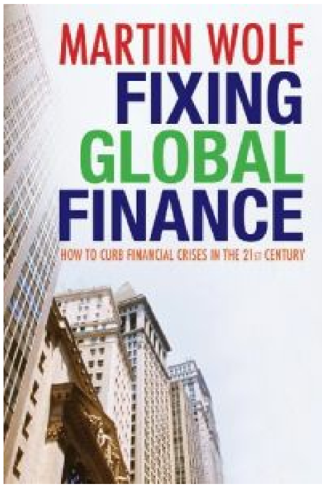

Book Fixing Global Finance

Martin Wolf
Yale UP, 2008

Recommendation

Questions about current account deficits and international savings rates send many fiscal analysts into jingoistic declamations. But Martin Wolf isn't that kind of economic commentator. He's the sort who realizes that global financial markets are fiendishly complex and, thus, that easy answers are likely to be too easy. In this study, Wolf adds depth and texture to such hot topics as China's massive savings rate and its huge foreign-currency holdings. This is primarily an economist's analysis, so Wolf doesn't address the way financial markets affect everyday consumers and entrepreneurs. *BooksInShort* recommends his book to observers who seek a learned, lucid, forward-looking perspective on global financial markets.

Take-Aways

- For all its benefits, the global financial system has proven far too prone to chaos and collapse.
- Mistakes and misjudgments are inevitable because of the novelty and complexity of financial markets.
- In this era of big risks, taxpayers often bear catastrophic losses while the private sector reaps lucrative paydays.
- Financial crises buffeted emerging markets, which have taken steps to avoid collapses.
- Developing nations have been cautious about current account deficits and borrowing.
- But the U.S. runs a huge current account deficit and acts as the world's savings account because it is a secure place to invest.
- The International Monetary Fund, long dominated by rich nations, must do a better job of addressing the needs of nations that borrow from it.
- Innovations like an emerging market currency index could help global finance.
- China has turned into the biggest saver and investor in world history.
- However, China must spend some of its massive savings at home.

Summary

The Boon and Bane of Global Finance

Financial markets, which are the global economy's nerve center, offer many advantages: finance new businesses, makes home buying possible and allows insurance markets to exist. While critics love to hate financiers as profit-driven speculators, modern market economies couldn't exist without finance. Alas, though, finance has proven far from perfect. This nerve center often suffers breakdowns, bringing bubbles, busts and costly crises.

> "The age of financial liberalization became the age of crisis, with consequences that still mark the world economy."

Financial markets are so prone to meltdowns because they are built on "a pyramid of promises." Bonds promise future payments; stocks promise ownership in a company; insurance promises a payout if a mishap occurs. Even currency now represents little more than a promise from the issuing government. Gold once backed the value of cash, but now governments issue money based on pure fiat. This web of promises has grown to encompass $140 trillion in financial claims worldwide. While promises grease the wheels of the global economy, when those promises are broken, the world's economic engine sputters, showing the limitations of markets built on trust.

> "These disasters have turned global finance into the biggest economic challenge for those who support the integration of the world economy, a process now almost universally known as globalization."

In actuality, this system of global finance based only on promises has proven remarkably successful and has yielded big rewards, especially to the most fortunate market participants. But it also carries big risks, as demonstrated in crisis after crisis. The World Bank lists 112 banking crises from the late 1970s to 2000, and the world entered another crisis in 2007, sparked by the subprime contagion in the U.S. housing market. The complicated, intertwined financial markets are "accidents waiting to happen – and happen they did, again and again and again." The reasons that global financial markets are so prone to meltdown include:

- **A lack of understanding¬** – These complex markets are new to regulators, financial institutions and investors, so mistakes and miscalculations are inevitable.
- **A high degree of complexity** – Investors, policy makers and regulators must master such arcane concepts as currency risk, off-balance sheet transactions and offshore deals.
- **Rickety structures in emerging markets** – Poorer nations have lacked the financial, regulatory and legal systems to handle this new degree of complexity. Some of these nations even lack property rights legislation and bankruptcy courts. As a result, developing markets have suffered more acutely than more sophisticated countries.
- **Governments that bear the risk** – Formal and informal government guarantees are the rule; the private sector reaps the rewards, but the public sector absorbs the losses. Think of bank liabilities as "contingent public debt." In extreme instances, the cost of a crisis can eat huge chunks of a nation's economic output. A crisis in Indonesia in 1997 required bailouts totaling 55% of the nation's gross domestic product. The same thing happened in Argentina in the early '80s. Japan's meltdown in the '90s cost 48% of its GDP. Not all crises are so costly. The U.S. savings-and-loan crisis ate "only 3%" of its GDP.
- **Extreme volatility** – Financial markets always have ebbed and flowed on the vagaries of fear and greed, but liberalized and globalized financial systems intensify the waves.

Emerging Markets Get Smart

Private capital flows have been a fickle friend to emerging markets. Such foreign investments are primary sources of both financial market funds and of destabilization. Commercial banks, in particular, dangle short-term credit in front of emerging markets, and then yank it away at the first sign of risk. Current account deficits frequently have proven deadly to emerging markets. A current account deficit often results when a nation pays debts with borrowed funds. Such deficits frequently lead to capital outflows and misaligned currency values – a severe threat to an emerging market. When an emerging nation's currency loses value compared to the currency of its debt, collapse is inevitable. This happened repeatedly from 1994 through 2002, starting with Mexico's peso devaluation, followed by the Asian contagion and the crises in Argentina, Brazil and Turkey in the early 2000s. In the late '90s, Indonesia's currency dove 80% and its GDP fell 15%, even though severe inflation (considered a precursor of collapse) did not precede the crash.

> "If global finance does little more than bring catastrophe in its wake, it becomes almost impossible to defend existing, let alone increased, levels of financial integration."

For developing nations, the cycle is all too familiar: capital flows stop, the current account deficit plummets, the currency craters and credit evaporates. However, emerging nations have grown wise to this trap. Equating current account deficits with wrenching meltdowns, they have begun turning off the spigot of large capital inflows. Now, when they do receive money, they put it into foreign exchange reserves. They're also giving a cold shoulder to International Monetary Fund (IMF) bailouts that create suffering at home, complete with political fallout. Emerging nations have not solved their financial problems, but they have learned a bit about moderating the ups and downs that can come with entering cutthroat financial markets.

The United States and China: the World's Borrower and the World's Saver

The U.S. is now the planet's largest borrower. As of the mid-2000s, it was responsible for "three-quarters of the current account deficits in the world." This has lent stability to global markets, but it is risky, as the 2007 subprime crisis proved. Meanwhile, the U.S. has proven to be the rare economy that can sustain a large current account deficit without suffering the usual fallout of soaring interest rates. That's in large part because it remains an alluring place for other nations to park their savings. The U.K. and many other developed nations also have relatively low saving rates. But the U.S. is the primary destination for the world's savings, largely because it has successfully encouraged its citizens to consume voraciously. It benefits from a phenomenon sometimes called the "savings glut." Four factors have created this oversupply of savings:

1. Savings and investment rates are on the wane as rich nations save and invest less.
2. Emerging nations and oil exporters are saving and investing more.
3. Rich nations are now "importers of savings," since their savings rates are lower than their investment rates.
4. Emerging nations and oil exporters are also becoming exporters of capital as their savings rates outpace their investment rates.

> "If we look at the world as a whole and at many significant countries, we find the notion of a savings glut is not right. It might be better thought of as an investment dearth."

In 2006, the U.S. had the world's lowest savings rate, 14% of GDP, mostly in corporate savings. China's savings rate was 59%. The average Chinese person is not responsible for this outsized savings rate, although Chinese households do save prodigiously. China's corporations and government save huge chunks of their profits. However, the authorities have declined to put some of the nation's savings into such programs as aid for laid-off workers or pollution controls.

> "The requirements of a sound fiscal policy are so simple in principle yet so difficult in practice."

Unlike the U.S.'s large current account deficit, China runs a huge surplus; it was $250 billion in 2006. Though it is the biggest saver and investor in world history, its system isn't perfect. It has huge excess capacity in some materials, such as steel. Pollution is a severe health and environmental problem. Job growth is modest and income inequality is soaring. Meanwhile, however, China has amassed huge foreign-currency reserves. From 1999 to 2007, those reserves shot up by more than $1 trillion, far more than any other nation's. U.S. and U.K. foreign currency holdings were flat, while EU reserves fell.

> "The performance of the financial system has been the Achilles heel of the era of globalization."

Global markets are adjusting to the reality that the U.S.'s massive trade deficits won't last forever. For years, the U.S. has gorged at "an apparently ongoing free banquet," where spending can outpace income and creditors are generous. That is bound to end as the U.S. grows more sensitive to foreign influence over its financial markets. Americans' willingness to participate in global markets is limited, as shown by political outcries over China's effort to buy Unocal and the Dubai Ports World initiative to manage some U.S. ports. Richard Cooper of Harvard University raises five trenchant points about the U.S. current accounts:

1. It's simplistic and incorrect to say the U.S. saves too little. This ignores Americans' ability to use financial markets to pull cash from once-illiquid assets, such as homes, and fails to understand "the relevant forms of saving in the contemporary...economy."
2. Savings rates are likely to remain large elsewhere, particularly in Germany, Japan and other rich nations with stagnant population growth.
3. It's perfectly reasonable for the rest of the world to put 10% or more of its gross savings in the U.S., which has proven to be a safe, rewarding destination.
4. If the U.S. deficit remains a "nominal" $600 billion a year and the U.S. economy grows 5% a year, "the ratio of net foreign claims on U.S. GDP would peak at 50% in 15 years and the current account deficit would fall to 2.5% of GDP by 2019."
5. While the deficit can't keep expanding, it can remain elevated for a long time.

Goals for Global Finance

Globalization has brought numerous benefits, and its onward march appears inevitable. However, financial markets are the global economy's weak spot. To smooth the boom-and-bust cycle, policy makers should pursue some new market goals. The global financial system should be:

- Liberal and market-based, but less likely to suffer spasms of insolvency.
- Less dependent on the U.S. as "borrower and spender of last resort."
- Less punitive toward emerging markets that run current account deficits.
- Overseen by an IMF and other institutions that support these goals.

> "As the financial system grows more complex, it piles promises upon promises."

While some espouse a return to the gold standard as a path to currency stabilization, that path is unlikely. Even sophisticated economies can fall victim to the inevitable crises, as the mortgage market meltdown shows. However, when the assets and liabilities in question are both in a nation's currency, it can contain the crisis more effectively. Emerging markets suffered devastating collapses when currency mismatches exacerbated what could have been manageable crises. Proposed strategies for making currencies more stable include:

- **An emerging currency index** – This index would create a basket of the currencies of the 20 largest emerging markets. The World Bank would issue debt denominated in the index. This could spur the use of emerging-market currencies.
- **Domestic-currency finance** – Former IMF official Anne Krueger suggested requiring G-7 institutions to accept foreign liabilities in the borrower's currency.
- **Sovereign debt restructuring mechanisms** – Institute an international bankruptcy process to allow for the restructuring of sovereign debt.

> "The people who benefit from roiling the world currency markets are speculators and, as far as I am concerned, they provide not much useful value."
> (former U.S. treasury secretary Paul O'Neill)

World financial markets also would benefit from retooling the IMF. For starters, rich countries govern the IMF though they never borrow from it. The U.S., the EU and Japan control more than half the votes. In the IMF's skewed world, tiny Belgium has more influence than India. The traditional, cozy way Europeans pick the head of the IMF (as Americans name the head of the World Bank) also saps credibility. To give the IMF true legitimacy, all member nations should participate in choosing its leader. Finally, the organization must realign its priorities. The IMF supports itself by collecting interest on emergency loans. If no emerging-market crisis exists, it doesn't get paid. As emerging markets grow increasingly suspicious of the IMF, they are less apt to turn to it for help. Leaders of emerging countries would be wise to keep seeing the IMF as an institution that can offer only limited assistance in times of trouble. A few other developments that would smooth chaotic financial markets include:

- **China should spend its excess cash at home** – China's huge current account surplus is a "massively destabilizing" force in world markets. Instead of sending such large wads of cash to the U.S, China should use its money at home.
- **Other countries should hold some of the world's savings** – Now, the world sends its excess savings to the U.S. Other rich, stable countries, like Japan and Germany, should absorb some of that surplus.
- **Emerging markets need to step up their game** – Many poor nations have created stability by building up huge foreign currency reserves. This is a start, but not an ultimate solution. These nations must create sound financial systems, lure foreign direct investment and take loans in their domestic currency. Nations unable to take these steps should steer clear of the financial markets.

About the Author

Noted economist **Martin Wolf** is the chief economics commentator at *The Financial Times* and professor of economics at the University of Nottingham. He is the author of *Why Globalization Works* and was named to *Foreign Policy* and *Prospect* magazines' list of Top 100 Public Intellectuals.