Business Times - 29 Oct 2008

Asia needs its own monetary facility

It would reduce the region's perceived impotence in future global crises

By RAMKISHENSRAJAN

A DECADE ago, the international financial community was focused on the financial crises in East Asia, Russia and other emerging economies, just as they are focused now on the US financial crisis and the ongoing global credit crunch. Just as in 1997-98, the initial emphasis now has rightly been on crisis management and regaining stability (with the International Monetary Fund playing a central role a decade ago compared to being practically invisible currently) before shifting to crisis prevention.

Also, just as now, there were some initial discussions a decade ago on the need for reform of the international financial architecture and the creation of a new Bretton Woods Agreement, with emerging economies like China and India being given a bigger say. Bold suggestions were also made for an international lender of last resort (ILOLR), a global banking regulator, and the like.

However, as the crisis dissipated from 2000 onwards, so did any serious discussion on and interest in a fundamental reform of the financial architecture.

Given the absence of any significant reform of the global financial system and the roadblocks Asia faced in creating a viable regional monetary facility, on the one hand, and an anxiety not to see a repeat of the crisis, on the other, many emerging economies in Asia started to rapidly accumulate reserves as a means of self-insurance against future financial crises.

The reserve stockpiles were then reinvested in relatively liquid assets like US Treasury bills and bonds as well as some US agency bonds (like Fannie Mae and Freddie Mac). While there was ample demand for US government assets, the sharply rising US twin deficits (current account and fiscal deficit) ensured that there was an insatiable appetite in the US for foreign financing.

The seemingly paradoxical situation in which emerging economies had excess national savings which were funding the excess consumption in the US was what became known the 'global macroeconomic imbalance'. This topic was the centre of attention for the international financial community over the last few years until the advent of the current massive financial meltdown.

The predominant concern with regard to the global macroeconomic imbalances pertained to why they persisted and how they could be resolved. The conventional wisdom was that the problem post-2000 was primarily due to sharply declining national savings in the US (as opposed to rising domestic investment as occurred in the Bill Clinton era).

This, in turn, led to concerns about the sustainability of the US current account deficit; would the US ever reach a stage where growth would induce a rise in national savings to help reverse the persistent decline in the external deficit?

The debate was given a new perspective by US Federal Reserve chairman Ben Bernanke in an important speech given at the Sandridge Lecture, Virginia Association of Economics, in Richmond, Virginia in March 2005. He noted that there were at least two sides to the US external imbalances: the mirror image of its current account deficit was the current account surplus - that is, the US was drawing in foreign savings to finance the domestic savings shortfall. He then turned the spotlight on the rest of the world (Japan and emerging economies mainly in Asia and oil producers) and correctly noted that there was a global savings glut overseas and asked the question why it was so.

No generalisations

While this is the right question to ask, the answer, unfortunately, is not straightforward and there are no obvious generalisations.

While the glut in the case of Japan is due to declining domestic investments - a result of the decade-long recession of the 1990s - that in China is largely due to sharply rising domestic savings, which in turn were fuelled by corporate savings. In the case of the oil-producing countries, it was also a sharp rise in national savings due to the commodity price boom.

Most interesting - and likely most relevant to the current situation in the US - is the case of Asean and the newly industrialising economies (NIEs), where the pointed rise in the current account surplus (and therefore 'excess savings' which found their way to the US and elsewhere) was because of the decline in investments post-1998.

The financial crisis and the consequent credit crunch seemed to lead to a persistent deleveraging of financial systems and corporate entities.

Regardless of the reasons behind the imbalances, the IMF - which was anxiously searching for new responsibilities (and sources of revenue) in the absence of any financial crises in emerging economies and borrowing by these economies - proposed to play a coordinating role in helping facilitate the orderly adjustment of these imbalances. Others had suggested the need for some sort of summit to discuss the situation.

However, with a buoyant and relatively stable world economy, there was no obvious impetus to follow up on any of these suggestions.

Fast-forwarding to the current situation, it is likely that the US need for foreign savings going forward may decline somewhat as the economy deleverages, leading to a steady decline in domestic investments and consumption. While the rising fiscal deficit may partly counteract the rise in private savings, there is reason to believe that national savings in the US will tick upwards as investment declines.

The decline in end demand from the US is likely to lead to emerging economies having to reflate their own economies domestically if they are to offset the decline in export demand - the implication being that the excess national savings in their economies will shrink somewhat.

This shrinkage is likely to be greater and sharper in oil-producing economies with the abrupt reversal in commodity prices. Domestic reflation could involve a combination of expansionary monetary and fiscal policies and the use of accumulated reserves (or net income from previous investments) to finance domestic physical and social infrastructural spending (as in the case of Singapore).

While the global macroeconomic imbalances may well become far less significant, the recent proposal by French President Nicolas Sarkozy and British Prime Minister Gordon Brown for a global finance summit to overhaul the global financial system immediately after the US presidential election is an important one, but one cannot help feeling a sense of dejÃ vu.

The primary aim of the Brown-Sarkozy proposal is to discuss the need for greater global oversight, ensure a greater degree of transparency of financial markets, tighter global accountability and more standardised accounting standards - although Mr Sarkozy has also emphasised the need to re-examine the international monetary system as a whole, including exchange rates among major currencies and the financing of the US deficits.

It is unclear whether such a meeting will take place at all and, if it does, how effective it would be (given the very differing philosophies of the US and European Union) and how big a role Asia would have in such a summit; indications are that the participants would be the G-8 (Group of Eight) industrialised nations plus at least China, India and Brazil.

The issue of exchange rate coordination is a particularly important one for Asia. While Asian currencies have moved to a greater degree of flexibility, they remain far from being flexible per se. In fact, there appears to be a degree of asymmetry in the sense that, while many of them are willing to allow for sharp currency depreciations, they are much less willing to tolerate sharp currency appreciations.

Accumulation of reserves

Apart from keeping the currency relatively undervalued, this asymmetric exchange rate intervention has been one of the significant contributors to the reserve accumulation in the region.

Part of the unwillingness to allow for exchange rate appreciations arises from the potential loss of cost-competitiveness vis-Ã -vis other regional export competitors. Conversely, the desire to hoard reserves in the event of a major crisis has precluded them from allowing the reserves to decline much in the event of relatively orderly or small downward pressures on their currencies.

This seeming Prisoners' Dilemma suggests the need for a greater coordination of monetary and financial policies among regional economies. Given that Asia houses two-thirds of the world's international reserves (with China, Japan, India, Taiwan and Korea being five of the six biggest holders), it may well be time to revisit the 1997-98 proposals for an Asian monetary facility, though its objectives will have to be clearly spelled out.

Regional economic and financial surveillance, coordination (not integration) of regional monetary and financial policies, coordination of crises responses and the sharing of best practices would be some of the possible objectives of such a facility. Having a shared facility may also reduce the perceived impotence of Asian countries in future global crises that would transcend national borders.

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