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Keynote Address by Professor Joseph Stiglitz, 2001 Nobel Laureate in Economics

Global Financial Integration, Economic Stability, and Asian Regional Cooperation

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Singapore

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10^{th} Anniversary of Asian Financial Crisis

- Have we learned the lessons?
  - What were the causes?
- Is another such crisis likely?
- Can regional financial cooperation enhance stability and prosperity?

- There has been no fundamental change in the global financial architecture
- The IMF diagnosis of the source of the source of the problem was wrong:
  - Not caused by lack of transparency
    - Countries that were less transparent did not have crises
    - Last set of crises were in Scandinavia

Capital Market Liberalization

- Long been associated with crises
  - – Money flowed rapidly in
  - – And flowed even more rapidly out
- Brought risk without rewards
  - – Can't build factories and jobs on money that can go in and out overnight
  - – Countries need to put aside large amounts in reserves to protect themselves
    - High opportunity costs
  - – Increasing exposure to risk; raising cost of capital

- East Asia didn’t need external capital, given high savings rate
  - – Told it would enhance stability
  - – But flows to developing countries often pro-cyclica
    - Bankers like to lend only to those who don’t need money

- *Finally,* IMF did study confirming long-standing results
  - Said it contradicted economic theory
  - But only “their” economic theory—assuming perfect risk markets, perfect competition, perfect information, infinitely-lived individuals
    - Even if all the other assumptions hold, if individuals are finitely-lived, CML can lead to increased volatility
  - Tried to say benefits of CML felt indirectly, through other channels (like governance)
    - Reduced-form effects should still come through in data
    - Links to other channels not established, either in theory or in data

IMF policies contributed to problems

- Both in causing crises
- And in responses
  - – Pro-cyclical monetary and fiscal policies
  - – Lack of sensitivity to distribution
  - – Contributed to political and social instability
    - With high economic costs

Another East Asian crisis is not likely

- In spite of the fact that risk premia are unusually low
- Asian countries are protected by large reserves
- More borrowing in domestic currencies
- Fewer running large current account deficits
- But there are some countries that still have large debts denominated in hard currencies that could be affected by a change in global interest rates
- But not all is well with global financial markets

Anomalies and problems

- Capital is flowing from poor countries to rich
- Poor countries are forced to bear risk of exchange rate and interest rate fluctuations
- Large number of financial crises
- High level of volatility
- Large number of countries facing excessive debt burdens
- No systematic way of resolving debt burdens

Problem of debt

- If only one country had a problem, could ascribe it to borrower profligacy
- But large numbers suggests there is a systemic problem
- Debt forgiveness welcome
  - But unless something is done about underlying problems, debt problem may reappear

Preventing Excessive Debt

- Limiting borrowing in foreign currencies
  - Bearable debt levels can quickly become unmanageable
    - Moldova
  - Real advantage of high savings rates
  - Requires establishing local debt markets
    - Asian bond market
    - Tax and other policies to encourage?

Global Financial Imbalances

- IMF just beginning to debate topic
- But has not been able to do anything
- And may not be able to do anything, given its governance
- Standard discussion involves shared blame
  - U.S. fiscal and trade deficit
  - European slow growth
  - China’s undervalued currency

U.S. Bears Disproportionate Blame

- U.S. deficit is more than $850 billion
  - China's multilateral surplus is only about $150 billion
  - So even if eliminating China's surplus fully translated into a reduction in U.S. deficit, U.S. deficit would still be more than $700 billion
  - Likely would have no effect: U.S. would just buy textiles from Cambodia and Bangladesh
  - But Cambodia and Bangladesh less likely to be willing to finance U.S deficits
  - **So global instability might actually be increased if China revalued its currency**

China is trying to reduce multilateral trade surplus

- Through reducing savings
  - Unique problem: savings too high
  - One of key parts of 11th “five year plan”
  - Debate about best way to do this
  - But so far has failed
- More effective than through adjustment of exchange rates
  - Huge disruptive adjustments might be required
  - Which could exacerbate some key problems, such as rural poverty

Are global imbalances a problem?

- "Normal" economics has some countries borrowing from others. Why worry about U.S. borrowing?
  - Something peculiar about richest country in the world not being able to live within its means
    - $500 billion last year flowed from poor countries to rich countries
  - Deficits OK when money is being spent on investment to make economy more productive
    - Problematic in the U.S.
  - Given demography, this is a period in which the U.S. should be saving, not borrowing
- Worry is that there will be a disorderly adjustment

Many reasons to worry

- Fears of U.S. economic downturn
  - Growth during last few years led by real estate
    - Investment
    - Taking money out of real estate through refinancing mortgages, home equity loans
  - With declining real estate prices and crisis in the sub-prime mortgage market, this is all coming to an end
    - Problems not limited to sub-prime mortgage market
    - Speculative real estate investment already stalled
- What will replace it?

Not consumption…

- Real incomes of average Americans have not been doing well
  - Median income of males in their 30s lower today than it was 30 years ago
    - Problems exacerbated in last five years
  - At the same time that real labor costs are increasing, we have:
    - Slowing rate of productivity growth
    - Increasing costs of health care

Not investment…

- Investment is weak
  - – And likely to remain so, as long as there remains uncertainty about growth
  - – Risk of increasing interest rates
    - Fear of inflation

Anomalous juxtaposition

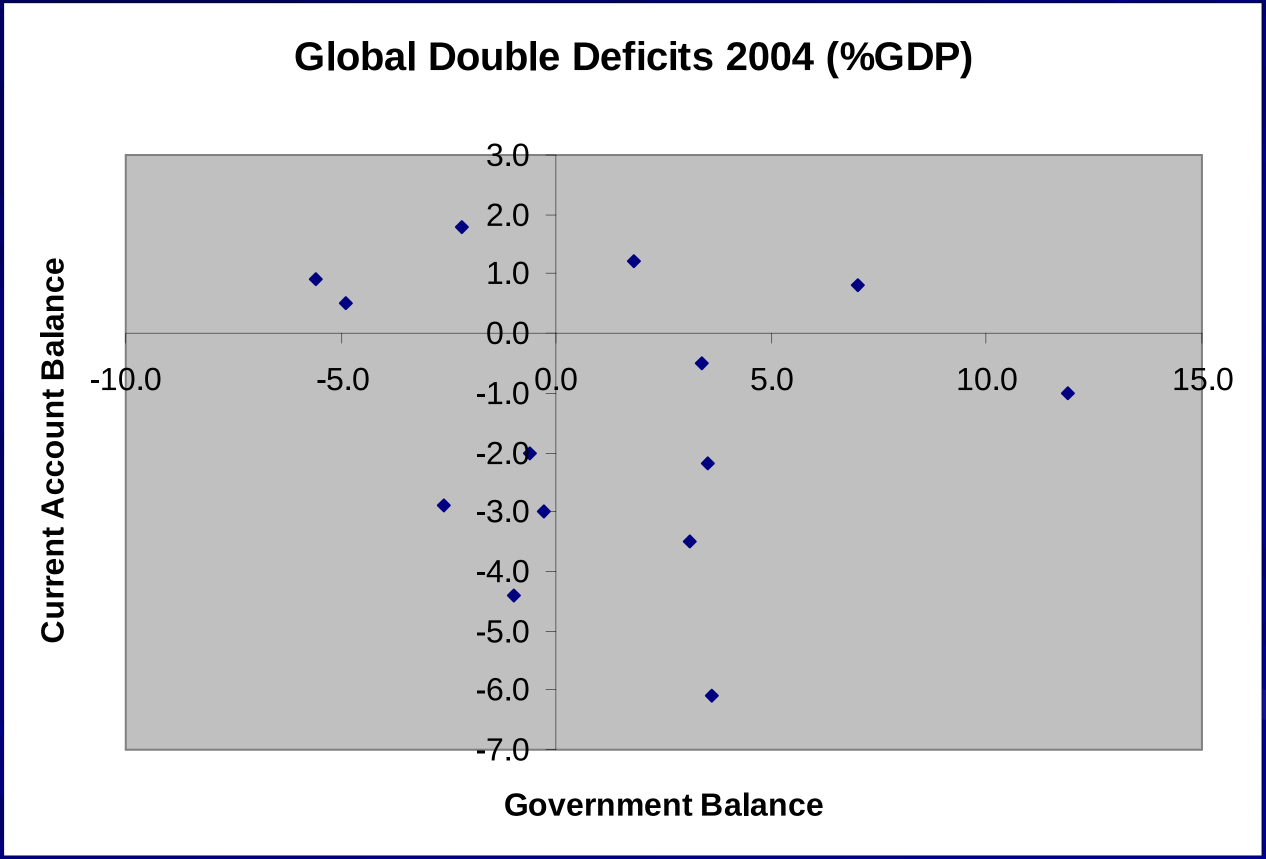
- Period of high risk with low risk premium
  - Added risk of return to more normal risk premium
  - Effects would be felt in many markets
    - Highly indebted developing countries
    - Medium and long term bond markets
      - Exacerbating problems in real estate

- Bears have been predicting problems for some time
  - It didn’t happen last year
- Two views:
  - Bears are wrong: downturn is unlikely
  - Bears are wrong in *timing*: downturn *more* likely, but has not happened yet

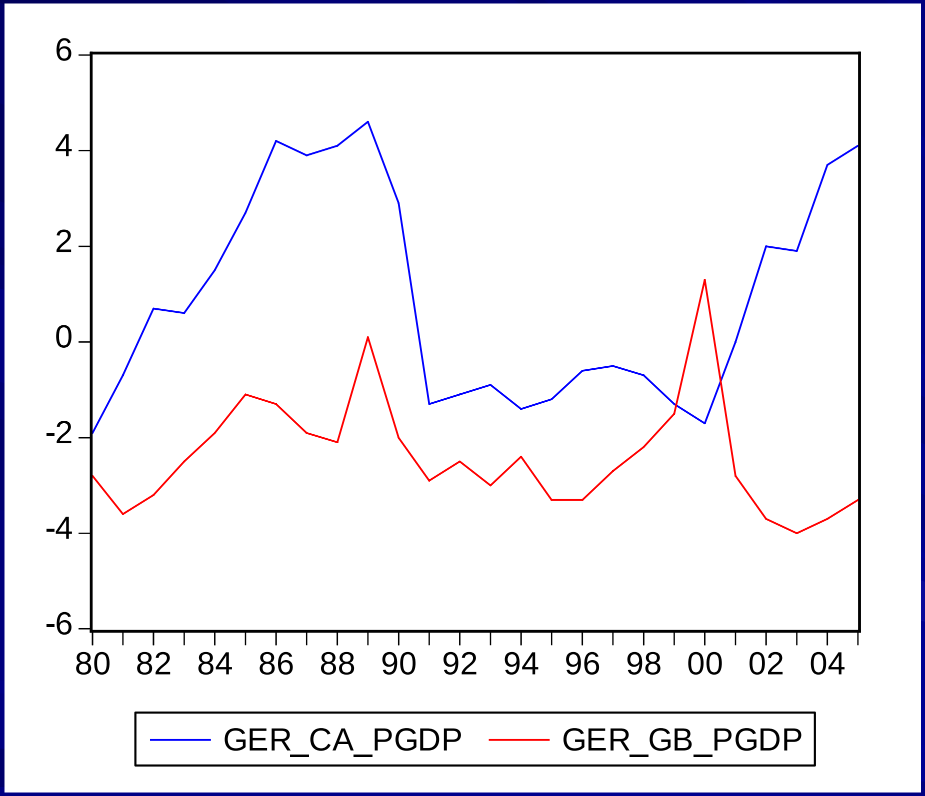
Who is to blame for Huge Trade Deficit?

- Standard argument: twin deficits
  - Fiscal deficit leads to trade deficits
  - In partial equilibrium setting, relationship is clear
    - TD = CF = Investment – Domestic Savings
    - *Ceteris Paribus,* an increase in the government deficit reduces domestic savings, and exacerbates the trade deficit (TD)/Capital inflows (CF)
      - On the other hand, in a Barro-Ricardo world, public borrowing is offset by increased private savings
      - But even if there is *some* effect, it is not large enough
    - More to the point: we are not in a *ceteris paribus* world
- Data tells a different story…

Cross Section: No systematic relationship between fiscal and trade deficits for most countries



Germany



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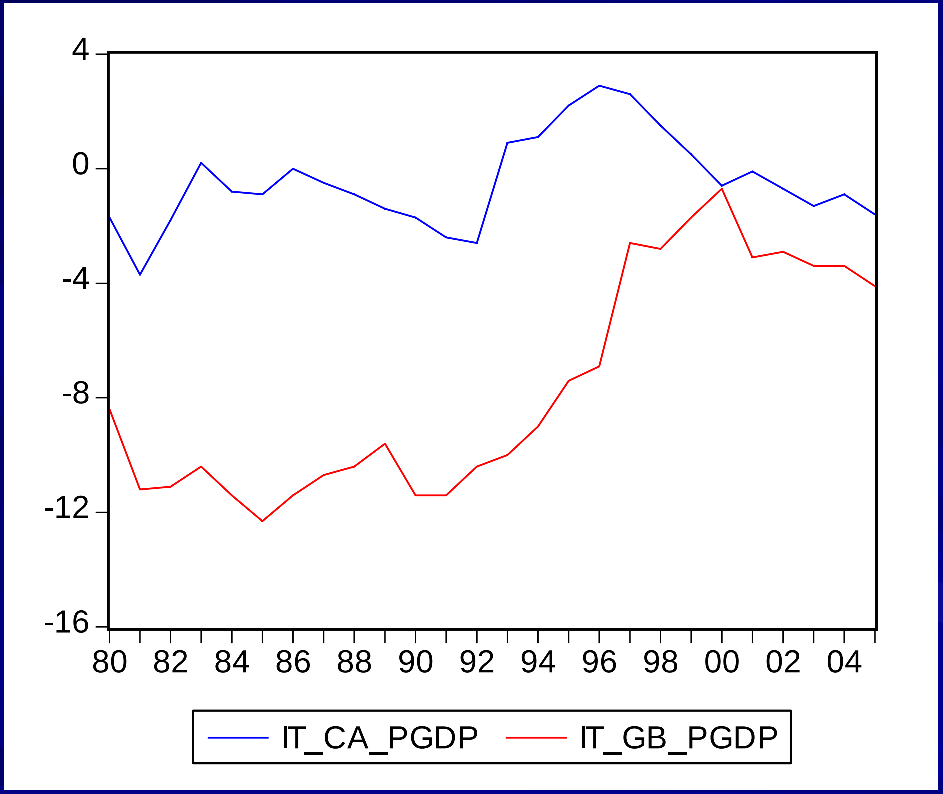

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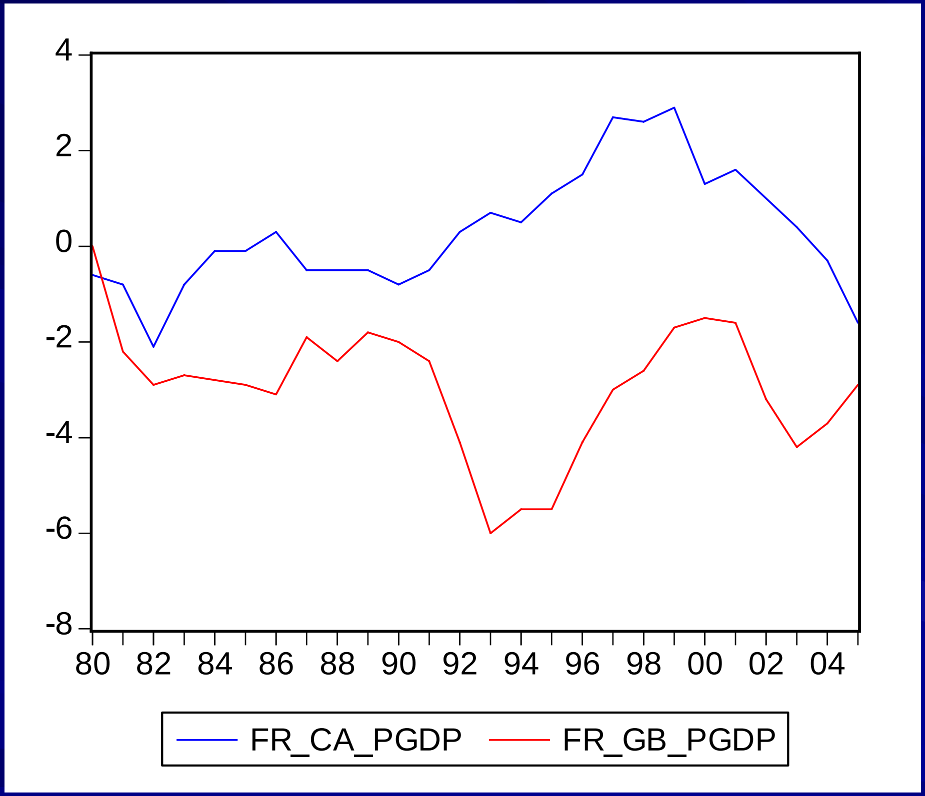

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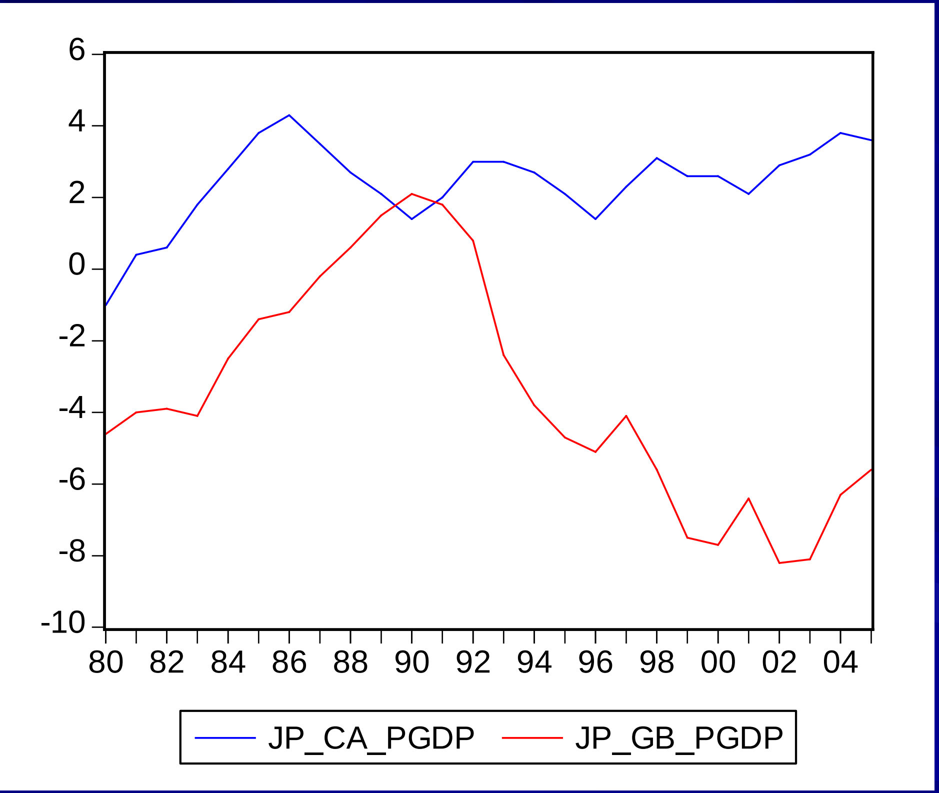

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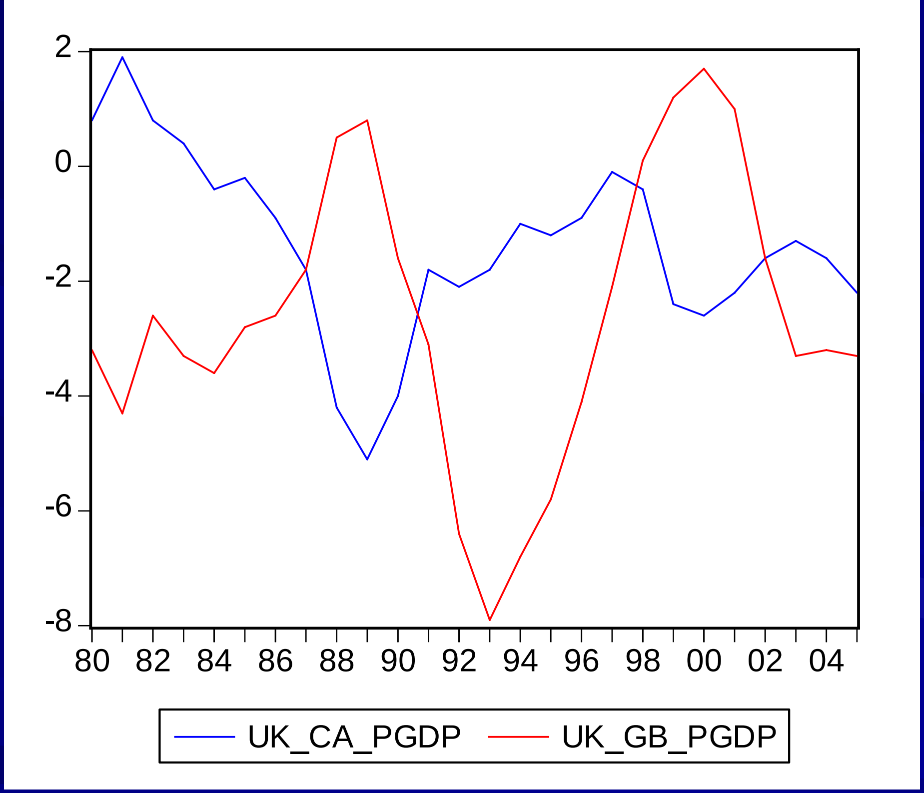
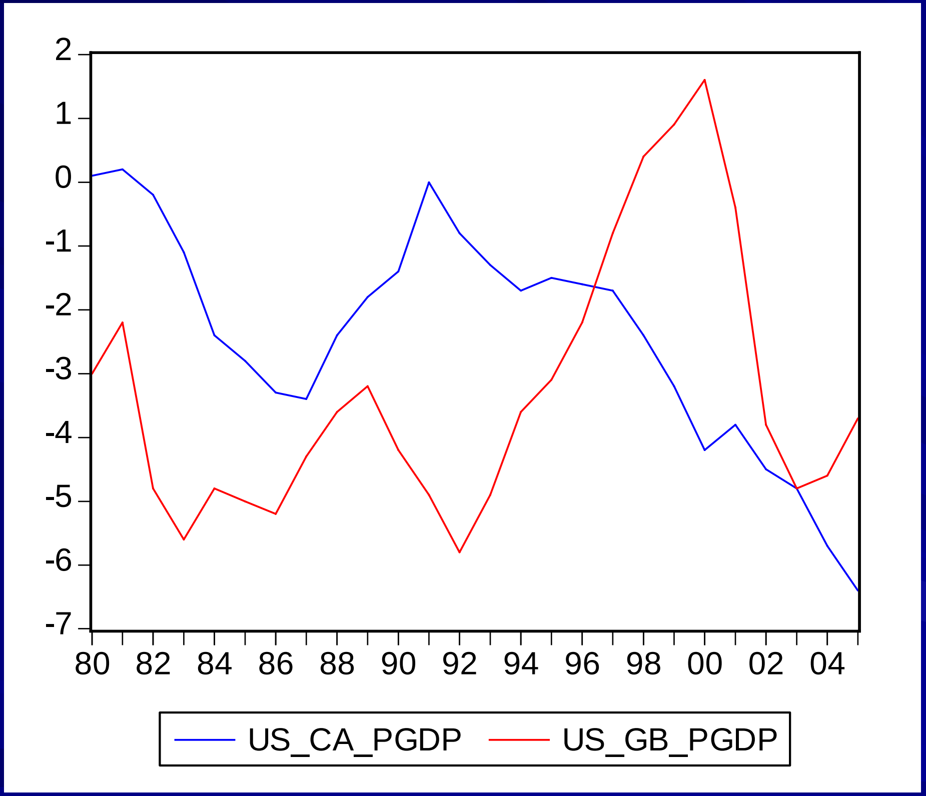


US



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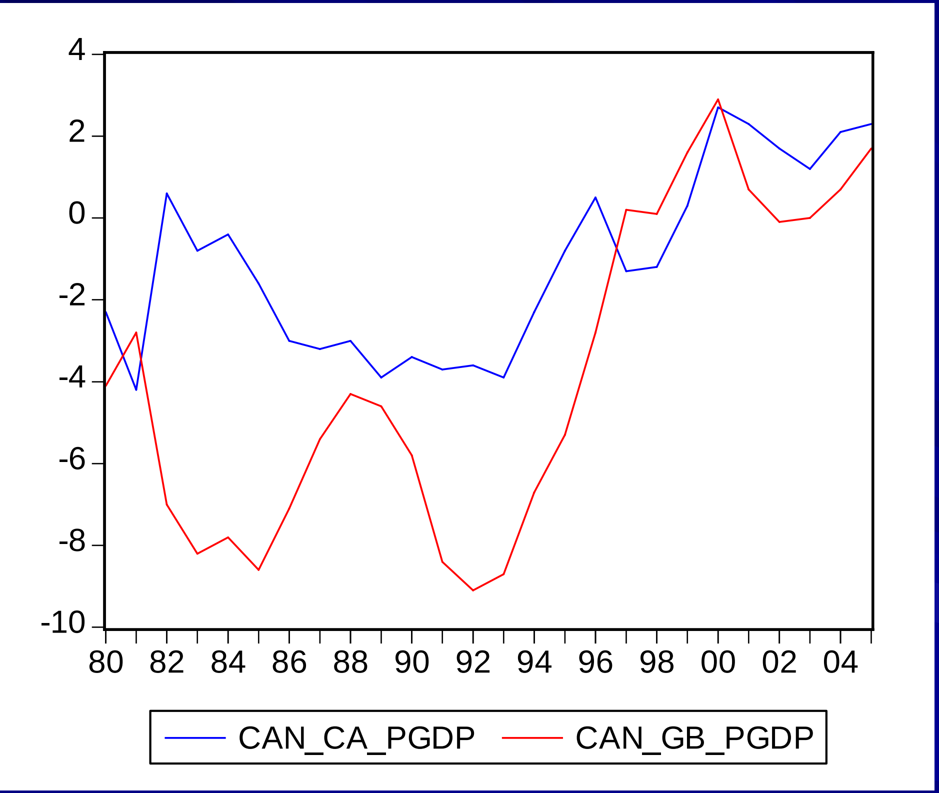
Canada displays apparent causality



- In the case of Canada, the Current Account Balance appears to cause the Government Balance, but not vice-versa

An alternative view

- Fiscal deficits are endogenous
  - What is required to maintain the economy at full employment?
  - Capital inflows are *exogenous*
    - Foreigners want to hold T-bills in reserves
    - Exchange rates and other asset prices adjust to make sure this is possible
  - But since Trade deficit = CF, that means trade deficit is effectively exogenous
    - Negative effect on domestic aggregate demand
      - U.S. is exporting T-bills rather than automobiles
      - But T-bills do not generate employment
    - Government must offset this, either through monetary or fiscal policy
    - It is in this sense that trade deficit *causes* fiscal deficit
    - In the 90s, irrational investor boom meant government deficit was not needed — but that was an exception

Implications

- It is the dollar reserve system that is at the root of the problem
  - UK had a similar problem when sterling was reserve currency
- The U.S. — and world — would be better off shifting to a global reserve currency
  - Current system is inherently unsustainable
  - As IOU’s accumulate, confidence in dollar erodes
  - If confidence erodes, Central Banks may move out of dollar, weakening dollar, reinforcing problem
  - Is there a tipping point? Are we near there?
  - The dollar reserve system is fraying

Instability

- Basic trade identity: sum of surpluses = sum of deficits
  - If some countries insist on having a surplus, some others must have deficit
  - Hot potato of deficits: as one country eliminates its deficit, it appears somewhere else in the system
  - US has become deficit of last resort
    - Apparent in statistic
    - But is this sustainable?

Implication

- Surplus countries are as much a part of systemic problem as deficit countries
  - Keynes emphasized negative effect on global aggregate demand
  - Should “tax” surplus countries to provide appropriate incentive

Further problems: Insufficiency of global demand

- Purchasing power “buried” in ground
- In past, deficiency was made up by loose monetary and fiscal policies
  - But countries who provided this global service were punished through crises
- U.S. has become consumer of last resort
  - Prides itself on providing this global service
  - But something is wrong with a global financial system which requires the richest country of the world to spend beyond its means to maintain global prosperity

Further problems: Inequities

- Developing countries are lending trillions of dollars to the U.S. at very low interest rates
  - Consequences most clear at micro-level, with standard prescription—keep dollar reserves equal to short term dollar denominated debt
    - Firm in poor country borrows $100 million from U.S. bank at 20% interest
    - Country has to put $100 million in reserves: $100 million in T-bills implies lending to US
    - Net flow zero *except* interest received 5%, interest paid 20%
    - Form of foreign aid by poor countries to U.S.
      - Magnitude greater than U.S. aid to developing countries

Current system is fraying

- Process may be unstable
  - Growing lack of confidence in dollar
    - Feeding on itself
- Problems getting worse
  - Risk of crises and IMF intervention has contributed to countries accumulating huge amounts of reserves, mostly in dollars
  - Increase in risks one of major underlying factors in reserve increases

- Asia is major source of global savings
  - Paying high price for re-circulating savings in West
  - Beginning to explore alternatives
    - Investing in more attractive alternatives
  - Chang Mai initiative—sharing reserves
    - Still limited
    - And can't move out of dollar without affecting exchange rates

PROPOSAL: Global reserve currency

- Issued in amount commensurate with reserve accumulation
  - Offsetting negative effect on aggregate demand
  - Would thus not be inflationary, would avoid deflationary bias of current system
- Would enhance global stability
  - Inherent in any single country being reserve currency
  - But would provide an additional degree of flexibility
    - Countries could run a small trade deficit without having a problem
    - Net reserves would still be increasing

- Could provide incentives to *not* have surplus by reducing surplus country's allocations of global reserve currency
- New allocations could be used to finance global public goods and development
- Would not be inflationary as long as annual emissions were less than or equal to increases in reserves

- There are two actual precursors—IMF SDR's and Chiang Mai Initiative
  - SDR's episodic, and U.S. has vetoed last expansion
  - Proposal can be thought of as globalization and refinement of Chiang Mai initiative
  - A European/Asian joint endeavor would be a way of introducing it
  - U.S. will resist, since it thinks it gains from low interest loans
  - But it loses from high instability
  - And amounts of loans will in any case be decreasing

- Some in Europe aspire for the Euro to become global reserve currency
  - Europe would have same problem: high price to pay for getting cheap loans
  - Worse because Europe’s hands are tied
    - Growth and Stability Pact
    - Central Bank focusing only on inflation
  - Two-country reserve system may be even more unstable
- Can only hope this wish is not realized

Summary

- Reform of global reserve system is essential if we are to deal effectively with global imbalances
- A global reserve system is required
- Many alternative institutional arrangements
- Likely to lead to a more stable — and more equitable — global financial system