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Currency Crisis: Are There Signals to Read?

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Abstract: Financial crisis is nothing new in the annals of history of the capitalistic path of economic development; it is a part of the business cycle. The theoretical basis is well entrenched in the concept of 'Keynesian Cross'. The tale of crisis, dating back centuries, has taken a new turn with the call for more globalization—liberalize trade and open up the financial sector. This has made many nations vulnerable to crises that are likely to be repeated, perhaps frequently. Based on recent experience, warning signs can be read from the dollar-centric exchange rate, the mainstay for the stability of the current global financial system. To a careful observer, fatigue in the system cannot be overlooked.

Keywords: China; Special Drawing Right; international monetary system; reserve currency; RMB internationalization; mortgage crisis; default swap; derivative; Asian crisis; LIBOR

The 2008 financial crisis was the worst economic calamity since the Great Depression. By some estimates, the toll it took runs into the trillions. The collapse of the Lehman Brothers, which required huge sums of money for bail out, nearly brought down the global financial system, was contained by monetary and fiscal stimulus and prevented another great depression. The pace of recovery remains feeble relative to prior post-war upturns. Europe's crisis evolved into the euro crisis, as GDP failed to pick up. The Fed has mostly remained monetary policy-centric.

The first sign of trouble surfaced in 2006 when housing prices started to fall. Realtors failed to realize that many homeowners had dubious credit sources, blamed on the subprime loans when the real culprit was the banks' ability to engage in trading with profitable derivatives, and then sell them to investors. The derivatives created an insatiable demand for even more mortgages. While hard to believe, the Fed had thought the subprime mortgage crisis would stay within the housing sector alone or that they didn't understand the actual causes of the crisis until much later (well, so they claim).

Hedge funds and other financial institutions owned the mortgage-backed securities, spread to mutual- and pension funds; and corporate assets. The banks had chopped up the original mortgages and resold them in tranches. This made it impossible to price the derivatives, which are contracts that allow businesses, investors, and municipalities to transfer risks and rewards associated with commercial or financial outcomes to other parties. Holding a derivative contract can reduce the risk of bad harvests, adverse market fluctuations, or negative events like a bond default.

Each derivatives transaction is like a stock or bond trade—one party wants to increase its exposure to a specific risk as the other moves in the other way. Derivatives derive their values from its price, volatility, and risk of an underlying stock, bond, commodity, interest rate, or exchange rates. The price is a function of the price of the above listed items. Some derivatives, like stock equity options and credit default swaps remain contingent on future events. Others, such as commodities, futures contracts, and interest-rate swaps, are more explicit contract exchanges, such as a specified number of items on a specified date in the future for a certain price.

The pension funds bought risky assets thinking that the insurance product—credit default swaps—would protect them. The American International Group (AIG) sold these swaps. As the derivatives lost value, AIG lacked the cash flow to honor every swap. Banks panicked and stopped lending to each other, fearing that they would have to absorb the loss and that other banks would dump the useless mortgages as collateral. This raised interbank borrowing costs—the LIBOR. The growing mistrust was part of the financial crisis. The Fed's action to pump money via Term Auction Facility, a temporary program managed by the Fed to address elevated pressures in the short-term to support markets, was inadequate.

Clearly, multiple players, in different roles, were acting behind the crisis. Central bankers and other regulators were no less to blame for tolerating this mess. The "Great Moderation"—years of low inflation and stable growth—fostered risky enterprise (See Batabyal et al. 2018). In Asia, a "savings glut" pushed global interest rates down. In Europe, banks borrowed from the US money markets before the crisis to purchase suspicious assets. These factors created a corrosive chemistry leading to a debt surge that had the appearance of a less risky world.

The most obvious feature of the onset of a currency crisis, or the result a manifested in a sharp and large decline in exchange-rate for the affected countries/region before it transmits to others. The severity varies by the strength of the trade and financial linkage. A shock in the exchange-rate can be initiated by the actions of a powerful organization, government or large corporations, triggering a loss of confidence in a government or its monetary policy. The case in point is illustrated by the Asian flu (1997), which raises much controversy about the outside players. In Malaysia, the Prime Minister Mahathir stood his ground and took decisive steps that many see as the gold standard for dealing with crisis for his nation to date. (Collins et al. 2019)

Although widely acclaimed, it remains a mystery why his actions were ignored by the "mainstream economists" and the US media. How can one believe that the American economists were unaware of the fragility of the US financial system, or that they knew but kept silent? Some even ask who they are: "Do these so-called experts really understand the problem? Or would their advice aggravate the problem? Or do they have an agenda of their own?". (See Collins et al. 2019). Much the same criticisms apply to the 2008 crisis. Solving a problem of this magnitude is the central goal of the Public Banking Institute (PBI) and the American Monetary Institute. As we know, at the heart of the collapse of the Lehman Brothers (2008) was the loss of money from holding too many toxic securities and loans, linked to the then chaotic US property market. World Trade Org. (WTO) reports that trade fell in every country. Credit supply to the real economy fell to the tune of $2 trillion in America alone.

Curiously, even when a government/business is following sensible policies, the currency may still be targeted for destabilization for political reasons. This includes the threat of "regime change" in places such as Russia, North Korea, Iran, Venezuela, and Syria. The US continues to use its dollar power to arm-twist others and pressure them to follow America's position, regardless. Because of such abuses, many nations are trying to bypass the US dollar through bilateral trade by paying in their own currencies, which assumes that the currencies preserve an acceptable level of stability in their relative values (Collins et al. 2019).

The historical context may help us to learn and take lessons from the experience for the future. Two papers seem to have identified several weak spots that could prove to be Achilles heel: (i) the current state of the international monetary system (IMS); and (ii) China's monetary relations with the rest of the world. A solution might be to find ways to expand the use of the International Monetary fund's (IMF) Special Drawing Rights (SDRs), where China can unilaterally kick-start an SDR market to transact with other nations. Emerging markets suffer more from rising US interest rates. Their indebtedness (mostly domestic) has reached 225% of GDP—higher than the post 2008 financial crisis. Central banks were forces to pour some $10 trillion to ease the post 2008 crisis.

Some authors see the present monetary setup as 'a deficient, non-system' (White 2015; Ocampo 2017); and inherently crisis-prone because of the following drawbacks such as the IMS's reliance on the US dollar, which is the global currency, but which appears unstable, in need of some reform. The most recent uptick in tension includes the Sino–US trade war, along with rising domestic indebtedness of China. The brighter spots however are, a political will on all sides to resolve the war, China's sizeable US dollar chest, and her policy to internationalize the RMB[1]. This final point will help to stay outside the dollar arena. For this to work, China will need to open its capital account and establish financial links with the world. A fully-fledged currency of SDRs might shrink global imbalances. It will happen if the cooperating members for multilateral initiatives show interest. If the SDR takes effect, as a different currency, it would help China to open up its capital account and pave the way to easier dollar–RMB fungibility. The Hong Kong–China axis can be helpful in this regard. Is the time rife for taking a closer look with an open mind for a workable solution before it is too late?

The dollar-centric single currency system is an enormous economic gift for the US. Sadly, it is being used more as a political tool against the actors deemed unfriendly to US interests by denying banking access. Such a policy is likely to backfire and harm American leadership. Poorer developing countries thus must hold precautionary surplus dollar as insurance against the potential future balance of payments (BOP) problem for related adjustments when they are least able to do it. The G20 comes close to an economic policy coordinator, but is mostly ineffective. The US, the largest beneficiary, favors the status quo to gain seigniorage and prestige. The problem is in the attempts to leverage on excessive foreign policy—clearly, a mistake. To maintain the status, the US must run unsustainable current account deficits to provide the world with enough dollars. Nations buy US debt, which explains why the US can afford to run such reckless fiscal policy. The tax cuts by Trump are considered by many as irresponsible. The above narrative suggests that the dollar likely will come under considerable pressure in the times ahead. Should that happen, it is plausible that we will see significant rise in disorders in the global economy—perhaps just the tip of the iceberg. Whether or not it will take place, or where it would lead us to, is anybody's guess, and remains to be seen.

The world is cognizant of potential vulnerability in the global financial order and the risk each economy might end up bearing. In this regard, the risk associated with the economies that maintain pegged exchange rate has been highlighted by Ellis and Gyoerk (2019). The choice for a country's exchange rate regime has wide implications for the effectiveness and the flexibility of policy tools, and for economic and financial stability[2]. The author examines the interaction of currency peg abandonment with the occurrence of a banking crisis. He finds that countries that simultaneously suffered a systemic banking crisis during the period of exchange rate regime shift saw a greater economic and financial damage following the change. Regardless of a banking crisis, countries begin to recover after the same gap in time since the float.

To shield from shock, several reform proposals have been tabled including granting the SDR a larger role. The IMF appears to favor the idea. It is hard to assess if an SDR-based true global currency will achieve better macro-economic coordination. Some suggest that an IMS with a multicurrency arrangement is a viable option, with a broader role for the SDR. This may not materialize for lack a geopolitical alignment and the veto power of the US in the IMF (Harrison and Xiao 2019). However, given a changing global order, rooted in rising nationalism and populism, things likely will have to change for better or worse. While access to global markets and currencies is seen as a matter of right, the openness to private capital flows has made more diversification possible, and created opportunity for improved returns in the post Bretton–Woods world. One wonders if the genie is already out of the bottle. A top-down reform of the current IMS might have to be replaced by a bottom-up one.

China and the IMS need each other. If China were to unilaterally make the SDR central to its next phase of capital account opening, the Chinese institutions, corporates and individuals would embrace it. China, with the support from the rest of the world and Hong Kong, could

1 The official currency introduced by the Communist People's Republic of China in 1949 was named as "Renminbi" (RMB), meaning "the people's currency", while. "Yuan" is the name of a unit of the renminbi currency, like the price is say cost one yuan or 10 yuan etc.

2 He examines 21 instances where exchange rate pegs were abandoned to assess the potential economic damage associated with pegs failing. The sample includes major exchange rate shifts over the past thirty years, covering 1990's Latin American crises and the peg abandonment in Egypt (2016). Given the close link of banks to the sovereign and the real economy, risks tend to flow through, and possibly be magnified by the banking system.

promulgate SDR, ushering in an era of reduced tensions where China will have a more prominent role. (See Harrison and Xiao 2018, 2019).

Fast forward to 2017. Growth rose in every big advanced and most emerging economies (except a few European ones). Global trade surged, America boomed, and the slide of China into deflation had been out of consideration; even the Euro zone was thriving. In 2018, the story is very different. The stock markets tumbled a few times due to worry about a slow-down in global growth and its broader ramifications.

Despite some unusual surges here and there, the overall economic scenario across the world in 2018 saw some notable unevenness. In the US, President Trump's tax cuts have helped lift annualized quarterly growth above 4%, although it is likely to be short-lived. Unemployment is at its lowest since 1969, a historic episode! Yet the IMF thinks US economic growth will see slow-down, and maybe every advanced economy too. The situation in the emerging markets appears soft, which is a sign of broader trouble.

Against the above backdrops of the global economic condition, many predict rough days ahead. It would help to gain a better understanding of the scenario occurring across the globe, through the prism of political economy and finance. This special issue, a collection of well thought out papers from well-known academics working in the field of international money and finance, is a modest and timely effort, offering a logical perspective of professionals. The collection will hopefully add to the list of resources and be considered of much import for students, and perhaps, for the policymakers engaged in global finance and economics, despite whatever limitations it might have.

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