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Comment Takatoshi Ito

Maury Obstfeld covers three deep topics in this chapter: the Triffin dilemma, liquidity, and global imbalances. This chapter presents the balanced views on a wide range of topics: from old to new and from academic to policy oriented.

The first topic is the Triffin dilemma. The classic Triffin dilemma is about the impossibility of having and maintaining credibility of the international reserve currency, namely the US dollar: current account deficits of

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the United States are needed to provide international liquidity, but more liquidity means accumulated deficits, which would eventually lead to loss of credibility and eventual devaluation of the key currency. Obstfeld correctly points out that the classic version of the Triffin dilemma is not valid anymore in the modern world of free capital flows. However, he argues that there is now a modern version of the Triffin dilemma. Since reserve assets of the emerging market economy has to consist of liquid and safe assets, only assets that qualify are US Treasuries. Hence, in order to provide liquidity, the United States has to run fiscal deficits. Or, larger and larger deficits can be absorbed by the emerging market (EM) countries, as long as EM countries continue to grow. This is another way of looking at the exorbitant privilege of the key currency country.

A small puzzle is that no other advance country is providing reserve assets. According to the IMF (International Monetary Fund), COFER (Currency Composition of Official Foreign Exchange Reserves) statistics, the US dollar consists of 62 percent of global reserve assets in 2009, down from 72 percent in 2001. The decrease in the US dollar is mostly matched by the increase in the euro (19 percent in 2001 to 28 percent in 2009). So, is the euro on its way to share the status of the reserve currency? We might have thought so, until the European sovereign debt crisis erupted in 2010 and 2011. As of this writing, Greece government bonds are on the verge of default (Credit Default Swap shows the default probability of 98 percent), and yields of several other countries in the eurozone are rising and deviating from German bonds.

Obstfeld considers several scenarios for the future of the Triffin dilemma. One possibility is that EM countries start accumulating risky assets rather than traditional reserve assets. This takes off the burden of issuing more and more Treasuries on the part of the United States, and higher returns can be pursued. After accumulating so much reserve assets, China and Korea established their own versions of the Sovereign Wealth Fund, modeling them after a Singaporean one. Having a reasonably high reserve level, extra buffer can be managed in a portfolio with slightly higher risk, and slightly higher return category. Hence, this scenario is very likely to be realized. The second possibility that Obstfeld considers is deceleration of EM countries. But, as convergence in the per capita income is expected to take place, high economic growth of BRICS (Brazil, Russia, India, China, and South Africa) for another decade or two is expected. The third scenario is that some countries graduate from attack-prone EM country status and become stable advanced countries. The best precedent is Japan.

The second topic is liquidity. Many EM economies suffered financial crises resulting from sudden capital outflows in the last two decades: the Mexican crisis of 1994–1995, the Asian crisis of 1997–1998, and subsequent crises in Russia, Brazil, Turkey, Argentina, and some emerging market economies during the Global Financial Crisis of 2007–2009. Many of these crises were characterized as a liquidity crisis.

The IMF was supposed to be a leading organization to provide liquidity to countries that are temporarily in shortage of international reserves. However, for several reasons, the IMF could not provide sufficient liquidity to these crisis-hit countries. One of the reasons was the IMF itself did not have an unlimited source of liquidity—it is not a central bank, after all. Another reason is that there was a limit that one country can borrow from the IMF in proportion to its contribution toward the IMF quota. Countries (i.e., members of the IMF) could borrow under Stand-by Arrangement (SBA) only up to three times of its contribution to the IMF (i.e., quota) before the Mexican crisis occurred. This was called an access limit. During the Mexican crisis management, the access limit was raised to five times. Later, during the Korean crisis management, the access limit was raised to twenty times of quota under a new facility, Supplemental Reserve Facility (SRF). If a liquidity crisis is to be avoided by providing liquidity by the IMF as an international lender of last resort, these two limitations should be removed. Moreover, policy conditions—conditionality—for liquidity assistance have been vastly unpopular among the liquidity recipient countries. (See Ito 2007a.)

Whether it is a good thing to have an international lender of last resort is an old question. Most famously, it was debated between Harry Dexter White and John Maynard Keynes at the Bretton Woods conference that essentially created the IMF and the World Bank. Keynes advocated that bancor should be issued by the IMF as international reserve currency, while White, opposed to the idea, instead argued in favor of the gold-dollar peg system that later was adopted.

During the EM financial crises in the 1990s, voices that blame EM countries for poor macroeconomic policies and crony capitalism were strong and unconditional liquidity provision was not favored. Instead, the IMF imposed structural conditionalities that might help a country to raise their potential growth rate in the long run, but that were irrelevant to the urgent liquidity needs. The EM countries maintained that they were the victims of volatile capital flows. In order to cope with large capital flows, there are two options: an international lender of last resort providing liquidity or EM countries adopting capital controls to regulate flows. The IMF conditionalities and countries' not meeting them seriously eroded market confidence in the country. Asian countries felt conditionalities were misguided or mistimed so that they became part of the problem instead of part of the solution. After the dust settled, Asian countries started to accumulate foreign reserves in order to protect themselves from a future crisis. This would become known as a "self-insurance" motive of reserve accumulation, which will be discussed later.

During the Global Financial Crisis of 2007–2009, especially after the Lehman Brothers failure of September 2008, the United States and Euro-

pean central banks and Treasuries provided almost unlimited dollar provision and capital injection to Western banks.

As of this writing, the European sovereign debt crisis of 2010–2011 has become a test of political will among the euro area countries, whether to provide unlimited liquidity to fiscal deficit countries or to allow Greece to default with a large haircut.

In the wake of the Asian crisis, the IMF has attempted to overcome the problems of access limit and stringent conditionality in response to the criticism against the IMF. A basic idea is to certify a country with strong fundamentals to be qualified to a credit line without conditionality or negotiation should the need for liquidity emerge. A series of new facilities have been introduced with little success: Contingent Credit Lines (CCL), Flexible Credit Line (FCL), and Precautionary Credit Line (PCL). The CCL was abolished without any applicant, and FCL and PCL applicant countries are limited to several countries, mostly European peripheral countries.

During the Global Financial Crisis, the Federal Reserve Bank of New York extended a swap arrangement to central banks of four emerging market economies (Korea, Singapore, Mexico, and Brazil in October 2008) as well as major advanced countries' central banks. The swap agreement did help Korea to overcome vulnerability to its currency (see Dominguez, Hashimoto, and Ito 2011). This showed that the Federal Reserve, instead of the IMF, could act as liquidity provider to EM countries, if it chooses to do so. However, this was a very exceptional case where internationally active western banks were in shortage of dollar funds and withdrawing their funds (i.e., deleveraging) from all over the world.

As Obstfeld argues, there are several well-known objections to having an international lender of last resort, even if it can be possible. First, it may encourage fiscal authorities to be irresponsible. This is an extension of the logic that the central bank should not buy newly issued government debt in the domestic context. Irresponsible fiscal policy—that is, moral hazard of the fiscal authority—should not be encouraged by unconditional lending to a country. Second, having an international lender of last resort may make EM countries careless in managing its external liabilities of the banking sector as well as fiscal authorities.

My comments on this topic are as follows. Moral hazard is not necessarily limited to borrowers. If the lender of last resort is expected to rescue the indebted countries, lenders to EM countries and banks in EM countries may underestimate risks of lending too much. In fact, for every "bailout" operation that the IMF has engaged, a criticism of "who really is bailed out" has been heard. The criticism goes as follows: in the case of the Mexican crisis, it was not Mexico that was bailed out, but the Wall Street lenders (holders of Mexican government debt securities); in the case of Asian crises, it was not Thailand, Indonesia, and Korea that were rescued, but Japanese and

Western banks that had lent to banks of these countries. Those who emphasize the lenders' responsibility often advocate the private sector involvement (PSI)—that is, haircut for liabilities—as a part of solving the sovereign/banking crisis.

In order to discuss the lender of last resort, it is essential to distinguish illiquidity and insolvency. For illiquidity, IMF facilities (FCL and PCL) can be expanded, and central banks can provide liquidity, and for insolvency, insolvency procedures can be devised and introduced. The Sovereign Debt Restructuring Mechanism (SDRM) proposed by First Deputy Managing Director Anne Krueger in 2002 was such an attempt, although it did not materialize. But the distinction is often blurred. Illiquid banks and countries may become insolvent, if liquidity is not provided in time.

It is often argued that the lender of last resort operation should come with a higher interest rate in order to avoid moral hazard. (This is an application of the Bagehot rule.) The SRF was constructed on this principle. Korea borrowed under SRF at the high interest rate in December 1997, but repaid within a year, by generating large surpluses.

Asian countries, most notably China, have massively accumulated foreign reserves from 1999 to 2007. The phenomenon is often called self-insurance, since those countries explicitly desire to avoid future liquidity crisis, without the help of the IMF. They have stigma with IMF conditionality.

When the global financial crisis came, some of these countries experienced the capital outflows. Dominguez, Hashimoto, and Ito (2011) showed the following: first, the EM countries did use accumulated foreign reserves to moderate the currency depreciation pressure. There were marked decline in foreign reserves of some of the Asian countries, including Korea. Second, those with higher reserves before the onset of the 2007–2009 crisis experienced better growth recovery in 2009–2010. In a sense, self-insurance worked.

The third topic is the exchange rate and global imbalances. Obstfeld illustrates that the exchange-rate regime decision may depend on the exchange-rate decision of other (export competing) countries. His example is China and Brazil. A Nash equilibrium problem is explained. A similar theoretical framework has been pointed out in the wake of the Asian currency crisis. Ito, Ogawa, and Sasaki (1998) and Ito (2007a) explained why East Asian countries maintained a dollar peg before the crisis. In East Asia, the intra-regional trade ratio is as high as the EU area. Hence, if one country departs from the fixed exchange rate and appreciates its currency, the country will be adversely affected in its competition in the region and also final destination of products, the United States. However, if they collectively float against the US dollar and the European currencies, a country in the region may not suffer as much. One way to achieve the joint float is to create an Asian regional monetary unit (RMU), just like ECU before the euro, and each country pegs the currency to the RMU.

Global imbalances have been a topic of international discussions since the mid-2000s. First, it was discussed in the IMF multilateral consultation and then the G20 mutual assessment program (MAP). In 2011, the IMF started spillover reports for five countries, which examines the impact of macroeconomic policy on other countries.

In general, current account imbalances per se cannot be a major concern. However, if one country continues to run current account deficits, then external liabilities may become unsustainable. If the country to run deficits is the key currency country, like the United States, then the worry of the Triffin dilemma reappears, even in the flexible exchange-rate world for advanced countries.

My take on the exchange rate and global imbalances is as follows: global imbalances become a symptom of something problematic, only when it is a reflection of policies that are not consistent or sustainable. If the exchange-rate regime of China is a problem, and there are several good arguments for this, then its exchange-rate policy should be discussed instead of global imbalances. Discussing multilateral consultation, MAP, and spillover reports seem to be avoiding the crux of the matter, namely, the exchange-rate policy.

In conclusion, in light of Obstfeld chapter and this discussion, the current euro sovereign debt crisis can be put into perspective. The origin of the euro crisis is fiscal deficits. In that sense, the crisis is similar to the repeated crises among the Latin American countries, including one with syndicated bank loans in the 1980s. So, fiscal austerity is the standard textbook recommendation to these countries. If a country is insolvent (debts being unsustainable under plausible assumptions on growth and tax revenues), then debt reduction is necessary. Providing liquidity on the pretense of liquidity crisis will not solve the crisis. In that sense, the solution to the Greek crisis seems to be tilting toward orderly default. Germany insisted on the haircut through "voluntary" rollover to longer maturity bonds, and this is part of the second rescue package. Thus, the crisis is of a different nature than the EM crisis, but the principle and challenges of providing assistance is the same.

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