



The Crisis: International Financial Linkages and Lessons

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Passion to Perform

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Outline I: Issues covered

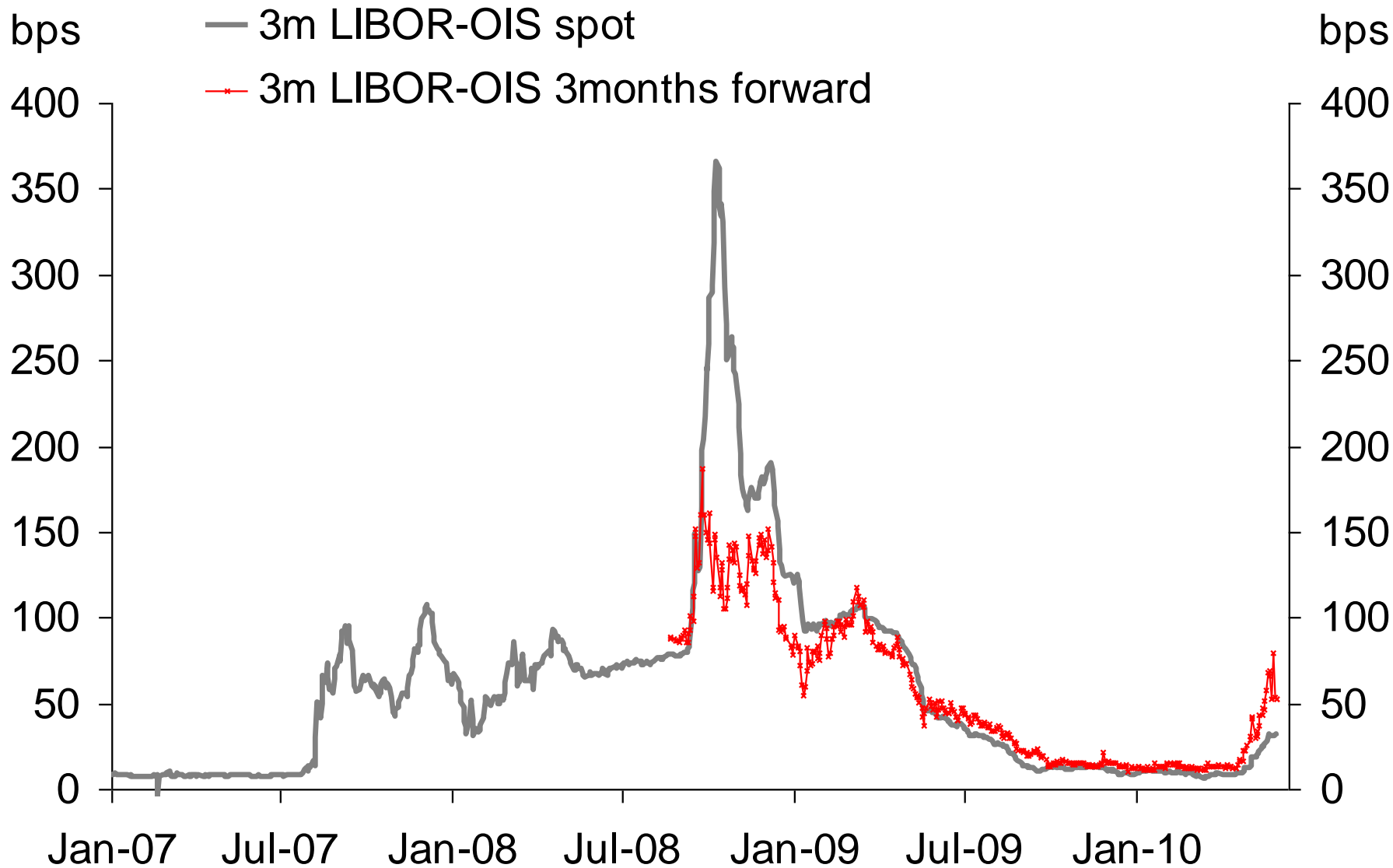
1. Money market crisis returns.
2. Roots of money market crisis in European bank dollar funding problem that has developed in train with surges in gross and net international capital flows.
3. Resolution of global imbalances not occurring as it normally does after financial crisis; this poses risks ahead



Outline II: Some lessons we have learned (or relearned) from the crisis

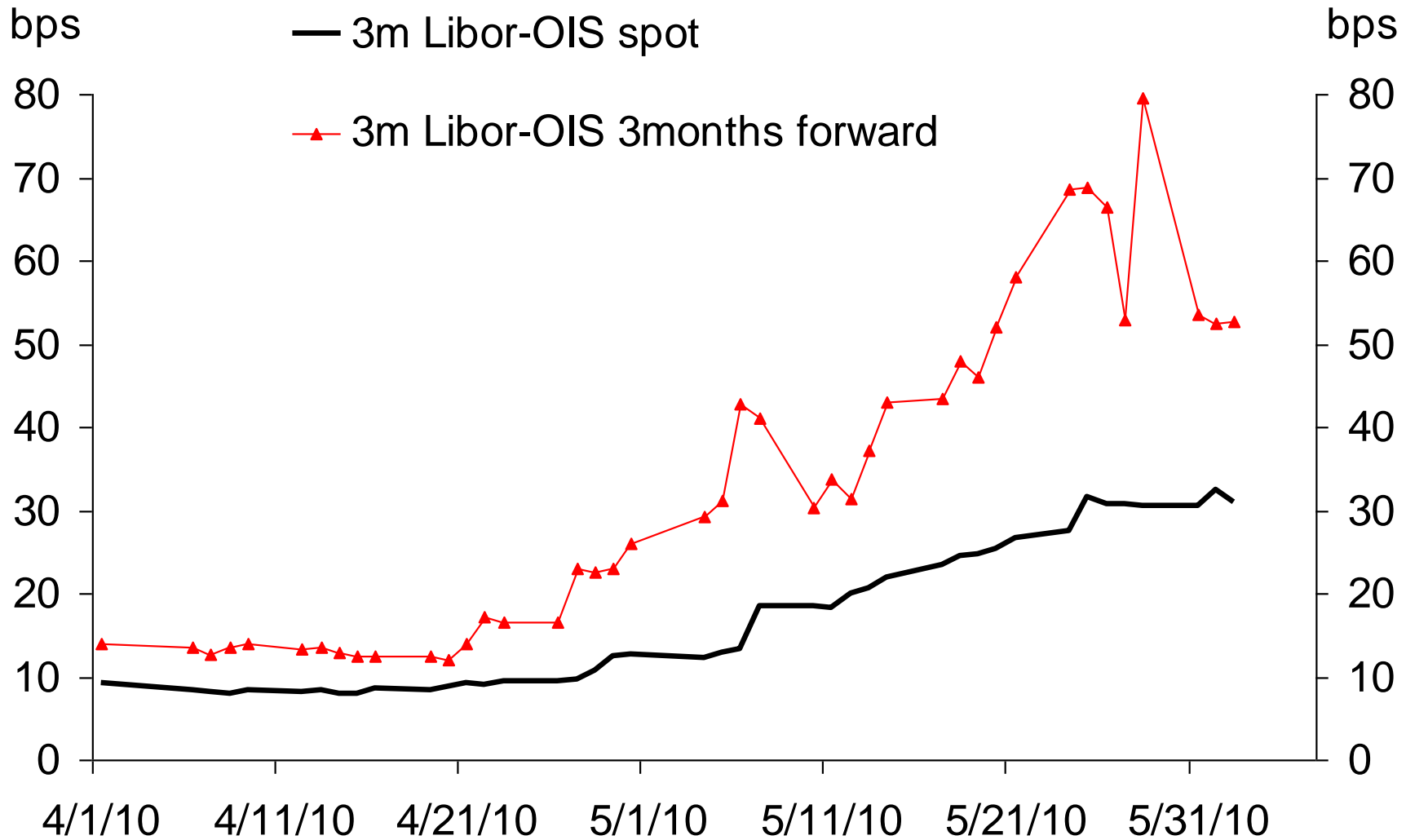
1. Bad things can happen suddenly, massively, with lasting impressions. Consider money markets.
2. Free flow of capital desirable, but abnormal increase in gross flows should be a warning sign.
3. Uptrends in net capital flows (global imbalances) not necessarily a good thing.
4. Financial crises can happen to the best of US (and the worst may be yet to come).

Bad things can happen quickly, with lasting impressions





Money market crisis flaring up again



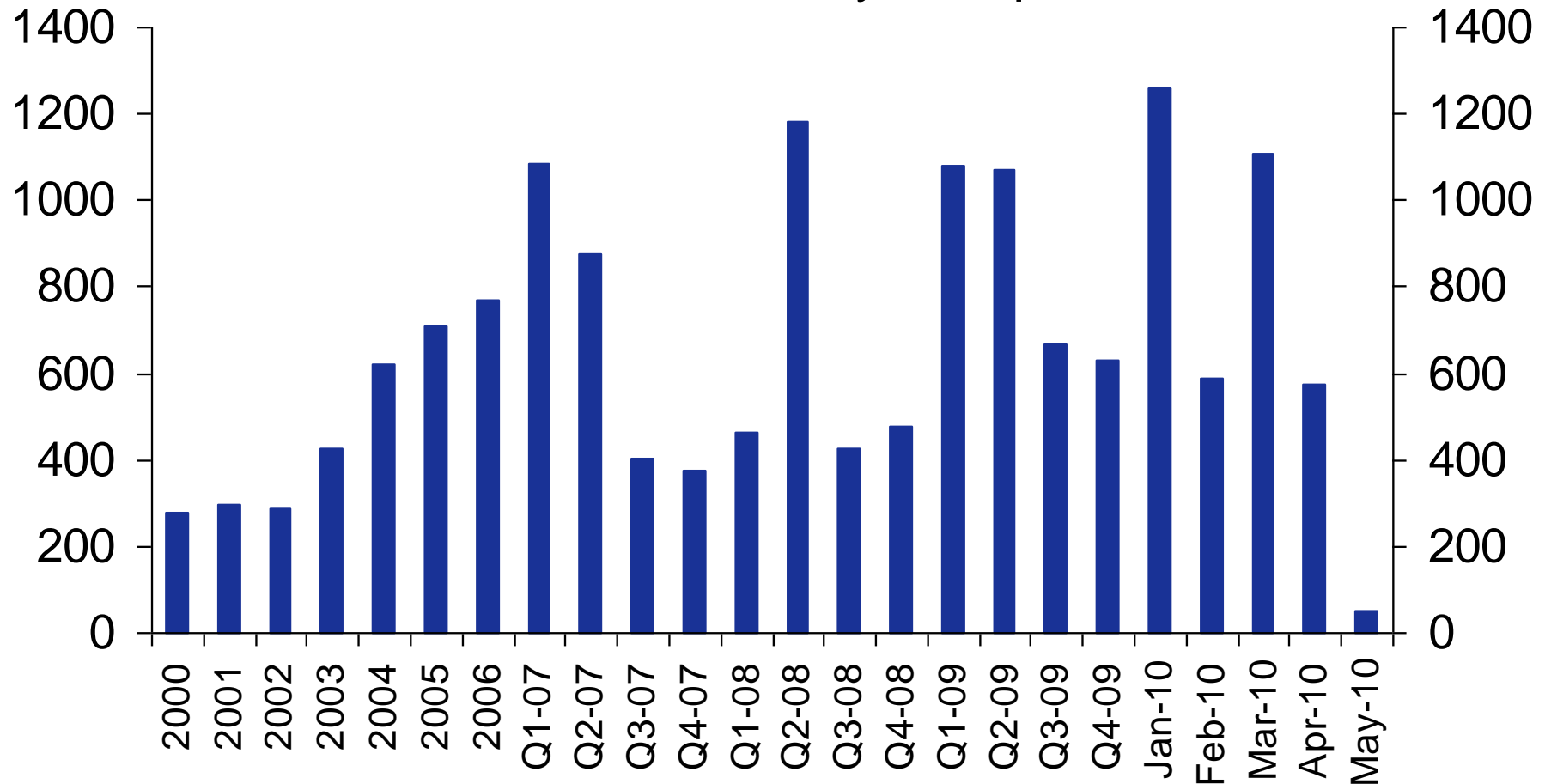
Long-term euro funding for European Banks has dried up too



\$ bln, annual rate

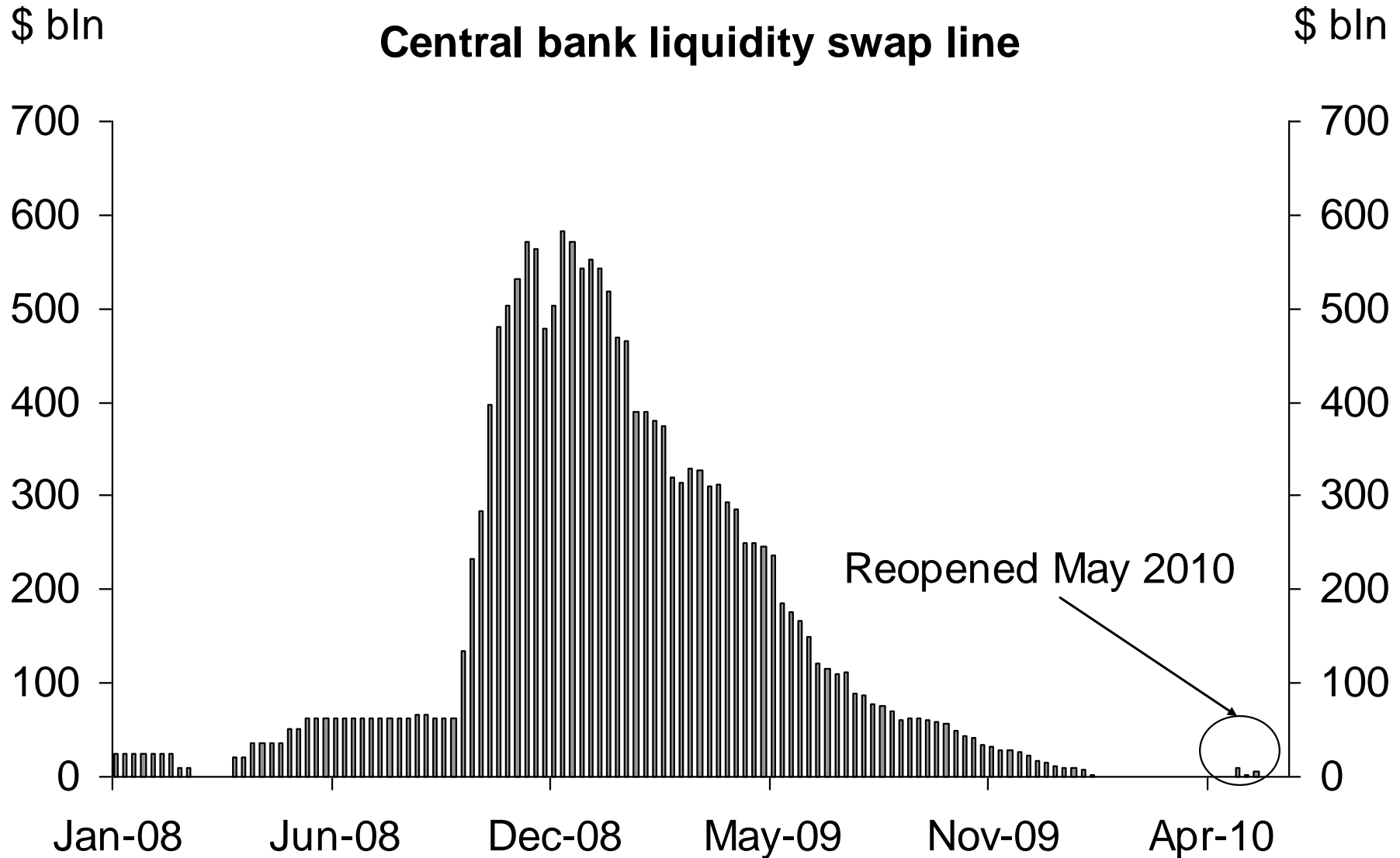
\$ bln, annual rate

Issuance of term debt by European FIs



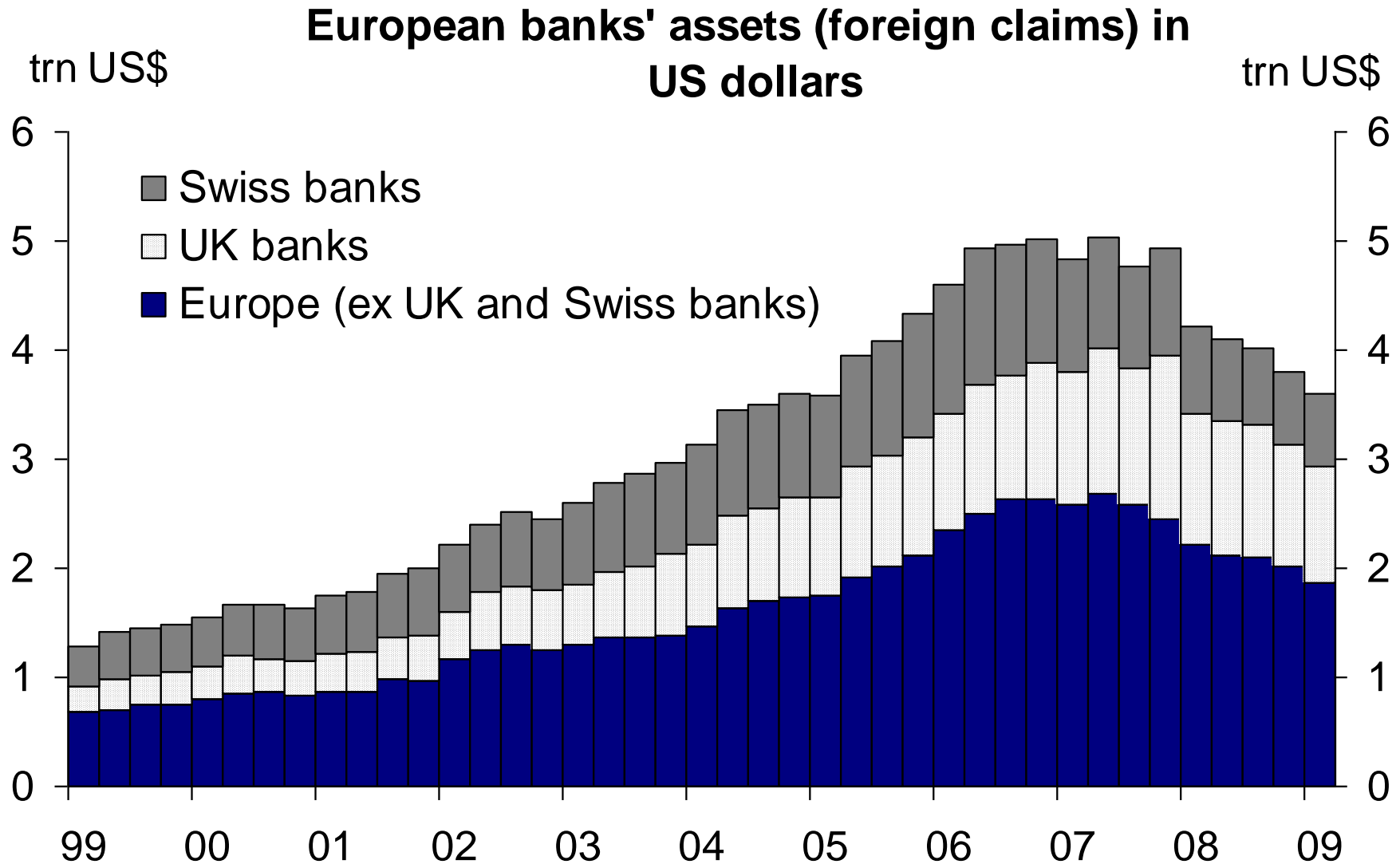


FX Swap line reopened but little used





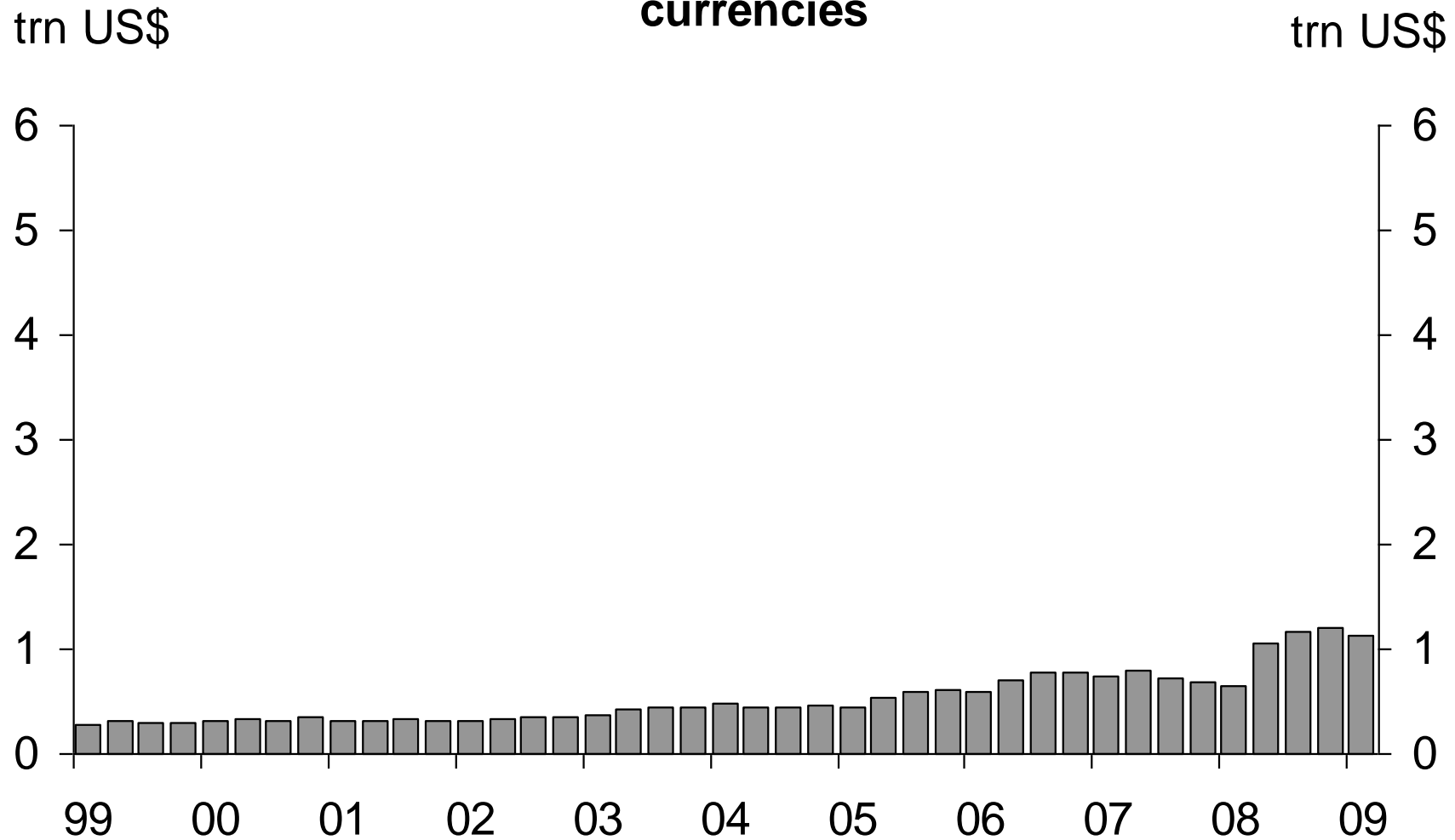
Roots of European Banks' dollar funding problem



US banks have relatively small euro assets

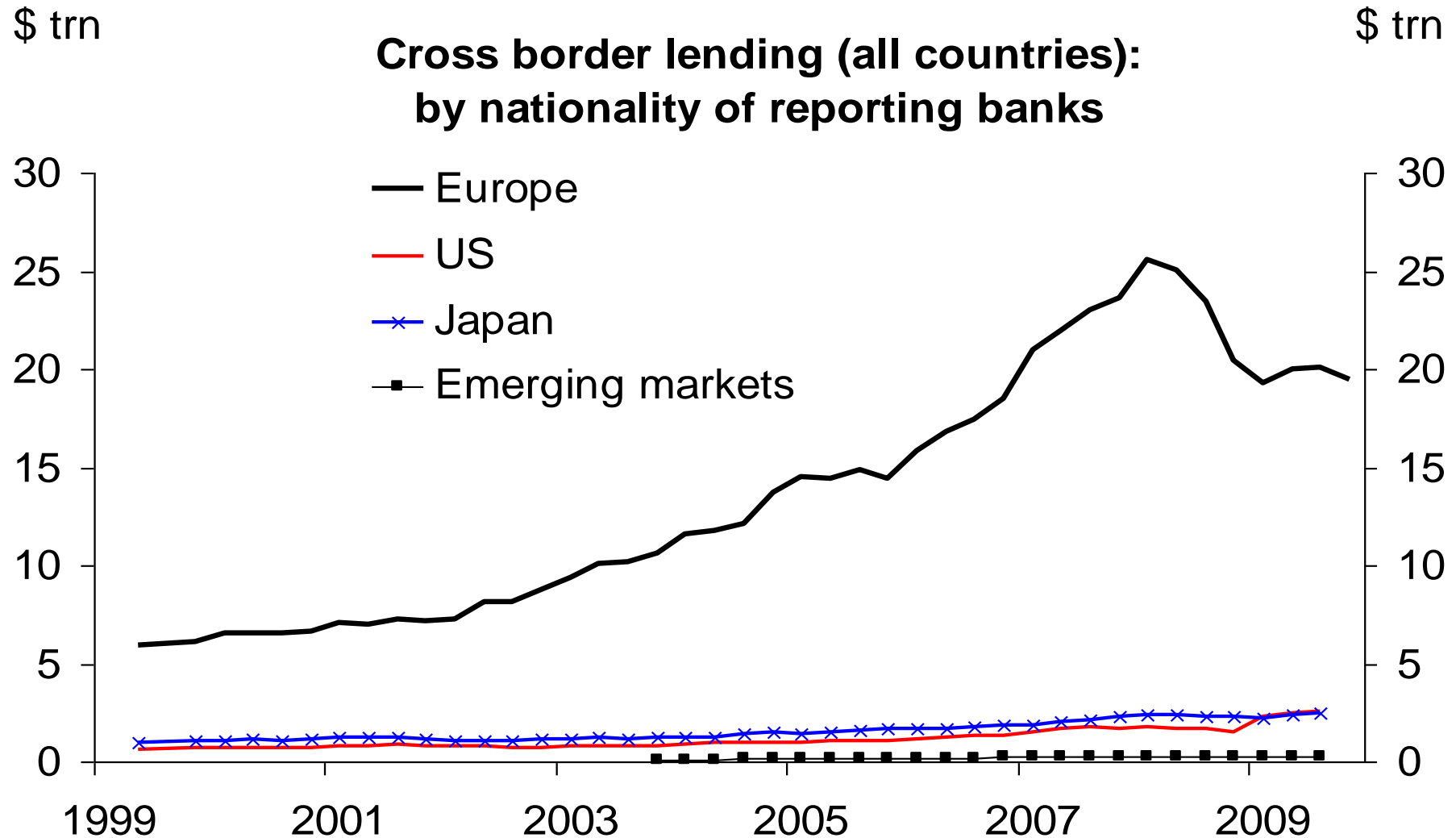


U.S. banks' assets (foreign claims) in European currencies





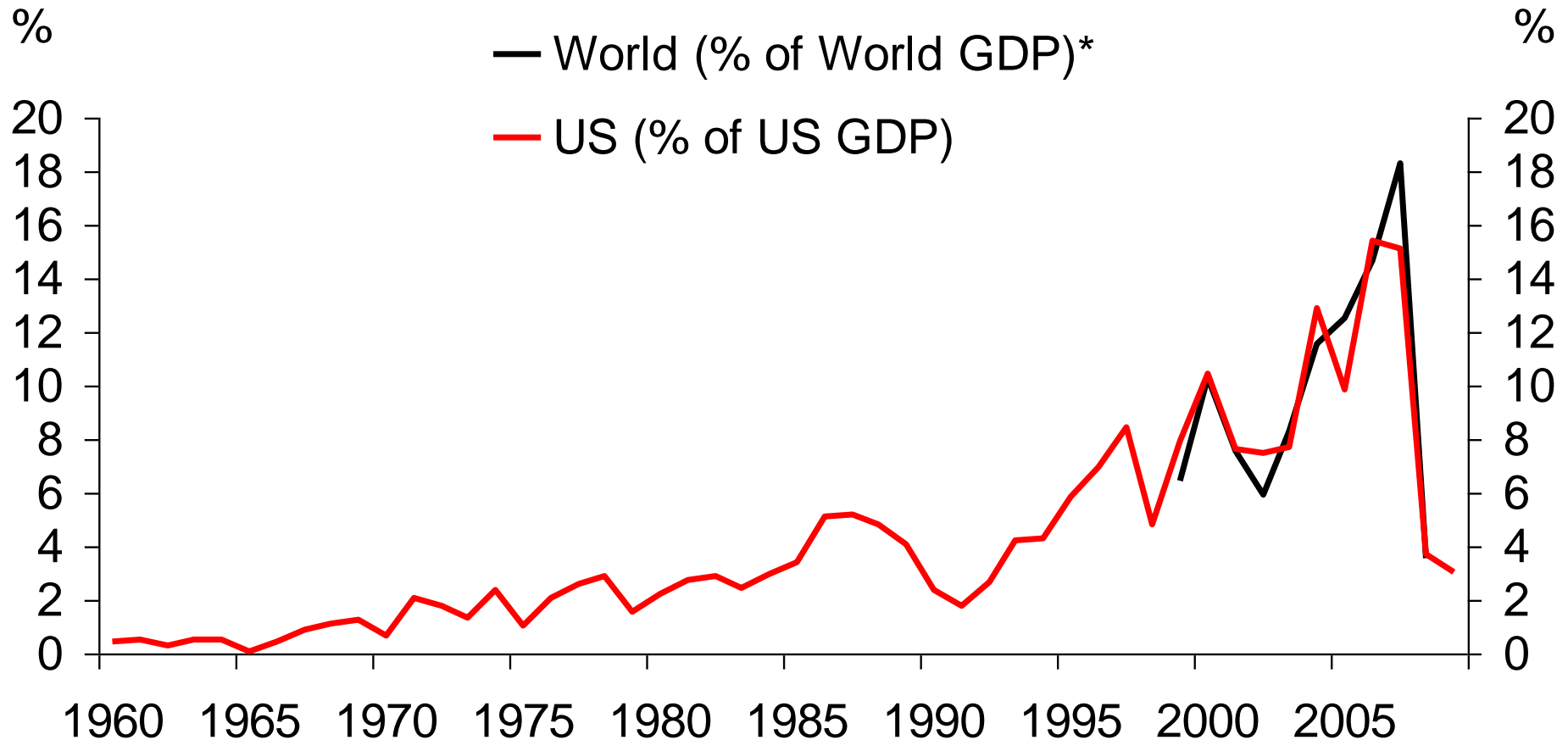
European banks heavily into cross-border lending





Gross capital inflows soared and then plunged around crisis

Gross capital inflows

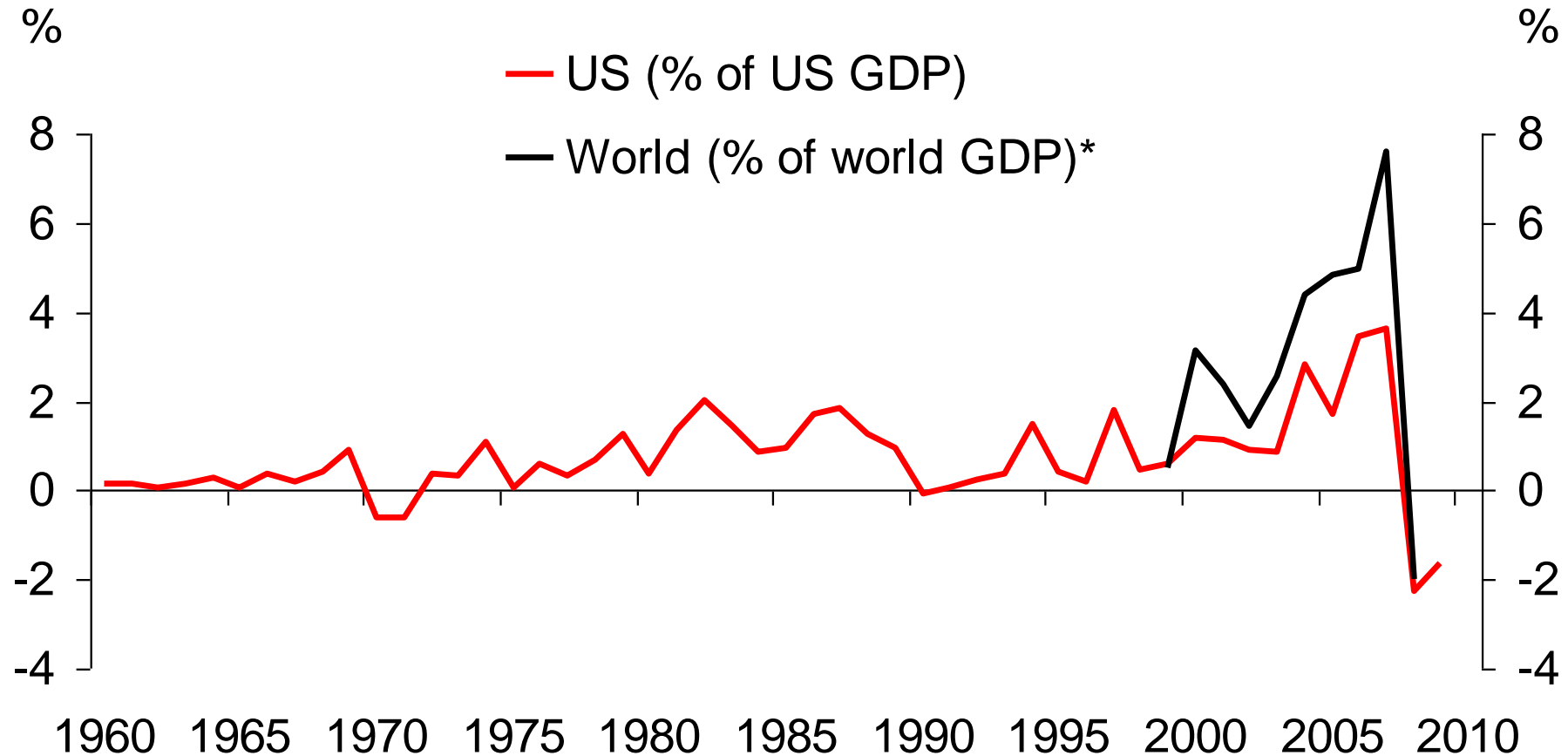


*Note: World capital inflows include US, Canada, Japan, UK, Euro Area and Emerging & Developing countries



Bank related capital inflows

Gross capital inflows: bank reported

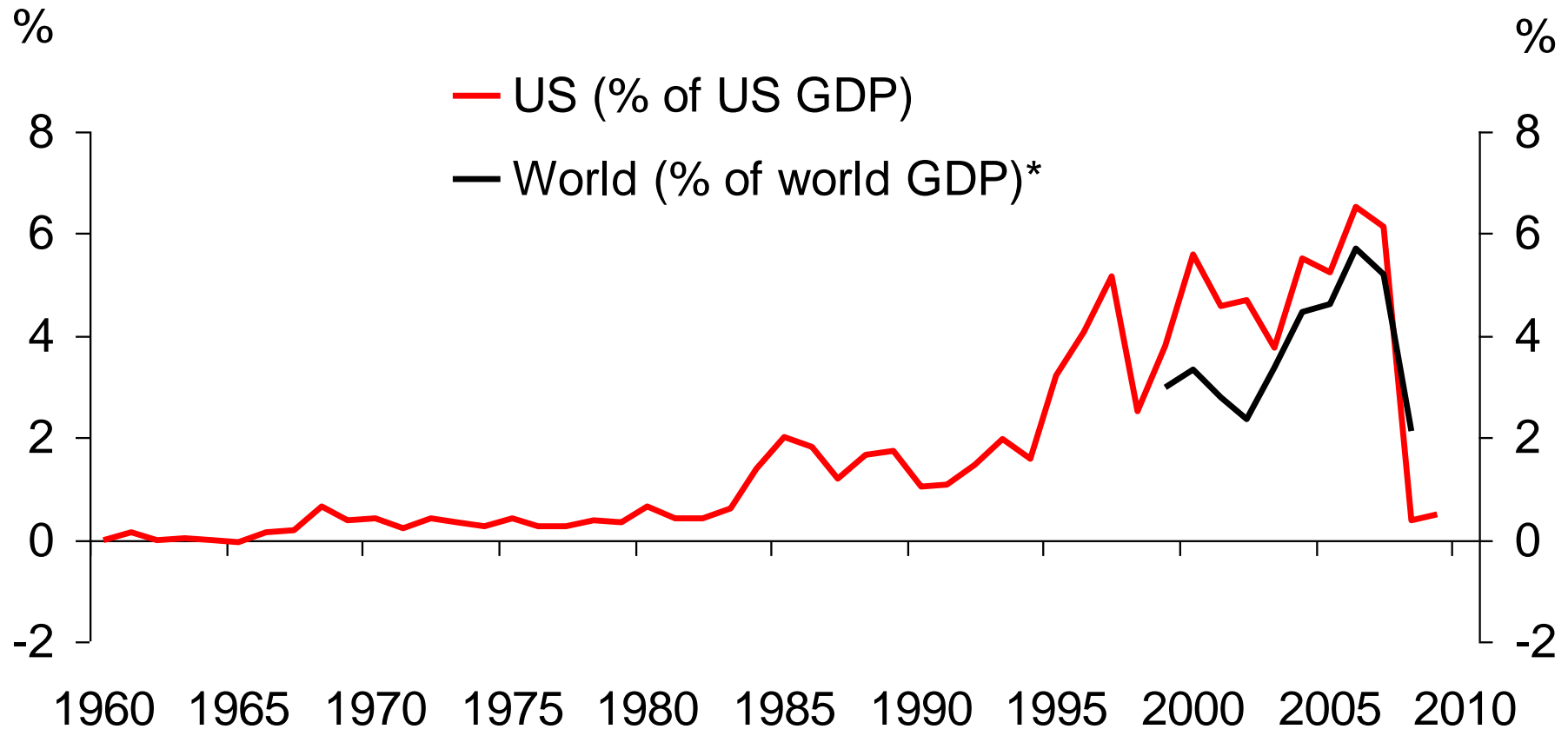


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Gross portfolio investment inflows

Gross capital inflows: portfolio investment

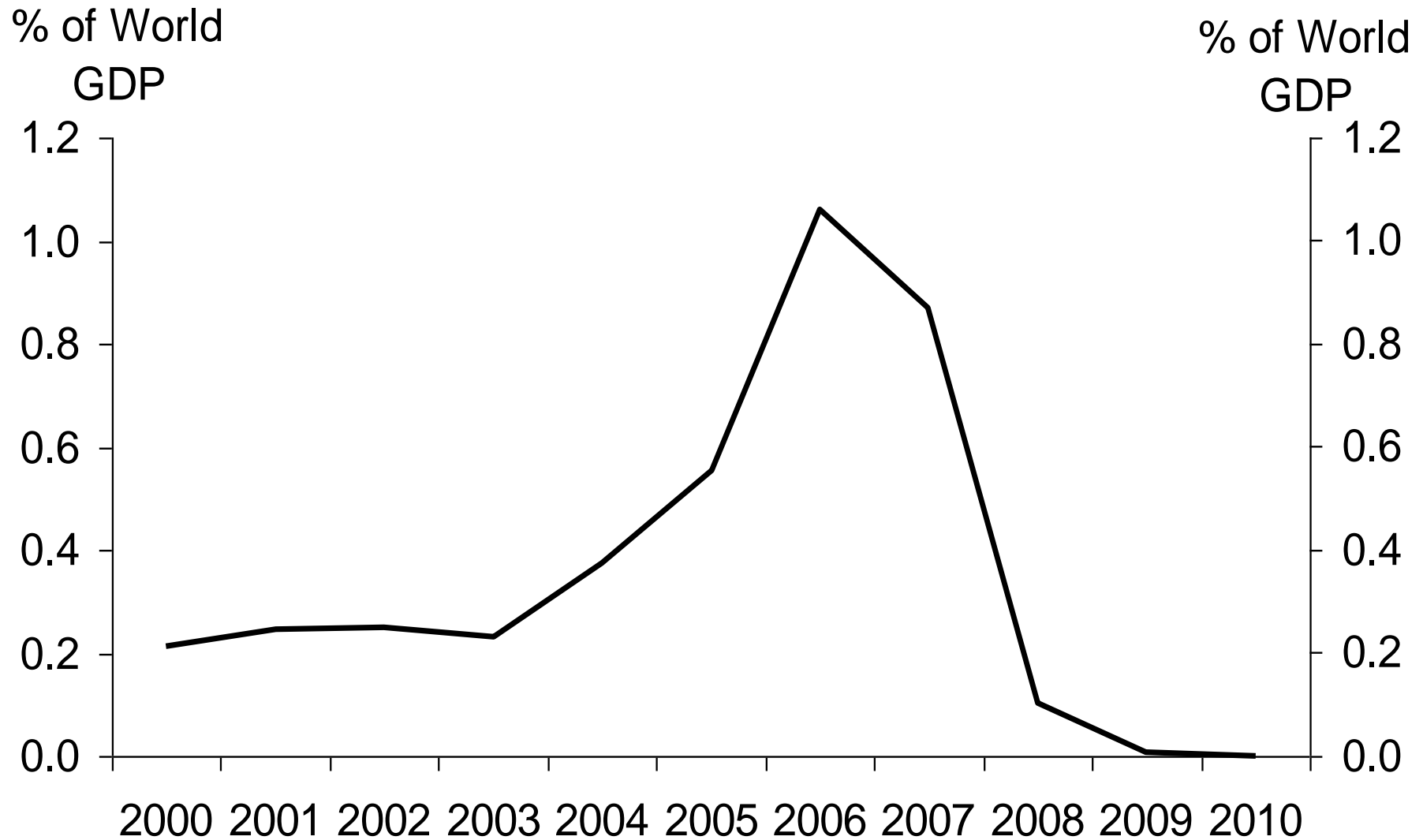


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CDO bubble

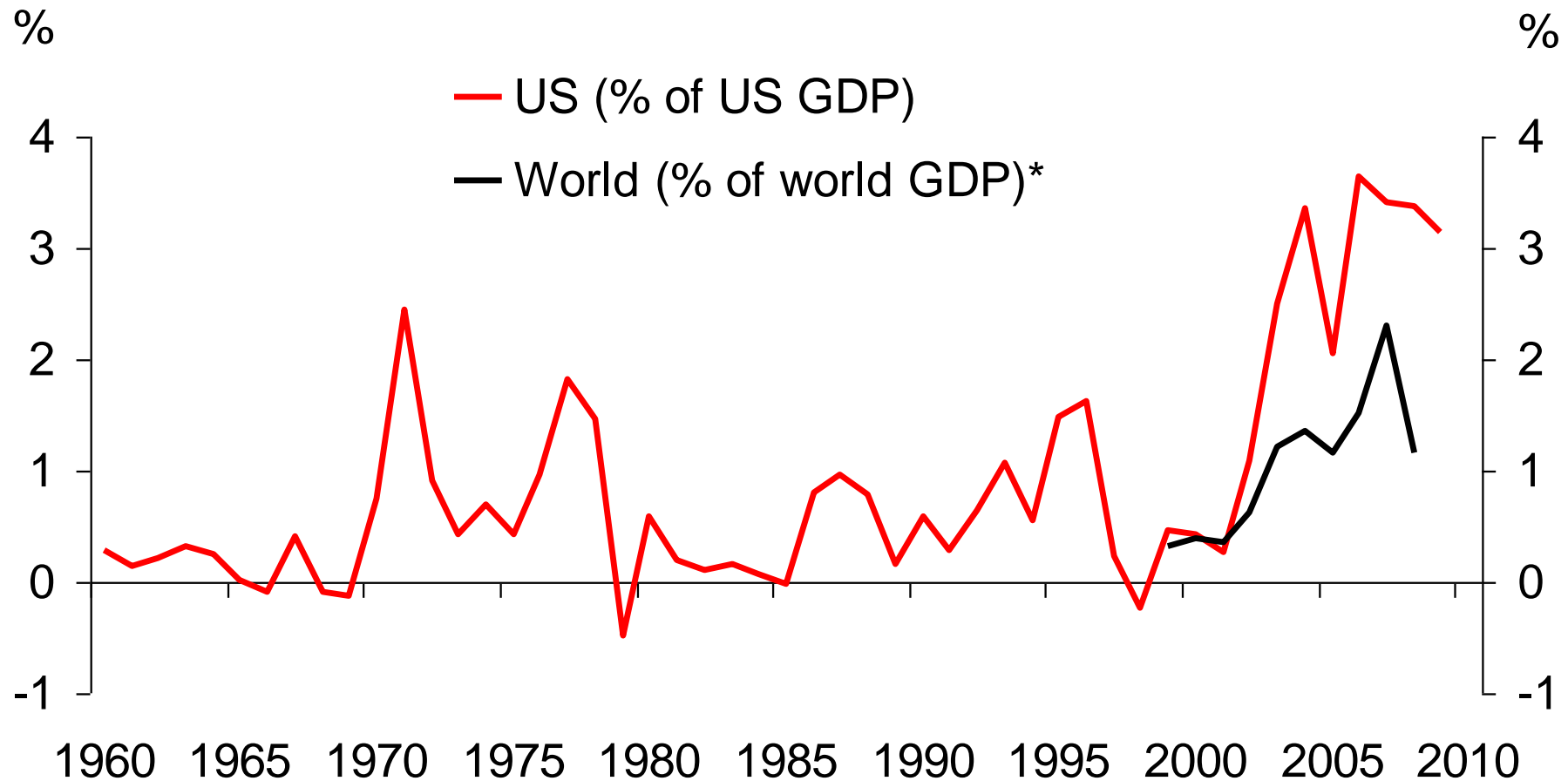
Global CDO issuance





Official reserve flows

Gross capital inflows: reserve assets

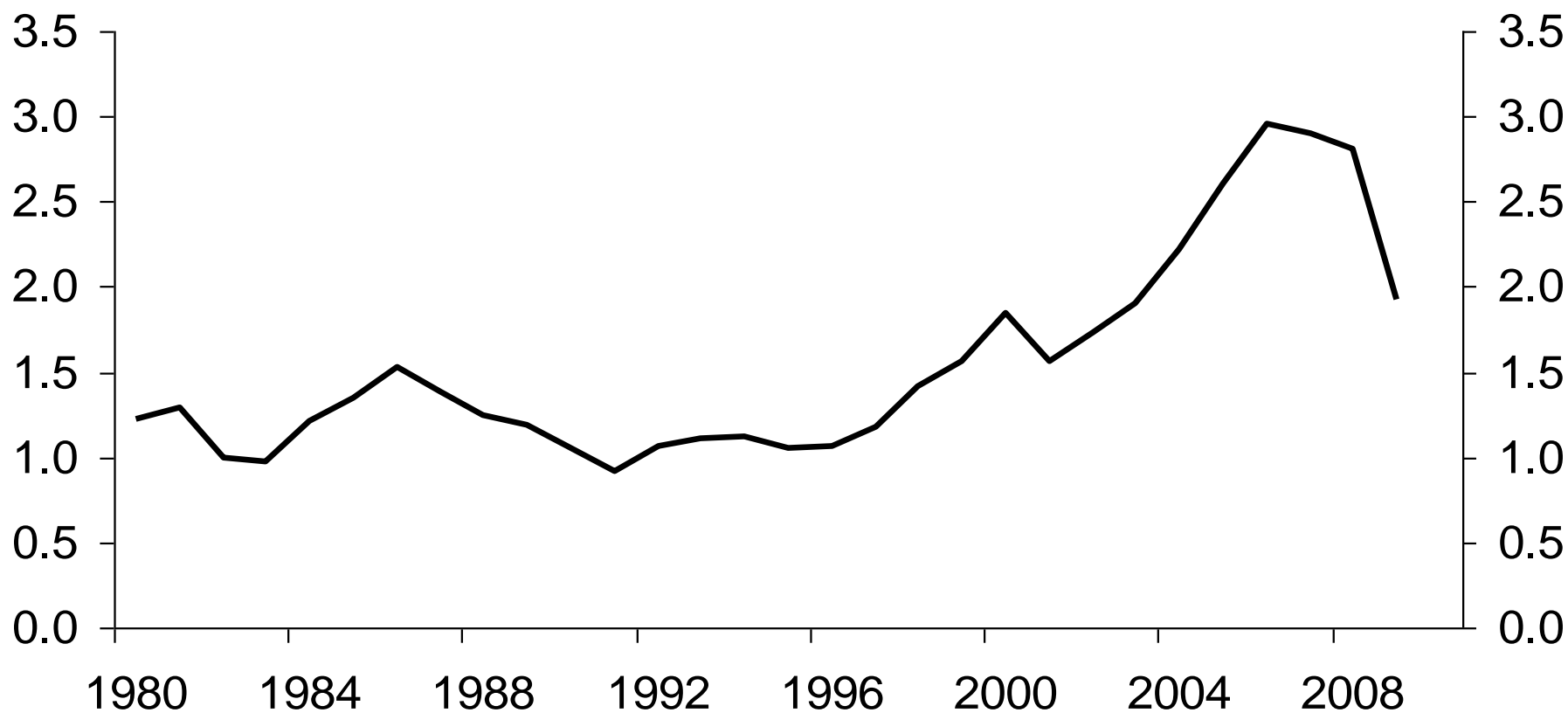


*Note: World capital inflows include US, Canada, Japan, UK, Euro Area and Emerging & Developing countries; US data are official reserve inflows

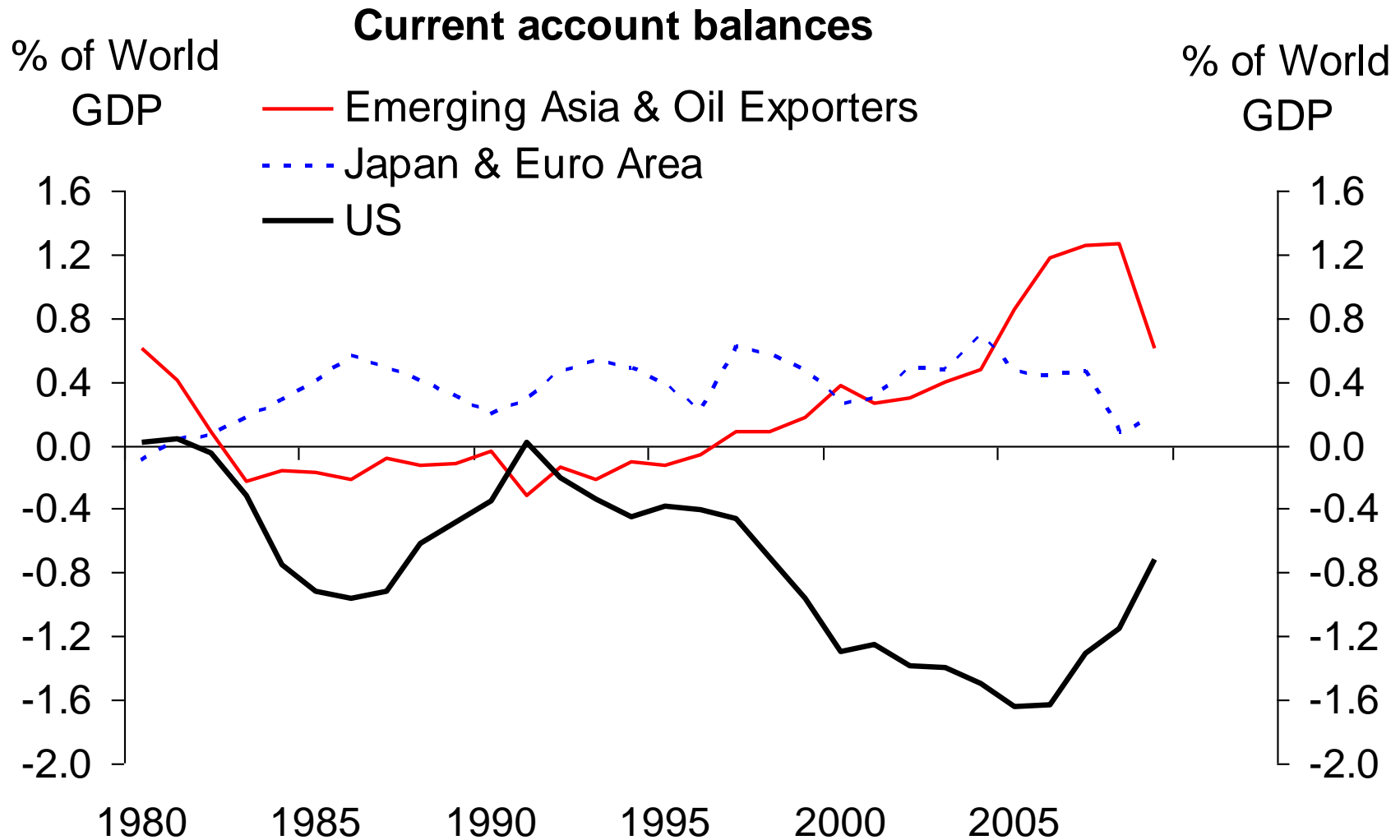
Global imbalance grew substantially over past decade



% of World GDP **Absolute sum of global current account imbalances (divided by two)** **% of World GDP**

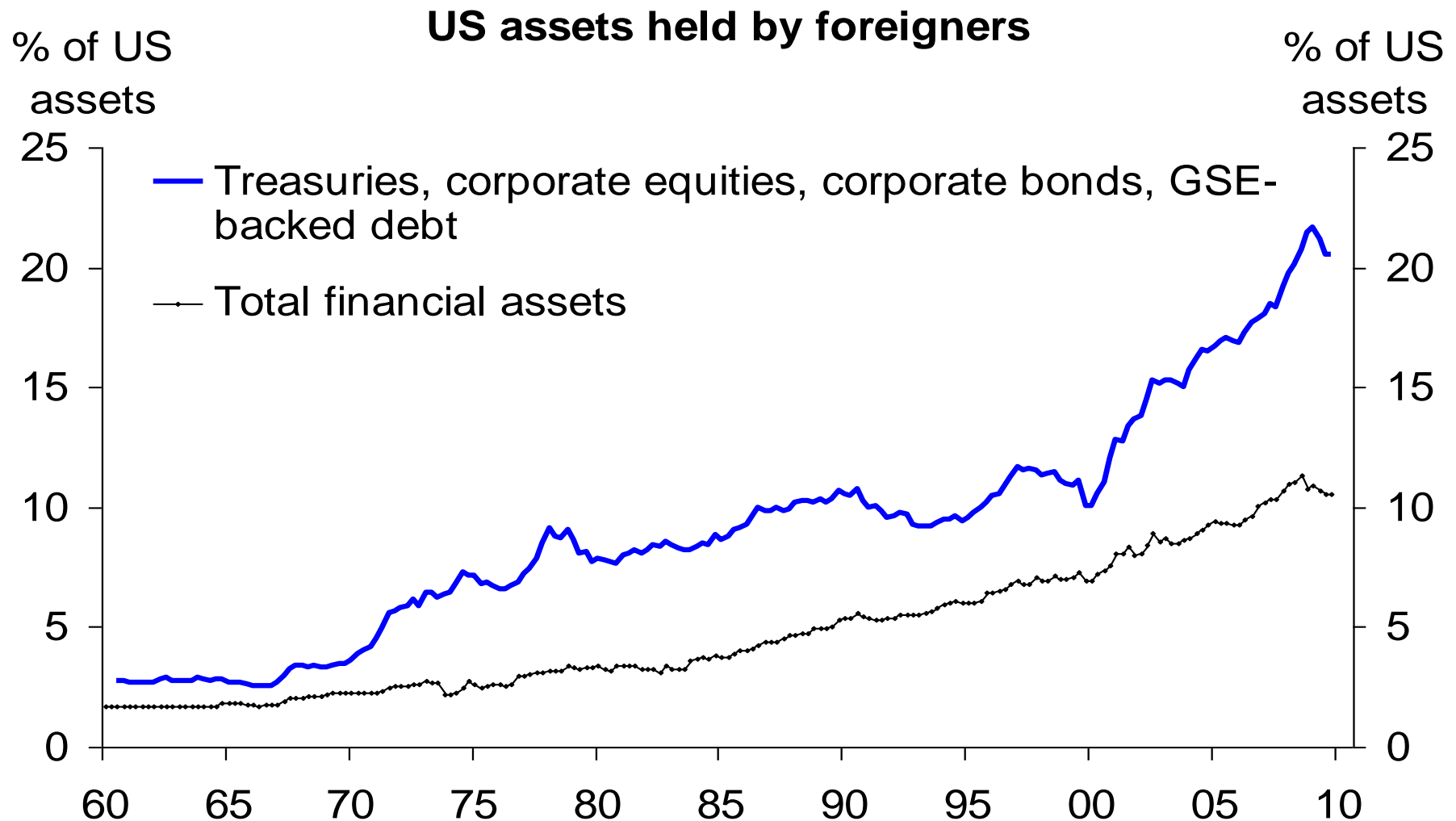


US external imbalance has driven the global total

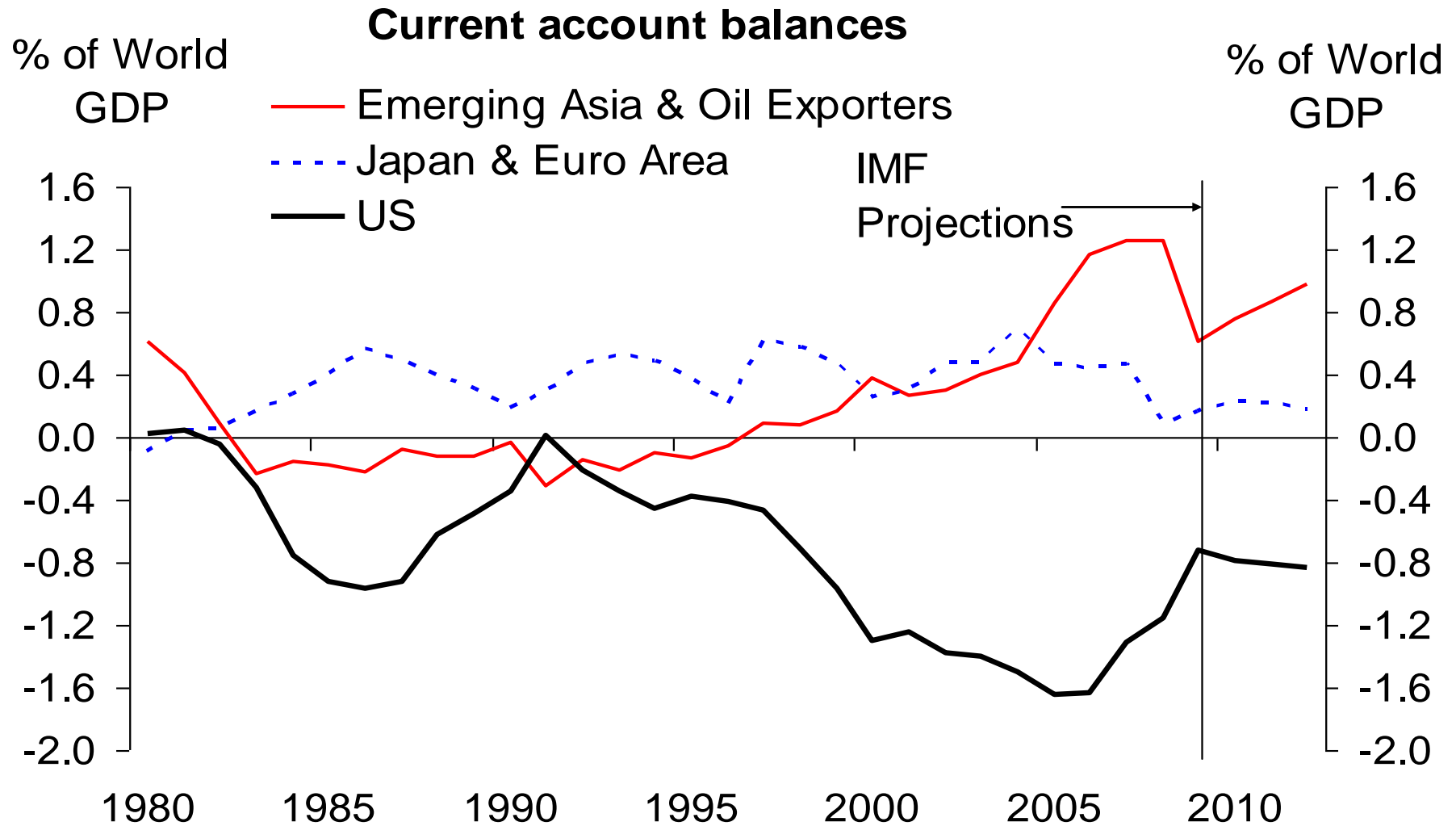




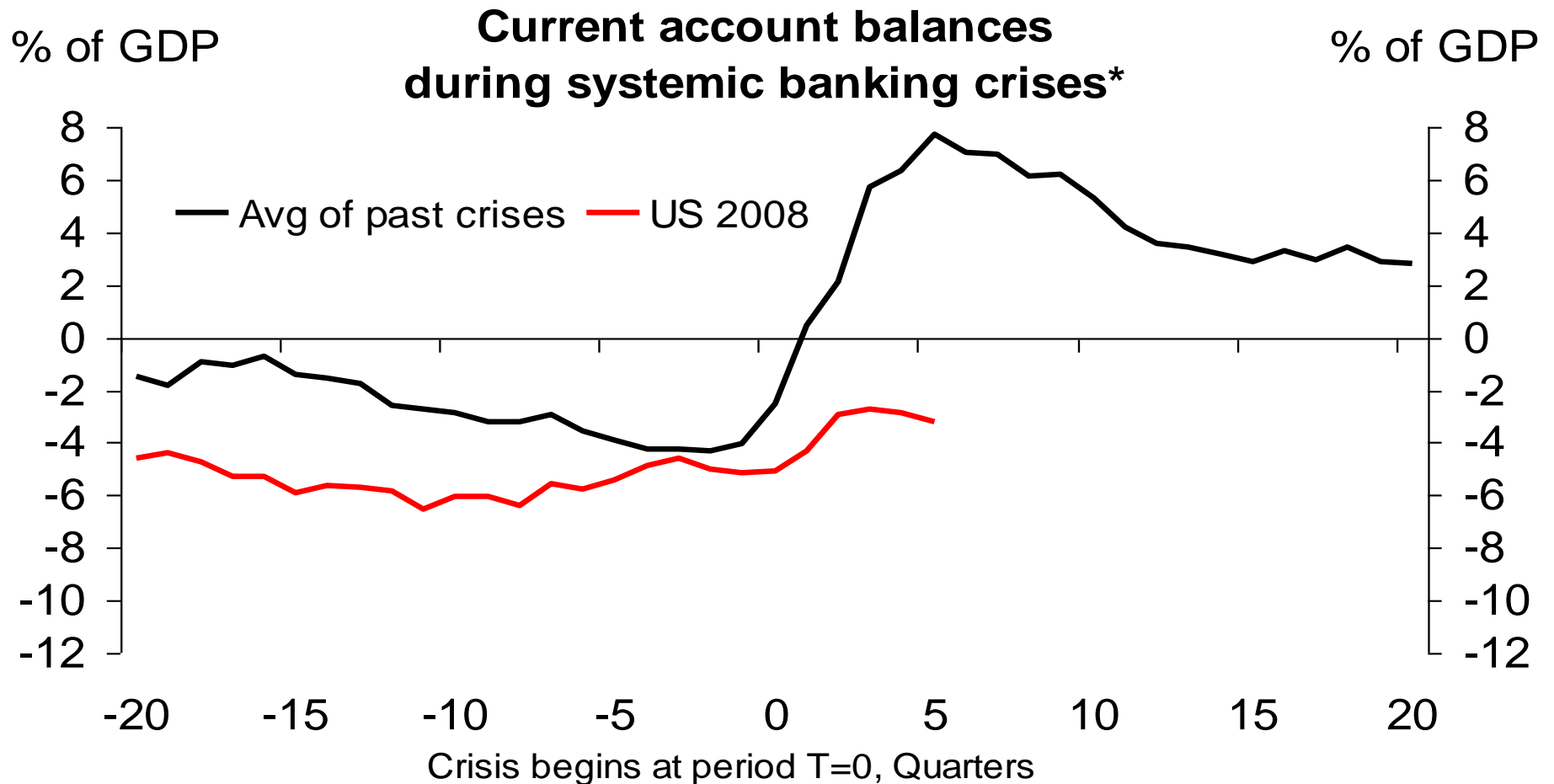
Share of US financial assets owned abroad doubled in past decade



US external imbalance expected to widen again



External imbalances normally reverse following financial crises



*Includes Sweden (1991); Mexico (1994); Indonesia (1997); Thailand (1997), Korea (1997); Russia (1998); Argentina (2001) **Includes Euro Area periphery (Greece, Ireland, Portugal, and Spain), IMF 2010 forecast used as 2010Q1 figure

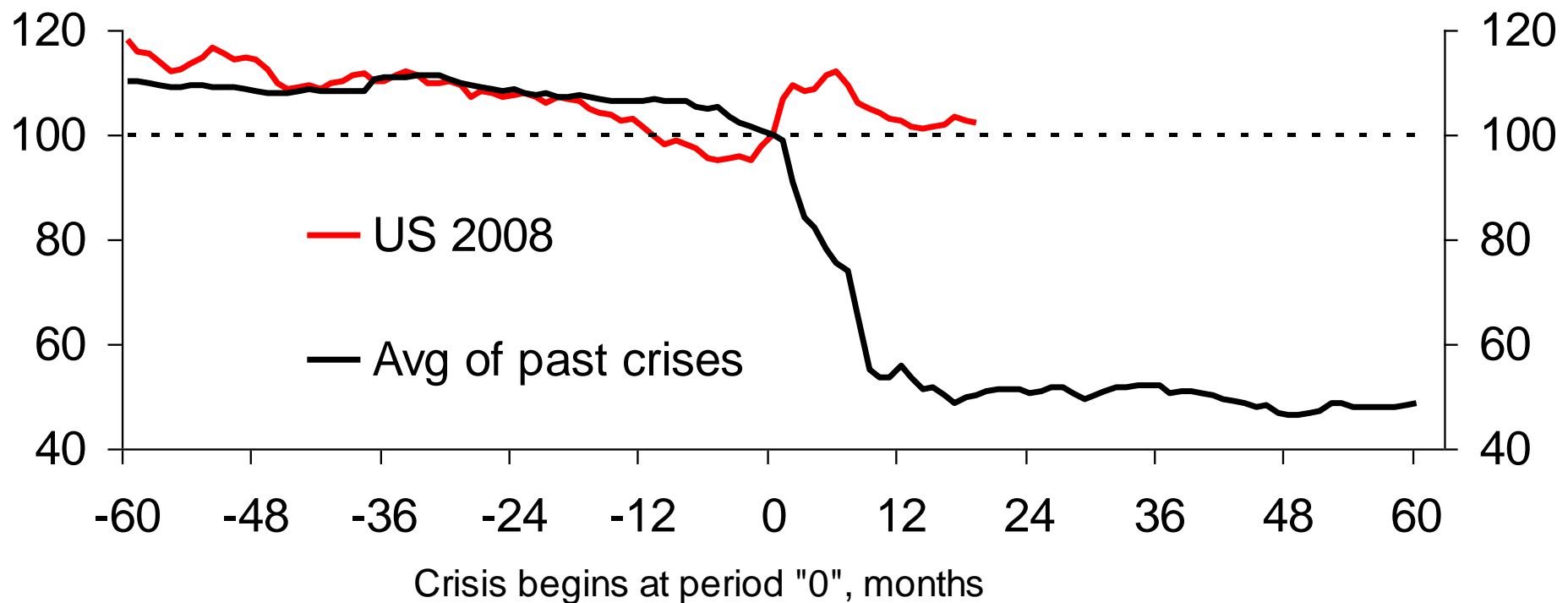
Currencies normally plunge in financial crises



Exchange rate during systemic banking crises

Index, crisis
month=100

Index, crisis
month =100



Note: Includes , Sweden (1991); Mexico (1994); Indonesia (1997); Thailand (1997) ; Korea (1997) Russia (1998); Argentina (2001)--- exchange rate vs USD; decrease in all lines indicates home currency depreciation; US is broad nominal TWI



Conclusions: Policy Implications

1. Stresses in bank funding raise risks globally and augur for caution in policy exit strategies; Fed's backstopping via FX swaps appropriate.
2. Abnormal increases in global flows augur for increased supervisory vigilance.
3. High premium on fiscal adjustment in the US and a phasing out of Bretton Woods II.