The End of Financial Globalization 3.0

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China's unprecedented reserve accumulation, along with that of other emerging markets, has been a defining feature of the global economy in the past decade. This policy, designed to insure against the vagaries of economic and financial integration, paid off. Countries with more comfortable reserve cushions have weathered the financial storm of 2008-2009 better than those who have bought less insurance as noted by Maurice Obstfeld, Jay Shambaugh, and Alan Taylor.

Purchasing insurance policies might have been sensible from the perspective of each individual country, but collectively these currency interventions prepared the ground for the global crisis: relatively poor emerging markets—most notably China—helped to create the macroeconomic backdrop for the current financial crisis by subsidizing interest rates and consumption in the United States. Niall Ferguson and I coined the term "Chimerica" to describe this historically unique financial symbiosis that had developed between China and America.

The paradox of reserve accumulation is that attempts to make individual economies safer have contributed to macroeconomic imbalances and the mispricing of financial risk on a global level. It is possible, and indeed likely, that this paradox will mark the end of yet another attempt to make the world safe for global finance.

First let's look back over some recent and not-so-recent history. Financial Globalization 1.0 took place in the late 19th century ending with the First World War. Financial Globalization 2.0 started in the 1980s and lasted to 1997 – 1998. It was based on the idea that removing restrictions on capital account transactions would enable emerging markets to tap into the pool of global savings and import much-needed capital for development. Market forces would allocate capital efficiently to its most productive uses across the globe. Financial Globalization 2.0 ended painfully with the Asian crisis when it became clear that private capital flows were too volatile and pro-cyclical to rely upon. In difficult times capital flows could seriously complicate economic management. Moreover, during the crisis some emerging markets' governments

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had to go on a humiliating trip to Washington to ask the IMF for emergency financing. Unsurprisingly, governments in the developing world decided that they wanted to avoid finding themselves in the same situation again.

What followed was Financial Globalization 3.0. Emerging markets heeded Martin Feldstein's advice and took out an insurance policy against the vagaries of financial globalization. By running current account surpluses, intervening in foreign exchange markets and building up currency reserves, Asian and other emerging economies were sustaining export led growth and buying insurance against future financial instability.

These policies turned developing markets into net capital exporters to the developed world, mainly to the U.S. Between 1990 and 1998—during what I have termed Financial Globalization 2.0—emerging and developing economies (according to the IMF classification) were running an average current account deficit of about 1.7 percent of their GDP. Between 1999 and 2008—during financial globalization 3.0—this deficit turned into a surplus of 2.5 percent of GDP according to IMF data.

Looking more closely at the patterns of reserve accumulation in recent years, Maurice Obstfeld and his co-authors have shown that varying degrees of openness to financial globalization go a long way towards explaining the differences in international reserve holdings between countries. The more financially integrated a country is, the more it aimed to protect against the risks stemming from such financial openness, in particular if high trade openness makes the real economy sensitive to exchange rate swings.

Financial Globalization 3.0 seemed a success story for a while, generating financial stability and high rates of economic growth. Yet the accumulation of large war chests of foreign reserves through currency intervention carried negative externalities. The arrangement opened up a Pandora's box of financial distortions that eventually came to haunt the global economy. As Ben Bernanke noted, a "glut" of savings from emerging markets has been a key factor in the decline in U.S. and global real-long term interest rates—despite the parallel decline in U.S. savings. Chris Hunt at the Reserve Bank of New Zealand makes this point as well.

Lower interest rates in turn have enabled American households to increase consumption levels and worsened the imbalance between savings and investment. And because foreign savings were predominantly channeled through government (or central bank) hands into safe assets such as treasuries, private investors turned elsewhere to look for higher yields. This led to a more general re-pricing of financial risks and unleashed the ingenuity of financial engineers to develop new financial products for the low interest rate world—such as securitized debt instruments.[1]

Reserve accumulation was certainly not the only cause for the crisis. One has to add additional ingredients to achieve the financial disaster recipe: fraudulent lending and short-term incentives for bankers; loopholes and mistakes in financial regulation and oversight; Federal Reserve policy that failed to spot and stop the credit cycle because the market apparently knew better than policymakers; and last but not least, the willingness of consumers to turn themselves into levered investment vehicles.

Yet without the Chinese willingness to fund America's consumption and borrowing habit, interest rates in the United States would almost certainly have been substantially higher—acting as a circuit breaker for the developing debt-consumption bubble.[2] The opposite happened: thanks to the combination of strong growth, low inflation and low interest rates asset markets boomed and household wealth increased further—at least on paper. Households felt richer and saved even less, reinforcing the cycle. Beijing and others cannot be blamed for reckless lending into the housing bubble or irresponsible leverage in Western financial institutions, but it is equally clear that a vast amount of capital was flowing from a developing country with a per capita income of one tenth of the western world to one of the richest economies in the world. Water was flowing uphill in unprecedented amounts.

This brings us back to the paradox raised before: there are good reasons to argue that individual policies at the country level meant to insure against financial crisis have collectively distorted global interest rates, helped to sustain excess demand and contributed to the mispricing of financial risks. Moreover, it is unlikely that emerging markets' behavior will change. From the perspective of emerging markets, the academic debate whether reserve levels have grown excessive has been answered almost overnight in the current crisis.[3] It is clear to policymakers from Buenos Aires to Budapest and Beijing that there is no such thing as too many reserves in a world of volatile capital flows.

Have we therefore come to a crossroads for Financial Globalization 3.0? Unless emerging markets can be convinced to take on global finance without the protective shield of large currency reserves (and it is not clear that we should try to convince them), we will either have to learn to live with the economic and financial distortions caused by capital flowing from poor to rich, or once again alter the model of financial globalization. Emerging markets are as unlikely today as at any point during the past decade to embrace the instability of global capital flows and accept large swings in exchange rates. Maybe it is time then to rethink the risks and benefits of global financial integration? Dani Rodrik and Arvind Subramanian have raised this point recently in an insightful paper.

There were good economic reasons to doubt that a financial globalization model premised on large scale capital flows from poor to rich economies was a smart idea. It is no surprise that empirical studies have failed to identify a robust growth effect from financial integration. One key reason could be that financial integration today is essentially uncorrelated with investment rates, presumably the main channel through which foreign capital would spur growth.[4] Globalization during the past decade was diversification finance, not development finance in the form of net transfers of capital. Also a study by the research department of the International Monetary Fund (IMF), one of the main proponents of capital account liberalization in the 1990s reached a rather sobering conclusion: "…taken as a whole, the vast empirical literature provides little robust evidence of a causal relationship between financial integration and growth."[5]

Overall, the past decade has shown that capital outflows from emerging markets, including China's currency interventions within the constellation we called Chimerica, have themselves contributed to the build-up of macroeconomic imbalances and financial risks that brought the financial system to the brink of collapse in the second half of 2008. After the dust has settled, members of the economics profession will have to think hard what the right policy advice drawn from the past two decades of financial globalization should look like. The question whether the benefits of financial globalization really outweigh the costs will have to be addressed with new rigor. One can make a case for the benefits of foreign direct investment and portfolio equity flows into developing countries, but in the light of recent experience the blessings of cross-border lending and portfolio debt flows seem particularly hard to identify. It could finally be time to ask how we can make financial globalization safe for the world instead of trying to make the world safe for financial globalization.

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NOTES

1. Economic Report of the President (2009); see also Hunt (2008).
2. Setser (2009).
3. See the contributions by Summers (2006), Stiglitz (2006) and Jeanne (2007).
4. Schularick and Steger (2009).
5. Kose et al. (2006), p.8.

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