



The financial crisis and its international transmission: selected lessons

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Comments by Michael Hutchison



M-F Key Points on Financial Integration and Exposure

■ Financial Integration Points

- Boom in cross-border holdings amongst advanced economies
- Reduced exposure from changes in balance sheet structure for emerging markets (less external debt, higher reserves, etc.)

■ Pre-Crisis Exposure to U.S. Bonds

- **Net terms**: high holdings of US securities by China, Japan, SWF in oil exporters (mostly Treasury and agency bonds)
- **Gross terms**: large cross-border positions of European countries vis-à-vis the US (large holdings of corporate bonds, including ABS), also through US subsidiaries and offshore centers



M-F Crisis Points

- Direct “hit” on banks (mostly in Europe), esp. due to leverage and maturity mismatch (ABS holdings through short-term borrowing)
- Direct effect of risk reappraisal for countries running large CA deficits and on other EM via liquidation of portfolio instruments/bank capital repatriation
- Deleveraging process
- Flight from risk
- “Dollar shortage”
- Increase in home bias

A few lessons?

- Dangers of large current account deficits
 - Selected small (mainly Eastern European) countries...what about a systematic study of how hard affected, and related to deficit and other positions
- Importance of Sectoral Exposures
 - High leverage
- Exchange Rate flexibility became a “shock absorber”
 - Especially with high reserves, small deficits and little currency mismatch
- Dangers of credit booms under fixed exchange rates
- Structural fiscal deficits “masked” by economic booms and asset prices
- International Financial Structure
 - Need rapid provision of resources when facing sudden stops
 - Many questions...



What I think is critical

- High leverage...agreed
 - But can't highlight problem of high leverage without links to incentives/financial regulation
 - Sub-prime problems from bottom to top
 - Lessons: will “resolution” of financial crisis lead to higher or lower leverage in future?
Moral hazard
- Understanding collapse of international liquidity, flight to quality and underpinnings of a classic financial panic



Critical points...continued

- Securitization, rating agencies, risk evaluation
- Regulatory failures and separation of financial institutions from government
- Financial integration / cross-border linkage played a role in transmission (agreed)



What I think is secondary...

- Global imbalances

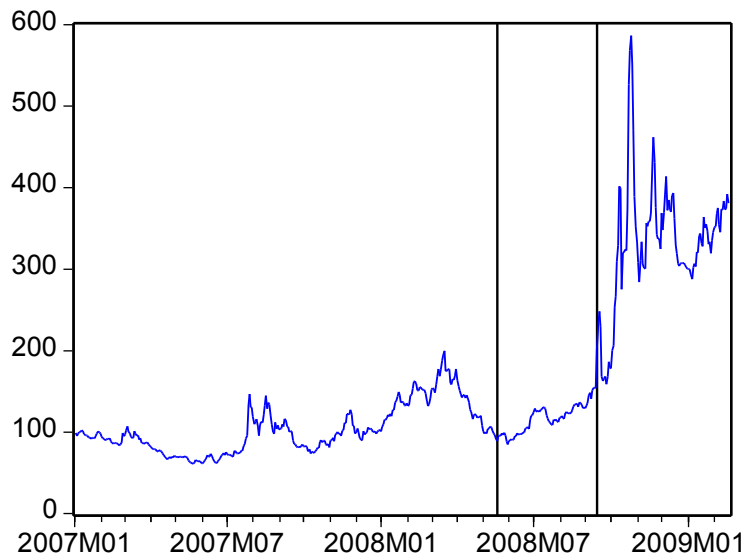
- Not central to asset price bubble or leverage
 - Did capital inflows into US fuel housing bubble?
- Though stronger external balances helped

- Fiscal imbalances

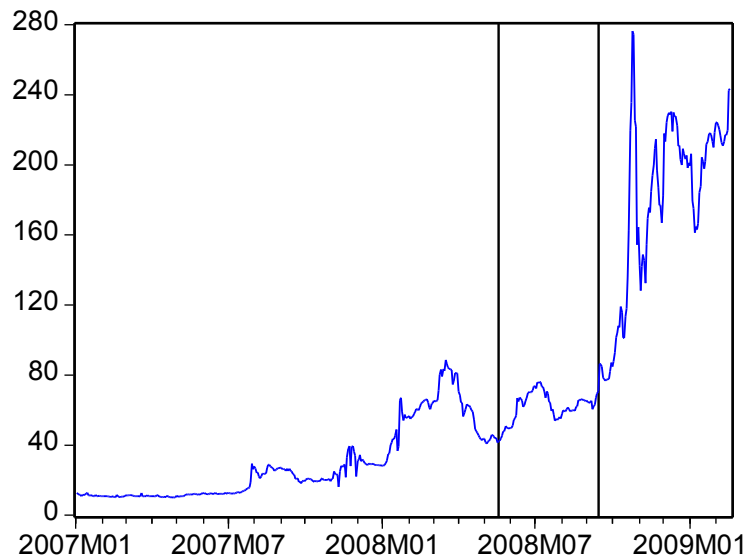
- This was not a fiscal crisis

- Exchange rate regime

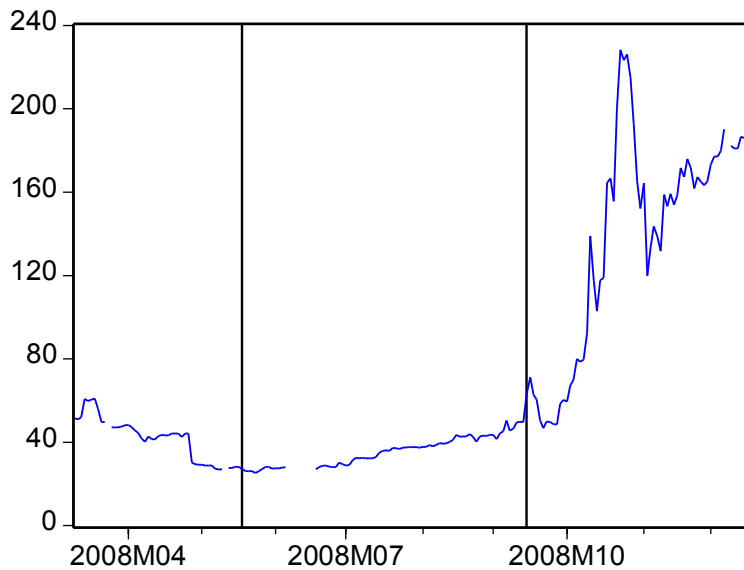
- Did nature of exchange rate regime play a role? Evidence on whether fixed rates more prone to credit booms? Less shock absorber?



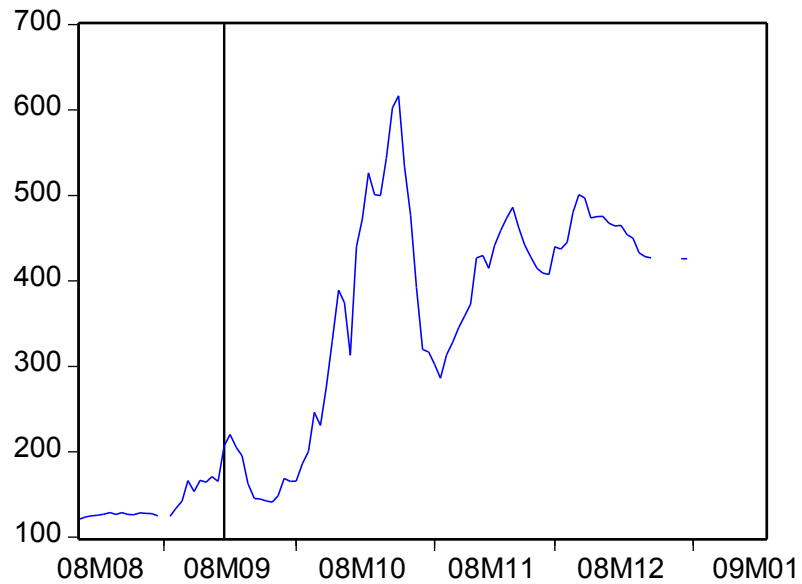
BRAZIL




CHINA



CZECH REPUBLIC



CDS5Y_HUNGARY



“The extent of pass-through of financial stress is related to the depth of financial linkages between advanced and emerging economies. Higher current account and fiscal balances do little to insulate emerging economies from the transmission of financial stress in advanced economies, although they may help dampen the impact on the real economy.”

From Abstract:

The Transmission of Financial Stress from
Advanced to Emerging Economies
*Ravi Balakrishnan, Stephan Danninger,
Selim Elekdag, and Irina Tytell*

IMF Working Paper 09/133 June 2009



Overall

- Agree with most of the points...but NOT the emphasis
- Need to address international financial architecture...but mainly to ask why so unstable
 - Dollar shortage easy to fix ex post
 - Problem is avoiding crisis ex ante