The Macroeconomics of Asset Shortages

Ricardo J. Caballero
MIT

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Introduction: The View

- The world has a shortage of financial assets
  - Excess demand for **store of value** and **collateral** by households, corporations, governments, insurance companies, financial intermediaries
- It is the result of shocks and structural changes
  - Shocks: Japan (early 90s), European stagnation (90s), EMEs (late 90s), Oil (00s)
  - Structural: China, globalization; Financial development (net collateral consuming)

Introduction: Positive implications

- Equilibrium response of asset prices and valuations have macroeconomic implications (Occam's razor)
  - "Global imbalances"
  - Recurrent speculative "bubbles'' (eme, dot-coms, real estate, gold,…)
  - Low long real interest rates
  - Low inflation and deflations

Introduction: Normative implications

- The policy prescriptions that follow from this asset-shortage view include:
  - Recognize that high valuations (bubbles) are part of the equilibrium (reflect scarcity of store of value instruments). Idem for global imbalances and low interest rates
  - Focus on risk-managing them rather than on choking them
  - Ultimately, the problem is one of financial underdevelopment in increasingly important regions of the world

Emerging Markets

- Three reasons, from a global perspective, to look at them:
  - Asset shortage is a chronic feature
  - Important to identify the right, not **all**, the lessons (in particular, fragility of high valuations)
  - Coordinated crises of the late 90s, and fast recent growth have played a central role in generating a worldwide asset shortage

Emerging Markets

- Capital's ability to produce output is only imperfectly linked to its ability to generate assets
  - Weaknesses: Institutional, macroeconomic, political, liquidity
  - Result: Asset shortage is a chronic feature: Cycles of capital outflows (store value abroad) and domestic bubbles (store value in fragile coordination dependent assets)
- There is a good side of bubbles (store of value), however financial underdevelopment generates pecuniary externalities which lead to *excessive risk-taking*
- Lessons for the world at large:
  - Shortage of assets can naturally lead to speculative valuations, and there is a positive side to these high valuations
  - Bubbles are fragile when there are many substitutes and there is domestic financial underdevelopment
    - Neither of these conditions apply (to the same extent) to the world at large or to the US (sudden stop analogy is not a good one)

The World Economy

- Globalization transfers local asset shortages to the world at large
  - Asset crashes around the world (Japan, EMEs) reduced the supply of assets
  - Large asset shortages in China and commodity-economies
- Anglo-Saxon economies, and the US in particular, are the main asset producers
  - Large capital gains and flows to producers of scarce assets

The World Economy: Outcomes

- The so-called “global imbalances” is a symptom of asset-scarcity
  - Capital gains and losses are very heterogeneous across the world
  - No clear end to this process
- Low interest rates
  - It is one of the market mechanisms to create assets (increase value) out of the few one it has
- Low inflation is another
  - It is the market mechanism to increase the value of scarce nominal assets

The World Economy: Bubbles

- … and yet another market mechanism (recall EMEs) is high valuations or speculative bubbles
  - Speculative bubbles have many origins, many of which are bad ones (risk-shifting, etc)
  - But there is also good reasons for them, in particular when they are part of the market solution to an asset shortage
- When there is a good reason, bubbles can be much more stable
  - Unique equilibrium at the *aggregate* level
  - *Location* is the source of instability (huge issue for EMEs, less so for the world at large)

The World Economy: Policy

- Ultimately, the “solution” is financial development in EMEs
- While we get there…
  - Understand that some of the “anomalies” are symptoms and market-based solutions
    - Chasing bubbles, “global imbalances,” and low real interest rates can have dire consequences
    - Forcing a reduction in the value of assets is likely to lead to large excess demand for assets and excess supply of goods
      - Deflation and depression (very slow mechanism)
      - “Reallocation” costs (bubble will re-emerge)

The World Economy: Policy (cont.)

- Instead, learn to live with the fact that in aggregate we may need some bubbles (high valuations) and focus on managing their risks
  - Aggregate control: inflation targeting in developed economies (modified in EMEs)
  - Location:
    - Spread the bubble as much as possible
      - Monetary policy is **not** a good instrument for this purpose… if something, loose may be better to let banks do the job
      - Need a more sector/investment specific instrument
    - Non-resource consuming investments
      - Land and gold are better than wasteful physical investment
      - Caveat: it is better to spread it to reduce input cost shocks

Economizing assets: A Lender of Last Resort

- Financial intermediaries have significant demands for store of value (collateral)
  - In an environment with asset shortages, holding (freezing) collateral is expensive
  - Incentive to reduce collateral makes the system more susceptible to panics. Knightian uncertainty
- Regulator's incentive is to impose larger collateral holdings
  - Costly in an environment with asset scarcity
- Lender of last resort (for extreme events) is a particularly valuable instrument in this environment
  - If anticipated, it leads to an improved use of scarce private collateral. This is the main benefit, not the intervention itself

Final remarks

- Many of the main macroeconomic events in the last two decades can be explained as the natural byproduct of asset shortages and the heterogeneous world distribution of asset-production capacity
- This view also has important policy implications:
  - It gives the highest priority to asset value creation and preservation
- For the world at large, financial development in EMEs is the path… forcing artificial fixes to global imbalances and asset valuations is not

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