Is global finance out of control?

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Dear Anatole

26th October 2007

Newspaper accounts of the current financial turmoil have focused on its specific causes, beginning with its origins in the US market for sub-prime mortgages. But serious financial crises have occurred in parts of the rich world every three to four years over the past two decades; and in the "emerging market" periphery, 94 countries experienced at least one severe currency crash between 1990 and 2003. These frequencies are an order of magnitude higher than during 1945 to 1970. A "system" which permits this much instability is not much of a system. To understand the current turmoil we need to examine not only the specific causes—the inner wheels—but also the outer wheels driving financial instability in the world at large over the past two decades.

One outer wheel is the dollar standard. Under this arrangement the US dollar is the main global currency, and the US Federal Reserve can create dollars without a supply-side limit (such as convertibility into gold). Provided US trading partners are prepared to accept payment in dollars, the US can run almost unlimited deficits just by printing the dollars or treasury bonds with which to pay for them.

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The dollar standard contains no mechanism to correct trade imbalances between countries. The US current account deficit has increased almost without interruption since the early 1980s. These deficits have enabled the US to enjoy both guns and butter at the same time (rising military expenditure and rising consumption), financed by increasing amounts of domestic and foreign debt.

A second outer wheel is the response of central banks in the countries running trade surpluses, such as China. Without central bank intervention their currencies would tend to appreciate. To maintain export competitiveness and boost employment—and in the case of China, to support the currency peg with the US dollar—the central banks buy the dollars in the hands of exporters in return for newly created domestic currency. When the People's Bank of China buys dollars, it holds the yuan steady and prevents the dollar from falling against it—yet the dollar "should" fall against the yuan to reduce the US external deficit.

Meanwhile, the central banks use their increasing stock of dollars to invest in US assets in order to earn a return. This pushes up asset values in the US, including property and treasury bonds. Higher bond prices go with lower yields and lower interest rates. Lower interest rates push up US consumption, US domestic debt and US imports, and cause the US deficit to grow even bigger.

The interaction of these two outer wheels has generated impressive economic growth in both deficit and surplus countries, but it is inherently unstable because of its impact on trade imbalances. Large trade imbalances generate financial fragility through several channels. One of them is the borrowing from the rest of the world that is needed to finance deficits. The capital inflow pushes up the deficit country's currency—shifting it in the wrong direction for reducing the deficit.

The perversity of the system is seen in the fact that of the 17 non-minnow countries with the biggest current account deficits between 1996 and 2006, 14 experienced appreciation of the real effective exchange rate, three had no change, and none depreciation. Of the seven countries with the biggest surpluses, five experienced a depreciation.

This is a topsy-turvy world, where the international financial system pushes exchange rates the wrong way, amplifying rather than reducing current account imbalances. Bubbles in the markets for credit, foreign currency and houses become more likely, often followed by crashes. It is not that financial markets are irrational. The problem is that unrestricted capital inflows prevent the mechanism of depreciation from working. More recently, the instability has been amplified by a third outer wheel, consisting of the arrangements for splitting, spreading and hiding risk, to the point where no one is able to assess it or take responsibility for it.

We need to reconfigure these outer wheels. We need stronger co-ordination on exchange rates, which could be global but more feasibly will be regional (as we see between the eurozone and east/central Europe, and also within east Asia). We also need a change in international norms in order to sanction governments' use of restrictions on certain types of capital flows in certain conditions. We need central banks to set interest rates with more attention to the exchange rate. And we need an international arrangement that puts adjustment pressure on both surplus and deficit countries, as Keynes

urged at Bretton Woods in 1944.

Unsurprisingly, the financial services industry is hostile to these ideas, for it thrives in the present architecture of the dollar standard, free capital movements and unregulated markets for hiding risk. This architecture helps to blow up a constant supply of bubbles around the world, new bubbles emerging as others collapse. Bubbles are good for the financial industry, because they provide expanding opportunities for profitable arbitrage. In this way the financial industry accrues a steadily rising share of national income, the share of labour income falls, and the share of world income accruing to the top 0.1 per cent of recipients continues to soar. Where is the countervailing power?

Yours

Robert

Dear Robert

1st November 2007

There are four main problems with your argument. The first is that most of your so-called financial crises have not been real crises, but simply large fluctuations in prices, with minimal impact on the world economy. After all, if, as you say, the world has suffered a "crisis" every three years, given that it has grown steadily richer throughout that period—with unemployment and inflation at record lows and real per-capita incomes growing rapidly in every region of the world (including, in the past five years, even Africa)—perhaps one should question the use of the word "crisis." Alternatively, we ought to be praying for more of these "crises."

The "financial turmoil" which you say has characterised the past 20 years has coincided with much better economic conditions—in terms of both growth and stability—than the world ever knew in the good old days of fixed exchange rates and regulated financial markets for which you seem to pine. The remarkable decline in economic instability during the past 20 years—which has been well documented by academic researchers and has been titled "the great moderation"—is closely connected to the abandonment of fixed exchange rates and the deregulation of financial markets, since these reforms have given competently run central banks the freedom to fine-tune macroeconomic demand with a degree of precision that Keynesian economists of the 1960s would never have dreamed possible. The best example of the benign macroeconomic effects of abandoning fixed exchange rates has occurred right here in Britain. It is not a coincidence that the only 15-year period in British economic history without a recession or even a single quarter of falling GDP began in the summer of 1992. This was precisely the point when the treasury was forced by the ERM crisis on Black Wednesday to abandon its century-old effort to control the pound by linking it to gold, dollars, deutschmarks or any other external standard of value. As a result, the Bank of England was able, for the first time in history, to use monetary policy to manage domestic economic activity, instead of vainly trying to stabilise the currency or defend some arbitrary exchange rate. The result has seen Britain transformed from the most volatile, poorest and slowest growing economy in the G7 into the second richest and most stable of the G7 economies in just 15 years.

ROBERT WADE:

Bubbles are good for the financial industry, because they provide opportunities for making money

Your second, even bigger, misconception is the assumption that international trade imbalances are somehow unhealthy or even unnatural. You seem to believe that there is something inherently unstable about the US economy buying more from the rest of the world economy than it sells, while other countries export more than they import. There are many theoretical arguments against your proposition, but the most persuasive objection is simply empirical. These deficits have been described as "unsustainable," yet they have been sustained for decades with no apparent ill effects. You believe that America's trade deficits will have to be "corrected" with potentially catastrophic consequences. My conclusion is, I believe, more logical: if the US deficits have been sustained for 20 years with no ill effects on the economy, this surely implies that they are not "unsustainable." But how could the US deficits of over $700bn—more than 6 per cent of GDP—have been sustained for so long? It boils down to one point: the ability of economies as big as America, Spain or Britain to finance trade deficits is limited only by their capacity to create productive assets which they can sell to foreigners or use as collateral for foreign borrowing. The stock of these assets is several orders of magnitude bigger than the deficits these countries have been running in the past 20 years. In the case of the US, for example, the net assets of the private sector are worth roughly $60 trillion—almost 100 times the amount which America has to borrow annually to finance its current account.

ANATOLE KALETSKY:

The "financial turmoil" of the past 20 years has actually meant higher growth and more stability than before

My third disagreement is with your assertion that large persistent trade imbalances, even if they can be financed, are an unhealthy symptom of America's excessive consumer spending, underwritten by the dollar's privileged status as a reserve currency. There are two objections to this proposition. The first is that America has not been unique in running large and persistent deficits. In fact, Britain, Australia, Spain, New Zealand and many other major economies have run accumulated deficits as large or larger than America's, relative to the size of their economies. Spain, for example, has had current account deficits of 8 to 10 per cent of GDP since the start of this decade, while the US deficit peaked at 8 per cent of GDP and is now in clear decline. Yet the British, Spanish and Australian currencies have no special status in the global financial system, which suggests that the dollar's use as a reserve currency is a red herring in this debate. Moreover, large trade deficits have done none of the economies concerned any visible harm. On the contrary, among the large OECD countries, those with persistent trade deficits have mostly had the healthiest economic conditions—faster economic growth, lower unemployment, tamer economic fluctuations and greater improvements in living standards—while the countries with big surpluses, most notably Japan and Germany, have been falling behind in all these respects. This is no coincidence, because large trade deficits, far from being a cause of economic dislocations, have actually been a *consequence* of rapid economic growth. If some countries (such as America, Spain and Britain) run their economies at full speed in order to maintain maximum capacity employment, while their main trading partners (such as Germany and Japan) allow their economies to stagnate, then the fast-growing countries naturally

ROBERT WADE:

Privatisation of exchange-rate risk means everyone has to hedge. But hedging contracts last just six months

tend to experience trade deficits.

Finally, you suggest not only that international imbalances have been a cause of instability but that the alleged crises in the financial system have been responsible for the extraordinary prosperity of the global financial industries and for the relative impoverishment of the working class. It seems a paradox, to put it mildly, that a distortion which supposedly weakens the global financial system simultaneously enriches the companies and individuals who work within it. The linkage with the declining share of labour income in the world economy is even more obscure. You end your argument with a rhetorical question: "Where is the countervailing power" to the growing dominance of global finance? You may be surprised to learn that I am as worried by this question as you are. Sooner or later, something will have to happen to reverse the ever-widening inequality created by unrestrained global capitalism. But such intervention, whenever it occurs, will have to reflect explicit political decisions, consciously taken by accountable government authorities. To imagine that unacceptable political outcomes necessarily reflect failures or imbalances of the global economic system is not just wishful thinking—the idea that financial crises will automatically correct the social injustices created by the global economic system is market fundamentalism of exactly the kind you denounce.

Yours
Anatole

Dear Anatole

3rd November 2007

I wish I could share your optimism. It reminds me of the person falling from the 36th floor who reports at the 23rd floor that everything looks fine. Yet banks and mortgagees are gripped by anxiety and central banks in Europe, the US and Britain have had to inject nearly half a trillion dollars into the credit system.

In the same spirit of optimism, you say that over the past 20 years, real per-capita incomes have been growing rapidly throughout the world, and that economic progress has been significantly faster in this period compared to the post-war decades of fixed exchange rates and regulated financial markets. What are your sources? I provide lots of evidence to the contrary in my essay in the book *Global Political Economy* (OUP). For example, growth of world GDP per head fell by almost half between 1960 and 1978 and between 1979 and 2000, from 2.7 per cent to 1.5 per cent (B Milanovic, *Worlds Apart*, 2005). Most regions experienced the big slowdown. For the OECD as a whole, and for the US, Europe and Japan separately, the rate of growth per head fell in every decade from 1960-73, 1973-79, 1979-90 and 1990-2004. The fall between 1990 and 2004 is especially telling, because by this time the 1980s policies of squeezing inflation, deregulating, privatising and liberalising trade and capital movements had worked themselves through.

You say that financially advanced countries can run large trade deficits, and have periodic "domestic" financial crises, without disturbing the international economy because they can count on flexible exchange rates and accommodating financial capital flows. So we should not worry about trade imbalances, because the capital account (capital flows) can be relied on to balance the trade account (trade flows).

It is true that the advanced countries have been able to balance their trade account via the capital account for the past 15 to 20 years. But for how much longer? Instability in domestic asset markets (equities, property) is making foreign financiers more wary of investing in their assets and accepting their currencies as means of payment. In the case of the US, balancing capital flows depends on the willingness of foreign banks, especially central banks, to add dollars to their assets. Their willingness may well weaken as US interest rates fall and as the US credit crunch causes asset prices to fall.

There is also a longer-term reason why the sustainability of trade deficits is in question. Growth rates in deficit countries like the US, Britain and many in eastern Europe may, as you say, look good compared to surplus countries like Germany and Japan, but their deficits go with a loss of competitiveness as wages rise faster than productivity. The deficit countries experience an erosion of their industrial base as a result of living beyond their means. For the overall economy there is no way to regain competitiveness other than a large devaluation—which will likely come with a crisis, because with free capital flows financial markets can get exchange rates wrong for a long time.

Your City of London perspective leads you to hardly mention the emerging market countries, and you vastly underestimate the real costs of internationally generated financial crises in developing countries over the past 20 years. Think of east Asia in 1997-99, Brazil in 1998-99, Argentina 2001-02. Indeed, the real-economy costs were high in most of the 94 countries which in 1990-2003 experienced at least one currency crash.

So both rich countries and emerging-market countries do have to worry about the impact of persistent trade imbalances on financial stability. Global economic governance has to find a better way to rein in trade imbalances, which are intensified by the way that foreign exchange markets push exchange rates in the wrong direction.

Now to your "paradox... that a distortion which supposedly damages and weakens the global financial system simultaneously enriches the companies and individuals who work within it." It is not a paradox. Under the Bretton Woods system of international monetary relations, exchange rate risk was managed by states. A businessperson in Britain wanting to do long-term trade with the Americas or anywhere else knew that states would ensure that most exchange rates remained aligned (and the IMF defended the system). The post-Bretton Woods non-system has privatised exchange rate risk. Now nobody has a clue where exchange rates will be in three years' time, so no one can make rational calculations of the profitability of investments or credit over the long term. So everybody has to hedge. But hedging contracts last only six months. So everybody also has to go short term and be concerned with quick gain. This is what Wall Street and the City cater to. The more short term, the more millions they make.

Doesn't that solve the paradox?

You say that the link between the mushrooming growth of the financial sector and the declining share of labour income is obscure. The link comes through the fact that national economies are growing at single-digit growth rates, while the financial industries are receiving double-digit rates of return (Deutsche Bank advertises that it "needs" a 25 per cent rate of return annually). In the OECD, the share of labour remuneration in business income hovered around 70 per cent for decades after the second world war, rose to 72 per cent by 1982, and then fell steadily to 64 per cent by 2003.

Finally, we agree that "something will have to happen to reverse the ever-widening inequality created by unrestrained global capitalism." You go on to say that this "something" will have to come from explicit political decisions, as distinct from a serious market downturn. But what might prompt the political decisions to rein in income inequality? There's not much sign anywhere—not in the west, not in China or Russia or Brazil—that governments are worried about the prospect of inequality going still higher. What has pushed governments to act in the past is an economic or security crisis serious enough to generate a sense of a "fate-sharing community."

Yours
Robert

Dear Robert

9th November 2007

You hark back to the 1960s and 1970s as a golden age. You claim that the weakening of state control over currency relations coincided with a slowdown in economic growth from 1979 onwards. While statistical quibbling is often unproductive, the difference in our figures is worth probing here because it sheds light on our contrasting views of financial reform.

Our real dispute relates not to statistics but to the driving forces of economic history. The rapid growth rates of the 1960s were mainly driven by the postwar reconstruction of Europe and Japan and their technological catch-up with the US. This process ended by the mid-1970s, and it is hardly surprising that global growth rates declined. I think it is more illuminating for our debate to split postwar economic history into three periods.

The first period, which might be described as a "golden age" of state-led economic management, lasted from the end of the Korean war until the breakdown of the Bretton Woods system in 1972 and the global inflationary crisis of 1973-74. This era of very rapid—but increasingly unstable—growth was followed by a period of economic chaos when some regions were trying to revive a state-led system based on fixed exchange rates while others were adopting free market solutions based on domestic monetary targets. This period of confused experimentation lasted from 1974 to around 1990, ending definitely in Europe in 1992 with the break-up of the ERM and the acceptance of a bipolar approach to international monetary relations: an irrevocably fixed single currency within Europe and a completely free currency float against the rest of the world. I generally take 1992 as the starting point of the next, much more stable, period because that year also marked the final collapse of the Soviet Union and the universal acceptance of the market system as the only effective way of organising economic activity in all societies.

If we look at the economic performance of these three distinct eras, statistics show that the "non-system" of the 1992-2007 period has worked pretty well. Of course, the global growth of 4.9 per cent achieved in the 1950-73 period was faster, when Europe and Japan were catching up with the US. But the 3.9 per cent growth rate from 1992 to 2007 was substantially stronger than the 3 per cent growth in 1974-91 (IMF World Economic Outlook database). More importantly for the purpose of this debate, the past 15 years have been remarkably stable. Since 1992 there has been only one, very mild, global recession and no serious inflationary outbreaks, in contrast to the three serious crises between 1974 and 1991. Growth has also been better distributed around the world. While the US has enjoyed only a modest acceleration from 2.8 per cent growth in 1974-91 to 3.2 per cent in 1992-2007, and Europe has seen almost no improvement, conditions in the poorest regions of the world have been transformed. Developing Asia's growth has benefited most, accelerating from 4.9 per cent in 1974-91 to 8 per cent in 1992-2007. But sub-Saharan Africa also made progress, improving from 0.9 per cent to 3.6 per cent, while Russia and central Europe have emerged from their communist-era stagnation to average 3.7 per cent growth. Latin America is the one developing region where performance has hardly improved. Significantly, this was the last major region to adopt monetary arrangements focused on domestic inflation, rather than exchange rates.

Having established that the market-based "non-system" of global finance has worked rather well, let me consider your second main objection. You ask how much longer this system can be sustained, given the present "instability in domestic asset markets which is making foreign financiers more wary of investing." My answer is that the present instability in the US property market (which I also expect to hit Britain and most of Europe soon) will probably make international financial flows even more stable. This is because the fall in house prices will slow US consumption growth and boost exports. As a result, the trade imbalances, which you find so worrying, will diminish of their own accord. This process has, in fact, already started and the US trade deficit is likely to narrow by several hundred billion dollars in the next few years.

This rebalancing will be achieved without any great international disruptions, partly because the "large devaluation" which you recommend for every deficit country has already occurred in America, without any government intervention or international co-ordination, but simply through market forces. A deficit country such as Spain, by contrast, may experience greater problems because its membership of the euro precludes a market-led adjustment of this kind. The developing economies, on the other hand, will not suffer at all if investors ever become less willing to finance trade

ANATOLE KALETSKY:
The main cause of weaker wage growth is not "over-mighty finance" but the competition from China

imbalances, since most of these countries have large surpluses.

Finally, what about inequality? You are right that the share of wages in global income has fallen, but this decline has had very little to do with deregulated finance. The main cause of weaker wage growth is the increase in the global labour force caused by the integration of China and other populous countries into the global capitalist system. This has resulted in a huge increase in the global supply of labour relative to capital, and a decline in labour's relative price. The only role of finance in this process has been to accelerate it somewhat by making jobs and technology easier to transfer from Europe and America to the developing world. The global transfer of skills and investment has exacerbated inequalities in the rich capitalist countries. But it has dramatically reduced the inequalities in the world as a whole, by allowing China, India and other very poor countries to improve their living standards much faster than any comparable economies in the history of the world.

I would agree that government action to stop or slow down international development, whether through capital controls or through protectionist trade restrictions, might temporarily protect the wages of some American and European workers—although these wage gains would be offset by higher consumer prices and greater economic instability. But any such gains for middle-income Americans and Europeans would come at the cost of poorer workers in the third world—not of international financiers. If you want the people of China, India and increasingly also Africa, to enjoy the benefits of participating in the global capitalist system, then "over-mighty finance" is something you will have to accept.

Yours
Anatole

Dear Anatole

10th November 2007

You exercise selective inattention to evidence which questions your picture of post-1992 as a golden age. The high growth rates since 1992 are the result largely of China and India, plus recovery in Africa and the transitional economies from foreign debt crises and collapse of state investment. China's boom comes from an unsustainable 42 per cent of GDP going to investment. The unsustainable Chinese investment boom underpins high commodity prices, on which fast growth in Russia, the middle east, Latin America and Africa depends. Relatively fast growth in the US and Britain comes from consumer booms based on asset inflation.

You remain sanguine that currency depreciation will cure trade imbalances smoothly. Yet it is well known that adjustments tend to be long and prone to crisis. In any case, even if the dollar falls substantially further, the major imbalances between the US and Asia will remain, because the Asians (Japan excepted) link their currencies to the dollar. Reducing the US deficit will be at the expense of Japan and Europe.

You say that the continued ascendancy of already "over-mighty finance" is an unavoidable by-product of developing countries reaping the benefits of globalisation. No one doubts the benefits of participating in international trade. But "over-mighty finance" is not a general feature of today's capitalism. It is a characteristic of Anglo-American capitalism, where it favours balance-sheet restructuring over long-term investment. There are plenty of economies with lean and efficient financial systems—in Europe and in major "emerging" economies.

I end by confessing to a moral gut feeling. A world in which profligate Anglo-Americans eat, drink and are merry, while gradually selling off their trillions of family silver, and winning plaudits for their high growth rates, while hard grafters like the Germans and the Japanese (the only ones who try to compete with the Chinese in manufacturing) are written off as hopeless because they have low growth rates owing to the fact that they save a lot and consume only 97 per cent of what they produce—is morally out of joint.

Yours
Robert

Dear Robert

11th November 2007

There are several things we can agree on. First, that the role of financial markets and trade imbalances is an important issue which deserves more serious treatment than the *a priori* assertions which tend to dominate this debate—on your side, that large deficits are always unsustainable and currency fluctuations are inherently unhealthy; on my side that untrammelled currency markets always produce better results than government intervention, or that large international capital flows always deliver better results than more constrained financial systems.

Second, I strongly agree that the present decline of the dollar against the euro and sterling will have very little effect on global imbalances. As long as China and other emerging economies continue to peg their currencies to the dollar, dollar depreciation will simply transfer the pressure of Chinese competition from America to Europe. We disagree, however, on the inference we draw from this. The last thing Europe needs is an overvalued euro to knock out its export industries; it is already suffering inadequate demand and high unemployment. But if the Europeans want to prevent the euro from becoming even more overvalued, then they will have to do something about it—by cutting interest rates and intervening to support the dollar on currency markets. Expecting America to stabilise the dollar is absurd, since the present situation gives them the best of both worlds: the fall of the dollar against the euro allows them to squeeze Europe out of high-value industries such as aircraft, while the steadiness of the dollar against the Chinese yuan allows American consumers to continue enjoying cheap Chinese consumer goods and low inflation. In 1972, US treasury secretary John Connally famously taunted European finance ministers that "the dollar is our currency, but your problem." This is even truer today than it was then.

Finally, let me suggest a surprising convergence between our views on economic morality and the role of finance. I fully agree that some economies should have much smaller financial sectors than Britain and the US. This is not because finance is unproductive or wicked, but simply because everyone is better off in a free-trade world if different countries specialise in their areas of comparative advantage. If Germany has a comparative advantage in precision engineering, Italy in luxury goods, Spain in tourism and Britain in finance, it is both natural and desirable that this should be reflected in their economic structures. You say this has allowed profligate and lazy Anglo-Americans to get richer, while the hard-working and prudent Europeans have become poorer. Hardly. Americans (and Brits) work far harder than Europeans: working days are longer, holidays shorter and far higher proportions of the elderly and female populations are employed. So maybe there is less injustice in the world economy, at least in the relations between America and Europe, than you suppose.

Yours
Anatole