U.S. Financial Crisis, Spillover to Asia, and Opportunities for Asian Regionalism

C. Randall Henning

Peterson Institute and American University

Presentation to the 22nd Asia Pacific Roundtable

Panel on the Potential for A Global Recession and

Its Impact on Regional Economic Security

Kuala Lumpur, Malaysia, June 2-5, 2008

Preliminary Version

Introduction

I have been asked to assess the risk that the U.S. financial crisis and probable recession will spread across the Pacific to Asia and the challenges and opportunities this risk poses for regional cooperation in East Asia. I will do so against the backdrop of the challenge posed by the global balance of payments adjustment and the debate among scholars over the longevity of the so-called "Bretton Woods II" regime. My bottom line is that the risk that Asia will be negatively shocked by economic developments in the United States is substantial but that this risk presents an opportunity to bolster regional financial cooperation.

Over the last five years, many international monetary officials and scholars have been preoccupied by the large current account imbalances in the global economy, those of the United States and East Asian economies in particular. The concern of many was that the flows of capital that financed these imbalances could halt abruptly, causing a "hard landing" among the deficit countries, the United States in particular. Although the U.S. current account deficit has declined lately, it is still large and its further decline cannot be taken for granted. Thus, one might well ask whether the US financial crisis, originating in but no longer limited to the subprime mortgage market, will at some point impede the ability to finance the external deficit. If so, international adjustment could be forced and abrupt, rather than smooth, with negative consequences for Asia and the rest of the world as well as the United States.

Debate over Bretton Woods II

During the first half of this decade, many Asian countries managed the external value of their currencies fairly tightly against the dollar, what Ronald McKinnon called an Asian "dollar standard." Pegging currencies at a competitive exchange rate usually entailed substantial foreign exchange intervention, an accumulation of dollar reserves, and growing current account surpluses on the part of the Asian economies. The purchase of foreign exchange has an expansionary effect on domestic liquidity; but central banks were able to re-absorb liquidity in offsetting operations. "Sterilization," as these operations are known, was reasonably effective over the medium term, at least in several countries. China was at the center of this configuration of Asian exchange rate policies, with many of its regional neighbors and trading partners unwilling to allow their currencies to appreciate against the renminbi for several years.

Economists debated the merits of the Asian dollar standard. One group of scholars argued that the pattern was benign: high rates of domestic savings and underdevelopment of indigenous financial markets effectively forced governments to act as the conduit for portfolio diversification abroad, in the form of intervention, reserve accumulation, and investment of reserves. Meanwhile, on the real side of the economy, competitive valuation of the currency and expansion of the traded goods sectors would absorb excess or underemployed labor. This process could continue until the stock of excess labor was fully absorbed and domestic wages began to rise – which in the case of China was thought to be a matter of decades rather than years. The resulting international monetary arrangement, characterized by fixed or tightly managed exchange rate and international financial intermediation on the part of the United States, was dubbed the "revived Bretton Woods" regime or "Bretton Woods II."

The proponents (Dooley, Garber, Folkerts-Landau) of this view conceptualized the system in terms of the relationship between the center (advanced or "capital account" countries) and the periphery (emerging or "current account" countries). As emerging countries developed and migrated to the center, the system would simply "reload another periphery." Given the availability of potential additional "peripheries," this regime, which entailed large current account deficits for the United States, could continue almost indefinitely. Equally importantly, given the structural conditions in the center and periphery, this pattern of exchange rate policies and external balances was thought to be desirable.

The Bretton Woods II view was controversial, and challenged by scholars from different analytical perspectives. One critique argued that pegging to the dollar implied adoption of U.S. monetary policy, which would not be consistent with the needs of Asian economies. Another critique observed that the effectiveness of sterilization would be temporary, that the liquidity effects would become more pronounced as intervention continued and create substantial upward pressure on prices. A third critique questioned whether the Bretton Woods II portrayal of the structure of Asian economies was accurate (Goldstein and Lardy 2005). A fourth critique argued that Asian countries would be unlikely to manage the collective action problem created by the accumulation of reserves and temptation to diversify out of dollar assets before other dollar holders did the same. (Eichengreen) The conclusion of these critics was that the Bretton Woods II regime would be short-lived.

The last couple years provide something of a test of the longevity of this regime. US financial crisis and probable recession comes at a crucial point.

Potential Recession Spillover

Recent price increases in many Asian economies suggest that the liquidity consequences of foreign exchange intervention have finally come home to roost. Some of these economies have apparently reached the point of diminishing marginal ability to sterilize the effects of intervention. Some Asian economies are thus experiencing overheating, and a reduction in growth and inflation would be welcome. But any such reduction should be gradual and moderate rather than abrupt and extreme.

One additional possible consequence of liquidity expansion is a decline in the quality of newly issued financial assets. A number of analysts have worried that the quality of loans issued by Chinese banks, for example, could deteriorate in the absence of tighter lending standards and improved credit analysis. The U.S. experience suggests that such a decline in the quality of financial assets did indeed occur during the middle of this decade and that the decline might not become apparent until the liquidity bubble is pricked.

The US financial turbulence and economic slowdown could be transmitted through three possible channels: direct losses on U.S. financial assets, broader financial linkages, and trade. Consider each in turn.

First, with respect to direct losses on U.S. financial assets, the exposure of Asian financial institutions appears so far to be less than that of European banks. The IMF estimates European losses related to the subprime market to amount to $123 billion with another $43 billion yet to come. By contrast, the Fund estimates total Asian subprime-related losses at $13 billion with only and additional $3 billion yet to come. (Global Financial Stability Report, April 2008) The difference in the estimates might be a function in part of lesser transparency of Asian financial institutions compared to European; Asian banks might be more exposed than the Fund knows. But even if Asian losses are a couple multiples larger than those anticipated by the Fund, Asian institutions will have considerably fewer losses than European banks.

Second, Asian monetary authorities are allowing their currencies to appreciate against the U.S. dollar, albeit at different rates, in order to contain domestic liquidity expansion and price pressures. The appreciation can be expected to be a drag on exports but also more immediately a drag on domestic equity markets, which in turn could have a dampening effect on investment and growth. If the subprime debacle stimulates a more widespread reassessment of risk in international financial markets, moreover, emerging markets in general could experience declines in capital inflows. A drying up of capital inflow and decline in asset prices could reveal a decline in the quality of financial assets in countries that have experienced liquidity booms, thereby reinforcing a shift on the part of investors toward safer assets.

Third, Asian countries' exports can be expected to suffer from the slowdown and possible recession in the US economy. A reduction in the external surpluses of Asian countries would reduce economic growth accordingly. (By the same token, the shift in external balances will moderate the slowdown in the United States. Much of the growth that the U.S. economy experienced until the first quarter of 2008 was due to the recent increase in net exports.)

The magnitude of the spillover to Asia will depend on the effectiveness of US authorities' efforts to contain the losses in the US financial system and to counteract the slowdown in the US economy with expansionary monetary and fiscal policy. Analysts range from the optimistic to the pessimistic. Michael Dooley, one of the proponents of the Bretton Woods II view, remains optimistic (IMF conference, April 25, 2008) that the US financial crisis will not become a balance-of-payments crisis. If so, we could expect the spillover to Asia to be more limited. By contrast, Nouriel Roubini is pessimistic, projecting large spillover from the U.S. financial crisis (*Foreign Policy*, March/April 2008, pp. 44-48.) My own view is that Asia is likely to experience substantially more spillover than it has to date before the US financial crisis is fully resolved and the global adjustment process is complete.

Exchange Rate Movements

Meanwhile, it is worth noting, the exchange rates of Asian currencies have been moving. Since mid-2005, the currencies of China, Malaysia, India, Taiwan, and Indonesia have appreciated roughly 10-20 percent against the U.S. dollar. Those of Japan, the Philippines, Singapore, Korea and Thailand have moved further, roughly 20-25 percent against the U.S. dollar since the beginning of 2002.

Notably, however, appreciation has not alleviated reserve and liquidity pressures in some of these economies. Although China has allowed the renminbi to appreciate against the dollar since July 2005, for example, the volume of Chinese purchases of U.S. dollars has accelerated, rather than decelerated. At the same time, its domestic inflation has risen to more than 8 percent.

Relatedly, although most Asian countries have appreciated their currencies against the dollar, one group has appreciated on a real effective basis while another has depreciated on a real effective basis since early 2002. Singapore, Thailand, the Philippines, Korea, and India have appreciated on this basis, while China, Malaysia, Taiwan, Japan and Hong Kong have depreciated. Measured since mid-2005, China, Malaysia and Indonesia show little change, while Taiwan, Japan and Hong Kong show depreciations.

Clearly, not all Asian governments are moving together. These exchange rate movements, intervention and price developments bring into question the sustainability of the Bretton Woods II regime. The US financial crisis could prove to be the event that breaks the weakened system apart.

Asian Regional Cooperation

Spillover from the US crisis and the adjustment problem poses both challenges and opportunities for regional economic cooperation in East Asia. This adjustment cycle occurs against a regional backdrop that has changed since the last cycle. Regional cooperation is more robust than in the past; the present challenge will demonstrate exactly how robust.

After the Asian financial crisis, East Asian governments embarked on a set of regional initiatives across several policy dimensions. Under the aegis of ASEAN+3, the Chiang Mai Initiative established a network of bilateral financial facilities on which members could draw in a balance of payments emergency. The finance ministers also created a regional policy dialogue to complement the financial facilities. The region embarked on several bond market initiatives, created regional bond funds, and explored the possibility of creating an Asian Currency Unit (ACU), among other initiatives.

Meanwhile, on the trade side of the policy agenda, they launched negotiations on a plethora of bilateral, sub-regional, and cross-regional free trade agreements, successfully concluding many of them.

The potential importance of regional arrangements can be illustrated by the relative absence of regional cooperation at the outset of the Asian financial crisis. In his book on that crisis, Paul Blustein recounts a game of golf between the governors of the central banks of Taiwan and South Korea, during which the Taiwanese negotiated the devaluation of the New Taiwan dollar in multiple conversations over his cell phone but did not mention the purpose of these calls to his golfing partner. With weeks, of course, the Korean was facing his own financial crisis.

The case for a coordinated response to the adjustment challenge is strong. The extent of appreciation of the renminbi against the dollar that is desirable for China depends in part on the response of the other monetary authorities with in the region. The extent to which the others move, depends of course on the appreciation that China is willing to countenance. During 2005, therefore, several of my colleagues (Cline, Bergsten) advocated an "Asian Plaza Accord," whereby governments in the region would agree to a substantial revaluation of their managed currencies, thus contributing to global adjustment. Coordination is especially compelling with respect to management of international reserves and the diversification of those reserves out of U.S. dollars.

The relevant question has been not whether the Bretton Woods II regime will last but how will it end. Would Asian countries choose to manage their exit from a tightly managed dollar peg collectively? Or would they each move independently, some more than others? By moving together, they could hope to build cooperation for further regional monetary integration, proceeding step by step along a path paved by the European Union. By moving separately, Asian governments would have to put off such aspirations into the future. (Sapir)

The last two years provide a tentative answer to these questions: The movements in exchange rates suggest that Asian authorities are in general not coordinating their response to the challenge of global adjustment.

East Asia might not be ready to create an Asian Monetary System modeled after the European Monetary System. Nor do governments within the region appear ready to manage their currencies against a common basket. But they could undertake a basic first step toward regional monetary cooperation by enhancing the regional surveillance or policy dialogue. The dialogue is presently being conducted within the ASEAN+3 deptuties meetings. While the quality of the discussion there has been improved, I believe it is fair to say that it could be improved further. It might also be expanded beyond the relatively limited group of officials in this forum. During this critical period, it is important for governments and central banks of the region to bring their concerns and intentions with respect to exchange rate and macroeconomic policy to this forum, and discuss the risks and vulnerabilities, including of course the potential for contagion across the Asian area. The layering of the US financial crisis on top of the global adjustment problem substantially strengthens the need for strengthened policy dialogue. If successful, the newly bolstered surveillance mechanism can then become a critical building block in the construction and expansion of other regional initiatives, such as the multilateralization of the Chiang Mai Initiative and more explicit exchange rate arrangements.