International Monetary System:

Implications for EMEs and Asia

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Goodhart's Law of Economic Relativity

- Agree with Charles Goodhart that current international monetary system (IMS) is asymmetric and moving from unipolar to multi-polar environment
- Fed Yellen (2014): "*effects of tapering on emerging market turmoil do not pose a substantial risk to US economic outlook*" (our dollar, your problem)
- Subramaniam and Rodrik (2014): EMEs enjoyed low interest rates but did not make needed reforms – victims of own mistakes
- Feedback effect from EME to advanced markets (Eichengreen 2014) – synchronized global slowdown if no leadership in leading economies (G2, G7 or G20?)

Section 1

Global Economic Environment

Asian transition to New Industrial Revolution

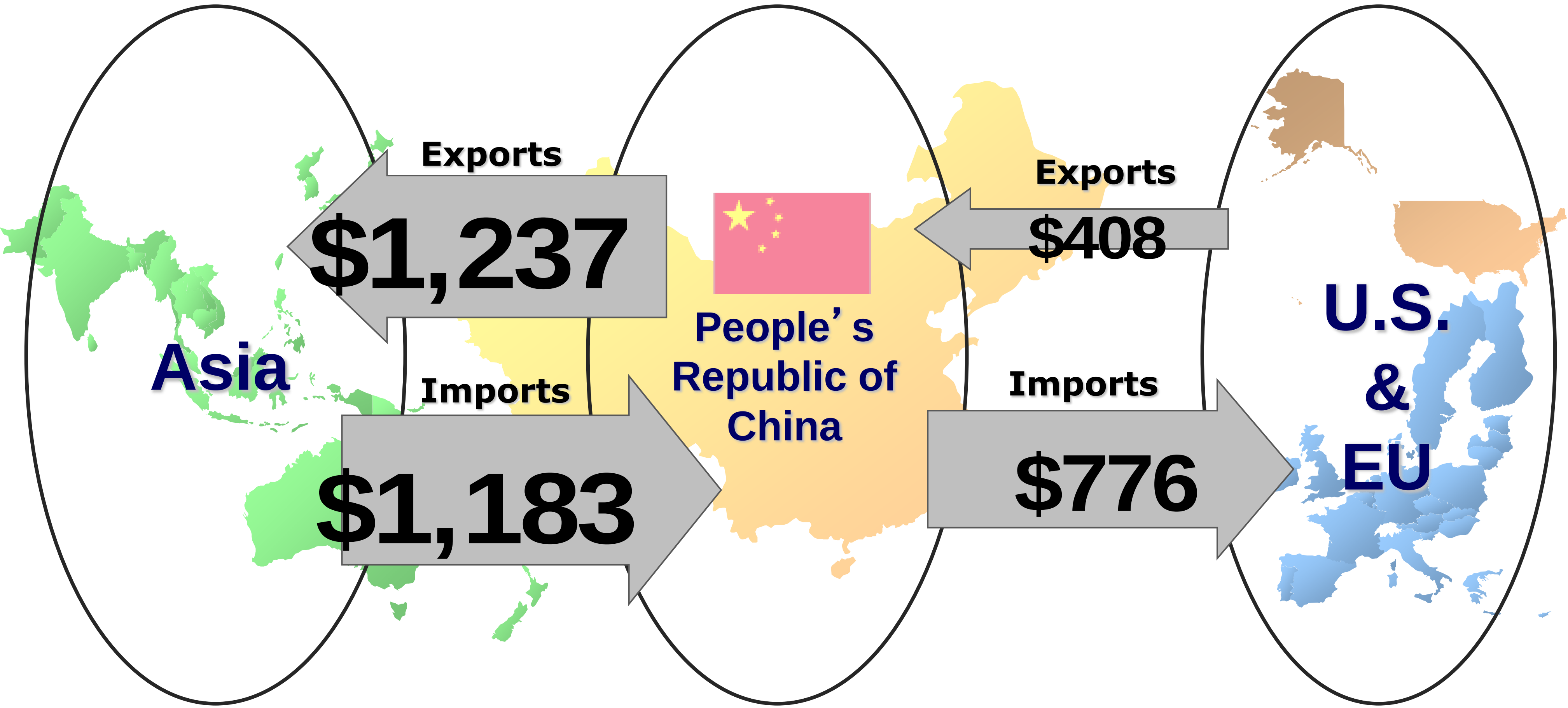
Global economic turbulence amidst structural change

- US in recovery mode with QE tapering
- Europe – Ukraine crisis drives political unity within Eurozone, and economy may be bottoming out.
- QE tapering would lead to rising interest rates and currency depreciation in EMEs, including Fragile Five (India, Indonesia, Turkey, Brazil, South Africa) + Argentina, all in varying degree of adjustment
- China – complex adjustment, as economy switches from reliance on exports to domestic consumption; manufacturing to services.
- Major structural change in Asian transition to Innovative, Green Growth, Inclusive (New Industrial Revolution) economy – Malaysia's New Economic Model. .

Fundamental Challenges for Asia transition from polluting, CO2 emitting, unequal growth model to New Economic Model

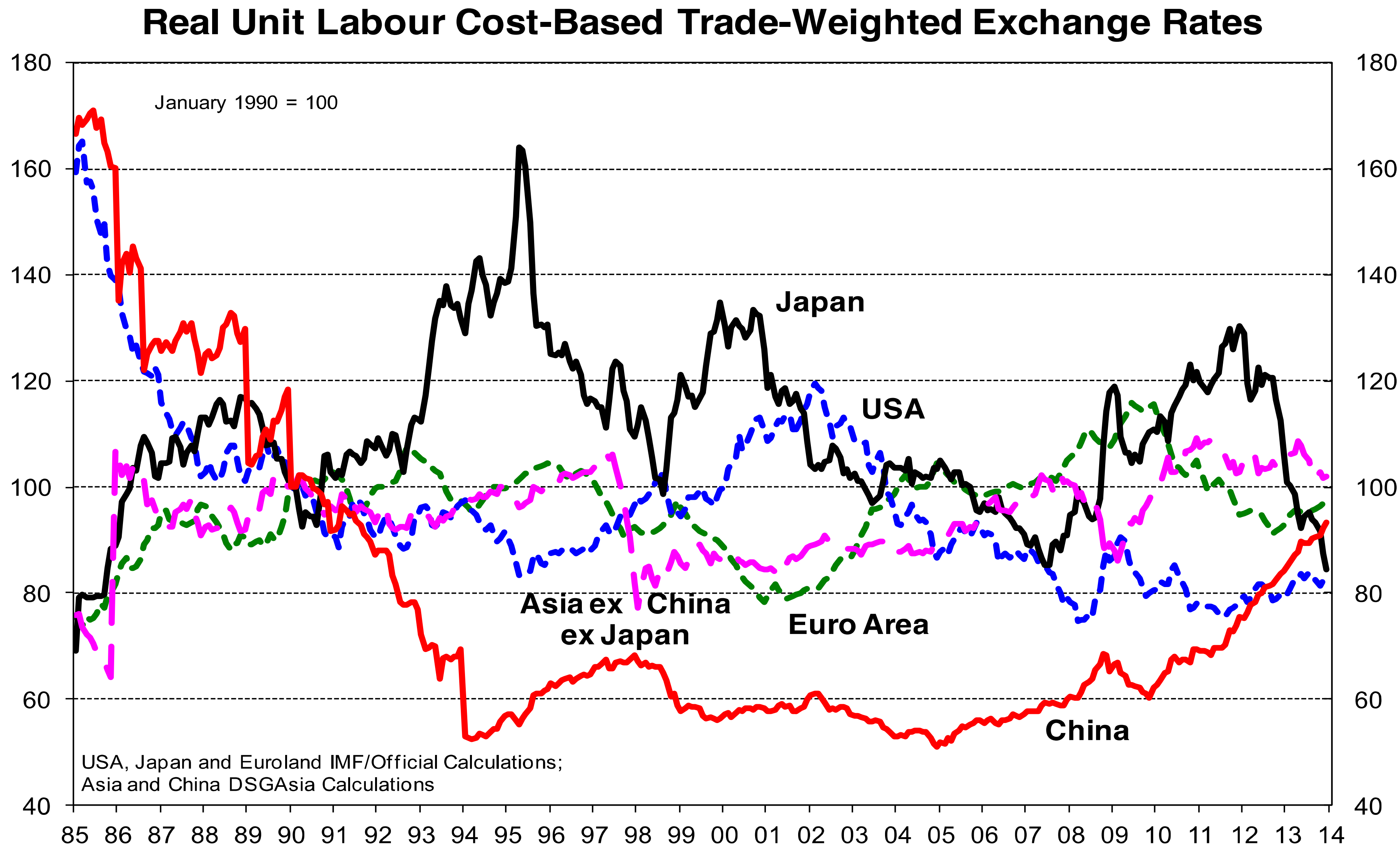
- Technology (Robotics etc) + Demographics are creating Value and Job Destruction, but also creating Value at consumption level. Trick is to balance growth in "value creation + job creation", simultaneously with "value and job destruction".
- Schumpeterian "creative destruction" in "Factory Asia", NPLs in Asia will rise as interest rates rise in response to US tapering.
- China has sufficient resources to deal with key transition, but this requires skillful handling – go for Grandfather, son, grandson reform model; (grab big and free small SOEs - 抓大放小)

China's Role in Global Trade



Source: National Bureau of Statistics of China, 12-months through January 2014

Global exchange rates and current accounts moving into broad balance



Section 2

Central bank swap lines – new foundation of International Monetary System

Fed or IMF no longer lender of last resort to EME

- Asian Financial Crisis proved that IMF not lender of last resort. Loans with conditionality limited and delayed.
- Global Financial Crisis (2007-2009) proved that central bank swaps most useful tool as FX swaps can be used immediately also for domestic liquidity.
- EMEs on their own in defense against capital flows and financial market volatility
  - Asian economies built up sizeable reserves as self-insurance policies against future shocks
  - South Korea, Mexico, Brazil, Chile experience with macro-prudential measures as protection against hot flows
  - Chiangmai + AMRO as a regional self-help and safety net

Five Facts on new IMS

1. FX trading markets averaged $5.3 trillion per day in April 2013, up from $3.3 trillion in April 2007. 2012 Global merchandise trade (X+M) $30 trillion (6 days FX trading) and $6.6 trillion G4 monetary base.

2. US Congress torpedoing IMF quota reforms; IMF and multilateral development banks (WB, ADB etc) constrained in lending due to unwillingness to increase capital

3. Fed's $333 billion dollar swap lines to only 5 central banks: UK, ECB, Japan, Canada and Switzerland)

4. PBOC $426 billion bilateral currency swaps with 26 central banks, focusing on trade facilitation

5. CDB Balance sheet of $1.3 trillion larger than IMF + World Bank together.

Central Bank swap lines as foundation of IMS

- Central banks becoming lender of first resort, particularly in advanced country inter-bank markets
- RMB internationalization through trade facilitation natural extension of path for RMB to go global
- Central-bank-to-central-bank swaps incur sovereign credit risk, but that is outweighed by its positive effects on global liquidity
- Central bank swaps trump IMF lending because it can be provided almost instantly
- BRIC Bank may be convening platform for EME debate on IMS reform

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