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The dampening effect of bank foreign liabilities on monetary policy: Revisiting monetary cooperation in East Asia

Xiaofen Chen*

Department of Economics, Truman State University, 100 East Normal Street, Kirksville, MO 63501, USA

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A B S T R A C T

This paper addresses the cost of formal monetary cooperation from the perspective of monetary policy effectiveness. As banks tend to borrow from abroad in foreign currencies to fund domestic lending, monetary policy may have a reduced effect on the credit market and the economy. Results derived from bank level data in East Asia indicate that bank foreign liabilities significantly reduce the effectiveness of the credit channel of monetary policy, implying a relatively low cost of giving up monetary autonomy.

1. Introduction

Since the 1997 Asian crisis, there has been an increased interest in monetary cooperation in East Asia.[1] Formal monetary cooperation, such as monetary union, reduces the cost of intra-regional trade and promotes economic integration, while its major cost is the loss of monetary policy autonomy. Existing literature on the feasibility of a monetary union or a common currency peg in East Asia often takes an indirect approach to address the cost. A common approach in empirical studies is to examine the similarity of shocks across the region in order to understand the need for monetary policy autonomy.

In contrast to the existing literature, this paper addresses the cost of forming a monetary union through the effectiveness of individual economies' monetary policy. The cost of abandoning

* Tel.: +1 660 785 4644; fax: +1 660 785 4337.
E-mail address: xiaofen@truman.edu.

[1] See reviews in, for example, Kawai and Takagi (1999), Fabella (2002), Wilson (2006), and Chung and Eichengreen (2009).

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monetary autonomy is directly associated with the effectiveness of monetary policy. Losing a highly effective monetary policy is, of course, costly. However, monetary policy in many emerging and developing countries is ineffective. The ineffectiveness may be caused by many factors. For example, in China, the government often directly intervenes in bank lending in favor of state enterprises; banks' practice of maintaining large amount of excess reserves also plays a role (Goodfriend and Prasad, 2006). This paper proposes that foreign liabilities held by banks undermine monetary policy effectiveness, implying a relatively low cost of giving up monetary autonomy. Thus, when considering forming a monetary union, the issue of monetary autonomy should be less of a concern for these economies. To date, this point has not been established in the literature on the feasibility of monetary union.

The issue of bank foreign liabilities is particularly relevant to East Asia. Emerging economies, including those in East Asia (even though some of them are now classified as high income economies), continuously face the "original sin" problem and the threat of sudden stops of financial inflows. The lack of sufficient flexibility in their exchange rate regimes encourages banks to borrow from abroad in foreign currencies to fund domestic lending, and lending booms may occur in the absence of monetary stimulation. When international funding dries up, the problem of balance sheet mismatches (in currency and maturity) is exposed, especially when accompanied with an exchange rate crisis. In such circumstances, banks are forced to cut loans, or even become insolvent. Thus, the cycles of dollarized borrowing create lending cycles and interfere with the normal functioning of the credit channel of monetary policy.

This paper also contributes to the understanding of liability dollarization and the monetary transmission mechanism in emerging economies. Particularly, the connection between the two has not been explored much in existing studies. Through the study of the role of foreign liabilities in the functioning of the credit channel for eight East Asian economies (China, Hong Kong, Korea, Indonesia, Malaysia, Philippines, Thailand, and Singapore), where external liabilities are generally dollarized (as in other emerging economies), this paper can shed some new light on these issues.

The remainder of the paper is organized as follows. Section 2 discusses the weakness of the East Asian exchange rate arrangements and the justification for considering monetary cooperation. Here, the literature related to this paper is also reviewed. Section 3 presents a testable model and describes the data. Section 4 discusses the diagnostics of the empirical model and reports the results. Section 5 contains the conclusion and final discussions.

2. Bank foreign liabilities, sudden stops, and exchange rate regimes

Recent financial crises in emerging economies (for example, the Asian Crisis in 1997–98, Russia in 1998, and Argentina in 2001) are often preceded by buildups of foreign liabilities prior to the crises and accompanied by sudden stops of financial inflows. Sudden stops are viewed as both a symptom and a cause of financial crises, and can lead to current account reversal, real exchange rate swings, and growth slowdown. Facing the "original sin" problem and unable to borrow in their own currencies, emerging and developing economies' foreign liabilities are generally in foreign currencies, a phenomenon termed liability dollarization.[2] Liability dollarization contributes to and magnifies the effect of sudden stops, as demonstrated in the literature, such as the theoretical work by Arellano and Mendoza (2003) and the empirical work by Calvo et al. (2004).

Before the 1997 crisis, most East Asian economies (including both crisis and non-crisis economies) witnessed a surge in financial inflows when banks and firms over-borrow from abroad in foreign currencies. The inflows reversed during and immediately after the crisis. East Asia's experience shows that when dollarized foreign liabilities are used to finance domestic credit growth, severe bank balance sheet mismatches can occur, and the ups and downs of foreign liabilities can create credit cycles. The changes in foreign liabilities and the association with domestic credit growth for these economies between 1989 and 1999 are illustrated in Figures 1–3 in the Appendix.

[2] More precisely, it is external liability dollarization, as opposed to domestic liability dollarization (domestic banks' deposit dollarization).