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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- **BIS statistics** as useful real-time monitor for global crisis
  - Early warning indicator

- **Financing Structure**:
  - From **Bank debt** financing to **capital market borrowing**
    - Hold-out problem ⇒ CAC
  - **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)
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  - Early warning indicator

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

- **Lenders:**
  - Latin America: US banks
  - AFC: Japanese banks for Thailand and Indonesia
  - GFC: European banks dominant in cross-border financing

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  - GFC: Emerging market generally moves together

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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
Lessons learned for AFC

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

  1. Official Reserves

  2. IMF credit/liquidity lines

  3. Central Bank SWAP LINE arrangements
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”
Problems with Buffer Approach

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- Private carry trades
  - EME corporate sector $-borrowing
    - Bruno & Shin 2016
  - Hungarian/Polish household €-borrowing
    - Verner 2017
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
“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
International: Flight to Safety

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- Problem: Safe asset is *asymmetrically supplied* by AE 
- Flight-to-safety  
  \[ \rightarrow \]  
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International: Flight to Safety

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

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- Analogy
“Rechanneling Analogy”

- Address root cause: Safe asset is supplied asymmetrically

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

![Diagram showing flight-to-safety and under attack/siege](image)
“Rechanneling Analogy”

- Address root cause: Safe asset is supplied asymmetrically

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

  ![Diagram of a castle under siege with a flight-to-safety pathway and a safe haven.](image)
How to build safe haven in finance?

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

- Address root cause: Safe asset is supplied asymmetrically

- 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  
  [Diagram showing arrows indicating 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](http://www.emeap.org)

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

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- Pooling and Tranching

  ![Diagram showing Pooling and Tranching](image)

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