Comments on

Fear and Market Failure: Global Imbalances and "Self-insurance"

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by
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Main points

- Pronounced Loss Aversion in EM ➔ precautionary saving can generate substantial ‘global imbalances’, especially if there is an inefficient supply of global ‘insurance.’

- Fear & market failure generates imbalances, as a general equilibrium outcome.

- Lower real interest rates will ensure

Aggregate demand = supply at a global level; but disequilibrium may result if the required real interest rate is negative.

Comments The paper links the pronounced Loss Aversion in EM to the looming liquidity crisis of 2007.

- A nice general equilibrium, Edgeworth Box analysis.

While the EM block plays a role, note that

- The big new story of 2007 is the "flight to quality" in the West, triggered by the Sub-prime crisis.
- Flight to quality may be better accounted by Knightian uncertainty, and the slow diffusion of information [Caballero and Krishnamurthy (2007)].
- The EMs are diversifying away from IR via SWFs…

Lately, EMs' SWFs have diversified, purchasing assets affected by the flight to quality, alleviating the "flight to quality"

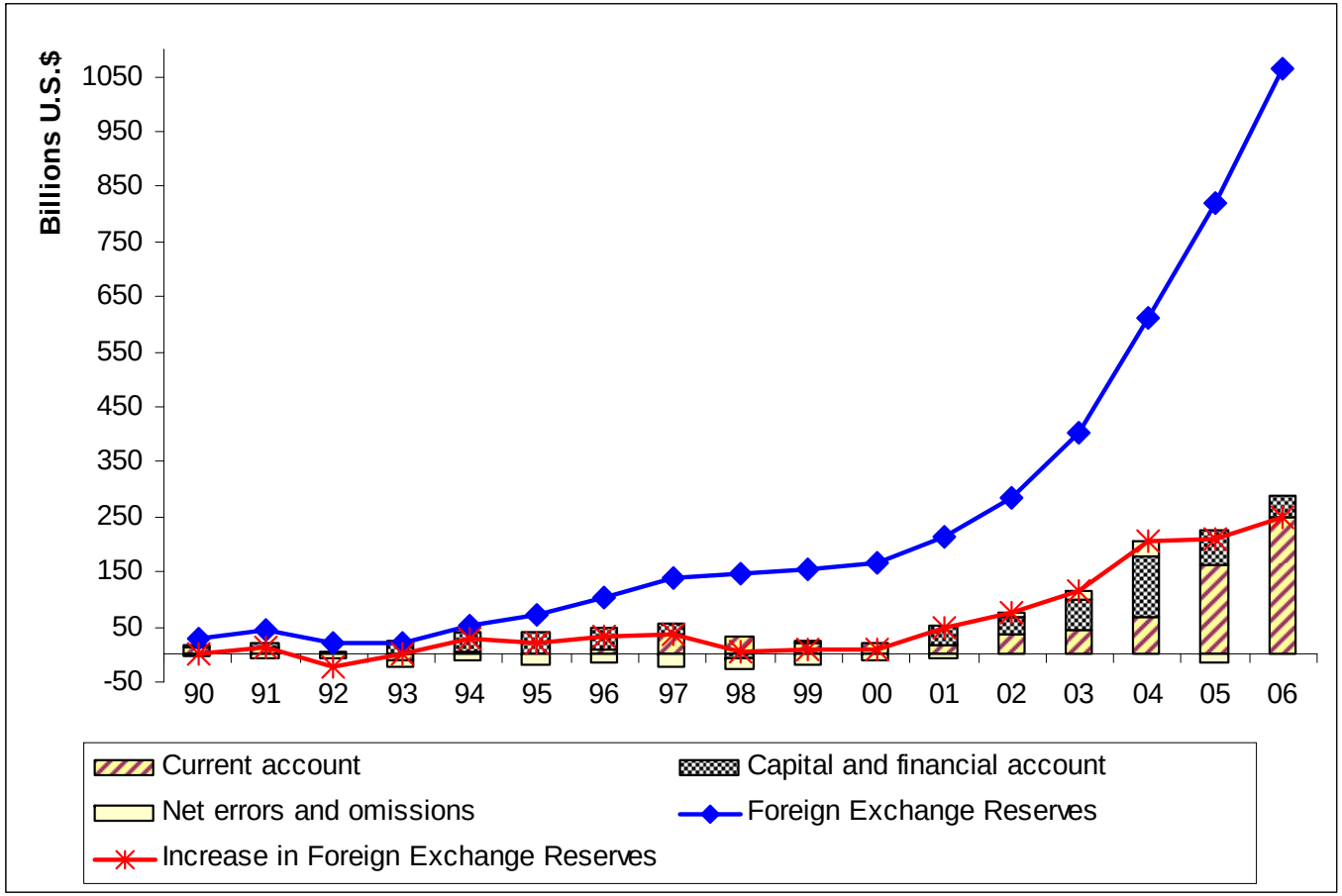
New Money on Wall Street Foreign companies and governments have announced large investments in five Wall Street firms in recent months, including one in Merrill Lynch on Monday.

	INVESTOR	DATE	AMOUNT, IN BILLIONS	STAKE
UBS	*Government of Singapore; unnamed Middle East investor*	Dec. 10	$11.5	11-12%
Citigroup	*Abu Dhabi Investment Authority*	Nov. 26	7.5	4.9
Merrill Lynch	*Temasek (Singapore)*	Dec. 24	5.0	10
Morgan Stanley	*China Investment Corporation*	Dec. 19	5.0	10
Bear Stearns	*Citic Securities*	Oct. 22	1.0	6

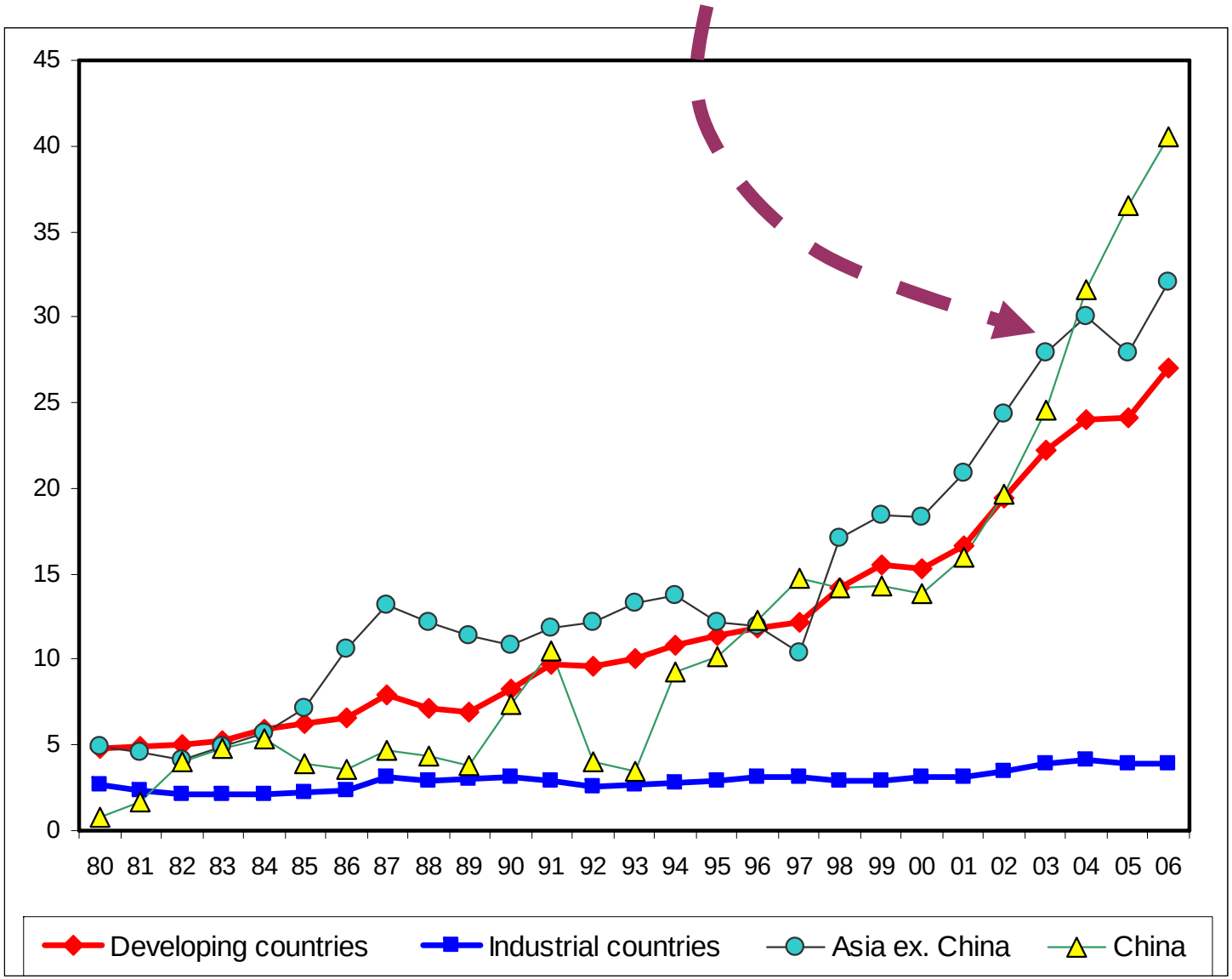
- Hoarding IR as the outcome of heightened Loss Aversion explains the first wave of hoarding during 1997-2000, in Korea and other countries affected by the crisis. [Aizenman and Marion (2003), JJIE].
- Yet, for plausible parameters, loss aversion can't explain Chinese IR hoarding!

Chinese hoarding of IR

- $1455 (October 2007), approaching 45% of the GDP



Chinese IR patterns diverge from other EM Asian patterns



Claim: Loss aversion (*LA*) accounts for IR/GDP of about 20% for very high volatility, but not for the China's 45% +

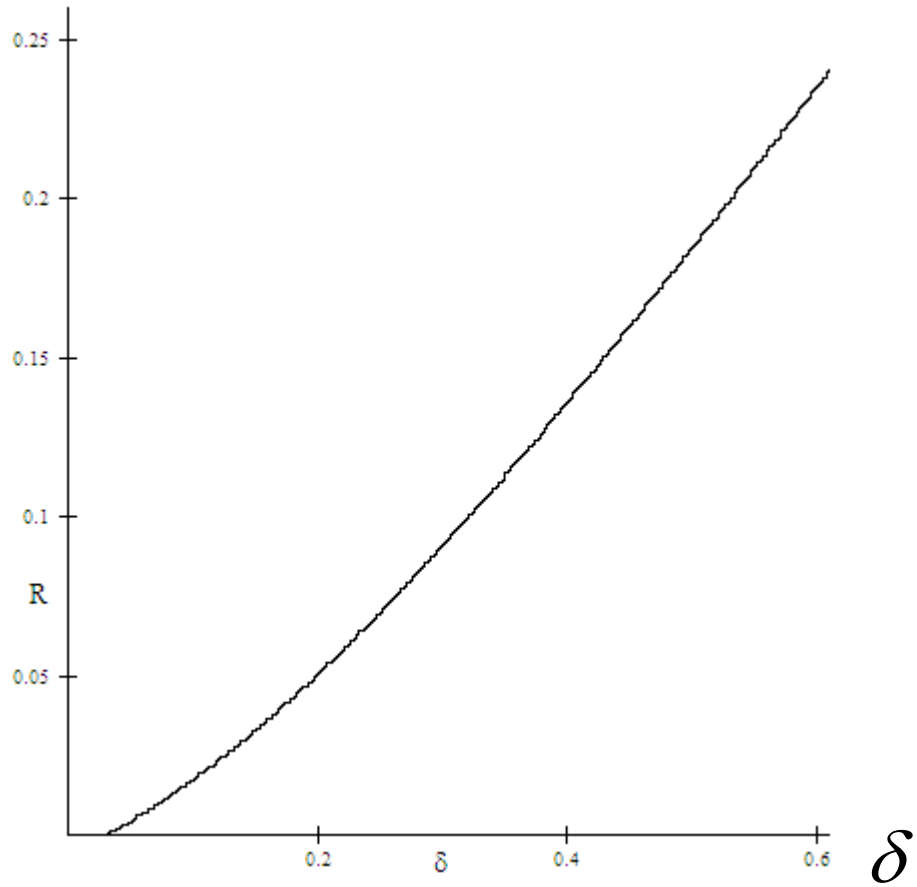
Illustration: simulating the loss aversion model in Aizenman and Marion (2003), plotting IR that maximizes

$$\frac{(1-R)^{1-\alpha}}{1-\alpha} + \frac{1}{1+\beta}\left(\frac{[1+R+\delta]^{1-\alpha}}{1-\alpha}[1-\theta] + \frac{[1+R-\delta]^{1-\alpha}}{1-\alpha}[1+\theta]\right)0.5$$

for L.A. weight $\theta = 1/3$ [*LA* ratio, $(1+\theta)/(1-\theta) = 2$, see the studies of Tversky & Kahneman, 1991, and Kahneman et al., 1990]; $\alpha = 2$ (the degree of RR Aversion), $\beta = 0.02$, we get IR/GDP of about 25% for $\delta = 2/3$.

Downside risk of melting 2/3 of the GDP with prob. 0.5 half, *LA* ratio 2, explains IR/GDP of about 0.25 <<< 0.45.

R (International Reserves)



The graph plots (δ, R) that solves

$$\frac{\partial}{\partial R}\left(\frac{[1 - R]^{1-\alpha}}{1-\alpha} + \frac{1}{1+\beta}\left[\frac{\{1 + R + \delta\}^{1-\alpha}}{1-\alpha}\{1 - \theta\} + \frac{\{1 + R - \delta\}^{1-\alpha}}{1-\alpha}\{1 + \theta\}\right] 0.5\right) = 0$$

An alternative interpretation for China:

A hoarding game, part of a mercantilist strategy, where the downside risk is buffered by IR [Aizenman and Lee (2007)].

- Most of the recent hoarding of IR in China is "accounted" by current account surpluses.
- Political Economy may be the key to explain China:
  - The manager [i.e. the Communist party] is "gambling for resurrection" -- maximizing Chinese growth rate is the way to prolong manager's reign.
  - The manger's downside risk can be (and is) buffered by capital flight to offshore accounts...
  - The export led growth strategy is supported by a hoarding game, capital controls and heavy sterilization. So far, the gamble has worked very well.

To conclude: A timely and interesting paper.

- Overstates the role of *LA* in explaining the recent patterns of hoarding in China, and the impact of EMs on the dynamics triggered by the Sub-prime crisis.
- Intriguingly, SWFs of emerging markets have provided liquidity, alleviating the liquidity crunch generated by "flight to quality."
- One expects greater scrutiny of the role of SWFs, as well as the impact of lax regulations of the mortgage industry at times of abounded supply of credit.