

COMMENTARY
Crowding Out Redefined:
The Role of Reserve Accumulation

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Let me second what Alan Taylor said. This is another high-value paper by Carmen Reinhart and Takeshi Tashiro. And it shares the four traditional high-quality characteristics of Carmen Reinhart papers:

1 It uses data that we have not looked at before or that we have not looked at in this way before.

2 It presents the data in a very interesting and thoughtful manner that makes us think very hard about important questions.

3 It does not focus on either the trend or the cycle exclusively, but looks hard at the interrelationships between them—interrelationships between the cycle and the trend that are traditionally ruled out, or at least not at the forefront of, our back-of-our-envelope first-cut.

4 It does not bow to current theoretical perceptions, but attempts to focus our attention on what the important and interesting features of the economy are.

This paper, in brief, is about the long and dark shadow cast by the cycle on the trend. In this case, the cycle is the 1997–98 Asian Pacific Rim financial crisis. The trend is what that crisis has meant for the development of Asia's Pacific Rim since. The at least partial motivation for this paper is that, right now, the European periphery is going through something somewhat similar to the sudden stop experienced by Asia's Pacific Rim in 1997–98. The point is to look at the European periphery today in the Asian Pacific Rim 1997–98 mirror, to see what we see. What do we see?

The origin of the sudden stop is that something bad happens to foreigners' willingness to invest in a particular region. Something bad happens to foreigners' willingness to hold assets located in a particular country. The financial system has to deal with this disruption to the previous pattern of financial intermediation. And the economy then has to deal both with the changed financial situation and with the real side concomitants of that shift in foreigners' preferences.

When we back up and assume the economist's 30,000-foot perspective, there is no reason why a shift in foreign investors' preferences and even a disruption of financial intermediation should materially disturb the real economy of production, employment, and investment. The market—or the central bank or the government—should be able to build, should have already built, firewalls to guard against financial disruptions of real production, employment and investment. The marginal rate of time preference hasn't changed. The marginal profit of capital hasn't changed. The marginal product of labor hasn't changed. All that has happened is that foreigners have suddenly lost their taste for buying assets denominated in a particular currency, located in a particular place. And we have a price—the value of the currency—that is supposed to smoothly match demand and supply in the market for assets located in a particular place, and markets are well designed to deal with both the partial and the general equilibrium adjustment to preference shifts.

Markets deal with such a shift in preferences by lowering the price. In the case of demand for Asian Pacific Rim or European periphery assets, the market's natural adjustment path is to bounce the value of the currency down. Bounce the value of the currency far enough that speculators think its next move is at least as likely to be slightly up as it is down. There is then no reason for safe interest rates in the region to rise. The situation stabilizes. And you have, at worst, a short, sharp, V-shaped downturn followed by an export boom. And yet that is not what happened. On the Asian Pacific Rim in 1997–98, the fact that so much of the region's debt was denominated in dollars meant that bouncing the value of the currency and thus of domestic production down far enough raised universal and valid fears of bankruptcy, and sharply raised risk premia. The Asian Pacific Rim thus had to, to a certain extent at least, defend its currency. And in Europe's periphery, nations are tied by treaty, by the deep and close technical integration of the financial system, and by hopes for a united and peaceful European future in the euro zone. Thus when the crisis comes both regions must generate rapid adjustment of the current account: a sudden stop.

The problem is general. There are lots of reasons why the natural market's bounce-the-value-of-the-currency-down adjustment mechanism will not work. Overwhelming reasons to maintain a fixed parity. High levels of harder-currency debt. A tight coupling of import prices to domestic inflation and a belief that the costs of accepting domestic inflation are unacceptable—*cough cough*, why we all today feel sorry for Raghuraj Rajan. In any of these cases, when the crisis comes you must generate a rapid adjustment in your current account, and the easiest and the most straightforward way to do this is via domestic

investment collapse. This is the first failure of the veil of the financial system to be merely a veil—the first coupling of financial distress to destructive real economic consequences.

But this should be temporary. This should produce a V. What Carmen and Takeshi impressively document is that investment does not come all the way back. We have a long-run 6 percentage point of GDP delta in the investment share in the post-financial crisis period relative to the pre-crisis normal on the Asian Pacific Rim. We have a long-run 2.5 percentage point per year delta in real GDP growth. We do not have a V. We have an L. And there does not appear to be anything going on in terms of exogenous breaks in long-run trends that would lead us to say that the trend break was going to come anyway, and that the financial crisis disruption and accompanying depression was not the cause but the consequence of the trend break.

Now when I was young I was taught that the trend was the trend and the cycle was the cycle, and that sometimes breaks in the trend caused cycles, but not vice versa—or at least not vice versa enough that we needed to worry about it. When I was young I was taught that Say's law held in the long run, even if not in the short run, because the interruptions of Say's law that caused demand cycles were driven by sudden excess or deficient demands for the stock of liquidity, and those had a natural end because flows accumulated to make up stocks.

Furthermore, when I was young I was taught that central banks were large and powerful enough to make Say's law roughly true in practice even though it wasn't true in theory even in the relatively short run—that the short run of aggregate demand shortfalls, and the durations of V's, was limited to two or at most three years. There could be surprises, and long and variable lags. Those blocked offsetting demand shocks immediately and instantly, but the duration of the surprise was limited to the period of predetermined prices.

And I was taught that capital should flow downhill; that at the level of international economics, governments really, really were agents of the citizens so we could view the country as a whole; and that we could expect to find conditional convergence of living standards and productivity levels across nations—convergence conditional on getting good institutions, that is.

Yet these do not appear to be so. The fallout from the 1997–98 financial crisis has been very large, very persistent. This is even more puzzling because, as Alan Taylor said, the post-crisis policy reaction of building up reserves should not be a drain on national savings at all.

The way such situations were supposed to be handled was that when there was, in the words of the Articles of Agreement of the International Monetary

Fund (IMF), a “fundamental disequilibrium,” the IMF was supposed to step in. The IMF was there to take the blame for getting the country to do the things that had to be done in the long run to balance resources against commitments—to take the political fallout, and thus induce politicians to do what was necessary rather than kicking the can down the road while they hoped for a miracle. The IMF was there to get the country back onto its proper long-run trend growth path. And the IMF was there to provide bridge financing to make the process of adjustment as painless as possible.

In this case, the Asian reserve accumulation after 1997–98 is best viewed as a recognition by the Asian periphery that they really did not believe that they could trust the IMF to do its proper job.

In 1997 and 1998, from the Asian Pacific perspective at least, first-world international speculators suffered a great failure of nerve, an irrational panic, and fled the region. This panic was irrational: Those that held on did fine, and those that bought into the crisis did enormously well. But in the crisis the IMF did not do its job—did not provide enough funding fast enough with appropriate conditionality. And the sovereigns of the Asian Pacific Rim reacted to this by deciding to build up their own reserves so they would never be forced to rely on the IMF again.

That decision should create added confidence. That you can now invest in Malaysia or Korea or Indonesia without worrying about any kind of financial disruption because its own central bank stands ready to smooth adjustment and does not need the IMF cavalry should lead to a higher investment share, not a lower one. Thus, relative to what is my and what I suspect is Alan’s counterfactual, the investment gap is even larger than Carmen makes it sound.

Could the investment gap possibly be crowding-out by China’s production—the idea that there is a niche in the world economy for export-oriented rapid development by some emerging market countries with low-valued currencies, but that in 1997–98 it became clear that China was going to occupy that niche and bigfoot everyone else out of it? In response to that recognition, the argument would go, the returns to investment in the Asian Pacific Rim would drop, and so investment would drop. I do not believe so, largely because I have sat at the feet of Chang-Tai Hsieh and learned from him how very tightly coupled the Chinese export sector is to the other economies of Pacific Asia. More exports from China mean more work and more profits elsewhere on the Asian Pacific Rim. China actually getting its act together and taking up a position as the supplier of the low-wage component of the value chain seemed and seems to me more likely to raise the marginal product of the capital in the rest of the Asian rim rather than lower it.

Could it be that there was a negative shock to the expected pace of globalization in the aftermath of 1998? Again, I find this hard to credit. If anything, globalization has proceeded faster since 1998 than anyone had previously imagined it could before. Before 1998, we were gradually realizing that the moving of industrial production out of the North Atlantic core to the periphery was a thing that was now possible. We were realizing that containerization had produced another great downward leap in costs of transport. But we had little idea then how much difference the coming of modern telecommunications would make in tying the world together.

Thus I find myself puzzled when I try to think of how 1997–98 could have seen a shift in trend that then caused the cycle. I cannot see any exogenous change in the trend that would validate either the post-1998 slowdown in growth and investment or the financial crisis itself as a reaction to bad news about future growth in Asia.

Thus I am left hunting for other explanations. One of them is definitely Carmen and Takeshi's: that this particular 1997–98 financial crisis is casting an extraordinarily long shadow on the economy. This may in some way be tied up, in a manner I do not understand, with the astonishing role that the dollar has played over the past 15 years. There is an economist in the front row who, back in 1979 and 1980, made me read at extended length about Robert Triffin and the Triffin dilemma. And at the time I thought that this was a waste of my time—how could we ever again get into a situation in which it would be useful to characterize the world economy as suffering from a dollar shortage—a shortage of dollar-denominated and U.S. property- and taxing capacity-backed liquid assets? Yet, now, we have seen not just Bretton Woods II but the return of Robert Triffin at a scale that even back in 1998 I would never have believed possible in a thousand years. The bottom line, I think, is that we have a difficult task before us. Our old belief that you have a trend, and you calculate the trend; that you have a cycle, and you argue over whether the cycle falls below the trend or fluctuates around it; but that you can carry this discussion along two separate and largely disconnected tracks—that belief looks to be simply wrong. Carmen and Takeshi's paper here is another nail in the lid of its coffin, another demonstration that by trying to think in such ways over the past generation we have not done ourselves or the world a very good service.