A Paradox of Risk Aversion: Structural Uncertainty and the Challenges of A Dysfunctional International Monetary System

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The Sovereign Wealth Funds are entrusted with managing the risk/returns for their citizens in the current anxious environment. It is not surprising that investors charged with this task during a time of structural unraveling respond to the Knightian uncertainty and political discord by seeking safety.¹ Any given small investor by herself would be rational in “seeking a port in a storm”, but when looking at the size of the accumulated holdings of the emerging countries, one cannot help wonder if we are on the brink of a collective “paradox of risk aversion” that is analogous to Keynes’s paradox of thrift.

Financial theorists characteristically consider the distribution of risk and reward as exogenous. When we pass from the realm of structural economic analysis through the curtain and emerge into the domain of quantitative finance theory, we rarely translate our structural parameters into the higher moments of the statistical distributions. Yet, as we learned when AIG underpriced credit default swaps in 2006-8, the collective behavior of financiers does tend to morph the statistical distributions, meaning that the distribution itself becomes endogenous. ²

It is in this spirit that I am asking whether, collectively, the safety seekers managing the large funds of the surplus countries do not together present the world macro/monetary system with an impossible task that heightens our structural uncertainty, political discord, and the resulting riskiness of our financial assets, whether stocks, bonds, currencies, or even sovereign credit. Do we experience a

paradox of risk aversion by all trying to hold the safest assets? Are we not collectively fighting in the tension between financial sustainability and social/political sustainability that Tommaso Padoa Schioppa writes about in his paper "The Ghost of Bancor"?

One leader of an Asian fund described the challenge to me as rolling a dime down a saddle. Ordinarily there is a large flat runway on the top of the saddle with deflation and runaway inflation at remote distance from the plateau. In the current context, the plateau narrows to a knife’s edge and the difference between deflation and inflationary trajectories is very narrow. Why are these seeming polar extremes both considered feasible in the current context? I believe it is because we are in a rare period of structural disequilibrium in the world economy not unlike the interwar period when the leadership of the world economic system passed from the United Kingdom to the United States. We are not in a period when expectations can be easily and stably formed. This complicates the challenge that protecting wealth entails.

Furthermore, in this instance, the very effort to preserve wealth by a concentrated group of investors with large holdings may actually make things more fragile and unstable. Not everyone can be safe in accumulating wealth. To paraphrase Martin Wolf, the question is: how will surpluses of accumulated wealth be destroyed? The degree of wealth destruction is not known or predetermined \textit{ex ante}. The sovereign wealth funds are not small atomistic actors in the world system. While everyone can feel small in the sea of international capital flows, I will conclude that the management of large aggregations of sovereign wealth is tantamount to an oligopoly problem with cooperative and non-cooperative outcomes that are inherently unstable. (Cooperative outcomes invite cheating if one cannot easily detect noncompliance). Yet the redirection of these large surplus flows from the sanctuaries of sovereign debt into channels of expanding risk and investment has the potential to play a key role in moving the world economy from the trajectory of austerity and dysfunction to one of greater growth and prosperity. The adverse feedback loop where fear creates risk aversion, and risk aversion leads to an investment pattern that is socially destabilizing, which in turn heightens risk aversion, can be reversed. Sovereign investors, through their actions, could alleviate some of the fear and uncertainty that currently drives the propensity to be risk averse in investment behavior.

\footnote{See The Ghost of Bancor at \url{http://www.uclouvain.be/cps/ucl/doc/triffin/documents/TPS_EN_finale_clean.pdf}}
Radical Uncertainty: The Dark Knight of the Investment Soul

The concept of Knightian Uncertainty was developed in a period of structural turmoil following the First World War (Frank Knight, Keynes in his Treatise on Probability, and Hayek all saw the world through similar lenses at that time). Similarly, we are now in a period when the “unknown unknowns” loom large in our world economy. While I think these concerns are relevant to nearly all of the developed economies in the world, I will explore this particular challenge from the vantage point of the United States, which has been at the center of the world system since the 1940s. The turmoil in that country is, I believe, the most threatening to system coherence in the coming period.

Charles Kindleberger, the man who inspired me to become an economist when I was an undergraduate at M.I.T., wrote on the Great Depression and posited that the dysfunction of the world system at that time was the result of the center of power no longer being able to provide the “public good” of residual stability. In some respects, the United States is now in a position similar to that of Great Britain in the Interwar period. Meanwhile, China is felt by some to be the advancing center. Note that the transition from Britain to the USA was between two cultures that had deep similarities in philosophy and tradition. A transition from U.S. to Chinese leadership may not be endowed with these cultural understandings, and this could make such an adjustment much more challenging. If one models this challenge as a cooperative game with incomplete information, it could be said that the ability to understand the reaction function of the other player would be more difficult to discern and achieving cooperative outcomes more difficult.

Zbigniew Brzezinski recently gave a speech at the Council on Foreign Relations that highlighted two ominous themes. First, the structure of power had changed from roughly a North Atlantic Alliance to the G-20. That the structure and distribution power was changed was not dangerous in and of itself, but the fact that there was not a design for an orderly system upon which all elites could agree was very dangerous.

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Second, Brzezinski expressed the view that the spillovers from the excesses of the financial sector culminating in the Crisis of 2008 had caused great losses for many across the planet. The ugly nature of the way public balance sheets were used to keep the financial system from collapsing, while necessary, appears to have ignited the rage of the body politic in many parts of the world, perhaps most importantly in the United States, which is has been the lynchpin of the world economy in the previous epoch.

One need not argue whether the bailouts were necessary. I believe they were. But as they say, there are ways, and there are ways -- and the most recent episode was a way that inflamed the public. We have been through an episode in which we made the abused body politic pay the perpetrators, rather than proceed as we did during the S&L bailout, where wiping out or dilution of stock, changing management, and restructuring of creditors dominated the resolution process. That the United States government, through TARP and thereafter, seemed very able to mobilize large-scale funds on very short notice and rescue the financial system was a good thing. That it seems only able to do this in response to, and on behalf of, a powerful financial elite has set in motion some very sour psychology that is likely to heighten our sense of Knightian Uncertainty for a long time to come. As Amartya Sen illustrated in a convening of economic historians I attended at Harvard in the spring of 2010, to do the bailouts was a cooperative game in the sense that we lost less than was possible. Yet the distribution of the burden of moving us to the cooperative outcome sowed the seeds of distrust for the repeated games of governance that would follow. The financial leaders made a very strong and accurate case that they must be rescued because they could take the economy down with them. But this notion now stands in stark contradiction to the complacency that Wall Street demonstrates with regard to persistent joblessness in America and the resistance that they exhibit to financial regulation proposals that would restrain their capacity to spillover onto the real economy in the ways they acknowledged during the depths of the crisis. It appears to the public that Washington is very responsive to Wall Street and that we are “all in this together” only when Wall Street is in extreme jeopardy.  

This bold revelation of where power lies in U.S. society is reminiscent of the forebodings of Herman Melville who warned of the discouragement of society when it was revealed starkly that society did not operate according to the democratic premise that “all men are created equal”. Melville’s poem “Clarel”, written late in his life, explored these tensions. William Sloane Coffin, the American theologian, also referred to Melville when he wrote:

But today, because we have so cruelly separated freedom from virtue, because we define freedom in a morally inferior way, our country is stalled in what Herman Melville call the “Dark Ages of Democracy,” a time when, as he predicted, the New Jerusalem would turn into Babylon, and Americans would feel “the arrest of hope’s advance.”

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One can see some of what Brzezinski was referring to by looking at the recent polling on the impact of government policies done by the Pew Foundation in July of this year. Two tables make the point:

### Government Policies Seen as Doing Little for the Poor, Middle Class, Small Businesses

<table>
<thead>
<tr>
<th>Gov't econ policies have helped...</th>
<th>Great deal</th>
<th>Fair amount</th>
<th>Not too much/ at all</th>
<th>DK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large banks and financial institutions</td>
<td>53</td>
<td>21</td>
<td>18</td>
<td>8=100</td>
</tr>
<tr>
<td>Large corporations</td>
<td>44</td>
<td>26</td>
<td>20</td>
<td>10=100</td>
</tr>
<tr>
<td>Wealthy people</td>
<td>31</td>
<td>26</td>
<td>30</td>
<td>12=100</td>
</tr>
<tr>
<td>Poor people</td>
<td>7</td>
<td>24</td>
<td>64</td>
<td>5=100</td>
</tr>
<tr>
<td>Middle class people</td>
<td>2</td>
<td>25</td>
<td>68</td>
<td>4=100</td>
</tr>
<tr>
<td>Small businesses</td>
<td>2</td>
<td>21</td>
<td>68</td>
<td>8=100</td>
</tr>
</tbody>
</table>

Figures may not add to 100% because of rounding.

### Who’s Been Helped by Economic Policies?

Percent who say each has been helped a great deal/fair amount by the federal government’s economic policies since 2008

<table>
<thead>
<tr>
<th></th>
<th>Total %</th>
<th>Rep %</th>
<th>Dem %</th>
<th>Ind %</th>
<th>D-R diff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wealthy people</td>
<td>57</td>
<td>45</td>
<td>67</td>
<td>58</td>
<td>+22</td>
</tr>
<tr>
<td>Middle class people</td>
<td>27</td>
<td>16</td>
<td>37</td>
<td>58</td>
<td>+21</td>
</tr>
<tr>
<td>Small businesses</td>
<td>23</td>
<td>14</td>
<td>35</td>
<td>21</td>
<td>+21</td>
</tr>
<tr>
<td>Large corporations</td>
<td>70</td>
<td>61</td>
<td>74</td>
<td>74</td>
<td>+13</td>
</tr>
<tr>
<td>Poor people</td>
<td>31</td>
<td>33</td>
<td>33</td>
<td>29</td>
<td>0</td>
</tr>
<tr>
<td>Large banks and financial institutions</td>
<td>74</td>
<td>75</td>
<td>73</td>
<td>77</td>
<td>-2</td>
</tr>
</tbody>
</table>

After the creditors of heavily leveraged financial institutions were bailed out and the public balance sheet was expanded to stem the financial crisis, we are now entering a period when many people are rebelling against further use of the public balance sheet to support anything, including the real economy via infrastructure repair or other forms of stimulative deficit spending. In a sense, the rise of the debt/GDP ratio in the U.S. and other developed countries, coupled with the particularly difficult digestion of the distributional nature of the bailouts, has damaged the public’s trust in the capacity of government to manage the economy. It has reinforced in the mind of the citizens Ronald Reagan’s claim that government is the problem, not the solution. At a time when persistent unemployment is near 10 percent in official numbers, and those not working are a far greater percentage of the workforce, it would seem an obvious time to rebuild infrastructure and to emerge from the slump. Following the lessons of the Great Depression and the example of the New Deal, one would think we would have a broad social consensus for such action. Yet such an assumption does not take into account the deterioration of trust we have experienced or the success of persuasive forces in denigrating the capacities of government.  

Harold James, the historian at Princeton University, has written in his most recent book of how the deterioration of trust following a financial crisis renders government-centered efforts impotent.  

Not only is economic value destroyed in the acute downturn of the economy, but the capacity to function as a society experiencing market dysfunction is wiped out, too. Human values are destroyed along with economic value. James likens the crisis of 2008 to the banking crisis in Germany in 1931, and in his previous work on the German Slump he studies how parliamentary and interest group struggles lead to extreme government paralysis and dysfunction.  

One locus of the dysfunction is the federal budget, and the problem may be civil, not just financial. Asset management consultant Robert Dugger, in testimony to the National Commission on Budget Responsibility and Reform, expressed the view...

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7 The notion of persuasive forces that may or may not be creating perceptions that corresponded to “Truth” is explored in great detail by George Soros in his Budapest Lectures and in his essay, “What I Did Not Know: Open Society Reconsidered”, in What Orwell Didn’t Know: Propaganda and the New Face of American Politics, Public Affairs Books, edited by Andras Szanto. Soros differentiates between the cognitive function, where learning the truth allows an individual to better understand and operate in the environment, and the manipulative function, where the strategy of altering the perceptions of other people so that they advocate actions that make the manipulator better off.


that budgets are only in part about money. They express the fabric of civil commitments that citizens have made to each other over many decades. Those commitments – public safety, education, good roads, freedom from government over-regulation, and reasonable taxes -- are built into local, state and federal budgets. People organized their families and businesses around these commitments. The very slowness with which they accumulated and were reaffirmed year after year in budget legislation attested to their firmness and reassured people they could safely organize our lives around them.

For Dugger, a budget crisis is a crisis not because there is not enough money. It is a crisis because the fabric of our society is being ripped apart, threatening families and businesses. To restore trust and assure voters that the fabric of society will be preserved, a commitment, must be found – a commitment so compelling that if voters can be assured this commitment will be met, they will be agreeable to adjusting the others and to constructing a new fabric of civil relationships peacefully and cooperatively.

The economic and budgetary dysfunction we are seeing in the United States is in some ways similar to James’ scenario. The impending loss of trust in government, and the anti-incumbent nature of the current popular sentiment, is likely to put the Obama Administration into a much weaker position following the November election. However, it must be said that this is not a simple Democrats vs. Republican issue. Within the Democratic Party, this debate is raging all by itself.

Many economists are currently engaged in the fight over the magnitude of the Keynesian multiplier and other rituals about the efficacy of fiscal policy. The body of evidence, I believe, suggests that it is at times like these, with lots of slack in the economy, that the impact can be quite significant. Yet that is not the fight that I believe is really taking place. The “small multiplier” economists are just the current intellectual advance troops of the major fight in the United States about the size and role of government. Whether government stimulus works or not, and whether or not infrastructure augments productivity and private investment is crowded in or out, is of little matter to those who, as a matter of philosophy, do not want to see government play a major role in the economy. They are willing to endure the seemingly unnecessary short-term pain of a slump to purge American society of the dreaded government.

This is a major conflict, and with the Republicans likely to gain ground in November, we are likely to see this fierce battle continue. The stalemate will, in the sense of Kindleberger, likely render the center reserve currency country of the international monetary system more unstable because the essential degree of freedom and fiscal policy that must now be used to maintain aggregate demand in

light of interest rates being at the zero lower bound will be unavailable as the “conflict of visions” in the United States plays out. In the following section I will argue that this stalemate is what will make the international monetary system very unstable and uncertain. A look over to Europe and its similarly vigorous efforts at fiscal consolidation implies that the alternative to the dollar, the euro, is unlikely to be able to help balance the system, either.

The International Monetary System Dysfunction

The world economic structure has been based on a regime of export-led growth to the United States since WWII. The American market has been the buyer of last resort. The rise in private indebtedness of U.S. households on the back of the housing boom and decline of the U.S. savings rate gave that structure a burst of energy that came to a halt with the crisis of 2008. More ominous is the reality that expanding consumer spending was accompanied by declining real incomes for many Americans as any given dollar of income was supported by more and more credit.

At the same time, our open free trade system has favored outsourcing and offshoring of key elements of the production process that tended to put pressure on wage and compensation growth. This pressure on American consumers surged at the time of NAFTA and accelerated with the development of China and India in recent years. This contradicts the long-term notion of U.S. consumers being able to sustain their role as the buyer of last resort. Compressions of incomes for large portions of the U.S. population that resulted from competition with low wage regions of the world was incompatible with the maintaining the vitality of U.S consumption and export-led growth for everyone else. For a time, the credit innovations delayed a reckoning, but that systemic contradiction is now exploding into full bloom with the collapse of the consumer credit pump. This shock to the pattern and magnitude of global aggregate demand is, to my mind, the fundamental deflationary impulse that the world is now ill-equipped to address. We were dependent on this structure of trade for a very long time, and the financial debt bubbles suggest that we are not in a typical cyclical situation. It will take many years to rebalance the system, and that altered trajectory is now very stressfully beginning to work itself out.

Some economic commentators have seen on the distant horizon that a rebalancing of demand in the emerging markets involving less export led growth and more domestic development and spending is the path to harmonization of the world system. Unfortunately, the components of aggregate demand are not quite so protean in any significant shorter time frame. Regimes that are predicated on export-led growth involve a system of tax, subsidy, regulation and other structural priorities that are not easily shifted. It often requires a drastic realignment of domestic politics to shift from export-led growth to domestic-driven growth or vice versa. Powerful groups within the domestic political economy are put into conflict
with each other. The timing of the resolution, no less than the shape of the outcome itself, is not at all clear.\textsuperscript{11}

That is the dimension of uncertainty that the international monetary system is coping with as we look toward the future. One could see that the scale of imbalances, as measured by the degree of reserve accumulation in the surplus countries, has been soaring. With the U.S. dollar having many features that have given it the dominant structural role as the reserve currency, most importantly the broad, deep and transparent government bond market with the availability of the full spectrum of maturities, much of the reserve accumulation was recycled to the U.S. dollar and the U.S. Treasury market in particular.

For several years, particularly since the end of the Asian crisis in the late 1990s, rising surpluses (U.S. deficits) and the recycling of surpluses back into dollar denominated securities served to raise the foreign exchange value of the dollar, and added a deflationary impulse to aggregate demand in the United States. The Federal Reserve was able to offset this by lowering interest rates to manage its mandate of full employment and price stability.\textsuperscript{12} In analytical terms there is an isodemand curve in exchange rate/interest rate space that led to a combination of stronger dollar and lower interest rates to keep the U.S. macroeconomic system in a distorted form of balance. Large private imbalances with a dearth of savings, rising government deficits, and large current account deficits have been the American pattern.

That ability of the Fed to act as the balancing agent has come into question now with interest rates at the zero. The collapse of the securitization and consumer finance markets in the USA has damaged the U.S. buyer of last resort system of world commerce and has set in motion a musical chairs game in the international monetary system of passing the deflationary hot potato around. Deficient demand worldwide is being redistributed. The mercantilist tendency around the world of exporting deflation through exchange rate management often then cycles back to the U.S. economy, but the Fed is unable to offset this now at the zero lower bound of interest rates. As the European tensions over Greece and the other peripheral countries came to the fore earlier this year and showed how inferior the credit market structure of Europe is to the sovereign debt market of the United States (and Japan), the upward pressure on the dollar was compounded for a time and could not be offset with lower interest rates.

The deflationary shock to U.S. aggregate demand emanating from beggar-thy-neighbor exchange rate policies and the self-insurance behavior of surplus countries that leads to reserve building could theoretically be offset by the instrument of


A larger public works infrastructure project for the American economy could accomplish this if the political consensus were to exist, and that program could permit the U.S. to absorb some deflationary shock and could buy time for the transformation of the world economy. Fiscal policy could be the residual balancing element that monetary policy has been in response to the accumulation of dollar reserves by foreign governments. Yet in the current gridlock and conflict over the role of government in the United States, that component of aggregate demand cannot be as responsive as the Fed-interest rate mechanism has been until we hit the zero lower bound.

I note here that the scenarios of quantitative easing by the United States that are widely covered in speeches and the media are a different type of adjustment mechanism and a U.S.-only QE initiative may be tantamount to exporting deflation back out from the United States into the rest of the world.

At a deeper level, this international monetary dysfunction and the management of nominal exchange rates by many of the mercantilist minded export-led growth economies may be tantamount to letting real variables adjust via inflation differentials rather than nominal exchange rates. Efforts to resist exchange rate appreciation may lead to rising asset price inflation and eventually goods price inflation in some of the surplus nations. Suffice it to say that in the present situation, China, Japan, Germany, and many of the rising countries of Asia cannot all be export-led growth surplus nations when the U.S. grinds down to moderate deflation as a result of the retrenchment of the household balance sheet as the paradox of thrift tightens its grip on the frightened American citizen. Inflation in the emerging markets and deflation in the developed world are the results of this dysfunctional exchange rate pegging and reserve accumulation system that strives to protect the export strength in the emerging world that continues to accumulate a “self insurance” war chest of reserves to protect the emerging nations from the violence of the international capital markets. Both sides of the saddle I mentioned in the introduction are before our eyes simultaneously: deflation in the developed world and bubble-building inflationary forces in the emerging countries that defend their export sector. In addition, the tendency of the large developed countries to accumulate private and sovereign debt to ward off deflation may at some point lead to a drive for inflation to lighten that burden. It is unlikely that this system of imbalances will alleviate the uncertainty that breeds caution. It is also likely that fear and caution will lead to investment behavior that exacerbates structural uncertainty. We likely require both political and financial leadership that is currently in short supply before we can move to a systemic logic that transitions from the Dark Knightian anxiety of uncertainty and sheds light on a path that coheres.
Sovereign Wealth Funds: A Collective Paradox of Risk Aversion?

Can an international monetary system withstand such large flow imbalances as we have seen in the last 10 years on an ongoing basis? And can the system cope with a recycling of imbalances of these magnitudes into the riskless asset? Writers such as Charles Dumas of Lombard Street Research, in his new book entitled "Globalization Fractures", suggest that the key to adjustment in the face of the deficient aggregate demand caused by the exhaustion and retrenchment of the American consumer must take two dimensions. First is the reduction of the scale of those imbalances. Second is a cessation of the degree of risk aversion on the part of those investing what imbalances do remain to be recycled. 13

To alleviate what Ricardo Caballero refers to as the excess demand for safe assets, several responses can be pursued.14 First, the sovereign wealth funds could directly invest in more risky assets. They could move into equity or even direct investments in greater proportions. Obviously, given the sheer size of their investment capacity, it would entail some loss of liquidity. It would also involve what might be a good long-term investment in human capital in assessing more complex or information-intensive asset classes from within their institutions.

Second, the United States government could intermediate and buy riskier assets or make direct investments with the proceeds of its bond sales to the surplus countries. This would be somewhat difficult to achieve, given the American aversion to belief in the ability of the government to allocate capital efficiently. Though an infrastructure bank could be developed with private sector board and experienced financiers to provide the needed risk transformation services, it would likely face steep opposition from those who are enraged by the coexistence of the GSEs Freddie Mac and Fannie Mae with the housing related crisis. Setting up new government institutions to intermediate credit is likely to be a difficult task when the losses on the balance sheet of Freddie and Fannie become more and more evident to the public in the coming months. 15

Third, a public guarantee could be issued to support private risk transformation services on a large scale. This pathway is likely to be complicated by public aversion to giving any more support to the well-paid executives of financial institutions who were paid with taxpayer funds to clean up the mess that they made.

Beyond the politics, there is also the question of whether investors would support these institutions that have lost a great deal of the world’s confidence in an aggressive program to provide risk transformation services.\textsuperscript{16}

**Conclusion: Can We Break Out of the Paradox of Risk Aversion?**

I do believe that we are on an unsustainable path and that the United States will not, despite the logic of possibility, be able to provide the balancing role for the international monetary system in the coming period. Perhaps the best we can hope for is a system where America does not suffer the deflationary consequences of the mercantilist competition of the surplus countries and uses monetary policy to re-export deflation. But as I watch the debates favoring austerity in the U.S. and Europe, and I imagine central banks in the developed world pumping more liquidity into the system in response to U.S. quantitative easing, I can only envision this effort collectively as one that builds an even bigger bubble in asset and commodity markets to try and induce a wealth effect that stimulates consumption. That process seems well underway and it has reduced the cost of debt services while encouraging an ever-greater mountain of debt when business, household, and government debts are added together.

It seems to me that what is needed in the developed countries is not bubbles or austerity but a policy constellation directly targeted on investment spending, human capital investment, a modernization of the supply side, and a focus on productivity growth to inspire confidence the sovereign debt to GDP ratios can be managed. It is on that trajectory, rather than on one of austerity, that we can restore confidence. The question is: who will make the first move in that direction if the United States government cannot because of its peculiar struggles? Perhaps this time the bold endeavors will emanate from a new leadership coalition that uses the growing sophistication at the sovereign wealth funds as the vanguard of constructive change.\textsuperscript{17}


\textsuperscript{17} See Felix Rohatyn’s Bold Endeavors for a number of examples of system changing large-scale productivity enhancing government investment programs.