

## **The road map of the reform of the international monetary and financial system**

-- 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 as soon as possible; on the other hand, the global financial system should not be destabilized in the long-run because of reckless expansionary monetary and fiscal policy. In fact, in its effort for unfreezing the money market, preventing credit crunch from worsening, and prompting up financial institutions that are on the edge, the Fed has resorted to pump-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, it 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, such as paying interest on reserves and possible selling Fed bonds to the financial institutions. 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? In other words, will the US inflate away its debt burden? The result of such an inflation and devaluation scenario, let alone defaults, will be devastating for China, Japan and the rest of East Asian countries, which hold some 3 trillion USD foreign exchange reserves, collectively.

Currently, the Chinese government is facing two major challenges: minimizing the negative impact of the US financial crisis-led global slowdown on economic growth, and preserving the value of its foreign exchange reserves, which mostly are in the form of the US treasuries. More or less, this is a issue common to all North Asia. Hence the discussion of the reform of international financial system should put the issue of preserving the value of foreign exchange reserves high on the agenda.

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 whether it is a devious attempt or unintended result, if serious inflation and dramatic fall of the US dollar are allowed to happen, the consequences will be extremely grave. In other words, US policy in dealing with current financial crisis is not a pure sovereign matter but that it is an international matter. To achieve long-term stability, western countries' policy aimed at unfreezing money markets, pumping up failing financial institution, and financing stimulus plans should be discussed not only among G7. There should be a new framework to facilitate policy coordination among all major sovereign stakeholders in the world.

In the long-run, the key issue is that the US dollar's hegemonic position as virtually the sole international reserve currency should be changed. Because America's liabilities are denominated in terms of dollars, held by foreign countries as American assets, there are no effective disciplines can be imposed on the US monetary authority, and the smooth functioning of other sovereign countries will depend entirely on the good-will and competency of the US monetary authority. The current US financial crisis has damaged the credibility of US authorities and the dollar permanently, and shown that to use the dollar as the only store of value, unit of account, and vehicle money is an unaffordable luxury for the rest of the world. The US financial crisis is still unfolding. We do not know what will be the next step or misstep of the Fed and the Ministry of Treasury will take, let alone the possible consequences. China, as the biggest holder of the US Treasuries, is asking the question as Rogoff did: "Why would a government refuse to pay its domestic public debt in full when it can simply inflate the problem away?" The Chinese government has demanded guarantees by the US government for the safety of China's assets in the US. I do not know whether the Chinese government has got such any guarantees, or whether the US government has the ability to keep the promise, if they were given. No matter whatever the result is, the long-term solution lies in the reform of the international financial system that is characterized by the fact that the US dollar is the major reserve currency. The issue of a new reserve currency, a basket of reserve currencies or whatever, which will not be subject to the influence of a major country's domestic policy, should be high on the agenda of the reform of international financial system. Otherwise, the discussion of the reform of the international financial system cannot be very meaningful.

From China's perspective, there are three basic roads for the reform of the international

monetary system: reform within the current framework of international monetary system, strengthening regional financial cooperation and integration, and the internationalization of the RMB.

### **The reform of post Breton Wood system from within**

The reform within the current framework means the reform of the IMF. Since the Asian Financial Crisis, IMF's authority and credibility have deteriorated rapidly by its own missteps. Before 2007, the IMF failed to do anything to supervise, regulate, and contain the huge asset bubbles in international capital market. It even failed to forewarn the world on the coming subprime crisis in any significant way, let alone to had done anything to prevent the crisis from forming and breaking out since the turn of the century. 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? In 2008, the most important decision taken by the IMF was to toe the line of the US government to designate China as exchange rate manipulator. Here there is no need to discuss whether China erred or not. The thing is that the IMF has lost the sense of direction. I do not doubt the intellectual competency of IMF staffers. The thing is political influence. Lack of independence has damaged the authority of the IMF irretrievably. 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 increased significantly.

To make the IMF a more balanced international organization. The influence of the US should be reduced. Asia must have bigger say in the organization. At the operational level, there are five major issues should be discussed. *First*, the SDR should play a more important role. The question of whether and how the SDR should replace the US dollar as a reserve currency should be considered seriously. *Second*, how the BIS and the IMF should strengthen their cooperation so as to improve the supervision of financial stability in the global financial market. *Third*, IMF conditionality should be totally reconsidered. The action taken by the US government in dealing with current financial crisis has totally discredited the prescriptions provided to and imposed on the crisis-affected countries during the Asian Financial Crisis. *Fourth*, now we have G7-8, G20 and G whatever. How the division of labor of these forums and the IMF should be defined more

clearly. Maybe, the UN should have more say on international finance and the IMF should be more cooperative with the UN. *Last but not least*, the IMF has been pushing capital account liberalization dogmatically. It should play a more positive role in helping developing countries in strengthening the management of Cross-Border Capital Flows. So far, the 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 inundate its financial market after having implemented faithfully the IMF prescriptions during the Asian financial crisis. Now the Korea seems have no effective means to prevent capital from flowing out, which is attributable to the unwinding of carry-trade, and withdrawing of foreign capital because of liquidity shortage, credit crunch and need for capital injections. The IMF should adjust its position on capital account liberalization. The blindly push of free flows of cross-border capital flows should be stopped and a more measured attitude should be adopted by the IMF.

### **The regional financial cooperation**

The dissatisfaction felt by Asian countries to IMF's insensitivity towards Asian countries' suffering found its initial expression in Japan's proposal of establishing an Asian Monetary Fund (AMF). The most essential function of the proposed AMF is to provide emergency financial support to would-be crisis-affected countries. Ideally, the emergency financial support provided by the AMF will be more speedy and the condition for providing such support will be less harsh and more in line with "Asian way".

The "Chiang Mai Initiative"(CMI) is the most important milestone of Asian financial crisis. According to The Joint Ministerial Statement of the ASEAN + 3 Financial Ministers Meeting, published on 6 May 2000, Chiang Mai, Thailand, the ASEAN + 3 agreed to strengthen policy dialogues and regional cooperation activities in the areas of capital flows monitoring, self-help and support mechanism and international financial reforms. They recognized a need to establish a regional financing arrangement to supplement the existing international facilities. They agree to establish a network of research and training institutions to conduct research and training on issues of mutual interests. Besides these general statements, the statement declared that the "Chiang Mai Initiative" involves an expanded ASEAN Swap Arrangement that would include ASEAN countries,

and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea. The swap arrangement marked an important turning point in the road for Asian financial cooperation in history. In recent years, the swap arrangements have developed from bilateral to multilateral agreements. Now a prototype AMF is taking shape. However, currently, the problems faced by East Asia as a whole and by individual countries in the region are very different from those during the Asian Financial Crisis.

On the whole, during the current global financial crisis, the performance of the East Asian governments in terms of financial cooperation and coordination is rather 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 nonexistent. 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 their 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.

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. The Euro countries' performance seems rather disappointing. Maybe, regional financial cooperation needs to find another rally point. The urgency of exchange rate coordination may have faded into a place of secondary importance.

### **The internationalization of RMB**

China's situation under current financial crisis is paradoxical. On the one hand, as a captured lender to the US, it is facing the danger of making big losses. In the words of some financial observers, China has lost a lot already without knowing it clearly, or at all. On the other hand, due

to China's huge foreign exchange reserves and the appreciation of the RMB, China's currency—RMB is at a very favorable position. Hence, China is facing a historical opportunity for the internationalization of the RMB. Both the reasons why China should be interested in internationalizing its currency and the possible problems arisen following the internationalization are obvious. I will not dwell on them. Here, I just wish to mention a few possible measures that China may take to promote the internationalization of the RMB while minimizing the losses as a result of the biggest holder of US treasury securities.

#### *Currency swaps*

On the whole, in Asia, 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 Mai Initiative may find a better use for stabilizing the regional financial system.

In the early May 2008, Finance ministers from China, Japan, South Korea and the Association of Southeast Asian Nations (ASEAN) agreed to expand their system of bilateral currency swaps under the Chiang Mai Initiative to a more multilateral system. Under the currency swaps, an Asian country hit by a foreign exchange crisis could borrow US dollars from another country to bolster its reserves until the crisis had passed. Finance ministers from 13 Asian nations, including South Korea, Japan and China, agreed to create a pool of at least \$80 billion in foreign-exchange reserves to be tapped to protect their currencies.

On Dec. 12 2008, China and Japan agreed with South Korea on bilateral currency swap accords in an effort to ensure financial stability in Asia. China and South Korea will sign an accord worth 38 trillion won (\$28 billion). According to the accord, China gives South Korea access to 38 trillion won worth of yuan at any time for the next three years. The central banks of China, South Korea and Japan will meet again in 2009, starting regular consultations to ensure currency stability in Asia.

On 19 December 2008 the Central Government announced that 14 measures would be undertaken in seven areas to support Hong Kong's financial stability and economic development, including agreeing to the signing of a currency swap agreement between the People's Bank of China (PBoC) and the Hong Kong Monetary Authority (HKMA).

With the establishment of a currency swap arrangement, short-term liquidity support can be provided to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need. This will bolster confidence in Hong Kong's financial stability, and will also help to promote financial stability in the region and the development of renminbi-denominated trade transactions between Hong Kong and the Mainland. The currency swap agreement has a term of three years, which can be extended upon agreement by both parties. It can provide liquidity support up to RMB200 billion / HK\$227 billion.

#### *Settlement in RMB*

In December 2008, China announced that it will allow the settlement of trade in RMB with Hong Kong Macau and ASEAN nations on a trial basis. The pilot RMB trade settlement program will be tested in Guangdong province, the Yangtze River Delta, Hong Kong and Macau. The RMB trial will also be implemented between Guangxi and Yunnan provinces and the neighboring countries of the ASEAN trade group.

#### *Panda Bonds*

There are countries which need dollars, while there are other countries which wish to get rid of dollars in the region. China has huge amount of foreign exchange reserves which 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.

#### *Loans to foreign banks*

Three Chinese banks are the second, third and fourth most cash rich commercial enterprises at the moment. Presently, no international bank has any meaningful liquidity available. In contrast, Chinese banks are sloshed with excess liquidity. It is possible for those Chinese banks to lend long term RMB subordinated term loans to qualified foreign banks. Borrowers can buy dollars with the RMB borrowed from the Chinese banks and repay the RMB over a specified period of time.

#### *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.

#### **Free Trade Should Be Safeguarded**

FTAs should be promoted continuously. 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.