2010.05.28 (No.14, 2010)

Newsletter

Institute for International Monetary Affairs
(財)国際通貨研究所

What Comes Next?[1]

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Before discussing the revival of growth we need a moment to reflect what really happened in the world economy since 2007. In a nutshell, it was a same old drama but played on a different stage. Housing bubble and its burst is nothing new. It happened numerous times at numerous places. However, this time around, it happened in a new and very different environment. Since the end of the Cold War in 1989 there were three powerful currents transforming the world economy. The first is globalization, the second is global imbalance and the third is the prominence of finance. As the result of these transformations, the world economy has become more prone to contagion and exacerbation. The crisis which was triggered by the collapse of a same, old housing bubble has developed into a major crisis by way of global credit crunch and global collapse of demand.

Governments and Central Banks of major economies coordinated in the massive injection of liquidity into the financial market and in the provision of huge subsidy for domestic consumption and investment. The stimulative packages have stemmed free fall of the economy. Stock markets started to rebound from the bottom. Overall economic activities are showing signs of recovery. The first beneficiary is the financial sector. Supported by the unlimited amount of cost-free money and the reorganization of the industry the group of winners have made a strong comeback. In the real economy, however, the recovery is still slow and fragile. The burden of high leverage is still heavy and the psychological aftermath is still lingering, particularly in housing market and labor market.

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[1] This paper is based on the speech text delivered at the Group of Thirty Meeting in May, 2010.

Even more serious is the fallout of the fiscal binge. Compared with the period before the crisis the fiscal soundness of all countries has dramatically deteriorated. The Greece episode is an early symptom of the constitutional disease. When we consider how to make the post-crisis recovery we need to keep in mind that any efforts we try must be carried out against the backdrop of the sobering fiscal problem.

Thus, it is clear that the recovery from the crisis is not simple and easy. Yet, I want to stress that the challenge we are faced with today is not a mere recovery from a recession. I would argue that there are three fault lines running in the world economy. They have existed well before the crisis, but the crisis exposed them in a glaring fashion. My point is that we cannot revive the growth on a stable base without dealing with these fault lines. Three fault lines are as follows:

1) unsustainable growth model
2) bloated financial sector
3) unstable international monetary system

Let me briefly discuss each one of them.

1) Unsustainable growth model

For decades the global growth has been supported by the unsatiable American household consumption. Generally accommodating monetary policy was indeed helpful. American consumer goods producers lost international competitiveness and could not suffice demands. Imports soared, incurring a growing current account deficit. On the other hand, it created a large demand for exporting countries and supported their growth. Exporters received dollar obligations and reinvested them in American bonds and stocks. American interest rate remained low thus supporting consumption. So, although the process has aggravated the global imbalance, it was a virtuous circle making everybody happy. The current crisis, however, smashed the house of cards. The American household suffered a serious loss of their assets value and had to be frugal, and the market became apprehensive about the growing global imbalance. Exporting countries also suffered badly by the collapse of the global demand.

Thus, the old growth model became unsustainable. The loss of consumption for American economy and the loss of external demand for exporting countries will force them to modify their respective growth models. If they want to avoid falling into a contracting equilibrium they have to create new demands to replace the old. If they simply try to maintain the old model ignoring the global imbalance the market will punish them severely. The change of growth model will partly be forced by the market force, but it must also be carried out by the conscious effort of appropriate policy implementation. Indeed, some progress has already been made both in deficit ad surplus countries. Yet it is too early to say that the process of transformation has been firmly set in motion.

2) The bloated finance

It was a truly remarkable phenomenon in the history of the world economy during the last two decades or so that the role of finance in the whole economic activities has grown so prominent. Capitalism became a financial capitalism. Factors which promoted the development are not too difficult to identify. First, abundant liquidity was created by the generally easy monetary policy and the growing global imbalance. Second, by the process of globalization the world has become a huge single financial market which tremendously boosted the financial activities. Third, the revolutionary progress made in computer technology opened the door to the age of financial engineering, leading to the creation of whole variety of new services and products. Particularly noteworthy was the development of securitization and derivatives. Forth, last but not least, global addiction to greed.

The economy engorged with finance inevitably carried a risk of high leverage. The collapse of the sub-prime loan market in early 2007 was something like a strike of match on a powder keg. It should also be noted that regulators throughout the world were not aware of the sea change took place in the world of finance. In spite of the fact that there are new markets, new products, and new players regulators were not prepared. They were busy deregulating. Until the collapse of Lehman Brothers regulators around the world were incredibly untroubled. Lehman Shock caught them off guard and put them in a total flurry. They spent trillions of dollars to protect the financial system.

It is more than natural to see a strong global trend toward stricter financial regulation. I have two points to make. First, any regulator does have policy instruments to prevent birth of a bubble. What matters is not availability or adequacy of instrument but the regulators competence to discern the exact timing of implementation, to select the right kind of instrument, and to identify the correct objective of policy. Second, there seems to be a broad consensus that the financial service industry has misbehaved. What should be done? Is it suffice to establish a new code of conduct, or is it necessary to change the structure of the financial services industry? Nobody would deny that new services and new products do have function to manage risks and help stabilize the market. The problem is, however, in reality, those commodities were created and traded not for the genuine purpose of risk management or market stability but for the naked purpose of making profit. Thus, the point is whether we could trust human behaviour would not go beyond the boundary of modesty. If we could not, then, one may argue that we need a legal framework which imposes structural confinement on the activity of financial institutions.

The expansion of finance during the last two decades has clearly contributed to the growth of income and employment. If we are to decide to rein in the activities of financial industry, then we have to accept the loss and try to compensate it somewhere else. This is a particularly relevant issue for the U.S. During the last two decades American capitalism has come to depend too much on consumption and finance. The current crisis does have a feature of an endgame of the journey of profligacy. In that sense, I would humbly suggest, that the regulatory reform may turn out to be a gauge of American resilience and American ability of self-correction.

3) Instability of the international monetary system

Since 1971 when the Bretton Woods regime collapsed the world economy has managed to survive and grow with a de facto dollar standard. The value of the dollar was no longer guaranteed by the gold, but everybody held it and used it because the issuer of the dollar was the hegemonic power in the world. It is crucial to reorganize that the international monetary system under the Bretton Woods regime and the post-Bretton Woods regime was kept alive by the existence of the US, the super-power. In recent years, however, the economic and geo-political supremacy of the U.S. was dented. Also, the influence of the group of countries who do not accept the uni-polar leadership status of the U.S. has been growing. The current crisis has exacerbated the situation. The prospect of the ever-growing fiscal deficit and the mounting external indebtedness has eroded confidence in the dollar.

The problem with the international monetary system today, however, is not only the loss of confidence in the dollar. The equally serious problem is the lack of its replacement. Today, there is no currency, national or synthetic, which can replace the dollar as the global key currency in the foreseeable future. As is clear from the reflection on the history of transition from the pound sterling to the dollar in early 20th century, the stable key currency needs to be the currency of a country which possesses the strongest aggregate power, the power consisting of economic, military, diplomatic, technological, cultural, and, importantly, ideological might. Also, a stable key currency needs to have its international market, big, deep, fair, open and liquid. Our problem is that our leader is weakening but we have no candidate to succeed him. We have two options. One is to urge the U.S. to wake up and rejuvenate. Other is to accept a prolonged period of instability. Under such circumstances, it is legitimate to ask the IMF to assume a greater role as a bastion of the international monetary system. From its very inception in 1944 two assignments were bestowed on the IMF. One is to provide finance to member states and the other is to secure exchange rate stability among currencies of member states. The first job kept the IMF always busy. On the second job, however, the IMF has been virtually detached in recent years, partly due to the uncontrollable Tsunami of the volatile capital flow and partly due to IMF's inability to be engaged in a real surveillance exercise on major currency countries macro-economic policy. In my view, it is a crucial challenge for the IMF to restore the role of the guardian of the international monetary stability.

Summing up, it is obvious that we have a set of challenges. If the current crisis is once-a-century crisis as some people do argue then it should be legitimate to ask if the world is prepared to undertake a fundamental restructuring of the global economy. I am afraid the world is still pondering. Indeed, I already hear cynical voice whispering “We are not prepared for the daunting task yet. We will have several years of slower growth with accompanying uneasiness. Incremental reforms will be made here and there, but on the whole, things will carry on, until another bubble emerges and bursts.” Have I only fancied I heard it?

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