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Has the global financial crisis produced a New World Order?

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ABSTRACT

Described by Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, as the worst financial crisis in global history, the economic impact of the global financial crisis would have been much worse had it not been for Asia (excluding Japan). In broad terms, the crisis has accelerated the secular emergence of Asia, whereas the US recovery is weak by historical standards and problems in Europe continue. What accounts for this two-tier pattern of world growth? Does this juxtaposition signal a permanent re-ordering of world business – in other words, a New World Order?

1. From boom to bust

There is no shortage of books, articles and web-based material studying the causes of what Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, called 'the worst financial crisis in global history, including the Great Depression' (Mollenkamp, 2011),[2] and his predecessor, Alan Greenspan, described in similar words as 'the most virulent global financial crisis ever' (Wessel, 2010b). Nevertheless, there has been a marked change in the literature, in a direction that accords with our own views.

As the crisis unfolded, the immediate focus of those searching for explanations of the causes was almost exclusively on 'micro' factors, involving the behaviour of the banks and failures in the regulatory system. From the perspective of Axel Weber, President of the Deutsche Bundesbank there was 'a cocktail of causes' (Weber, 2008, p. 1). He identified three main reasons: lax lending standards, weaknesses in the credit transfer processes, and overly optimistic assessments of structured securities such as mortgage-backed securities and collateralized debt obligations (CDOs). Other ingredients in the cocktail came from the ambiguous status of Fannie Mae and Freddie Mac (Poole, 2007), the complexity of CDOs (Gorton, 2009), and the vast grey or shadow banking system in the guise of conduits and off-balance sheet specific purpose investment vehicles designed to engage in regulatory arbitrage (Goodhart, 2009). In the United States the shadow system 'grew in gross terms to be larger than the traditional banking sector' (King, 2010, p. 4), and according to the FCIC triggered a more than tenfold increase in financial sector debt from US $3 trillion in 1978 to US $36 trillion in 2007 (Mollenkamp, 2011). Much of the major banks' activities in the shadow system had to be eventually absorbed (along with the large associated losses) into the parent bank balance sheets. There were also questions about the impact of fair-value accounting rules (FMG Review, 2008; Wallace,

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[1] The author is writing in his personal capacity, and thus the usual disclaimer applies.

[2] This is the description given by Ben Bernanke to the Financial Crisis Inquiry Commission (FICIC) in October 2009 on the grounds that of the 13 most important US financial institutions, '12 were at risk of failure within a period of a week or two.' The exception was J P Morgan Chase (Mollenkamp, 2011).

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2008) and whether Basel II capital adequacy rules were pro-cyclical (Persaud, 2008). Some of these views were later echoed by Chinese central bank governor Zhou Xiaochuan who put the blame firmly on Wall Street and factors such as accounting rules, credit rating agencies, securitized lending and lax standards at banks (Batson, 2009). Others accounts have pointed to the role of greed, reckless behaviour (on the part of US homeowners, mortgage brokers, mortgage lenders, Wall Street investment banks, hedge funds and other investors alike), and excessive debt and leverage (Lewis, 2009, 2010).

Only later were these factors placed into a wider context when attention turned to the root global macroeconomic origins of the crisis. In the words of Pisani-Ferry and Santos (2009), 'there was a collective failure to grasp fully the link between global payments imbalances and the demand for safe (or seemingly safe) financial assets and the manufacturing of those assets'. They continue: 'it was the combination of strong international demand for such assets, largely in connection with the accumulation of current account surpluses in emerging and oil rich economies, and an environment of perverse economic incentives and poor regulation that proved to be explosive' (p. 9).

Matching the current account surpluses of China and other countries was the US current account deficit, which widened dramatically after 2001 to reach $811 billion or 6.1 per cent of GDP in 2006, when the United States was absorbing nearly 80 per cent of the international savings that crossed borders. The US current account deficit has been extensively studied by US economists and commentators. Indeed, Iley and Lewis (2007) examined no less than 41 hypotheses and explanatory factors that have been advanced in the extensive literature on the subject. Nevertheless, only two explanations have attained major status. These are the 'Bernanke thesis' and 'the Greenspan legacy'.

Attitudes to the fundamental causes of the financial crisis have polarized around these two positions. Ever since Bernanke (2005) advanced the 'global savings glut' hypothesis, policy makers in the United States have 'insisted that the key macroeconomic problem in the world economy was not its current account but rather China's high propensity to save' (Pisani-Ferry & Santos, 2009, p. 9). Instead of being 'made in the USA', due to excessive borrowing and spending and insufficient savings by US households and the US government, the deficit is perceived chiefly to be the result of decisions made abroad that have produced a glut of savings on world financial markets. The argument is that when China and other emerging countries switched to market-oriented economies in the 1990s, hundreds of millions of workers were absorbed into the world economy. Their consumption could not keep pace with expanding GDP growth and savings rose, unleashing a tsunami of capital onto global markets. In the case of the United States, flooded with inflows of capital, US savings fell and investment rose as households borrowed and spent on housing and other goods, generating the US current account deficit that is the statistical counterpart of its capital account surplus.

There are some today who still maintain that the global financial crisis originated in China (including notably Ben Bernanke and Alan Greenspan). Gradually, however, the 'glut of savings' hypothesis has given way to the view that the Federal Reserve, in the last four years of Greenspan's chairmanship, kept interest rates too low. From this alternative perspective, the Bernanke thesis failed to mention that central bank policy rates in the wake of the collapse of the dotcom boom in 2001 and September 11 were driven below levels in the Great Depression of the 1930s, which does seem a striking omission from any story about the factors behind low US saving and low world interest rates. Greenspan's particular style of monetary policy saw the Federal funds rate pushed down from 6.5 per cent at the end of 2001 to a (then) record low of 1 per cent in early 2003 and held at that level for over a year, fuelling a consumption and real estate boom and massive mortgage equity withdrawal. For their part, those countries (e.g. China) selling goods to Americans due to the trade deficit were only too happy to lend back the dollars they received so that the spending spree would continue, and thus accommodated insufficient savings in the United States with more savings of their own. On this interpretation, the same facts hold, but causation is reversed.

In considering these different viewpoints, it is fair to say that the role of the Federal Reserve in instigating and maintaining inappropriately easy money and so underwriting high asset prices has attracted considerable criticism. At the root of the problem has been the Federal Reserve's historic asymmetrical approach as to how monetary policy should deal with asset price bubbles, succinctly summarized by the current vice-chairman of the Federal Reserve Board, Donald Kohn. In 2006, Kohn noted that, 'because of huge uncertainties, it is too risky to respond to bubbles and therefore it is safer to 'mop up' by easing policy after a bubble bursts' (Kohn, 2006). The Fed's position has been characterized more pithily as: 'we can't spot 'em, but we can mop 'em''. In market parlance, the Fed's intellectual position was simply known as 'the Greenspan put'. While difficult, if not impossible to quantify, the Fed's philosophical approach and the perception that it would always ride to the rescue and 'cushion the busts' has doubtless helped fuel excessive risk taking and so contributed to the long, and ultimately unsustainable, consumption boom by encouraging downside risks to be downplayed and risk premiums to be compressed. At the very least, the 'hothouse' environment acted as an incubator for the mortgage lending explosion.

Two other contributory factors must also be highlighted. One is the acceleration of globalisation, particularly the flood of imports from Asia following the 1997–1998 Asian Crisis, and China's rapid emergence into the global economic system over the last decade. Cheap manufactured imports curbed inflation worldwide, that both encouraged expansionary monetary policy in advanced economies and helped further entrench the secular decline in nominal bond yields that was a key driver of higher asset valuations. Note, however, that this indirect linkage is rather different to the claim under the Bernanke thesis that a 'global savings glut' (read China) was the key cause of US asset bubbles.

Not only is this claim a misnomer (high net savings in many countries over the last decade was as much the product of an investment dearth as a savings 'glut') but also it seems almost fanciful to absolve responsibility from the Federal Reserve, and the United States in general. Moreover, it ignores the fact that, by 2003–2004 when countries such as Japan and most prominently China began to acquire foreign exchange reserves, the United States was already running a current account deficit of close to 5 per cent of GDP with a housing market boom well under way and US households already dissaving for