# A Reform of the International Monetary System

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## What is wrong with the current IMS?

$ as a de-facto global currency and a core of the IMS begin to show its serious limits

## How do we go about fixing it?

Introduce ACU assets, IMF as a GFSN, and install proper global institutions

## New mandates for a revamped global governance

# Snapshot of the current IMS

- Current system has worked relatively well for the past 40 yrs
- Consolidation between the finance-driven US and real sector-based Asian economy ➔ heightened dependence on the dollar
  - 85% of foreign exchange transactions, and over half of all bonds globally are $-denominated in dollars
  - About 60% of central bank reserves are in $-denominated assets.
- Prevailing Triffin dilemma:
  - Excessive dollar reliance ➔ perpetual US deficits to ensure sufficient global liquidity
- BUT,,, weakening dollar ➔ harder for export growth-driven Asian economies to adjust relative prices

# Snapshot of the current IMS (cont'd)

- Dollar based IMS also restricts the chances of portfolio diversification (Few viable choice → Asset Bubble)

- Most stabilization efforts hinge on dollar denominated debt securities with significant downside risks (Even deleveraging requires massive printing by central banks}

- Demand for vehicle currency denominated assets increases, but there is no real chance to diversify away from $ assets.

- Overall, the financial system is not functioning smoothly: resources are channeled into wrong uses.

# Excessive dependence on the dollar has created numerous problems

- Fear of systemic risk ➔ massive fiscal supports ➔ loss of market confidence ➔ CB dollar positions increase further
- Ordinary citizens and SMEs left to rely on globally systemically important financial institutions (GSIFIs) to obtain access to credit
- Chances of a bubble increased
  - Funding not being channeled efficiently
  - Flows unstable ➔ high stabilization costs
  - Essentially CB swap networks replacing LOLR
- Yet, no governance structure for the global public good

# Problems of dollar-reliance : (1) Missing anchor for stable global liquidity

- Financial capabilities concentrated in the major markets
- Volatile supply conditions prevail with perennial demands for $ funding
- Periphery countries' costs for stabilizing uncontrollable capital flows soar rapidly ➔ Subordinated credit supply to non-tradable sectors ➔ Erodes growth potential: no shared and sustained growth
- Emerging markets constrained in their ability to diversify risk
  - ➔External factors induce excessive hoarding
  - ➔Harder to achieve stabilization and resulting government intervention worsens moral hazard
  - ➔Harder to attract diverse market participants to promote capital markets

# Adjustment burden piling up in EM economies, where they cannot adjust ➔ recycled back to $ asset holdings

- Short-term funding and longer term use in EMs result in serious balance sheet mismatches
  - Only the US can borrow long and use short via existing network externalities and seigniorage
  - Biased market structure makes EM B/S adjustments difficult

- After QEII, emerging economies faced serious liquidity management issues due to sizable capital flows and asset market bubbles

- Even China engaged in overseas bond investment, transferring the FX burden to neighboring countries
  - Unlike mature economies, emerging countries cannot print money to transfer burdens to overseas.
    (The ultimate problem of the current IMS results in increased costs of emerging economies because they cannot print money with global acceptance)

# Problems of dollar-reliance:
# (2) Limits asset diversification

- **Global imbalances resulted from countries with shallow domestic financial bases relying on external financial system**
- Under the current IFS, few investment alternatives for adjusting external asset positions (lack of choices)
- Overflowing dollar liquidity and bias towards dollar-based assets and dollar network-based capital flows

  ➔ Source of systemic risk

  – Increased chance of asset bubble

  – Even greater vehicle-currency uncertainty

# Failing efforts without IMS reform

- Stabilization efforts will lead to:
  - ➔ Build-up of dollar-denominated debt
  - ➔ Greater debt exposes future wealth to the risk of a sudden fall in value
  - ➔ Hard to take policy steps to ensure sufficient retirement income or solidify the local economies
- Further, if US starts reducing deficit, shortage of safe assets will make asset management difficult, and stifle urgently needed portfolio diversification

- Deficit based dollar debt increase distorts capital flows and makes the necessary adjustment very difficult: *Even deleveraging, asset allocation cannot be carried out*
  - Debt securities comprise more than ¾ of global financial assets. Equity capital becomes scarce.
  - Current IMS cannot provide global financial stability that ensures shared, sustainable growth
  - Current global governance is not properly equipped to tackle serious global problems

Increased demand for safe assets boosted shadow banking with higher leverages in developed economies to precipitate financial excesses

# Problems of dollar-reliance :
# (3) System problems stifled growth potential

- Strong incentives to increase dollar debt ➔ Capital flows becoming more distorted and growth potential damaged
- Heightened risk awareness
  - ➔ Shift from equity capital to debt securities
  - ➔ Fiscal guarantees for crises give rise to moral hazard
  - ➔ Crowding-out of growth-boosting investment
- Serious concerns for efficiency of resource allocation
- Emerging markets: limited in their ability to diversify internal risk and to procure safe assets
- Thus, current IMS will exacerbate tail risk and threaten the core of the global financial system

# Trouble originates from the central banks' B/S in the region (Risk Accumulation)

- Reserve Asset Composition and the pattern of Credit Supply : Concentrated flows to real estates, procyclicality, volatility

- Huge burden on sterilized intervention leads to asymmetric development of government bond market

- Sluggish private corporate bond market

- Under the current IMS setup, EM remains in an <u>asymmetric trap of taking on non-diversifiable risks while supporting the US-centric capital flow</u>

# Stylized Sovereign Balance Sheet: Hardly a stable base for credit creation

| Type of Intervention | Assets | Liabilities |
|---|---|---|
| *Liquidity facilities* | Repo (+) / uncollateralized loans (+) | Currency in circulation (+/-)[1/] / Bank reserves (+) |
| | Central bank swaps (+) / other swaps (+)[2/] | Central bank swaps (+) / other swaps (+)[2/] |
| | Foreign exchange loans (+) | |
| | Foreign exchange reserves (-) | |
| *Capital injections* | Preference / ordinary shares (+) | Tbills / Tbonds (+) |
| | Warrants (+) | |
| | Convertible bonds (+) | |
| | Subordinated bank debt (+) | |
| *Purchase of assets* | Troubled assets (+) | Tbills / Tbonds (+) |
| | Corporate bonds / commercial paper / other fixed income securities (+) | |
| | Other financial assets (+) | |
| *Guarantees* | Guarantee fund (+) | |
| *Other financing of interventions* | Assets held in SWFs (-) | |
| | | Contingent claims (++)[3/] |

# (4) Missing elements of global governance

- Current IMS can offer no facilities for global financial stability
- What the global economy needs:
  - NOT the central banks printing more money
  - Global authority to address fundamental shortcomings of the IMS
- Cause of the recent global crisis:
  - "Absence of governance structure to make the necessary adjustments to overcome these shortcomings"

# Diagnostics: Symptoms require a Major reform of the IMS

Greater needs for global liquidity and $-based financial market network accentuates the dependency on dollar funding for countries with poor indigenous financial resources.

$ funding is the name of the game and even global banks heavily engaged in increasing $ assets.

The resulting herd behavior of engaging in dollar funding recycles $ liquidity into back to advanced countries to add to the bubble and to procyclical bank claims in EMs.

# Emerging market perspective

- EM export growth strategy, without supplying its own reserve assets, exacerbates its dependency on a dollar system.

- Greater outsourcing of its own financial system makes it difficult to develop capital market or issue a reserve asset(s) of global acceptance

- Asia needs to develop an open strategy for currency internationalization via EM index and seek greater regional efforts toward a balanced growth

“Fundamental vulnerabilities of emerging economies are closely related with the single reserve currency system”

# Obstacles for capital market development: (1) Original sin: Bureaucratic financial system

- Typically quasi-bureaucratic system leaves little room for private innovation and voluntary participation

- Common backgrounds for Asian Economies (A3): title roles of bureaucrats, only limited supporting role for private experts

- Bureaucratic vs. market oriented systems are orthogonal

  → Despite the intense effort, capital market in the region is still lagging behind

# (2) Huge FX stabilization needs

- Excessive holdings of FX reserves interfere with capital market development
  - Needs for bond issuance depressed
- Credit creation process:
  - Suppressed or distorted
  - Cannot accommodate the expanded private use of debt instrument as a funding vehicle.
- Mismatch of the reserve asset composition:
  - Dollar needs are not matched by market support
  - Need a monetary system based on multiple reserve currencies

# (3) Credit flows are not diversified: Inherent instability (B/S imbalance)

- Polarization, capital flow volatility, and the suppression of capital market developments are unavoidable.
- (1), (2), (3) are inevitable side-effects of export-dependent growth paradigm
- This setup is deeply engrained in a dollar dependent financial system

# (4) Distortion of Maturity Structure

- US
  - the only country able to finance short-term investing through long-term funding
- Emerging markets
  - severe maturity and currency mismatches
- Conflicted incentive for countries to stockpile dollar assets as insurance
- Leaves few other options outside of capital controls.
- Following QEII, non-reserve currency countries incurred great costs to manage liquidity and capital flow-related asset bubbles
- These costs being passed on to taxpayers across borders – *Clean-up costs being transferred to EMEs.*

# Integration achieved, but no significant benefits of securing stable FX liquidity

- Greater integration into a global financial network – some favorable outcomes in terms of market access
- Even bigger problem of increased exposure against external shocks, liquidity risk driven credit risk
- Greater G-SIFI dependency and increased stabilization costs
- Overall gains?

# Reform Directions for the International Financial System: Provision of Global Public Goods "Reserve Assets"

◆ Reality check and diagnosis help us hammer out two principles required for future reform:

1. Regional markets must mature to get away from over-reliance on the external financial system: *Root cause of the global instability*
2. We need a new reserve ACU-denominated asset and a multilateral dialogue and system-level rebalancing

* ***Key issues converge to securing factors for market development***

# Reform Directions for the International Financial System

- The new IFS should:
  - Bring down excessive dollar demand
  - Improve access to stable liquidity without excessive reliance on $ funding market – capital market development and **A3 provision of a new reserve asset**
- This must involve:

***AMF supporting EM index (e.g. ACU )with G-20 Consensus***

# Stable financial system in a new environment

- Global stability can be achieved with **tri-polar reserve assets** with SDR serving as an core anchor
- Tri-polar world with only two reserve assets is unstable
- Missing link can be bridged with ACU
- ACU is an index that consists of Yen, Yuan, and Won with other vehicle or Asian currencies to be included
- ACU is stable against other key currencies –stable exchange rate
- ACU basket can be a regional anchor for regional and global financial stability
- Daily transactions would not be affected
- Reserve operations can be made more stable due to a marginal shift from Dollar assets
- Regional FX reserves can be a capital base for AMF, ACU

## Reform directions
## (1) Place proper governance: Enhanced role of IMF as a GFSN

- The most pressing task:
  - establishing markets and IFIs for reliable global liquidity supply
  - multiple reserve currency system
- Must involve multilateral cooperation via the G20
- Anchor role of a global financial safety net (GFSN) needed to supply sufficient liquidity
- IMF-based global central bank with authority over GFSN
- FSB- and BIS-based global supervisory bodies
- Must move away from the untenable Federal Reserve-based governance structure to a mutually reliant structure

# A Pyramid structure for the proposed IMS

Since the AMF-ACU is missing, the system has become unstable, resulting in over-reliance on $ and its infrastructure.

This aggravated capital flow uphill, over-burdening the IMF, and busted the system. We have to reform the system not by overhauling, but by installing the missing link, which are AMF and ACU.

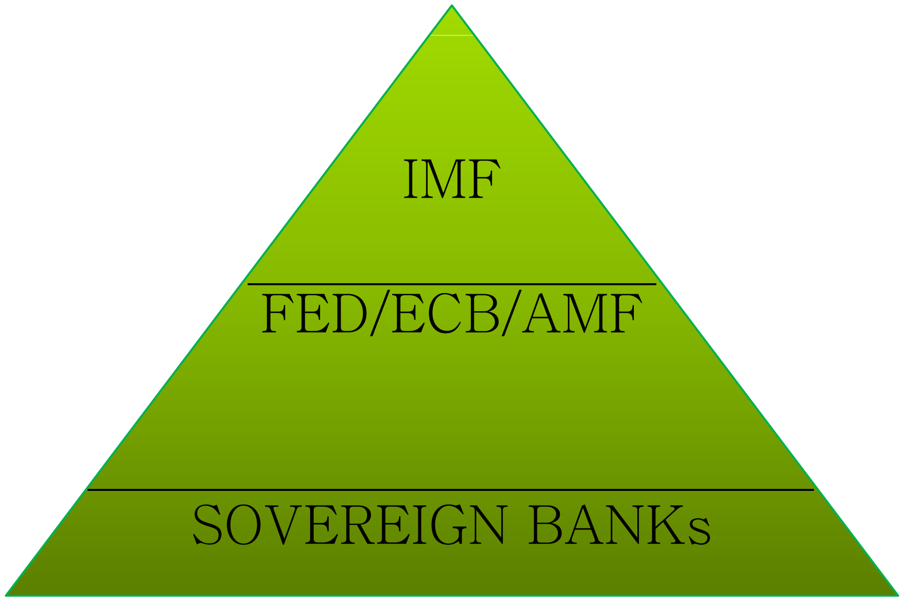
This would bring stability and ease the unnecessary burden on excessive hoard of $ reserves which further destabilizes the system. We have to get on to it ASAP.

# A Pyramid structure for the proposed IMS (Cont'd)

Regional buildup: ACU as a basket of currencies and CMIM as an AMF

FED, ECB, AMF: $-Euro-ACU

IMF: SDR



# Systemic risk management in an integrated environment

- We all need to get out of the country-specific mold and think globally to seek a truly global solution: Consensus building toward balanced growth

- Misplaced emphasis on sovereign based financial regulation while we need a better-functioning financial system

1. Institutional provision is of top priority for an integrated system
2. ACU-based transition path toward a multiple reserve system
3. Differentiated global guidelines for emerging economies

# Systemic risk management in an integrated environment (cont'd)

Mixed International Monetary System

Bretton Woods System – Flexible System – Mixed System

We rely on too much on financially advanced economies

"Internally there were no longer-term and across-the-border concerns for risks-Missing link needs to be restored by institutionalizing"

"Financial Centers" can only develop when they are fully connected with the world.

It is ok to move into multi-polar system, but capital market and derivatives need to be fostered first.

# Results of relying on an outdated IMS: Monitoring Failure

- Stability without reform can lead to even bigger instability
- Democratization of credit and wider homeownership
- Debt-fueled global growth process was justified by paradigm shifts: re-integration of emerging markets into the global economy; the Goldilocks high-growth/low-inflation economy
- The result: A consumption binge in deficit countries; an export surge in surplus countries;

# Financial imbalance as a determinant of systemic risks

**Unusually high demand for safe debt instrument: investment risk heightened + abundant liquidity**

Current efforts would shrink, distort the global financial system by constricting capital flows severely.

Renewed attention on reserve currency countries for their responsibility to contain spillovers is the most important recognition.

# Financial imbalance as a determinant of systemic risks (Cont'd)

The first step is to expand the role of the IMF as a GFSN, a real global central bank in terms of providing global liquidity.

Second, some of the reserves need to be used to foster the regional and global bank as lenders of last resort.

Third, global reserve currencies need to include Euro and ACU.

# Financial imbalance as a determinant of systemic risks (Cont'd}

Essentially, we need AMF to support ACU (EM index).

If we can agree on this, the IMS would be based on IMF as a global central bank, AMF and ECB as regional banks and sovereign banks.

With improved governance, the FED continues to maintain its unique position as the pillar of the new IMS.

Global liquidity can be $, ACU, Euro which has a common representation as a SDR with complete substitutability through the IMF.

## Reform directions:
## (2) Bridge the missing link-SDRs and the ACU

- Must formalize attempts to reduce excessive dollar-reliance
- Must diversify liquidity channels through multiple reserve currencies
- BUT rather than replacing the dollar system outright, must make gradual reform
- SDRs
  - Realistic alternative
  - Can ease concerns for inflation due to post-crisis measures
  - Can cut down on incentives to expand global imbalances
- Asian currency unit (ACU)
  - To enhance the under-represented role of Asia with SDRs

# China Factor: A super-sovereign reserve currency?

- Yuan in the basket of currencies for SDR-Limited success or not a legitimate choice

- Relax its requirement that the SDR be composed of 'freely usable' currencies-China's lack of an open capital account

- The SDR is a potential claim on the currencies that underpin it, and so its value will inevitably be determined by the ease with which those currencies can be exchanged internationally

# Constraints: Fixed exchange rate regime and high growth paradigm hinge on closed KA

- Financial opening would threat both the Chinese financial system and high growth dynamics.

- The stability of the Chinese financial system is currently supported by funding opportunities at lower-than-market rates.

- Banking sector reform should precede a capital account liberalization; otherwise financial opening creates new threats to Chinese banks' balance sheets.

# Straight Jackets: Current Global Mismatches

- Monetary integration vs. fiscal disintegration
- Mispricing of risks dumped into periphery countries
- Integrated global $ funding network vs. isolated local FX funding system
- Deficit-driven moral hazard and even bigger problem of deleveraging

# Best way to proceed with globalization

- Regions without proper market backup should start using common index to denote their external positions

- Index-based foreign transactions before proceeding with currency consolidation

- Parallel approach seems desirable, utilizing EM index as an extra layer of protection to develop regional markets

# Relative changes as compared with EM, EEM

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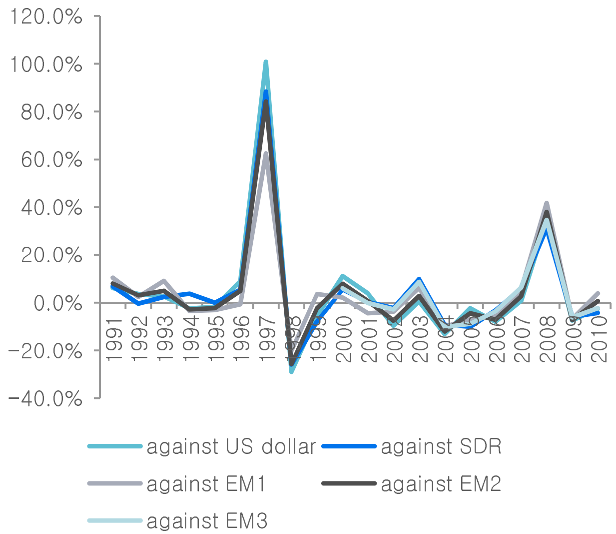


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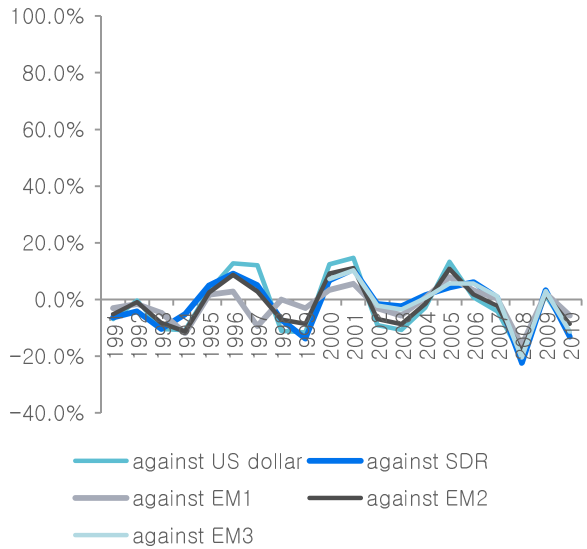


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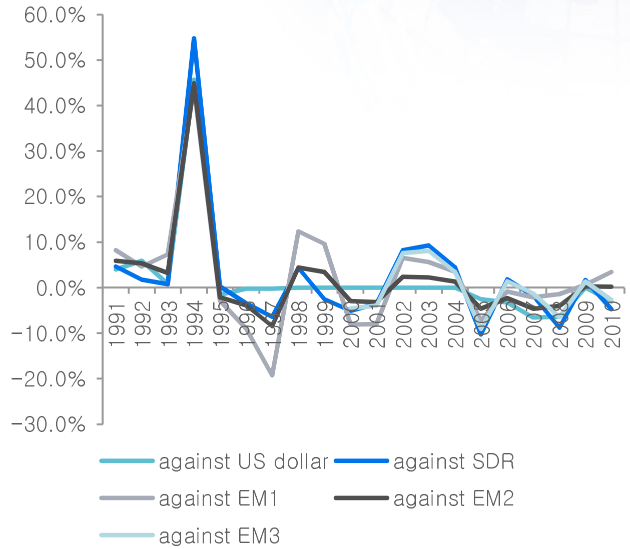


# Practical Suggestions

- EM indexed Supply of Asian Reserve Assets
- Various collateral assets: CDO, corporate and sovereign bonds
- EM index can be developed and maintained by commercial entities
- New rating methods can be applied

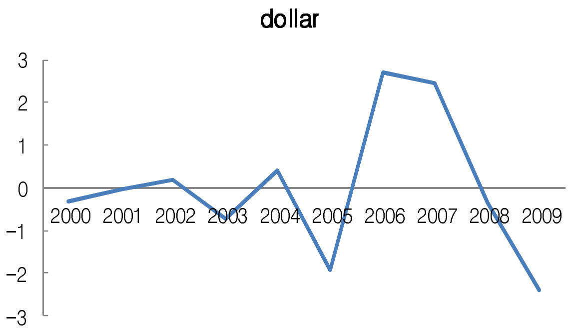
# Currency Internationalization

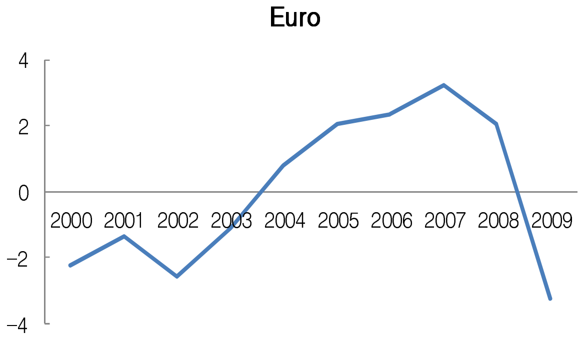
## <Basic Factors for Currency Internationalization>

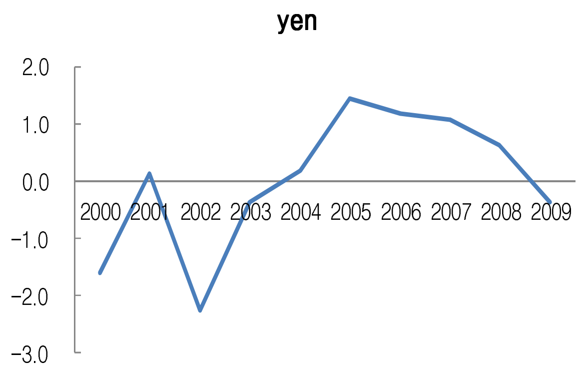
| | GDP[1)2)] | | CPI Inflation[3)] | | Exchange Rate Changes[1)4)] | | Financial Development[5)] | | Financial Opening[6)] | | FX Transactions[7)] | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000~2004 | 2005~2009 | 2000~2004 | 2005~2009 | 2000~2004 | 2005~2009 | 2000~2004 | 2005~2009 | 2000~2004 | 2005~2009 | 2004 | 2010 |
| US | 30.43 | 25.47 | 2.55 | 2.59 | 2.68 | 0.32 | 474.85 | 562.42 | 10.60 | 15.83 | 88.0 | 84.9 |
| Euro | 21.22 | 21.94 | 2.23 | 2.02 | -3.42 | -0.81 | 340.42[8)] | 357.99[8)] | 15.46 | 23.69 | 37.4 | 39.1 |
| Japan | 12.25 | 8.66 | -0.52 | 0.01 | 3.00 | -1.62 | 372.13 | 500.22 | 11.55 | 21.99 | 20.8 | 19.0 |
| China | 4.24 | 6.52 | 1.05 | 2.64 | 2.67 | -3.45 | 185.28 | 282.00 | 3.78 | 5.27 | 0.1 | 0.9 |
| Korea | 1.68 | 1.72 | 3.24 | 3.00 | 0.79 | 3.54 | 296.88 | 379.01 | 5.94 | 18.85 | 1.1 | 1.5 |

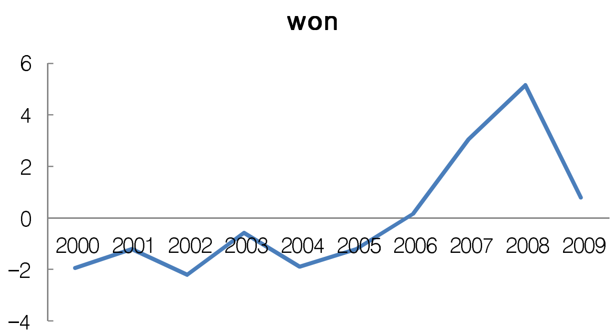
Note : 1) Period Average, annual 2) Nominal GDP over World GDP 3) Period average of yoy CPI inflation 4) Average change over the year-end, vis-à-vis SDR, (-) represents appreciation 5) Financial Assets over Nominal GDP 6) Capital inflow + outflow over Nominal GDP 7) Daily average of FX transactions, 200%
Source : World Development Indicators, World Bank, 2011. IFS, IMF. Triennial Central Bank Survey, BIS, 2010. Bloomberg.

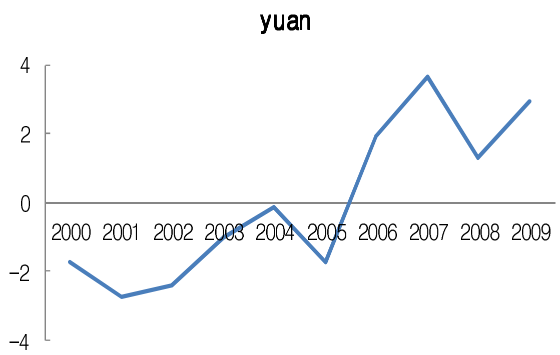
# Currency Internationalization Index



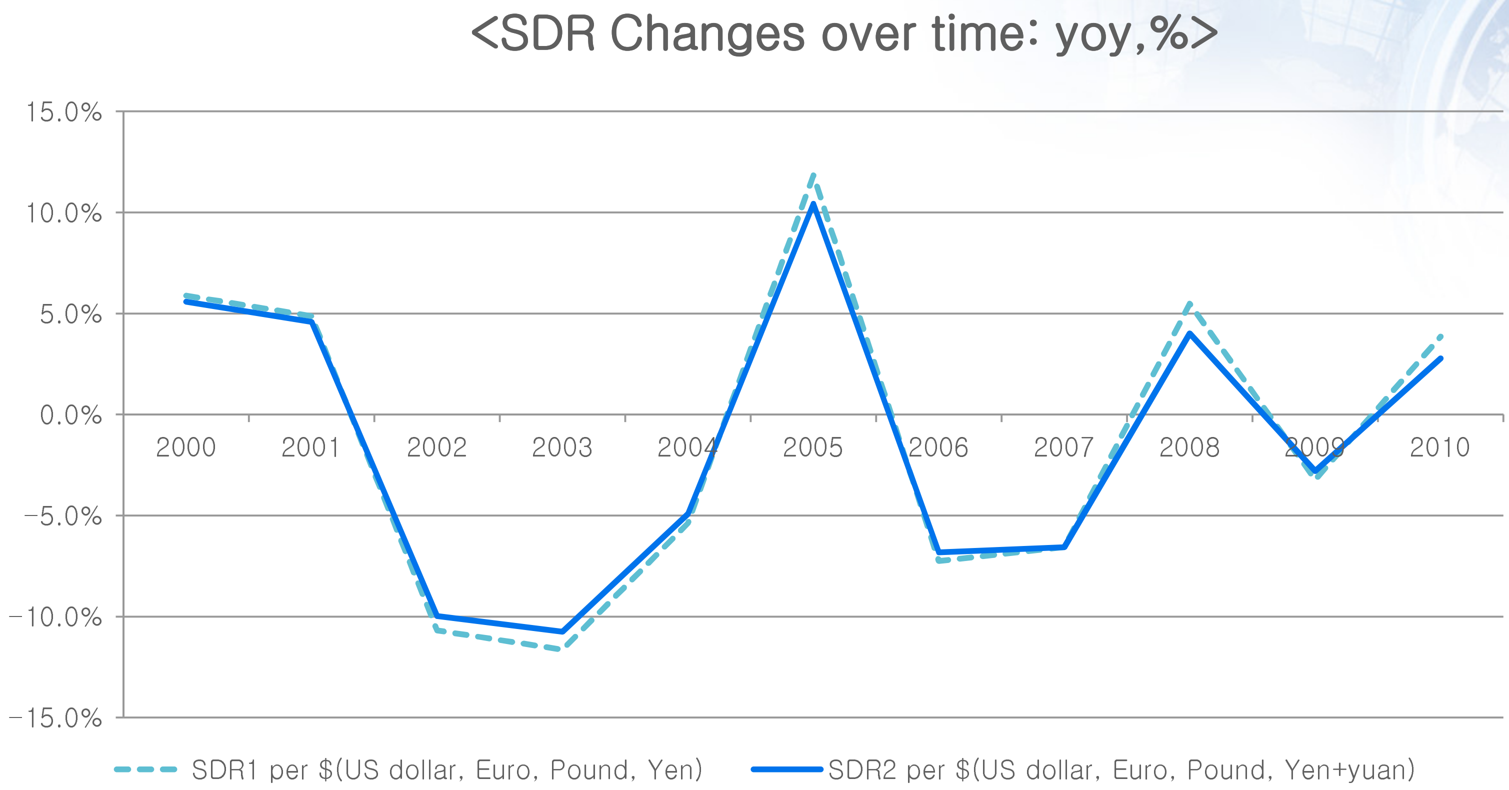



# Currency Internationalization Index




# Currency Internationalization Index


# SDR vs Yuan included in a new SDR Basket




$$SDR(t) = SDR(0) \times [w_1 \frac{E_1(t)}{E_1(0)} + w_2 \frac{E_2(t)}{E_2(0)} + \cdots + w_n \frac{E_n(t)}{E_n(0)}]$$

$$w_j = \frac{[Export + Holdings\ of\ SDRs]_j}{\sum_{i=1}^{n} [Export + Holdings\ of\ SDRs]_i}$$

# SDR vs Yuan included in a new SDR Basket

## Currency Weights of SDR

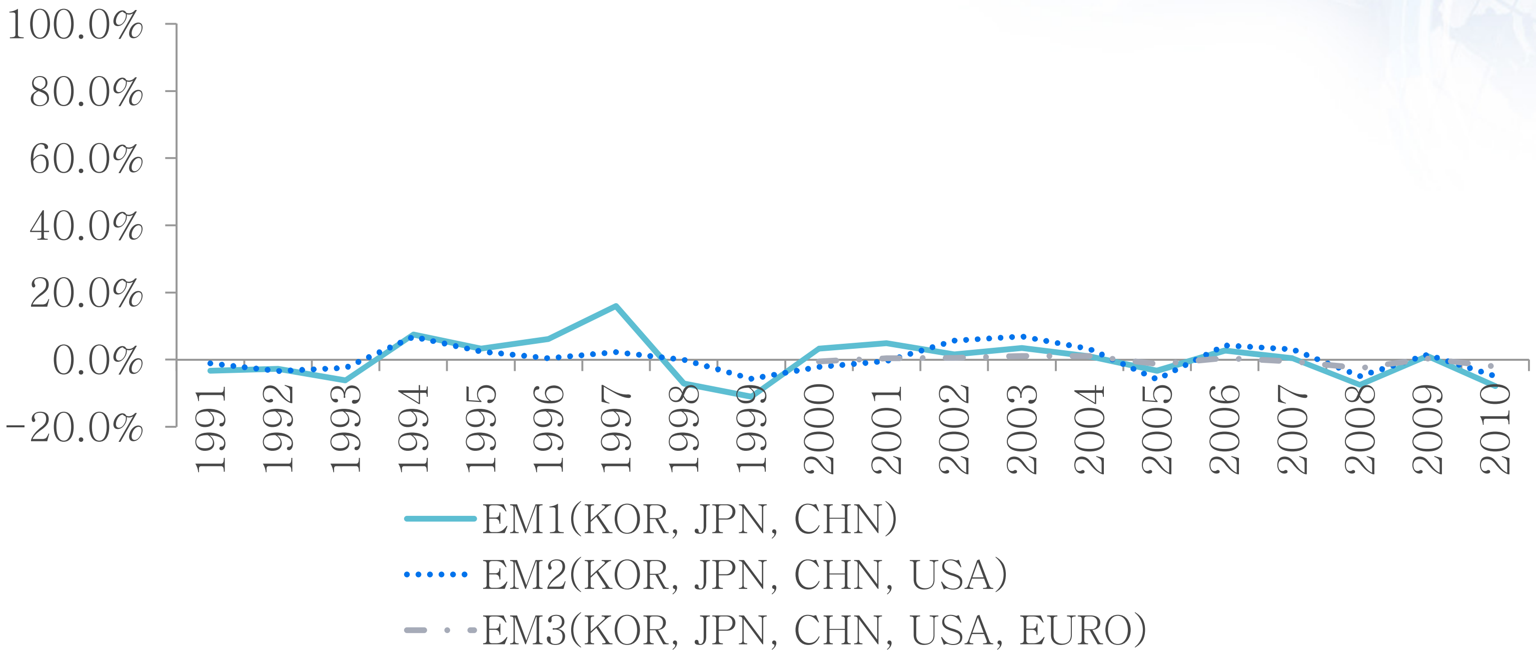
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Euro area | 52.4% | 50.3% | 52.7% | 53.8% | 56.2% | 56.6% | 55.7% | 55.6% | 56.7% | 57.8% | 57.9% | 56.3% |
| Japan | 11.1% | 11.7% | 10.7% | 10.5% | 10.3% | 10.4% | 10.1% | 9.6% | 9.1% | 9.3% | 9.2% | 10.3% |
| United Kingdom | 11.0% | 11.3% | 11.4% | 11.4% | 11.1% | 11.1% | 11.5% | 11.9% | 11.8% | 10.5% | 9.3% | 8.7% |
| United States | 25.4% | 26.7% | 25.2% | 24.2% | 22.4% | 22.0% | 22.6% | 22.9% | 22.4% | 22.4% | 23.6% | 24.7% |

## Currency Weights of SDR2

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| China | 4.4% | 5.2% | 5.6% | 6.6% | 7.7% | 8.5% | 9.8% | 10.6% | 11.4% | 12.4% | 13.3% | 15.6% |
| Euro area | 50.1% | 47.7% | 49.7% | 50.2% | 51.9% | 51.8% | 50.3% | 49.7% | 50.2% | 50.6% | 50.2% | 47.6% |
| Japan | 10.7% | 11.1% | 10.1% | 9.8% | 9.5% | 9.5% | 9.1% | 8.6% | 8.0% | 8.2% | 8.0% | 8.7% |
| United Kingdom | 10.6% | 10.7% | 10.8% | 10.6% | 10.2% | 10.1% | 10.4% | 10.7% | 10.5% | 9.2% | 8.1% | 7.4% |
| United States | 24.3% | 25.4% | 23.8% | 22.6% | 20.7% | 20.1% | 20.4% | 20.5% | 19.9% | 19.6% | 20.4% | 20.8% |

# ACU (Emerging Market Index) is noticeably stable

<EM Changes over time: yoy,%>




$$EM(t) = EM(0) \times \left[ w_1 \frac{E_1(t)}{E_1(0)} + w_2 \frac{E_2(t)}{E_2(0)} + \cdots + w_n \frac{E_n(t)}{E_n(0)} \right]$$

$$w_j = \frac{[(EX + IM) + (CI + CO)]_j}{\sum_{i=1}^{n} [(EX + IM) + (CI + CO)]_i}$$

# Calculation of Currency Amounts in the New SDR Basket (as of December 30, 2010)

| Currency | Initial new weight (share) | Illustrative currency amount[1] | Exchange Rate[2] on 12/30/10 | U.S. dollar equivalent |
|---|---|---|---|---|
| | | | | |
| Euro | 37.4 | 0.423 | 1.325 | 0.560475 |
| Japanese yen | 9.4 | 12.1 | 81.63 | 0.14823 |
| Pound sterling | 11.3 | 0.111 | 1.5435 | 0.171329 |
| U.S. dollar | 41.9 | 0.66 | 1 | 0.66 |
| | | | | |
| SDR1 = US$[3] | | | | 1.54003 |

1.Currency amounts are based on average exchange rates for a period from October 1 to December 30, 2010.
2.The exchange rate for the Japanese yen is expressed in terms of currency units per U.S. dollar; other rates are expressed as U.S. dollars per currency unit.
3.The value in U.S. dollars of one SDR, rounded to six significant digits

Source: IMF

# Asian Initiative

- Asia's financial base not mature enough compare to its economic level
- Asia Monetary Fund (AMF) must be set up
  - Should encompass CMI multilateralization
- AMF forms a regional currency base ➔ establish ACU
- Establishment of SDRs preferable, but takes too long
- In light of Asia's historical context, introducing a parallel currency regime works better
  - Reduce reliance on the dollar for insurance purposes
  - Reduce adjustment-related side-effects

➔ **ACU regime**

# Asian Initiative

- Without the regional efforts to supply alternative reserve assets, the current IMS will continue to experience serious problems going forward.
- A new reserve asset will help support the existing pillars of IMS to allow normalization of capital flows worldwide.
- A new reserve asset will help restore the vehicle currency status in an integrated environment

# Reform directions
## (3) Rebalancing – Asia's balanced growth framework

- ◆ Must move away from current export-led growth paradigm to a balanced growth framework
- ◆ The current paradigm will bring ever greater costs to maintain
- ◆ Thus, system-level adjustments needed
  - ➔ Such sustainable design holds important implications.
  - ➔ Growth drivers in lagging sectors must be uncovered to overcome the limitations of an unbalanced growth paradigm

# Installing proper gears in IMS is absolutely essential

- Sizable portion of the current global financial problems is due to lack of reserve assets

- Creation of a new reserve asset is in order

- Asia is the only region without reserve asset

- Results have been global imbalance and over-burden on the fragile global monetary system ➔**"Time to act"**

# Better IMS for Bigger Universe

- No longer can hold only-dollar reserve asset position in an increasingly integrated environment (risk diversification)
- Lack of enough reserve currencies led to abnormal FX swap market development
- Heavy central bank use of FX swap facilities
- Instead, we can legitimately create a vehicle ACU that would minimize capital charges

# Recap: Essential Ingredients

- ACU added financial system is more stable
- Stability measurement (CA, won, $, Yen, Yuan vs. CA and ACU, $) - regional vs. global
- ACU construction-ERM lessons
- Use of ACU and dollar interchangeably-parallel currency argument
- ACU-denominated CDO, Bonds, etc.

# Key questions: Why ACU?

- Without it, it is too costly to stabilize an even more volatile capital flow: Tremendous amount of stabilization

- Growth paradigm-distortions in the central bank BS-credit flows that seek shelter in real estates or Treasuries

- With ACU, both supply and demand for reserves will become more balanced, resulting in more stable flow of capital

- It would also introduce an anchor that would discipline sovereign currency values vis-á-vis other currencies

# ACU is based on EM index

- ACU can be easily constructed for reserve needs
- AMF issues ACU-denominated bonds based on $ reserves and local currencies
- Satisfies the needs for asset allocation
- Allows better portfolio diversification

# What are the expected benefits?

- Capital market development:
  Needs for various asset demand with rapid population aging
  - "Lingering uncertainties contained"

- Stable exchange rate against other key currencies:
  Reserve needs are satisfied regionally without excessively relying on $

# Bretton Woods III for New Asia

- ACU would expand the pool for FX market participation
- Bigger market contributes to enhanced stability against volatile capital flows
- Foster environment for overall capital market development: Stable market liquidity can be secured.

# How do we go about issuing ACU or maintaining EM index?

- Common pooling of dollar reserve assets
- Establish AMF or equivalent to maintain ACU or Emerging Market Index
- Local currencies for local use and ACU for reserve and other FX needs
- ACU value will be stabilized in a multi-currency framework

# What are the concerns?

- Eroding role of sovereign institutions?
- Greater uncertainty?
- Lack of necessary manpower and proper institutions, infrastructures?
- Inherent lack of mutual trusts and market confidence (historical and cultural background)

# In short,

- Simulation exercise shows that diverse supply of vehicle currency is a key to preserve global financial stability

- Diverse supply of reserve assets are crucially important for global financial stability ➔ ease the mismatch of supply and demand for reserve assets)

- By supplying a badly needed reserve asset, the global financial stability is better secured and the chance of regional capital market can be enhanced (sovereign authorities are relieved of the needs to stabilize FX liquidity)

# Recap: Directions for Change

## (1) Effective Governance for Asia's Institution Building

- A series of rebalancing efforts are called for, among which Asia's new reserve assets

- The bare essentials for emerging economies is the capital market development in the region: Without it, the current IMS will be overloaded and the spillovers will be too costly.

  - Global financial stability is a public good and can be secured with GFSN
  - GFSN should newly embrace IMF as a global central banks and other global systemic regulators of FSB and BIS

# Recap: Directions for Change

- Outsourcing of the financial system resulted in current problems: Lack of regional reserve asset

- By creating regional institutions such as CMIM (CMI Multilateralization) or a more advanced form of AMF (Asia Monetary Fund), regional currency unit can be maintained and promoted.

- Various proposals for a new exchange rate regime or ACU currency basket is considered for regional efforts
  - Drastic reforms can be far-fetched under the prevailing conditions
  - Circulating EM denominated assets can be a realistic solution
  - Euro-type of monetary integration can be problematic: Parallel currency idea is a realistic choice.

# Recap: Directions for Change

## (2) Regional supply of a new reserve asset

- Enhanced role of global currency, SDR, needs to reflect growing economic importance of the region by incorporating ACU(Asian Currency Unit)
  - ACU region can help restore balance in IMS by enhancing the role of SDR as a global unit
  - ACU can be utilized as a parallel currency, and various swap transactions can be carried out in ACU
  - Primarily, A3 can start issuing ACU bond
  - Given extensive collateral assets in Asia, EM-CDO(Emer ging Market-Collateralized Debt Obligation) can also serve as a de-facto reserve asset

# Despite current problems, Euro remains an indispensible pillar for international monetary system

- Vehicle currency countries have enormous obligations and responsibility to keep their currencies stable
- EM economies can help stabilize the IMS by supplying its own reserve assets with global acceptance
- For that EM index needs to be developed and used for external bond issuance and circulation
- EM index consists of A3+ Euro and possibly dollar for enhanced stability against FX fluctuations
- Marketing based on untapped collateral would be good for everybody, if not for stability purposes
- Bottom Line: Euro needs to be stabilized at all costs for the IMS to expect any future