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Comments on: Liquidity of US dollars in Tokyo market: Comparison with London and New York, and its Implications for Asian Financial Policy

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Main points

- Paper deals with an important issue—the implications for Asia of a dollar-centric global foreign exchange system in a period of financial crisis outside the region, focusing on Asian experience during the GFC
- Contributions:
  – Provides historical data on usage of major currencies in global FX markets
  – Identifies relative performance of Asian currencies and Tokyo, New York and London FX and interbank markets during GFC using covered interest parity, counterparty risk and market liquidity analyses
  – Provides explanations for this performance
  – Suggests policies to mitigate reliance on US dollar in FX market

Structural Features of Asian FX Market

- Double mismatches—currency and maturity
  - But this less of an issue than before Asian Crisis period
  - “Reverse flow” to a large extent reflects currency intervention
- Heavy reliance on US dollar for intra-regional transactions.
- Transaction volume in Asia & Pacific markets much thinner than in London and New York markets
  - London (37%), New York (18%)
  - Tokyo (6.2%), Singapore (5.3%), Hong Kong, China (4.7%)
  - Makes them vulnerable in times of crisis

Covered Interest Parity and Counterparty Risk Analyses

- Deviations from CIP were larger for Asian currencies than European currencies, even though no crisis in Asia
  - Could be explained by less market liquidity and high dependence on US dollar transactions, unlike Europe
- Deviations from CIP larger in the Tokyo market than in London and New York after the Lehman shock
  - Less market liquidity, London and NY closed
  - But differences rather small
  - No necessary connection with relative health of Japanese financial institutions, since FX markets are global
- Credit spreads for European financial institutions much wider than for Japanese institutions, as would be expected, but counterparty credit risk depends on currency denomination

Policy Recommendations

- Regional coordination to avoid shocks of dollar shortage
  - Fed swap lines cannot be relied on in advance
  - Bilateral swap agreements (already in place)
  - CMIM enhancements
    - Scale can be expanded further beyond $240 bn
    - Kinds of lending programs being increased
    - Conditionality remains a problem, although is gradually easing
- Other points
  - CMIM issues
    - Disbursement process has not yet been tested
    - AMRO needs to be strengthened
  - Need to reduce dependence on dollar funding
    - Asian Bond Markets Initiative
    - Asia Financial Stability Dialogue

Conclusions

- Important topic given vulnerability of Asia to US dollar shortages stemming from shocks outside of the region
- Findings show the vulnerability of the Tokyo FX market to reduced dollar liquidity despite lack of crisis within the region
  - Useful to analyze actual costs resulting from dollar shortage
  - Useful to extend analysis to Hong Kong, Singapore
- Policy recommendations to expand regional coordination
  - Are current CMIM and regional bilateral swaps enough?
  - If not, how much more is needed?
  - How to encourage greater local currency funding—this is already a well-covered topic
  - Any comments about rising role of RMB?

Thank you
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