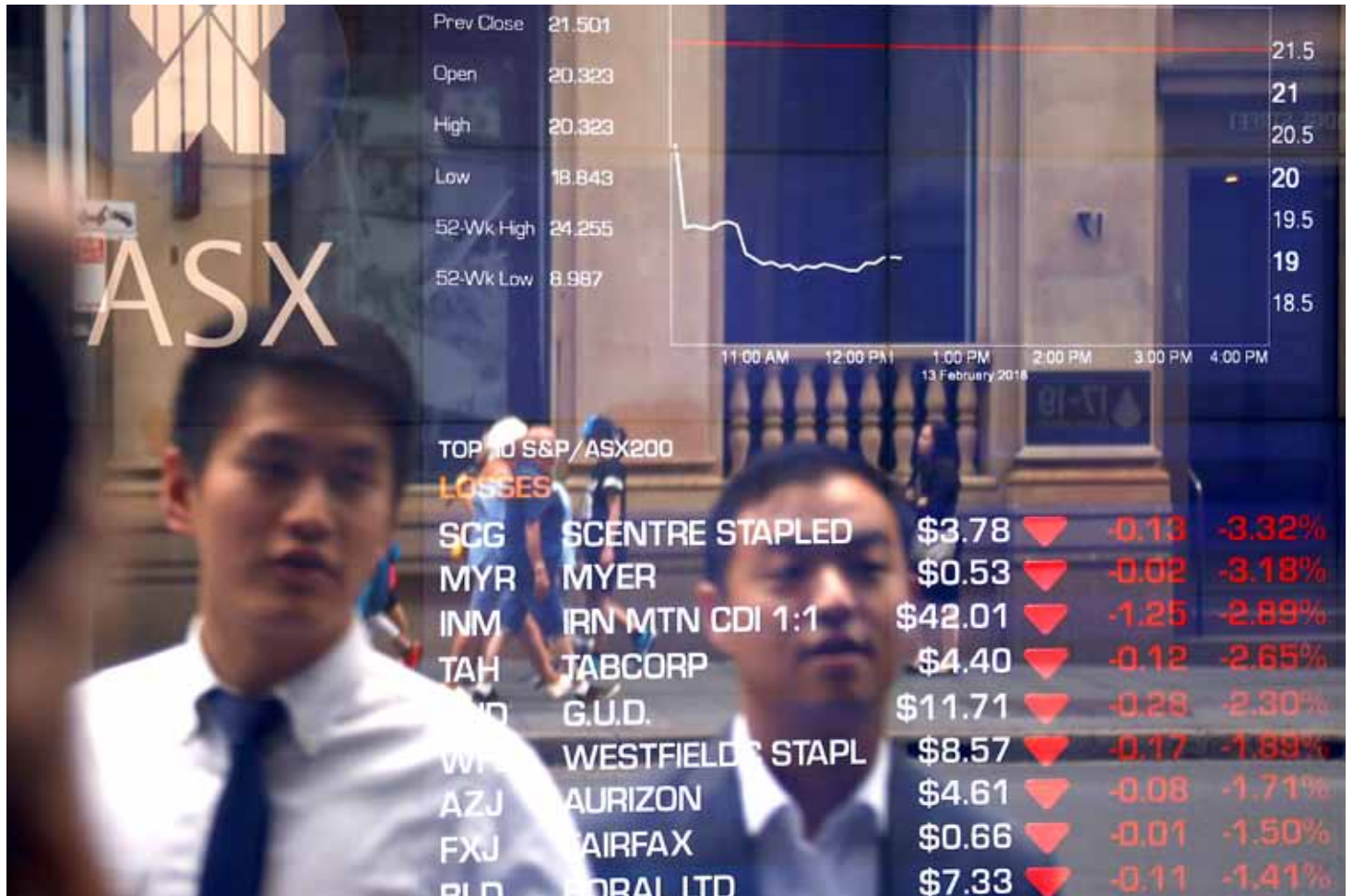


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Asian crisis, ready or not

Edwin M. Truman Is the global safety net ready for the next Asian crisis?

Paola Subacchi Lessons from Europe

Mari Pangestu How to save the world trading system from Trump

M. Chatib Basri Financial risks could derail Asia's growth ... **and more**

ASIAN REVIEW

Neil Thomas – New and old: foreign policy under Xi Jinping

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Quarterly

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From the editor's desk

'Brighter prospects, optimistic markets, challenges ahead.' That was the title of the International Monetary Fund's World Economic Outlook update in January this year.

How quickly things change.

Since that report was published, turbulence, volatility and crises have dominated the landscape. The trade war between the United States and China has escalated at an alarming rate. The World Trade Organisation appellate body looks set to be shut-down. Argentina is in crisis. Turkey is not far off. Markets have been rattled in Indonesia, Myanmar, Italy and Spain as financial conditions tighten. The fallout from Brexit is more uncertain than ever. Populist politicians continue their rise. China's financial system remains problematic. The United States faces bitterly contested congressional and presidential elections with a possible 2020 recession thrown into the mix. Geopolitical tensions remain high with Iran, North Korea and Russia.

With all these risks, now is a good time to review our capacity to respond to crises. This issue of *East Asia Forum Quarterly* does that. It explores the major financial and economic risks facing the Asia Pacific today and the region's capacity to withstand and respond should those risks materialise.

The authors in this edition start by surveying the major risks facing the region and its economies. They explore the capacity of global institutions like the IMF to respond in different crisis scenarios. They look at the critical role played by regional financing institutions, such as the Chiang Mai Initiative Multilateralization, in supporting stability. They explore what role development banks can play in bolstering financial resilience and supporting countries facing a crisis. They examine how bilateral currency swap lines can be better coordinated and what role they should play in supporting countries in trouble. They assess what can be done domestically to strengthen the resilience of Asia's economies and financial systems and how regional forums like APEC can support these initiatives.

As the Chinese proverb tells us, 'The best time to plant a tree is 20 years ago. The second-best time is now'. The same is true in preparing for crises.

Asian Review features a fresh assessment of Chinese foreign policy and the strategic repositioning of APEC beyond 2020.

Adam Triggs

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Domestic resilience a defence against crisis

COVER: Red markers show the falling listings on the Sydney Securities Exchange in February 2018. Like other countries in the region, Australia is not quarantined from financial instability. Picture: David Gray, Reuters.



Indonesian Finance Minister Sri Mulyani Indrawati speaking in front of a backdrop of a flag-carrying child at the Finance Ministry in Jakarta. 'Upgrading human capital' is one area on which Indonesia must focus to achieve its growth potential.

Financial risks could derail Asia's growth

M, CHATIB BASRI

A SIA has the potential to continue to be one of the main contributors to global growth. But this does not mean that the road ahead will be easy. Financial risks stemming from volatile capital flows are presenting challenges right now. And ageing populations across the continent look set to cause headaches that could last for generations.

In the short term, Asian countries including Indonesia, India and the

Philippines, are at risk of financial instability arising from the volatility of capital flows. Since portfolio investments play a substantial role in financing these countries' current account deficits, they are vulnerable to capital flight when investment in other economies becomes more attractive. And the US Federal Reserve's normalisation of monetary policy—which involves raising the target range for federal funds and reducing its holdings of securities—is providing exactly that shock.

Although a variety of reforms, such as getting rid of the fuel subsidy, have been put in place, Indonesia remains particularly vulnerable to this type of external shock. In Indonesia, panic is usually triggered by the bond market, due to the relatively large role of foreign holders in funding the government's deficit. Historically when a shock occurred in the United States—as happened during the Taper Tantrum or in the current normalisation of monetary policy—bond market investors withdrew

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their portfolio investment, triggering turmoil in financial markets.

A large current account deficit is not necessarily a bad thing, as long as it is financed by long-term and productive foreign direct investment (FDI), such as that in export-oriented sectors of the economy. But if it is financed by portfolio investment, it can increase a country's vulnerability because these funds can be withdrawn at short notice. This is part of what makes the 'Fragile Five' countries—India, Indonesia, South Africa, Turkey and Brazil—so volatile.

Economic vulnerabilities make portfolio investors nervous, and that induces them to withdraw their portfolio from emerging economies. In the future, if Indonesia does not resolve this problem, it will continue to be dogged by the volatility of capital flows. For now, Indonesia should consider introducing a tax on speculative international financial transactions or other macro-prudential policies to minimise the impact of volatile short-term capital flows. But the depth of this problem necessitates structural shifts.

In Indonesia, there is a strong correlation between investment and imports of capital goods and raw materials. The higher the economic growth from increases in investment, the higher the current account deficit. Thus, Indonesian economic growth in the short-term is always constrained by the current account deficit. When external shocks occur, like that which is happening now, capital outflow from portfolio investment spikes and the rupiah weakens significantly. But if the current account deficit were financed by FDI the risk of capital volatility would be smaller, since capital wouldn't be able to leave as quickly.

Thus, to stimulate economic growth while also maintaining economic

Although Indonesia will be one of the 10 biggest global economies in terms of economic size, by 2050 its per capita income will still be relatively low if economic growth remains flat at 5 per cent

stability, Indonesia must improve efficiency and productivity; therefore the same investment will generate higher returns and be less susceptible to shocks from changes in other countries' policies. Indonesia should focus on economic deregulation to increase efficiency, and improve human capital, infrastructure development and governance to improve productivity. Another option is to steer FDI towards the export-oriented manufacturing sector.

Fixing short-term capital volatility will only go so far if long-term structural issues—such as demographic shifts—are not managed. In the long run, the fiscal burden of an ageing population must also be considered a financial risk.

Many Asian countries have ageing populations. This often affects fiscal health. An increase in the dependency ratio, resulting from an increase in the proportion of older citizens, negatively impacts government savings because expenditure on pensions and health services rises while revenues fall. For example, as the population is ageing, the fiscal allocation on social spending

in Singapore and Hong Kong is rising dramatically. Japan and South Korea are facing clear financial pressures due to their ageing populations.

It is true that both India and Indonesia will benefit from a demographic bonus in 2025 and are expected to be ranked among the top 10 countries in terms of economic size. But in the case of Indonesia, this demographic bonus will run out in 2050, and by 2060—while its situation will not be as severe as that in Japan or South Korea—Indonesia will also have an ageing population.

The challenge is for Indonesia to stimulate higher economic growth more quickly. Why? Because although Indonesia will be one of the 10 biggest global economies in terms of economic size, by 2050 its per capita income will still be relatively low if economic growth remains flat at 5 per cent. If Indonesia is unable to grow faster, it risks growing old before it grows rich. This could be very difficult to manage because Indonesia's fiscal burden will be very heavy. The same issue will likely be faced by many other Asian nations, especially China.

Even though Asia is one of the largest contributors to global economic growth, these financial risks could damage potential growth in coming years. To address these issues, countries like Indonesia must focus on increasing economic productivity and efficiency, upgrading human capital, building infrastructure, improving governance and mobilising tax revenue for public spending. If these steps are not taken, Asia's and Indonesia's contribution to global economic growth cannot be guaranteed. **EAFQ**

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Is the global safety net ready for the next Asian crisis?

EDWIN M. TRUMAN

N EITHER Asia nor the global financial safety net (GFSN) is ready for the next crisis in the region. There are three reasons for this. First, there is a lack of consensus about the purpose of the GFSN and the place of the Chiang Mai Initiative Multilateralization (CMIM) within it. Second, threats to the size of the resources of the International Monetary Fund (IMF) at the centre of the global system are emerging. Third, mechanisms to manage the GFSN are not agreed.

The IMF staff state that the purpose of the GFSN is 'to provide countries with insurance against crises, financing when shocks hit, and incentives for sound macroeconomic policies'. Many countries would not include the third element of this triad. They see the GFSN more narrowly as a framework to provide unconditional liquidity support to countries that are 'innocent bystanders', receiving spillovers from economic and financial crises in other countries, or that are exposed to the fickle vicissitudes of global financial markets.

This narrow view of the GFSN is specious. No country is truly an innocent bystander. Countries only exhibit different degrees of vulnerability to foreign or domestic crises. The task of national policymakers is to manage the tradeoff between excessive risk and excessive caution in their pre-crisis policies.

When they get the tradeoff wrong in the face of a foreign shock, domestic shock or both, their policy choices are at fault.

Failure does not mean that countries should not have access to the GFSN, as narrowly defined. The principal questions are how far a country falls before it is rescued and what the associated conditions for rescue should be. In the broader sense of the GFSN, all forms of conditional IMF lending should be viewed as providing a safety net for the borrowing country, preventing a crisis from worsening, as well as for other countries in the system that might be subject to negative spillovers from the policies of a country in crisis.

The broadest estimate of the size of the GFSN today is that it includes countries' international reserves excluding gold (US\$11.8 trillion), total IMF quota resources (about US\$700 billion), IMF potential borrowed resources (about US\$725 billion), regional financial arrangements (about US\$850 billion), limited bilateral swap arrangements (about US\$200 billion) and bilateral swap arrangements whose size is unlimited for a total of US\$14.3 trillion, not including the last component. A narrower definition would exclude international reserves and any IMF lending facilities that are associated with economic policy conditions for countries drawing on the GFSN for short-term liquidity purposes, or about \$1.2 trillion.

Where does the CMIM fit within



Casting a net for the small fry is one thing, but will the global financial safety net be able to contain the next big crisis?

the GFSN? The CMIM is a regional financial arrangement of US\$240 billion. But the CMIM is a cross between a narrow, unconditional GFSN mechanism and a broader, potentially conditional mechanism designed to supplement financing from an IMF-supported adjustment program. Subject to agreement to activate the CMIM, a participating country may draw up to 30 per cent of the 'purchasing multiple' of its financial contribution to the mechanism without an IMF program. For example, Korea's financial contribution to the CMIM is US\$38.4 billion and its purchasing multiple is 1.0. In 2008 during the global financial crisis, Korea might have qualified to draw US\$11.5 billion from the CMIM. In contrast the Federal Reserve established a US\$30 billion swap agreement with Korea. The Fed had to

approve each drawing, but drawings peaked at US\$16 billion.

The IMF must be at the centre of the GFSN in the provision of temporary financial assistance because it is the only institution that is empowered to provide a financial and economic policy backstop to the GFSN if that financial assistance proves inadequate because a country's ex-ante policies were not up to the test of the shock. To play this role the IMF must be accepted as the final arbiter of whether a country needs to adjust its policies in the face of a shock and must also have adequate resources to help cushion the shock.

Unfortunately, neither countries potentially in need of temporary external financial assistance nor potential major creditor countries currently embrace this role for the IMF.

Countries looking for what they see as liquidity assistance reject the idea that their policies may need adjustment in the face of changed global economic conditions. They are looking for financial assistance with no policy strings attached.

The changing mix of creditor countries, on the other side, is reluctant to fully fund the IMF to play its role at the centre of the GFSN alone. Concerns over moral hazard lead member countries not to provide the IMF with unlimited financing. They prefer to rely on ad hoc mechanisms over which they have more control.

During the peak of the global financial crisis, the Federal Reserve provided a financial safety net for much of the international financial system. In December 2008, the Federal Reserve's balance sheet included

more than US\$1 trillion in advances to foreign central banks and financial institutions that were chartered in other countries: \$583 billion in swap lines with foreign central banks, \$334 billion using conventional lending tools (repurchase transactions, discount window advances, and the term auction facility), and an unspecified amount under emergency authority. However, US\$693 billion was outstanding under this authority in December 2008. An estimate that 15 per cent of the total benefitted foreign institutions would be conservative given that almost half of the conventional lending was to non-US institutions.

In December 2008, total IMF financial resources were only US\$362 billion. The IMF was not in a position financially to backstop extensions of credit by the US Federal Reserve. This, in turn, was one factor limiting the Fed's appetite for further expanding the swap network to more than four emerging market economies: Brazil, Korea, Mexico and Singapore.

TODAY, the IMF's financial resources are US\$1.4 trillion consisting of US\$700 billion in quota resources and about US\$700 billion in potential borrowing from the New Arrangements to Borrow (NAB) (US\$265 billion) and bilateral borrowing arrangements (\$US450 billion). As of the middle of August 2018, the IMF's available resources for lending out of quota resources were reduced by lending commitments of US\$222 billion and its forward commitment capacity out of quota resources was estimated at only US\$261 billion. Resources potentially available from borrowing arrangements were US\$516 billion for a total lending capacity of less than US\$800 billion. Moreover, \$450 billion

of the headline \$1.4 trillion consists of bilateral lending commitments that expire in 2020. The \$41 billion commitment by the United States to the NAB will expire in 2022 unless the US administration asks Congress for its renewal.

Observers hoping that the United States will not withdraw from the NAB or will support an increase in IMF quotas large enough at least to replace the expiring bilateral borrowing arrangements are likely to be disappointed. In July, Treasury Secretary Mnuchin stated, 'At this time, the United States finds that the IMF's resources are adequate following the 2016 implementation of the 2010 Quota and Governance Reform.' The problem with his statement is that a judgment about the adequacy of IMF financial resources should not be based on estimates of the IMF's needs at present but in the future, in the decade after 2020. The challenge of obtaining congressional support for an increase in the US quota was reinforced in a 3 August 2018 letter from US Senators to Treasury Secretary Steven Mnuchin expressing concerns about potential requests for IMF financial assistance from countries that had become overly indebted to Chinese lending in connection with China's Belt and Road Initiative (BRI). US support for IMF lending is likely to be increasingly and overtly politicised, complicating the IMF's role at the centre of the GFSN.

Even if adequate IMF financial resources were assured, a consensus on how to manage them in support of the GFSN as a liquidity support mechanism has not been established. At present moral hazard concerns prevent the fund from having the financial resources to support a GFSN on the scale sufficient, by itself, to cover all eventualities. Consequently,

the IMF must turn to the major central banks because that is where the high-powered money is. The central banks require, at a minimum, that the IMF has both sufficient resources and the policy clout to provide a financial and policy backstop for any short-term financing the central banks may advance as part of the GFSN.

MANY mechanisms have been proposed that in principle could meet the needs of the major central banks and induce them to be lenders of first resort in the GFSN. With respect to a policy backstop, two approaches dominate the current debate. The first is an ex-ante procedure in which the IMF finds that a country's policies are sufficiently strong for it to be eligible for an IMF flexible credit line that it could use to repay the central banks. The second is a commitment by the drawing country that if it cannot repay the central bank or central banks within a set time period of, say one year, the country would ask for an IMF adjustment program. The two mechanisms could be combined.

Neither Asia nor the GFSN is prepared for the next crisis in the region. The IMF is likely to lack sufficient financial resources to backstop the GFSN as a short-term liquidity facility. Asian countries are not prepared to accept the potential need for a policy backstop from the IMF if a country receives temporary liquidity support from central banks inside or outside the region. Consequently, the major central banks are not prepared to commit to be a first line of defence. **EAFO**

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How to save the world trading system from Trump

MARI PANGESTU

DESPITE expectations that the US Federal Reserve would raise interest rates, capital flows to the United States have led to the appreciation of the US dollar against most major currencies. The hardest hit countries are Argentina and Turkey, which are experiencing fiscal issues complicated by their political situations. Brazil, South Africa and the emerging countries in Asia have also been affected—albeit at a lower rate of depreciation of their currencies in the 10 to 12 per cent range. Even Australia has experienced depreciation of around 8 per cent and China around 5 per cent.

The level of depreciation experienced by different economies reflects how investors perceive their different fundamental macroeconomic conditions and policy outlooks. Especially relevant to this calculation is the level of their current account and fiscal deficits as well as their exposure to dollar denominated debts.

The rising US dollar raises questions about the capacity of emerging economies to service their dollar-denominated debts, and the vulnerabilities this could expose in their financial systems. Even if the current economic conditions point to a low potential for contagion from Argentina and Turkey, IMF Managing Director Christine Lagarde recently warned that ‘these things could change rapidly’. The uncertainty that already exists is a clear and present danger.

The ‘danger’ has been building, especially since January 2018, and has dampened the upbeat outlook that existed in 2017. In January 2018, US President Donald Trump made good on his threats to protect what he sees as American national interest against ‘unfair trade’—as measured by bilateral trade deficits—by imposing tariffs on imported solar panels and washing machines, followed by aluminium and steel

Since March, the greatest uncertainty has been from the brewing trade conflict between the United States and China, which then started with the imposition of 25 per cent tariffs on US\$50 billion of China’s imports to the United States. China retaliated with the same sized tariffs

The most concerning aspect of all this is that, after 75 years of being its greatest advocate, the United States is now the biggest threat to the future of the rules-based trading system

on the same amount of trade. The United States has since escalated its threat to expand its tariffs to US\$100 billion of Chinese imports, then US\$200 billion and then to US\$400 billion—the size of US trade deficit with China. On 17 September, he escalated the trade war with China with the announcement of 10 per cent tariffs on US\$200 billion worth of Chinese exports to the United States.

The global impact from US policies and the uncertainties surrounding them are clearly evident from the Economic Policy Uncertainty Index which is now much higher than it was during the global financial crisis in 2009. It peaked in June 2016 with Brexit, and again at the beginning of Trump’s term in office as the US left the Trans Pacific Partnership and began to take to task countries with which the United States has a trade deficit. The threats did not materialise into action, so the uncertainty index went down in 2017, but since January 2018 it has been rising again as we have seen trade conflicts escalate. That has been driven especially by China retaliating and the threat of a trade war increasing after the China–US talks in late August failed to resolve the dispute. The US–China trade conflict and the uncertainty surrounding it is expected to have knock on effects on global trade and investment flows.

This impact is expected to be particularly large for emerging economies, since their external balances are already in a vulnerable situation. And the reduction in exports



Mechanics at a Bangkok garage work on a Harley Davidson motorcycle. The iconic Milwaukee marque plans to expand production in Thailand for non-US buyers.

from China to the United States and its consequent impact on China's growth will reduce Chinese imports, which in turn will impact the entire world, given that China has become a major trading partner for many countries.

This means that China and other countries facing US trade restrictions will look for new markets for their goods. The situation has already led some countries to impose restrictions or initiate trade remedy investigations, for instance on steel. This uncertainty has and will continue to influence trade and investment, as businesses evaluate how the increased restrictions will affect their supply chains.

For example Ford, the US vehicle manufacturer, has announced that

it has cancelled plans to export China-made Focus cars to the United States from the beginning of next year because it would be subject to a 25 per cent tariff. Harley Davidson earlier in the year also announced that it planned to expand production in Thailand to service markets where US exports were going to be hit by tariffs.

A recent survey of business uncertainty by the Federal Reserve Bank of Atlanta indicates that 20 per cent of businesses are reassessing their capital expenditure plans in the light of the recent trade instability, including fear of retaliation. Concerns were even higher for manufacturing firms. Similar surveys in Japan and by Reuters indicate concerns that

are leading business to postpone investment decisions because of uncertainty in trade policy.

It is too early to tell how large the disruption will be, as it is not easy to dismantle supply chains. The costs down the line could be great as businesses re-evaluate their trade and investment decisions, basing them not on the notion of competitiveness but for protection and to insulate themselves from tariffs.

The most concerning aspect of all this is that, after 75 years of being its greatest advocate, the United States is now the biggest threat to the future of the rules-based trading system that has provided predictability and fairness in the way the world engages in trade.

There is no clear light at the end of the tunnel.

The key question is: what is Trump's real intention? Is it to change the rules of the game to benefit the United States and address the 'non-market oriented policies' of China, especially with regard to intellectual property and technological transfer? Or is it just anti-trade and America First? Assuming it is the former, there are at least three important responses needed.

First is safeguarding the stability of the World Trade Organization as the overarching framework to provide predictability, fairness and stability. To this end, it is vital that the WTO dispute settlement mechanism continues to operate. The test case is the Chinese and EU case of US tariffs on steel and aluminium and getting past the blocking of panel judge nominations by the United States. On the latter issues the majority of members need to get behind this. Japan, the European Union and other

major Asian countries can lead.

Ensuring that the United States does not use blunt unilateral instruments to address its concerns also means that reforms to the WTO rule book will be needed. More must be done to address concerns around intellectual property rights, investment, the environment, labour, competition policy, subsidies, tax, digital data and the treatment of developing countries—emerging economies are expected to play a bigger role.

The major countries need to take a leadership role to initiate the changes. Ideally it would involve the United States and China, but there could be a number of pathways, such as a US–EU–Japan push, as suggested at the recent trilateral meeting of their trade ministers. Another possibility is an East Asian push: Japan and China could also provide the required political capital. And ASEAN, South Korea and other middle powers may be able to play a role too. It is in the interest of East Asia to be part of this

push given the past and future benefits to their development predicated on an open and rules-based trading system.

Second, the process of opening-up must continue, with or without the United States. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership is a good start. And it is of the utmost importance that the Regional Comprehensive Economic Partnership negotiations are concluded in November this year. Consolidation in the future can also expand to a region-wide agreement. These are all important processes to signal the continued commitment of East Asia to expanding markets and fostering flows of trade and investment.

Third, and what most will agree is the most important process, is unilateral reforms. Given increased uncertainties and limited policy space for fiscal stimulus, structural reforms are a must for the many countries in East Asia, especially China. These range from trade and investment reforms, as well as reforms to factor markets such as labour, and issues related to competition policy, intellectual property, the role of state-owned enterprises and sustainability, which are important for the country's own structural change and development. It is important to note that, as in the past, unilateral reforms are more successfully conducted with peer pressure and benchmarking from international commitments.

Without these steps, the future of the rules-based trading system will remain under threat. [EAFQ](#)

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US President Donald Trump with Treasury Secretary Steve Mnuchin: is Trump's intention to change trade rules to benefit the United States, or is it 'anti-trade and America First'?

PICTURE: KEVIN LAMARQUE / REUTERS



Trumping financial risks in Asia

The US Federal Reserve building in Washington DC. President Donald Trump is opposed to the Fed raising interest rates.

ANDREW SHENG

IN JULY 2018, the Bank for International Settlements (BIS) asked whether the world was heading towards a perfect financial storm, with the US stock market heading for record highs even as emerging markets like Argentina and Turkey were running into foreign exchange problems. Twenty years after the Asian financial crisis of 1997–98 and the global financial crisis of 2007–08, storm clouds are gathering once again.

Conventional economic models failed to predict the last two crises because the technical definition of financial risk is measured volatility. The global financial crises proved that current models of financial risk, largely

used by banks and financial regulators, are totally blind to Black Swan or Grey Rhino events of unmeasurable uncertainty.

This time round, the consensus is that the Grey Rhino (an event with high probability and high impact, but where the trigger is uncertain) is the looming rise in US interest rates in response to a domestic economy that is running at nearly full capacity, with low unemployment levels and signs of creeping inflation. As the BIS has warned, non-financial borrowers outside the United States owe US\$11.5 trillion dollars, of which US\$3.7 trillion is owed by emerging markets.

Turkey’s recent currency woes are symptoms of domestic policies badly managed, aggravated by the US threat

of economic sanctions. Turkey alone has US\$467 billion of foreign debt. As global risks rise, capital is flowing back to the booming US stock market and potentially higher interest rate yields. Emerging markets have no alternative but either to allow exchange rate depreciation or defend themselves with higher interest rates that depress their own growth potential. Recently both Indonesia and Hong Kong had to defend their exchange rates through higher interest rates and intervention, respectively.

The tricky thing about US interest rates is that economies with high domestic and foreign debt are vulnerable to tighter liquidity and financial fragility, because their interest rates and credit-risk spreads

rise non-linearly. Doomsayers of East Asia's financial collapse argue that China's debt of 250 per cent of GDP is the tipping point.

Financial risks are rising not just in China, but globally. Dun and Bradstreet's Global Risk Matrix, published in May 2018, suggested that US interest rate rises could trigger a fresh debt crisis, sending the global economy into contraction. Echoing this sentiment, the International Monetary Fund's July 2018 World Economic Outlook argued that rising trade tensions are threatening growth recovery in Europe, Japan and Britain more than predicted. Any overheating in the United States would trigger currency crises for some emerging markets.

In short, we cannot separate financial risks from geopolitical risks. Any unforeseen event arising from a geopolitical miscalculation, climate change disaster, war or cyber-induced disruption could trigger another round of financial crises.

Global financial fragility comes from two structural imbalances. First, the United States is the leading deficit country in terms of trade and debt, owing the world a net US\$7.7 trillion, or 39.8 per cent of GDP. This amount is growing because of rising fiscal debt and the low level of national savings. Second, below-par global growth since 2008 has been underwritten almost completely by central bank unconventional monetary policies, which have brought interest rates to an unsustainably low level.

Market fears that the large central banks will withdraw quantitative easing—QExit—threaten to jeopardise the current frail recovery, which is why US President Donald Trump is also against the Federal Reserve raising interest rates.

If geopolitical risks trump financial

President Trump assumes that bilateral negotiations can reverse the unsustainable growth of national debt, which tripled in the last decade and may grow to 100 per cent of GDP in another decade

risks, what could go wrong in the coming months?

Western analysts think that the trigger will be a Chinese debt meltdown. But Chinese debt is internal debt, as China has foreign exchange reserves equivalent to 188 per cent of its foreign debt and still runs a current account surplus. China's debt problem is an internal debt issue, very much like that of Japan. While Japanese debt is owed largely to Japanese households, Chinese debt is largely owed by state-owned enterprises and local governments to state-owned banks. In such a situation, China is well positioned to rewrite its national balance sheet, a privilege not possible for more privately dominated markets.

A possible Black Swan (a low probability but high impact event) is an unexpected sharp increase in the yen-dollar exchange rate. Japan is the third largest economy after the United States and China and has been increasing its overseas assets since the 1990s. Between 2007 and July 2018, the Bank of Japan has grown

its assets the most among the major central banks to US\$4.9 trillion, or just over 100 per cent of GDP. By the end of 2017, Japan's gross foreign and net assets grew to US\$9 trillion and US\$2.9 trillion respectively, equivalent to nearly one quarter of US growth in gross foreign liabilities during the same period.

US trade deficits have been sustained by foreign inflows (which had central bank origins) in which Japan is a major player. During the Asian financial crisis, sharp volatility in the yen-dollar exchange rate caused a dramatic withdrawal of Japanese bank loans from Asia, aggravating a regional liquidity crisis that was already spurred by speculative currency attacks.

What complicates today's financial fragility is Trump's attempt to control the US trade deficits. He assumes that bilateral negotiations can reverse the unsustainable growth of national debt, which tripled in the last decade and may grow to 100 per cent of GDP in another decade. But tariffs only increase inflation for the consumer, which would trigger higher interest rates and jeopardise the fragile financial stability achieved through unsustainable monetary policies.

The next global crisis will most likely be triggered by geo-political mistakes. In an age when politicians are proving fickle in their decisions, central bankers are perhaps the only professionals who appear able to do something about financial risks. But since Trump does not care much about professional advice, Asian markets worry less about measurable financial volatility than unmeasurable personality risks. **EAFC**

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The public face of government: a police officer directs the response to a fire in Hazira, India. Greater public trust in officialdom builds domestic resilience.

Getting ahead of the next crisis in Asia

GORDON DE BROUWER

THE tenth anniversary of the global financial crisis has provided the occasion for serious reflection about the prevention and resolution of financial and economic crises, and whether the key lessons from the crisis have been addressed. In Asia and the Pacific, there are other crises to think of: it has been two decades since the Asian financial crisis, two-and-a-half decades since the Latin American crisis, three decades since Australia's and Japan's

home-grown financial crises, and four decades since the collapse of the Bretton Woods system of fixed exchange rates.

Financial crises are regular and serious, and they have devastating economic and social effects. It is hard to reform, given that change affects vested interests and can be hard to explain politically. And it is hard to prevent crises, given the structural vulnerabilities and trigger events that lead to a collapse of confidence vary in each case. Much of the focus of reform is on how to improve the

resilience of financial systems and economies, particularly on market design, risk management, regulation and supervision, and the adequacy and effectiveness of safety nets.

The world—and the Asia Pacific region maybe more than other regions—is vulnerable to spillovers from events like trade and currency wars, military conflicts and security posturing getting out of hand. Government and bank debt exposure can also undermine public and market confidence in financial systems in big economies. In a world of changing

strategic balance and nationalism, these events are all too possible.

Addressing the sources of financial risk is right. But it is useful to complement work on financial resilience with a broader reflection—and action agenda—on the strength of economic and social institutions and frameworks across countries. These institutions and frameworks tell us something about the resilience of an economy and society as a whole to shocks and how shocks are transmitted and affect a country.

There are many indicators of a country's institutional health, but a good proxy to start with is Transparency International's index of perception of corruption in the public sector. Across Asian and Pacific economies, there is still a wide spread in the quality of transparency around lobbying, political finances, government spending and public institutions. The top end is consistently dominated by New Zealand (89 out of 100 in 2017) and Singapore (84), followed closely by Australia and Hong Kong (77), the United States (75) and Japan (73), Taiwan (63) and South Korea (54) in the middle of the pack, followed by Malaysia (47), China (41), India (40), Timor Leste (38), Indonesia and Thailand (37), Vietnam (35), the Philippines (34) and Papua New Guinea (29), with North Korea (17) at the bottom.

Some low- to middle-income economies have significantly improved their rating in the past five years: nine points up in North Korea from (8/100), five points up in Indonesia and Timor Leste, and four points up in Papua New Guinea and Vietnam. People's trust in government in Malaysia and South Korea, as measured by the Edelman Trust Barometer, improved in 2018 from 37 per cent of people surveyed in 2017 to 46 per cent in

... it is the right time to lift and energise cooperation with other countries in the region and beyond wherever an opportunity to do so can be found

2018 in Malaysia and 28 to 45 per cent in South Korea. This may suggest further improvement in public sector transparency is to come in those countries. The only country in the region with a big fall in the perceived quality of its public institutions since 2012 was Australia, down eight points, although Singapore's high rating eased back slightly by three points.

Action to build resilience always starts at home. Consistently looking to improve governance of domestic public and private institutions, the integrity of market processes and regulation, and lifting competition is a no-brainer. Small steps are fine; incremental improvements in openness about how decisions are made is better than none when there is still a lot of room to improve. These deserve as much policy and public focus as strengthening the financial system itself.

There is a clear case, for example, for a national body in each country to protect integrity in public-sector decision-making, full transparency and rules in public grants. The same is true for proactive regulation of markets to ensure that all those

markets are competitive and deliver for consumers—which is the whole rationale for markets in the first place. These steps would facilitate greater public trust and confidence in the decisions made by ministers, officials and businesses, and build resilience across the economy.

In a world of shifting geopolitical power, rising nationalism and stressed global frameworks and institutions, it is also the right time to lift and energise cooperation with other countries in the region and beyond wherever an opportunity to do so can be found.

In addition to strengthening domestic institutions and frameworks, the better response to global uncertainty is to build and strengthen relationships and strategically and pragmatically engage with other countries in areas of mutual interest. Building a coalition of economies in APEC, for example, to work together in areas like facilitating and retaining foreign investment, strengthening competition in domestic markets, improving decision-making and management in infrastructure, can help build trust, lift capacity and improve economic and social outcomes in all economies. This complements work on regional and global crisis financing. In key groupings like ASEAN, APEC and the East Asian Summit, the Asia Pacific region has a solid and broad-based apparatus to build up its resilience and improve outcomes for its people. The opportunity is there to take. 

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News from the top: passers-by in Shanghai watch a live public broadcast of President Xi Jinping introducing his Politburo Standing Committee in October 2017.

New and old: foreign policy under Xi Jinping

NEIL THOMAS

THERE is a risk of a 'new Cold War' between the United States and China. After decades of bilateral engagement and multilateral collaboration, the Trump administration's first National Security Strategy (NSS) branded China a 'revisionist power' that seeks to 'displace the United States in the Indo-Pacific region' and 'shape a world antithetical to US values and interests' in an age of renewed 'great power competition.' This premise has serious

implications for the international order that underpins global peace and prosperity, as US policy on China will in turn affect China's attitude toward the current system.

Rising powers like China rattle ruling powers like the United States because their ascendance creates tension within existing structures of global power. US power lies in its unmatched military capabilities and the 'international order' of multilateral institutions, interstate rules and global norms that promote economic openness and rules-based dispute

resolution. The particular charges of 'revisionism' levelled in the NSS show that the Trump administration fears that China will replace the United States as global hegemon and threaten the basic tenets of the international order.

China under the leadership of Xi Jinping, who took office in November 2012, has indeed become a more active participant in global affairs. China is building militarised islands to press sovereignty claims in the South China Sea; has escalated its territorial dispute with Japan over the Diaoyu/

Senkaku Islands; has created the Asian Infrastructure Investment Bank (AIIB); and has launched the Belt and Road Initiative (BRI), an immense domestic development strategy that aims to increase international infrastructure connectivity and commercial cooperation between China and the Eastern Hemisphere. China also continues to strengthen its People's Liberation Army, master advanced technologies, protect domestic industries and oppose the values of human rights and liberal democracy.

Signs of China's growing power are a natural result of its growth. More important is what China intends to do with its newfound capabilities. Analysts will interpret the same facts in several ways based on their different views of the world, so it is vital to consider the subjective perspective of the Chinese Communist Party (CCP) under Xi with regard to its own strategies. Does Xi intend to revolutionise Chinese foreign policy? Stop opening China's economy? Overturn the international order?

International politics is a fickle field of scientific endeavour in which there exist major theoretical disagreements about how the world works and why countries behave as they do. Foreign Affairs recently surveyed over 30 China experts on whether they believe 'US and Chinese national interests are fundamentally incompatible'. The respondents split almost perfectly evenly between those who agreed and disagreed. Economics, an academic discipline with more rigid foundational principles, offers solace in the idea that more information generally elicits better decision-making. So, in a spirit of academic eclecticism, this essay examines an information source on official Chinese perceptions that is under-analysed in much coverage of foreign policy and international

relations. This data is the political discourse of the CCP.

Why should CCP discourse be studied? The CCP, a Leninist organisation with almost 90 million members, rules China through the dissemination of binding directives down its organisational hierarchy and through the censorship of alternative political views. To wield power, leaders must convert their policy preferences into written documents that establish the correct 'line' for CCP cadres to follow.

This system of 'documentary politics' elevates the importance of political expression. Many pundits dismiss the soporific statements of Chinese politicians, but the CCP's grip on public language means that its discourse carries significant information about official views. This discourse is composed primarily of 'formulations' (tifa): set-phrases that represent official policy judgments. The presence or absence of certain formulations typically signals continuity or change in CCP thinking. After Mao Zedong died in 1976, for example, the CCP leadership soon ceased mention of 'world revolution' and the 'three worlds theory'.

International policymakers therefore need to study Xi's words because he, as CCP General-Secretary

... the CCP has absorbed Soviet errors of external overreach and antagonism toward the US-led system

and head of the Central Foreign Affairs Commission, is pivotal in setting the fundamental orientations and overarching strategies of China's foreign policy. Like his post-Mao predecessors—Deng Xiaoping, Jiang Zemin and Hu Jintao—Xi's foreign policy is expressed, interpreted and understood within the CCP's official discourse. This information needs to complement the analysis of more observable data like budgets, bureaucracies, diplomatic initiatives and military manoeuvres. A study of Xi's foreign policy speeches and writings suggests that there may exist more continuity than often assumed between the strategies of Xi and those of his predecessors.

The most authoritative articulation of Xi's policy agenda is his 'Report' to the 19th CCP National Congress in October 2017. He also made important statements on foreign policy at two Central Conferences on Work Relating to Foreign Affairs, first in November 2014 and then in June 2018. Xi's views on the world contain both changes and continuities. This intersection between past and present is captured neatly in the title of the foreign policy section of Xi's Report: 'Following a path of peaceful development and working to build a community of common destiny for humankind'.

What's new is that Xi stamped his authority on CCP foreign policy under his signature formulation of 'building a community of common destiny for humankind' (although Hu had used the phrase previously). The 'community of common destiny' is basically an international system in which deeper economic integration and political dialogue eases conflict and bolsters security. Xi is actively 'building' this future through an intense focus on the BRI and global governance.

PICTURE: NICOLA SOLIC / REUTERS

What's not new is that Xi retains the 'peaceful development' strategy articulated by Hu in the mid-2000s, which derives from the CCP's 'basic line' of 'peace and development' in international relations that Deng established in 1985. In the Report, Xi framed the foreign policy achievements of his first five-year term, including the BRI and the AIIB, as 'new contributions to global peace and development'. He has told CCP leaders that the 'peace and development' strategy is 'aligned with the fundamental interest of the country' and is a 'fundamental foreign policy goal'.

This 'peace and development' strategy reflects the belief that China's economic development requires a peaceful external environment and amicable relations with economic partners. It replaced the Maoist creed of inevitable conflict between the capitalist and socialist worlds as the CCP's official 'assessment of the international situation'. Deng believed this strategy would help China 'exert a much greater influence' in a global system that the CCP perceived as dominated by Western powers. Deng believed this system should be adjusted to create a 'new international political and economic order' that enabled greater self-determination for developing countries within the framework of existing international structures.

Xi's policy statements imply that the overarching concern of China's foreign policy remains the creation of a 'more enabling international environment' for China's continued development. As China's interests continue to expand, so too has its desire to shape global affairs. But contrary to some recent commentary, it seems unlikely that 'world power' or 'world domination' are China's



Hu Jintao: Xi Jinping has followed his example in expressing policy through 'official discourse'.

priorities. Xi has warned, 'looking back on history ... those who launched aggression or sought expansion by force all ended in failure'—the CCP has absorbed Soviet errors of external overreach and antagonism toward the US-led system. China now interacts with the international order like other major states: it complies with the order because to do so serves China's interests and tries to influence this order where it does not. China's desire for greater heft in bodies like the World Bank and International Monetary Fund, for instance, does not imply a new will to military conflict.

Xi's Report also reaffirmed Deng's 'opening to the outside world' as a 'basic national policy'. Deng inherited a poor country with an autarkic economy. He believed the 'historical experience' of Maoism showed that a closed China could not develop and voiced admiration for places like Japan, Singapore and Western Europe that rebuilt their postwar economies through foreign trade, loans and technology. But Deng echoed Maoist beliefs that China should

'avoid the mechanical application of foreign experience' and maintain a 'foundation' of 'self-reliance' on which to advance its 'long-term interest' in developmental catch-up. 'Opening' meant China would integrate into the global economy, enter international institutions and improve living standards in a manner that sustained CCP control.

Xi has insisted that China 'absolutely must not waver' from 'reform and opening' because it is the 'propelling force' behind China's 'international status'. He even framed his signature economic policy—a 'new normal' focused on consumption, services and markets—as a 'new structure' of reform and opening that just 'improves its quality and level'. Xi's Made in China 2025 policy, which aims to foster 'independent innovation abilities', is inspired by a desire to not be a 'technological vassal state'. Xi, who rules a far richer and more powerful China, seems to share Deng's conviction that the country must promote trade, investment and multilateralism as it pursues modernisation without democratisation. While Xi pursues industrial policies like Made in China 2025 to try and avoid the middle-income trap, he has also advanced economic openness through market concessions, cooperation against Trump's trade war and advocacy for the Regional Comprehensive Economic Partnership.

The official views communicated by the formulations in Xi's discourse provide a deeper understanding of Chinese intentions. Xi unquestionably brought new attitudes and new initiatives to Chinese foreign policy, but his continuation of key strategies like 'peace and development' and 'reform and opening' suggest he may not have changed China's

objectives so much as the means by which the CCP pursues them. This reading implies that, even as Xi disrupts domestic politics, his foreign policy still prioritises development, continued opening of non-critical markets, diplomatic approaches to security hotspots, close engagement with global governance and peaceful relations with major powers. Xi's China is 'revisionist' in the narrow sense of hoping for changes within the international order that reflect its rising profile but not in the existential sense of wanting to supplant the current order or become a global hegemon.

It is oft-remarked that Xi's 'assertive' foreign policy has annulled the oft-quoted Deng dictum, spoken after the Beijing Massacre of 1989, that China should 'hide its strength and bide its time' in international affairs. This change is real, but Xi embodies not so much a break as an inflection. Chinese foreign policy was always more than 'hide and bide'—people often forget that Deng also believed 'we cannot simply do nothing in international affairs, we must have some impact'. Before Xi, China joined the World Trade Organization, co-founded BRICS and the Shanghai Cooperation Organization, financed broad swathes of UN peacekeeping and championed the G20.

How should the United States approach its relationship with Xi's China? Until recently, White House views on China were quite consistent: The United States would 'welcome the rise of a stable, peaceful, and prosperous China' and 'reject the inevitability' of 'confrontation' if China acted within the international order. But the latest NSS assumed the 'engagement' strategy had 'failed'. A growing number of analysts and pundits share this assessment.

Such sentiment motivates Trump's escalating economic war against China, which is already convincing certain Chinese elites that the US wants to keep China down.

The endurance of 'reform and opening' and of 'peace and development' in Xi's foreign policy discourse imply that engagement is not such a failure. Formulations distill the historical learning of the CCP, and the continuance of these two key foreign policy concepts intimate that, while Xi's CCP does want to project China's power, it is still constrained by a belief in the benefit to China of global order and stability. This official view provides context to interpret the observable actions of Xi's foreign policy.

Where an analyst stands on these issues probably depends on where they sit regarding the US national interest—should its priority be preserving absolute US supremacy over competitors or cooperation in a more multipolar world to address global issues like climate change, pandemic diseases and arms control? The latter assessment appears more promising, and continued engagement would encourage China to support the key tenets of the global system as it becomes a more influential actor. While China, like most nations

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'end of history' in China

(including the United States), has 'cheated' on international rules, the country rose mainly through legitimate trade, investment, diplomacy and defence spending—activities that continue to create substantial benefits for other countries. China is also too large and globalised to contain without punishing costs. While China's rise dilutes US power, the United States can only do so much to constrain China without risking its own interests and the credibility of the very order that it purports to uphold.

Engagement is not craven endorsement of Chinese preferences. It is constructive diplomacy that encompasses military deterrence, political hedging and human rights advocacy. It seeks to influence Chinese behavior and to solve problems through positive-sum compromise. Recent successes include the Paris Agreement on climate change, the Joint Comprehensive Plan of Action for Iran and a fairly effective deal to reduce China-US cyber-hacking. Engagement also works because third countries have agency and naturally balance China even as they profit from economic cooperation—Australia, Sri Lanka, Japan and Malaysia come to mind—thereby pushing China to act more responsibly. But a strategy of containment toward China would accelerate the US–China security dilemma, reduce the United States' diplomatic leverage and weaken normative constraints on Chinese clout.

A stronger China does, of course, create issues that the United States must continue to address via increased attention to China and Chinese activities abroad. The United States should boost its alliances; invest in political and economic diplomacy that increases US participation relative to China in Asia, Africa and

South America; coordinate with others to press China to enhance its markets and its openness, especially through the WTO; reinvest in global governance to reform or create international organizations that acknowledge new power balances yet uphold fundamental norms; upgrade universal rules and standards through multilateral mechanisms like the Trans-Pacific Partnership; reinforce official support for high-tech innovation to keep the United States at the cutting edge; and bolster its political institutions to counter illegal interference from other countries, including China.

At his second Central Conference on Work Relating to Foreign Affairs in June, Xi, possibly motivated by present political calamities in the United States, said for the first time that China is at a 'historical juncture' in its relationship with the world and should 'lead reform of the global governance system.' The United States also seems to be at a historical juncture in its relationship with China. The country would do well to heed historians' warnings that Xi does not represent the 'end of history' in China. The future is contingent, and on external stimuli too—rash actions today will taint the memories of tomorrow.

The United States should work to avoid a 'new Cold War'. But a policy of containment would increase significantly the likelihood that China seeks to displace US leadership, undermine existent international structures and adopt a truly adversarial foreign policy. Historical analysis of official CCP discourse suggests that Xi's external strategy, while novel in the level of its activism, retains significant continuities with Dengist policy paradigms that back the fundamental tenets of global order.

The 'old Cold War' shows the cost of



Men at work at the Colombo Port City, being built as an extension of Sri Lanka's commercial capital by a subsidiary of China Communications Construction Company Limited. President Xi Jinping has declared China's 'peace and development' strategy to be a fundamental foreign-policy goal.

a confrontational international order of the type imagined by the Trump administration. Balance proves elusive. Security remains tenuous. Threats always lurk. Countries redirect vast resources from domestic development and transnational threats into competitive aid-spending, ideological alliances, arms races and proxy wars. In short, containment would prove far costlier than simply balancing China's rise through a strategy of robust and prudent engagement.

The United States' relative power in global affairs is declining. But this trend is mostly the result of other countries' embrace of the international order built by the United States, which nonetheless retains significant advantages in military, diplomatic, commercial, technological and cultural

power. The United States would best advance its national interests by accepting but actively managing China's rise within an improved iteration of this order. And other countries in East Asia, including Australia, would wisely do likewise.

EAFO

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Reinvigorating APEC for the post-2020 world

ADAM TRIGGS

MUCH has changed since 1994. Just think of some of the events from that year. The Channel Tunnel was officially opened, symbolic of the United Kingdom's continued integration with Europe. Then-US president Bill Clinton organised a US\$50 billion support package for Mexico, 'helping our friend and neighbour in a time of need,' he said. The World Trade Organisation completed another round of multilateral trade talks. Property-developer and reality TV star, Donald Trump, unveiled Trump International Tower and Hotel.

That year was an important year for APEC, too. The leaders of the 21 APEC economies met in Indonesia for their annual gathering. When they concluded their meeting in Bogor in West Java, they announced what became known as the Bogor Goals: the commitment to achieve free and open trade and investment in the Asia Pacific by 2020.

With a little over a year to go, that deadline is fast approaching. And just as the world has changed dramatically since 1994, so too must APEC.

At its core, APEC is a strategic instrument. When used effectively, it has demonstrated its ability to achieve substantial outcomes. APEC was responsible for paving the way for China's engagement in the global economic order. It facilitated China's entry into the WTO and remains the forum in which China is the most

heavily invested, often using APEC to help steer reform domestically. APEC has been critical to securing a host of international agreements, from the Information Technology Agreement to the Environmental Goods Agreement.

APEC has achieved much success in its pursuit of the Bogor Goals. APEC economies are trading more with the world, and each other, than ever before. Since 1994, goods trade has increased four-fold and services trade has increased six-fold. Average most favoured nation tariffs have been reduced by more than two-thirds. Cross-border flows of investment are at an all-time high.

APEC economies now represent 50 per cent of world trade. Reflecting their deep integration, more than two-thirds of the trade by APEC economies is with other APEC economies. Regional production networks have

It is difficult to think of any areas of APEC's agenda that will not be touched, if not radically reshaped, by technological change

flourished. More than half of all trade is now in intermediate goods, more than 70 per cent when it comes to services trade.

These are not vacuous statistics. The actions of APEC economies have dramatically improved the living standards of their peoples. Almost 90 per cent of the reduction in extreme poverty since 1981 was in APEC economies. This improved, or saved, the lives of 880 million men, women and children.

By their nature, the Bogor Goals will never be completely achieved. But substantial progress has been made.

Evidence shows there has been a strong 'APEC effect' in delivering that progress. Controlling for factors such as geography and economic structure, APEC members' trade is 32 per cent higher against its potential compared with EU members and 10 per cent higher than that of NAFTA members. APEC is a powerful force in influencing domestic policies through its non-binding, consensus-driven approach.

In-depth interviews with policymakers reveal that global forums help them to sell important reforms domestically. It gives them new ideas and new approaches. It influences their thinking and helps shape their priorities. It helps them to resist domestic populist pressures and defeat free-rider concerns in the community.

Now should be a time to celebrate APEC's achievements, which have been substantial. But the international order, which APEC has helped



Employees check solar panels of a photovoltaic power generation project in Jingzhou, China. Energy in Asia will be 'profoundly shaped' by new technology.

shape, is challenged by more risks, uncertainties and perils than at any other time since its creation.

The current wave of anti-globalisation sentiment strikes at the core of APEC. It threatens not only its objectives, but its existence. While the specific leaders of this movement may be temporary, they have revealed and exploited deep, structural angst in many communities. This targets the pillars of prosperity for the Asia Pacific: trade, investment, immigration and cooperation. Global surveys and polls and the elections in Austria and Germany suggest this anti-globalisation wave is yet to crest. The structural factors that underpin this movement—inequality, automation and the unfair distribution of the burden of economic adjustment—will likely persist for some time.

The post-2020 environment will also be characterised by vast technological change. It is difficult to think of any areas of APEC's agenda that will not be touched, if not radically reshaped, by this phenomenon. The advent of the digital age and advances in artificial intelligence require a rethinking of education and training, labour policy, competition policy, financial regulation, macroeconomic policy and social security. While claims of a wave of 'technological unemployment' are overblown, increased automation will require smart policies and fresh thinking to manage difficult economic transitions.

Two areas that will continue to be profoundly shaped by technology are trade and energy. Technology will radically change what is being traded and who is doing the trading.

A significant deepening in regional production networks will see the composition of trade shift further towards intermediate goods, digital trade and services.

Expanded internet access will see the entry of small and medium-sized enterprises (SMEs) into the global trading system on an unprecedented scale. This will radically reshape the trading system, channelling the benefits of trade directly into communities. But it will also strain outdated governance and old policies. The 'noodle bowl' trading system (cross-cutting trade agreements with different rules, regulations and tariffs) is the opposite of what the market needs. This architecture, domestic policies and the disjunction between them will cause increasing strain.

With technological change

underpinning each APEC economy, there are major trends that will shape the energy landscape for members post-2020. America's shale revolution has turned the United States into the world's biggest combined producer of oil and gas. This will continue to reshape global energy markets, with unknown geopolitical consequences.

The shift of major economies away from energy-intensive industries towards services will reshape global energy demand. And the need to create low-carbon economies to fight climate change will require deep structural reforms and substantial investment in wind and solar power, batteries and electricity grids, setting off a global race for the best technologies and the rare earths they are made of. Each of these challenges will face outdated global institutions like the International Energy Agency, which were designed in, and for, the 1970s.

The post-2020 world will be shaped by changes in demographics and urbanisation. APEC's populations will be larger, older and working longer. More of them will be living in cities. They will be more empowered and connected than ever before. Without investment, existing stocks of infrastructure will buckle. Inflexible labour markets, weak social security systems and inefficient tax systems will see living standards decline.

More than ever before, the post-2020 environment will be shaped by the reforms undertaken domestically by APEC economies. By 2030, Asia will be on track to surpass North America and Europe combined in terms of global power, based upon GDP, population size, military spending and technological investment. Asia is forecast to account for two-thirds of global economic growth. But all of this will depend on

the policy settings adopted by APEC economies in furthering financial liberalisation, deepening their capital accounts, liberalising their exchange rates and product markets and further opening their economies. These reforms will be made more difficult by a hostile external environment and the uncertain role the United States might play.

Considering this challenging post-2020 environment, the fundamental question is how APEC can be used, and strategically repositioned, to harness the post-2020 world, address these challenges and steer the region in the right direction. APEC is not bound by its membership. The flexibility of APEC and its ability to connect with other frameworks and institutions makes it perfectly suited to this role.

APEC's first focus should be to take stock of and celebrate its success on the Bogor goals. The actions of APEC economies have dramatically improved the living standards of its citizens. The goal of achieving 'free and open trade in the Asia Pacific' is never complete. But pausing to highlight the success of APEC will underscore the importance of the forum, the importance of multilateral cooperation and the cost

Liberalising services trade is a practical way to address political concerns around trade without taking a backwards step on trade liberalisation

of protectionism.

APEC requires a new agenda for a new era. The Bogor Goals acted as an aspirational focal point which articulated a common economic agenda and common view. A new focal point is required. An agenda of 'shared prosperity' can help to deliver APEC economies' aspirations. It must be a targeted agenda, with top-level political buy-in, focused on a few issues that resonate with leaders and their communities and which are critical to the post-2020 world. It must be focused on sharing the benefits of globalisation and mitigating its costs. It must engage all members in areas of common interest, bringing the United States and China into a common framework, while standing resolutely against attacks on the rules-based open international economic order.

A 20-year infrastructure agenda should sit at the core of this agenda. Seldom does a leader give an international speech or intervention that does not mention infrastructure. Already the region includes some of the best-managed, most modern internationally connected infrastructure in the world. The ambition should be to achieve this APEC-wide.

A formal infrastructure ministers' process should be established with the goal of '40 by 40': a commitment to increase annual public and private infrastructure investment in the Asia Pacific by 40 per cent above that implied by the current average by 2040. Infrastructure ministers can open a dialogue on achieving greater standardisation in contracts and project preparations and directing more global finance into infrastructure. Infrastructure Vision 2040 can engage East Asia and all the ASEAN+6 economies.

Second, APEC's long-term goal



Asia-Pacific leaders at the APEC-ASEAN dialogue, held on the sidelines of the November 2017 APEC summit in Danang, Vietnam. Continuing high-level leadership will be crucial to positioning APEC policies and initiatives.

should be an international framework on investment facilitation. The focus should be on fostering a transparent, predictable and efficient regulatory and administrative framework for investment that maximises the benefits to the host economy. The framework for trade in intellectual property and technology needs to be a central element. APEC should begin by agreeing on common principles, policies and action to deliver this ambition. Over time, each member would commit to putting these principles in place, providing a benchmark for APEC economies and a focal point for investors in assessing an economy's investment environment.

Third, APEC should adopt a modern trade agenda, centred on structural reform, services trade, digital trade, cross-border data flows and engaging small and medium-sized enterprises. As Andrew Elek

has noted, readily achievable gains from better connectivity far exceed those which come from getting rid of all remaining traditional border barriers to trade. Given that many of today's trade barriers relate to domestic regulatory regimes, APEC economies should commit to undertaking root and branch reviews of their competition laws and policies to help liberalise services markets and industries.

Analysis from the Bank of England shows that global trade imbalances would be reduced by 40 per cent if the world's major economies achieved the same level of trade liberalisation in services trade as they have in goods trade. Liberalising services trade is a practical way to address political concerns around trade without taking a backwards step on trade liberalisation.

On digital trade, APEC should

focus on developing a leader-level dialogue to agree on the principles around digital trade and data flows. It could expand the work of the APEC Electronic Commerce Steering Group on interoperability beyond the EU's policies. Economies should finalise their participation in the APEC cross-border privacy rules and seek a common approach to these critical issues. Enhanced digital trade is the critical way to engage SMEs in global trade and better distribute the benefits of trade throughout the community. APEC should complement this with an SME international trade advisory council to better identify the barriers to SME engagement in the trading system.

A modern trade agenda does not mean that existing trade issues should be abandoned. APEC should continue to push for further reductions in tariffs (particularly those recently

introduced), further liberalisation in agriculture and a rationalisation of the current noodle-bowl trading system through such agreements as the Regional Comprehensive Economic Partnership, the Trans-Pacific Partnership and the Free Trade Area of the Asia Pacific. There is opportunity to work with China, the United States, Japan, ASEAN and other APEC members to lay the ground for strategic dialogue on how to come to grips with the big digital trade, intellectual property and investment issues.

There is an opportunity for APEC to lead the discussion on cross-border issues with global implications. APEC's agenda should continue to include initiatives that can be implemented among members and then in global forums like the WTO. It can also lead the reforms of rules and norms at the international level in areas like intellectual property protections, investment facilitation and dispute avoidance and settlement.

Rising and shifting energy demand and the global energy transformation in shale gas, renewable energy and technology makes regional cooperation more important than ever. Though they open many new opportunities, there is a risk that these transformations will strain regional markets and relationships.

APEC should establish an energy ministers' group to work with the G20 in reforming global energy governance to include the major emerging market economies with a modern approach to global energy security. On regulatory frameworks, the focus should be on better coordination and transparency around the energy policies of APEC members, including domestic energy security policies. There is much to be gained from having a better understanding of what works in the region to deliver low-cost energy and energy security. On technology, sharing policies and experiences on how to best harness and manage these technologies will help APEC

economies ensure low-cost energy and energy security.

APEC is a substantial economic and security asset for the Asia Pacific. It builds the confidence, trust and political certainty that underpins security in the region. APEC is a political framework for implementing a common economic agenda based on cooperation, open economies and free markets. It has been a critical institution in the region's prosperity and it is needed now more than ever. APEC's fundamental goal must be ensuring it adapts to the environment, challenges and risks it faces today and after 2020. By celebrating its success on the Bogor Goals while strategically positioning itself and its agenda for the post-2020 world, APEC can remain at the forefront of regional cooperation.

EAFO

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A worker puts finishing touches to a social robot at an assembly plant in Suzhou, China. A framework for trade in technology should be central to APEC's future.

PICTURE: ALY SONG / REUTERS



Preparing Asia for the next financial crisis

YASUTO WATANABE

THE continued challenges of a changing economic environment are not new to the ASEAN+3 region, which consists of the 10 ASEAN members plus China (including Hong Kong), Japan and Korea. The region has weathered several external shocks in the past decade, including the global financial crisis in 2008 and episodes of risk-aversion and capital outflows.

But how prepared is it for the next financial crisis? What more needs to be done?

The region has become much stronger through the increased integration of trade and investment compared with the situation before the 1997 Asian financial crisis. The ASEAN+3 region now accounts for more than a quarter of world GDP and

30 per cent of global trade. But the expansion in international trade and the increasing complexities in financial networks and other activities are increasing the risks of volatile capital inflows and outflows. Mitigating these risks warrants concerted efforts at the national, regional and global levels.

Many risks remain in the short-term, notably the threat of protectionism, tightening global financial conditions and tail risks of geopolitical events. Amid these immediate concerns, the region needs to watch the global, structural forces that affect its economies, especially in the financial sector.

As global trends such as digitalisation, changes in global supply chains and the use of new technology transform the nature of cross-border economic and financial transactions

Cyclists pass the Hanoi venue for World Economic Forum on ASEAN in September 2018: developing global trends demand a region-wide response.

and spillovers, the changed conditions demand not only a national but a region-wide response, desirably in a harmonised manner. The demands and expectations placed on the speed of policy reaction and the clarity of policy communication are rising. Take, for example, capital flows to emerging markets in the region. With technology facilitating lightning-speed trading, sudden shocks in capital flows driven by herd behaviour are risks that policymakers have to grapple with.

Although the International Monetary Fund (IMF), at the centre of the international monetary system, is the best-known firefighter to help

governments that find themselves in trouble during a crisis, it is no longer the only one. Nowadays a large part of the world, but not all, is also covered by regional financing arrangements that can mobilise financial resources for countries facing temporary liquidity problems during a crisis. One such arrangement is the Chiang Mai Initiative Multilateralisation (CMIM) that evolved from a system of currency swaps among economies in East Asia after the 1997 Asian financial crisis, with the ASEAN+3 Macroeconomic Research Office (AMRO) as its surveillance arm.

Regional financing arrangements (RFAs) are considered to be a key component of the global financial safety net, the other components of which are foreign reserves, bilateral swap lines between central banks, and the IMF. In an increasingly integrated world, global and regional financial arrangements are being enhanced and must improve cooperation with one another to form a comprehensive and effective safety net against financial crises and contagion.

At the global level, the IMF is reviewing its facilities periodically to ensure that they are adequate to meet the financing needs of its members in light of developments in the global economy and financial markets.

With regional financing arrangements there have been continuous efforts to strengthen their own internal mechanisms, as well as at collaboration among RFAs and between RFAs and other layers of the global financial safety net. Although challenges remain in anticipation of any possible crises in the future, the strong upswing of the global economy is an opportune time to undertake a more comprehensive review and reform of these regional arrangements.

In East Asia, AMRO, in its support

function of the CMIM, has supported its member authorities over the past three years to undertake joint test runs with the IMF to enhance the operational readiness of CMIM facilities. Recognising the importance of cooperation among different layers of the global financial safety net, AMRO has strengthened relationships with various partners to draw on the expertise and knowledge of each institution.

Building a robust regional safety net is a long-term project. In the changing regional and global economy, there are several aspects that need to be enhanced to boost regional financing arrangements' contribution to the global safety net.

THE FIRST is enhancing coordination among multiple layers of the global financial safety net. This is the prerequisite to provide timely and efficient support for countries that are in need of financing to support their external position. Countries should be able to combine the use of different tools to generate synergies in terms of timing and size of intervention, sequencing and conditionality design.

Second, we need to strengthen regional economic integration and the role of regional financing arrangements. With rising protectionist risks in major economies as well as changes in production networks, there is a need to strengthen intra-regional connectivity and integration in many areas to meet growing intra-regional demand and improve the region's resilience against external shocks.

Third, it is important for RFAs, in addition to their role in providing short-term liquidity support, to upgrade their function to provide policy recommendations for their

members to achieve macroeconomic and financial stability, in particular, during crisis time. The specific aspects of the beneficiary country and strong sense of the ownership of its government is important in implementing such policy recommendations. Those will be the key when the recommended policies will be adopted by the country. Those considerations will enhance the positive impact on the economy when it is well in place in the domestic policies and legal structures.

Besides enhancing the regional financial safety net, and the build-up of foreign reserves by individual economies, authorities are looking at using local currencies to invoice trade. At present regional trade is heavily reliant on the use of the US dollar, even though intra-regional trade has grown substantially. Increasing regional currency use will help reduce exchange rate risks vis-a-vis the US dollar. It will also help to reduce the amount of foreign reserves in US dollars needed as a liquidity buffer for trade purposes. About US\$6.2 trillion of the world's US\$12.7 trillion worth in US dollar foreign reserves is held by the authorities in our region.

In the highly interconnected global economy and financial markets, financial crises are bound to recur every now and then, although it cannot be predicted when and where. That is why the region must prepare for the coming crisis now. **EAFO**

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All at sea? Supporters of the 'Fishing for Leave' group protest against British Prime Minister Theresa May's Brexit transition deal in April 2018.



Lessons from Europe

PAOLA SUBACCHI

MORE than a decade on from the most devastating financial crisis since the crash of Wall Street in 1929, politicians and commentators have been extremely careful in offering predictions on when the next crisis will occur. Playing with economic predictions is like playing with fire. Nobody knows this better than former British prime minister and chancellor of the exchequer Gordon Brown, who repeatedly promised 'no return to boom and bust'.

But there are reasons to be concerned. The gradual normalisation of US monetary policy could generate adverse spillover effects and disrupt

global financial stability. Red lights are already flashing in Turkey and Argentina. A major correction in the United States' stock market could trigger a significant shock for the rest of the world. High levels of debt, maturity mismatches and carry trades financed by short-term debt could fuel contagion through financially integrated markets. In addition, the deterioration of multilateral economic relations in the last 18 months might make crisis resolution more difficult than it was in 2008–09.

As things stand, even if we don't know how the next crisis will materialise, where the epicentre will be and which countries will be hit, we can infer that it will be more disruptive

than its predecessor.

What lessons can be drawn from Europe and its experience during the global financial crisis?

The European economy is expected to grow, in real terms, by 2.5 per cent in 2018, a slight slowdown from 2.7 per cent in 2017. Countries that were badly hit by the crisis have finally come out of the tunnel and some, like Ireland and Spain, are in very good shape. Against this overall positive background the European Central Bank (ECB) is slowly and gradually preparing to normalise monetary policy.

For years the economy was Europe's key problem, now it is politics. The integrity of the European

Union (EU) and its single currency is being challenged by populist politics that is building consensus on voter disaffection with rising inequality and the deterioration of living standards. Brexit, refugees and tensions between Germany and Italy on fiscal leeway are now threatening the entire EU project. Europe's brand of populism is anti-migration and anti-financial globalisation, and resents a supranational construction like the EU that by definition is at odds with economic nationalism.

Italy is the country that could trigger a perfect storm. Some members of the Italian cabinet have been playing with the idea of severing ties with Europe's monetary union in order to regain control of monetary policy. Italy has been struggling for years with poor productivity growth and GDP growth. After some recovery in the past two years, the latter is now slowing down. Youth unemployment is at 35 per cent, one of the highest rates in the EU. Interest rates are on the rise, making it more expensive to pay interest on public debt that currently stands at 132 per cent of GDP. And the expansive fiscal policy promised by the two populist parties now in government is undermining investors' confidence.

But Italy is not an isolated case. Euro-scepticism is on the rise, especially in countries in eastern and central Europe that joined the EU in 2004. In Britain it has been driven by the idea that an independent trade policy would better serve the interests of the United Kingdom. Having served notice to the EU on March 2017, the UK is due to leave Europe's single market and custom union in March 2019.

It is unclear what the new relationship between the EU and the UK will look like. Political rifts inside

the British government and the ruling Conservative party have resulted in a deadlock. In the meantime, a number of foreign companies, especially those in the banking and financial sector, have announced that they will relocate to the continent to maintain access to the EU market.

The prospect of a hard Brexit has taken a toll on sterling, which has dropped by almost 12 per cent against the US dollar between mid-April and mid-August 2018. The British economy is expected to grow, in real terms, by 1.6 per cent in 2018. But increasing interest rates forced by inflationary pressures and a weak sterling may pose further constraints on economic growth. The UK is a deficit country, with a deficit in the current account of 5.2 per cent of GDP and a high level of personal debt. A series of corporate collapses—most recently, the bankruptcy of the infrastructure company Carillion—may trigger some financial instability.

If there is a lesson from Europe's experience with the financial crisis, it is to consider the long-term effects of crisis resolution. In 2011 and 2012, at the peak of Europe's sovereign debt crisis that followed the global financial crisis, efficiency in crisis resolution took priority over legitimacy.

People ... whose economies had been decimated by the crisis, felt the hit and resented being told what to do by unelected bodies

Draconian measures were imposed on Greece while fiscal austerity became the norm across the whole region. People, especially those in southern Europe whose economies had been decimated by the crisis, felt the hit and resented being told what to do by unelected bodies such as the ECB, the European Commission and the IMF. Today's dysfunctional politics is significantly a response to those mistakes.

In 2008–09 international cooperation played a key role in crisis resolution. Even if the G20 did not deliver overall reform of the international monetary and financial system, its broad-based governance system, inclusive of emerging markets, managed to get member states to work together.

Today this cooperation would be more difficult to achieve. While in 2008 politics was fairly neutral, today it is hugely divisive. The United States is in retreat and increasingly unwilling to lead. China is not ready yet to take over and to provide the financial safety net that would be necessary in case of a crisis. Europe, especially the leading countries such as Germany, France and the UK, are primarily focussed on domestic politics.

In 2008, crisis resolution was also possible thanks to the concerted effort of key central banks. Nowadays the power of unelected bodies is rightly questioned and scrutinised. The main lessons from the long financial crisis in Europe may be lost amid economic nationalism. Experts tend to be the repository of such lessons, but there is little respect for experts in today's politics. [EAFQ](#)

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A man walks past an advertisement promoting renminbi, US dollar and Euro exchange services in Hong Kong. China is keen to internationalise the renminbi.

Bilateral currency swap lines: facility and risk

KAZUMASA IWATA

RECENT decades have seen Asian economies make greater use of bilateral currency swap lines. Both Japan and China deploy these facilities, though some difference in approach has become apparent, with China allowing its facilities to be used not only to facilitate settlements in trade and investment using the renminbi but also to resolve balance of payment crises—an approach that is not free of risk.

In May 2018, Japan resumed its bilateral currency swap line with China. The line was originally launched in 2002 although it had been suspended in 2013 due to increased political tensions over the Senkaku/Diaoyu Islands. China seems to be re-positioning diplomatically towards neighbouring countries under the intensifying pressure of a potential trade war with the United States.

Bilateral currency swap lines, unlike measures to mitigate balance of payment and liquidity crises, mainly

aim to facilitate trade and investment. They serve in essence as a ‘credit line’ at a predetermined exchange rate. Currently, the Japanese Ministry of Finance has bilateral currency swaps with central banks in Indonesia, the Philippines, Singapore and Thailand, which are based on the framework laid by the Chiang Mai Initiative. Japan is also expected to conclude another swap arrangement with Malaysia. In the past, Japan had swaps with South Korea and India but these have been suspended or expired.

The Bank of Japan also has six central bank liquidity swap arrangements with the central banks of the United States, the European Union, the United Kingdom, Switzerland, Canada and Australia. The arrangements with the first five central banks have no limits on amounts and time periods, but the arrangement with the Reserve Bank of Australia was limited to AUD\$20 billion (US\$14 billion) and is effective only until March 2019.

Bilateral currency swap lines are different from the central bank liquidity swap lines extended by the US Federal Reserve, which basically involve a 'repo transaction' at the prevailing exchange rate. The Bank of Japan obtains US dollars through the central bank liquidity swap line, which allows it to provide dollar liquidity to private banks through market operations. The Bank of Japan must eventually buy back the yen sold to the Federal Reserve.

Japan has concluded three bilateral currency swap arrangements with South Korea, which have all been terminated or expired. The first bilateral swap arrangement was launched in July 2001 within the framework of the Chiang Mai Initiative. The swap was a unilateral transfer of funds amounting to US\$2 billion from Japan to South Korea, using the US dollar and the South

China's currency swaps have also been used to bail out countries in financial crisis

Korean won. The fund was eventually transformed into a reciprocal arrangement and expanded to US\$10 billion, but was terminated in February 2015 as the diplomatic relationship deteriorated due to historical grievances and territorial disputes over the Dokdo/Takeshima Islands. By then, both the second and third arrangements had already expired.

For South Korea, facing a currency crisis during the global financial crisis there was a delicate policy issue revolving around the choice between a number of financial safety nets. South Korea could have relied on the resources of the International Monetary Fund (IMF) despite the 'IMF stigma', a regional safety net such as the Chiang Mai Initiative Multilateralization (CMIM), the central bank liquidity swap line or bilateral currency swap lines. After South Korea's central bank swap line with the Federal Reserve was so effective in stopping the won's depreciation, the country made repeated requests for the central bank swap arrangement to become permanent. Although the Federal Reserve terminated the line in February 2010, it was reintroduced in May 2010, resulting in a network of swaps among six central banks (the Bank of Canada, European Central Bank, Bank of Japan, Federal Reserve and Swiss National Bank) in 2011.

Looking to the future, Japan will widen the scope of its bilateral swap

arrangements with Asia-Pacific countries, in view of expanding the CMIM both in terms of the number of member countries and the active use of ample foreign reserves. This may serve to prevent the spillover of negative financial shocks and minimise losses arising from the next financial crisis.

Meanwhile, the People's Bank of China intends to employ currency swaps as an important instrument for internationalising the renminbi. Trade settlement and payment in renminbi has surged, in part due to China's bilateral currency swap arrangements with 32 countries.

China's currency swaps have also been used to bail out countries in financial crisis. In 2014, Argentina drew upon its currency swap line with China to mitigate a dollar liquidity shortage. The line was employed as a substitute for the central bank liquidity swap arrangement with the Federal Reserve. The yuan obtained through the currency swap arrangement with China could be converted into dollars on the offshore renminbi market, even though the renminbi is not fully convertible on capital account transactions.

The case of Argentina may suggest that if the renminbi depreciates, partner countries will be prompted to use their currency swap arrangements with China to obtain dollar liquidity. This will cause the renminbi to be sold off against the US dollar, thereby undermining the strategy of internationalising the renminbi using bilateral currency swaps and offshore markets. And this may aggravate the risk of financial crisis in China. **EAFO**

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Bullet trains nose-to-nose at Yantai station, Shandong province. Infrastructure projects have contributed significantly to China's economic performance in recent decades, but some commentators believe the marginal return on such investments has turned from positive to negative.

Déjà vu? Old policy tools and old risks in China

JIAO WANG AND
YIPING HUANG

THE communiqué of the Chinese Communist Party Politburo meeting, held on 31 July 2018, identified maintaining economic and social stability as the top policy priority. China's real GDP growth rate edged down from 6.8 per cent in the first quarter of 2018 to 6.7 per cent in the second quarter, and is expected to soften further in the coming quarters

due to increasingly difficult external and domestic conditions.

At the same time, infrastructure spending has accelerated. According to one count, by mid-2018 realised expenditure on mega-infrastructure investment projects in 13 provinces alone already totalled 3.4 trillion RMB, very close to the planned investment total for the entire year. This development reminded many people of the 4 trillion RMB stimulus package that the Chinese government

announced nearly 10 years ago in response to the global financial crisis.

That policy played a major role in stabilising economic activities in China and some neighbouring economies during the global financial turbulence. But the aggressive fiscal spending and the accompanying monetary expansion also had serious side effects, such as excess capacity, high leverage ratios, asset bubbles and low productivity.

Today, containing systemic financial

risk is the first of the three economic policy battles that the government confronts. Many of the financial risk factors that exist today can be traced back to the stimulus package from 10 years ago. The high aggregate leverage ratio is a result, for instance, of extraordinary expansion of money supply. And the high local government debt burdens are a consequence of reckless borrowing by local government investment vehicles.

Soon after the introduction of the stimulus package ten years ago, policy circles in Beijing reached a clear consensus that the government should tolerate more moderate economic growth and should not engage in aggressive monetary and fiscal policy expansion. And even if it became necessary to adopt some fiscal expansion, it would be better to spend the money on household welfare and structural upgrading, rather than building more infrastructure.

Yet whenever growth softens, the government can't resist going back to the old policy tools. It seems that this year is no exception. The politburo meeting suggested that active fiscal policy would not worsen the local government debt problem at this time, since the infrastructure projects will be financed by issuing local government special bonds. But the real consequences are yet to be seen.

In the past decade China has struggled to keep a balance between the short-run growth target and structural reforms. Hitting the growth target was closely tied to maintaining short-run stability. The extremely low degree of tolerance for economic volatility associated with the goals set of doubling growth rates by 2020 has often encouraged the leadership to sacrifice or postpone reforms whenever the economy experiences uncertainty and downward pressure



Former People's Bank governor Zhou Xiaochuan: every window of opportunity to push structural reform forward needs to be seized.

on growth. The approach Beijing has adopted for stimulating growth has been large-scale fiscal stimulus, paired with accommodating credit conditions.

This was the case in 2008, in 2012 and once again now. According to the National Bureau of Statistics of China, the average annual growth rate of infrastructure investment in the past decade stands at 20 per cent. By

Steering through financial reforms even in difficult times ... would reduce costs of resource misallocation in the longer term

2017, total fixed investment reached 63 trillion RMB, accounting for 76 per cent of GDP, and infrastructure investment reached a value of 14 trillion RMB, accounting for 17 per cent of GDP.

These infrastructure projects used to contribute significantly and effectively to economic performance, but some believe that the marginal return of infrastructure investment in China has now turned from positive to negative due to underestimating actual construction costs and the deteriorating efficiency of some of the infrastructure projects, among other problems.

Investing in unproductive projects may lead to a boom during the initial stage, but in the longer term it becomes a source of inefficiency, inducing problems of build-up of debts and economic fragility. This is especially relevant to the local government debt issue that the leadership has tried to rein in during the past few years. Introducing large-scale infrastructure stimulus now will only make the debt problem worse, even with the issue of special bonds.

Another problem associated with the policy choice of fiscal stimulus is its impact on the pace of domestic structural reform, especially financial reform. Implementing fiscal policy requires stronger government power in the market. This means a retreat of market mechanisms in the decision-making process and a reversal of the market-oriented reform processes.

More importantly, it comes at the expense of reform efficiency. Large-scale infrastructure investment in unproductive or duplicated projects worsens the efficiency of capital allocation, which in turn is detrimental to effective financial resource allocation. Steering through financial reforms even in difficult times, such as

now, would reduce costs of resource misallocation in the longer term, boost economic growth on a sustainable path and build up market confidence during bad times.

Financial reform has a central place in the leadership's work agenda. Over the past few years, there have been significant achievements in the financial sector, such as inclusion of the renminbi in the Special Drawing Rights basket, increased exchange rate flexibility and the removal of a ceiling to deposit interest rates. And throughout, the Chinese government has emphasised its determination to prevent the accumulation of systemic risks and sudden breakdown of the financial system. This has motivated the implementation of a macro-prudential policy framework and the establishment of the National Financial Stability and Development Committee in 2017. But there remains a lot left to do.

As Zhou Xiaochuan, former governor of the People's Bank of China, wrote in an article published at the beginning of 2018, there is no ideal sequence for reform, so every window of opportunity to push forward structural reform needs to be seized. A difficult time with growth pressure is an ideal opportunity for reform. The future of growth relies on structural reform and industrial upgrading, underpinned by effective risk management. No more fiscal stimulus déjà vu, please. **EAFO**

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Domestic resilience a defence against crisis

KOJI NAKAMURA

INTERNATIONAL trade and capital flows provide mutual benefits for both debtor and creditor countries. Debtor countries usually have investment opportunities but limited production capacity and capital funds. Creditor countries are matured with sufficient production capacity and capital funds—sometimes coinciding with an ageing population.

Debtor countries import capital goods from creditor countries, with international finance provided by creditor countries. Debtor countries can grow by increasing their production capacity, and creditor countries can receive higher investment returns from debtor countries. This system has worked well in the Asian region over the past several decades.

However, this system sometimes faces difficulties because of excessive capital flows, overly optimistic expectations of the economy, and asset price bubbles. As we have seen, reversals of these movements can throw countries into crisis.

Let's look back on the Asian experience when the perfect storm hit the region's economies in 1997. Many Asian emerging economies had enjoyed high growth, thanks to deepening manufacturing-sector supply chains in the late 1990s. Investment opportunities were

abundant and were financed by international capital flows. Behind the booming economies, however, imbalances had built up. The banking sector provided excess loans with maturity and currency mismatches. Asset prices surged beyond their fundamentals. Fixed exchange rate regimes promoted international capital flows based on the assumption that fixed exchange rates would be maintained forever. Then the crisis broke. Exchange rates plunged, capital flows reversed, asset prices collapsed and banks failed. Financial assistance by international organisations and individual countries alleviated the pain to some extent but did not eradicate all of it since the situations ran out of control so quickly.

This history shows that, while strengthening the international financial architecture is important, the first line of defence is to increase domestic resilience, as has been shown in the recent situations in Argentina and Turkey.

What can Asian economies do to make their financial systems more resilient?

First, the domestic financial system should have a sufficient capital base and liquidity cushion to weather negative shocks to the economy and the financial system. In this regard, the commitment by each jurisdiction to full, timely and consistent implementation of the bank regulation

and standards framework, called Basel III, is necessary. The Financial Stability Board (FSB), standard-setting bodies and national authorities carefully monitor the implementation process and evaluate the effect of the reform. The possible costs and unintended consequences of imposing higher prudential requirements are carefully monitored. Evaluating the reforms of infrastructure financing and over-the-counter derivatives is making good progress at the FSB under the Argentine G20 Presidency in 2018. The impact of financial reforms on small- and medium-sized enterprises has already been agreed as the next evaluation topic and will be discussed under the Japanese G20 Presidency in 2019.

Second, macroprudential surveillance and monitoring should be strengthened. Based on bad experiences in the late 1990s and early 2000s, the Bank of Japan (BOJ) began publishing the Financial System Report (FSR) semi-annually, which examines the Japanese financial system from a macroprudential perspective. The BOJ has also developed analytical tools, such as

The effectiveness of such macroprudential policy measures as countercyclical capital buffers is largely untested

the Financial Activity Index and a macro stress-testing framework. Since financial activities are evolving over time and the boundary of the financial system is blurred by technological progress, attention needs to be paid to developing financial activities in a broad context.

It is true that the banking sector has become much safer than before. But there is an increasing share of market-based financial activities all over the world. Is there sufficient data and capacity to monitor these activities? Are there policy tools if excessive activities in the shadow banking sector are detected? Continued efforts will be needed to pursue a safer financial system.

Third, a sound macro policy framework needs to be in place. In the past there were common features among crisis countries: high inflation, large current account deficits, large fiscal deficits and asset price bubbles. Currency speculators have attacked these countries. To avoid these speculative attacks, national authorities need to maintain healthy macroeconomic management with strong institutional settings such as central bank independence and secure long-term fiscal sustainability. While monetary and fiscal policy measures are classical tools, there also may be a need to calibrate macroprudential policy measures with more care. It is true that some countries have implemented macroprudential policy measures successfully to mitigate financial excesses.

However, we have limited experience of implementing such policy measures so far. The effectiveness of such macroprudential policy measures as countercyclical capital buffers is largely untested. Is it possible to raise the capital buffer held by banks sufficiently to prepare for large strains? Can the capital buffer



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A man makes an offering outside a foreign exchange shop in Kuta, Bali. Flexible exchange rates contribute to smooth adjustments of macro imbalances.

level during a financial downturn be reduced without creating distrust in the financial system? Would banks be ready to maintain levels of lending in times of stress as buffers are drawn down? The effectiveness of such macroprudential policy will be examined in coming years.

Fourth, fostering domestic financial markets with their sovereign currencies is desirable. We have seen and experienced currency and external crises when the domestic currency cannot be used to borrow abroad. Based on the experiences of the financial crisis, emerging Asian economies have made efforts to foster their domestic currency bond markets. The Asian Bond Fund Initiative—started in 2003 by the 11 central banks that comprise the Executives’ Meeting of East Asia and Pacific Central

Banks—has contributed to supporting these efforts. Still, many countries have experienced turmoil when their domestic currency cannot be used for foreign borrowings.

Finally, flexible exchange rates, where feasible, contribute to smooth adjustments of macro imbalances. Stable and rigid exchange rate arrangements are preferred by investors during calm periods and ‘fear of floating’—a reluctance to let the currency’s value fluctuate—remains a popular idea. But countries with rigid exchange rate arrangements will suffer enormously when these arrangements collapse. The combination of sound macroeconomic management and flexible exchange rate regimes contribute to improving economic welfare in the long run.

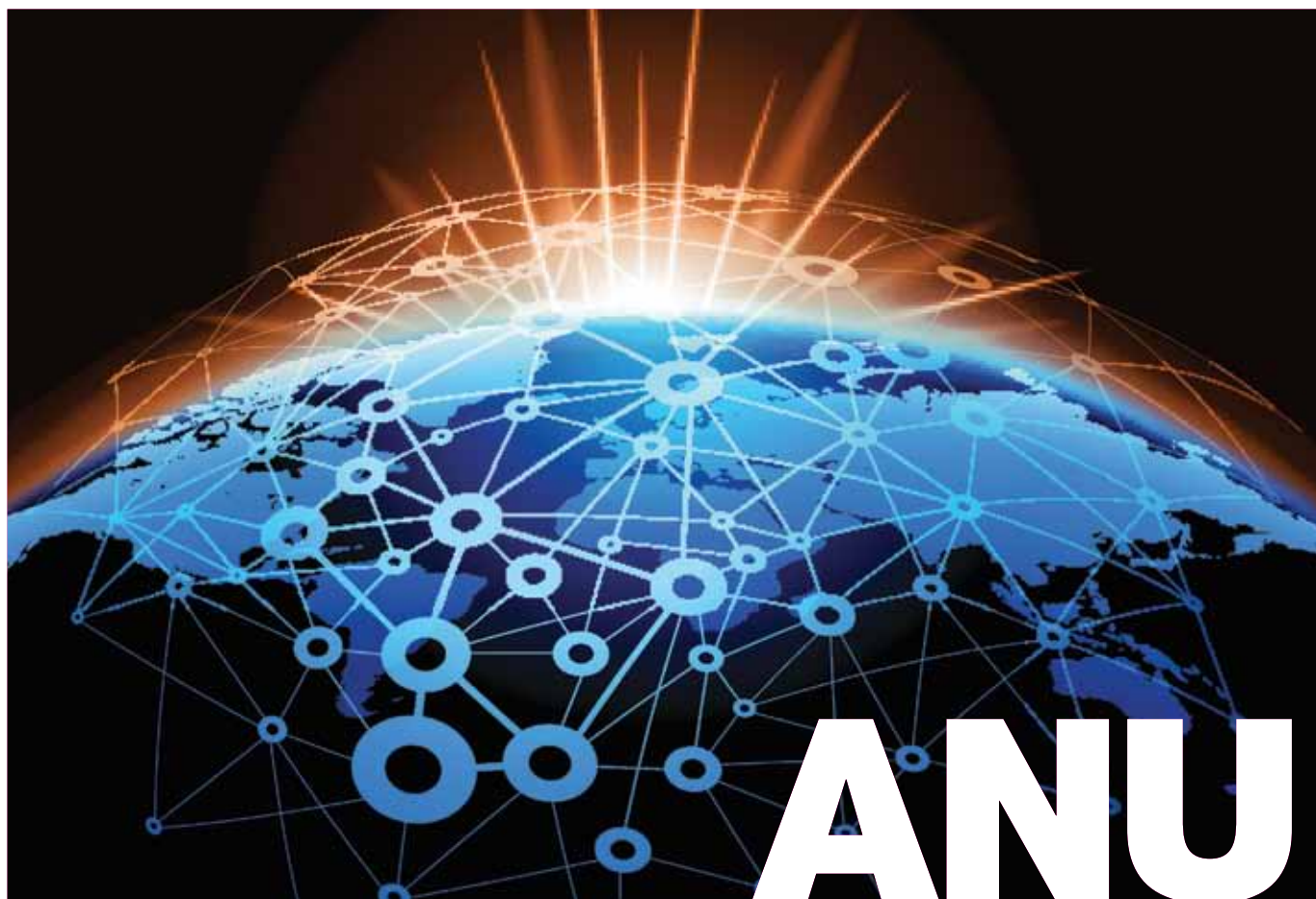
Domestic macro policy frameworks

have improved, but still there has been a recurrence of currency and financial crises. Preparing for the next crisis during the current calm period is difficult work. There is a tendency for a ‘this time is different’ syndrome to develop, and for people to stop thinking about ‘unthinkable’ incidents. Together with a strong international financial architecture as a last line of defence—including the IMF’s lending capacity, swap agreements and regional financial arrangements—strengthening the domestic financial system and macro policy framework is imperative. [EAFQ](#)

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