



The World after the Financial Crisis

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The world after the financial crisis

“Things that can’t go on forever,
don’t” Herbert Stein

The world after the financial crisis

“Simply stated, the bright new financial system – for all its talented participants, for all its rich rewards – failed the test of the market place.” Paul Volcker, April 8th 2008

The world after the financial crisis

“A sound banker is one who, when he is ruined, is ruined in a conventional and orthodox way, so that no one can really blame him.” John Maynard Keynes.

The world after the financial crisis

- I am going to ask five questions:
 - First, how did we get into this mess?
 - Second, how do we return to stability?
 - Third, what are the lessons of the crisis for macroeconomics?
 - Fourth, what are the lessons of the crisis for finance?
 - Fifth, what are the big risks ahead?
- I will focus on what has happened to the UK, but from a global perspective.

1. How did we get in to this mess?

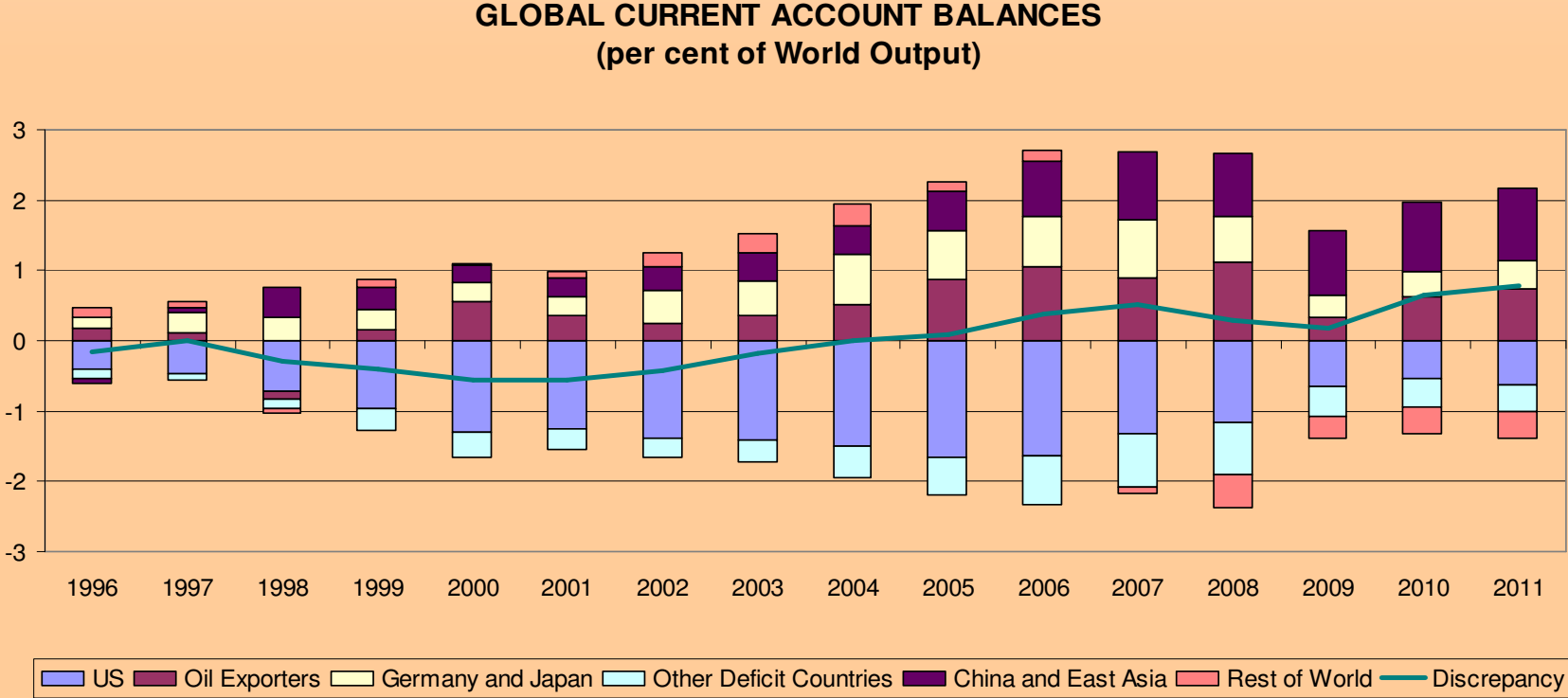
- What we have seen is a developing country financial crisis, but at the core of the world economy.
- What does such a crisis consist of?
 - A new opportunity – “sub-prime borrowers”
 - New lenders – buyers of securitised assets
 - An asset price bubble – housing
 - A lending spree – by the world’s biggest banks
 - A bursting of the bubble
 - A “sudden stop” or panic
- A classic “Minsky cycle”, in fact

1. How did we get in to this mess?

- Why did this extreme Minsky cycle occur?
 1. Undue belief in the “great moderation”;
 2. Emergence of global imbalances and extraordinary reserve accumulations in the late 1990s and early 2000s;
 3. Low real and nominal interest rates and a “reach for yield”;
 4. Accommodative monetary policy aimed at targeting inflation;
 5. Innovation in the financial sector, to provide notionally safe, high-yielding assets; and
 6. Failures of commission (risk-weighted capital ratios and reliance on ratings) and omission (deregulation of securities and housing markets) in financial regulation.

1. How did we get in to this mess?

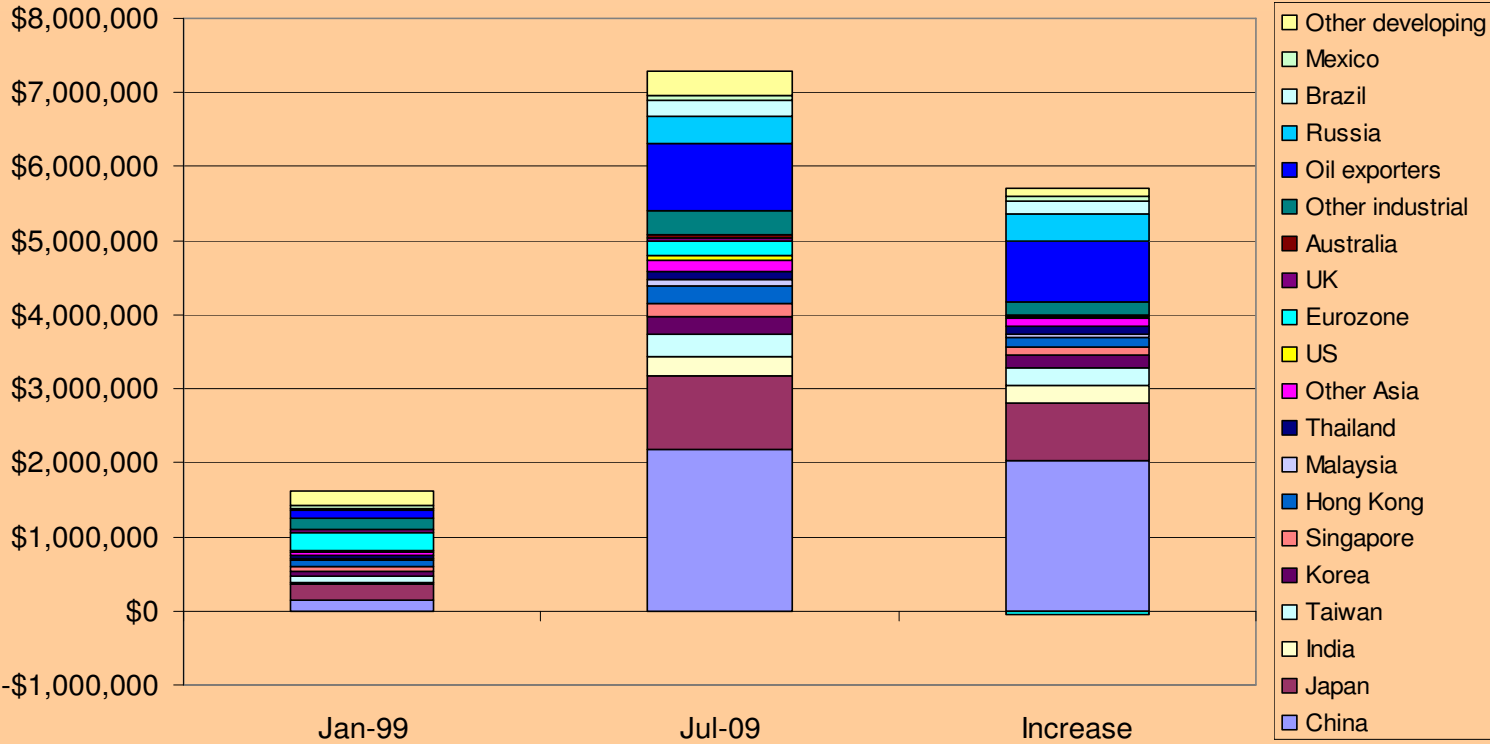
THE RISE OF THE IMBALANCES



1. How did we get in to this mess?

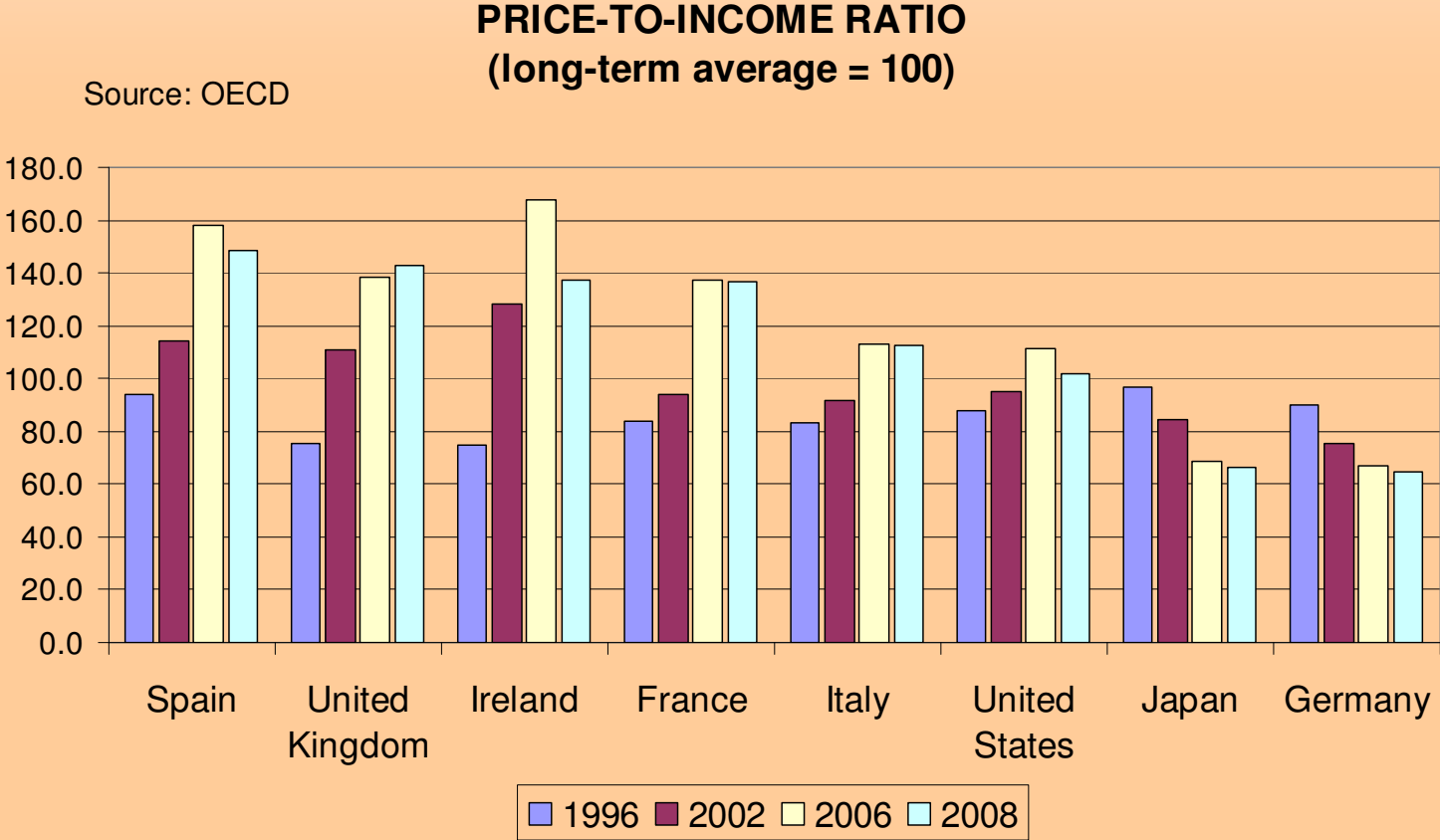
RISE OF FOREIGN CURRENCY RESERVES

FOREIGN CURRENCY RESERVES (bn)



1. How did we get in to this mess?

HOUSING BUBBLES

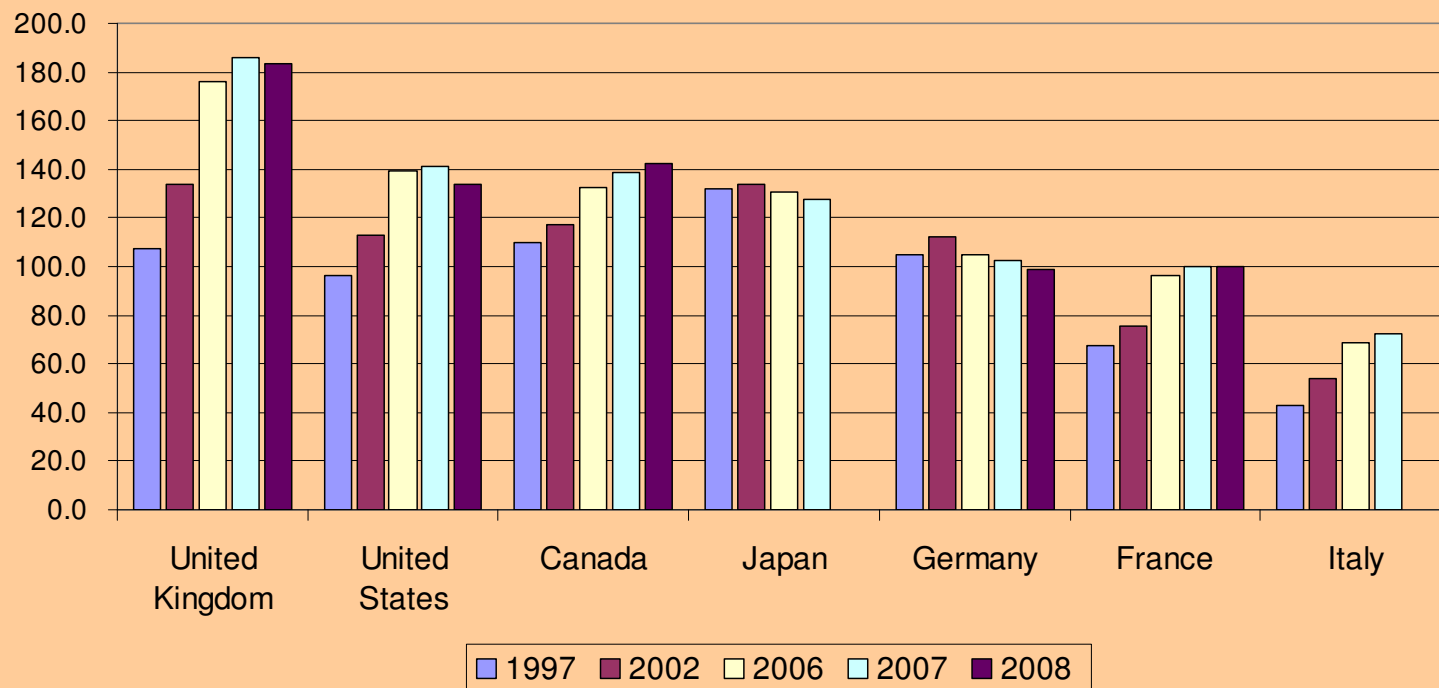


1. How did we get in to this mess?

WHERE THE BORROWERS WERE

HOUSEHOLD INDEBTEDNESS (relative to disposable incomes)

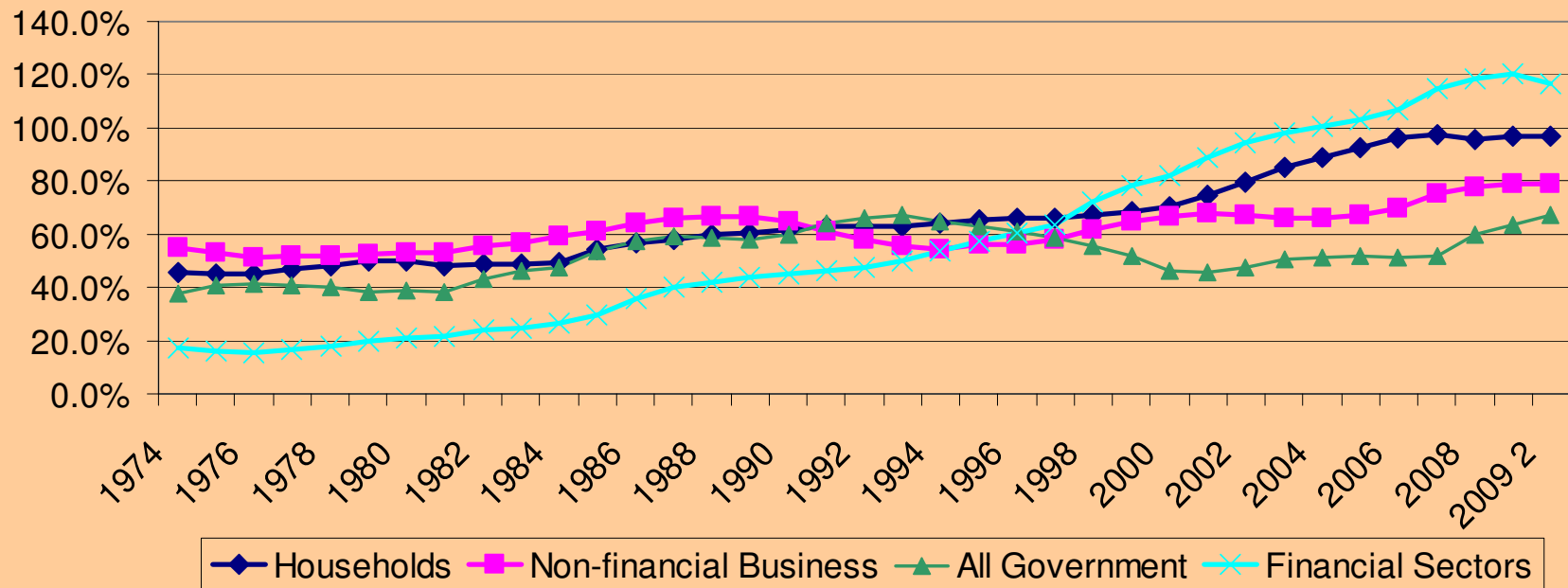
Source: OECD



1. How did we get in to this mess?

FINANCIAL SECTOR DEBT EXPLOSION

SECTORAL RATIOS OF US DEBT TO GDP



1. How did we get in to this mess?

- The rise in financial sector debt was even more extreme in the UK. At the dawn of the crisis, the gross debt of the UK financial sector had reached 250 per cent of GDP.
- As Andrew Haldane of the Bank of England has noted, the aggregate assets of UK banks rose from 50 per cent of GDP to 500 per cent over the past half century and from 200 per cent of GDP to 500 per cent over just the past 15 years.

1. How did we get in to this mess?

- Financial systems are always fragile – they make bets on the unknowable future and are subject to extreme incentive problems
- This time they made bad bets.
- So “is this time different”? Yes, it is - in three ways:
 1. The countries directly affected account for about half of the world economy.;
 2. The patterns of lending were vastly more sophisticated than in any normal financial crisis;
 3. The IMF cannot bail out the US and the rest of the West, but they are able to bail out themselves - at least so far.

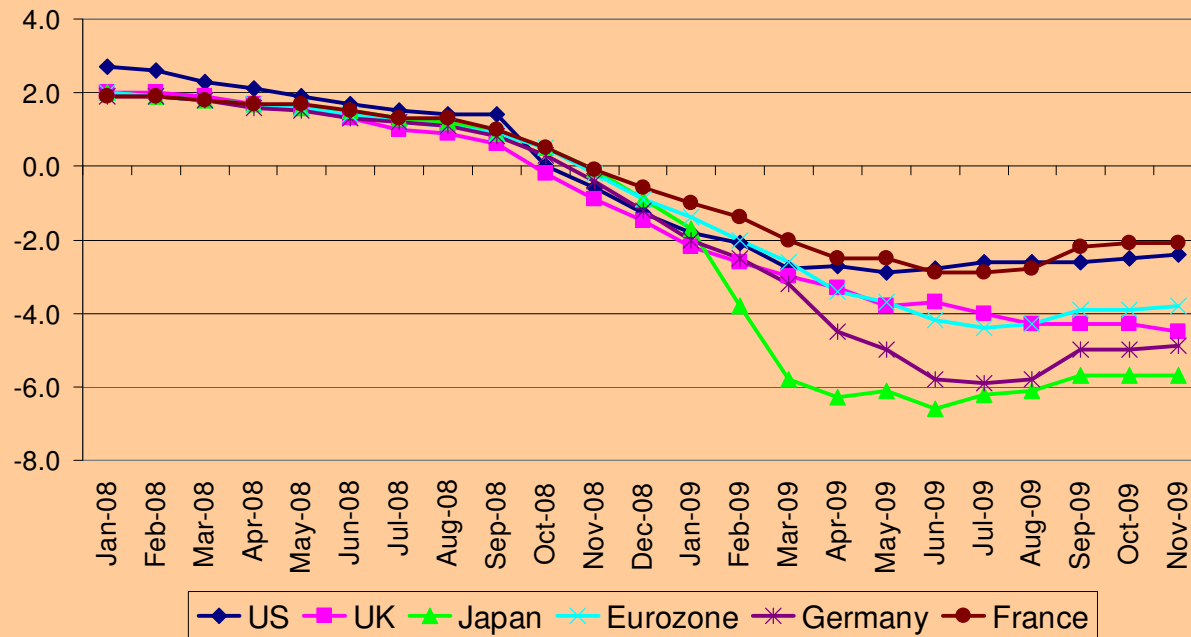
2. How do we return to stability?

- The economic collapse has been large.
- The rescue has also been extremely expensive:
 - The financial sector is very big;
 - The shift in the private balance is huge;
 - And the losses were very great.
- Fundamentally, we overestimated sustainable GDP.
- And sustainable private spending.
- We have a long road back to private sector-driven health.

2. How do we return to stability?

THE UNEXPECTED COLLAPSE IN 2009

CONSENSUS FORECASTS FOR 2009



2. How do we return to stability?

UK LEADS THE PACK IN RELATIVE COSTS

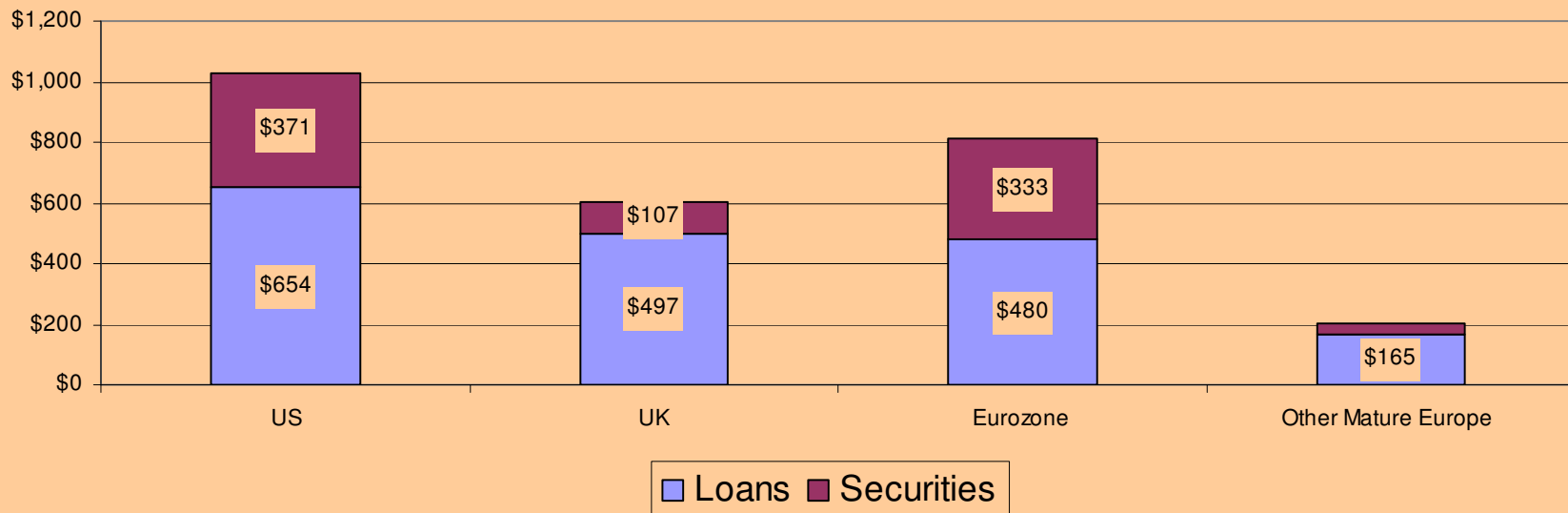
	Support (\$ trillions)		
	UK	US	Eurozone
Central Bank			
“Money Creation”	\$0.32	\$3.76	\$0.98
Collateral Swaps	\$0.30	\$0.20	\$0.00
Government			
Guarantees	\$0.64	\$2.08	>\$1.68
Insurance	\$0.33	\$3.74	\$0.00
Capital	\$0.12	\$0.70	\$0.31
Total	\$1.71	\$10.48	\$1.29
Per cent of GDP	74.0%	73.0%	18.0%
Source: Bank of England			

2. How do we return to stability?

UK LEADS THE PACK

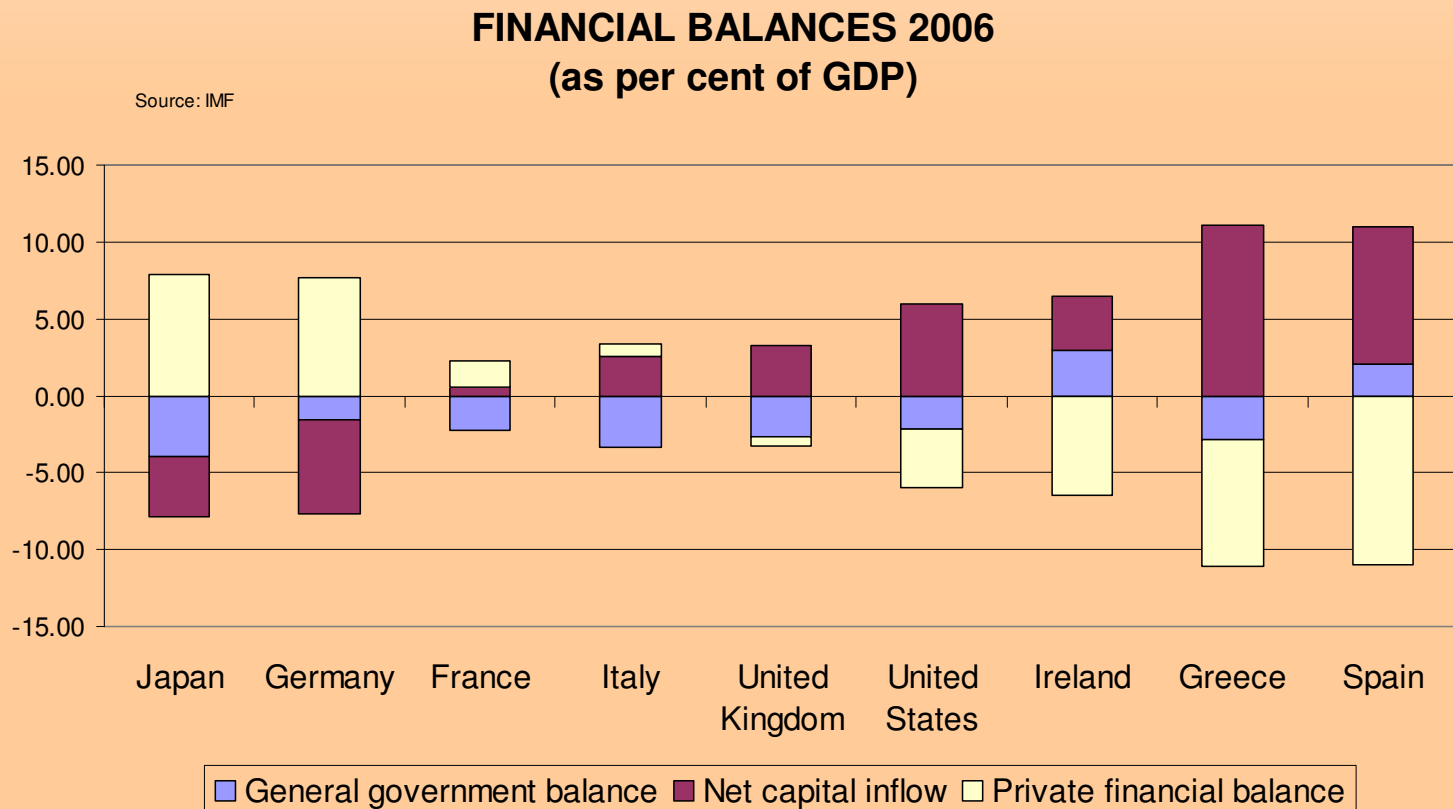
TOTAL ESTIMATED WRITEDOWNS ON BANK HOLDINGS (\$bn)

Source: IMF, GSFR, October 2009



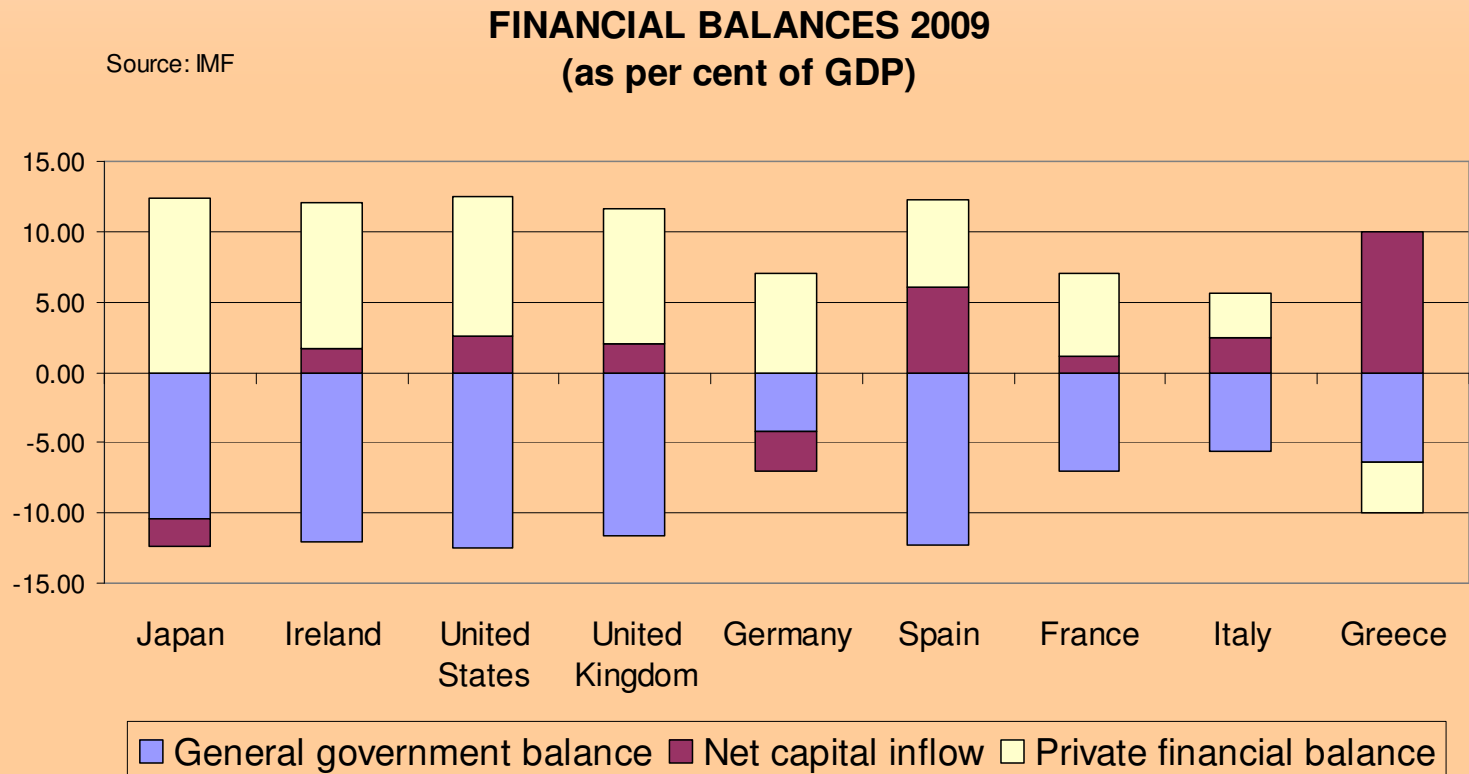
2. How do we return to stability?

IMBALANCES INSIDE HIGH-INCOME COUNTRIES



2. How do we return to stability?

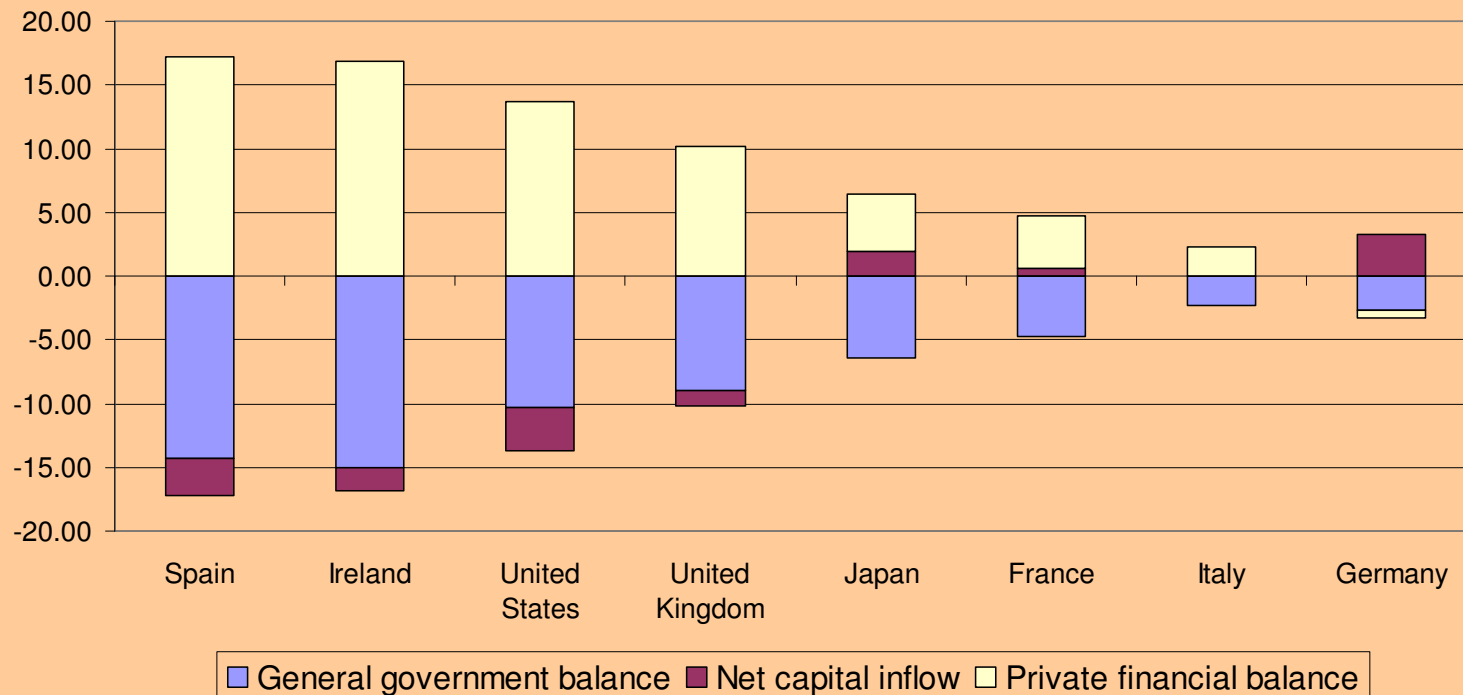
BRUTAL CORRECTION OF PRIVATE DEFICITS



2. How do we return to stability?

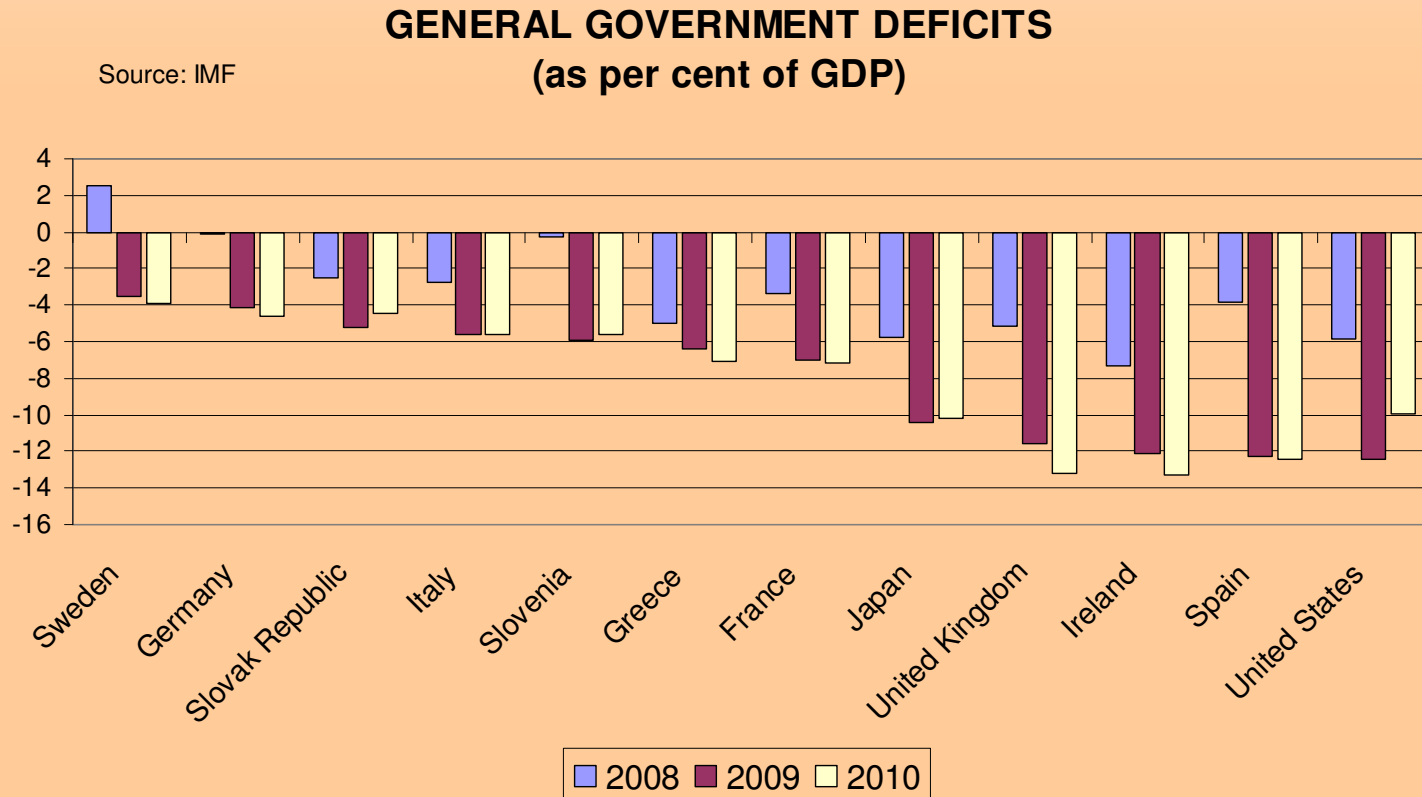
HOW THE IMBALANCES CHANGED

CHANGES IN FINANCIAL BALANCES 2006-09
(as per cent of GDP)



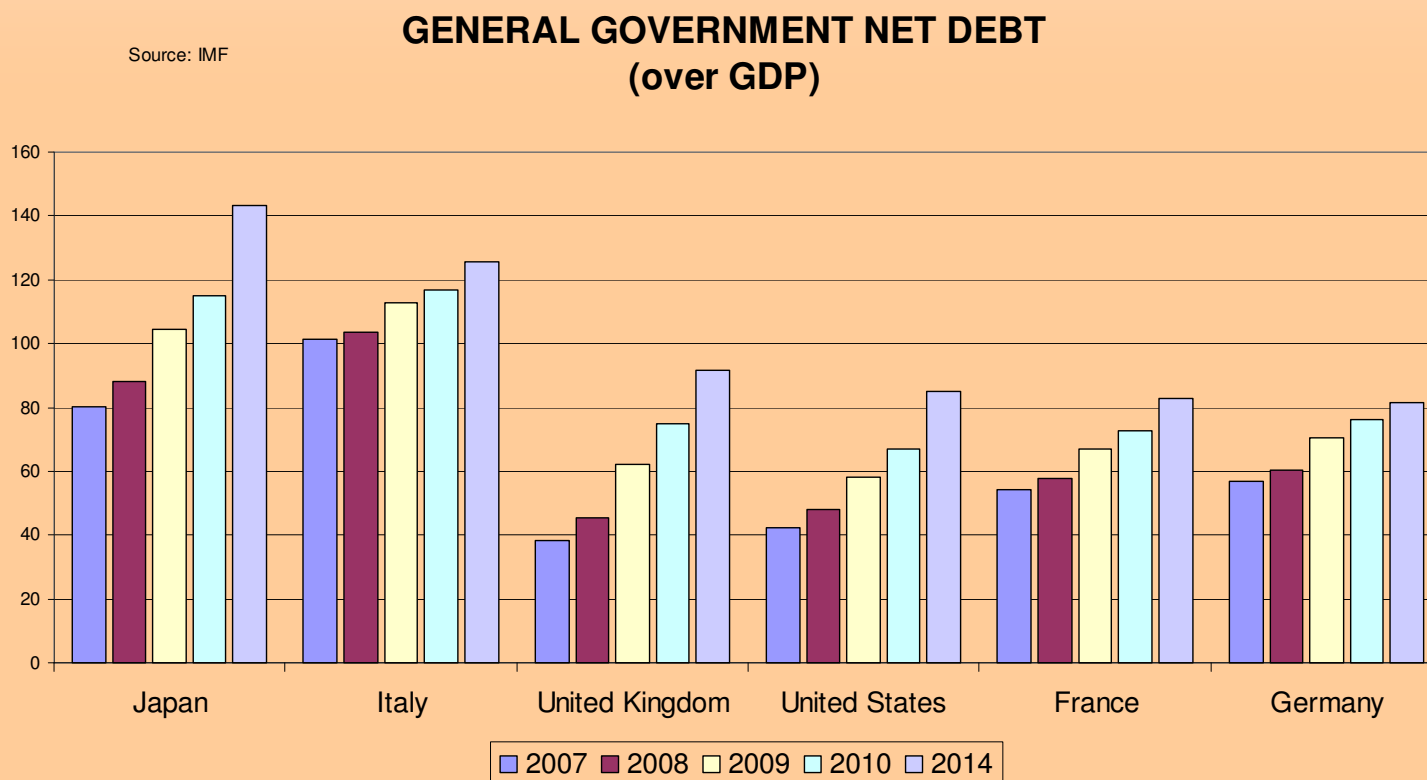
2. How do we return to stability?

FISCAL FIREPOWER USED



2. How do we return to stability?

FISCAL FIREPOWER USED UP



3. How do we return to stability?

- If the UK is to return to stability, there must be:
 - A strong recovery of either domestic private demand or foreign demand;
 - The former runs into the problem of the debt overhang;
 - The latter runs into the problem of a lack of competitiveness;
 - Certainly, it needs a strong global economic recovery.
- If neither happens, the fiscal deficit will not be easily cut.

3. How do we return to stability?

COMPETITIVENESS BOOST AT LEAST

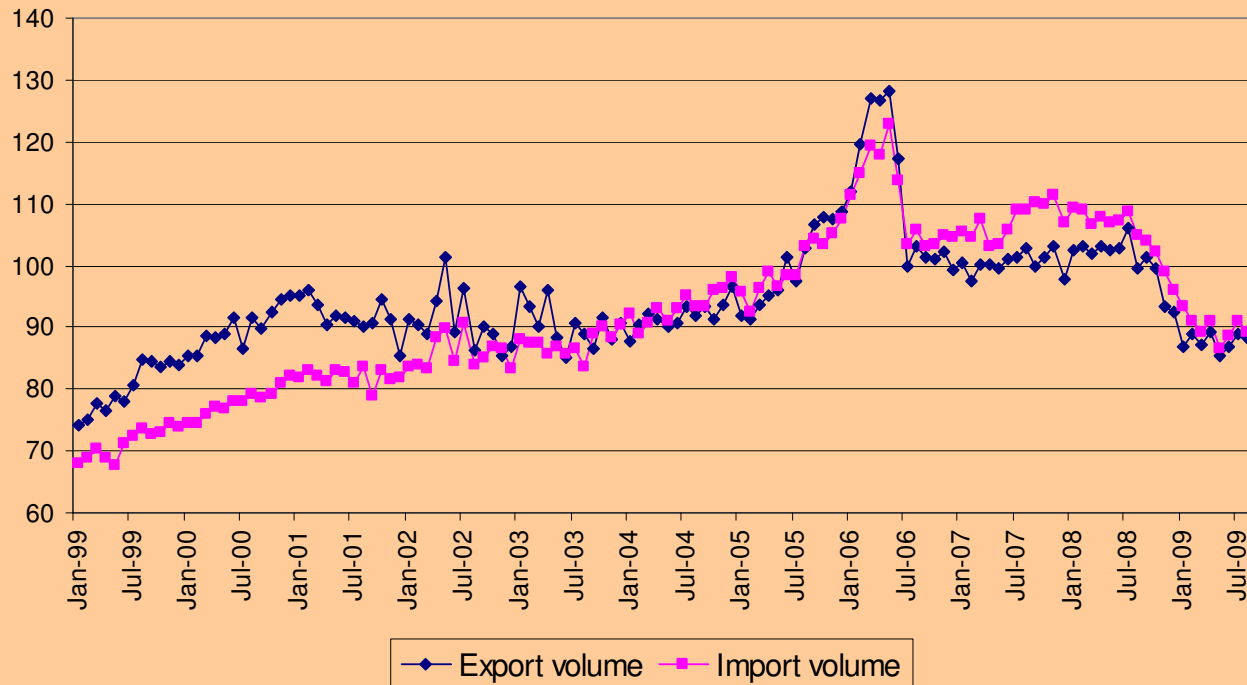
UK JP MORGAN TRADE WEIGHTED INDEX UK, REAL, BROAD



3. How do we return to stability?

DISAPPOINTING EXPORT RESPONSE

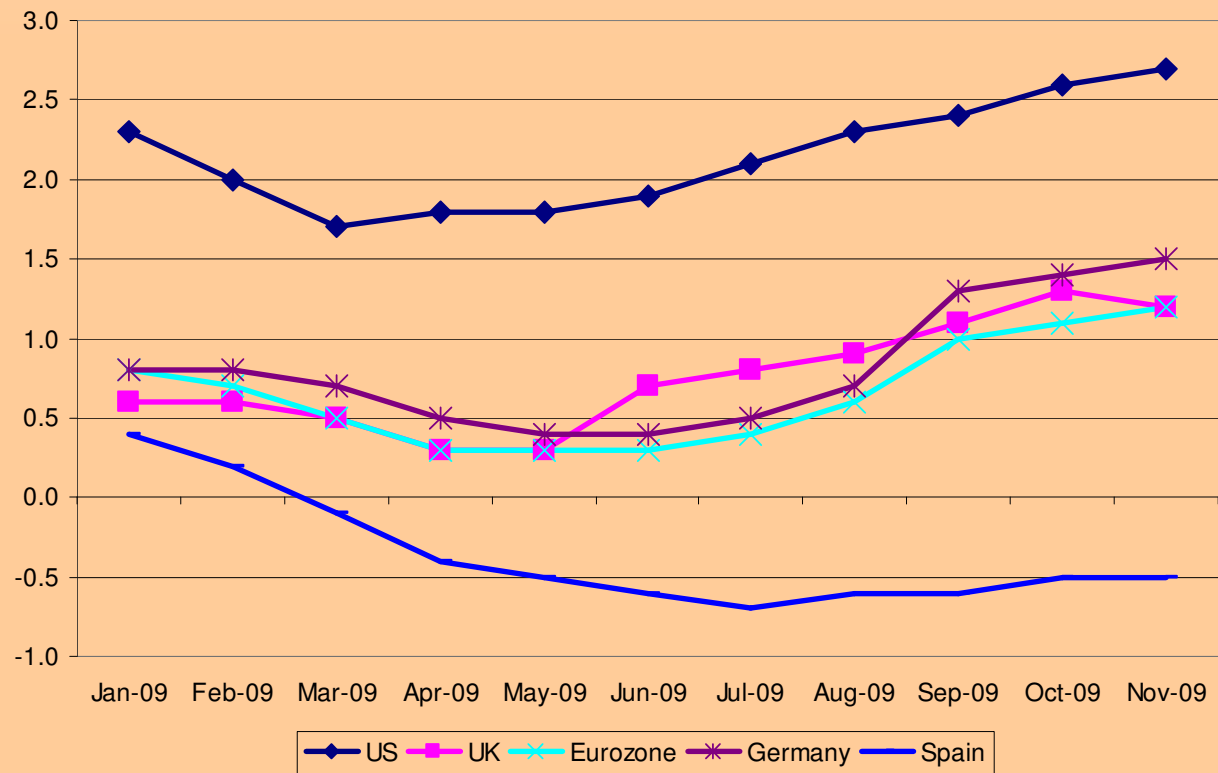
EXPORT AND IMPORT VOLUMES



3. How do we return to stability?

WEAK RECOVERY

CONSENSUS FORECASTS FOR 2010



3. What are the macroeconomic lessons?

- The crisis has three implications for macroeconomics:
 - Modern macroeconomic theory does not work very well;
 - Inflation targeting is not enough;
 - Global imbalances cannot be handled by today's global monetary system.
- Let me take each point in turn

3. What are the macroeconomic lessons?

- Modern macroeconomic theory does not work:
 - Real business cycle theory is just a joke;
 - It is not just money that matters; so does credit;
 - The financial system has an ability to generate huge mistakes, via a mixture of asset price bubbles with increased leverage in the economy and undercapitalised intermediaries;
 - These are ultimately linked to the human capacity for euphoria and panic;
 - Keynes lives.

3. What are the macroeconomic lessons?

- Inflation targeting is not enough:
 - Yes, it is hard to identify bubbles, but ignoring them is potentially catastrophic, particularly when large credit expansions go along with them;
 - These generate intense fragility in the economy;
 - It is better to be roughly right than precisely wrong;
 - Central banks should “lean against the wind”;
 - They also need “macro-prudential tools”, to deal with bubbles; and
 - Fiscal policy should be extremely aggressive, in the context of asset price bubbles.

3. What are the macroeconomic lessons?

- Global imbalances cannot be handled:
 - Emerging and developing countries have, in aggregate, become large net capital exporters;
 - This is partly to reduce financial risk, by accumulating reserve assets, and partly to promote export-led growth;
 - This has proved unstable, because advanced countries are unable to absorb these inflows effectively;
 - Part of the solution is rebalancing of demand across the world;
 - That will not happen if deficits are not made safer, via better insurance mechanisms and more generous creation of official reserves, via something like the SDR mechanism.

4. Can we fix the financial system?

- It is not true that we do not learn from history: we do - and then we forget.
- What would we have do to ensure such a mess is a really rare event?
- Answer: frighten people more or control them better.
- If you rescue everybody, you don't frighten them.
- Yes, those who worked in the “sacrificial Lehman” lost a great deal. But creditors and companies are still alive and kicking and shareholders took rational risks.

4. Can we fix the financial system?

- The big lesson here is: get into trouble together with everybody else, as “sound bankers” should and indeed did.
- You will then be fine, particularly if you are very big and very interconnected.
- This is a huge moral hazard.

4. Can we fix the financial system?

- So can we at least control the financial system?
- If we try to save the existing system, this is what we would probably have to do:
 - Raise capital requirements across the board, with a strong bias against very big, too-big-to-fail institutions;
 - Introduce an effective resolution regime for all financial institutions;
 - Push almost all trading of financial products onto exchanges.
- I think of this as making both the “nodes” and the “network” safer.

4. Can we fix the financial system?

- More radical solutions:
 - Narrow banking (John Kay), with removal of deposits from commercial banking:
 - Advantages – perfectly safe;
 - Disadvantage – almost everything that matters would be outside banking, with all the risks that government would respond to.
 - Back to Glass-Steagall:
 - Advantages – makes banks notionally safer;
 - Disadvantages – how does one draw and police this line?

4. Can we fix the financial system?

- De-leverage the economy, via taxes (or even more drastic means):
 - Advantage: fewer crises; and
 - Disadvantage: less risk-taking.
- Force pass-through of valuations, with end of limited liability for banking institutions:
 - Advantage: risk to final holders of claims;
 - Disadvantage: end of a familiar (but grossly undercapitalised) system.
- My view is that the last two radical options make a great deal of sense, particularly de-leveraging and pass through.

5. The longer-term future

- Each time we have a crisis, we launch still more aggressive monetary policy
- What is the end game here?
- Are we on a never-ending treadmill?
- Is the end game a fiscal collapse?