Lorenzo Bini Smaghi: What future for financial globalisation? – sovereign debt and the global economy

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Ladies and gentlemen,

It is a pleasure to welcome you to this conference on "*What future for financial globalisation?*" A discussion on this topic could not be more timely as policy-makers and academics are currently making great efforts to make sense of what happened before and during the financial crisis. Questions are being asked about what lessons can be learned and what adjustments need to be made to economic policy in the future.

When policy-makers have the opportunity to talk to academic researchers many synergies can be identified. That is why I am pleased that this conference has attracted so many excellent researchers in the fields of international macroeconomics and finance. I am especially happy that the conference has been co-organised by the Journal of International Economics. I should like to thank the journal's Editor, Charles Engel, for helping to organise this two-day event.

At the latest Economic Policy Symposium held in Jackson Hole a couple of weeks ago, in a very stimulating paper, Eric Leeper set out a long list of questions that he felt should be addressed by researchers in order to fill the large knowledge gap in the field of fiscal policy and guide it closer to scientific analysis and away from its current state of alchemy.[1] Tonight I would like to add a couple of issues to that list, which are partly related to the international dimension of fiscal policy (often ignored by US academics). I will try to inspire our academic colleagues to give more thought to some issues which are key to the functioning of the global financial system and about which policy-makers often do not have sufficient understanding to inform their actions.

The legacy of the financial crisis

One feature of the financial crisis that has become apparent only at a relatively late stage has been the dramatic and widespread increase in public debt, especially in advanced economies. I will focus on this legacy and its implications for both the global financial system and the global economy as a whole.

First, regarding the global financial system, high levels of public debt in major advanced economies are likely to have a non-negligible impact on financial market conditions over the next few years. We have seen in some cases how financial markets react to delayed fiscal consolidation, at times in a rather non-linear fashion. The uncertainties associated with such reactions make it very difficult for policy-makers to calibrate the appropriate budgetary path. There is a risk of a cliff effect, beyond which market participants tend to loose confidence in the ability of sovereign states to repay their debts and regain it only after a very long and painful adjustment. The contagion effects we observed last spring suggest that this risk should not be underestimated, raising a series of issues that have not yet been considered in

[1] Leeper, E., "Monetary Science, Fiscal Alchemy", presented at the Economic Policy Symposium organised by the Reserve Bank of Kansas City, August 26–28 2010.

full, even in the literature. What kind of scenarios could develop if the sovereign debts of several advanced economies are no longer perceived as risk-free assets? How do financial markets work in the absence of a risk-free rate?

Second, the asymmetric distribution of public debt across the world economy has important implications for the adjustment of global imbalances. On the one hand, there is the risk that the protracted and excessive public and external indebtedness of advanced economies could ultimately prove to be – once again – unsustainable. On the other, if debtor countries adjust internal imbalances and lift national savings, who will assume the role of consumer of last resort once played by the United States? This is an oft-posed question in international policy debates.

Let me address these two issues in reverse order.

Global fiscal and current account imbalances

The negative correlation recorded during the crisis between the current account and the fiscal balances has been largely in line with expectations. In the long run, however, current account deficits could well increase again globally if the fiscal expansion which has taken place in recent years is not reined in. In fact, the available evidence suggests that the adjustment of current account imbalances has so far been largely cyclical. The reduction in trade imbalances following the crisis has slowed and, in several cases, has started to reverse. In both the United States and China we are already close to pre-Lehman levels in absolute terms.

The sheer asymmetry in size and composition of the fiscal stimulus in advanced countries compared with any measures taken in emerging economies is likely to magnify the expected resurgence of current account imbalances. Similarly to the pre-crisis situation, advanced economies' indebtedness would be financed with capital flows from emerging economies. This implies not only a massive misallocation of global capital, but also undermines the credibility of any initiative to rebalance savings and investments both within and across the main regions of the global economy. As a result, it risks creating – once again I should say – delusional expectations in financial markets about the sustainability of imbalanced financial and trade flows.

Policy discussions are likely to return to where they were a few years ago. The crisis has given us the opportunity to question their analytical and practical basis.

There are concerns regarding the burden of adjustment on deficit countries and its impact on the world economy. If debtor countries adjust internal imbalances and raise national savings – thus avoiding the scenario of resurging global imbalances – which country would then act globally as the consumer of last resort? In other words, can we avoid a scenario in which there is protracted slow growth across all regions of the global economy until imbalances are eliminated? Admittedly, this is not a new question, but it is more pertinent than ever.

The typical answer is that, in order to avoid the slowdown, surplus and, in particular, creditor economies should rebalance growth within their economies by increasing domestic demand, strengthening non-tradable sectors and reducing reliance on export industries. Thus the policy recommendation to surplus countries is to stimulate domestic demand, in particular through fiscal policies or structural reforms aimed at reducing the level of net savings.

The problem is that surplus countries are in surplus in the first place either because they are fiscally more conservative, at least compared with the more profligate countries – and rightly so I should add – or are facing a situation in which private savings are very high and might even increase if public dis-savings were to rise. Since surplus countries are reluctant to embark on expansionary domestic demand policies, the correction of payments imbalances is faced with some form of asymmetry, a situation that is often disliked by deficit countries. At the global level it has at times been used by the latter as an excuse for delaying adjustment. Global imbalances are the result of a lack of policy coordination.

It seems to me that we need better economic analysis in order to address this issue. First, we need to understand whether a given level of world growth, if achieved through unsustainable imbalances, is in itself sustainable. In 2003–07 the world economy grew at an unprecedented pace, also owing to the large imbalances financed through the recycling of large capital flows. If these imbalances were not sustainable, the underlying rate of growth of the world economy, and of some of its components – in particular the deficit countries – was probably in itself not sustainable. Accordingly, asking who will provide the demand of last resort if the deficit countries save more might not be the right question to ask, because it is based on the presumption that the unsustainable pre-crisis growth rate represents the post-crisis objective.

We certainly need a better understanding about the potential growth of the various economies and its structure, taking due account of how comparative advantages have changed, also as a result of the crisis. My intuition is that such an analysis would suggest that potential growth in the United States is substantially lower than the average growth it experienced over the past decade and requires a shift of resources from the non-tradable to the tradable sector. Given that such a shift in resources cannot occur instantaneously, it should not be surprising if the US economy experienced a period of temporary higher unemployment. In that case, trying to stimulate growth and reduce unemployment to achieve the pre-crisis equilibrium through macroeconomic policies, as some are suggesting, might only delay the adjustment and lead again to an unbalanced path. On the other hand, some surplus countries, such as Germany, might be able to achieve higher growth than in the past decade, because of the increased potential resulting from their better positioning in international trade specialisation achieved over the years and if they are able to employ resources more efficiently in the non-tradable sector.

The second issue that I would like to raise relates to the endogenous factors that induce rebalancing of growth between deficit and surplus countries. Theory suggests that if external demand falls, owing to the lower levels of growth in deficit countries, surplus countries will be able to export less and thus also experience lower growth. This would free up resources in the latter countries which should then be allocated to the non-tradable sector. Furthermore, the interest rate in surplus countries should fall, inducing residents to save less and consume more. However, these adjustment mechanisms may take time and may lead to temporary sub-optimal growth. It is necessary to investigate whether the adjustment process is indeed slow, especially after a crisis such as the one we have experienced. For instance, some recent figures for the euro area, and Germany in particular, as well as China seem to show that over time the contribution of the external sector may be decreasing. The ability of global trade to sustain growth and contribute to global recovery also seems to have been stronger than expected.

The implications for global finance

Let me now turn to the second issue, namely the implications of rising public indebtedness in advanced economies. Although deficits are expected to start narrowing gradually next year, the fiscal burden remains huge. Government debt levels among advanced economies are expected to increase further and approach 100% of GDP. The International Monetary Fund estimates that by 2015 the general government gross debt will reach 110% of GDP in the United States and 95% of GDP in the euro area. This amounts to an almost doubling in the United States and an increase of around 40% in the euro area. Looking forward, the issue of the sustainability of the debt in several industrial countries is looming. This raises several analytical problems, which in my view have not been fully examined in the literature, but which are very important for policy-makers and financial market participants. Here I will consider two of them.

The first analytical problem relates to the assessment of a country's solvency. This task is not as simple as assessing the solvency of a company, a household or a financial institution. It ultimately depends on the country's ability to raise taxes and sustain a level of primary surplus that enables the debt to be stabilised and reduced over time. This depends both on economic and political factors that are not easy to summarise in the nice differential equations that economists like to work with. It is thus inevitable that simplifying assumptions are made, but it is often forgotten that excess simplicity may lead to partial or even wrong results. Let me briefly elaborate.

The analysis of the sustainability of sovereign debt has largely been based on the experience of developing or emerging market countries. It is now applied to advanced economies, starting with Greece. How often do we hear that Europe should learn from the Brady bond experience to address the Greek debt problem? We should, however, examine the risks associated with reasoning by analogy in this way. The risk is that solutions devised for a particular case are not applicable to other cases. Let me give you some examples.

First, in many debt crises of the past in emerging market economies, the fiscal problem was not necessarily the main cause of the crisis. More usually, the crisis originated in the combination of an unsustainable exchange rate peg and foreign denominated debt. The devaluation of the currency would raise the stock of the debt in relation to GDP, which in turn would further contribute to make the peg more difficult to sustain and thus fuel speculative attacks against the currency, in a vicious circle. Under these circumstances, if a peg could not be sustained, the devaluation would have to be accompanied by a restructuring of the debt or a partial default to stabilise the situation. This is not the case in most advanced economies, either because the debt is generally denominated in domestic currency or because the peg is a “super-hard” one, as in Greece’s case. Certainly, if Greece were to exit the euro – a hypothesis that I make just for the sake of reasoning, but which I consider absurd – its debt burden would de facto worsen given that it is denominated in euro, and partial default or restructuring would in that case be unavoidable. However, thanks to the irrevocable nature of participation in the euro, the debt trap is avoided. What many analysts – or I should say doomsayers – have not understood is that the debt problem is the biggest incentive for Greece to remain in the euro area.

Second, in many previous crises in emerging market economies, the debt issued by the country was largely held by foreigners. A restructuring of the debt thus mainly hit foreign citizens and was thus, from a political and economic viewpoint, relatively less costly for domestic residents. In advanced economies, the difference lies in the fact that domestic wealth is more relevant in relation to GDP and is partly composed of domestic debt instruments, including government bonds. A debt restructuring or default thus has an immediate and direct impact on the value of the residents’ wealth and thus on the real economy. The larger the impact of a (partial) default on the financial and real economy of the country, the more costly a (partial) default would be, compared with the alternative of achieving the primary surplus necessary to stabilise and reduce the public debt.

What is often forgotten is that the wealth effect does not depend only on the direct effects of a default or restructuring of the public debt, but also on the chain of events that would be triggered throughout the entire banking and financial system. Owing to the role of advanced economies as lenders of last resort to their own financial system, as has been confirmed by this crisis, a debt problem at the level of the state would cripple the economy as a whole. This is often ignored by those who claim that there can be such a thing as an “orderly” debt restructuring mechanism for the public debt of advanced economies. We need better analysis also in this domain.

The second issue which deserves more analytical work relates to the functioning of global financial markets in allocating resources and setting relative prices in an environment in which the probability of sovereign default becomes significant and widespread. In other words, what happens when certain assets that are considered relatively safe, and in some cases are used as safe havens, are not considered as being that safe any more?

The crisis has shown the importance of financial markets relying on liquid and safe assets to protect against systemic risk. Traditionally, the government bonds of advanced economies have played this role. What scenarios open up if advanced economies' sovereign debt assets are no longer perceived as risk-free assets? How would this affect the functioning of financial markets? There is no doubt that there would be some direct spillover to all other assets. The riskiness of the global portfolio can be expected to rise more than proportionately. Indeed, if the public sector is itself over-leveraged, who can back up the public sector?[2] It can be expected that higher yields and lower asset prices would exert downward pressure on economic activity through increases in the costs of external finance, negative wealth effects and negative effects on confidence.[3]

A world without default-free assets would have further implications for economic activity because these are the prototype of "information-insensitive" instruments, i.e. they serve as "money" and provide the basic functions of money when the opportunity cost of holding money becomes too high.[4] For instance, information-insensitive assets are an important source of collateral in financial markets. The disappearance of "good" collateral would reduce credit supply and thus impair economic activity.

Higher solvency risk also increases other risks at the macro level, such as the risk of "financial repression".[5] As public debt rises to unsustainable levels, domestic financial institutions may be "encouraged", if not forced, to hold domestic sovereign debt in their portfolios. This would lead to inefficient allocation of capital, high costs of financial intermediation and thus lower growth.[6] Finally, in the case of reserve currencies, higher solvency risk would potentially hamper the stability of the international financial system. These questions are just a few examples of the issues on which we need further work.

To conclude, it is clear that current and increasing levels of public debt in advanced economies raise problems which are not only of a macroeconomic nature, but affect many other dimensions of the global economy. On the other hand, our ability to understand the complexity of the issue is still limited. This situation is worrying, to the extent that our societies may take decisions on the basis of imperfect models and wrong assumptions.

Not everybody agrees with the concerns I have just raised, and many take the current very low yields on some government bonds as a comforting sign. My impression is that they may be confusing relative and absolute concepts of risk. And such a mistake could entail very high costs for our societies.

Thank you for your attention.

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[2] Reinhart, C. and K. Rogoff, 2010, "From Financial Crash to Debt Crisis", NBER Working Paper 15795.

[3] Reinhart, C. and K. Rogoff, 2009, "This Time Is Different: Eight Centuries of Financial Folly", Princeton University Press.

[4] Gorton, G. and A. Metrick, 2009, "Securitized Banking and the Run on Repo", NBER Working Paper 15223.

[5] Reinhart, C. and K. Rogoff, 2009, "This Time Is Different: Eight Centuries of Financial Folly", Princeton University Press.

[6] Roubini, N. and X. Sala-i-Martin, 1995, "A growth model of inflation, tax evasion, and financial repression", *Journal of Monetary Economics*, Vol. 35(2), pp. 275–301