

Current Financial Stresses and Persistent Global Imbalances

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I'm delighted to speak at this event sponsored by the Southern Center for International Studies.

It's especially gratifying to me to be the speaker here today. Shortly after moving to Atlanta in 1978, I became aware of the Southern Center and began attending its programs. I recall—being the know-it-all I was in those days—being pretty aggressive with my questions of speakers. I made my presence felt enough to be invited ultimately onto the Southern Center board. And recently I've rejoined the board after a hiatus of 20 years. In remembering my questions, I couldn't imagine back then that the tables would be turned someday and I would be here fearing that some young know-it-all will ask a tough question. After my remarks I will be happy to answer your merciful, untaxing questions. And I will oppose board membership for anyone who violates that plea.

Today, I want to focus most of my remarks on the interplay between the recent stresses and problems of our financial system—particularly the credit capital markets—and the reality of persistent global financial imbalances. But let me begin with a very brief summary of a subject that is top of mind for many of you in this room. And that subject is the current state of the economy and recent Federal Reserve actions.

Current economic and market situation

In recent months, there has been a sharp deceleration of economic growth. The pace of job creation has slowed. And at 4.9 percent, unemployment is measurably higher than it was a few months ago. When I joined the Atlanta Fed almost a year ago, the unemployment rate stood at 4.5 percent.

Troubles in the housing sector have been well publicized, with house prices declining in many parts of the country. These developments have led many observers to express concern that the economy is going into a recession. Also, with the surge in energy prices last year, recent measures of inflation have been elevated and above my personal comfort zone as a policymaker.

Interpretation of recent policy actions

In response to recent economic circumstances, the Federal Open Market Committee (FOMC) has acted decisively. Over a period of nine days, from January 22 to January 30, the FOMC lowered the fed funds rate 125 basis points, from 4.25 to 3 percent. Since last August, the committee has dropped the fed funds rate 225 basis points.

These actions were taken to avert a deep and protracted economic downturn. In the face of economic weakening, the FOMC acted to avoid a restrictive posture and to move rates toward a level that might support a stronger pace of growth in the second half of 2008.

You may also be aware that in response to recent strains in financial markets the Fed has injected liquidity into the financial system. In December, the Fed introduced the Term Auction Facility as another way to address immediate liquidity needs in financial markets.

I believe recent actions helped address the risks to the economic forecast just referenced. My baseline forecast envisions weakness in the first half of 2008 followed by improvement in the second half, with inflation moderating from recent levels. The liquidity injections and easing of monetary policy should help housing and financial markets stabilize and avoid an "adverse feedback loop" in which a decline in housing prices fuels financial market volatility with spillover to the broader economy.

These immediate, seemingly domestic, economic challenges demand attention. But I believe it's important to keep in mind the larger context—that our economy continues to deal with the reality of persistent global imbalances. So I will take some time this afternoon to comment on the interplay between periods of financial system stress, the actions and policies required to remedy system weaknesses, and the reality of continuing global financial imbalances. Some of these thoughts are in the nature of a hypothesis. They are my tentative views and those of members of my economic research staff at the Federal Reserve Bank of Atlanta. I do not speak for the Federal Reserve System or my colleagues on the FOMC.

Trends in credit markets

To set the stage for this discussion, let me review some of the key evolutionary trends in banking and credit over the last 20 years. The choice of 20 years of hindsight is arbitrary, but I do remember strategic consideration of these directions in the mid-1980s—when I was a corporate banker working for Citicorp here in Atlanta.

I will cite four trends I see as formative of our current situation.

First, credit intermediation has evolved from being bank-centric to market-centric. To a substantial extent, the modern model of the banking business—at least for larger banks—is that of originate-to-distribute. This means banks work with business clients and consumers to create a new loan but often sell that loan into a secondary market for such assets.

Second, the business of credit has evolved from the old style of booking a loan and holding it until repayment to the financial technology called securitization. This term refers to the pooling of many similar loans into a single package that is then funded in the debt securities market. Securitization has been one of the major financial innovations of the last two decades. The master security is then broken into tranches with different risk and return characteristics.

Charles Sanford, a native of Georgia who rose to head Bankers Trust, wrote of "particle finance." As I recall, he envisioned particles of risk and reward. He meant that credit and financial risk would be parsed, tranced, and transformed into derivatives to match the exact risk and return preferences of diverse lenders and investors. Along with

securitization, the growth of derivatives—financial contracts based on the price fluctuation of a distinct asset, commodity, or risk—has been a major innovation of our age.

Third, for many banks, particularly our larger banks, lending to corporations has evolved from general corporate lending to leveraged lending. For some time it's been the case that banks seldom make direct loans to the top-rated corporations, especially where the bond markets offer a better deal. The rise of the private equity industry offered a lending alternative with better fees and spreads. Financing leveraged buyout transactions has become a big business for many banks. And these loans too have been sold off into secondary markets.

Fourth, credit extended to American corporations and consumers has evolved from domestically funded to global distribution of securities and loans. There is little argument that capital markets—including credit markets—have become global. To some extent, this is in response to the accumulation of large pools of dollar capital held offshore. I want to explore this notion further in my remarks.

Role of foreign dollar surpluses

Analysis of the causes of current financial market instability cannot ignore the possible role played by the interconnected phenomena of trade imbalances, savings and investment imbalances, fiscal imbalances, and foreign-owned dollar surpluses. Such imbalances have emerged as a persistent—and some would argue ominous—feature of the global economy as the world's goods markets and capital markets have become ever more integrated.

I believe it's important to recognize that this aspect of globalization is both effect and cause. The effect is that large, mature countries like the United States are able to be net debtors to the rest of the world for sustained periods of time. But in addition, the channeling of capital from net saving countries is itself a cause of financial market, product, and deal innovation as bankers try to design investments that appeal to investors, including foreign investors. In my view, analysis of the causes of current financial market instability cannot ignore the role of foreign dollar surpluses.

Looking at economic history over the past few decades, it appears that the recycling of large dollar surpluses has presented recurring challenges. My career actually involved direct dealing with both offshore dollar surpluses and the resulting challenges. In the early 1970s I worked in Saudi Arabia when the first momentous oil price change occurred. The world was flabbergasted when oil went from \$2.50 a barrel to around \$12 a barrel. The oil producing countries suddenly generated enormous—for that time—dollar surpluses that needed to be invested elsewhere in the world. There was a rush of lending to developing countries—especially Latin America—that seemed to offer so much growth potential and, in turn, high rates of return.

Borrowing countries and their bankers overindulged, and this flow of capital resulted in the less-developed country, or LDC, debt crisis of the 1980s. At that time, I had the job for a year of swapping bad loans to South American countries for equity in local companies.

The point of this commentary is that the accumulation and investment of large pools of dollar capital in the hands of institutions and individuals abroad may have direct linkage to periodic financial market cycles in this country—both rises and falls—as well as banking system problems. This argument has recently been put forward by academic economists Carmen Reinhart and Kenneth Rogoff. Reinhart (of the University of Maryland) and Rogoff (of Harvard) draw a line from the channeling of petrodollars to South American sovereign debt in the 1970s to disruptions of the U.S. banking system in the 1980s. Whereas the large foreign dollar holdings of the 1970s and 1980s were channeled through banks to risky emerging market debt, in recent years the accumulation of dollar holdings abroad helped finance risky U.S. household debt, again with banks in the middle.

Each period of financial market systemic stress, regardless of root causes, is followed by the predictable period of sharp adjustments and reform of the financial markets and their institutional architecture. The interaction among all the factors I have mentioned—trade imbalances, global saving and investment imbalances, market innovation, and reform—is complex. It's tempting to carry analogies from the past too far. At this point conclusions about cause and effect are more speculation than science. But I am persuaded that the liquidity conditions created by foreign-owned dollar surpluses trying to find an investment home in this country contributed to markets' recent unstable conditions.

I am also persuaded these financial imbalances are not likely to disappear in the foreseeable future. We must live with them, and policymakers must be mindful of them.

Why are financial imbalances likely to persist? One reason is that U.S. dependence on foreign energy resources will last some time. Another is that the conversion of large-population, surplus-generating, saver countries (such as China and Japan) to consumer societies will take time. So will the conversion of the United States to a saver society. If you need be convinced of the scope of this transition, just consider the primacy of the U.S. consumer in world product markets. By one measure, nominal U.S. consumer spending was 18 percent of gross global product in 2007.

This nation will need foreign owned dollar capital well into the future. As we address the recently exposed inadequacies of our financial system and implement necessary fixes, we must not discourage foreign investors. What could do this? The answer is the same whether the recipient country is a small emerging market or the largest economy in the world. Inward investment is discouraged by:

- seemingly arbitrary changes in legal and tax rules, including changes favoring local resident interests;
- confiscatory treatment of property and assets, including financial assets;
- excessive regulation;
- capital controls; and
- investment protectionism.

Let me elaborate on some of these factors. In my view, we should not rewrite the rules of the game after the fact. The efforts of private-sector players with the encouragement of the U.S. Treasury Department under the banner of the Hope Now initiative promote a voluntary framework for mitigating subprime mortgage foreclosures. I support this approach. It is far better for the parties in financial arrangements to work through the process of apportioning losses by mutual consent or through traditional adjudication channels.

In my view, we should not—in pursuit of market order—impose excessive regulatory constraints that undermine the innovation and competitiveness that are, in the long run, the foundation of thriving financial markets and institutions.

Finally, in my view, we should not become identified with "investment protectionism." Trade protectionism is widely understood and debated. Investment protectionism refers to differentiated treatment of capital providers based on national identity and citizenship as well as denial of certain investment opportunities to nonresidents or noncitizens.

There are some legitimate national security concerns in certain industries, such as defense, but such concerns can be easily exaggerated.

Much has been written and said recently on the latest concern—sovereign wealth funds. Sovereign wealth funds are special purpose investment vehicles sponsored and overseen by governments to allocate some of their foreign currency reserves (dollar surpluses) to a diversified portfolio of securities and direct investments. I have had some direct experience with sovereign wealth funds in the Middle East. I share the views expressed by a number of commentators—sober and sensible, in my view—who argue that we should not misconstrue the intent of these investors and exaggerate their threat to our national welfare and security. I think it is far-fetched that investments would be made for nefarious political purposes and that investment funds would—or could—somehow impose noncommercial decisions on investee companies. In my experience and observation, these funds are serious, responsible, commercially minded, and professional stewards of their countries' wealth. I think concerns about sovereign wealth funds can be overwrought. To the extent that trade and capital-account imbalances are the source of potential instability, the answer is to address the fundamental causes.

The opposite fear is abandonment by foreign investors of the dollar and the United States as an investment destination. We need not, in my opinion, fear a precipitous, wholesale withdrawal of foreign-owned capital. The most extreme versions of this scenario are simply not possible. Though some diversification of global capital will proceed from the natural reapportionment of economic power as economies and capital markets develop, the United States and its currency remain at the center of the world's trade and investment system. So long as we follow sensible policies, the cost to the global economy of materially altering these arrangements would be far too high.

To close, let me summarize the thesis presented here and add a few thoughts. The United States has experienced periodic episodes of financial system stress followed by curative adjustment and reform. We are in such a period now. Large and persistent global financial imbalances are contributing factors. The accumulation of large dollar balances owned by foreign parties must be recycled into investments. Large volumes, resulting from concentrated dollar holdings abroad, encourage financial innovation but also excesses. There are excesses because popular investment products and strategies are pushed beyond prudent limits under the pressure of competition and linear assumptions.

If global imbalances are unlikely to disappear for some time, and we must live with them, then market practitioners and financial authorities must improve their ability to monitor global investment flows and recognize incipient problems.

As I said earlier, there is a fair dose of conjecture in these ideas. They deserve further exploration and research. My colleagues and I at the Atlanta Fed intend to do this.

Thank you very much.

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