Closing Remarks

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The Federal Reserve Bank of San Francisco's Asia Policy Conference provides as always a welcome opportunity to reflect on where Asia stands and where it is headed. These questions are even more interesting than usual this year. Where the region stands and where it is headed are, first and foremost, questions about China and Japan, which together account for the vast majority of regional GDP. Both countries are embarked on unprecedented experiments whose outcome is uncertain. In the case of Japan I am referring to the Great Reflation, in the case of China to the Great Rebalancing.

As for how these experiments will turn out, it is appropriate to quote Chou En Lai, who when asked by Richard Nixon, on the latter's trip to China in 1972, to assess the French Revolution, famously remarked, "It's too early to tell." Actually, we have learned recently that Chou was referring not to the 1789 revolution but to the student demonstrations and sit-ins of 1968. So it does not seem that it will be necessary to wait two centuries to evaluate these policy experiments.

My assessment of Japan's Great Reflation is: So far, so good. Governor Kuroda's policies of shock and awe have begun to show up in price-level trends, with inflation having hit a five-year high of 0.8 percent in August.[1] This is not especially impressive by absolute standards; after all, it is also what core inflation in the euro zone ran in the most recent month, and in the euro zone context this is regarded, rightly, as a policy failure. Still, it is an immense improvement for a Japanese economy mired in deflation for 15 long years. Two percent inflation is not yet at hand, but it is in sight, at least for those with 20/20 vision.

In terms of Abenomics' second arrow, I think the government has done a good job at balancing the need for fiscal stimulus in the short run, both to support growth and to lend credibility to the Bank of Japan's reflationary monetary policy, with the need for medium-term fiscal consolidation to prevent the public debt from spiraling out of control. It made the right call by not deferring the 3 percentage point increase in the consumption tax rate scheduled for next spring, with more to follow, while at the same time offsetting any negative impact in the short run with a one-time fiscal stimulus.

As for the third arrow, structural reform, here we must channel Chou En Lai. Mr. Abe continues to talk a good game, but actions speak louder than words. Recently he appears to have deferred to strong political opposition to reducing hiring and firing costs. Joining the negotiations over the Trans-Pacific Partnership may be a way of applying pressure to open up product markets like agriculture and automobiles, but it will do nothing to promote labor market reform, which the experience of other advanced economies, like those in Europe, suggests is key.

China, meanwhile, is engaged in the monumental task of rebalancing its economy from investment to consumption and from exports toward domestic demand. Monumental is the right word, given the extent of the shift that China will have to complete in order to begin to resemble a normal economy. Household consumption is only one-third of national income, where in a normal economy it is more like two-thirds. Investment is nearly 50 percent of national income, where no economy can productively invest more than a third of national income for an extended period. I think it is accurate to say that we have never seen a change in the composition of spending of this magnitude over a short period of time in any country in peacetime.

Raising the question of whether China really is committed to rebalancing dramatically in a short period of time. If rebalancing means significantly slower growth, then the authorities may hesitate. Whenever growth has shown signs of declining below 7½ percent, they've ramped up infrastructure spending and turned on the liquidity tap. (That's different from the liquidity trap.) M2 money supply growth has continued to exceed the official 13 percent target, which is inconsistent with the goal of clamping down on the shadow banking system.

The question thus comes in two parts. Does rebalancing mean slower growth? And, if so, are the authorities prepared to accept it?

The answer to the first question is clear. Rebalancing means slower growth. Much of the increase in consumption will be on services. We know from international experience, and specifically from the experience of East Asian countries like Korea, that it is harder to boost productivity in services than manufacturing. The service sector still accounts for a smaller share of Chinese GDP than manufacturing. As that changes, with rebalancing, growth will slow.

The answer to the second question—are the authorities really prepared to sacrifice some growth in the interest of rebalancing?—is less obvious. Stay tuned for the Communist Party plenum.

The other issue that must be confronted when contemplating where East Asia is headed is the crisis question, as we have heard in the course of the past two days. The year 2013, clearly, is not 1998. Asian countries have more flexible exchange rates. More debt is in local currencies. They have more international reserves. In most cases they are running current account surpluses rather than deficits. They have stronger monetary and fiscal policies and better regulated financial and corporate sectors, by and large. Note the “by and large.” In other words, there are risks.

Most obviously, there is China. Credit broadly defined has increased from 125 percent of GDP to nearly 200 percent of GDP in just five years. If we know one thing about credit booms, it is that they end badly. One has to be more of an expert on Chinese shadow banking than I am to know exactly where the time bombs are. But we can hear them ticking.

Then there are Indonesia and India. Both have been running current account deficits. While they have substantial foreign exchange reserves, those reserves only cover about six months’ worth of imports. It is no coincidence that their currencies were hit the hardest last summer when Mr. Bernanke engaged in his tapering talk. They will have difficult adjustments when tapering actually occurs. Whether these are simply difficult adjustments, involving currency depreciation, inflation, and economic slowdown, or something worse will hinge, as it always has historically, on whether currency depreciation and the greater difficulty of tapping foreign finance expose fissures in their banking systems. We are told that their banking systems are prudently managed. We will see.

Allow me now to say a few words on the papers, starting with that by Lant Pritchett and Larry Summers. They remind us that mean reversion in growth rates is a robust regularity. They also remind us that no country grows at double-digit rates forever. That China has done so for more than two decades is historically unprecedented. This means either that mean reversion is overdue or that China’s experience is, well, historically unprecedented. Which interpretation is correct? We are about to find out.

Lant and Larry’s paper also reminds us that forecasting growth is difficult. Another way of saying this is that there is a significant probabilistic element in the answer to questions like whether there will be a sharp slowdown in Chinese growth. But I do think we know some things about the policies that make for reversion to the mean (in their terms) and sharp growth slowdowns in fast growing economies (my term). Slowdowns are more likely in fast-growing economies as they approach the technological frontier. They are more likely in countries that have been growing fast on the basis of exceptionally high investment (that is, when they have been throwing a lot of capital at the growth problem). They are more likely in countries with undervalued exchange rates (which limit the incentive to move up the technological ladder, out of assembly operations). They are more likely in countries that underinvest in secondary and tertiary education.[2] Some of these conditions suggest that there is a significant probability of a sharp Chinese slowdown, others not. It is not surprising, then, that commentators disagree.

Reinhart and Tashiro in their paper make an important point, that reserve accumulation and lessened dependency on foreign finance in East Asia since 1998, while prudent, is not without costs. Raising savings relative to investment so as to invest more abroad and accumulate reserves has been associated with a decline in the investment/GDP ratio of about 6 percentage points in the countries they consider compared to the pre-Asian crisis decade. I was not entirely surprised by this finding, for it was heavily emphasized by Raghuram Rajan in his days as chief economist at the International Monetary Fund (IMF), when he spoke of trans-Pacific imbalances as reflecting less a "savings glut," à la Greenspan and Bernanke, than an "investment strike"; it was also highlighted by the Asian Development Bank in various reports.[3]

The important question in this connection is whether reduced capital formation has had costs in terms of growth. Some would argue that a significant share of this earlier investment was unproductive, like investment in toll roads in Spain or country estates in Ireland more recently. It pumped up growth in the short run but set the stage for subsequent problems. Remember all those high rises in Bangkok in the mid-1990s and the expansion of Korean chaebol into unrelated business lines? It is at least conceivable that lower investment since the crisis has been good for stability and free of negative consequences for medium-term growth.

Olivier Jeanne's paper similarly speaks to the management of capital flows and credit booms, asking whether macroprudential policies, including capital controls, can provide an efficient alternative to reserve accumulation. There is an analogy here with the "lean-versus-clean" debate—should central banks lean against credit booms, capital-flow surges, and asset bubbles with macroprudential policies and, in the open economy context, capital controls? Or should they limit themselves to cleaning up after the fact, which in the open economy means accumulating reserves to deal with capital flow reversals? Jeanne takes the answer as uncontroversial, appropriately in my view. Cleaning up after the fact can be very costly, as we have learned the hard way. The case for using macroprudential policies and temporary capital controls has been strengthened by recent experience.

The more controversial question is whether macroprudential policies, including controls, have significant cross-border spillovers, creating a case for international oversight and coordination. The IMF certainly thinks so, scenting an additional role for its staff. Within Asia, this is similarly a question that ASEAN+3's Macroeconomic Research Office could usefully take up. Both intuition and evidence, as provided by, among others, Kristen Forbes et al. (2012), suggests that scope for capital flow diversion creates a prima facie case for coordination. It is useful to have Olivier's formal demonstration of the case.

I am similarly happy to have him lay out, in what is the first formal modeling of an oft-heard point, that policy coordination is desirable in response to the currency war problem. In other words, if U.S. efforts to stimulate spending through low interest rates cause problems for countries like China through the capital-inflow channel, while China's efforts to accumulate reserves create problems for the United States by depressing spending on American exports, then mutually accommodating policy adjustments can leave both countries better off. As always, the unanswered question in the policy coordination literature is whether the gains are large.

Turning to Andy Rose's paper on the impact of the crisis on countries with different exchange rate regimes, I learned a lot, as always from Andy's papers. But I for one still find the results surprising. I did not expect to learn that countries that peg and those that float and inflation target had indistinguishable outcomes in the 2007–12 period. This is certainly a striking finding.[4]

Anil Kashyap suggested that the explanation lies in the nature of the shock and the nature of the policy response. Everyone experienced the same deflationary shock. Everyone wanted to cut interest rates to zero in response. The Fed cut rates to zero. So if you pegged to the dollar, you got zero interest rates. And if you targeted inflation instead, you also got zero interest rates, since your central bank cut rates in response to the deflationary shock.[5]

This may be right. But here's another interpretation. Not every one of the 180 countries in the sample experienced a deflationary shock. The financial crisis had multiple dimensions; the global environment after 2007 was quite complex and varied. Some countries experienced deflation and wanted zero interest rates, but others experienced excessive inflation after 2007 and didn't want zero interest rates. Different countries experienced different internal versus external, real versus nominal, monetary versus financial, and price level versus terms of trade shocks, all at the same time. It may be that if you were able to cut up the sample appropriately, distinguishing countries by the type of shock they predominantly experienced, you would find that one exchange rate/monetary regime outperformed another, just not in the same direction in different subsamples.

So should Asian policymakers take the exchange rate cum monetary regime as given and concentrate on the pursuit of sound and stable policies, rather than worrying about whether they have the appropriate rate/regime in place? I for one am not yet ready to endorse that recommendation.

On the other hand, I am quite happy to endorse the recommendation of Gerard Caprio's paper. Caprio suggests that our current system of financial regulation is excessively opaque, overly complex, and inadequately robust. He documents how each successive crisis, by revealing gaps in regulation, has caused policymakers to pile still more complex regulation on top of an already shaky edifice. The system relies excessively on mechanisms—risk weights and commercial credit ratings—that are too easily rigged and evaded.

It would be better to throw the baby out with the bathwater, as it were, and rely on simple rules and market discipline. The most important rule would be an unweighted capital or leverage ratio. For those worried about the stability of particular markets—property markets or funding markets, for example—this might be supplemented by ceilings on loan-to-value and foreign currency lending and borrowing ratios. Market discipline would be strengthened by requiring financial institutions to issue contingent convertible debt, which would give bondholders strong incentives to monitor banks and, not incidentally, protect taxpayers from losses. Regulators can be better incentivized by strengthening their accountability—in other words, by requiring them to release more of the information on which they base their decisions. More radically, one can imagine tying their compensation to financial stability outcomes, in the same manner that the compensation of the governor of the Reserve Bank of New Zealand is tied to inflation outcomes. Writing that contract would be harder, admittedly, since financial stability is multidimensional. But that's the world in which we live.

These are radical recommendations. They run up against standard objections, like the Morris and Shin (2002) argument that more information can be destabilizing under certain circumstances. But given the serial failures of the current approach, I am inclined to agree with Caprio that it is worth running some risks in order to explore an alternative. It's not as if the current system itself is without risks.

An interesting question is why there has been a reluctance to go in this direction. Implicit in Jerry's paper is a political economy argument. The Western countries that dominate the Basel Committee on Banking Supervision have too much invested in the current approach to entertain radical alternatives. The central bankers on the Basel Committee have an intellectual investment. Their commercial banks have made strategic investments to maximize profitability under the current system. The rating agencies like the system. The hotels and restaurants of Basel like the system. Asian countries, by comparison, are outsiders. They are the plausible revolutionaries.

I wish it were so, but I'm not convinced. Big banks in Asia, and there are plenty of big banks in Asia, have invested every bit as much as big banks in the West at adapting to Basel III. More and more Asian central bankers and regulators are being invited to partake at the bimonthly buffet at the Bank for International Settlements. They are too invested in the current system, I fear, to be true revolutionaries.

Here's hoping they prove me wrong.

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NOTES

1 This is the most recent data point available at the time of our meeting.

2 I refer to the results of my collaborations with Park and Shin (Eichengreen, Park, and Shin 2011, 2013).

3 See, for example, Rajan (2006). Hence I do not entirely agree that "previous studies have not made a connection between the sustained reserve accumulation and the persistent and significantly lower levels of investment in the region."

4 Note that there were no inflation targeters in our sample, although there was, arguably, a price-level targeter, namely Sweden. Leaving this aside, our comparison was tantamount to Rose's comparison between peggers and countries in the "sloppy center." Thus, the contrast between our respective findings stands.

5 This interpretation can also explain why Rose's results for 2007–12 are so different from what Jeffrey Sachs and I found for the 1930s (Eichengreen and Sachs 1985). (The paper is cited by Rose, but he does not comment on the strong contrast in results.) We found that the exchange rate regime mattered importantly—that countries that did not peg to the dollar or gold did significantly better in that earlier deflationary environment. The reason, of course, is that the Fed did not take adequate action to counter deflation until four years into the crisis.