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**Financial markets and growth**

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**When one conundrum can mask another or, the role of market operators**

In February 2005, Alan Greenspan made the old-fashioned term “conundrum” popular once more when he spoke of the length of time it was taking long-term rates to rise, despite sustained increases in short-term interest rates. What could be causing the time-lag? In recent months, we have gained an improved understanding of the decisive US Treasury bond recycling role played by the trade surpluses of China and Asia in general, and by those of the energy-commodity exporting countries. This effect enhances the credibility of central banks, which they happily trumpet, and increases the profoundly deflationary effects of globalization, and in particular of Asian exports, not forgetting internet-based trade.

Since then we have seen long-term rates rising slightly and also that we have accordingly moved into a post-conundrum phase. The Fed’s short-term interest rates now stand at 5%, and the return on 10-year Treasuries likewise, or even slightly higher, and the markets are wondering where the rise in short-term interest rates will stop, which is currently pushing long-term rates higher. The question of the reversing of the yield curve is worrying players, even if the idea is gaining ground that it does not mean the same thing as before and that it will therefore not have the same effects. The same trend is visible in Europe, although it is lagged, with the slope in the yield curve remaining unmistakably positive, at 2.75% for the key rate and probably more than 3% at year end, and 4% for 10-year paper.

A more important question, however, is that of the conundrum of the financing of the United States. There is a budget deficit, and there is a trade deficit. Which means there is an American savings deficit. Under this same approach, we ought to see an adjustment, clearly involving a weakening of the dollar, but that is not in itself enough, especially when, in the opposite corner, the only currency that can appreciate is the euro, unless the burden is shared by all the other currencies. This is currently the case, but the room for manoeuvre is limited. This is because the only other real currency counterpart to the falling dollar is the euro, a euro that cannot appreciate very much as it is tied to European economic growth. Along with rising long-term rates, therefore, we must foresee a phase when the US economy grows more slowly to adjust the imbalances, and at least as much, a concerted appreciation of all the other currencies. But this is obviously complex, as anyone will understand that the appreciation of the euro alone cannot suffice and that the US adjustment is as necessary as it is complex to achieve, and fraught with global risks.

Clearly, this issue of imbalances, which is not simply a US issue but quite clearly a global one, is exercising the markets. If the United States is not saving, then others must do it for them, notably the Chinese and the countries that export commodities, and energy

commodities in particular. But how far should they do so, and what are the risks involved? At the same time, many experts, and not the least among them, are putting the issue into perspective. If the United States doesn't save enough, they say, it is because the rest of the world is saving too much. The United States is the consumer of last resort since Europe and Asia are not playing their roles as engines of growth. Asia in particular is pursuing a mercantilist policy in the shadow of the Chinese peg. This is the argument of the so-called global savings glut proposed by Alan Greenspan's successor, Ben Bernanke. The basic idea is that over time, and, in reality, with growth, these tensions could ease, and it is therefore a matter of managing the longer term by "using" growth. Other academic researchers, who do not share Mr Bernanke's position, attach importance not to flows but to inventories, without being any more pessimistic. They highlight net US assets. The trend in the net US position thus becomes a central issue since it determines the sustainability of underlying flows such as the current account deficit. In their view, a depreciation in the dollar, although it does not influence the current account deficit in particular, nevertheless pushes up the value of US assets owned by other countries, along with the revenues they derive from them, which is what makes the US position bearable. This is the argument of Professor Hélène Rey of Princeton, who says the United States is not so much the world's banker as a venture capital undertaking. In addition to borrowing short and lending long (just like any other financial intermediary), they borrow "secure and low cost" in the shape of Treasury bond issues and bank loans, and lend "risky and high yield" through the purchase of equities and foreign direct investment, FDI. Should we therefore be worried, at least as much as some US experts, or here in good old Europe?

Alan Greenspan perhaps helped us to answer these questions, in another of his major speeches in early December 2005, in which he focused on the importance of global imbalances. For him, these do not just derive from an imbalance between savings and investment on national foundations, but rather from more regional, if not individual imbalances, depending on economic agents. In reality, a national economy harbours imbalances between individual agents and it is generally the financial system's job to adjust the whole. We have thus lived for years with this role of finance managing localized imbalances. But with market deregulation and globalization, trade has expanded and become more widespread, and imbalances also are becoming international. What is happening is that we live in a world that may appear to be more imbalanced, but which is in fact a world where imbalances between individual agents are less and less regulated by national bodies. What is not regulated in isolation is transferred, to a degree, to the international sphere.

This is the main problem of global finance, where players with an international mission, myself, who are busy managing these new pressures and difficulties, but also these new opportunities. And that is how things happen, whereas one might be worried that they could collapse on the basis of an erroneous, or more precisely, obsolete, outlook, generated on a purely national basis. All economic agents have prospects and constraints, which boil down to how they manage their own assets and liabilities. Financial bodies gather up these differentials of situation and outlook in their own sphere of clientele, and manage them. What the States did very widely with national banking systems is increasingly becoming a global reality featuring international financial systems. We have become increasingly the ones who carry these differences in situation and outlook, and we are aware of the fact. The sophistication of our methods, the products we offer, and the checks that we carry out are simultaneously the proof of the globalization of asset and

liability situations and of their more or less satisfactory management by the leading international operators.

The conundrum of the conundrum is, therefore, that all of this operates with a learning process that is in fact relatively satisfying. The management of loans, their pricing and sale to other operators, and hence their allocation; the new approach to risk management with the rise of compliance, with increased transparency of agents and the strengthening of their equity capital is thus the reflection of asset and liability gaps, and differences in situation or in outlook, if not downright oppositions.

One can always say that we are more innovative and complicated, or taking greater risks for the fun of it, but one could also say that we are being asked to do more subtle things, which are more suited to different cases, and that we have to do this everywhere on earth and in increasingly efficient cost conditions, in virtually real time, cutting the risks of processing errors. And if we look at these global, economic, financial and geopolitical imbalances, which should be plunging us into a crisis at the very time that we have so much growth, we could say to ourselves that, until now, at least, we have not succeeded all that badly, by gathering up these thousands of individual imbalances, and probably more, and managing them. Which is to say by pricing, combining and opposing them.

“We appear to be revisiting Adam Smith's notion that the more flexible an economy the greater its ability to self-correct after inevitable, often unanticipated disturbances. That greater tendency toward self-correction has made the cyclical stability of an economy less dependent on the actions of macroeconomic policy makers, whose responses often have come too late or have been misguided,” said Alan Greenspan in the recent speech I mentioned earlier. But we have to admit here, between ourselves, that those very market forces badly need market people, and skilled ones at that. “Being able to rely on markets to do the heavy lifting of adjustment is an exceptionally valuable policy asset” said Alan Greenspan.

If I may make so bold, I could hardly agree more.