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Why So Many Financial Crises?

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The global financial picture continues to look bleak, with major current disruptions in the United States, Europe, and China that demonstrate a troubling overall pattern of weak recoveries and rolling crises. Boom-and-bust examples from Japan and China over the last forty years show how overinvestment can result in financial bubbles. When the bubbles burst, investors are pushed into less-risky assets that reflect a transition away from wealth enhancement to wealth preservation that complicates a much-needed return to economic equilibrium. Sound currency policy, including more exchange rate flexibility for rapidly growing economies, can help mitigate asset bubbles and financial crises that are hampering global growth.

At midyear, the global economy faces three major challenges, the fundamental causes of which have been building for decades. The US economy is slowing, to a growth rate that will probably be close to zero in the second half of the year. The European economy continues to weaken as the disruption of its financial crisis harms real economic activity while exports, especially Germany's, slow as the world economy slows. And China's growth rate continues to slip, exacerbating the extant weakness in the United States and Europe. As figure 1 shows, purchasing managers' indices have sharply declined, evidencing the erosion of global manufacturing as economic growth stagnates.

This is all pretty familiar, and although some observers point to hopeful signs that the global slowdown is being contained by stopgap measures like the late-June effort by European Union leaders to contain its financial crisis, virtually no convincing, proactive measures have emerged to deal with any of the three problem areas identified above. The United States is moving toward a "fiscal cliff" that will see tax increases and spending cuts worth over 4 percent of GDP take effect at year's end. That huge fiscal drag will require whoever occupies the Oval Office after January to work with the new Congress to

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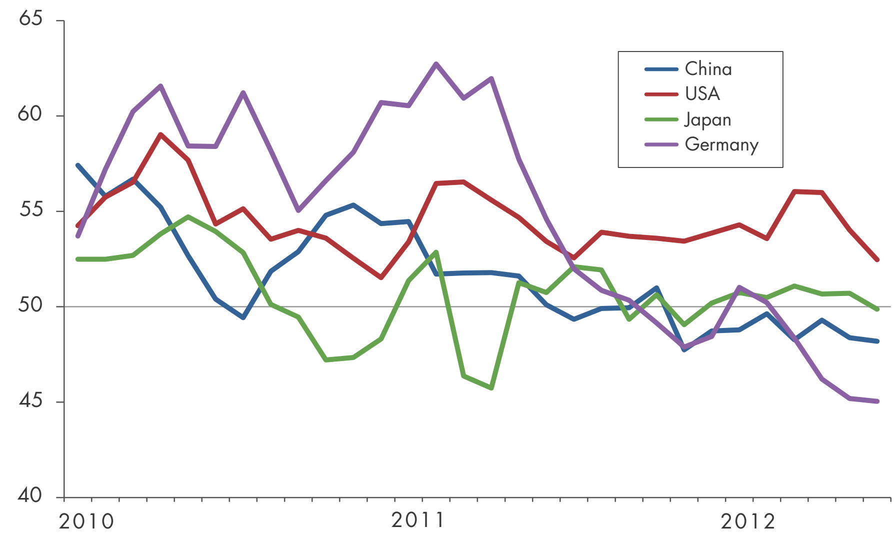
Key points in this *Outlook*:

- The global economy is facing three major challenges: US growth slowing to a near-zero rate, declining exports and a weakening economy in Europe, and sluggish Chinese growth.
- The current pattern of weak recoveries and rolling financial crises can be seen in economic meltdowns in China and Japan in the 1980s and '90s that led to overinvestment in risky assets and a transition from wealth enhancement to wealth preservation.
- These boom-and-bust examples from Asia show that suppressing currency adjustment can lead to asset bubbles and financial crises; we must find other ways to return the global economy to equilibrium.

FIGURE 1
MANUFACTURING PURCHASING MANAGERS' INDICES (2010–PRESENT)



Source: Markit Economics.
Note: Values below 50 indicate a contraction of activity.

move quickly to temper short-term deficit reduction while identifying ways to enhance deficit reduction in the medium term.

At the same time, European leaders are attempting to forge a fiscal union, a way to engineer financial transfers from Germany to the rest of Europe that does not simply reward the profligate peripheral countries for continuing to spend well beyond their means. Road maps have emerged to describe how this process might proceed, but the design of the "roads" has not been agreed upon, let alone any start made on their construction. For its part, China has cut interest rates and reduced reserve requirements, but its economy continues to slow as weakening global demand hampers growth of its export-led economy and Chinese households struggle with sharply reduced wealth as the value of the apartments they have purchased as favored investments erodes under the weight of substantial excess supply.

It is important now to ask whether the near-simultaneous emergence and persistence of problems facing the global financial system and economies is just an unlucky coincidence or indicative of a common underlying theme. After all, 2012 marks the third year in which an apparent recovery has stalled. There is no easy answer to this question, but evidence is accumulating to suggest that the problems associated with wealth storage and enhancement have played a role in the emergence of financial disruptions, including the 2008 Lehman Brothers crisis, the current European financial crisis, and an emerging disruptive slowdown in China with negative implications for its financial system.

An important clue to the underlying problem that has emerged surrounding wealth storage and enhancement lies with the seemingly paradoxical collapse in returns on government securities issued by the United States, Germany, and Japan. In view of the sharp rise in government deficits and debt in these countries, how could borrowing costs be driven to zero or below (when the effect of inflation is included) at a time when these governments have persistently failed to address their deteriorating fiscal situations? (As an aside, while it is fair to say that Germany's fiscal position is stable, the prospect of fiscal integration in Europe, coupled with more transfers from Germany to the periphery, should not reassure long-term lenders to Germany, yet real returns on longer-term debt have reached record lows.)

The simple explanation for the low returns on government bonds in the United States, Japan, and Germany is the rising fear among investors confronted with three years of rolling financial crises and failed economic recoveries. The high level of uncertainty and poor returns on risky assets have pushed investors to buy more sovereign bonds whose value has been supported by heavy central bank buying. The persistent erosion of risk appetite among investors has limited the financial recoveries and economic expansions that have emerged over the past three years. The pattern of weak recoveries and rolling financial crises goes back farther than the rolling crises that have emerged since 2008. The push for growth in Asia has contributed to the unusual economic and financial problems today.

Parallels between Investment Booms in Japan and China

The post–World War II path of the Japanese economy leading up to its 1990 financial crisis and collapse, as well as economic reforms and demographic changes in China in the late twentieth century, can shed light on the factors leading up to the recent boom-bust cycles in the United States, Europe, and China.

Japan came out of World War II with most of its stock of physical capital destroyed. The prospective real return on postwar capital investment in Japan was boosted sharply, provided that adequate demand could be found for goods produced by combining new capital with Japan's skilled labor force. The key to generating aggregate demand was, at the time, Japan's fixed exchange rate at 360 yen per dollar, which made the country's exports very cheap in global markets. Global demand for Japan's basic manufactured goods was virtually unlimited, and as its export mix evolved in the 1960s and '70s to include more sophisticated goods like automobiles, so too did the rapid growth rate in the United States boost the ability to absorb those exports.

Problems associated with wealth storage and enhancement have played a role in the emergence of financial disruptions.

Some demographic and cultural changes in Japan sharply boosted its savings rate in a manner parallel to the increase that occurred in China after Deng Xiaoping's economic transformation began in 1978. Along with faster economic growth in Japan came rising life expectancy and a rapid transition from agriculture to manufacturing that contributed to a reduction in the national birth rate. More prosperity brought longer life expectancy and higher savings flows aimed at accumulating more wealth to provide for retirement. The need to save more for retirement was enhanced by the lower birth rate and the concurrent reduction in future support from offspring. The desire and ability to save more for retirement came from rising real incomes and reduced outlays because of fewer children. Japan's appetite for enhanced wealth storage rose rapidly.

In the 1980s, as Japan's savers sought to invest more, the price of assets, the source of income streams from wealth, was bid up rapidly. During the 1980s, stock prices rose to high multiples of earnings. The price of other forms of wealth—real estate, land, and buildings—also shot up, and a real estate bubble emerged late in the decade. The intensity of the real estate bubble in Japan was enhanced by the relative scarcity of land. Inflation began to rise as wealth-driven spending increased. The Bank of Japan, fearing inflation, tightened monetary policy, and by 1990, the price of real estate began to fall rapidly. The Bank of Japan was slow to respond to the collapse of the real estate bubble, and the continued collapse of prices wiped out wealth worth two to three years of income in Japan. By comparison, the wealth lost in the United States after the Lehman crisis amounted to about two-thirds of a year of income.

The passive response by the Bank of Japan to sharply falling growth rates and prices allowed deflation to emerge. Japanese households turned to government bonds as their primary means of wealth storage. Returns on government notes and bonds fell to very low levels as the trauma of massive wealth losses on real estate and other riskier assets made Japanese investors highly risk averse.

As the Japanese bubble was growing in the 1980s, events were occurring in China that created another surge of savings alongside that in Japan, for many of the same reasons. China's single-child policy, enacted in 1978 alongside Deng's economic reforms designed to encourage more entrepreneurial private-sector activity, set in motion another jump in Asian savings a decade before Japan's financial and real estate bubble burst. As Chinese growth surged, life expectancy increased, and savings rose even faster. The unusually sharp drop in China's birth rate was especially important as a catalyst for increased savings in a traditional society accustomed to heavy reliance on children for old-age support. Clear parallels exist between China's population surge and savings boom and Japan's.

The lead-up to the 1997–98 Asian financial crisis was a sign of the enhanced pace of wealth storage efforts in China and among the Asian Tigers (Taiwan, South Korea, Hong Kong, and Singapore). Asset prices were bid up rapidly while a surge of capital inflows added to the pressures that created Asian asset bubbles that would subsequently burst. Some have attributed the first Asian crisis in part to Japan's ill-timed Spring 1997 effort to raise taxes in the face of rising debt accumulation, which was passed after the first sign of faster growth tied to what had been a period of fiscal stimulus. Whatever the primary cause of Asia's debt crisis, the investment surge tied to China's enhanced demand for wealth accumulation as faster growth combined with longer life expectancy to boost savings and investment played a major role.

China emerged from the 1997–98 financial crisis with a strong desire to avoid such setbacks in the future.

Its aggressive response to the fallout from the 2008 Lehman crisis, amounting to a government fiscal stimulus worth about 14 percent of GDP over two and half years, was probably preordained a decade earlier. Of course, much of China's fiscal stimulus in response to the Lehman crisis was composed of investment incentives that only exacerbated the excess capacity problems that high savings rates had been creating in Asia for decades.

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An Emerging Pattern

Asia's experience since Japan's investment boom ended abruptly in 1990, followed by the 1997–98 Asian crisis that signaled overinvestment in the region, may be part of a series of financial crises tied to overinvestment in risky assets (ex-post) that resulted in the 2008 Lehman crisis and the subsequent 2010 European financial crisis.

The familiar sequence of events that leads to a financial crisis includes an exogenous shock that sharply boosts the return on investment, such as occurred in postwar Japan and postreform China, followed by a surge in savings that drives down the return on investment while investors are still seeking enhanced wealth accumulation. In the cases of both China and Japan, enhanced investment is primarily being directed at the export sector, which can access the rapidly growing demands in markets of more developed economies.

Normally, a drop in the real return on domestic investment in China would cause Chinese savers to invest more abroad, but the Chinese government's policy has been the opposite: to sharply constrain investment abroad. As a result, its large current account surplus, driven by high domestic saving, creates pressure for a stronger currency. But in Japan, and far more in China, that pressure was deflected by government purchases of foreign exchange that in turn transmitted abroad a large demand for financial assets. With China's foreign investment directed largely by its conservative government managers, a favorite financial asset was US government bonds and notes. More purchases pushed down real returns, driving savers in the United States before 2008 to purchase riskier assets to obtain higher returns in a world of excess savings. The only way to obtain higher real returns is to take on more risk, so the lower the returns on safe assets, the more investment on riskier assets is encouraged. By 2008, the cumulative result of what turned out to be overinvestment in risky assets was the Lehman crisis.

Paradoxically, the US Federal Reserve's response to the Lehman crisis has been, as already noted, to take over the purchases of US government securities in quantities sufficient to drive down real returns by enough to enhance further purchases of riskier assets. This has artificially boosted the price of riskier assets, like stocks, commodities, and (before 2010) bonds issued by peripheral sovereigns in Europe, resulting in a series of false starts in asset markets where rallies have become difficult, if not impossible, to sustain. This has been especially true in the case of bonds of peripheral sovereign European countries, the value of which has sharply fallen over the past several months. At the same time, as I have explained, the preference for higher-grade sovereign bonds issued by the United States, Germany, and Japan has become even more pronounced because of both the rising risk aversion among investors and repeated failed efforts to boost riskier assets. The extra direct purchases of high-grade sovereign bonds by central banks have underscored their perceived value as safe assets, at least among household investors.

From Wealth Enhancement to Wealth Preservation

The year 2012 may mark a transition in the investment world, where wealth preservation has come to dominate wealth enhancement as the primary goal of most savers and investors. As already noted, global asset managers face, simultaneously, a collapse of demand growth in the United States (weaker investment and the year-end fiscal cliff), China (economic slowdown driven by rising excess capacity in the traded goods sector and a bursting real estate bubble), and Europe (bursting of the sovereign debt bubble). The excess capacity problems that emerged in Japan after its bubble burst in 1990 and have been emerging in China during its rapid wealth buildup have grown worse, and aggregate investment returns have dropped sharply. Now, savers—pension funds, households, and professional money managers—are forced to make the painful choice between virtually zero returns available on low-risk assets and the rising risks tied to investments offering (ex-ante, if not ex-post) higher returns. This painful choice probably forced JPMorgan's investment arm—heretofore known for its risk-management prowess—to push too far into riskier investments and suffer its well-publicized recent $2 billion (and probably more) loss.

The most discomfiting thing about this scenario of excess capacity, excess risk taking, and zero returns on safe assets is the implied adjustment path back to equilibrium. Adjustment along an economic path occurs as excess capacity causes prices to fall until the real value of wealth (assets) rises by enough to boost spending. This is the Pigou effect, widely discussed by John Maynard Keynes and others in the 1930s. It is highly disruptive because falling prices and rigid nominal wages lead to rising real wages and rising unemployment because employers cannot pay higher real wages when final demand is weak. Deflation also increases the real burden of debt accumulated by governments seeking to offset chronic excess supply conditions in the private sector that result from the overinvestment by Asian countries seeking to accumulate more wealth.

The political path to equilibrium in a world of excess capacity includes trade wars once all of the above means of sustaining growth have been exhausted. Beyond that, outright war may result, which has the effect of both destroying redundant physical capital and boosting the demand for new investment in armaments. This is surely not a desirable outcome, but events of the late 1930s come to mind as precedent.

Exchange Rate Adjustment Can Help Prevent Bubbles

We must attempt to understand the recent series of disruptive global financial crises—such as the bursting of the Japanese bubble in 1990, the Asian debt crisis in 1997–98, and the 2008 Lehman crisis and 2010 European financial crisis—to prevent them from persisting and recurring. The rapid wealth accumulation that follows exogenous shocks like the destruction of Japan's capital stock during World War II and China's post-1978 Great Leap Forward has resulted in asset bubbles that burst and led to financial crises.

Currency policy has played a key role in Asian investment booms and financial crises.

Currency policy has played a key role in Asian investment booms and financial crises. The postwar Asian booms have been driven by rapid export growth. High levels of savings that accompany and finance investment booms reduce domestic demand growth at a time when high levels of investment are boosting the output of goods, resulting in excess supply that threatens growth. Selling more exports abroad to compensate for a lack of domestic demand is achieved by suppressing the currency appreciation that would normally accompany a large trade surplus.

Efforts such as those by Japan, the Asian Tigers, and China to prolong export-led growth by suppressing currency movements contribute to the imbalances that result in asset prices bubbles. Suppression of adequate currency adjustment also created the strains that resulted in the collapse of the Bretton Woods system of fixed exchange rates after 1971. The suppression in exchange rate movements implicit in the European Monetary Union also resulted in a buildup of pressures that led to the European financial crisis after 2009. Long periods of suppressed currency adjustment to equilibrium levels may be more pernicious than previously supposed insofar as they often lead to asset bubbles followed by financial crises. The time has come to fundamentally reexamine what constitutes an appropriate currency regime in a world of disparate appetites for wealth preservation and enhancement. More exchange rate flexibility for rapidly growing economies would help to defuse the growth of asset bubbles that lead to financial crises.