FRAGMENTATION IN THE INTERNATIONAL FINANCIAL SYSTEM: CAN THE GLOBAL ECONOMY BECOME ONE AGAIN?

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?

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International Linkages

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The agenda

- The euro crisis and the challenges facing the OECD.
- The desirable defensive position of EMs.

The euro

- The euro zone is living in self-denial. The political process moves too slow to catch up with the speed of arbitrage forces moving the markets, deteriorating continuously the balance sheet exposures of the periphery.
- Short of major political U turn, the euro is converging to a crisis, where markets will force the political process to ‘catch up’ with reality.
- History may guide us in such a crisis [Aizenman (2012), Bordo et al (2011)].

The formation of the euro is an example of a common Panglossian attitude to policies:

- An upbeat attitude that by its optimism hopes to overcome the opposition:
- The hope has been that the formation of the euro may lead to dynamic forces inducing an ‘ever closer union’, as market integration and cooperation do mutually reinforce each other.
- Yet, the Panglossian attitude to policies may reflect built-in fiscal myopia:
  - the short-termism of policy maker’s associated with a limited time in office,
  - the short - sightedness of hyperbolic discounting voters, where belt tightening is delayed for tomorrow, but “tomorrow never comes.” [Leibson, 1997]

An alternative perspective: the evolutionary approach, where the formation of a new currency area is not uni-directional.

- Evolutionary pressure purges arrangements and institutions that do not survive the realized shocks.
- Yet, survival does not necessarily imply the ability to survive when new bad shocks hit.
- Convergence to an ‘ever closer union’ is not assured.

Unions and Regional Cooperation arrangements are challenged by exogenous forces, testing the willingness and ability to persevere during bad times

- Market integration and cooperation may

overshoot the willingness to integrate [see the collapse of Yugoslavia, the move towards more limited fiscal federalism in Canada, etc…].

- The reasons for the formation of currency unions and regional cooperation blend economics and politics.
- The Euro has been the outcome of Europe's 19th and 20th century history, rather than the 'optimal currency areas' logic.

Putting the euro crisis in the proper historical context

- The US $ is a ‘successful’ union of 50 states.

Yet, this is the outcome of painful learning and a bloody history of 200 + years, including:

- The Civil War,
- defaults of 8 states on sovereign debt in the 19th century (1841-2),
- the Great Depression,
- the emergence of the FED as a key institution,
- the greater fiscal role of the federal system, etc.

The euro crisis in the proper context, cont.

- The euro is a ‘baby union,’ facing its first painful maturing crisis.
- Options: progress towards a Canada or US type of a union, or aborting the euro.
- Euro countries attempted to ignore the learning process of the US and other unions, at their own peril.
- The crisis forces the emerging Euro to move fast on the learning curve. The process is quite painful, as has been the learning process of the US.

3 views on the stability of Unions

1. *Built-in fiscal restraints:*
   "After the fiscal crisis of the early 1840s, states changed their constitutions to eliminate taxless finance in the future." Wallis (2005).

2. *Is it enough?* von Hagen (1991) provided mixed evidence on the effectiveness of fiscal restraints on states in the US: "*Fiscal restraints significantly affect the probability of fiscal choices and performance, without however preventing extreme outcomes.*"

A realistic perspective on the stability of unions

3. Fiscal restraints supported by the proper allocation of bargaining clout:

- When the fiscal center gets sizable taxes from the states, and provides sizable transfers to the states, the Union's Center has plenty of bargaining clout.

- In the USA, state governments receive more than 30% of their general revenue directly from the federal government -- about 32% in 2009.

- If a state misbehaves, the center may cut the transfers to a degree that would make such behavior sub optimal [Aizenman (2012, NBER WP 18138)].

Implications

- For the euro project to move forward, it should deal with euro's trilemma (Pisani-Ferry (2012)), granting more bargaining clout to the center.
- There are numerous ways of doing so, and it's up to the members to choose a way fitting their vision.
  - Top priority: Moving towards a banking union, with tighter bank supervision - forming 'the FDIC of the Euro,' with the needed support of a stabilization pool funded by risk premia.
  - Improving fiscal discipline will help, thought dealing with the banking-sovereign debt crisis remains a top priority: ***Don't eat more than you can chew and digest***: borrow only if your tax base is big enough to support serving it.

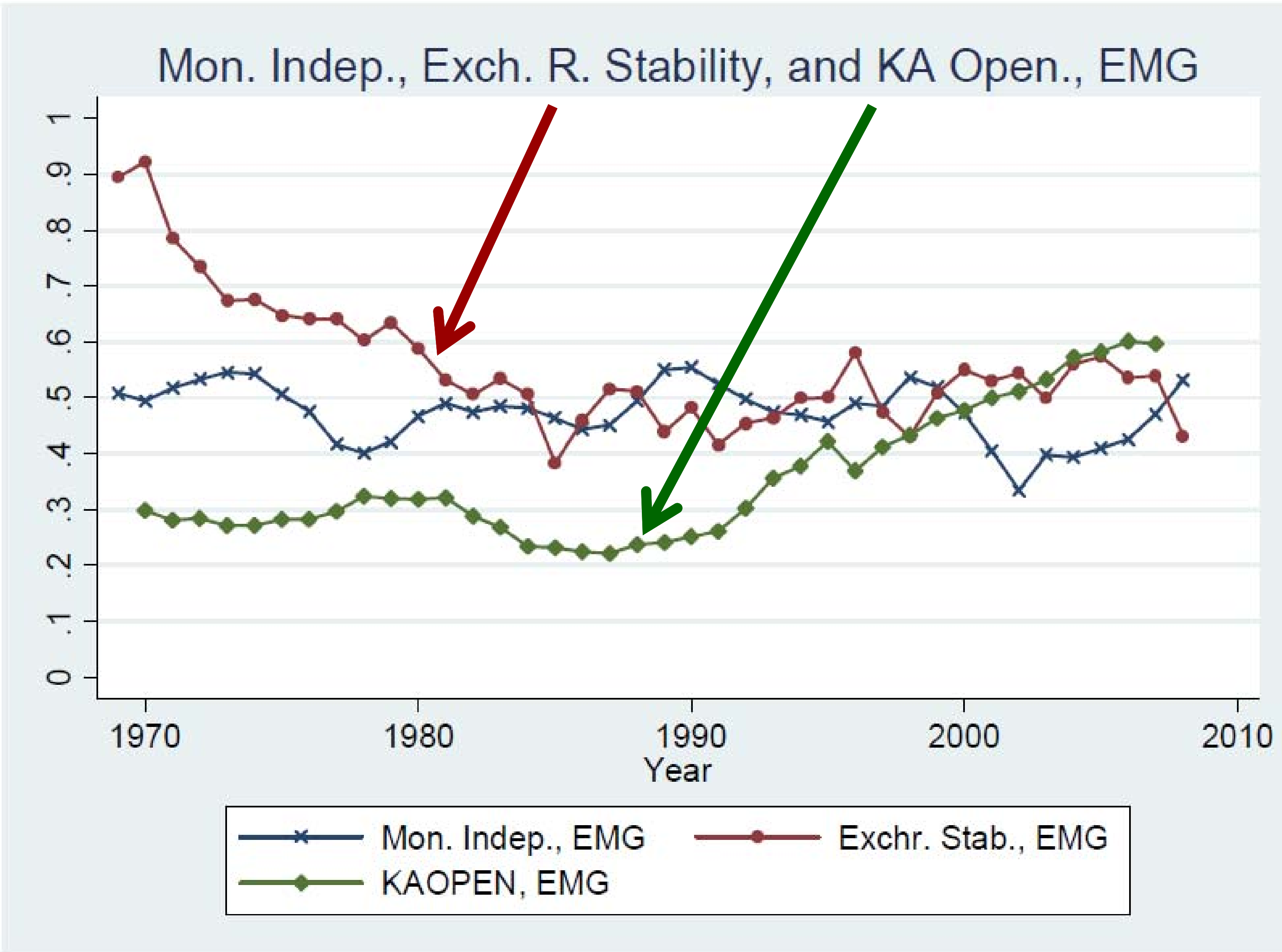
The road ahead

- Convergence to such a union would be messy, and may require yet a deeper crisis, possibly scaling down the euro from 17 countries towards a union of more homogenous countries, delegating greater supervisory role to center.
- Chances are that wider burden sharing is needed to galvanize the political support, but it's not clear if such a resolution would come without a deeper crisis.
- **The US and Europe are yet to grapple properly with restraining the financial system, and implement the needed fiscal adjustment.**
- **EMs are well advised to keep their defensive position.**

Key EMs trends

- Weak links between external financial integration of EMs and faster growth.
- Tendency of external financial integration to fuel costly crises (see the crises of 1994-2001).
- These crises induced learning in the EMs:
  - EMs converged to the middle ground of the trilemma, with growing (but controlled) financial integration, controlled exchange rate flexibility and proactive monetary policy.
  - EMs added financial stability as a goal, self-insuring by building up IR, and adopted a public finance approach to financial integration.

EMs Trilemma configurations



- Source: Aizenman, Chinn and Ito (2010)

Key OECD trends, and crisis

- The OECD moved much faster towards financial integration, a common currency in Europe, and flexible exchange rates in other OECD countries.
- The OECD "overshot" the optimal degree of financial deregulation.
- EMs resilience validated their public finance approach to financial integration.

Capital flows: Growth versus crisis

Over the past two decades, financial integration is less likely to have supported fast growth than fuelled costly macroeconomic crises.

- Fast-growing countries tend to self-finance their growth and on average run current-account surpluses (Aizenman et al. 2007, Prasad et al. 2007).
- This finding does not change over the 1990s in spite of the massive financial liberalization within EMs.
- Minor gains in switching from autarky to full capital mobility – unless financial integration somehow bridge the large gap in total factor productivity levels (or technology) between advanced and EMs economies, which is by no means automatically assured (Gourinchas and Jeanne 2006).

Capital flows: Growth versus crisis, cont.

The type of financial inflow matters.

- Net portfolio debt and equity inflows have a negative effect on manufacturing growth, although the effect varies over time and depends upon whether a given sector is financially constrained or not.

- FDI inflows tend to have the most positive effects overall, on aggregate manufacturing as well as financially-constrained sectors (Aizenman and Sushko 2011).

On the linkages between the the financial sector and growth in the nonfinancial sector

- Abrupt financial contractions are more likely to follow periods of accelerated growth, indicative of *up by the stairs, down by the parachute* dynamics.
- Sharp financial fluctuations have asymmetric effects, the majority of real sectors adversely affected by contractions but not helped by expansions.

Aizenman, Pinto and Sushko (2011), studying the links between the financial sector and growth in the nonfinancial sector, looking at 8 nonfinancial sectors in 28 countries over 1960-2005.

Overview, cont.

- Effects are magnified during particularly large financial contractions.

- The adverse effects of financial contractions are transmitted mostly by the financial openness channel, with IR mitigating these effects with a sizeable impact during sharp financial contractions (10 times greater).

- Consequent upon a financial contraction, the most severe real sector contractions occur in countries with high financial openness, relative predominance of construction, manufacturing, and wholesale and retail sectors, and low IR.

EMs Learned from past crises:

Tendency of financial integration to end up in tears

- EMs crises began with Mexico (1994-95), Thailand and East Asia in 1997, Russia (1998), Brazil (1999), Argentina and Turkey (2000-1).
- These crises also laid bare the domestic vulnerabilities in these countries.
- EMs recognized that they were on their own.
- **EMs accepted that they would have to assume primary responsibility for correcting the situation.**
- Swap lines extended to 4 EMs during the crisis do not negate the logic of self insurance via IR and prudential regulation [moral hazard & stigma].

EMs moved towards a "public finance approach" to financial integration and managing macro risks

- Steps have to be taken to minimize contingent liabilities from private sector balance sheets, especially in the financial sector.
- Steps have been taken to manage maturity and currency mismatches associated with external borrowing.
- Strengthening financial sector regulation and supervision.

Managing risks from capital flows

- Policymakers should balance the interests of the financial and real sectors.
- With vulnerability from capital inflows endogenous to what the private sector does, an optimal approach calls for a mixture of partial insurance and preventive methods.
- EMs should supplement reserve accumulation with policies to reduce the risk and the severity of sudden stops and deleveraging shocks.

Particular pressure points

- Through a combination of supervision and macro-prudential regulation, steps should be taken to ensure commercial banks remain largely deposit-based and limit their reliance on external, wholesale funding.
- This will minimize currency mismatches, which had ruinous effects during the 1997-2001 crises.

To avoid a situation where regulations lose their bite, regulation and supervision should evolves dynamically over time

- Emerging markets have been adopting various measures to tax surges of external borrowing and hot money.
- Taxing external borrowing surges by commercial banks recognizes that the social benefits to the real sector may fall short of the social cost to the taxpayers [and the need to bail out systemic financial players in bad times].

Lessons of the 2008-9 crisis

- The goal of desirable financial regulations and integration -- minimizing the cost of expected crises, and providing efficient financial intermediation services to the non financial sectors of the economy.

Implications: Financial depth is not a goal in itself.

- Financial intermediation may be "too lucrative," its total costs may exceed the total benefits.
- Financial innovations undesirable if the expected benefit to the non financial sector < the expected cost.
- Regulation level (leverage, reserve ratio) should be set at a level that probably would make financial intermediation less profitable.

Example of policy recommendations applying the public finance approach

- Bubbles in the real estate market and the wider economy, frequently associated with easy leverage and inflows of hot money, may be too costly to ignore.
- Even if one can't identify a bubble ex-ante, one can identify factors increasing the probability of a bubble.
  - o During the 2000s, the probability of a housing bubble was zero in Germany (experiencing constant valuation of real estate), positive and increasing in the US [see Shiller].
- Lowering the LTVC reduces the probability of a bubble.

Resistance to regulation

- The financial system may resist changes, as it will cut its rents -- "Where you stand depends on where you sit." [Nelson Mandela].
- There is a built in bias against financial regulations: All the crises that were avoided by tighter financial regulations are imperceptible and not credited to the policy maker. Yet, the cost of financial regulation is transparent and debited to the policy maker,

  → Higher regulator effort, while helping avoiding a crisis, tend to erode overtime the support for future regulation [Aizenman, WB ABCDE 2010].

Open economy issues:

- The 2008-9 crisis illustrated the risk of low & uneven standards of prudential regulation.
- **Financial integration during the 1990s-2000s globalized arbitrage, while the national tax bases fund the resultant bailouts at times of trouble.**
- **Consequences:** bailouts are associated with cross border redistribution, inducing both domestic and international political frictions.

Taxing surges in external borrowing is a discretionary tool supporting prudential supervision

- This policy tool is akin to an international version of FDIC's policies in the US [Aizenman (2010)].
- The FDIC covers deposits in US dollar. In contrast, external borrowing by EMs banks increases the balance sheet exposure to foreign currency debt.
- This exposure should be dealt by IR accumulation of *and* by charging the proper risk premium, inducing banks to internalize the impact of external borrowing on the taxpayers' exposure to bailouts.

More coordinated regulatory process would reduce regulatory arbitrage.

- Global minimum standards increase the costs of deregulation -- **a commitment devise**.
- Minimum prudential standards **mitigates “regulatory arbitrage” across countries**:
- Under-regulation attracts capital inflows in search of higher returns induced by the implicit subsidy provided in more under-regulated countries.

To conclude The crisis validated the logic of self-insurance and regulation by EMs, aiming at more desirable financial stability.

- **The agile combination of the policies adopted by the EMs has provided the needed tools preventing external shocks from inducing major growth and confidence crises.**
- **Self-insurance combined with the public finance approach to financial integration may well be an optimal second-best, while emerging markets wait for the G20 to collectively resolve global imbalances and under-regulated capital flows.**
- Yet, don't hold your breath for the euro zone and the US to move fast enough to avoid a deepening crisis.

Thanks for your attention

Further readings

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