Some Thoughts on Current International Financial Crisis and East Asia's Responses

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Safeguarding Asian Assets in the US

The global financial and economic crisis has reached a critical stage. The most fundamental challenges faced by decision makers are: on the one hand, the fall of the global economy should be contained in the short-run; on the other hand, the global financial system should not be allowed to be destabilized in the long-run. In fact, in its effort for unfreezing the money market, preventing the worsening of credit crunch and prompting up financial institutions that are on the edge, the Fed has resorted to pomp-priming. Value of goods depends on the scarcity. When helicopter-Ben drops tons and tons of dollar bills from the sky, what value does the dollars still have? When the balance sheet of the Fed is no better than a junk bond fund, i**t becomes a kind of junk bond fund**. The Fed knows very well the inflationary consequences of the extremely loosen monetary policy. Hence it has brought forward some new schemes. However, the basic question is still unanswered: when the situation has changed, can the Fed withdraw the liquidity quickly enough to prevent current liquidity shortage and credit crunch from turning into hyperinflation and a free fall of the US dollar? The result of such an inflation and devaluation scenario will be devastating for China, Japan and the rest of East Asian countries, which hold some 3 trillion USD foreign exchange reserves. No matter what policies the US government has adopted and will adopt, the stabilization of US financial market and US economy should not be achieved at the expense of the rest of the world. No matter of whether it is a devious attempt or unintended result, if serous inflation and dramatic fall of the US dollar are allowed to happen, the graveness of the consequences will be beyond the stretch of imagination. In other word, US policy in dealing with current financial crisis is not a pure sovereign matter but that it is an international matter or an internal matter for the global village. To achieve long-term stability, important short-term policy matters should be discussed not only between G7. There should be a new framework to facilitate policy coordination among all major stake-holders.

During the current global financial crisis, the performance of the East Asian governments in the front of financial cooperation and coordination is very disappointing. The only result so far is China-Japan-Korea currency swap agreements. It is pitiful that when the cooperation is most needed, the cooperation is basically non existent. If even at such critical juncture as current one, the ASEAN10+3 cannot coordinate somewhat, then what cooperation and coordination we can expect for this grouping in the future. Why the 13 countries cannot get together and take concerted acts to demand the US government to safeguard the safety of our hard-earned foreign exchange reserves, which mostly are in the form of the US government securities. Are the governments in the region so sure that their people's assets are safe and the US government will not get rid off its huge debt burden by inflation, devaluation of the US dollar and defaults? The East Asia has been ripped off once during the Asian Financial Crisis. This time around the East Asia seem ready to be ripped off for the second time even without murmuring.

Strengthening the management of Cross-Border Capital Flows

The US financial crisis has totally discredited the market-fundamentalism. The US government has been doing what it strongly opposed during the Asian financial crisis. The experience during the Asian Financial crisis has already shown that the closer you followed the IMF prescription, the worse you suffered. So far, the financial impact of the US financial crisis on Korea seems gravest in East Asia. I am wondering whether this is attributable to the unhindered cross-border capital flows. Korea allowed too much capital aimed at arbitrage and speculation to inflow in the wake of the Asian financial crisis. Now the Korea seems have no effective means to prevent capital from flowing attributable to the unwinding of carry-trade, liquidity shortage, credit crunch and need for capital injection by foreign investors. In 2007, China was on the verge of allowing domestic investors to invest in The Hong Kong H share market. The plan was postponed due to disagreement among decision makers. Now the plan is shelved indefinitely because of worsening international financial crisis. Until recently, China's international balance of payments was not under pressure. However, in the last month, it seems that abnormal capital outflows from China increased dramatically due to causes we do not know yet. To avoiding shocks created by large swing of capital flows, governments in East Asia may need to increase their cooperation in supervising cross-border capital flows and take actions to prevent attacks no other countries' from being launched from the domestic markets.

Increasing Liquidity in the Region

On the whole, liquidity shortage and credit crunch have not been as serious as in the US and European countries. However, due to various reasons, in many East Asian countries, commercial banks are becoming more and more reluctant to lend, which has affected the real economy significantly. How to provide liquidity for foreign firms in the domestic markets has become a serious issue. For example, a Japanese firm operating in China may need RMB loans. In this case, government currency swaps will help. Due to the changes in the situation, compared with situation during the Asian Financial Crisis, the money pooled together in line with Chang Main Initiative may find a better use for stabilizing the regional financial system.

Asian Bonds

There are countries that need dollars, while there are other countries that wish to get rid of dollars in the region. China has huge amount of foreign exchange reserves that China has not intention to accumulate further. But for China, to provide dollar loans directly to foreign borrowers seems to risky, due to exchange rate risk and default risk. Furthermore, China lacks necessary expertise to lend dollars to foreign borrowers. There are many ways China can help its neighbors: consortium loans, panda bonds and so on. Countries that need dollars can borrow from China by selling Panda bonds. ADB and some private international financial firms can involve in issuance, underwriting, credit rating, legal service and so on. Anyway, governments and ADB can get together to discuss the possibility of issuance of Asian Bonds. By doing so, the regional financial can be promoted and the role of the US dollars can be replaced by local currencies gradually.

Wider Use of Local Currencies

The credibility of US dollars has been decreased significantly. Efforts should be made by countries in the region to reduce the use of US dollar as median of exchanges, vehicle money, counting unit and so on. Efforts should be made by countries with strong currencies and advanced capital markets to encourage the use their currencies as store of value, or reserve currencies.

Regional Agenda with the Keystone International Financial Institutions

IMF's track record in the maintenance of global financial stability is poor if not pitiful. Last year, when the US financial crisis was deepening and a global financial crisis that had never seen since 1930s was unfolding, IMF had virtually done nothing to warn the world and to prepare the world with the inevitability, let alone to had done anything to prevent the crisis from forming and breaking out since the turn of the century. The biggest thing it has done in 2007 was to toe the line of the US government to designate China as a currency manipulator. Has IMF ever exposed the excess of the US financial institutions? Has the IMF ever pointed out that MBS, CDO and CDS have dangerous implications to the financial stability? Now has the IMF ever raised any questions on the Fed's desperate monetary policy? Lack of independence has damaged the authority of the IMF irretrievablely. Any reform of the IMF less than a total overhaul is not acceptable. As a first step, voting share should be redistributed, and the role of East Asian countries should be increase significantly.

Institutionalized summit among China, Japan and Korea may be necessary. So may be the ASEAN10+3.

Free Trade Should Be Safeguarded

FTAs should be continued to promote. No tax and non-tax barriers should be erected. Trade disputes should be solved between relevant parties in an amicable manner. No countries in the region should resort to beggar-thy-neighbor policy of devaluation and trade subsidies.

Exchange Rate Coordination

Over the past decade since the Asian Financial Crisis, discusses among economists have been concentrated in exchange rate coordination. However, no significant result has been achieved. And now when the global financial crisis has worsened rapidly, the issue of exchange rate coordination seems as irrelevant as ever, if it is not more so. The Euro countries' performance seems rather disappointing. Maybe, regional financial cooperation needs to find another rally point. The urgency of exchange rate coordination may be faded into a place of secondary importance.

Reform global monetary system
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Efforts should be made to establish a supranational currency as part of a new international financial order

The fundamental problem with the current system is that the US dollar is used as the key international reserve currency, which gives the US central bank the "exorbitant privilege" of printing the United States' way out of its economic difficulties.

And that is exactly what it is doing. Its printing presses are running at full speed in a bid to boost the US economy, regardless of the impact on other countries. This practice contradicts the role of the US dollar as the international reserve currency.

One of the most important functions of the international reserve currency is to serve as a store of value for the savers of the world. The stability of the value of the US dollar in terms of dollar index as well as purchasing power is the prerequisite for the dollar to implement this function.

As a reserve currency country, the US has the responsibility of preserving the value of the dollar. But the US monetary authorities have reneged on this responsibility by recklessly debasing the dollar without paying due regard to the consequences on other countries.

After its quantitative easing in 2008, the US Federal Reserve Board announced a second round in 2010. The US Federal Reserve Board knows very well the inflationary consequences of such a loose monetary policy. Whatever arguments the Fed uses to soothe the nerves of investors, nobody knows whether the Fed can withdraw the liquidity quickly enough to prevent hyperinflation and a free fall of the US dollar. This practice has never been tested in history. If the nightmare scenario of inflation and devaluation comes true, the result will be devastating for China, Japan and the other East Asian countries, which hold trillions of dollars of US government treasuries as foreign exchange reserves.

No matter what policies the US government has adopted and will adopt, stabilizing the US financial market and stimulating the growth of the US economy should not be achieved at the expense of the rest of the world. Unfortunately, the current international monetary system cannot impose the necessary discipline on the US monetary authorities. This implies that the current international monetary system fails to provide a stable store of value for countries which wish to park a proportion of their savings in foreign assets.

Nevertheless, to be fair, the world should not burden the US with the responsibility of maintaining the stability of the dollar at all costs, because the US needs the freedom to implement policies aimed at serving its own economy. Therefore, to replace the US dollar with a currency that is independent of any country's domestic policy is beneficial not only to the rest of the world, but also to the US.

The best candidate for such a supranational currency is the Special Drawing Right (SDR), which is a basket of four major currencies. A basket of currencies would be a much more stable store of value than a single currency. Efforts should be made to encourage the use of the SDR to denominate and invoice international transactions.

The first step toward this would be to use the SDR to denominate all transactions of the International Monetary Fund and transactions between central banks. For example, international financial institutions can issue more debts denominated in

SDR. The use of the SDR among key international financial institutions and central banks requires only the commitment by central banks to convert SDR into their national currencies when necessary.

The liquidity of the SDR market could be enhanced by private use of the SDR through denominating trade and then financial transactions. In the initial stage, it might be difficult to persuade the private sector to use the SDR. But this reluctance is not insurmountable. The higher stability of the SDR as a standard for measuring prices rather than any single currency may eventually prove a big attraction for the private sector. Thanks to technological progress, private trade and financial transactions can be SDR-denominated alongside local currencies, and a two-tier system of denominating prices for goods and services and financial transactions is easy to adopt.

A related but separate question is whether the yuan should be allowed to be included in the SDR basket. Some argue that China's financial move toward a flexible exchange rate regime is a precondition for the inclusion. The truth of the matter is that the yuan's convertibility and a flexible exchange rate are not immediately required for the inclusion of the yuan in the SDR basket of currencies.

But, it also seems true that at this stage, the inflexibility of the yuan's exchange rate is an obstacle to its inclusion in the SDR basket - for example, if the yuan is pegged to the dollar, inclusion of the yuan will make the SDR less stable, when the dollar moves.

The People's Bank of China has already started extending swap lines to a number of foreign central banks for the yuan, aside from the Chiang Mai initiative. China's effort in promoting the yuan's internationalization is conducive to its inclusion in the SDR.There are a number of things China can do to get more actively and constructively involved in the reform of the international monetary system. For example, China should welcome efforts to revive the idea of substitution account, which would not only have a positive impact on preserving the value of China's foreign exchange reserves, it would also be helpful in stabilizing the US dollar.

As the world's second largest economy, the largest trading nation and the largest foreign exchange reserve-holding country, China not only has the ability, but also the responsibility to play a more active role in the reform of the international monetary system.

China’s stealthy liberalisation of cross-border capital movements

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Out of the disappointment about the progress in regional financial cooperation and the reform of the international monetary system. China has shifted its focus away from the above-mentioned two endeavours. And the so-called RMB internationalization has become China's new policy focus, though the PBOC refuses to use the term of RMB internationalization.

Since the Chinese government launched the so-called Pilot RMB Trade Settlement Scheme in April 2009, China's efforts to internationalise the renminbi have made impressive headway. By September 2011, RMB deposits in Hong Kong reached RMB622.2 billion, and it was widely expected that the amount would surpass RMB1 trillion by the end of 2011.

One might ask how the renminbi could be internationalised without a liberalised capital account. In truth, internationalisation of the renminbi is capital account liberalisation in disguise. If some progress has been made in the renminbi's internationalisation, it should be regarded as a by-product of capital account liberalisation.

On the surface, the pilot scheme allows enterprises on the Chinese mainland to use renminbi to settle their trade transactions. But it also enables enterprises, especially large ones, to channel their funds between the mainland and Hong Kong in the name of RMB trade settlement. As a result, an offshore RMB market, known as the CNH market, was created in Hong Kong, side by side with an onshore market dubbed the CNY market. The former is a free market, while the latter is tightly regulated by the People's Bank of China (PBOC).

Hence, two RMB exchange rates coexist: an onshore CNY exchange rate and an offshore CNH exchange rate. Due to expectations about the renminbi's appreciation, and many other factors, the CNH was more expensive in dollar terms than the CNY until September 2011. The existence of the CNH–CNY spread thus encouraged arbitrage by importers on the mainland. Before the settlement scheme's introduction, importers had to buy dollars in the onshore market. Now they could sell renminbi for dollars in the CNH market, creating appreciation pressure on the CNY and depreciation pressure on the CNH. This arbitrage should have eliminated the CNH–CNY spread fairly quickly. But the PBOC's intervention and carry trade conducted by Hong Kong residents created offsetting pressure on the CNY and the CNH, respectively. As a result, the CNH–CNY spread was maintained and arbitragers gobbled up fat profits.

In mid-September 2011, financial conditions changed quite suddenly in Hong Kong. Due to liquidity shortages caused by the European sovereign debt crisis, banks from developed countries — especially those European banks with exposure in Hong Kong

— withdrew their funds. As a result, the CNH fell against the dollar, while uncertainty about the Chinese economy also contributed to the fall of the CNH. Because the CNH became cheaper, mainland importers stopped buying dollars from the CNH market, returning to the CNY market. At the same time, mainland exporters stopped selling dollars onshore, and sold dollars in the CNH market instead. The reversal of the direction of exchange rate arbitrage created an onshore supply shortage of dollars, and hence the devaluation of the CNY against the dollar. Needless to say, the unwinding of carry trade by Hong Kong residents, who dumped their holdings of RMB assets — because of a dramatic rise in funding costs for carry trade and the reduced attraction of holding RMB assets — also contributed to the fall of the CNY.

The PBOC duly intervened, but to prevent the renminbi from falling rather than rising. Now, the renminbi has resumed its long-established course of slow appreciation in line with fundamentals, probably due to the PBOC's intervention and a temporary lull in the global financial market.

This episode of devaluation shows two things. First, the use of the renminbi as a trade settlement currency has stealthily forced open China's firewall of capital control. As a result, the fluctuation of short-term cross-border capital movements has become an important factor in determining the RMB exchange rate, and consequently, China's exchange rate is becoming more volatile. Second, progress in the renminbi's internationalisation based on expectations of its appreciation can be rolled back very easily. In fact, after the exponential increase in the early stage of the Pilot Scheme's implementation, the increase in RMB deposits in Hong Kong has stalled at around RMB620 billion since last September, far short of the market expectation of RMB1 trillion.

The twists and turns of the renminbi's internationalisation begs a very important question: does China really want to take the risk of fully liberalising its capital account without first putting its house in order and allowing the market to determine interest and exchange rates? The question facing China is not about the desirability of the renminbi's internationalisation. It is about the prioritisation of China's financial reforms and regime changes. The question becomes even more acute when taking into consideration the fact that the global financial market is still in turmoil and China's financial markets are in a pretty messy state. It is a dangerous gamble to pin the hope of the emergence of a healthier and more robust financial system on the creative destruction of external shocks, while the existing system is still too weak to withstand such shocks.