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Prospects for Asia and the Global Economy: Conference Summary

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A new volume, *Prospects for Asia and the Global Economy*, summarizes the 2013 Asia Economic Policy Conference hosted by the Federal Reserve Bank of San Francisco's Center for Pacific Basin Studies. The conference focused on challenges faced by policymakers in advanced and emerging economies as they continue to recover from the recent global financial crisis. Issues discussed included the monetary policy spillovers from advanced economies to emerging markets, the costs and benefits of foreign reserve accumulation, and the desirability of macroprudential interventions, restrictions on cross-border capital flows, and financial regulatory reforms to reduce the likelihood of future crises.

This *Economic Letter* summarizes the proceedings of the third Asia Economic Policy Conference hosted by the Federal Reserve Bank of San Francisco's Center for Pacific Basin Studies, featured in the new conference volume, *Prospects for Asia and the Global Economy*. The conference focused on challenges faced by policymakers in advanced and emerging economies as they continue to recover from the recent global financial crisis. Issues discussed included the monetary policy spillovers from advanced economies to emerging markets, the costs and benefits of foreign reserve accumulation, and the desirability of macroprudential interventions, restrictions on cross-border capital flows, and financial regulatory reforms to reduce the likelihood of future crises.

Spillover effects of monetary policy

A major theme of the conference was the global spillover effects from monetary policy in advanced countries. Jerome Powell of the Federal Reserve Board of Governors discussed how accommodative monetary policy in advanced economies, particularly in the United States, has pushed capital into emerging market economies (EMEs) and put upward pressure on their currency values and asset prices. The consequent drag on EME exports has been largely offset by stronger demand from advanced economies. Moreover, from past crises EMEs have learned the importance of maintaining stronger fiscal positions, better regulating and managing banking systems, and, in many cases, focusing central bank policies on inflation targeting while allowing greater exchange rate flexibility. Martin Wolf of the *Financial Times* made a similar point in his address, observing that emerging economies proved far more resilient to the spillover effects from the 2007–09 financial crisis than to past shocks. However, Wolf argued that financial crises are inescapable features of greater risk-taking behavior fostered by economic and financial liberalization in a global economy.

Andrew Rose of the University of California, Berkeley, examined how monetary regimes in small open economies fared during the global financial crisis. He showed that countries with hard-fixed exchange rate pegs or inflation targets generally were able to sustain their regimes during the global financial crisis in comparison to those in the "sloppy center," including various regimes such as crawling bands, adjustable pegs, or monetary aggregate targets. Almost all of the countries that targeted inflation in 2006 were still doing so in 2012; almost three-quarters of those using a hard-fixed peg also survived. This stability is historically unusual because it was very common for countries to abandon their monetary policy regimes during previous crises. In contrast, less than a quarter of countries in the sloppy center maintained the same monetary regime during the crisis and its aftermath.

Rose also found that countries with hard-fixed exchange rate pegs and those with inflation targets had similar macroeconomic performances. This is somewhat surprising, since hard fixers have severely limited monetary autonomy, while inflation targeters are not directly constrained by concerns about the exchange rate. Thus, hard fixers with open capital markets would seem to be substantially less able than inflation targeters to insulate themselves from the spillover effects of foreign capital flows.

A possible explanation is that, because the financial crisis was a common shock, creating a deep recession and strong deflationary pressure virtually everywhere, both independent inflation targeting central banks and the central banks to which hard fixers were pegged all aggressively eased monetary policy. Any countries that had pegged to the dollar or the euro also experienced policy ease because of the actions of the Federal Reserve and the European Central Bank. Thus, for most countries monetary policy was appropriate during the global financial crisis. This might not be the case for other shocks, such as terms of trade or inflation shocks, when the outcomes may be very different for hard-fixed versus inflation-targeting regimes.

Benefits and costs of reserve accumulation

Another issue addressed at the conference was the significant increase in reserve accumulation by emerging market economies, particularly in Asia, in the aftermath of the 1997–98 financial crisis. Countries were motivated to build up reserves to limit currency appreciation in order to remain competitive. They also shored up reserves as insurance against the increased risk of capital flow reversals through currency mismatches, bank runs, and capital flight.

Reserve accumulation has costs, including earning lower interest on reserves than that typically paid on domestic instruments. Other costs may arise if sustained reserve accumulation fuels domestic credit booms and asset price bubbles or creates financial distortions.

Carmen Reinhart and Takeshi Tashiro of Harvard University emphasize that another cost of reserve accumulation could be the crowding out of domestic investment. They describe how, in the wake of the Asian crisis, many governments in the region redirected their borrowing toward the domestic market because external borrowing was either prohibitively expensive or altogether unavailable. Even when capital markets were still accessible, many governments sought to borrow more from "captive" domestic savers, such as pension funds, to lessen rollover risk. This fostered greater competition for domestic borrowers in the home market. The increased cost of borrowing "crowded out" domestic investment in Asia. To the extent that central banks also funneled domestic saving abroad to accumulate foreign reserves, a broader form of crowding out occurred.

Asia growth prospects

The Asian giants, China and India, have experienced historically unprecedented episodes of growth over the past 30 years. Consensus forecasts call for Asia—particularly China and India—to continue to grow strongly. Lant Pritchett and Lawrence Summers of Harvard University argue that past growth performance is of very little value for forecasting future growth, and there are good reasons to expect that future growth in China and India may be much less rapid than is currently anticipated. In their view, abnormally rapid growth is rarely persistent, while “regression to the mean” is empirically robust. Moreover, the risks of sharp declines in growth are much higher in countries with weak institutions, high levels of state control, and limited respect for the rule of law. For these reasons their forecasts for Chinese and Indian growth are much more pessimistic than consensus projections.

Capital account volatility and macroprudential responses

Volatile cross-border capital flows pose challenges for emerging market economies. Capital inflows can be disruptive, opening the scope for welfare-improving macroprudential intervention. This has made macroprudential intervention, particularly restrictions on cross-border capital flows, more acceptable.

During a policymaker panel, Bank of Korea Deputy Governor Woon Gyu Choi discussed the challenges faced by emerging market economies such as Korea. Choi argued that the removal of accommodative monetary policy in advanced economies was analogous to a negative external shock to EMEs and would exert deflationary pressure on their economies. However, the implications of removing accommodation will depend on fiscal policies and domestic economic conditions.

Difficulties with capital inflows are not limited to EMEs. Another panel speaker, Bank of Canada Deputy Governor John Murray, noted a number of similarities between Canada’s situation and that in Asia. These include most notably Canada’s openness and its vulnerability to external shocks from neighboring large economies. However, Murray argued that although Canada’s nominal exchange rate flexibility—which stands in contrast to many Asian nations—has led to episodes of instability, over the long run it has allowed market signals to feed through to the Canadian economy, making adjustments smoother and more timely.

Macroprudential policies, such as capital account restrictions, may involve spillovers to other economies. This raises the potential for welfare-improving policy coordination. However, as discussed by Olivier Jeanne of Johns Hopkins University in his paper, countries can often do best simply pursuing their own interests by designing policies to smooth their own output fluctuations, leaving little scope for mutually beneficial policy coordination.

Financial reforms

Another major policy issue raised by the global financial crisis was the need for financial reforms. Financial disruptions were prevalent throughout the crisis and clearly exacerbated the depth of the downturns in both advanced and emerging market economies.

While a number of regulatory reforms have been adopted since the crisis, Gerard Caprio Jr. of Williams College argued that these efforts need to be reconsidered. Caprio claims that the agreed-upon Basel reforms neglect the endogeneity of risk to the regulatory structure and the dynamic natures of finance and its regulation. In particular, applying similar risk weights for all banks in all countries could induce banks to move into similar asset exposures, increasing the correlation of bank asset returns if conditions deteriorate.

Instead of a complex system of risk weights, Caprio advocated a simple leverage rule supplemented by heightened levels of equity finance and conditional convertible debt, commonly referred to as "CoCos." CoCos automatically convert from debt to equity when equity levels fall below a specified threshold, which could induce banks to follow more prudent lending and funding practices. Caprio also argued for the creation of a "sentinel," which would monitor financial regulators against corrupt or obsolete practices. The sentinel would have no regulatory power but would provide commentary on regulatory practices, forcing the regulator to be more accountable to the public.

Note that financial vulnerabilities are no longer limited to the traditional financial sector, as highlighted in the conference keynote speech by Hyun Song Shin of Princeton University and the Bank for International Settlements. Shin described two distinct phases of global liquidity. In the first phase, from around 2003 to the 2007–09 crisis, looser financial conditions were transmitted across borders through the acceleration of banking sector capital flows. In the second phase, which started around 2010, financial conditions were transmitted across borders through the growth of offshore bond markets, particularly involving the debt securities of emerging market corporations.

Shin argued that, unlike most past financial crises that were based in the banking sector and centered on leverage or maturity mismatches, future crises are more likely to depend on corporate sector activities. This means financial indicators of vulnerability, such as bank leverage, will have limited use as signals. He suggested several alternative measures of vulnerability that better capture the exposure of nonfinancial firms to capital flow reversals. These include offshore borrowing, corporate bank deposits, and other short-term claims of the nonfinancial corporate sector on the domestic financial system.

The recovery also highlighted that the financial sectors of rapidly growing EMEs, such as China, are causing imbalances similar to those that prevailed before the crisis. In the policy panel, David Dollar from the Brookings Institution noted that Chinese deposit interest rates are exceptionally low, leaving households almost no return on savings. Meanwhile, investment options outside of the banking sector, including equities or securities, are very limited. This has caused a large amount of capital to flow into the real estate sector, inflating prices.

Some reform has already taken place. Dollar pointed out that Chinese banks can offer deposit rates up to 1.1 times the benchmark, and the margin may be widened. Moreover, the shadow banking system, in which higher interest rates prevail, has grown considerably.

However, light banking regulations increase the vulnerability of the Chinese financial system, so further interest rate liberalization in the formal banking sector would also be welcomed. In his closing remarks, Professor Barry Eichengreen of the University of California, Berkeley, also considered China's financial sector a potential risk, noting that credit booms rarely end smoothly.

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Conference volume

The conference volume, *Prospects for Asia and the Global Economy*, is available at
http://www.frbsf.org/economic-research/events/2013/november/asia-economic-policy-conference/

Caprio, Gerard. “Financial Regulation after the Crisis: How Did We Get Here, and How Do We Get Out?”

Choi, Woon Gyu. “Current Policy Challenges Faced by Emerging Market Economies and Korea.”

Dollar, David. “Financial and Fiscal Reforms in Support of China’s Rebalancing.”

Jeanne, Olivier. “Macroprudential Policies in a Global Perspective.”

Murray, John. “Transitioning to More Balanced and Sustainable Growth.”

Powell, Jerome. “Advanced Economy Monetary Policy and Emerging Market Economies.”

Pritchett, Lant, and Lawrence Summers. “Asiaphoria Meets Regression to the Mean.”

Reinhart, Carmen, and Takeshi Tashiro. “Crowding Out Redefined: The Role of Reserve Accumulation.”

Rose, Andrew. “Surprising Similarities: Recent Monetary Regimes of Small Economies.”

Shin, Hyun Song. “The Second Phase of Global Liquidity and Its Impact on Emerging Economies.”

Wolf, Martin. “The Shifts and the Shocks: Emerging Economies in an Age of Financial Crises.”

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