Journal of International Money and Finance 63 (2016) 89–111

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Does reserve accumulation crowd out investment? ☆

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A R T I C L E I N F O

Article history:
Available online 7 January 2016

JEL:
E2
E5
F30
F4
G15
H6

Keywords:
Crises
Growth
Investment
Reserves
Debt
Asia

A B S T R A C T

It is understood that investment serves as a shock absorber in times of crisis. The duration of the drag on investment, however, is perplexing. For the Asian economies we study, average investment/GDP is about 6 percentage points lower during 1998–2014 than its average level in the *decade* before the Asian crisis; the decline is greater if China is excluded. We document how in the wake of crisis home bias in finance increases markedly as public and private sectors look inward when external financing becomes prohibitively costly or undesirable from a financial stability perspective. Reserve accumulation involves an official institution (i.e., the central bank) funneling domestic saving abroad and thus competing with domestic borrowers in the market for loanable funds. We suggest a broader definition of *crowding out* and *leakages*, driven importantly by rising home bias in finance and by official capital outflows. We present evidence from Asia and advanced European economies with managed currencies to support this interpretation.
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1. Introduction

The literature on early warnings of financial crises identifies overvalued currencies, widening current account deficits, large capital inflows, rising leverage, and low and declining international reserves

☆ We wish to thank the editor, our referees, Brad DeLong, Olivier Jeanne, Kenneth Rogoff, Alan Taylor, comments and suggestions on an earlier version of this paper. The views expressed are our own and not necessarily shared by others at our respective institutions.

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http://dx.doi.org/10.1016/j.jimonfin.2015.11.004
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as precursors to disaster.[1] These patterns prevailed in innumerable emerging market crises and (with the exception of the depletion of international reserves) also preceded most of the recent financial crises in the advanced economies.[2] The mechanics were described by Calvo (1998) as a sudden stop of external finance. When current account deficits can no longer be financed by borrowing from abroad, sharp output declines and the scarcity and high cost of finance combine to produce often dramatic adjustments. In particular, as the current account balance swings from deficit to surplus, the brunt of this adjustment usually falls on investment.[3]

The Latin American debt crisis of 1981–1982 was influential in fostering an understanding of why a prolonged investment slump follows a deep crisis.[4] Kaminsky and Pereira (1996) show that public and private saving rates fell sharply in Latin America from 1982 to 1988, implying that current account deficits were closed by even larger declines in investment. In that episode, at least, investment was importantly crowded out by a rising share of public and private consumption.[5] We would add that the decline in measured domestic saving was also exacerbated by *leakages* to the domestic system in the form of private capital flight, which escalated in the region to record highs.[6]

The Asian crisis of 1997–1998 was most acute in Indonesia, Korea, Malaysia, the Philippines, and Thailand. Yet, investment as a share of GDP fell across the board in the major Asian economies in 1998. In Indonesia, the investment-GDP ratio was nearly halved, falling from 32 percent in 1997 to 19 percent the following year. The decline in investment-GDP ratios among the advanced economies since 2007 has also been drastic. For instance, from 2007 to 2014, Ireland's investment-GDP ratio fell 10 percentage points. Unlike Latin America in the 1980s (or modern-day United States), post-1997 Asia is a region of high domestic saving rates. There is little to suggest private capital flight has been a significant leakage in the past decade. Hence, it is unlikely that the many of factors that drove the investment slump during Latin America's lost decade have been at work in Asia (but both regions turned inward for financing sources in the post-crisis era).

While it is not difficult to understand the role of investment as a shock absorber at the time of crisis, it is perplexing why it takes so many years after the crisis to recover – if it recovers at all. For the nine Asian economies in this study, average investment/GDP is about 6 percentage points lower during 1998–2014 than its average level in the *decade* before the crisis; if China and India are excluded, the estimated decline exceeds 8 percent.[7] Over the same pre- and post-crisis sample the decline in growth is 2.5 percent for all countries and 3.3 percent if China and India are excluded.[8]

In this paper, we aim to shed light on some of the factors that may account for the sharp and sustained decline in investment as a share of GDP in many Asian countries since the events of 1997–1998. While the evidence does not support "one size fit all" explanations, the topic and our findings may have broader resonance outside Asia. China and India (for different reasons) appear to be in the cusp of a significant investment correction; other large emerging markets, such as Brazil may be similarly placed; and much of Europe and the United States are entering their seventh or eighth year of an investment slump.

[1] See Bussière et al. (2013), Frankel and Saravelos (2012) and Gourinchas and Obstfeld (2012) for recent analyses of early warnings as well as the comprehensive discussions of the existing literature therein.

[2] Gourinchas and Obstfeld (2012) observe that the only notable difference between the emerging and advanced economies is that the output declines during currency crisis were larger in emerging markets.

[3] Recall the current account balance equals saving minus investment.

[4] Diaz-Alejandro (1983) were among the first to single out this problem.

[5] In Kaminsky and Pereira (1996), the increases of public and private consumption (as a share of GDP) were of comparable magnitudes.

[6] See Claessens (1997) for a comprehensive analysis of the capital flight magnitudes involved.

[7] The countries are: China, India, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, and Thailand.

[8] This growth comparison, showing lower growth during the era of high reserves is not at odds with the finding in Bussière et al. (2013) that emerging markets with higher reserves performed better (in terms of output) during the global financial crisis of 2008–2009. The period we are comparing spans 26 years (11 years through 1997 and 1998 to 2012); our focus is on the long-term growth performance.

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