Discussion of
"… Financial Vulnerability in Asia …"
by Hyun Shin et al.
&
A Global Safe Asset from & for Emerging Economies

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Lessons learned from AFC & GFC

- BIS statistics as useful real-time monitor for global crisis
  - Early warning indicator
    - Trigger of a crisis -- differs from crisis to crisis
    - Amplifier -- repeated patterns (it rhymes)

  - **AFC: Korea**
    - Banks had *short-term* \$-claims on local corporate borrowers
    - Corporates had *long-term* \$-claims (export receivables)

  - GFC: Spain
    - No currency mismatch (within € area)
    - Spanish borrowed *long-term* €

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  - From **Bank debt** financing **to capital market borrowing**
    - Hold-out problem ⇒ CAC

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- Lenders:
  - Latin America: US banks
  - AFC: Japanese banks for Thailand and Indonesia
  - GFC: European banks dominant in cross-border financing
- Borrowers:
  - AFC: Indonesia, Korea, Malaysia, Philippines, Thailand
  - GFC: Emerging market generally moves together
- Maturity Structure:
  - Past: hot money
  - Now: longer maturity, but more interest rate sensitivity
- Currency Decomposition:
  - Externally financing mostly in dollar (Euro)

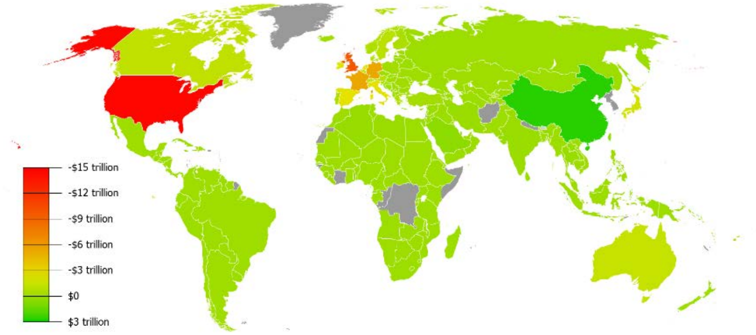
Academic literature after AFC & GFC

- Early 1990: domestic pull vs. external push factors
- 2000s: FDI, equity vs. debt capital flows
- 2008: from net flows to gross flows
  - Gross-flows are highly procyclical
  - Driven by
    - Global risk aversion: VIX (worked for a while)
    - US monetary policy: (not clear cut)
  - Banking flow are hit hardest

Lessons learned for AFC

- Build up an (official) BUFFER
  to lean against sudden (flight to safety) capital outflows

  1. Official Reserves



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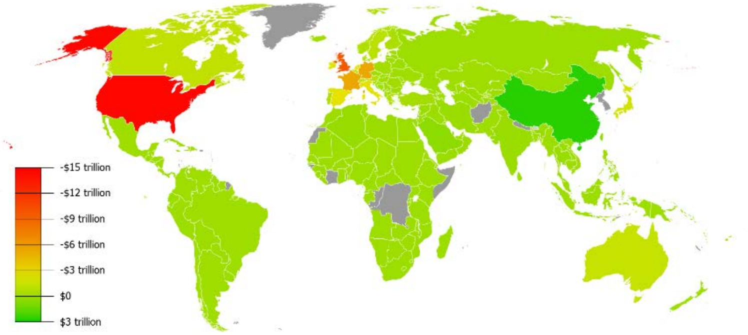

2. IMF credit/liquidity lines
3. Central Bank SWAP LINE arrangements

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Problems with Buffer Approach

1. Negative carry
2. Distorts exchange rate
3. Subsidizes “off-setting” private carry trades
    - Subject to carry trade risk
    - “Up the stairs down the elevator”

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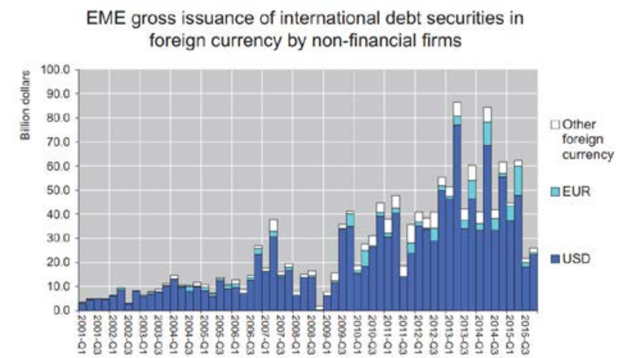
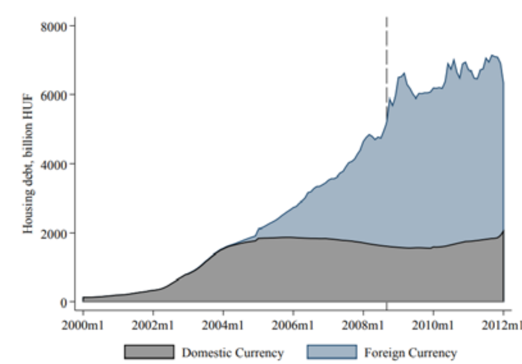


- Private carry trades
  - EME corporate sector \$-borrowing
    - Bruno & Shin 2016
  - Hungarian/Polish household €-borrowing
    - Verner 2017



(b) Housing debt in domestic and foreign currency

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International: Flight to Safety

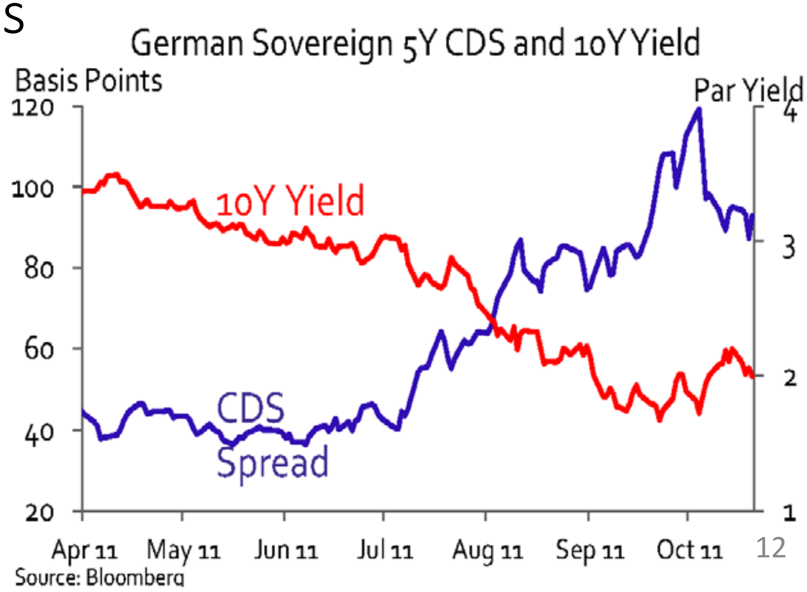
- Risk-on, Risk-off   Flight-to-safe asset

- Problem: Safe asset is *asymmetrically supplied* by AE

  Flight-to-safety ⇨ cross-border capital flows

Extra Slide: Safe assets

- "Good friend analogy" - like reserve assets
  - Safe/available at any horizon - "when it counts"
  - Precautionary buffer
    - held in addition to more risky assets
    - Risk↑ ⇒ demand for safe assets ↑
- "Safe asset tautology"
  - Safe because it is "perceived to be safe"
  - Safe independent of fundamentals
    - US Treasuries downgrade by S&P in 2011 ⇒ yield ↓
    - German CDS spread ↑ ⇒ yield ↓ during Euro crisis
  - Multiple equilibria
  - Bubble



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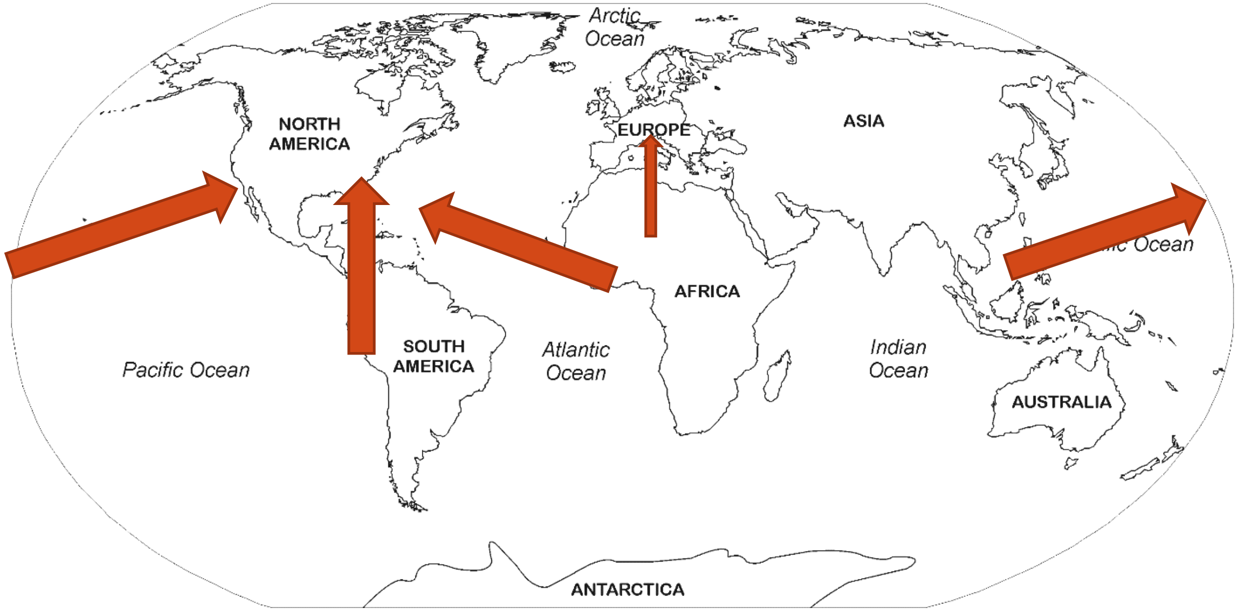

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  Flight-to-safety → cross-border capital flows

- At times of global crisis, issuance of new debt
  - For AE at inflated prices   eases conditions
  - For EME at depressed prices   worsens conditions

- Question: Who insures whom? *"Poor insure rich Paradox"*
  - Correct insurance only if buffer is large and debt long-term enough so that no new debt issuance needed & sell safe asset/reserves instead

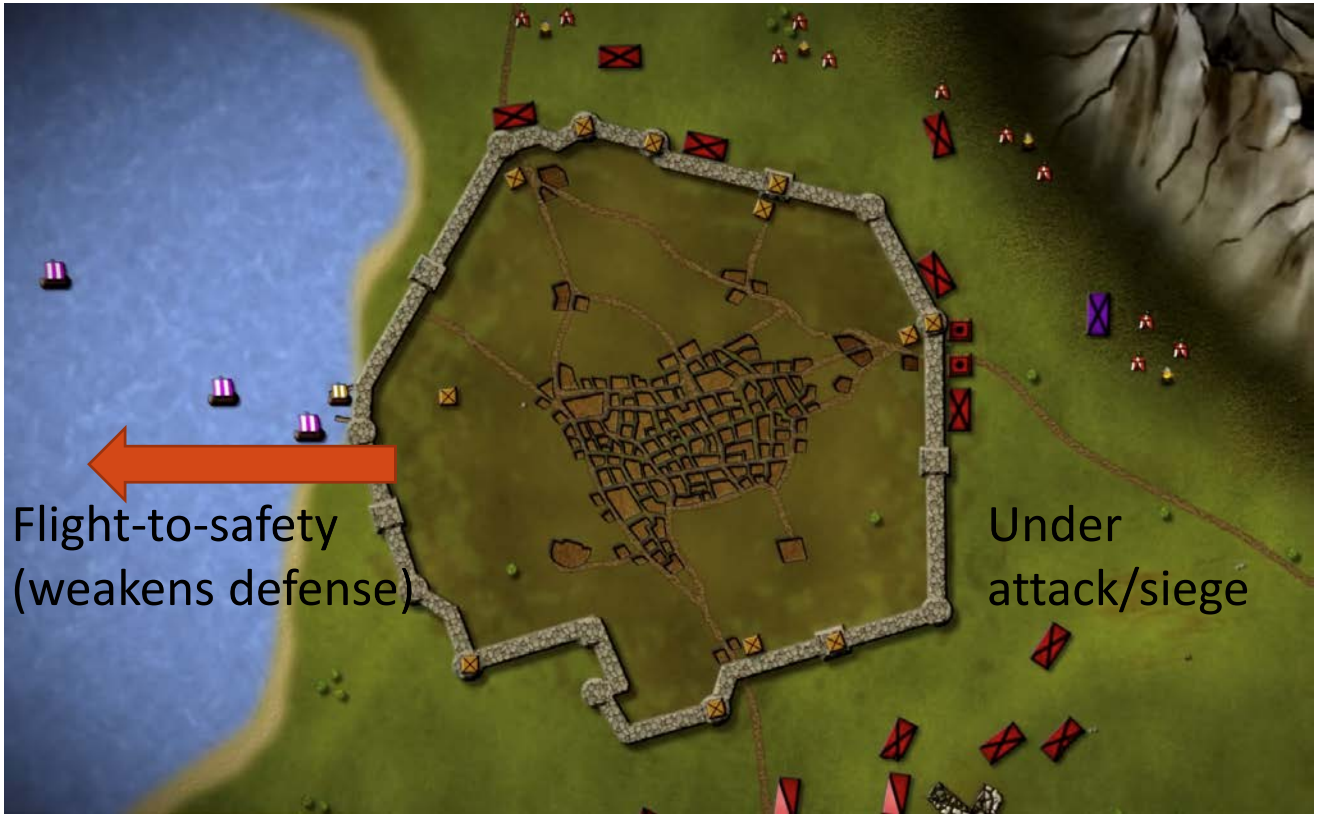
Alternative "Rechanneling"

- Address root cause: Safe asset is supplied asymmetrically
- Build a "safe haven" inside!
- Analogy

“Rechanneling Analogy”

- Address root cause: Safe asset is supplied asymmetrically

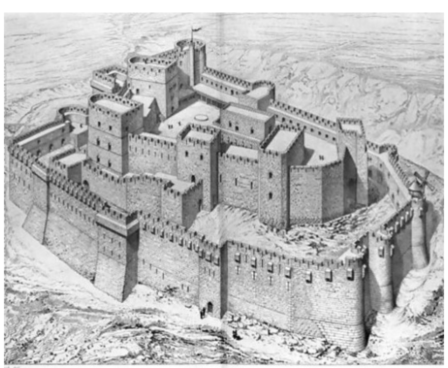
- Analogy



“Rechanneling Analogy”

- Address root cause: Safe asset is supplied asymmetrically

- Analogy
  - Two lines of defense
    - Stronger inner circle (keep)



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"Rechanneling Analogy"

- Address root cause: Safe asset is supplied asymmetrically

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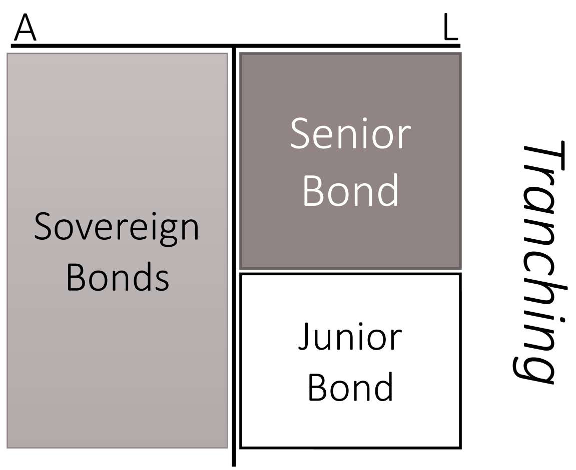
How to build safe haven in finance?

- (national) tranching
- Address root cause: Safe asset is supplied asymmetrically



A Global Safe Asset for & from Emerging Market Economies
Brunnermeier & Huang

“Rechanneling”

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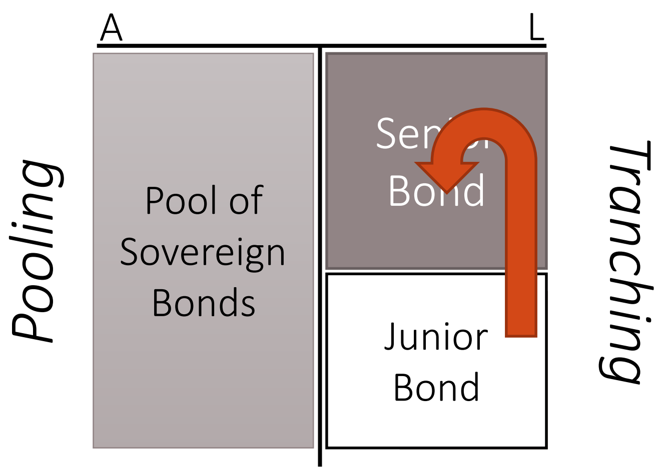


Rechannel:
Instead of cross-border
Across asset classes

- Expand ESBies idea for euro area to EME:
  “SBBS (Sovereign-Bond Backed Securities) for the world”

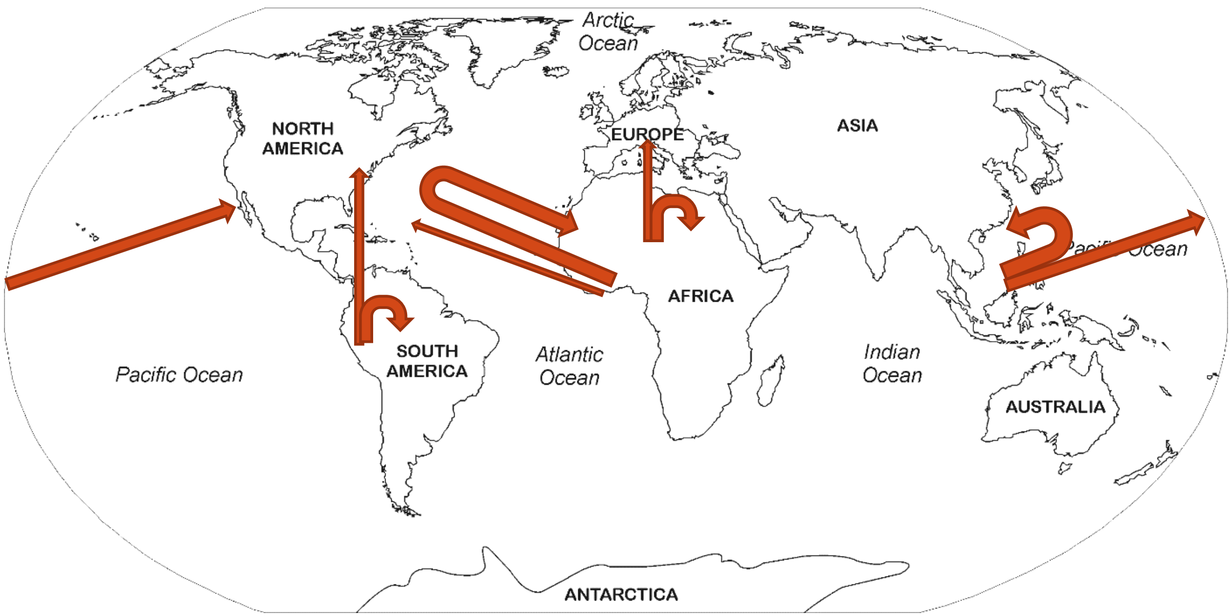
  Euro-nomics group 2011, 2016, 2017

International: Flight to Safety

- Risk-on, Risk-off — Flight to safe asset

- Channels back some of flight-to-safety capital flows

  ➡ fewer cross-border capital flows



Pooling & Tranching

- Pooling: like Asian Bond Fund (ABF)
  - EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks http://www.emeap.org

- *Pooling*
  generates diversification benefits
  but also spillover dangers!!!

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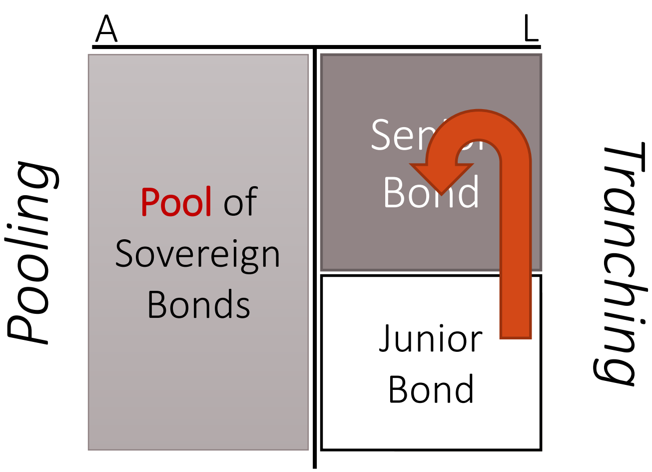
- Pooling and Tranching



- *Pooling*
  generates diversification benefits
- *Tranching*
  contains spillover effects

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Conclusion

- Paper provides nice overview and new insights of
  - AFC & GFC
  - Usefulness of BIS banking data – trigger vs. amplifier

- Global Financial Architecture

• Buffer approach	interventionistic
▪ Reserve holding	costly due to cost of carry & distortionary
▪ IMF support	very limited
▪ Swap lines	Limited (not all IMF member countries)
• Rechanneling approach	self-stabilizing (autonomous)

- Tranching completes the market
  - Allows catering to investors groups with different risk attitudes
  - Makes EME less crisis prone

- International pooling and tranching
  - Pooling like Asian Bond Fund (ABF)
  - SBBS/ESBies for the world