

# The Triad in Crisis

by Peter A. Petri and Michael J. Plummer

---

Comments by  
Willem Thorbecke, Senior Fellow  
RIETI

The People's Republic of China (PRC), Japan, and  
the United States: Deeper Integration  
28-29 May 2009

**The views expressed in this presentation are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank Institute (ADBI), the Asian Development Bank (ADB), its Board of Directors, or the governments they represent. ADBI does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequences of their use. Terminology used may not necessarily be consistent with ADB official terms.**

# Overview

---

- ❑ The paper presents valuable discussion of the crisis and how the Triad is responding.
  - ❑ It discusses the propagation of the crisis from the U.S. to China and Japan.
  - ❑ It then considers policy responses to achieve recovery and to return to a sustainable growth path.
  - ❑ It is a thoughtful and well written paper.
-

# Directions for the Future:

---

- ❑ Accommodative monetary policy and the crisis.
  - ❑ Reviving processing trade.
  - ❑ Improving financial sector regulation.
-

# Monetary Policy and the Buildup of Risks

---

- ❑ Most experts agree with the authors that monetary policy contributed to the expansion of risky products and the bubble.
  - ❑ There may be more to the story.
  - ❑ The Fed controlled the overnight interest rate.
  - ❑ Housing demand depends on longer-term interest rates such as mortgage rates.
-

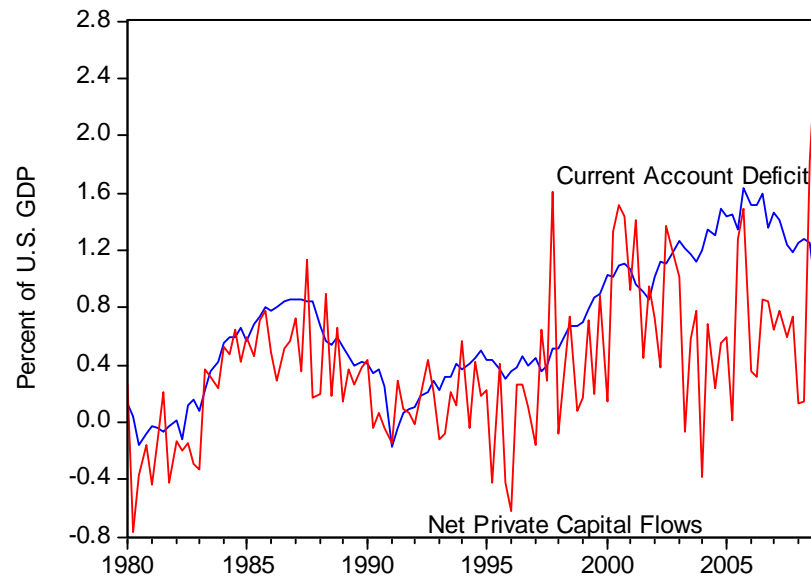
# Foreign Central Bank Reserve Accumulation and the Bubble.

---

- ❑ Since 2003 foreign government purchases of U.S. assets exceeded \$2 trillion.
  - ❑ Craine and Martin (2009) showed that this substantially lowered U.S. Treasury rates.
  - ❑ Low Treasury rates drove institutional investors into higher-yielding mortgage-backed securities.
  - ❑ The flow of funds into the mortgage market then inflated housing prices and stimulated excess spending in the U.S.
-

# Private Capital Inflows Could Not Finance the U.S. Deficit

---



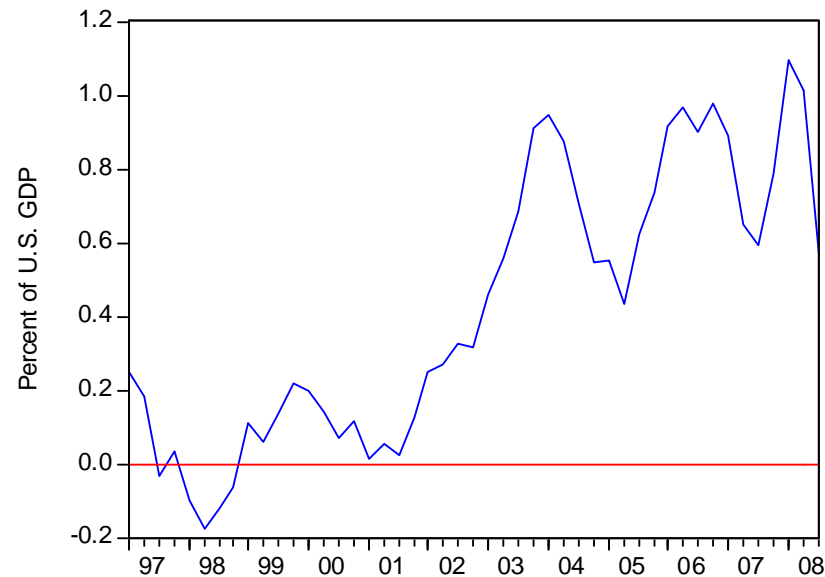
U.S. Current Account Deficit and Net Private Capital Flows

Source: U.S. Bureau of Economic Analysis

---

# Foreign Governments Purchased Trillions of Dollars of U.S. Assets

---



Official Purchases of Dollar Assets by Foreign Governments, 1997-2008

Source: U.S. Bureau of Economic Analysis

---

# Problematic for Asian Central Banks

---

- ❑ Chinese bank deposits in effect provided subsidized loans to U.S. consumers rather than financing cash-strapped Chinese SMEs.
  - ❑ Negative interest rate differential between U.S. and Chinese securities eroded the value of China's massive reserves.
  - ❑ The Requirement that Chinese banks hold large quantities of sterilization bills interfered with the allocation of credit.
-

# What is Happening to Reserve Growth in the Crisis?

---

- Zhang and Yu (2009) note that China's foreign reserves only grew by \$40 billion in the fourth quarter of 2008 and capital outflows totaled \$120-140 billion.
  - Capital outflows due to
    - i) expectation of limited RMB appreciation
    - ii) deleveraging of foreign investors
    - iii) sense of risk in Chinese economy and banking sector
  - What has happened to reserves and capital flows in the first quarter of 2009?
-

---

2009	January	February	March	Q1
<b>Headline reserve growth</b>	<b>-32.6</b>	<b>-1.4</b>	<b>41.7</b>	<b>7.7</b>
Trade surplus	39.1	4.9	18.6	62.6
Net FDI	7.4	5.8	8.4	21.6
Currency gains or losses	-31.0	-16.0	15.0	-32.0
Interest income	6.8	6.8	6.8	20.4
<b>Unexplained amount</b>	<b>-54.9</b>	<b>-2.9</b>	<b>-7.1</b>	<b>-64.9</b>

Source Michael Pettis (2009)

---

# Foreign Central Banks Again Accumulating Reserves.

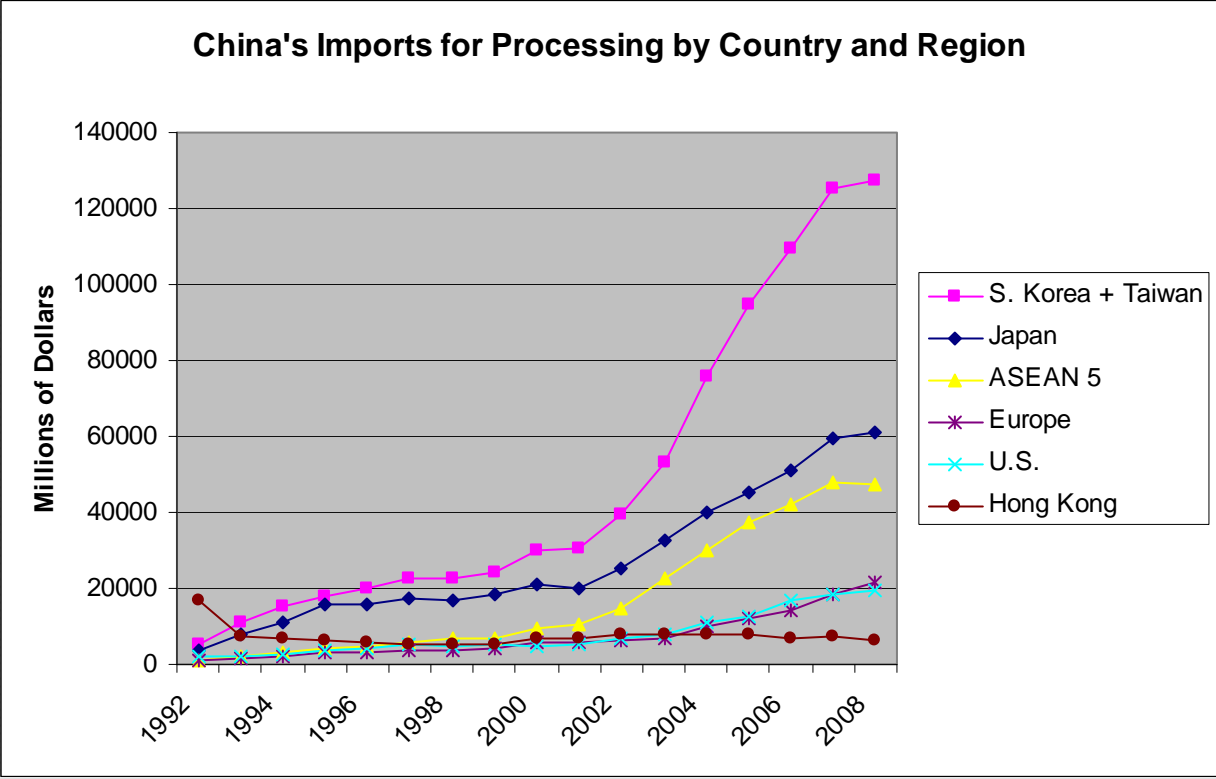
---

- According to Brad Setser (2009), pace of reserve accumulation by central banks now \$100 billion per month.
  - How can policy cooperation between the Triad help to redirect Asian savings to Asia?
-

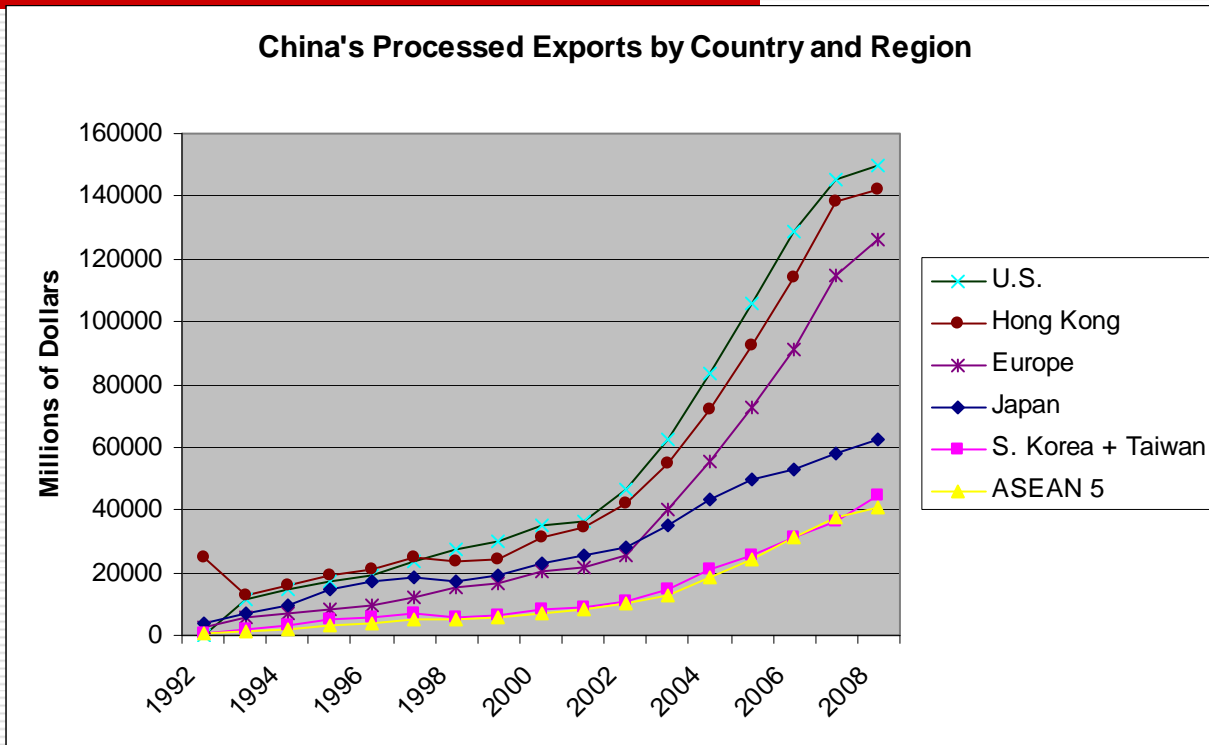
# How Has the Crisis Affected Exports and Imports?

---

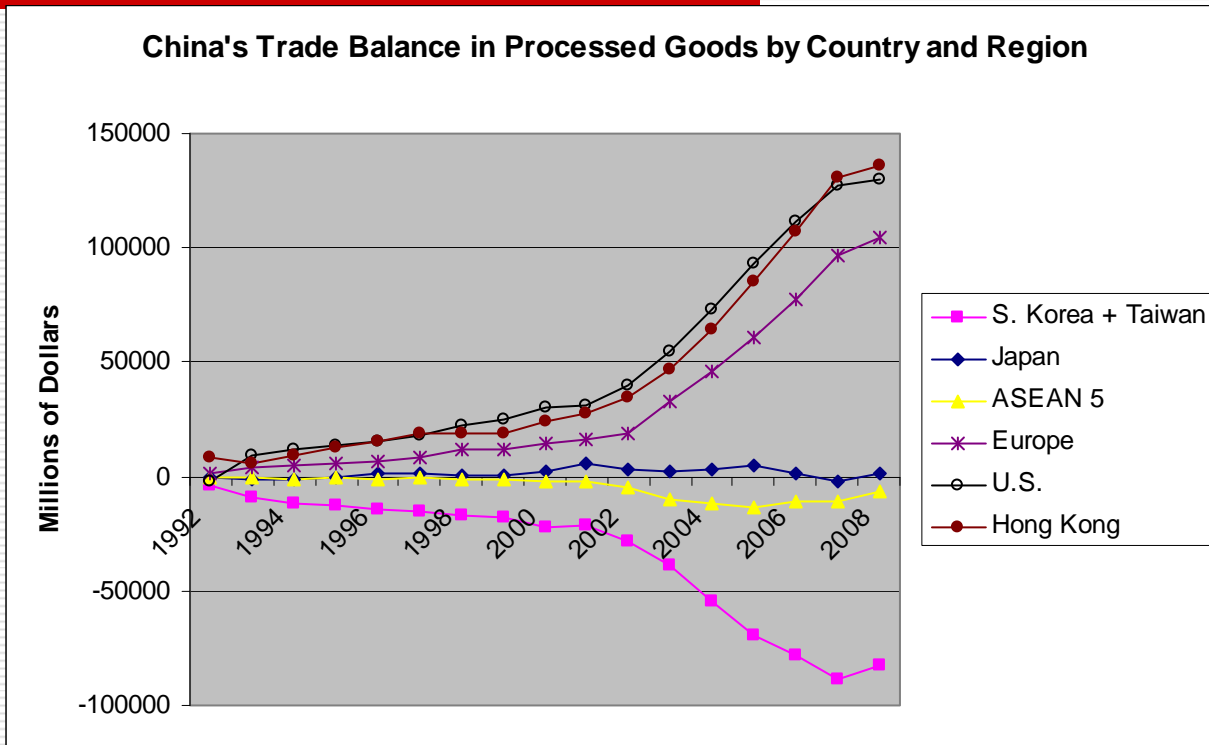
- ❑ The authors discuss exports and imports within the Triad.
  - ❑ China's Customs Statistics provide detailed data of China's imports and exports.
  - ❑ China's Customs Statistics distinguishes between imports and exports linked to processed trade and ordinary imports and exports.
  - ❑ Imports for processing are goods that are brought into China for processing and subsequent re-export. Processed exports are the goods that are produced this way. Neither the imports nor the finished products normally enter China's domestic market.
  - ❑ Ordinary imports are goods intended for the domestic market and ordinary exports are goods that are produced using local inputs.
-



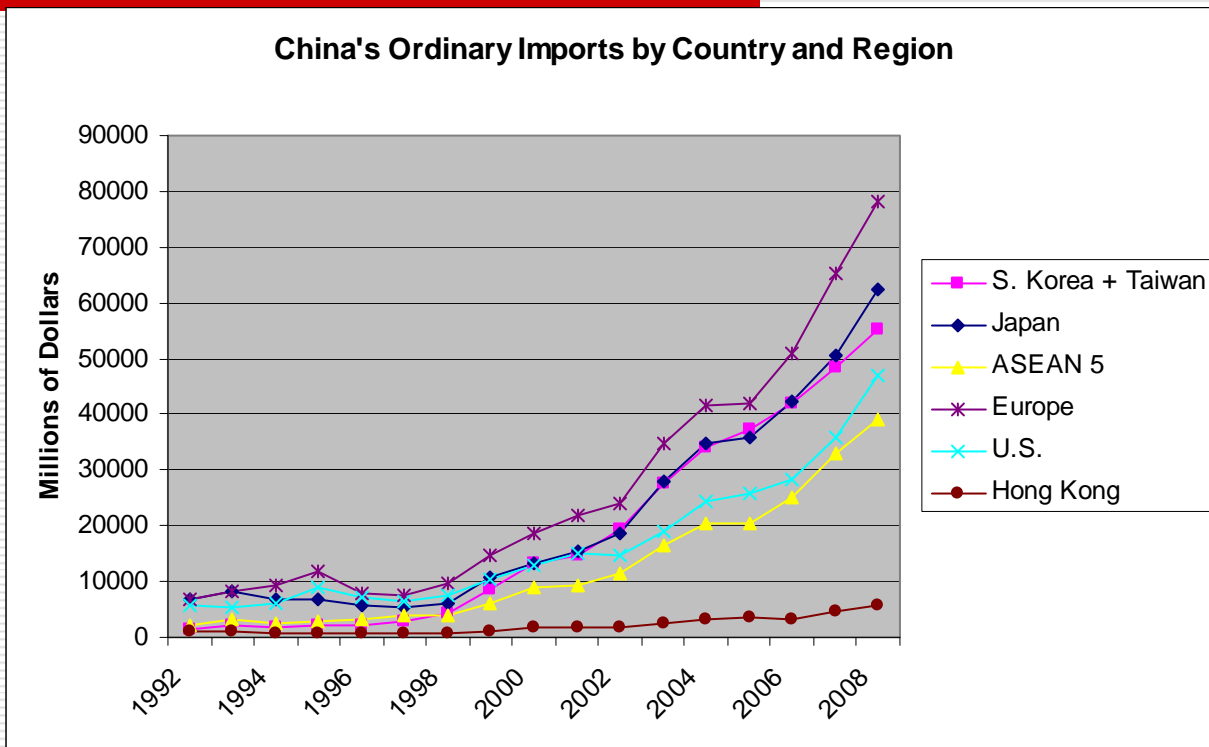
Source: China Customs Statistics



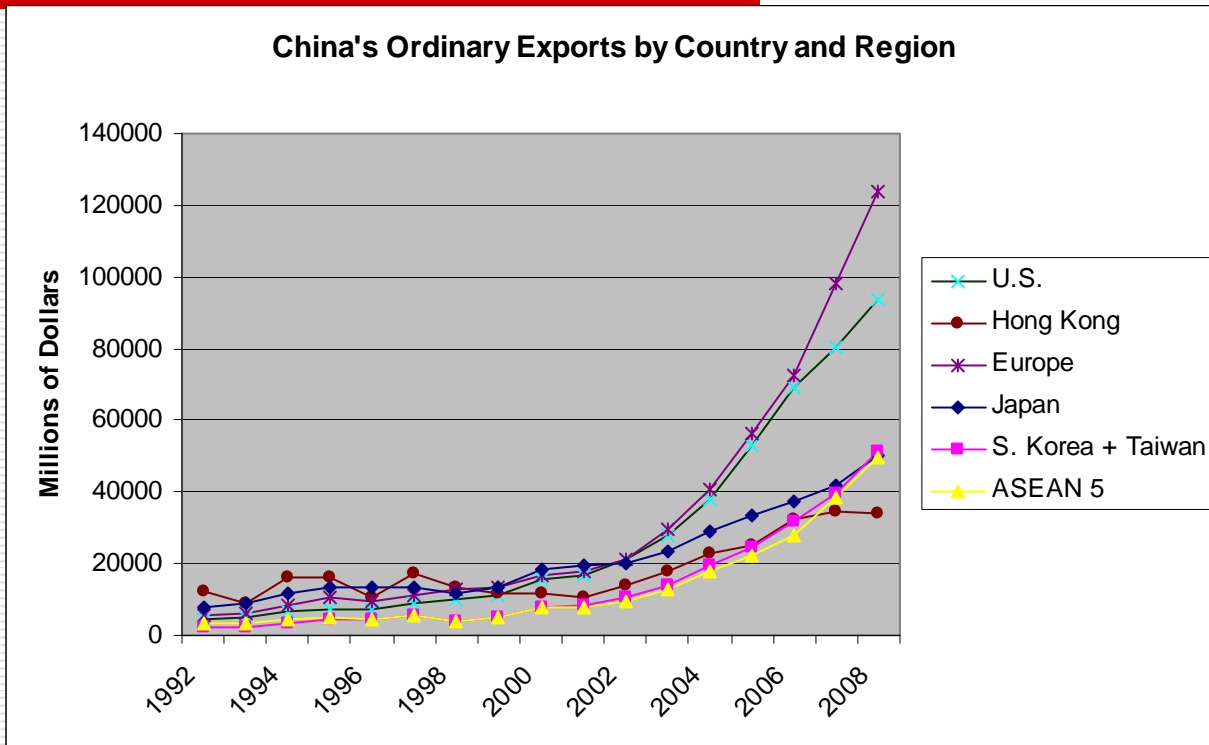
Source: China Customs Statistics



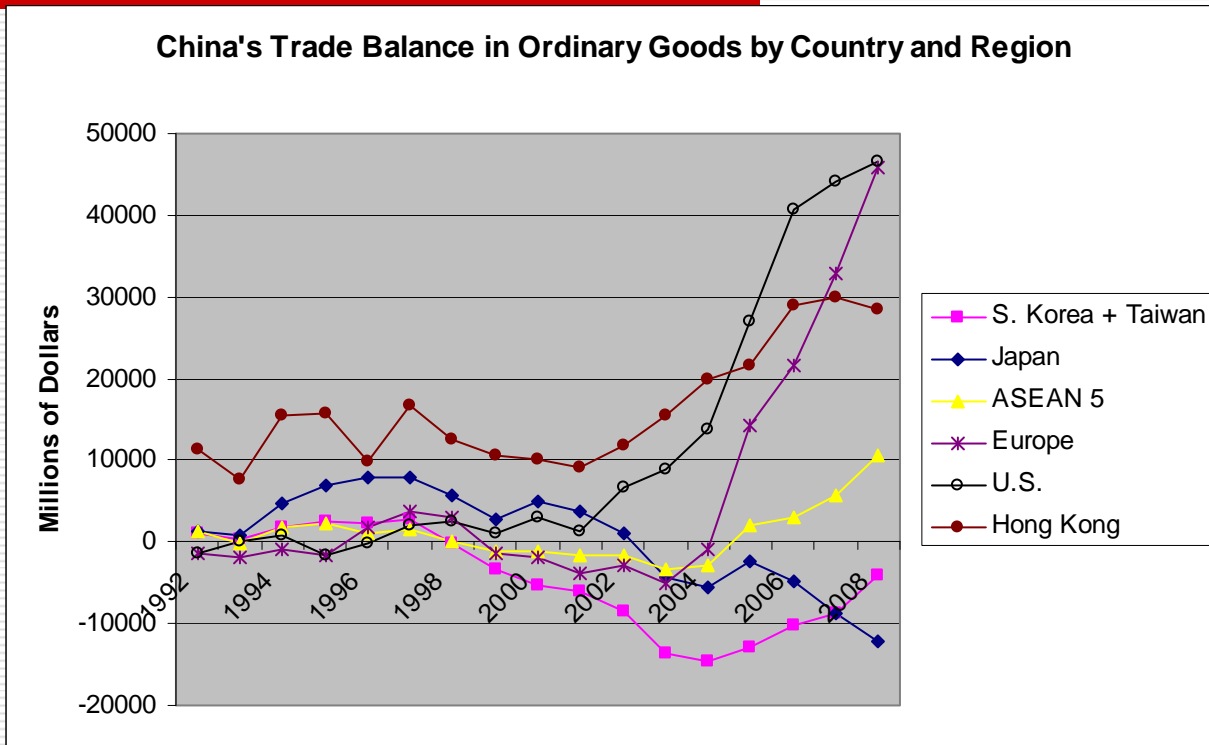
Source: China Customs Statistics



Source: China Customs Statistics



Source: China Customs Statistics



Source: China Customs Statistics

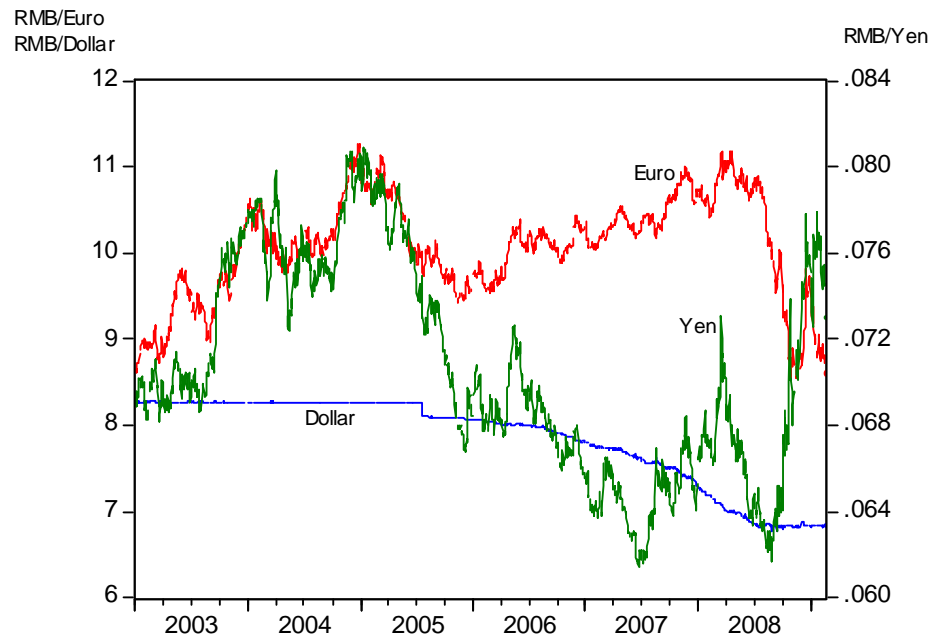
# China's Exports and Imports in the Crisis

---

- Processing trade is collapsing. Imports for processing, processed exports, and China's imbalances in processed trade are falling rapidly.
  - Ordinary trade is growing rapidly. In particular China's ordinary exports to Europe increased 23 percent in 2008 and China's trade surplus in ordinary goods with Europe approached \$50 billion in 2008.
  - Chinese Customs Bureau announced on 10 April 2009 that total exports were down year on year by 17 percent but that exports of labor-intensive goods such as garments and shoes had increased by almost 10 percent.
  - So parts and components exports from Japan to China have plummeted, along with sophisticated final goods assembled in China. Simple labor-intensive goods exports from China still doing well.
-

# Would Greater Stability against a Basket of Currencies Help Revive Processing Trade?

---



Nominal RMB Exchange Rate versus the Yen, Euro, and Dollar

Source: Federal Reserve Bank of St. Louis FRED Database

---

# Regulation of Financial Sector

---

- Need to think of the market failures we are trying to correct:

Liquidity Provision

Limits to Arbitrage

Contagion

---

# Need to Align Incentives

---

- ❑ Originate and Distribute Model. Brokers paid by number of mortgages they issue. They do not hold mortgages. Do not have incentive to screen borrowers.
  - ❑ Investment banks sell all tranches of mortgage backed assets they hold. Do not have incentive to monitor originators.
  - ❑ Ratings Agencies get paid by investment banks. Do not have incentive to rate accurately.
-

# Need Pragmatic Regulation

---

- ❑ The authors said that we need to revamp value-at-risk modeling because the tails of risk distributions are fatter than we thought.
  - ❑ Real problem was ideology. U.S. policy makers had extravagant faith in invisible hand.
  - ❑ More pragmatic approach needed to guard against systemic risk.
-

# Conclusion

---

- Very Valuable Paper
  - In Charting the way forward we should:
    - i) Seek to avoid excessive reserve accumulation by Asian central banks.
    - ii) Seek to revive processing trade and not rely on the U.S. as an engine of growth
    - iii) Implement thoughtful and pragmatic financial sector regulation.
-

# Thank You

---

---