The Broken Cash Register

Opinion seems nearly universal that what we are currently experiencing is not the typical business cycle with which we are familiar. Besides being the end of a long speculative bubble, and the magnitudes involved, the significance of what is happening is difficult to fathom. To the extent that some have thought about the bigger picture -- the discussion has tended to focus on things like the decline of America, Anglo-American capitalism, and the rise of China and emerging markets.

The tensions that are emphasized in such conceptualization have certain apocalyptic appeal, but really shed little light on the current challenges. However, it does seem as if the financial crisis has ended a historical period, leaving great anxiety and uncertainty over what is next. This short essay attempts to sketch out a different big picture view.

Accumulate

The narrative begins with the long expansion after WWII. The war destroyed much capital and reconstruction was the theme. It was based on fixed exchange rates, limited capital mobility, and declining barriers to merchandise trade. Unionization helped to keep wages linked to productivity and inflation. This was the basis of capital accumulation. For various reasons beyond the scope of this essay, that model broke down. A prolonged crisis ensued, not only in the US, but in Europe and Japan as well. It was called the 1970s.

Reagan-Thatcher helped build a new cash register -- one based on capital mobility and financial innovation. It meant the decline of organized labor and of labor's embrace of free-trade. Wages in the US were to varying degrees decoupled from inflation and productivity.

The globalization associated with the Reagan-Thatcher model was, to a great degree, predicated on opening the US economy. Not only did trade (defined as imports plus exports as a percentage of GDP) increase markedly for the world's largest economy; sustained, and often large, current account deficits ensued.

This posed one of the most profound challenges market economies face. They are so efficient at accumulating capital that managing those profits, in ideologically safe ways, becomes a primary cause of modern crises. And although the present elevated levels of unemployment throughout the world and insufficient aggregate demand persist, record corporate profits are being reported.

Surplus

It may sound counter-intuitive, but the issue that Federal Reserve Chairman Bernanke identified when he was a governor in response to the Greenspan Conundrum (why long term US rates were low while the Fed was raising short term interest rates) remains the operative challenge: surplus capital. From this perspective, the Reagan-Thatcher cash register operated on the basis that the US, and to a lesser extent the UK, would absorb savings that other countries could not. This capital account surplus in turn required or allowed the US (and the UK to a lesser degree) to sustain current account deficits.

Surplus capital lies at the heart of the so-called currency wars. Currency devaluations are not so much about beggar-thy-neighbor moves in order to boost exports. They are more about trying to minimize or neutralize capital flows which are pouring into a dozen or so emerging markets. Indeed, these countries can hardly absorb their own savings, let alone a chunk of the savings from the US, Europe and Japan. Namely, these large capital inflows could fuel a bubble in local asset prices by distorting pricing signals, by complicating policy, and by posing a serious risk when the flows go into reverse. EPFR, for example, reported $41 bln in flows to emerging market bond funds thus far this year. Meanwhile, the EPFR reported that more than $60 bln has flowed into emerging market equity funds in the year through mid-October, and almost 40% of which has come since the start of Sept. Of course some countries would feel like they have been hit with a tsunami of short-term capital flows.

There is a prisoners' dilemma playing itself out. No one wants to be overwhelmed with hot money. Cooperation would require that countries absorb the surplus savings, allowing currency appreciation to help re-balance the global economy. Few countries seem genuinely committed to this.

Instead many are pursuing a different strategy. They are creating (thus far) modest deterrents to some elements of portfolio inflows. The hot money that is deflected on the margins exacerbates some other countries' indigestion problem. Moreover, a number of countries are also liberalizing their own portfolio capital outflows, which aggravates the surplus capital challenge.

In this context, the resolution of the 1997-1998 Asian financial crisis was consistent with the Reagan-Thatcher cash register and tended to reinforce the US role in absorbing the world's savings. The rigidities in Asian currency markets prevented a fuller integration into the world of highly mobile capital. After the crisis many countries in the region shifted from running current account deficits to running current account surpluses. They outsourced the management of parts of their savings to the US.

Some Thoughts on Rebuilding the Cash Register

The current crisis is the breakdown of the Reagan-Thatcher cash register. Its own success seems to be the main culprit. It reached some logical conclusion. The leveraging and deregulation, and perhaps the sheer size of the capital stock, overwhelmed the US's ability to absorb it and, in some quarters, raised Triffin Dilemma-like problems: the magnitude and persistence of the current account itself began undermining the cash register.

When the Bretton Woods model of the post-war period broke down in the early 1970s, policy makers initially tried a triage strategy of modifying the Bretton Woods system. These were known as the Smithsonian Agreements. Similarly, the initial effort now is to preserve as much of the Reagan-Thatcher cash register as possible. Generally speaking, it is embracing the mobility of capital and globalization. The financial reform, if successful, will boost the US ability to absorb (and responsibly manage) the world's savings.

The dimensions of this crisis, as it has been since the beginning three years ago, are global in nature. By definition the solution has to be global. Another element of a rebuilt cash register is for other countries to absorb some of the world's excess savings. That requires the deepening of local capital markets -- measured as the size of the equity and debt markets as a percentage of GDP.

However, as most countries are presently still too small to absorb much of the huge pools of concentrated capital seeking a home, the obvious candidate is China. Demographic trends and growth differentials suggest that over time, China could very well become a current account deficit country and import a great share of the world's savings. It already runs a trade deficit with a number of Asian countries.

Ultimately the world economy must generate less surplus capital. The surplus countries need to reduce their savings by boosting consumption. One way China could reduce its incredible savings rate would be for the Chinese government to provide some of the basic public goods that most other countries provide their citizens, such as greater social security, unemployment compensation, and, yes, even national health care.

It is possible that the Reagan-Thatcher cash register cannot be salvaged. That would suggest a rather foreboding future. Yet, just as in 1971, it was impossible to have anticipated the features of the Reagan-Thatcher cash register, so too we may not be able to envisage a new one.

Just like China would still have to confront its massive reserves even if they were to shift of out dollars, so too does the challenge of absorbing the vast world savings transcend national or regional focus of the more common dramatic narratives. While some semblance of recovery is possible, without a solution to this problem, economic prosperity may not return -- no matter the configuration of geopolitics.