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OPINION ASIA

The Coming Currency Clash in Asia

Recent events have set the stage for uphill capital flows and rising currency tensions.

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Before the global financial crisis, the strange phenomenon of "uphill" capital flows—money moving out of middle-income economies and into richer ones—garnered considerable attention. While private capital was flowing in the opposite direction, net flows were driven by emerging markets' accumulation of foreign exchange reserves, mostly stashed in the government bonds of advanced economies.

A confluence of recent events, some of them little noticed, has set the stage for this trend to resume, with emerging markets stockpiling reserves in ever-greater quantities. Currency tensions, with Asian economies again at the forefront, are set to rise. A prime cause of the problem will be the lessons leaders learned from Washington's response to the financial crisis of 2008.

Most emerging markets now have more open capital accounts. So while they benefit from the free flow of capital, they are also increasingly exposed to volatility and other byproducts of those flows. The quantitative easing operations of the Fed and other advanced economy central banks pushed capital out to emerging markets, fueling rising inflation, asset price booms, and rapid currency appreciation in the developing world. Then the Fed's tapering of its monetary policy last year temporarily reversed those flows and exposed the ongoing vulnerability of many emerging market economies.

Couldn't the Fed help countries beset by problems triggered by its policies? The recently released transcripts of the Federal Reserve Open Markets Committee meetings in 2008 provide fascinating insights into the thinking of policy makers. They show that the Fed's actions are governed by strict national self-interest, not a wider sense of responsibility given the dollar's status as the global reserve currency.

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During the financial crisis, the group of developing economies that received the Fed's benediction in the form of dollar swap lines was highly selective. The list included Brazil, Korea, Mexico and Singapore –countries with close economic ties to the U.S. Moreover, Fed officials viewed their dollar reserves as a form of implicit collateral for the swap lines. In other words, higher levels of reserves increased the chances of getting a dollar swap line at crunch time.

Some Fed officials considered Chile and India as possible recipients, but were reluctant to open the "floodgates" to requests from other countries. The transcripts redact the other countries that requested swap lines, but it is clear from the context and from other sources that it was a large number.

Meanwhile, turning to the IMF in times of trouble is becoming less attractive for emerging economies, mainly because the institution lacks legitimacy in the eyes of policy makers. Reforms to give these countries greater representation at the IMF that befit their rising importance have stalled. These governance reforms were initially blocked by European countries that stood to lose ground. Now political gridlock in the U.S. has stymied the reforms. The U.S. administration has been a strong advocate for change, but its hands are tied by Congress.

Emerging markets realize that, no matter how sound their policies may be, they are subject to whiplash from the policies of advanced economy central banks. Top G-20 officials spoke loftily of central bank coordination at their recent summit in Sydney. But in reality, there is no mechanism to make central banks take measures that would contravene their national mandates for the benefit of other countries.

So it's not irrational for emerging-economy policy makers to conclude that the best way to insure themselves against a future crisis is to act today in a way that would encourage developed-economy leaders to help. And a reading of the criteria the Fed used when parceling out international assistance suggests dollar reserve accumulation is the best way to force the Fed to take notice.

The key question now is how much of a reserve is enough. Conventional views of reserve adequacy—enough to cover short-term external debt or six months of imports—are no longer relevant. During the worst of the crisis, some emerging markets with massive reserves lost nearly a third of them in less than a year.

What's for sure is that once speculators smell blood, they attack a currency relentlessly and reserves can evaporate quickly. The only way to protect a currency is to have enough reserves to deter speculators. No one knows exactly how much that will take. So the motto of central bankers has become more is better.

Today, while the Fed continues to taper, private capital has begun to flow back to emerging markets. Even economies such as India and Indonesia that were battered by capital flight last year have benefited. The Bank of Japan recently signaled it was getting ready to open the monetary spigots wider. The People's Bank of China has taken forceful steps to prevent the yuan from appreciating even as it widened the currency's trading band. These trends only add to the pressure on other Asian emerging economies to hold down the value of their currencies and accumulate reserves.

All told, the events of the past year presage a return to uphill flows of capital and rising currency tensions. It certainly feels like monetary déjà vu all over again.

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