Lessons of the global financial crisis

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Corden Lecture
17th October 2012
Melbourne
Lessons of the global financial crisis

• What has happened?
• Why did it happen?
• What are the lessons?
1. What has happened?

• What has happened:
  – A global financial crisis that has affected at least half the world economy, notably the US.
  – Within that, a massive crisis inside the Eurozone.
  – That is, in essence, a regional crisis embedded inside a global one.
1. What has happened? Global crisis

- The economic collapse in affected economies in 2008-09 was both large and enduring

- The rescue was also dramatic:
  - Liabilities of core financial system were nationalised;
  - Monetary policy was extraordinarily aggressive; and
  - Fiscal policy ended up on almost a war-time footing.

- In the case of the UK, for example:
  - Official interest rates are the lowest in more than 300 years
  - The rise in public debt ranks fourth after three world wars.
1. What has happened? Global crisis

• These exceptional circumstances have lasted for five years.
• There is a good chance that they will continue for many more.
• None of the four most important advanced country central banks show any sign of raising rates in the near future
• We are living in what I call a “contained depression”.
1. What has happened? Global crisis

THE LONG SLUMP

GDP IN THE "GREAT RECESSION"
1. What has happened? Global crisis

THE US LEVERAGE CYCLE

TOTAL US DOMESTIC PRIVATE BORROWING
(as per cent of GDP, at an annualised rate)

Source: Federal Reserve, Flow of Funds Accounts of the United States and US Bureau of Economic Analysis, National Income and Product Accounts
1. What has happened? Global crisis

THE SOVEREIGN DEBT IMPACT

NET PUBLIC DEBT OVER GDP (per cent)

Source: IMF WEO, October 2011
1. What has happened? Global crisis

FISCAL ROOM? YES - FOR SOME

YIELD ON 10-YEAR GOVERNMENT BONDS
1. What has happened? Eurozone

• The eurozone crisis is, in essence, a balance-of-payments cum financial crisis, not a fiscal crisis.

• It is directly the result of the easy financing of divergences that accumulated in years of excess.

• What made everything seem so good was laying the ground for an acute crisis.

• It mattered far less whether private or public sectors were financed than how big external finance turned out to be.

• When the flows of finance stopped, there were “sudden stops” and crises arrived.
1. What has happened? Eurozone

THE ROAD TO THE EUROZONE CRISES

CURRENT ACCOUNT BALANCES
(1997-2007 averages, per cent of GDP)
1. What has happened? Eurozone

ROAD TO THE EUROZONE FISCAL CRIZES

SPREADS OVER BUNDS
(percentage points)
1. What has happened? Eurozone

THE ECB’S INTERVENTION BLIPS

SPREADS OF 10-YEAR GOVERNMENT BONDS
OVER BUNDS

- France
- Italy
- Spain
1. What has happened? Eurozone

**LOST COMPETITIVENESS**

**UNIT LABOUR COSTS IN MANUFACTURING**

- Portugal
- Italy
- Ireland
- Greece
- Spain
1. What has happened? Eurozone

THE PATH TO STAGNATION

UNEMPLOYMENT RATES

Spain, Greece, Ireland, Portugal, Slovak Republic, France, Italy, Slovenia, Belgium, Finland, Germany, Netherlands, Austria

2007 vs 2012
1. What has happened? Eurozone

FAILURE OF NOMINAL WAGE ADJUSTMENT

Source: Bruegel
2. Why did it happen?

- Two causes:
  - The global imbalances and savings surplus; and
  - The long-term leverage cycle.
  - The former lowered the global real rate of interest and caused a huge rise in current account imbalances
- This was Hyman Minsky’s “displacement event”
- It triggered a wild asset price, *cum* financial bubble, which imploded in 2007-08
2. Why did it happen?

**ASIAN CRISIS BROUGHT THE SAVINGS GLUT**

**REAL INTEREST RATES**

- **Asian financial crisis**
- **Western financial crisis**

**UK INDEX-LINKED**

**US TIPS**
2. Why did it happen?

BOOM, BUST AND EVEN LOWER RATES

REAL HOUSE PRICES

Asian financial crisis
Western financial crisis

US  UK  Spain
2. Why did it happen?

THE RISE OF THE IMBALANCES

GLOBAL CURRENT ACCOUNT IMBALANCES
(as per cent of world GDP)

Source: WEO, October 2011
2. Why did it happen?

THE US LEVERAGE CYCLE

CUMULATIVE PRIVATE US DEBT
(as per cent of GDP)

Households  Non-financial Business  Financial Sectors
2. Why did it happen?

**BEGGAR-MY-NEIGHBOUR EUROZONE**

**EUROZONE IMBALANCES ON CURRENT ACCOUNT (as per cent of GDP)**

- EA surplus excl. Germany
- Germany
- Periphery
- EA deficit
- Euro area
3. What are the lessons of the crisis?

- We have a long slog ahead of us. The US may recover in a few years, but Europe has a huge challenge ahead of it.

- But we can try to learn some lessons.

- So here are three questions:
  - Can we prevent crises?
  - Can we make the financial system more robust?
  - Can we lower the economic costs of crises?
3. What are the lessons of the crisis?

• Can we prevent crises?
  • Probably not;
  • But we were extraordinarily foolish to believe that stabilising inflation would stabilise the economy;
  • The great moderation was precisely the environment in which everybody was happy to take on more risk;
  • The obvious way was to increase leverage; and
  • That made the economy far more fragile

− So the size of the crisis was the result of clear mistakes in macroeconomics and in views about the financial system.
− Similar complacency afflicted the Eurozone.
3. What are the lessons of the crisis?

- Can we make the financial system more robust?
  - Yes.
  - We need to make it stronger, less interconnected and easier to resolve. We also need to change incentives inside the system.
  - This means much more capital.
  - It means ring-fencing, as the Vickers Commission proposed.
  - It means changing incentives, by ensuring management shares in losses.
3. What are the lessons of the crisis?

• Can we lower the economic costs of crises?
  – Yes;
  – This means strong monetary and fiscal stimulus in the immediate aftermath of the crisis;
  – For countries with central banks and no risk of default, interest rates will be very low. This allows stimulus. The important thing is to make it count, in terms of high-quality assets, to go with the additional liabilities.
  – It is also necessary to lower debt, as quickly as possible.
  – There must also be global rebalancing.