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The Fundamental Principles of Financial Regulation by

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Debating the global roots of the current crisis

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While national policy considerations dominate debates on macroeconomic policies, this column argues that these debates need to take into account the global consequences of their policy choices. The sum of individual macroeconomic policy choices will determine whether large imbalances remain a defining feature of the global economy – and thus the risk of future trouble.

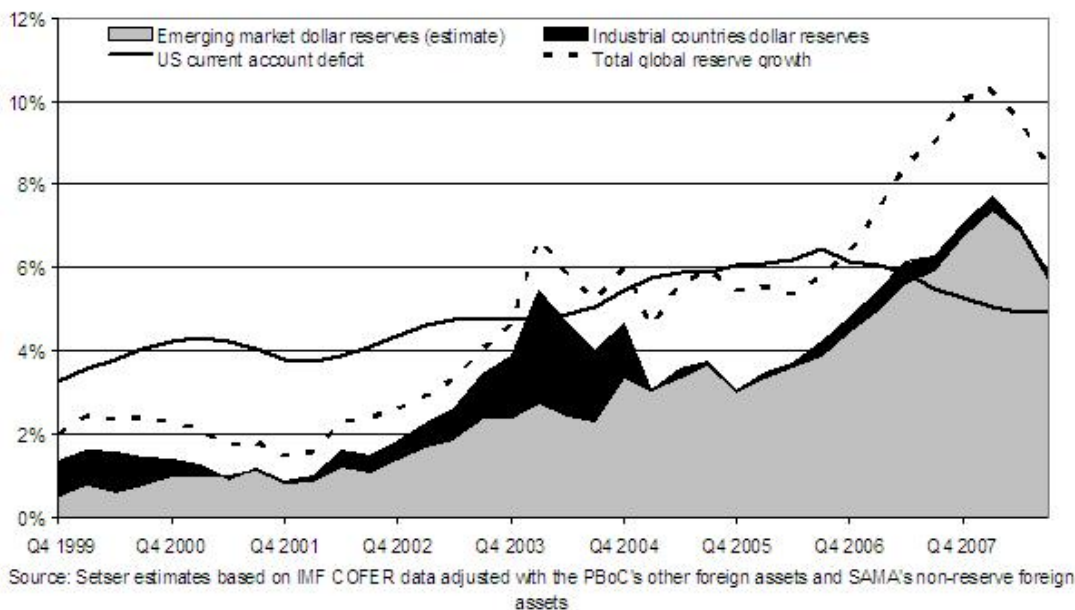
There is a broad consensus that regulatory weaknesses, distorted incentives and excessive leverage in the US (and European) financial sector contributed to the current, severe global financial crisis. The investment banks themselves presumably no longer think that doubling their leverage from 2004 to 2007 was a good idea. The Western financial sector made two big bets. The first bet was that US home prices wouldn't fall on a nationwide basis, and the second one was that macroeconomic volatility would remain low even as macroeconomic imbalances built. Both bets were made on a stupendous scale, as large financial institutions sought to maintain profits even as the yield curve inverted. Taxpayers in the US and Europe – and anyone who relied on the international banking system for financing – are now paying a severe price for this failure of risk management.

No comparable consensus exists on the role that the macroeconomic policies that contributed to large imbalances in the global economy played in the build-up of vulnerabilities that led to the current crisis. The losses US and European financial institutions incurred financing the American households triggered the current crisis, rather than the withdrawal of foreign financing for the US current account deficit. That has led many to argue that global imbalances – large external deficits in some countries, large surpluses in others – were not central to the current crisis.

At the same time it is difficult to see how the US could have sustained large household deficits for as long as it did if the build-up of dollar reserves in the emerging world hadn't supplied the US with so much financing. The expansion of the US current account deficit associated first with the rise in the US fiscal deficit and then with the rise in the household sector's borrowing need came even as returns on US financial assets lagged returns elsewhere. Unlike the expansion of the deficit in the early 80s or the late 90s, the expansion

wasn't accompanied by a rise in (net) private demand for US financial assets. Yes, private capital inflows rose for a time, but so did private capital outflows.¹ Net private demand for US assets actually fell from its dot-com era peak even as the US deficit rose. The resulting financing gap was made up by a surge in central bank demand for US debt, as the pace of global reserve growth soared (see Figure 1).

Figure 1. Emerging market central bank financing of the US deficit
(% of US GDP)



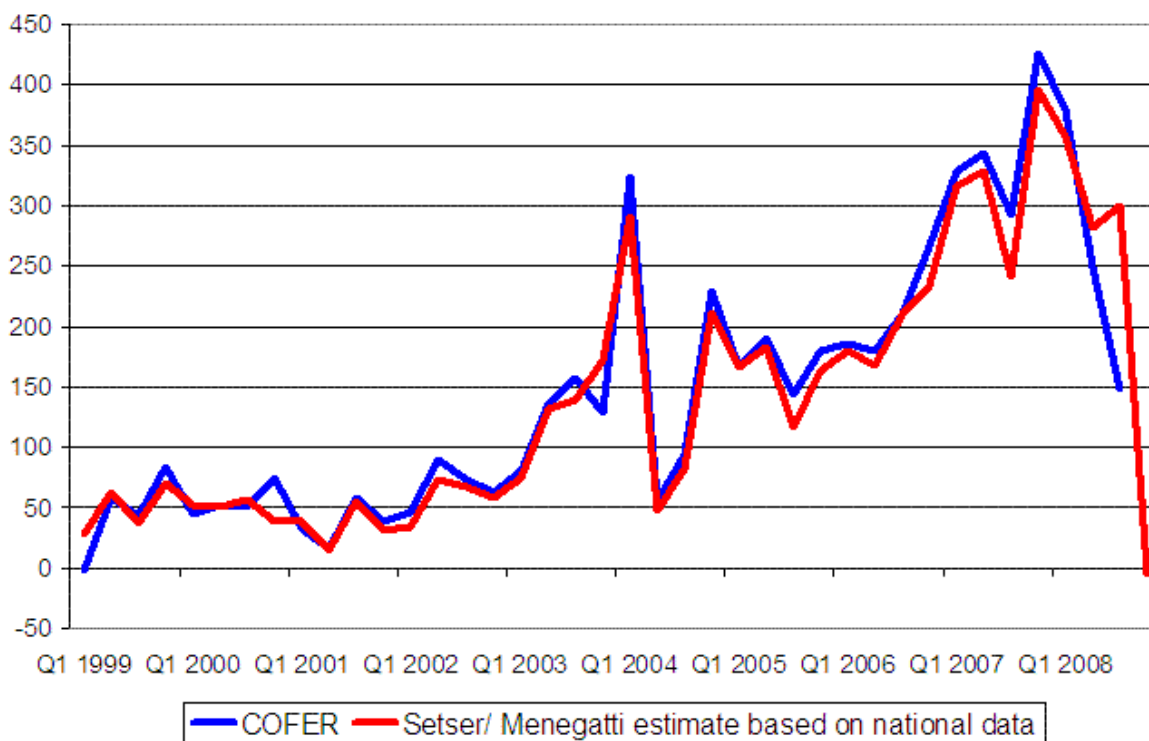
This reflected policy choices by many countries that opted to continue to manage their currencies against the dollar even as the dollar fell and their own current account surpluses rose. Had the dollar fallen against Asian not just European currencies in 2003 and 2004, the US recovery might have been driven more by exports and less by housing. Without the surge in reserve growth, the expansion of the US fiscal deficit might have put upward pressure on interest rates, and thus inhibited a rise in home prices. Absent a further surge in reserve growth – counting China's hidden reserves and the Saudis non-reserve foreign assets, global reserve growth peaked at over \$1.5 trillion in mid-2008 – after the US started to slow in 2006, the US would have been forced to adjust more quickly.

The bottom line is that private investors abroad did not want to finance the large external deficits created by excesses in the US' private sector. Vulnerabilities could not have grown so large without assists from both the US government – which didn't believe that the housing bubble posed much of a risk and showed no interest in reigning in the financial sector – and those governments who financed the US through the increase in their reserves.

In one sense this debate no longer matters. The crisis has changed the world economy. The US trade deficit is poised to shrink substantially. The per barrel price of US oil imports

averaged \$100 in 2008. If oil averages \$50 a barrel in 2009, that fall alone would knock around \$250 billion (almost 2% of US GDP) off the current account deficit. This analysis works from a savings and investment point of view as well. The fall in oil prices will lead to a dramatic fall in savings in the oil exporting economies – and US consumers look likely to pocket the windfall rather than spend more on other goods. This small deficit also will be financed predominantly by private flows – or perhaps the reversal of private flows – for the first time in a long time. In the fourth quarter of 2008, the US government almost certainly lent more to the rest of the world – through the Fed's swap lines – than it received from the world. Global reserve growth effectively stopped in the fourth quarter (see Figure 2). The pre-crisis world – one where expanding dollar reserves of key emerging market central banks provided much of the financing needed to sustain the US growing external deficit – ended when Lehman failed.

Global reserve growth by quarter, \$ billion
IMF COFER data, adjusted for valuation changes, the PBOC's other foreign assets and SAMA's non-reserve foreign assets



In another sense, though, this debate matters more than ever. There are two plausible courses through the current crisis.

In the first course, the expansion of the fiscal deficit in the US offsets the rise in household savings. Once the impact of the fall in oil prices works its way through the balance of payments, the stimulus leads the US current account deficit to rise. Large surplus economies – notably those in Asia – would see their external surpluses rise. If capital

outflows from Asia subside, this would put pressure on their currencies to rise. However, the surplus countries would resist this pressure, opting instead to build up their dollar reserves – in part because the world's pool of shared reserves is far too small to offer effective insurance against the kind of shocks that today's global economy generates. Korea would resist won appreciation. Japan would resist yen appreciation. And China, which "re-pegged" the renminbi to the dollar (at 6.85 RMB to the dollar) in the summer of 2008, would maintain this peg as its current account surplus grows. The global path out of the current crisis wouldn't be that different from the path out of the 2000-01 recession. The entire world would end up relying on the rise in the US fiscal deficit for growth – leaving many of the underlying weaknesses in the global economy intact.

In the second course, the US fiscal stimulus helps to offset the contraction associated with a fall in household spending and private investment, but it doesn't drive the global recovery. The US current account deficit continues to improve. The non-oil trade balance continues to improve, as exports bounce back from the current slump offsetting the rise in imports associated with the US own recovery. Such an outcome requires that the large surplus countries take strong steps to stimulate their own economies. Key countries wouldn't resist renewed pressure on their currencies to appreciate with massive intervention in the currency market. The large surplus countries would in effect pull themselves out on their current tailspin – not rely on the stimulus of the deficit countries. The resulting global economy would have fewer large surpluses and deficits and, in all probability, give rise to fewer problems in the future.

The scope of the global response to the current crisis has yet to be defined. National policy debates dominate, as major countries struggle individually to find any way to right their respective economies. Yet the sum of their policy choices will determine whether large imbalances remain a defining feature of the global economy – and thus the risk of future trouble.

Footnote

1 Foreign demand for US corporate bonds in particular was exceptionally strong from 2004 to mid-2007. It is now relatively clear, though, that this surge in demand reflected the expansion of the shadow financial system. This system operated offshore, but otherwise supplied little net financing. Various vehicles – some operated by US banks but domiciled offshore and some owned by European banks – borrowed dollars from US investors and used the proceeds to buy longer-term US assets. The best evidence that these flows didn't drive the financing the deficit is simple. They collapsed after August 2007 without impinging on the US ability to sustain a \$700 billion plus external deficit.

Editors' note: This column is a Lead Commentary on Vox's Global Crisis Debate page; see

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