36th Asian Shadow Financial Regulatory Committee Statement
January 30th, 2023 – Bangkok

What can Asian Economies do about the US Dollar Global Cycle?

1. Despite the shift to a system of floating exchange rates 50 years ago intended to decouple countries from the US dollar under Bretton Woods, the world remains on a US dollar standard. By large margins, the dollar is the world's premier funding, reserve, invoice, anchor, and vehicle currency. This is an important reason for the outsized impact of US monetary and financial conditions on global activity. For example, as in the past, global inflation rates have not diverged and remain highly synchronized today.
2. The US monetary policy cycle is driven by the current needs of the US economy, but this impacts countries in the rest of the world which often are in different phases of their own economic cycles. Tightening monetary policy may be appropriate for the US to tame inflation there, but this exerts recessionary pressure in the rest of the world, as US tightening tends to reduce US GDP growth and, therefore, US demand for the rest of the world's exports. At the same time, higher yields on US treasuries induces capital outflows from other countries into the US and leads to currency depreciation relative to the US dollar in these countries. The depreciation of their currencies makes these countries' exports relatively cheap and boosts the demand for their output,[1] but it also makes their imports relatively more expensive and so reduces the supply of these goods in the domestic economy, both of which impart inflationary pressure on these countries. In an attempt to prevent large depreciations of their currencies against the US dollar and consequent adverse effects, central banks have responded by intervening directly in foreign exchange markets, selling US dollars and buying local currency to dampen US dollar appreciation, and by raising domestic policy rates, both of which further aggravate

[1] Whether the export boosting effect is stronger than the import dampening effect from a depreciation of the currency depends on the so-called Marshall-Lerner condition. If this condition holds, a currency depreciation by a country will have a net expansionary output effect.

recessionary pressure in these countries.

For Emerging Markets and Developing Economies (EMDEs), in particular, using a set of 26 EMDEs over 1999-2019, Obstfeld and Zhou (2022) find that US dollar appreciation shocks predict declines in output, consumption, and government spending, a decline in the traded-goods sector, a fall in the terms of trade, a decline in domestic credit, and a widening of the sovereign borrowing spread for foreign currency loans. The impact on EMDEs is stronger as these countries typically have relatively weaker institutions and policy frameworks, weaker policy transmission, shallower and more distorted financial markets, dollarized liabilities, and a greater vulnerability to capital flow reversals.

Trade and invoicing are predominantly in US dollars. The use of the US dollar in global trade invoicing is approximately 50% whereas the use of the US dollar in world FX transactions is approximately 90%, where one side is the US dollar (Obstfeld and Zhou 2022 p17). The overwhelming use of the US dollar in financial transactions, relative to that based on the requirements of goods trade alone, implies that financial market stability may be threatened. The huge amount of US debt and US actions taken from the perspective of US national interests under the existing US dollar standard make all countries holding or needing to trade in US dollars vulnerable to financial and economic shocks emanating from the US. For example, disrupting the global payments system by blocking specific countries negatively impacts not only the countries targeted, but also the countries with whom they trade.

3. The benefits of a multi-polar currency system

A multi-polar currency system will be better as there will be less dependence on a single monetary authority's actions, which increase the vulnerability of other countries when their economic cycles are not in sync with the phases of US monetary policy and economic cycles. The dominance of US monetary policy under the prevailing US dollar standard also circumscribes the ability of authorities elsewhere to respond more independently to external shocks that hit them. A multi-polar currency standard will likely reduce the risk of adverse externalities on the rest of the world.

4. Moving to a multi-polar currency world

The merit of the safe-haven notion relating to US dollar alone needs to be critically evaluated. Diversification in the global currency standard reduces the risk of externalities having outsized effects arising from changes in the value or liquidity of a single currency. It has been shown, for example, that the rate of currency depreciation relative to a basket of currencies of major trading partners is less than that relative to the US dollar alone (Kamin, 2022). At the same time, studies have shown that a flexible exchange rate regime under an inflation targeting monetary framework is not a silver bullet to attain the macroeconomic goals of output growth and inflation control, and the goal of financial stability. However, countries that adopted more flexibility in their exchange rate regime had better outcomes in both, than those that had less flexibility.

Recommendations:

- Continue to enhance and expand regional economic integration in ASEAN and other Asian economies particularly by deepening regional financial markets. A priority in market development should be the creation of a regional corporate bond market. To this end, Gochoco-Bautista and Remolona (2012, pp. 36-37) make three proposals which we endorse:

  Improve the Asian Bond Market Initiative (ABMI) by (i) having common standards for issuance, (ii) having an interdealer regional trading platform in which designated corporate bond market makers from each jurisdiction agree to provide liquidity in exchange for certain privileges such as special access to a regional repo market, (iii) having a regional centralized counterparty for credit default swaps on ASEAN names.

  Establish a zone of free capital mobility in ASEAN+3 to include the mutual recognition of funds and instruments of the different jurisdictions, the removal of withholding taxes for flows within the region, and the harmonization of macroprudential rules for managing capital flows from outside the region.

  Extend the Chiang Mai Initiative Multilateralized (CMIM) into a regional repo market to provide a daily source of additional liquidity rather than only during a crisis. Central banks could agree to accept cross-border collateral in the form of government and corporate bonds from within ASEAN +3.

We suggest that multilateral institutions like the Asian Development Bank and Asian Infrastructure Investment Bank help build the regional financial infrastructure to facilitate regional market integration.

- Encourage the greater use of regional currencies in goods and financial trades. One recent initiative is an agreement that the People's Bank of China signed with the Bank for International Settlements (BIS) to establish a Yuan pooling scheme with the central banks of Indonesia, Malaysia, Hong Kong, Singapore, and Chile to create a reserve pool and provide liquidity support to these central banks during periods of market volatility. This would incentivise firms to invoice international trade in local currencies and assist in the search for alternative "safe assets" to the US dollar.
- Build local risk management capacity at the firm level and greater financial inclusion as part of central bank initiatives to encourage the use of fintech in transactions.
- Digital currencies and distributed ledger technologies (DLT) can potentially be used to deliver real-time, cheaper, and safer cross border payments and settlements. An example of such an initiative is a prototype of multiple Central Bank Digital Currencies (mCBDCs) known as the mBridge project, developed by the BIS Innovation Hub and four central banks.

References:

Gochoco-Bautista, M.S. and Remolona, E.M., "Going Regional: How to Deepen ASEAN's Financial Markets." ADB Economic Working Paper Series, No. 300, January 2012.

Kamin, Steven, "Will the Strong Dollar Trigger a Global Recession?" AER Economics Working Paper 2022-13, October 2022.

Obstfeld, M and Zhou, H., "The Global Dollar Cycle." Brookings Papers on Economic Activity, BPEA Conference Drafts, September 2022.