

SEVENTH EAST ASIA CONGRESS

6-8 December 2009
Kuala Lumpur, Malaysia



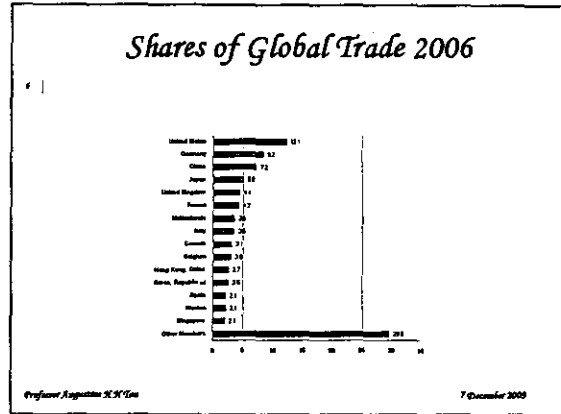
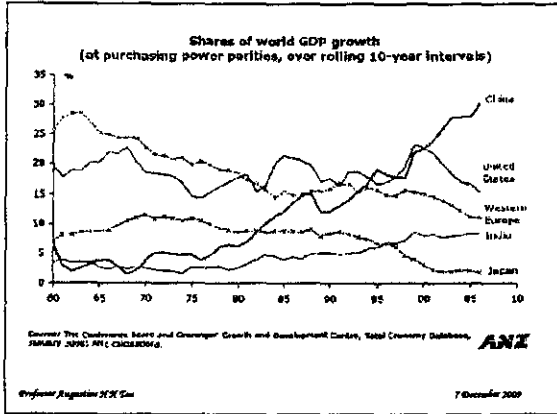
SESSION TWO

**“Financial Cooperation and the Future of the
Dollar in East Asia”**

by

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A TALE OF TWO POWERS

China's rise as an economic powerhouse is reminiscent of the U.S.'s ascent last century, only it's happening faster. Here are some parallels:

	SHARE OF GLOBAL GDP			REAL GDP PER PERSON
	1820	1913	1950	1820-1913
U.S.	1.8%	18.9%	27.3%	1.5%
China*	3.2%	13.0%	20.3%	8.2%

*Based on purchasing power parity as reported. Projected to reach 2015 level by the year 2010 and beyond. Source: Angus Maddison, Organization for Economic Co-operation and Development, International Yearbook of Statistics, 2006.

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The Peterson Institute for International Economics

- projects that the international economic position of the United States is likely to deteriorate enormously
- the current account deficit rising from a previous record of six percent of GDP to over 15 percent (more than \$5 trillion annually) by 2030 and
- net debt climbing from \$3.5 trillion today to \$50 trillion (the equivalent of 140 percent of GDP and more than 700 percent of exports) by 2030.
- The United States would then be transferring a full seven percent (\$2.5 trillion) of its entire GDP to foreigners every year in order to service its external debt.

Frédéric Bergsten, The Dollar and the Deficits: How Washington Can Prevent the Next Crisis, Foreign Affairs, Nov 2008

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Bergsten: Triple Threat To US

- If the rest of the world again finances the United States' large external deficits, the conditions that brought on the current crisis will be replicated and the risk of calamity renewed.
- At the same time, increasing US demands on foreign investors would probably become unsustainable and produce a severe drop in the value of the dollar well before 2030, possibly bringing on a hard landing.
- And even if the United States were lucky enough to avoid future crises, the steadily rising transfer of US income to the rest of the world to service foreign debt would seriously erode Americans' standards of living.

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Bergsten.

- Other countries gain from the convenience of a worldwide currency (as they do from having English as a worldwide language) and the subsequent reduction in transaction costs.
- Whatever their complaints, most governments are happy with the trade surpluses and the jobs created by the US deficits that their dollar financing allows.
- In fact, if the United States stopped running large trade deficits and acting as the consumer of last resort, many countries would be forced to rebalance their growth strategies to expand domestic demand instead of relying on exports.

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Paul Craig Roberts

- If the US government cannot balance its budget by cutting its spending or by raising taxes, the day when it can no longer borrow will see the government paying its bills by printing money like a third world banana republic. Inflation and more exchange rate depreciation will be the order of the day.
- *Paul Craig Roberts was Assistant Secretary of the Treasury in the Reagan Administration. Global Research , February 6, 2008, Online*

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Financing US Debt

- ◆ American households: net sellers of Treasuries in the second quarter of 2009
- ◆ Printing money: Federal Reserve buys Treasuries
- ◆ Banks: using depositors money to buy Treasuries
- ◆ Banks: borrowing money at close to zero cost from the Fed and using it to buy Treasuries
- ◆ Foreigners: bought \$380 billion in the second quarter of 2009
- ◆ Morgan Stanley projection: next year there will be a shortfall of \$598 billion— a third of the new Treasuries issued
- ◆ Bond yields will rise

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Rising Real Interest Rates

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Real interest rate [R] = Nominal interest rate [i] – rate of inflation [p]

- ◆ i can rise even when p is not rising or falls:
 - ◆ France in the 1930s
 - ◆ Japan now: i is rising [bond yields] but there is deflation again
- ◆ For a heavily indebted Government and public, rising R means an increasingly heavy debt burden
- ◆ Rising R also means slower consumption and investment

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Defence Cut-back?

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Niall Ferguson

Professor of History, Harvard University

Newswatch, 7 December 2008

"If the US does not come up with a credible plan to balance the budget, the danger is a major weakening of American power"

"This is how empires decline. It begins with a debt explosion. It ends with an inexorable reduction in the Army, Navy, and Air Force"

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US Growth Rate To Decline

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- To deleverage to a more sustainable trend, real consumer spending would need to grow by just 1.3% a year from 2009 to 2013, the weakest such five-year stretch since the 1930s.
- It could grow even more slowly than that if taxes rise faster, or if productivity is stagnant, impeding real-income growth.
- For America to grow at a trend rate of about 2.5% exports and investment will have to be the engines: unlikely, given the global economic malaise

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Jim Rogers, LivingOffDividends.com 18 Nov 07

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- Jim Rogers thinks the US has lost its title as the world's economic engine.
- He thinks the subprime mess will last for years,
- The US \$ is on a permanent decline
- China will become the world's foremost power

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\$ Share Drops: Bloomberg 30 Sept 2009

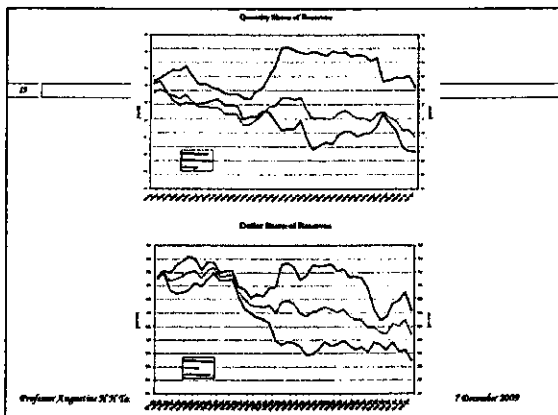
- The U.S. currency's portion dropped to 62.8 percent in the period ended June 30, from 65 percent in the prior quarter and 62.9 percent a year earlier. The euro's share rose to a record 27.5 percent from 25.9 percent while the pound and yen gained.
- The increase in the euro's shares may encourage more criticism of the dollar's role as the world's main reserve currency.
- World Bank President Robert Zoellick said in a speech on Sept. 28 that the dollar's status will be challenged and shouldn't be taken for granted.

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Dollar loses Reserve Status to Yen & Euro
By Paul Thompson, New York Times, October 11, 2009

- Over the last three months, banks put 63 percent of their new cash into euros and yen – not the greenbacks – a nearly complete reversal of the dollar's onetime dominance for reserves, according to Barclays Capital.
- The dollar's share of new cash in the central banks was down to 37 percent – compared with two-thirds a decade ago.
- Currently, dollars account for about 62 percent of the currency reserve at central banks – IMF

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Jeffrey Frankel

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- ♦ Econometric simulations show the euro overtaking the dollar by 2022.
- ♦ The euro is not the only alternative to the dollar. The yen, pound and Swiss franc remain viable alternatives for national authorities to put some of their reserves.
- ♦ 2009 has seen the resurrection of two international reserve assets that had previously been written off as dead: the SDR and gold.
- ♦ We are gradually moving from the dollar standard to a global monetary system that features multiple reserve assets.

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IMF MD Dominique Strauss-Kahn

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- ♦ The world can no longer rely on a currency issued by a single country, and
- ♦ A new global currency may evolve out of the IMF's in-house unit of account, known as Special Drawing Rights
- ♦ Amended later: The U.S. dollar will remain the world's primary reserve currency for many years or decades

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Robert Zoellick

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- World Bank President Robert Zoellick said on Wednesday that the U.S. dollar's role as a reserve currency was "relatively secure", but the Chinese yuan will provide an alternative over time.
- "Over the next 10-15 years, you will firstly see renminbi to be internationalised and provide an alternative," he said at a World Bank conference in Singapore.
- Zoellick also said the U.S. should not be complacent about the dollar.

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Governor, People's Bank of China

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Zhou Xiaochuan



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China Takes Aim at Dollar -- WTO March 24, 2009

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- Zhou Xiaochuan, Governor, People's Bank of China
- Called for the creation of a new currency to eventually replace the dollar as the world's standard, proposing a sweeping overhaul of global finance that reflects developing nations' growing unhappiness with the U.S. role in the world economy.
- "The outbreak of the crisis and its spillover to the entire world reflected the inherent vulnerabilities and systemic risks in the existing international monetary system," Mr. Zhou said. The increasing number and intensity of financial crises suggests "the costs of such a system to the world may have exceeded its benefits."
- Because other nations continued to park their money in U.S. dollars, the argument goes, the Federal Reserve was able to pursue an irresponsible policy in recent years, keeping interest rates too low for too long and thereby helping to inflate a bubble in the housing market.

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Zhou Xiaochuan.

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- Mr. Zhou's idea is to expand the use of "special drawing rights," or SDRs -- a kind of synthetic currency created by the IMF in the 1960s. Its value is determined by a basket of major currencies.
- Mr. Zhou suggested countries could increase their contributions to the IMF in exchange for greater access to a pool of reserves in SDRs.
- "The dollar reserve system is part of the problem," Joseph Stiglitz, the Columbia University economist, said in a speech in Shanghai last week, because it meant so much of the world's cash was funneled into the U.S. "We need a global reserve system," he said in the speech.

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History: From £ To \$

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- The only previous shift from one reserve currency to another in the modern era -- from the British pound to the U.S. dollar -- took a number of decades.
- It took two world wars and major changes in the conduct of international business
- Dominant economic/military power
- Requires large, deep, and highly traded markets

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Asian Monetary Union?

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- The European Currency Unit, or ECU, was created as a unit of account in 1979 and never gained great acceptance
- The EMS—European Monetary System, 1979-98
 - Formal network of mutually pegged exchange rates
 - Until 1987, capital controls shielded members' reserves from speculative attacks
 - Went through 11 currency realignments between 1979-87
 - September 1992: Britain & Italy left. Remaining members forced to have very wide exchange rate margins
 - 1993: Maastricht Treaty ratified by 12 EU countries
 - 2002: European Monetary Union emerged with Euro

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Special Drawing Rights?

- SDRs are a kind of synthetic currency whose value is determined by a basket of major currencies.
- Created to increase liquidity
- In the early 1970s, some banks took deposits denominated in SDRs and some companies even issued bonds in the currency.
- But the market always remained small, and
- the main use of SDRs today is to account for transactions between the IMF and its member nations.

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East Asian Integration: EAEC Revived!

- Regional FTA proposed by former Malaysian Prime Minister, Dr. Mahathir in 1990, comprising ASEAN + China, Japan & S. Korea
- In deference to the US, Japan declined to join
- PM Yukio Hatoyama "I would like to firmly promote regional cooperation in East Asia with a long-term vision of forming an East Asian Community."
- Question: How inclusive or exclusive?

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Intra-regional Trade

- Intra-regional trade among member states of the East Asia Summit has grown three-fold over the past decade and accounts for 54 percent of their total trade, higher than that of North American Free Trade Agreement (NAFTA).
- The GDP of East Asia Summit members combined now accounts for around 23 percent of the world's total output.
- In addition to increasing economic interdependence, Asia has many issues to tackle together, including the financial crisis, outbreaks of H1N1 flu, climate change and natural disasters.

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East Asian Community Report, Sat Oct 24, 2009

- Foreign Minister Katsuya Okada has envisaged opening membership to Japan, China, South Korea, ASEAN, Australia, New Zealand, and India – the same members as the East Asia Summit.
- But he has recently toned down his comments, saying there is no immediate need for concrete details, and has tried to soothe worries in Washington about the United States being excluded.
- Tokyo acknowledges that it will take decades to boost political integration and create a common currency in a politically, culturally and economically diverse region.

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China's Massive Reserves

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- China has amassed \$2.27 trillion of foreign exchange reserves, the world's largest stockpile, and
- Analysts think about two-thirds of this is invested in dollar-denominated assets.
- China has a huge trade surplus with the United States, and is
- The largest foreign holder of U.S. government bonds.

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Chinese Financing US

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IMF's View

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- BEIJING, Nov 17 (Reuters) - The imperative of greater global currency stability means the world can no longer rely, as it has done since the end of the gold standard, on a currency issued by a single country, the head of the IMF said on Tuesday.
- Dominique Strauss-Kahn, the managing director of the International Monetary Fund, restated his view that a new global currency might evolve out of the Special Drawing Right, the Fund's in-house unit of account.
- "That probably has to be a basket," Strauss-Kahn said of the eventual replacement for the dollar. "In a globalised world there is no domestic solution,"

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Former IMF Chief

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- A former IMF chief, Michel Camdessus, said time was of the essence to embark on reform of the global monetary system.
- "This favourable window of opportunity is there. It will not stay open forever," he told the forum at which Strauss-Kahn spoke.
- Camdessus gave broad backing to a recent proposal by Chinese central bank governor Zhou Xiaochuan that an expanded SDR could eventually replace the dollar as the global reserve currency.
- "Our Chinese friends mean business," he said of Zhou's plan.
- As a corollary of a strengthened role for the SDR, governance changes were needed at the Fund to shift power to big emerging economies, Camdessus said.
- To that end, the SDR basket must be modified to include the yuan and perhaps the Indian rupee and Brazilian real as well.
- "The RMB must be there. Period," Camdessus said. (Reporting by Alan Wheatley and Simon Rabinovitch; Editing by Neil Fallick)
- © Thomson Reuters 2009.

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Yuan: China's Moves....

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- ◊ A similar arrangement has been proposed for exporters in Guangxi Zhuang Autonomous Region and Yunnan Province in south China, which will be allowed to use the yuan to settle trade with ASEAN (Association of Southeast Asian Nations) members starting this year.
- ◊ Since mid-December, the Chinese mainland has signed currency swap contracts worth 650 billion yuan (US\$95.6 billion) with central banks in Hong Kong, the Republic of Korea, Malaysia, Belarus, Indonesia and Argentina.
- ◊ These swap accords allow other overseas central banks to sell yuan to local importers who want to buy Chinese goods.

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Internationalizing the Yuan

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- ◻ Agreement with Brazil to facilitate the use of the two countries' currencies in bilateral trade
- ◻ Yuan swap agreement with Argentina, Belarus, Hong Kong, Indonesia, S. Korea & Malaysia
- ◻ These swap accords allow other overseas central banks to sell yuan to local importers who want to buy Chinese goods.
- ◻ Summer 08:
 - ◻ expanded yuan settlement agreements between Hong Kong & 5 mainland cities
 - ◻ Authorized HSBC Holdings to sell yuan bonds in Hong Kong
- ◻ September 09: Issued US\$1bill worth of Yuan-denominated bonds

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Yuan: China's Moves.....

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- ◻ The central government is also studying a proposal to extend financial aid to developing countries in yuan instead of in US dollars, according to a report by the South China Morning Post.
- ◻ China will then allow beneficiary nations to trade yuan reserves in Hong Kong (if they do not use up all the aid) to buy Chinese products, the report said, quoting unidentified sources.

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Richard Cooper: The Future of the \$

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- ◻ The gains usually mentioned are three:
 - ◻ seigniorage,
 - ◻ ease of financing budget (and possibly other) deficits, and
 - ◻ Employment and profits in the financial market.
- ◻ Seigniorage arises from the difference between the face value of a unit of currency and its cost of production.
- ◻ It is entirely true that the United States benefits from seigniorage on the estimated \$380 billion of greenbacks (currency notes) held around the world; Americans received goods and services or assets for them and pay no interest on them. But notes are a small part of the international holdings of the dollar.
- ◻ Most dollar assets owned abroad pay an interest rate in competition with interest rates on other financial assets, denominated in either dollars or other currencies.

The Peterson Institute, Washington, D.C. Policy Brief, Number PB 09-21

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Requirements for Reserve Currency
— Barry Eichengreen

- Deep and liquid financial markets
- More reliable and transparent clearing & settlement systems
- Benchmark asset
- Well-defined yield curve
- Critical mass of market participants
- Hence—need to have fully open capital account
 - Banks and state-owned enterprises fully commercial
 - Flexible exchange rate
- Time: US\$ took from 1914-mid 1920's when New York eclipsed London as a source of trade finance
- Dollars exceeded sterling in reserve holdings in second half of 1920's
- China's target date: 2020

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\$: Safe Haven

“For now, the safe haven aspect of the dollar has overwhelmed other concerns. When people need liquidity, they go to the United States,”

— Morris Goldstein, Peterson Institute for International Economics, Washington D.C.

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