



The “Asset Crisis” of Emerging Economies

BEIJING – In theory, the difference between capital inflows and outflows in developing countries should be positive – they should be net capital importers, with the magnitude of the balance equal to the current-account deficit. Since the 1997-1998 Asian financial crisis, however, many East Asian countries have been running current-account surpluses – and hence have become net capital exporters.

Even odder is the fact that while they are net capital exporters, they run financial (capital) account surpluses. In other words, these countries lend not only the money they earned through current-account surpluses, but also the money they borrowed through capital-account surpluses – and they do this lending mainly to the United States. As a result, East Asian countries are now sitting on a huge pile of foreign-exchange reserves in the form of US government securities.

While China has attracted a large amount of foreign direct investment, it has bought an even larger amount of US government securities. Whereas the average return on foreign direct investment (FDI) in China was 33% for American firms in 2008, the average return on China’s investment in US government securities was a mere 5% over the past 10 years, and it is much lower more recently. So, why does China invest its savings so heavily in low-return US government securities, rather than in high-return domestic projects?

One answer lies in the fact that China's highly concessional FDI policy over the past 30 years, which in turn is a result of fierce competition for FDI among local governments at all levels, has crowded out many Chinese investors from high-return projects, forcing them to settle for less lucrative projects. But there are still potential investors who cannot find break-even investment opportunities in China, generating excess resources, which, being facilitated by a competitive currency, tax rebate and other measures, translate into current account surplus and then are invested in US government securities.

It is worth noting that, while China's foreign assets are denominated in US dollars, its liabilities, such as FDI, are mostly denominated in renminbi. When the dollar depreciates against the renminbi, the value of China's foreign liabilities increases in dollar terms, while that of its foreign assets remains unchanged. As a result, China's net international investment position (NIIP), which is the difference between China's gross assets and its gross liabilities, automatically worsens. The deterioration of China's NIIP is a reflection of the transfer of wealth from China to the US.

Since the 2000's, China's gross assets and gross liabilities have increased dramatically, owing to the success of China's trade-promotion and FDI policies. In 2010, China's capital-account surplus stood at \$230 billion, and capital inflows remain large this year. Consequently, China's net international investment position has become very vulnerable to the devaluation of the dollar. With ever-increasing gross dollar assets and gross renminbi liabilities, a stronger renminbi means that on top of the welfare losses due to "twin surpluses", China will suffer additional welfare losses from the valuation effect of exchange-rate movements.

Capital inflows into developing countries have surged in the wake of the global financial crisis. Welfare losses due to the valuation effect are not solely a Chinese phenomenon; all major emerging-market economies are faced with the same challenge. During the 1997-1998 Asian financial crisis, East Asia's economies paid heavily for excessive accumulation of dollar-denominated debts. Governments tried but failed to defend their currencies and hence lost hundreds of billions of dollars in foreign-exchange reserves to international speculators.

Whether for self-insurance or to maintain a competitive exchange rate, East Asia has since then accumulated huge amounts of dollar-denominated assets—mainly US government securities. This time around, thanks to the deterioration of the US

fiscal position and the Federal Reserve's expansionary monetary policy, "the long-term risk [for] emerging markets' external balance sheets is shifting," as Eswar Prasad of the Brookings Institution has pointed out, "to the asset side."

Rather than confronting a debt crisis, as in 1997-98, emerging-market economies now face an "asset crisis," but essentially the result will be the same: great welfare losses. Indeed, the magnitude of the losses can be on par with that of the Asian financial crisis, if not higher.

While China's government should make greater efforts to rebalance the economy by conventional measures, it also should pay adequate attention to adjusting the currency structure of the country's gross assets and gross liabilities. In particular, China should try to replace a good portion of its dollar-denominated assets with renminbi-denominated assets, and its renminbi-denominated liabilities with dollar-denominated liabilities.

If China cannot do very much about existing gross assets and gross liabilities, it should address the currency structure of new assets and liabilities. In short, China must take into consideration the ongoing asset crisis facing emerging economies, especially when considering highly consequential questions such as full renminbi convertibility and the currency's internationalization. Undoubtedly, the valuation effect will complicate China's policy on renminbi appreciation. The ideal solution is to eliminate excess saving gap without resorting to renminbi appreciation. Unfortunately, over the past 10 years, this approach has failed to work. The truth of the matter is still that the longer the adjustment progress takes, the higher the costs will be.

Comments by readers

gamesmith94134 07:26 30 Sep 11

Gamesmith94134: **Outraged European Citizens**

Based on the recent fiasco of sovereignty debts in PIIGS, it has tilted the balance of

the equality and autonomy that created the civil war within the European Union. After the series of defaults on the loans, austerity programs many applied did not concur with IMF or Moody who gave negative result in matching the demands; treatment on higher interest payments added on the loans for PIIGS after the rating and privatization program was advised and enforced that put its citizen hostages.

I would suggest the zoning on prevention on the hot cash and tax evasion that each zone will have substantiate the standardized exchanges that each must carry its own bonding if necessary and fee on the transcontinental exchanges. Under the shadow of the Lehman Brothers and the failing equity bonds under the appearance and insurance of the Central banks, it needs a guarantor and an arbitrator from the World Bank and a valuator on the exchange like IMF.

Perhaps, bonds that carries over the intercontinental transaction should be scrutinized and settled through the third party medium like World Bank if such transaction is see as part of the sovereignty debts or loan since some may surpass the regular board of securities exchanges of the local central banks; or such transaction would be considered as the laundry like elements that requires policing

The division of arbitrator of World Bank should have taken an advanced procedure safeguard of economical crashes if such lesser of long term investment and creates vacuum by the outflow. Such transaction should use the World Bank to guarantee these transactions are genuine investment instead of laundering purpose or act of trade war that harms the exchange currency nations or parties. Again, these transactions must pay by reserves on the value it acclaimed, or a checkpoint must be established on the transcontinental purposes instead of the later court action in disputing the rightful bearer of the devalued bonds or loans.

World Bank must develop it insurance element and the appraisal power to adjust to the need of the abused including sovereignties debts if World Bank may act in the loaner position that after the central bank failed. It must establish the reserves on the funds in handling the transaction and not by the insurance company or appraisal firm that either failed to see the loophole of the fraud or defiant act on the truth in just collecting fees to pass on like kicking the can down the road like PIIGS, eventually, it may comes as part of the function amending the global economy that World Bank will offer the loans through the reserves it may developed from the guarantee commission or appraisal commission.

In term of losing track of the transaction that goes through the protective elements, many use the political power through the governments, many of these transactions concealed national secrecy that would not be taxed or revealed by the bankers or receiving parties. So, in order to set a proper track record of these transactions, they should be regulated under IMF or the board of intercontinental exchange which is identified by its Zone. So, the transcontinental transaction must come in the checkpoints or IMF, a fee of authorization would use as tax or tariff that comes through each checkpoint and reported to the involved parties to reestablish the sovereignties right to tariff and tax.

Offering of the World Bank and IMF to boarder service can be a helpful way to ease the tension from dragging on to the global recession if there is no better alternative for the change of guard of the world economics. Now, it is the calls of World Bank and IMF to take the stand to work within the sovereignties that carry its own currencies and controls all transactions in the fairer trade within its continents while free trade had reaches the epic of manipulation.

In term of currencies, I think after each sustains its sovereignty, the non tradable sector can use the local currencies which can be supervise under the scrutiny of OCED and EU can control itself under the ruling of the World Bank. However, each may join or utilize the EU Euro, British pound, and Russian Rubles in the tradable sectors can achieve the collective bargain in the open trade markets. Perhaps, WTO could cut monopoly or abuse from diversification of limited currencies in the open trading market and each can contribution to the integration of globalization and being monitored by the global security.

Perhaps, the theory in the half full and half empty may put in use of the price and value of the currencies refreshing the preset EU system that each may return to its own sovereignty that gives the flexibility and elasticity on the monetary and political system to sustain the growth in a multispeed world.

May the Buddha bless you?

gamesmith94134 07:29 30 Sep 11

Gamesmith94134: **Why Financial Reform Hasn't Stopped Rogue Traders**

A part of the Dodd-Frank bank reform bill named after former Fed chairman Paul Volcker was supposed to halt rogue traders. It is delayed. (Brian Snyder / Reuters)

Lucky for Kweku Adoboli with three counts of accounting and financial fraud which equals more than 10% of the economy of Ghana, which is where Adoboli's family is from - is at a Swiss bank. With much of the genius and computerized calculations, he missed the Basel II rule and fell off the sea saw, and he was just a naiveté or scapegoat for the RBS believing in the free market system.

If Swiss was not stand on it SFR1.2 to a euro, he would be another star among those geniuses. One goes up, must come down may not apply to sovereignty rule; it was less of the invisible hands for hedge fund managers anymore. It would same apply to Soros or El-erian if it was not the gold standard application or IMF makes Euro in 1.4 to a dollar or 80 yen to a dollar. Then, the gold and oil may come down and the world may change as well significantly.

Perhaps, we better learn the invisible hands go to our governments, instead of, most can believe free-market system that hedge fund manager became gods. They can rely on the principle of the see saw; and often there is the invisible hands shifted the leverage that cause or cost him to fall.

Perhaps, I do not believe in the free-market system even Basel II can do justice on the deal; especially when some come to destroy the integrity of the exchange rate system by manipulation. So, some can trade its currencies to make other expensive for its hosting population; and remorse over the withdrawal. Therefore, I prefer the fixed rate on all currencies and commodities; and they must be traded under the scrutiny of the IMF and WTO if the exchanges would cause hardship for the hosting entities. In all word, invisible hands or enterprises or not, harmony should be the top priority of the global economies, and profit can come afterward; officially, the oversights of the IMF and WTO can make adjustment on the change of all values.

How can we stop rogue trader, if sovereignty change leverages at will?

May the Buddha bless you?

gamesmith94134 11:50 30 Sep 11

Gamesmith94134: **the Asset crisis of Emerging Economies**

There is the identical crisis in EU and US like the one China had in 1997-1998 Asian financial crises, East Asia's economies paid heavily for excessive accumulation of dollar-denominated debts; and it is reversed after the industrialization of the Emerging Market nations. In my calculation of the cash flow or the Circuitry of wealth, the imbalance on the accumulated and consumed under their nominal standard of living has gone much above what their citizens can afford.

I would suggest the lower nominal living standard would help unemployment and enhance competitiveness in their exports; but deflationary measures caused the great unbalance equity to its dollar-denominated liabilities; eventually the outflow to the emerging nations made them defensive as inflation hits. The polarization both the creditor and debtors made the stand-off.

It also create a vacuum on the exchange rate due to the exporter's account's surpluses that US demands RMB to rise to cut deficits, which "China has paid more attention on adjusting the currency structure of the country's gross assets and gross liabilities. In particular, China should try to replace its dollar-denominated assets with renminbi-denominated assets, and its renminbi-denominated liabilities with dollar-denominated liabilities." How would China avoid the sovereignty leverage and become a "rogue" trader like your oversea operations, or reduce renimbi-denominated liabilities from making itself as a reserve in the global economy?

Mr. Yu, would you put your asset in the 10 million Euro worth of bonds in full to the World Bank which guarantees a 3% annum in coupon? The coupon to you is tradable in open market to your exporters, and serves for tax credit to your nominated sovereignty nation like Greece, and the 10 million Euro worth of bonds is withheld a parcel which the World Bank will guarantee Greece will return in full parcel in nominated currency or equity applied. Since the parcel may not adequately applied with equity or privatized assets, such parcel will come through arbitration by World Bank to ensure Greece will comply with integrity for its liabilities. Thereon, the quarterly payments of 4% will come from Greece that 1% no-

refunable applies to the services and reserves to World Bank; and 3% will subsidize privatized programs would be used as collateral, under the scrutiny of the global observers. The funding of these installments are used to promote growth within Greece in order to create its foundation in the tax system to make it effective in the fiscal processing and politicians. What if Greece default again on its installments of the loan or the loan? The 3% of investment in the privatised programs will goes to China, and the parcel can settle on the performance after arbitration.

It sounds naive to accept such "Seven Percent Solution" when inflation rate is way higher than 7% in China, but what if Euro or its currency dropped over 7%. However, it is more important that the stand-off in the liabilities in both sides, then, rebalancing both the exchange rates or economies could make the situation worsen; then, not even the 3% is guaranteed. If the slowdown of EU or US is contagious to the system, I doubt China can run on its 8% growth in the next year; but, the funding to the 7% coupon can stop Euro going down from 1.4 to 1.8 or RMB 4.5 to a dollar; or 15% write-off is demanded by the banking of China after default.

"If China cannot do very much about existing gross assets and gross liabilities, it should address new assets and liabilities in order to minimize future capital losses." Perhaps, it is not a best solution to the anemic growth to Europe or US, but contagion is immense. It is time for the World Bank and the communities to act, and not to wait, since the everyone knows the outcome of it.

Mr. Yu, It is not your asset crisis only because our bond crisis could jeopardize the global economy too. Your highly consequential questions such as full renminbi convertibility and the currency's internationalization would be resolved; if we are not just debtors and creditors in the system and we can stop contagion and work on the global economy.

If it sound like buying rare stone in your country, everyone bargains inside the bag. Throw in yours on the zoning and multi-speed economic growth, or the system you would agree or allow. It is the foundation of bargaining.

May the Buddha bless you?

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