidity in the financial markets, bubbles and excessive leverage. The current financial crisis will make macro developments more volatile and put a stop to the Great Moderation. A decoupling of these developments is not in the offing.

Financial markets are procyclical and prudential regulation amplifies this procyclicality, which is a problem when dealing with general macroeconomic shocks. Here, it is necessary to integrate buffers. Monetary policymakers are faced with the problem that they have multiple mandates and only a limited number of instruments at their disposal. Hence, one can either reduce the number of targets (the Eurosystem solution) or increase the number of (short- and long-term) instruments. As for central bank cooperation, Swoboda sees three and a half players, namely the Federal Reserve, the Eurosystem, the Bank of England and the Swiss National Bank as half a player.

Banks that are too big to rescue rather than too big to fail, such as UBS in Switzerland, pose another problem, especially for smaller countries with large banking systems.

Stijn Claessens (Division Chief, Research Department of the IMF) presented results of IMF analyses showing that 21 OECD countries experienced 122 recessions between 1960 and early 2007. Furthermore, there were 114 cases of falling real estate prices, 233 occurrences of declining stock prices and 105 cases of a credit crunch. Most macro and financial variables respond procyclically to a recession. A credit crunch amplifies a recession; recessions that go hand in hand with falling real estate prices last longer. Real estate investment and credit growth have the best forecasting properties for recessions. Today's slowdown in U.S. economic growth corresponds to the pattern of previous recessions, but U.S. monetary policy has responded more quickly and more aggressively than in earlier periods of recession.

Harold James (Professor, Princeton University) stated that financial institutions tended to act procyclically in financial crises. However, in the past there has always been the odd big financial market player that acted in an anticyclical fashion and thus defused crises. Cases in point and thus quasi-forerunners of the IMF were the Rothschilds in the 19th century and JP Morgan in the 1907 crisis.

In the current crisis, the sovereign wealth funds could assume this anticyclical role. Were he still alive, Lenin would describe the SWFs as the highest form of capitalism.

The IMF, whose influence has been decreasing over the past few years, might take on a new role and invest SWF reserve assets. This would, on the up side, depoliticize SWF investments (guaranteeing no problems with the host countries of investments) and efficiently ward off speculative attacks. Naturally, IMF governance would have to be adapted accordingly.

Servaas Deroose (Director, European Commission) affirmed that the euro had established itself as the second most important international currency after the U.S. dollar. It is particularly popular in countries geographically close to the euro area. Some 40 countries use the euro as an anchor or reference currency; reserves have been diversified away from the U.S. dollar to the euro. Despite warning calls predating its introduction, the euro has on balance successfully promoted stability.

The euro and the U.S. dollar dominate the global monetary system (bipolar system), and some, e.g. Chinn, believe that the euro could overtake the U.S. dollar in the coming decades. Deroose, by contrast, sees a tripolar monetary system on the horizon. To strengthen the international role of the euro, the euro area has to remain economically sound and to deepen financial integration. Furthermore, a consolidated representation would raise the profile and increase the bargaining power of the euro area in the international arena. In other words, the euro area has to speak with a single voice in international fora such as the IMF, the G-7 and the G-20.

In the discussion, some called for tightening financial market regulation – variable minimum capital requirements for banks, preventing excessive leverage, special regulations for major banks, strengthening oversight in the EU under the auspices of the Eurosystem.

U.S. participants stressed that the euro's role as an international reserve currency had been underestimated, recalling former Federal Reserve Chairman Greenspan's statement that it would take the euro 100 years to become a challenge to the U.S. dollar. Some warned of impending instabilities in the battle for predominance between the euro and the U.S. dollar (citing the interwar years when the U.S. dollar replaced the pound sterling), while others found a stable system with several reserve currencies conceivable, giving the pre-World War I period as an example.

SWFs rather got a vote of confidence as they were seen to help stabilize financial markets by buying undervalued companies and by injecting additional capital into banks. The IMF as a reserve manager was regarded with skepticism because SWFs are unlikely to shell out capital to the IMF and the IMF would have to compete with private reserve managers and the BIS.