

# Globalization and the Crisis

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Hans-Werner Sinn has asked me to consider the connections between globalization and the crisis. He did so, I suspect, because I am an international economist and there are international economists who will claim that globalization is at the root of recent events. I hate to disappoint but, in my view, the roots of the crisis lie elsewhere.

Fundamentally, I see the crisis as the result of flawed regulation and perverse incentives in financial markets. Regulators bought into the arguments of the regulated that financial institutions could safely operate with a thinner capital cushion. They accepted the premise that capital adequacy could be gauged on the basis of the banks' internal models and, where these were absent, ratings of securities provided by commercial credit rating agencies, notwithstanding the incentives for the proprietors of the former to tweak their models to minimize estimated risks and capital requirements and the tendency for the latter, as investment advisors as well as issuers of ratings, to fall prey to conflicts of interest. The regime that resulted was capital poor and dangerously procyclical. Regulators neglected liquidity, assuming away problems in wholesale money markets. Banks were allowed to hide risks in conduits and structured investment vehicles and window dress their balance sheets. Agency problems flourished at each stage of the originate-and-distribute process. Mortgage brokers had no fiduciary responsibility to homeowners. Banks not keeping a participation in the complex derivative securities they originated felt no responsibility to investors. The structure of compensation encouraged bank executives to roll the dice, disregarding the implications of their actions for the survival of the firm. And the regulators averted their eyes. If you want my summary of the crisis, there you have it, in one paragraph.

Of course, this summary goes only an inch below the surface. The deeper question is how these indefensible circumstances were allowed to arise. Here I would cite a powerful ideology of deregulation stretching back to at least the Reagan-Thatcher years. I would cite excessive confidence in quantitative methods of risk management, Value at Risk, and of asset pricing, the Black-Scholes model. I am not acquitting the academy, in other words; we too fell prey to a powerful collective psychology. I would cite the intensification of competition, with the Glass-Steagall restrictions starting to crumble even before passage of the Gramm-Bliley-Leach Act in 1999, encouraging banks to take on additional leverage in their desperation to maintain normal returns. Finally, I would cite the conscious policy of the Bush Administration to starve the regulators of human and financial resources. It is hard to understand the pre-crisis behavior of the Securities and Exchange Commission any other way. There's my summary of the deeper causes of the crisis, again in one paragraph.

What about globalization, which is what I was in fact asked to talk about? There are two connections. The oblique connection is between globalization and the competitive pressure that

encouraged excessive risk taking. Financial institutions stretched for risk and gambled for survival as their profit margins were squeezed by growing competition. The intensification of competitive pressure reflected the increasing ability of commercial and investment banks to infringe on one another's turf. It reflected the growing overlap between banks and markets resulting from the dual processes of securitization and disintermediation. But another source of pressure was international competition, as finance was globalized, and in Europe in particular as the single market led to increasing in cross-border competition. It is no coincidence that previously sleepy Landesbanken were so heavily invested in toxic securities. I regard this as an indirect but important consequence of financial globalization.

The subsidiary connection is between global imbalances and the asset bubble. As I have said, the match that ignited the fire lay elsewhere, in lax regulation and perverse incentives in financial markets. But global imbalances poured fuel on the flames, leading to a once-every-hundred-year firestorm. With significant amounts of foreign capital—official capital in particular—flowing toward the United States, long-term interest rates were lower than otherwise. This, of course, is Mr. Greenspan's own explanation for his now-notorious bond market "conundrum." The low level of long-rates encouraged households to assume additional mortgage debt. It encouraged portfolio managers to stretch for yield. It encouraged additional risk taking by fund managers who found it increasingly difficult to meet historical benchmarks.

The question is how much difference the capital flows associated with global imbalances made for the course of the crisis. I regard them as secondary factors—which is not to dismiss them. but only to put them in their place. Empirical studies put the impact of foreign inflows on U.S. treasury yields in 2004-6 at 50 to 90 basis points.<sup>1</sup> The incentives created by this fall in long-rates no doubt encouraged the excesses that culminated in the crisis. Still, I would ask: How different would the crisis have been had U.S. long-rates been 50 or 70 or even 90 basis points higher? Not that different, I would submit. Agency and regulatory problems in financial markets, in conjunction with what would have still been a relatively permissive credit-market environment, would still have produced a major bubble and then significant dislocations when it burst.

What do I expect now in terms of regulatory reform? I expect a drawn-out process. We have yet to fully excavate the subterranean foundations of the crisis. And until we do so, we will be uncertain about which fundamentals to reinforce. The presumption in the Dodd bill and the Obama Administration plan for financial reform that we should ban proprietary trading in commercial banks rests on the presumption that the implicit subsidy received from deposit insurance encouraged all manner of excesses by those banks' proprietary traders. It does not rest on actual evidence of a connection. I'm not sure the evidence is there. More generally, I would submit that the direction of reform should be guided by evidence, not presumption.

In terms of evidence, the Valukas Report on Lehman Bros., released two months ago, is an eye opener.<sup>2</sup> It described a financial institution engaged in the most blatant window dressing

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<sup>1</sup> See Frank Warnock and Virginia Warnock (2009), "International Capital Flows and U.S. Interest Rates," *Journal of International Money and Finance* 28, pp.903-919; Roger Craine and Vance Martin (2009), "Interest Rate Conundrum," *B.E. Journal of Macroeconomics* 9, pp.1-27.

<sup>2</sup> United States Bankruptcy Court, Southern District of New York, "Report of Anton R. Valukas, Examiner" (11 March).

of its balance sheet and arbitraging regulation to the greatest possible extent. It described a Securities and Exchange Commission (SEC) and Federal Reserve Bank of New York that had supervisors embedded in Lehman Bros. and had even been warned by one of the firm's competitors that its practices were jeopardizing the stability of the system, and yet still took no corrective action. The SEC has an excuse, of course: it was starved of resources for political reasons, something that had been flagged by the General Accounting Office already in 2002.<sup>3</sup> In this sense, inadequate enforcement and regulatory arbitrage were at the root of the crisis. But if this is right, then there are no particular implications in terms of financial re-regulation or de-globalization. We don't need new regulation. The main thing we need to do is to enforce the regulations already on the books. Nowhere more so, of course, than in my country.

However, the difficulties of effectively coordinating regulation across countries suggest that there may be pressure to make finance a more national affair. Cross-border financial institutions will be tolerated only where the risks they create can be safely managed. And they can be managed only where there is agreement on the risks requiring regulatory cooperation. In practice, however, national officials continue to disagree about the nature of the problem. European officials see hedge funds and private equity firms as significant threats to financial stability and recommend clamping down on their operations. U.S. and UK officials disagree. The EU can go ahead and apply strict regulation to hedge funds and private equity firms, but the latter will then simply have an incentive to relocate in the United States. EU officials have indicated in this case that they will adopt regulations limiting the ability of European residents to invest in foreign-headquartered hedge funds and private equity firms. This is as good—or bad, depending on your view—an example of the dynamics of financial deglobalization as one can imagine.

And even where there is agreement, there are problems. There is consensus in both the U.S. and Europe, for instance, on the need for an orderly resolution mechanism as a third way, besides uncontrolled bankruptcy and bailouts, for dealing with troubled banks, bank holding companies, and nonbank financial firms. But many of our big banks, bank holding companies and nonbank financial firms are international, even global, in scope. The best efforts of the Basel Committee's Cross-Border Bank Resolution Group notwithstanding, there has been little progress in creating a global resolution mechanism.

If regulators are serious about creating an orderly resolution mechanism as an alternative to uncontrolled bankruptcy and bailouts, they have no choice for the time being but to do so at the national level. The geographical domain of big financial organizations will therefore have to be made to more closely coincide with the domain of the respective resolution authorities. I would note that the Cross-Border Bank Resolution Group recommends making large financial entities less complex and interconnected. By implication it is pointing to the need to make them less international.

Finally monetary policy and global imbalances: I suspect that the immediate future will resemble the immediate past to a greater extent than many observers stipulate. To paraphrase a familiar quip about the weather, everyone says that monetary policy should be reconceptualized to better deal with the risks posed by asset bubbles, but no one does anything about it. We have

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<sup>3</sup> General Accounting Office (2002), "SEC Operations: Increased Workload Creates Challenges," Washington, D.C.: GAO (March).

yet to move beyond statements of principle. Specifically, there is no agreement on whether central bankers can in fact identify bubbles, how they should do so, on the circumstances under which they should lean against them, and on exactly how hard they should lean. Absent answers to these questions, I suspect that talk about adjusting monetary policy in response to asset market conditions will remain just that, talk.

Global imbalances will be smaller than they were at their pre-crisis peak, because U.S. investment rates will be lower and because foreign finance for the U.S. current account will be less freely forthcoming. But they are not going away. Surplus countries like China and Germany need to raise their consumption, while the U.S. needs to raise its saving, in order to make further progress in rebalancing the world economy. This, and not the exchange rate, should be the focus of the rebalancing debate: what can be done to accelerate the rate of growth in consumption in China and Germany, and what can be done to accelerate the rise in saving in the United States. Chinese households, when they consume more, consume disproportionately Chinese stuff. U.S. households, when they consume less, consume disproportionately less U.S. stuff. So the price of Chinese stuff will have to rise relative to the price of U.S. stuff. This is just another way of saying that the real exchange rate will have to adjust. It will have to adjust either through inflation in China and deflation in the U.S., or else through a change in the nominal exchange rate. Personally, I prefer achieving the requisite change in the real exchange rate by allowing the nominal exchange rate to adjust.

This way of putting things has three implications. (There is a fourth implication, for the internal dynamics of the euro area, but I will resist the temptation to go there.) First, adjustment of the exchange rate goes together with the adjustment of spending levels: it is not the catalyst for them. But even if it is not the catalyst, exchange rate adjustment is needed to clear markets in general equilibrium.

Second, adjustment of the exchange rate will be slow and gradual rather than abrupt and discontinuous because the evolution of U.S. and Chinese spending patterns will be slow and gradual rather than abrupt and discontinuous. It will take time for Chinese households to change their habits. It will take time for the Chinese government to build the social safety net that those households require to feel comfortable with lower levels of precautionary saving. It will take time to strengthen the governance of big state enterprises so that they pay out more of their earnings in wages, fringe benefits and dividends. And it will take time, like it or not, to narrow the gaping budget deficits that are now the main cause of low national savings rates in the United States, household savings rates already having risen.

Finally, because these adjustments will take time, the elimination of global imbalances will take time. They will be with us for years to come. In the short run, they are likely to widen out again as U.S. investment recovers.

That's bad news. The good news, such as it is, is that global imbalances were not the prime mover in the recent crisis.

Thank you very much. I look forward to your comments.