

On Further Economic Globalisation

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Hong Kong, 16 January 2011

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Outline

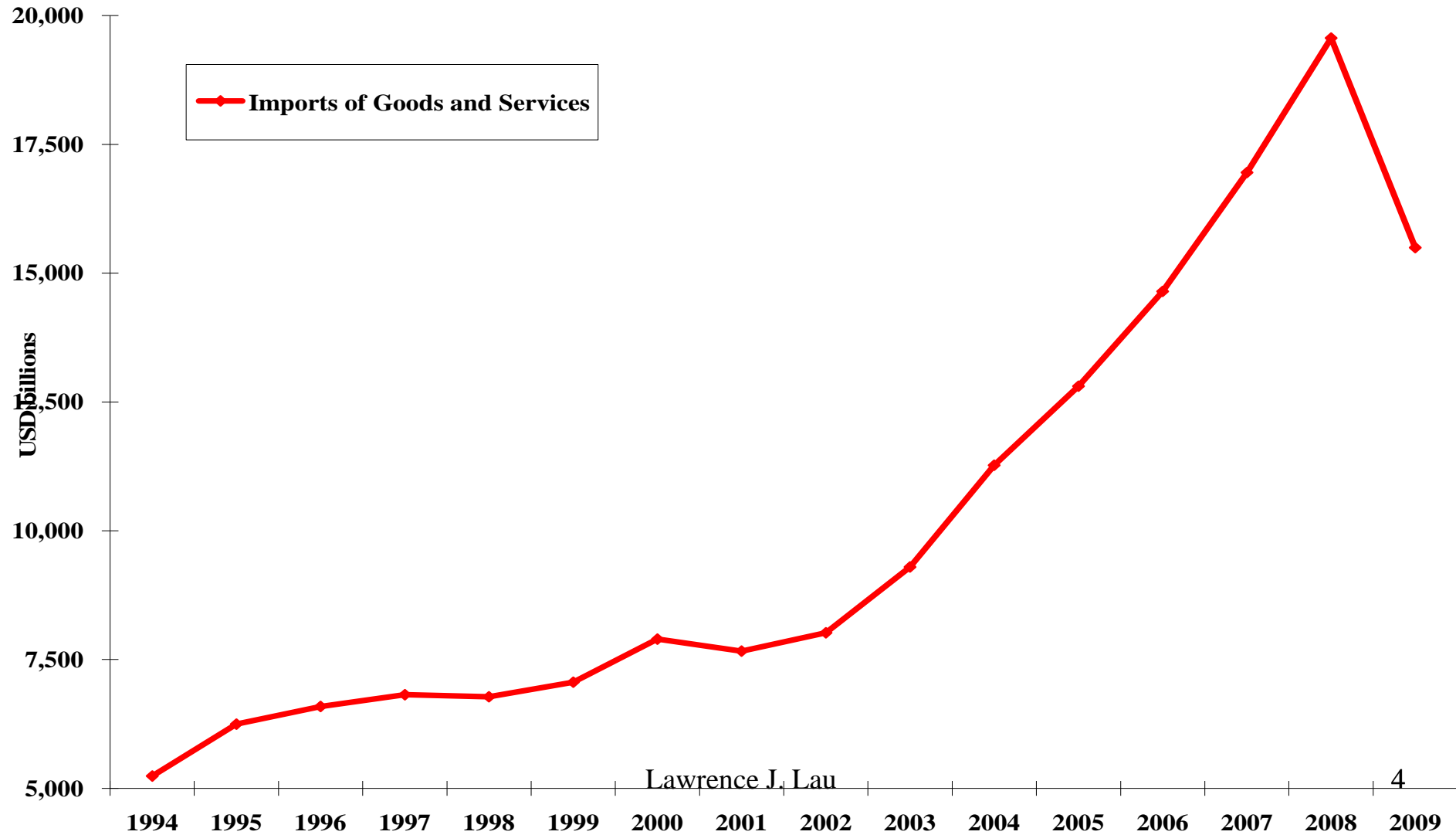
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- ◆ Exchange Rate Volatility
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- ◆ Is There a Role for Gold?
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Introduction

- ◆ Economic globalisation increased by leaps and bounds over the past two decades, until the occurrence of the 2007-2009 global financial crisis. Global trade and capital flows have been rising over time, notwithstanding the successive financial crises. The entry of new participants such as China, Russia and Eastern Europe and more recently Brazil and India (and for some of them the accession to the World Trade Organisation (WTO)), the fragmentation of production through specialisation, division and sub-division of labour, and outsourcing, made possible by the information, communication and logistics revolution, and the ease of international capital flows that can literally occur at the speed of light, have all contributed to the rising degree of economic globalisation.
- ◆ In the following charts, the growth of global trade flows, direct investment flows, and portfolio investment flows are presented. There are similar pictures for cross-border loans, government assistance, and other cross-border capital flows.

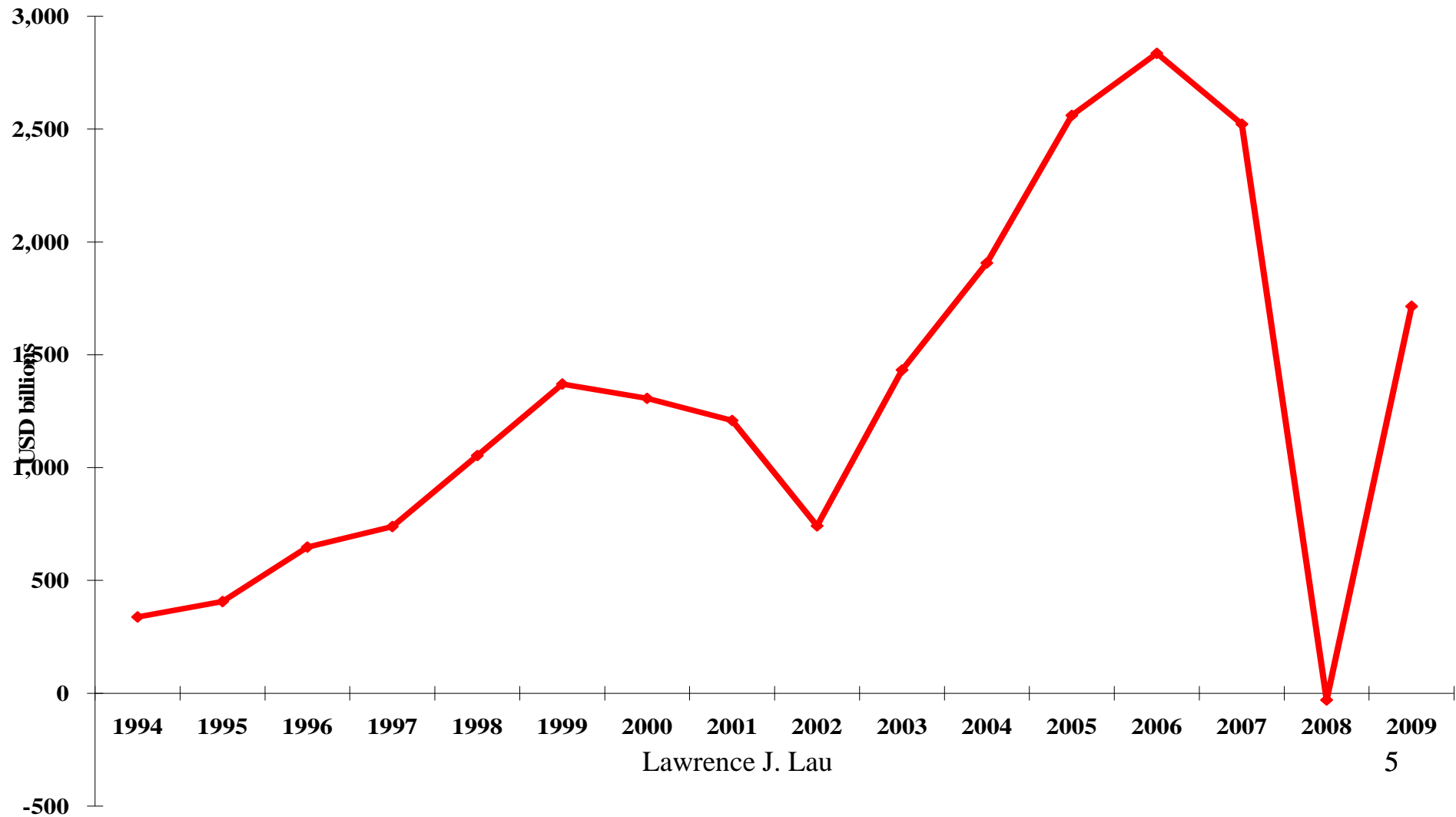
Worldwide Annual Trade Flows, billions US\$

Worldwide Annual Trade Flows, in USD billions



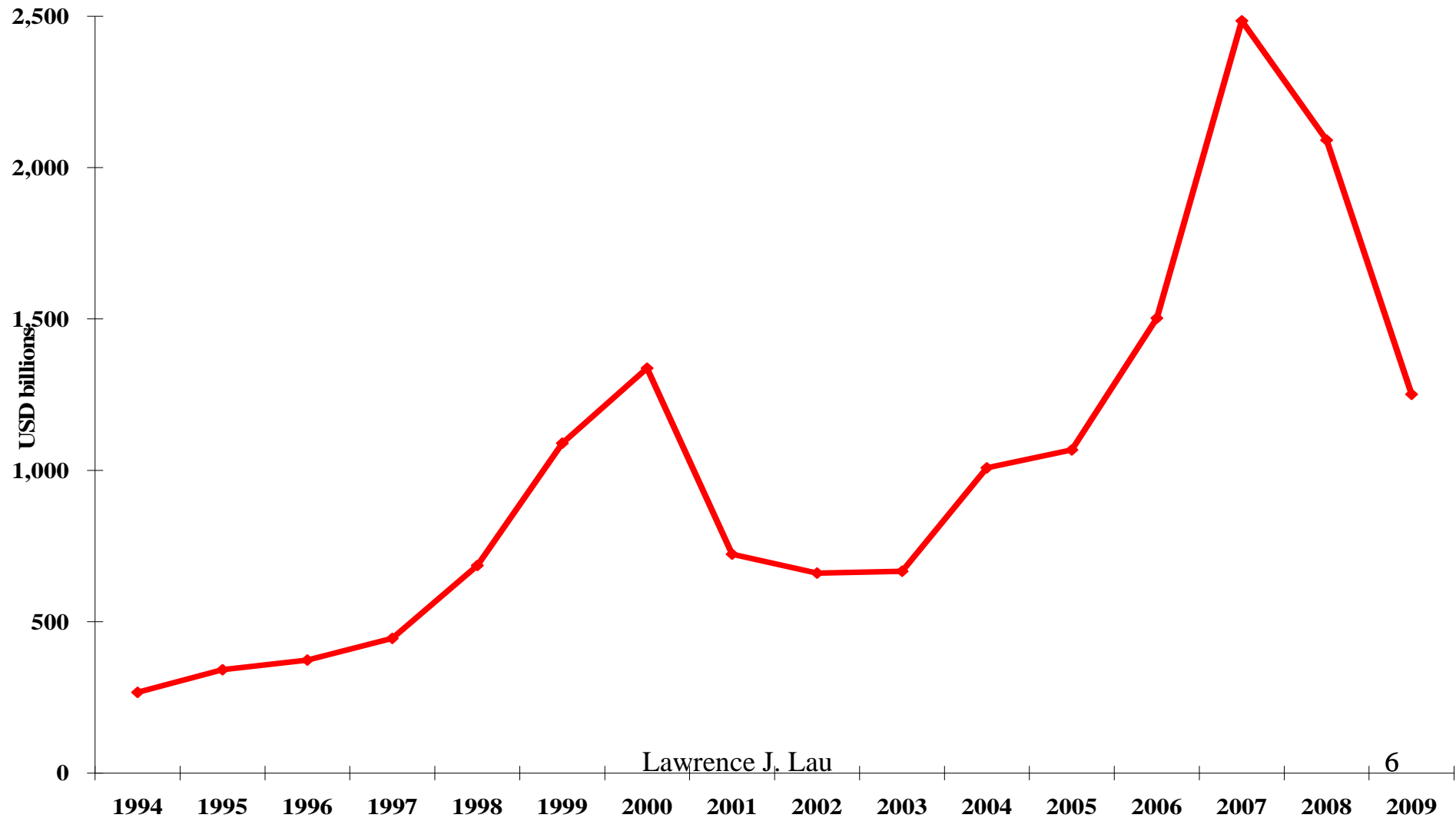
Worldwide Annual Portfolio Investment Outflows, billions US\$

Worldwide Annual Portfolio Investment Outflows, in USD billions



Worldwide Annual Direct Investment Outflows, billions US\$

Worldwide Annual Direct Investment Outflows, in USD billions

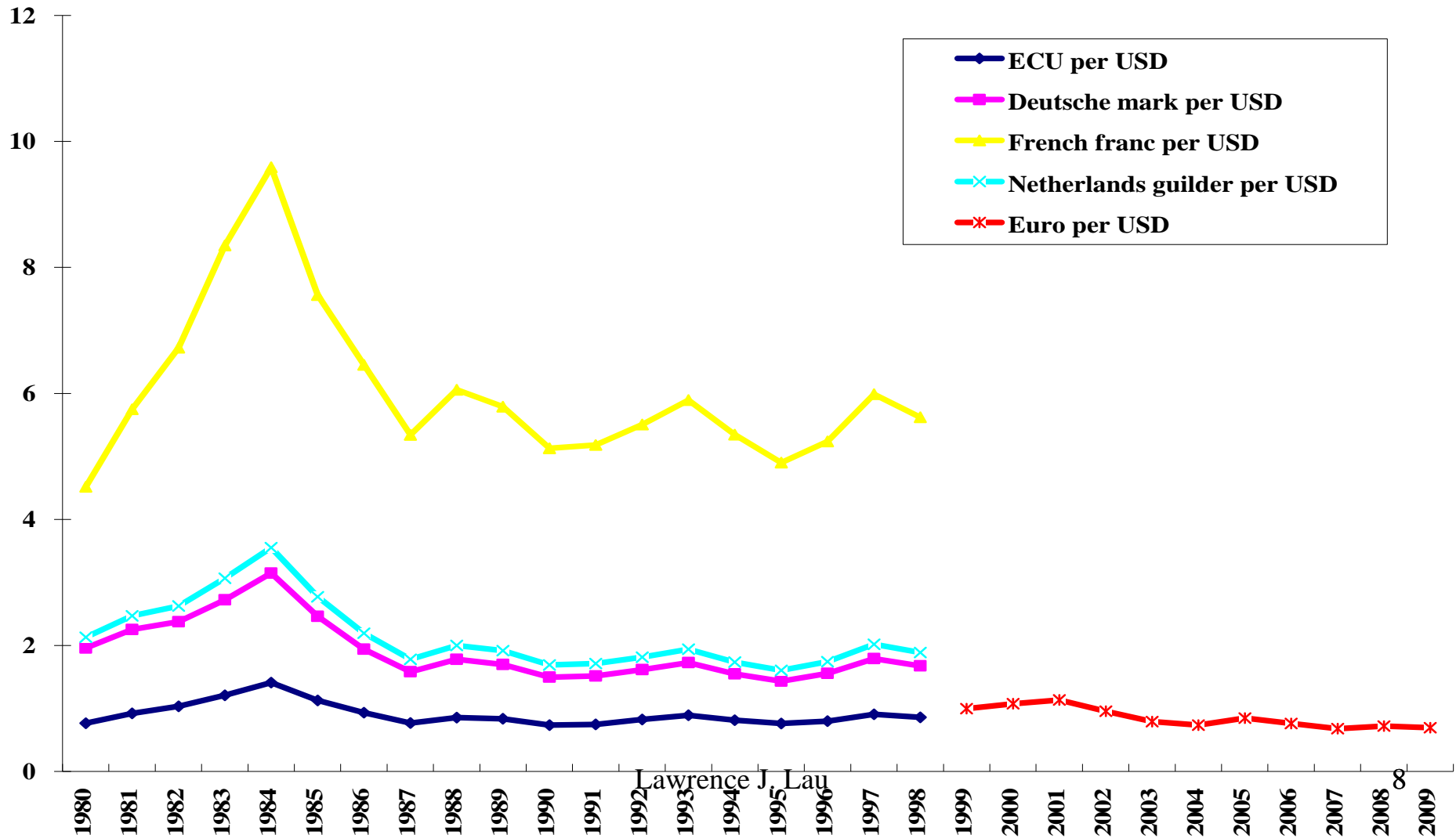


Introduction

- ◆ Economic globalisation has brought benefits to all, albeit to varying degrees, even though in some countries a segment of the population might have been hurt because the gains from economic globalisation were not evenly distributed or re-distributed.
- ◆ However, economic globalisation seems to have stalled, especially since the global economic crisis of 2007-2009, for many reasons.
- ◆ Volatility of relative exchange rates is an important impediment to trade and capital flows, much more so than a tariff and other protectionist measures, and hence to economic globalisation.
- ◆ A stable exchange rate contributes to the domestic economic development of an economy and to its active participation in the global economy as a trading partner and as either an investor- or an investee-country. The Euro Zone is an example— intra-Euro Zone trade increased significantly after the introduction of the Euro as the single currency in the late 1990s.
- ◆ Stable relative exchange rates between economies that are in approximately balance of payments equilibrium vis-à-vis the World can enhance the trade and investment flows among them significantly.

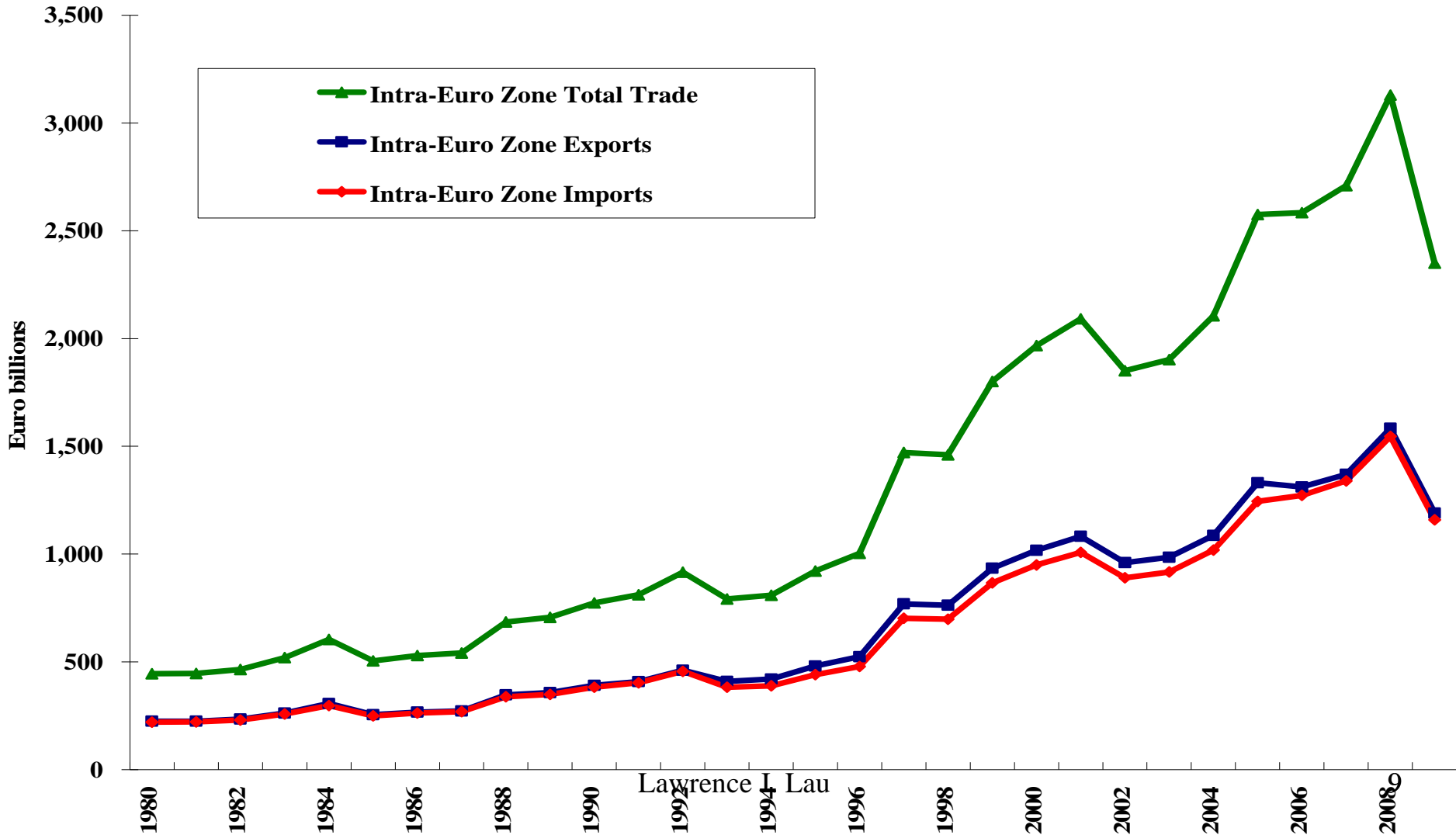
Euro Zone Exchange Rates, Pre-and-Post the Introduction of the Euro

European currencies vis-a-vis the U.S. Dollars



Intra-Euro Zone Trade, Billions Euro

Intra-Euro Zone Trade, in Billions Euro



Global Trade and Capital Flows

- ◆ The volatility of the short-term capital flows contributes to the volatility of the exchange rates, and vice-versa, as hedge funds take advantage of the volatility to speculate on short-term exchange rate changes.
- ◆ Despite free trade agreements and free trade areas (for example, AFTA—The ASEAN Free Trade Area—and its various variations of AFTA + 3—China, Japan, and South Korea), volatile exchange rates tend to reduce international trade and investment.
- ◆ The fluctuations in the relative exchange rates are largely unrelated to the basic economic fundamentals of the economies. For example, in 2010, the Euro went from a high of over 1.4 US\$ per Euro to a low of 1.15 US\$ per Euro and then almost back to 1.4 again. Did this reflect the relative economic fundamentals between the United States and the Euro Zone? Could this be good for the Euro Zone, for the United States, or for the World?
- ◆ Volatility and long-term instability of exchange rates also tend to reduce long-term cross-border investments, including both direct and portfolio investments.

Short-Term Capital Flows

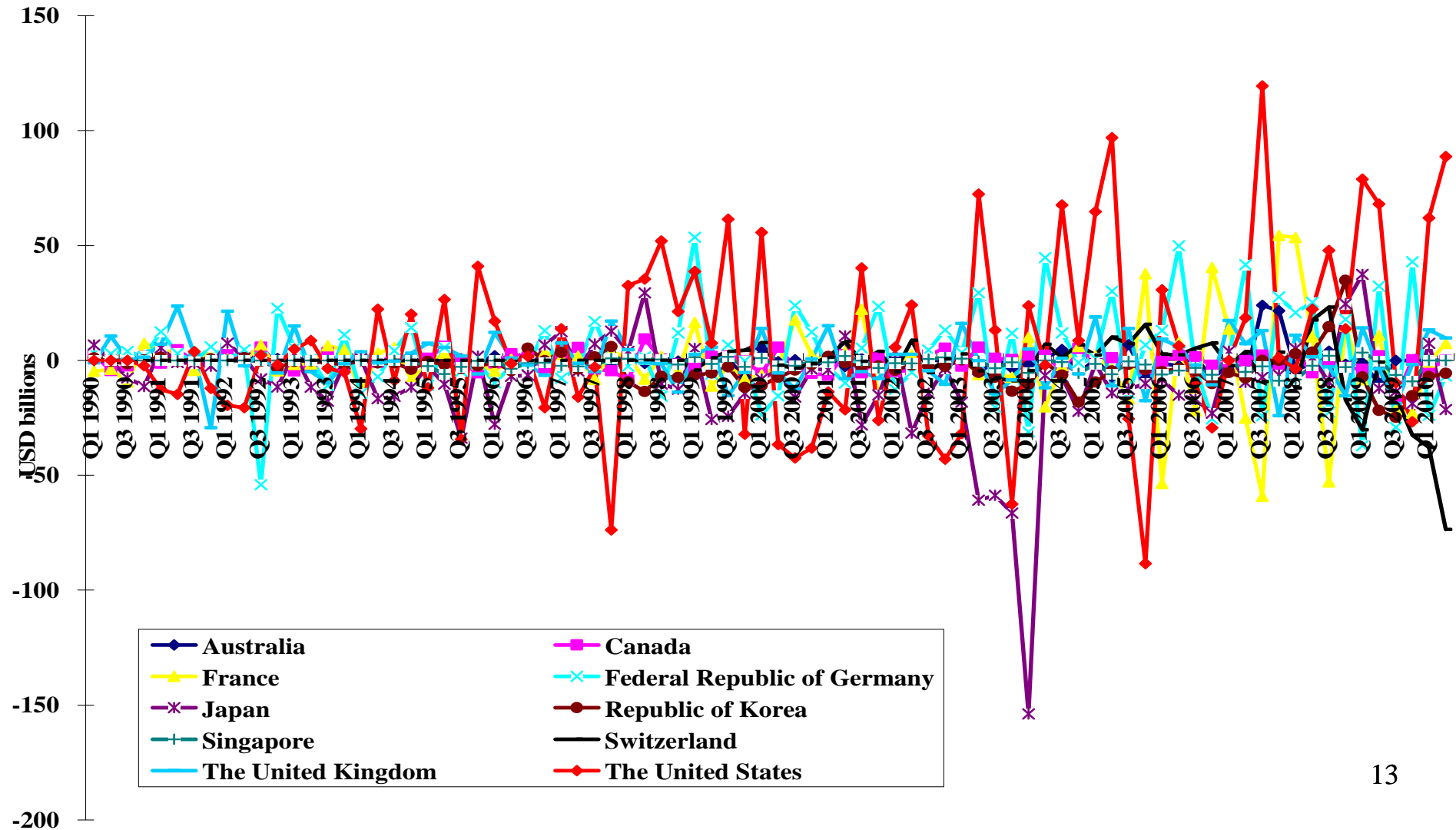
- ◆ The theory of comparative advantage shows that two economies trading with each other voluntarily will both benefit, although possibly to varying degrees. This is the intellectual basis for supporting international trade, and in particular, free trade.
- ◆ It is also well demonstrated that foreign direct investment undertaken in the absence of special privileges will always benefit both the investor-country and the investee-country. The same argument applies to foreign portfolio investment.

Short-Term Capital Flows

- ◆ However, there is no similar argument in favour of short-term international capital movements. It is simply an article of faith that the freer the movement of capital, the better. However, short-term non-trade related capital inflows that can be withdrawn at a moment's notice, does not really benefit the destination country and on the contrary may do significant harm, as the East Asian currency crisis of 1997-1998 demonstrated. Short-term capital inflows cannot be usefully deployed in the destination country and when they are used to finance long-term investment they invariably lead to trouble because of maturity mismatch. It is also not clear what good short-term capital flows do to the origin country. (Under “Quantitative Easing II” of the U.S., the liquidity released, if it stays in the U.S., may do the U.S. economy some good; but if it flows out of the U.S., it is not clear how it benefits the U.S. economy.)

Quarterly Net Capital Outflows of Selected Economies, billions US\$

Quarterly Net Capital Outflows of Selected Economies, in USD billions

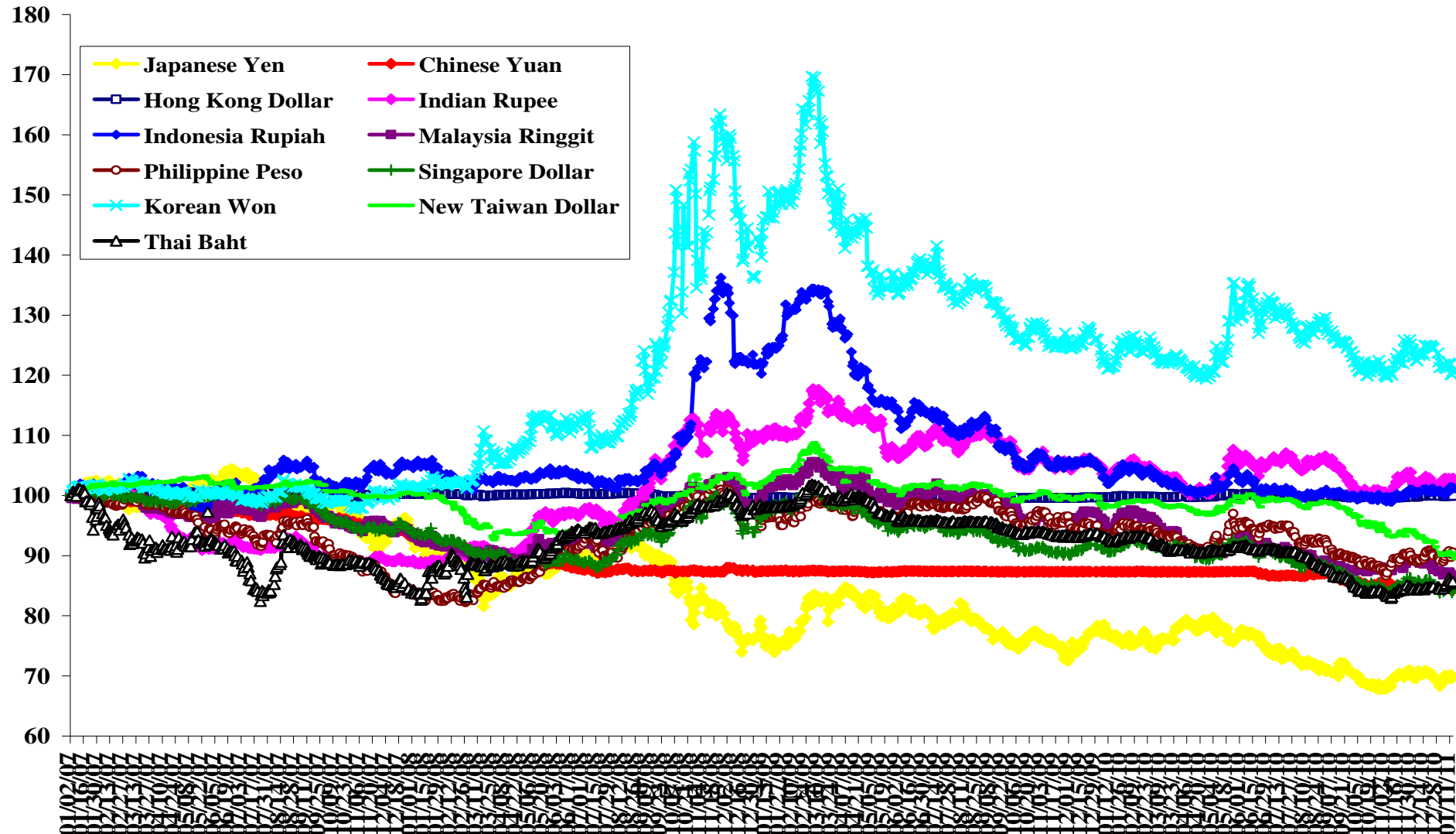


Exchange Rate Volatility

- ◆ Exchange rate volatility is mostly caused by the volatile short-term capital flows. However, exchange rate volatility also encourages speculation, and hence may lead in turn to even more short-term capital flows looking for a quick return.
- ◆ Exchange rate volatility is unrelated to trade flows or to direct investment flows, which have been much more stable.
- ◆ There is evidence of predatory cross-border speculation on currencies (e.g., the double-short strategy used in the 1997-1998 East Asian currency crisis, and the more recent double-long strategy used again in many of the East Asian economies). Basically a double-short strategy consists of simultaneously shorting the currency and the bonds (or stocks) of a country. If the country defends the currency by raising the interest rate, the bond or stock market will fall. If the country does not defend the currency, the exchange rate will fall. Either way, the speculator wins. The double-long strategy works similarly but in the reverse direction.
- ◆ However, exchange rate volatility per se, as opposed to exchange rate flexibility, does not benefit anyone except the currency speculators. The benefits of a daily fluctuating exchange rate freely determined in the market are exaggerated. In any case, the foreign exchange market is also subject to manipulation by the currency speculators.

Exchange Rate Indices of Selected East Asian Economies (2/Jan/2007=100)

Exchange Rate Indices of Selected East Asian Economies (1/2/2007=100)

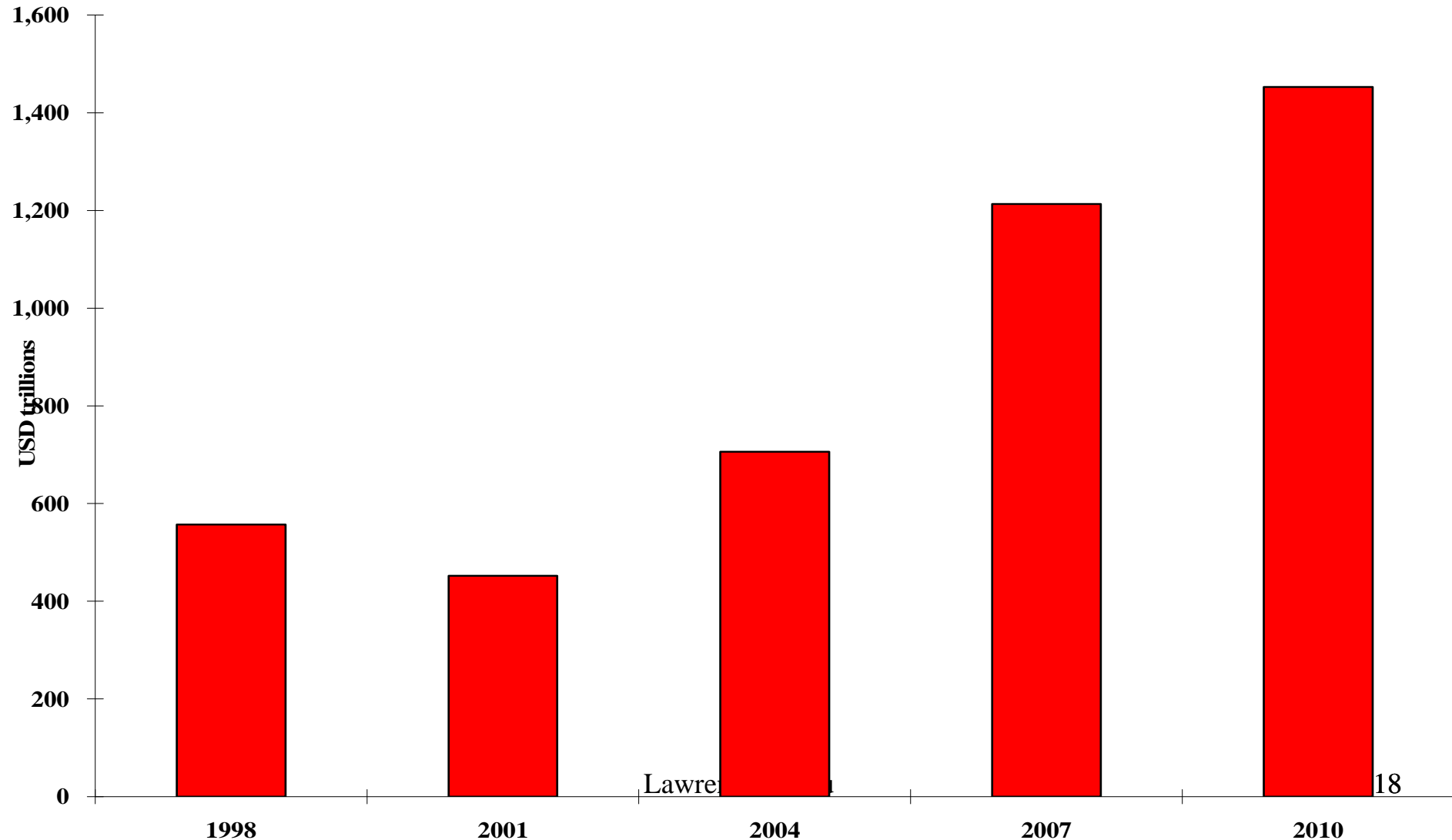


Exchange Rate Volatility

- ◆ There is far too much currency speculation in the World today. Forward and future foreign exchange markets are beneficial to bona fide exporters and importers because they allow them to hedge the risk. For example, a Chinese exporter that sells its goods to a U.S. exporter in US\$ has to protect himself by selling the US\$ forward so that he can be sure that the Renminbi he will realise is sufficient to cover his cost, a significant part of which, including wages for his workers, will be in Renminbi.
- ◆ The volume of foreign exchange transactions in the World is huge—currently at approximately US\$1.5 quadrillion annually and definitely dwarfs everything else. It is far too much than can be justified by the “real” international transactions: international trade, foreign direct investment, and foreign portfolio investment (even if we take into account that the stocks of the direct investment and portfolio investment can be much bigger than the annual flows and that they may need hedging).

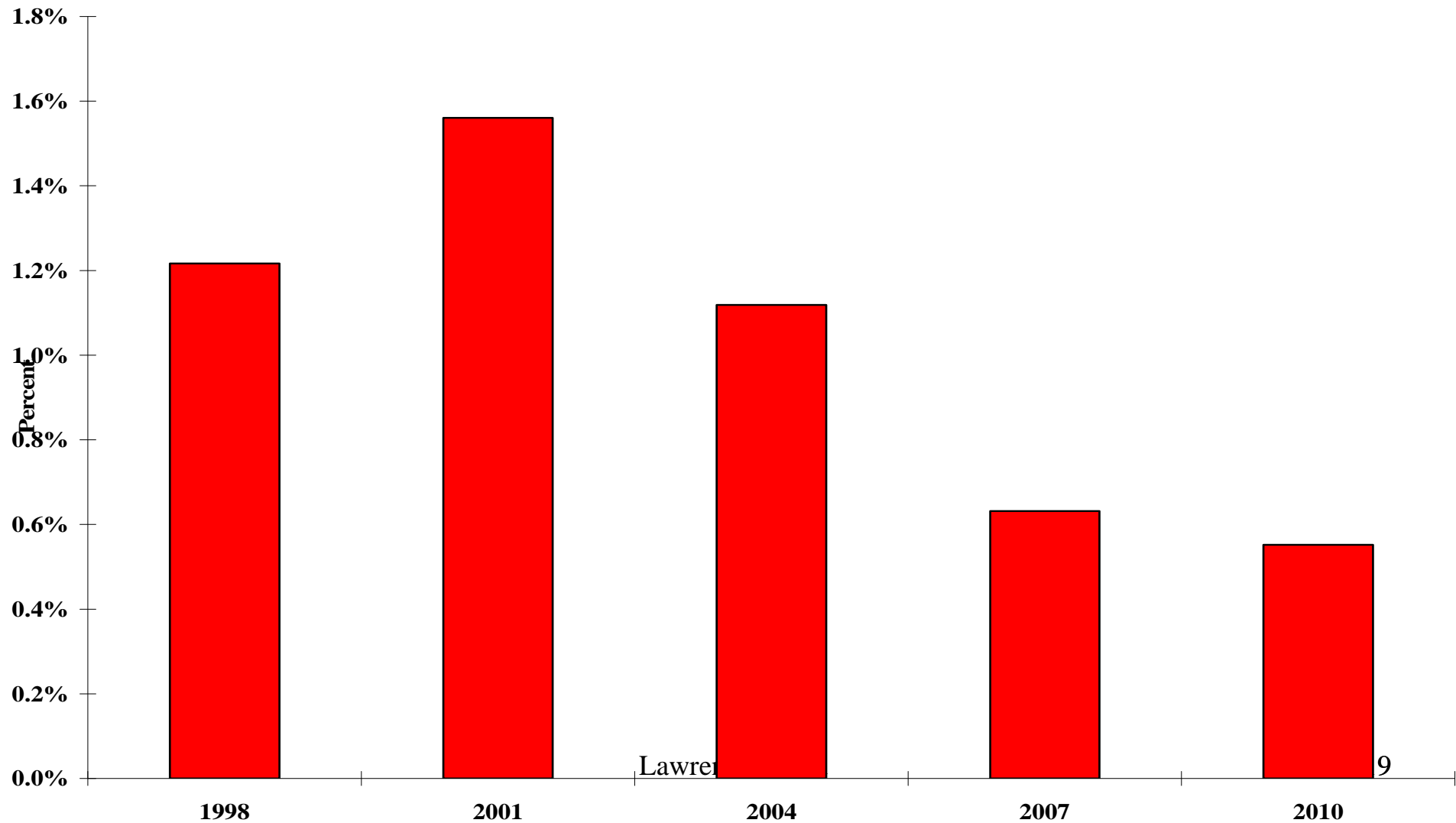
Global Foreign Exchange Market Annual Turnover, trillions US\$

Global Foreign Exchange Market Annual Turnover, in USD trillions



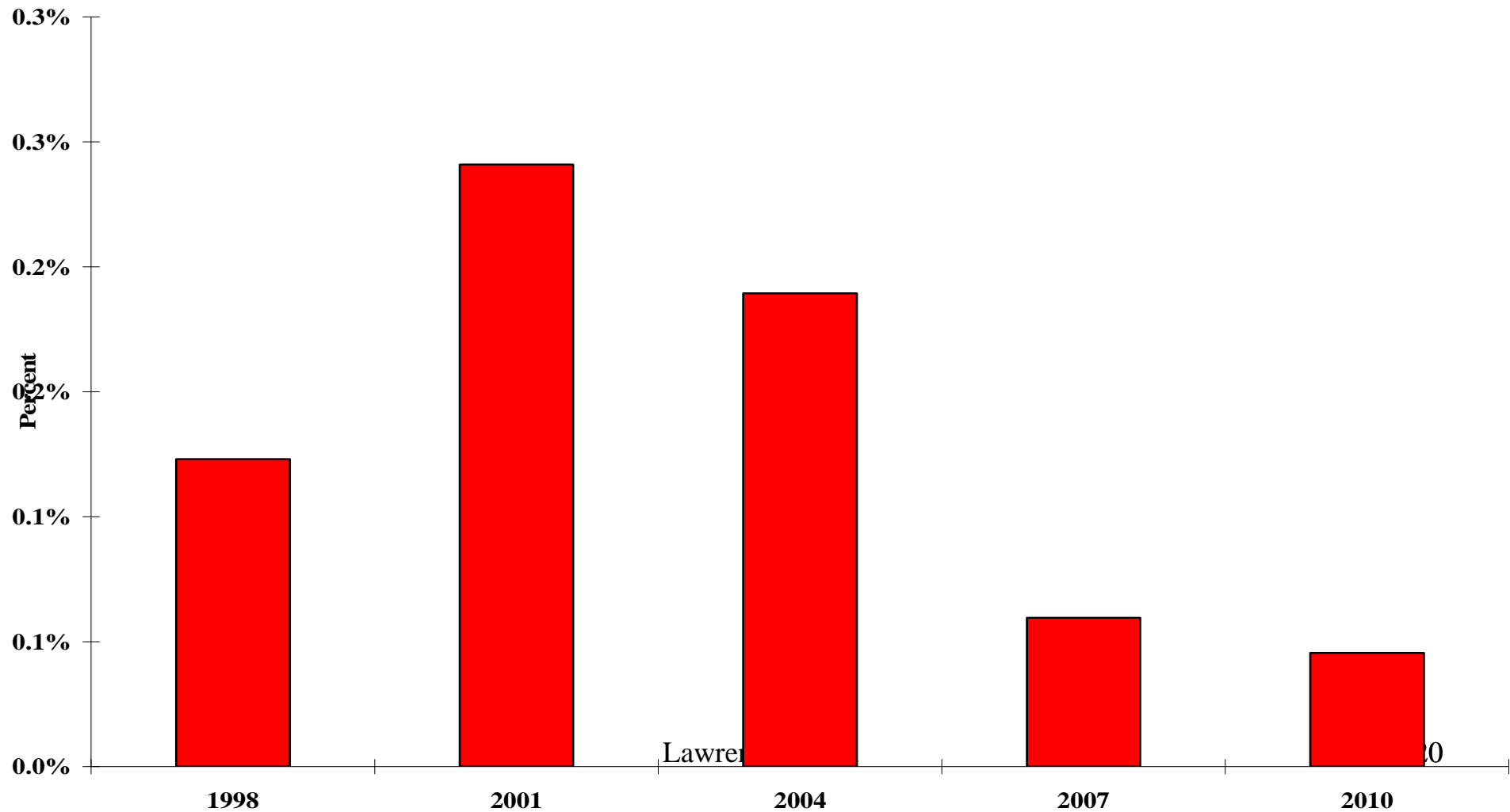
The Ratio of Worldwide International Trade Flows to FX Market Turnover

The Ratio of Worldwide Annual Trade Flows to Annual Foreign Exchange Market Turnover



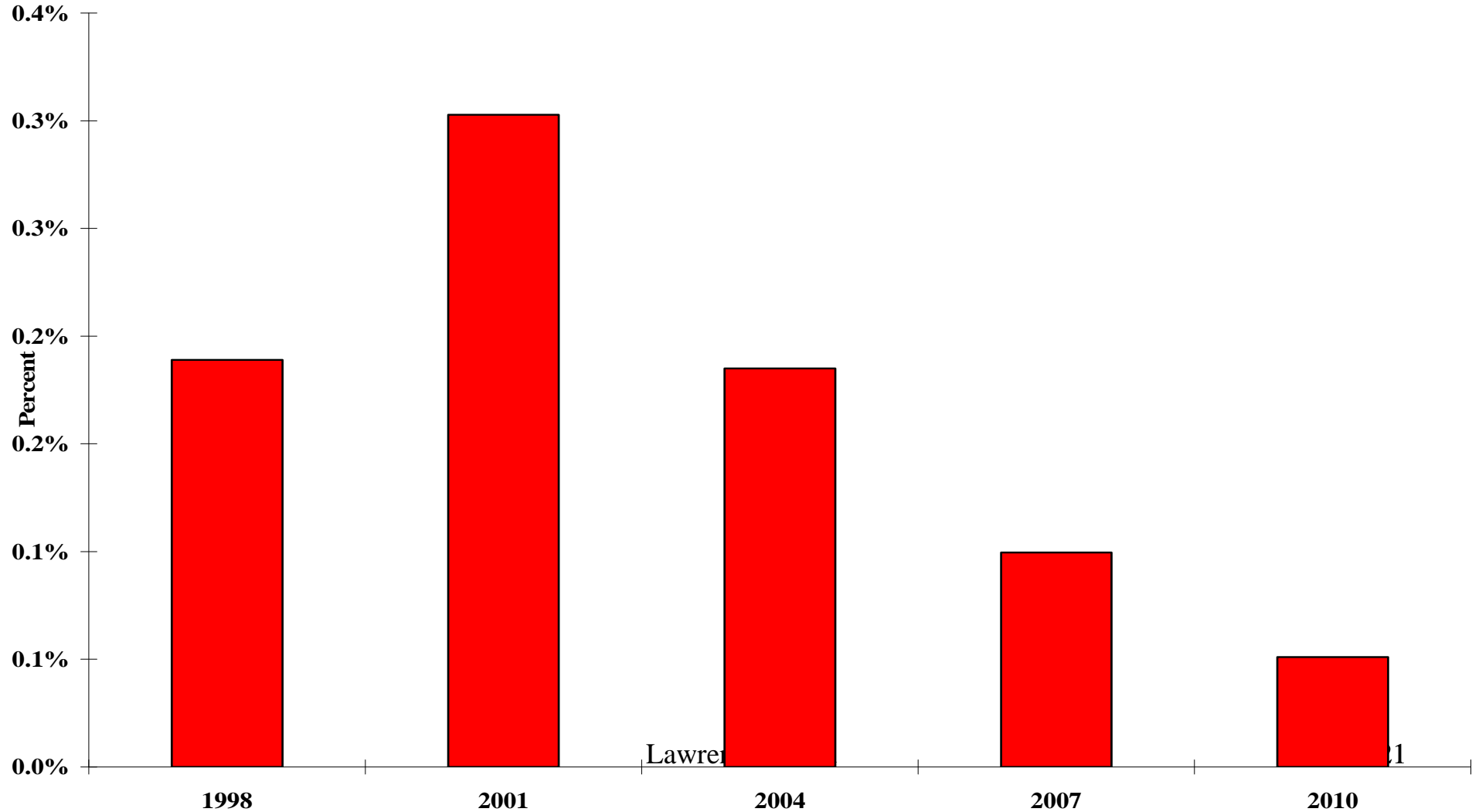
The Ratio of Worldwide Direct Investment Flows to FX Market Turnover

The Ratio of Worldwide Annual Direct Investment Flows to Annual Foreign Exchange Market Turnover



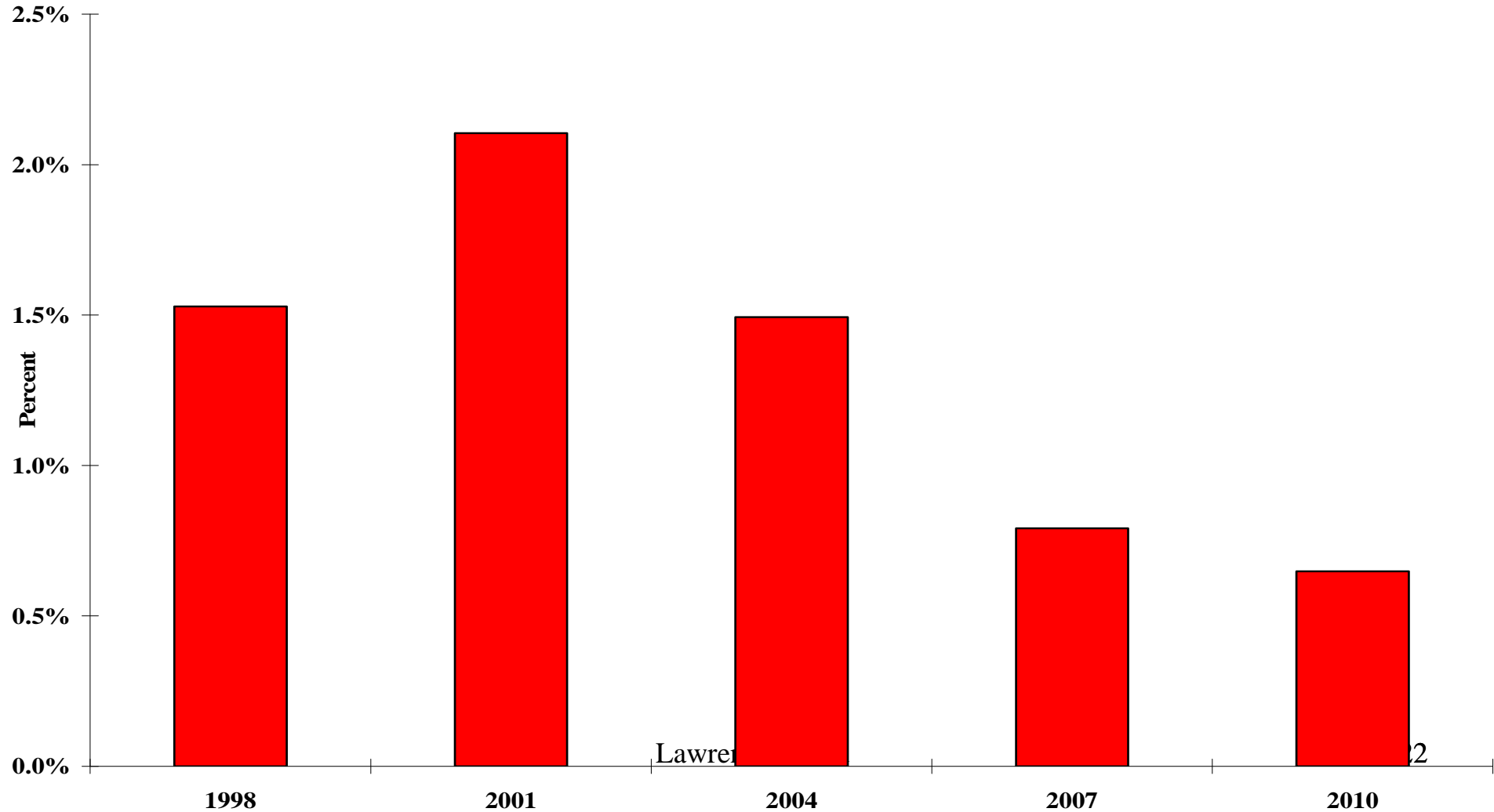
The Ratio of Worldwide Portfolio Investment Flows to FX Market Turnover

The Ratio of Worldwide Annual Portfolio Investment Flows to Annual Foreign Exchange Market Turnover



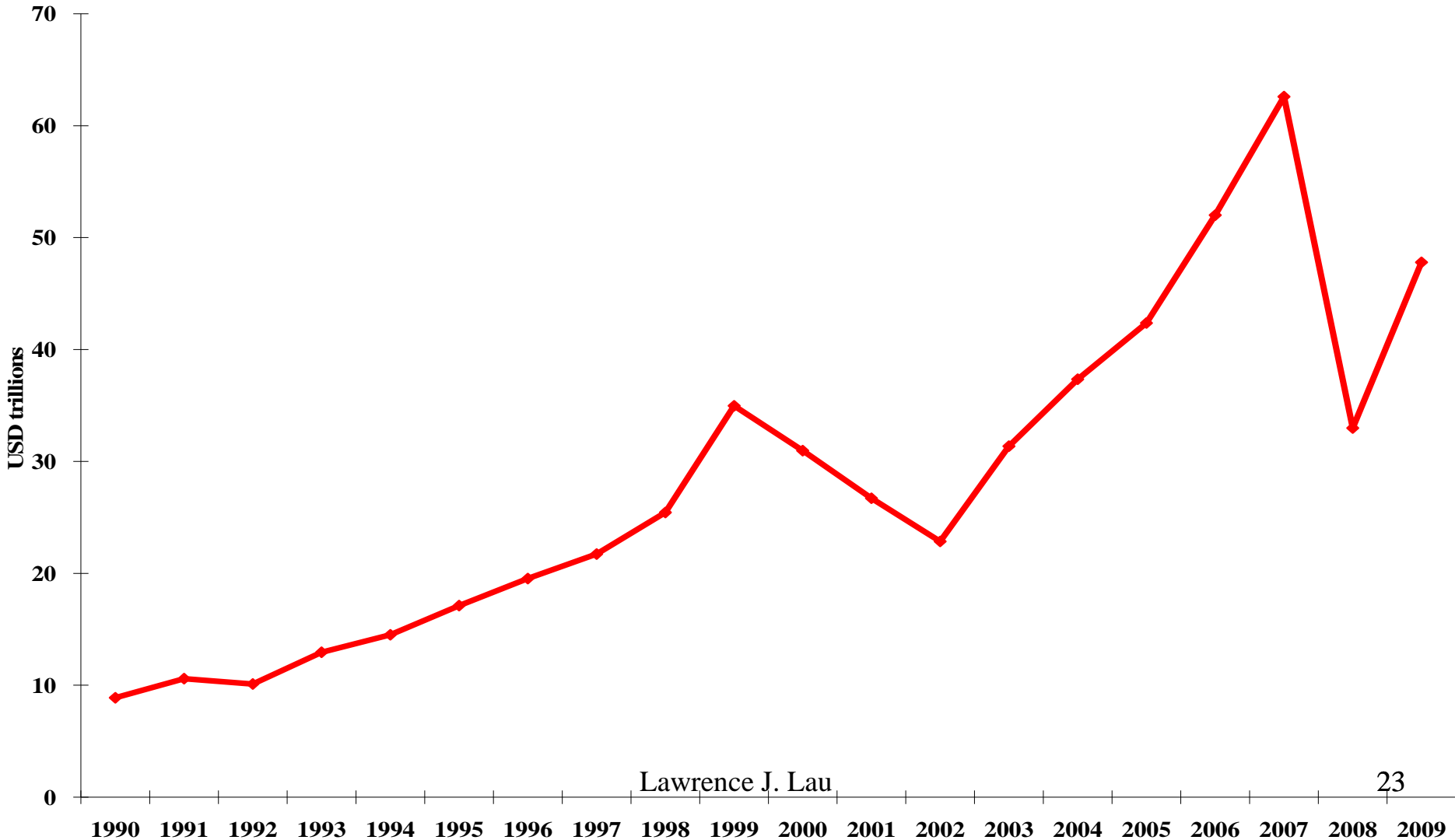
The Ratio of Worldwide International Transactions to FX Market Turnover

The Ratio of Worldwide Annual Trade, Direct Investment, and Portfolio Investment Flows to Annual Foreign Exchange Market Turnover



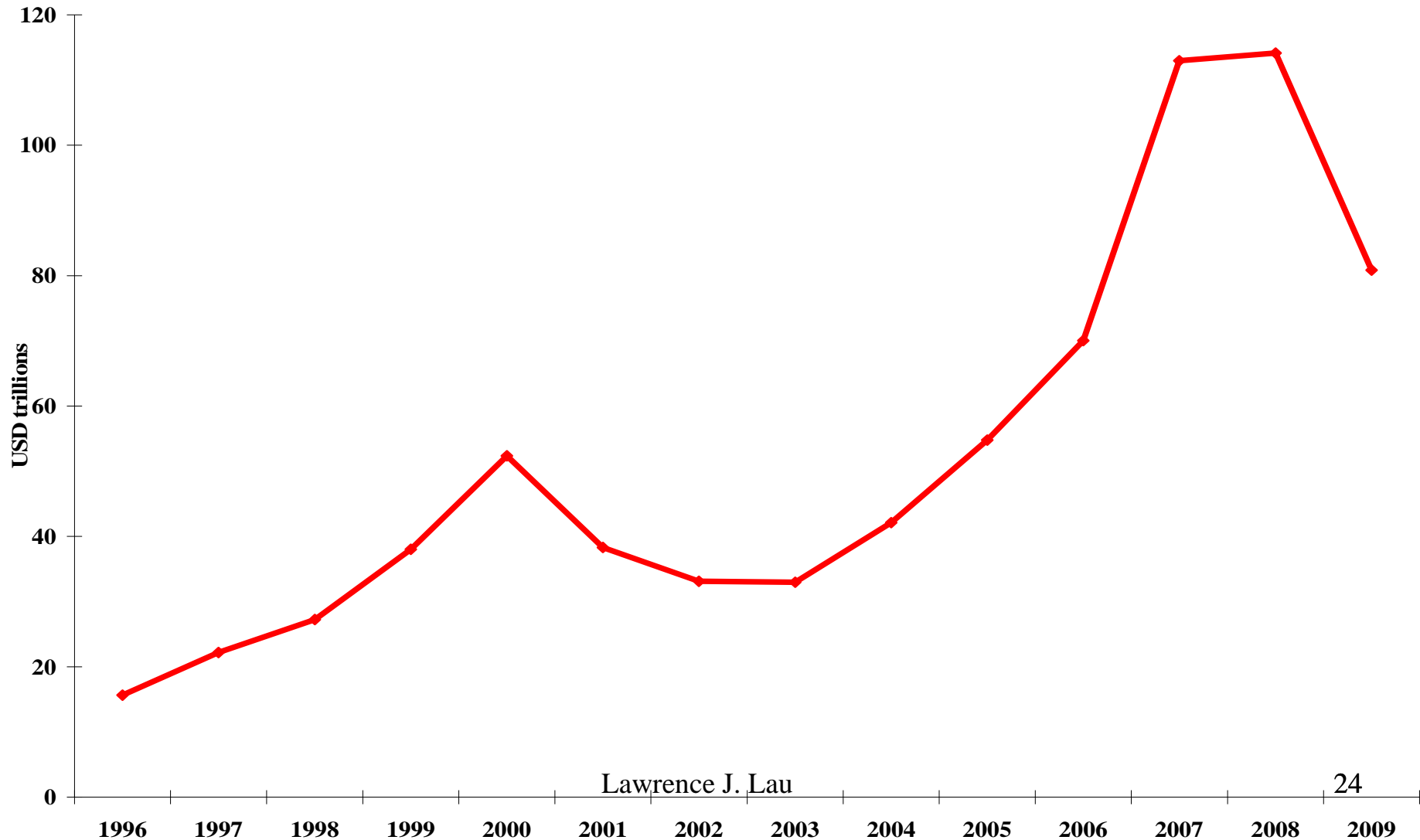
Total Market Capitalisation of World Stock Markets, trillions US\$

Market Capitalisation of World Stock Markets, in USD trillions



Total Value of Transactions on World Stock Markets, trillions US\$

Total Value of Share Trading of World Stock Markets, in USD trillions



Exchange Rate Volatility

- ◆ The annual total value of international trade, direct investment and portfolio investment flows amounts to less than 1 percent of the annual total value of foreign exchange transactions in 2010.
- ◆ The total value of foreign exchange transactions, approximately US\$1.5 quadrillion in 2010, is more than 10 times the annual total value of transactions on all World stock exchanges combined (which peaked in 2008 at less than US\$120 trillion).
- ◆ The purpose and the social and private benefits of the bulk of these foreign exchange transactions are not clear.

Possible Measures for Reducing Exchange Rate Volatility

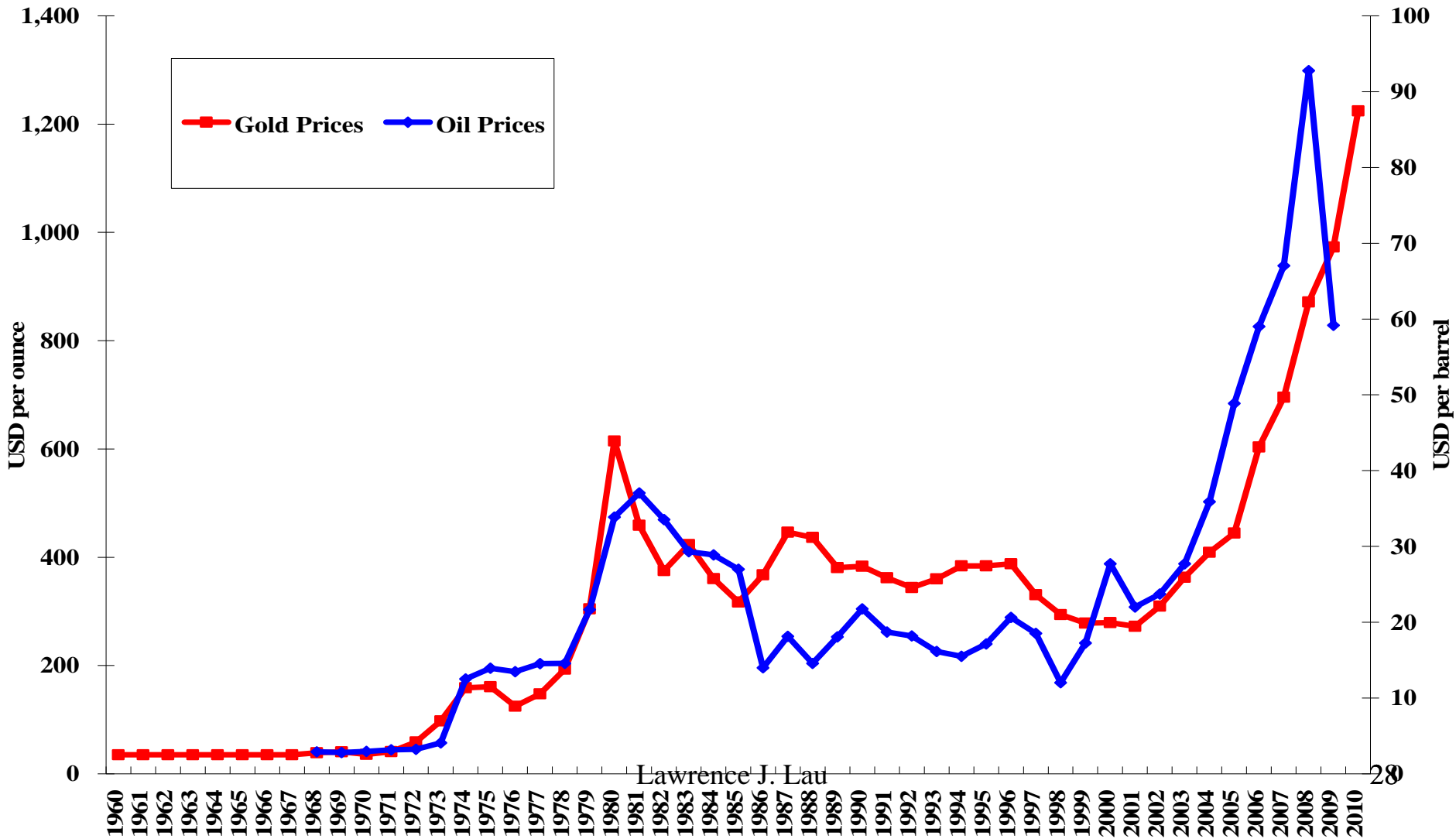
- ◆ The regulation of short-term non-trade-related capital flows, both inbound and outbound, e.g., requiring a minimum period of one-year between repatriation, a withholding tax on short-term income and capital gains, etc. The device of “Qualified Institutional Investors,” both inbound and outbound, has been used with some success.
- ◆ Reduction of the necessity of frequent currency exchange: e.g., multiple listing of shares (e.g., through the use of depositary receipts); local currency financing of foreign direct investment.
- ◆ The regulation of forward and future markets for foreign exchange: e.g., restricting participants to those with bona fide interests; restricting the use of margins and leverage by pure speculators.
- ◆ The coordination of real relative exchange rate parities between and among economies on a voluntary basis.

Is There a Role for Gold?

- ◆ Under the gold standard and the gold-exchange standard before 1971, there is flexibility without constant volatility. Relative exchange rates were fixed until an economy encountered balance of payment difficulties, in which case it would make adjustments, including the settlement of balance of payment deficits with gold or with the US\$ and possibly a devaluation of its currency to a new fixed rate.
- ◆ One can always re-introduce gold as an instrument for settling imbalances between two economies that have agreed to do so. Excess currency of one economy held by the central bank of the other economy can be sold back to the currency-issuing economy at a pre-agreed price of gold in terms of the currency and vice versa.
- ◆ If an economy is unable to honour its commitment to redeem its currency with gold, it will have to change its exchange rate vis-à-vis gold.
- ◆ The International Monetary Fund (IMF) can resume its former role as the monitoring and enforcement agency for such bilateral agreements.
- ◆ This scheme can actually be implemented regionally if it cannot be implemented globally. Formerly the IMF could maintain this discipline only among its members. Thus, the gold-exchange standard can be used by a sub-group of members of the IMF under an additional agreement among themselves.

Prices of Gold and Oil, US\$, Annual Average

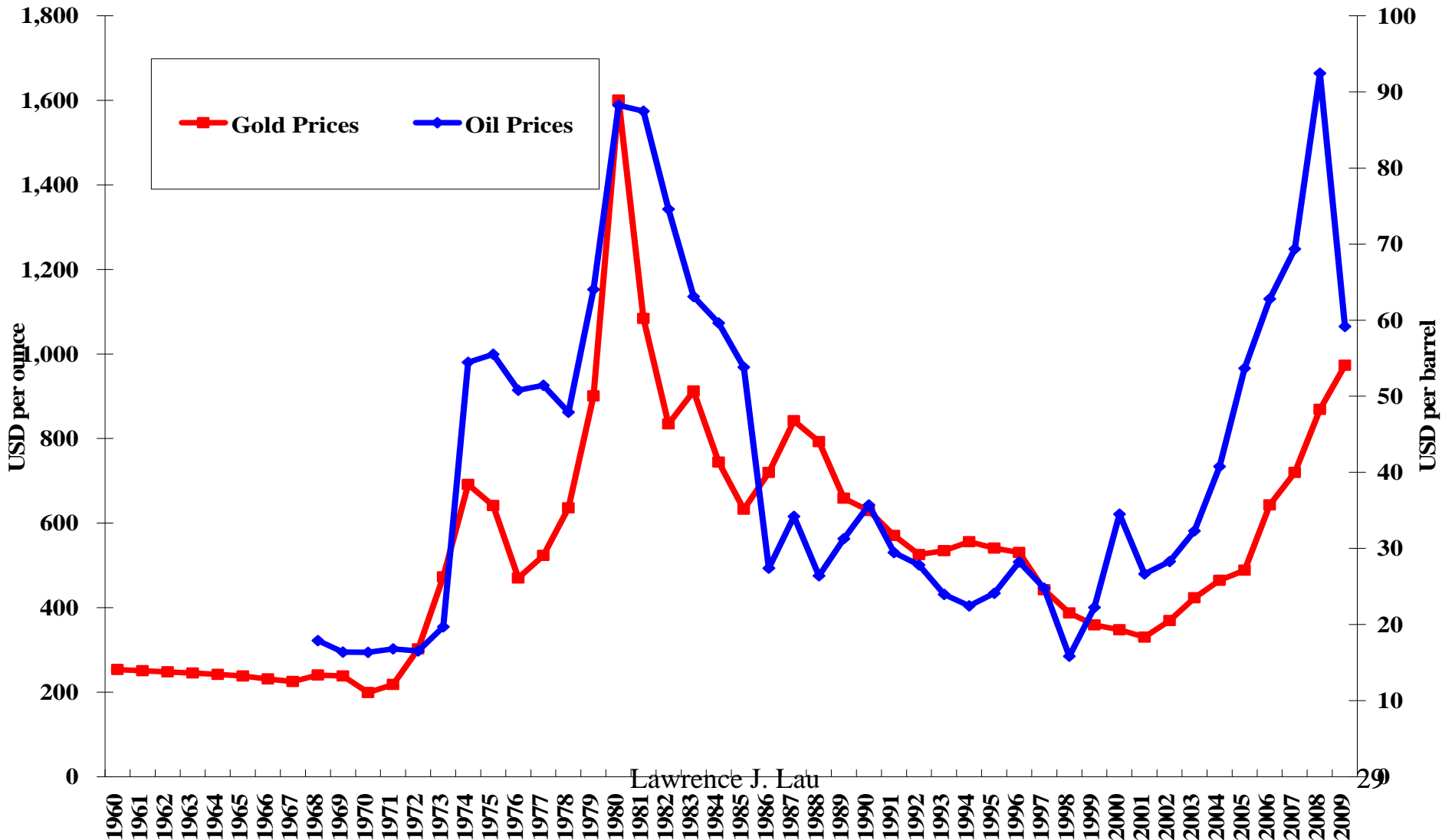
Annual Average Prices of Gold and Oil



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Real Prices of Gold and Oil, 2009US\$, Annual Average

Annual Average Real Prices of Gold and Oil, in 2009 USD



Arguments Against the Use of Gold

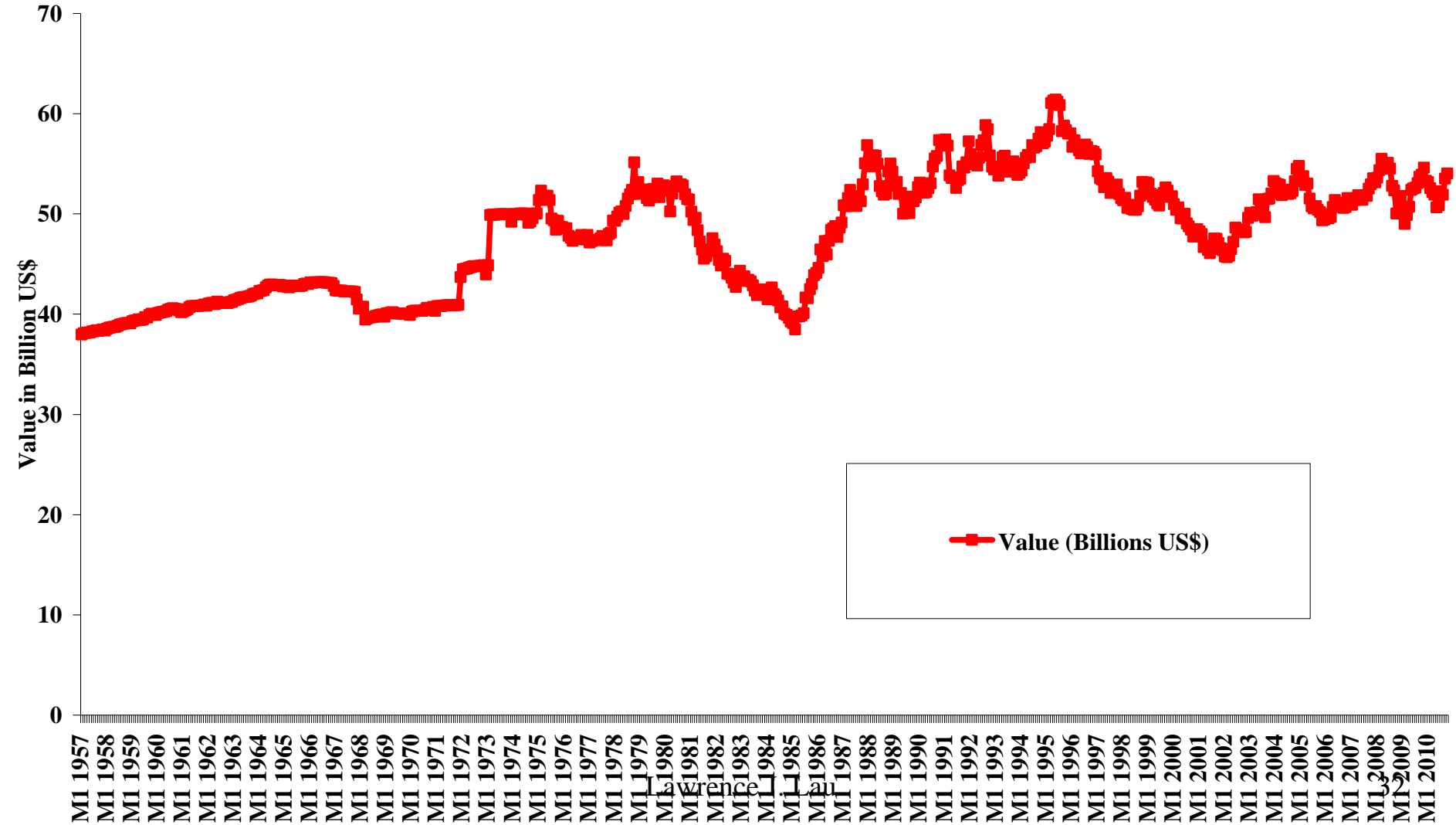
- ◆ There is not enough gold in the World to finance all the international transactions, and the rate of growth of gold production is not able to keep pace with the rate of growth of international trade and investment.
- ◆ Whether there is enough gold depends on the price of gold in the various currencies. At a sufficiently high price of gold, there should be enough.
- ◆ Moreover, it should be noted that only the trade imbalances need to be settled in gold, and not the aggregate volume of trade. If, under a set of exchange rates, every economy has balanced trade, there is no need to use any gold for settlement purposes.

Estimates of the Value of “Monetary” Gold Held by Central Banks

- ◆ A rough estimate of the value of gold held by the central banks of the World can be obtained by subtracting from the total foreign exchange reserves figure, published by the IMF, the total foreign exchange reserves minus gold figure, also published by the IMF. The result, approximately US\$60 billion, is an estimate of the value of “monetary” gold held by central banks around the World, evaluated at US\$35 an ounce (it could be US\$38.5 but the difference is only 10%).
- ◆ At a price of US\$1,400 per ounce, which is at the top end of the recent market prices, the estimated market value of gold held may be estimated at approximately US\$2.4 trillion, compared to a total World trade flow of some US\$20 trillion a year.

The Value of “Monetary” Gold Held by Central Banks at US\$35 an ounce, billions

Monetary Gold

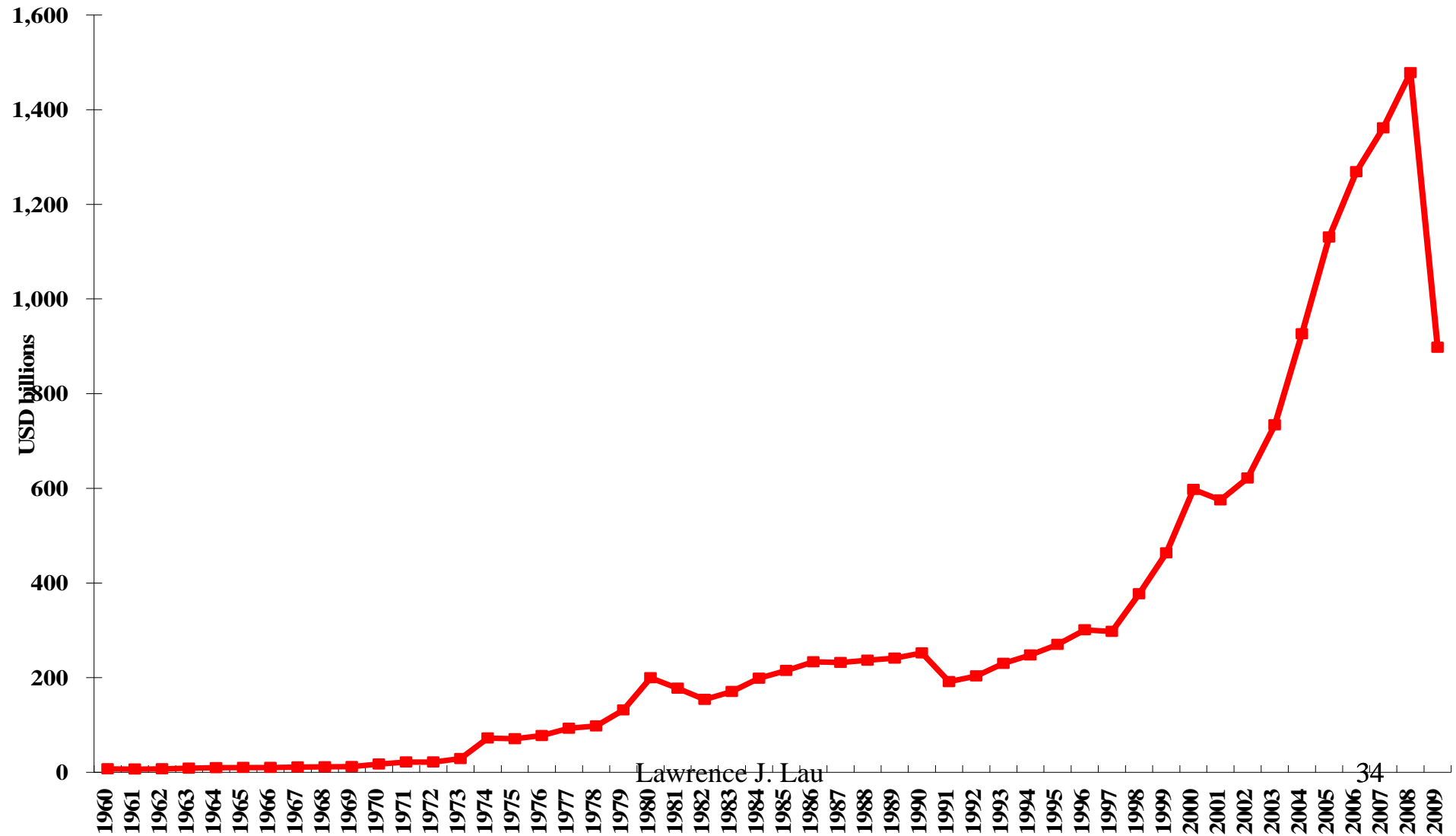


Estimates of the Value of Gold Held by Central Banks

- ◆ The aggregate World trade deficit in goods and services can be calculated by adding up all the trade deficits of the trade-deficit countries. These figures are presented in the following chart.
- ◆ The aggregate World trade deficit has increased rapidly in recent years. From only US\$270 billion in 1995, it rose to US\$600 billion in 2000, reaching a peak of almost US\$1.5 trillion in 2008 before falling to approximately US\$900 billion in 2009. It is expected to decline further.
- ◆ Going forward, the World is clearly unable to support such large aggregate deficits in a sustainable way, no matter what system is used for the settlement of these imbalances. It should, however, be borne in mind that world trade can grow without the world trade deficit growing.
- ◆ The amount of gold held by the central banks of the World, at say US\$1,400 per ounce, should be sufficient to settle all the trade deficits, going forward, if needed, bearing in mind that the adjustments required under a gold-based system, will most likely occur much sooner than is currently the case.

Total World Trade Deficit in Goods and Services, 1960-2009

World Trade Deficits in Goods and Services, in USD billions



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Estimates of the Value of Gold Held by Central Banks

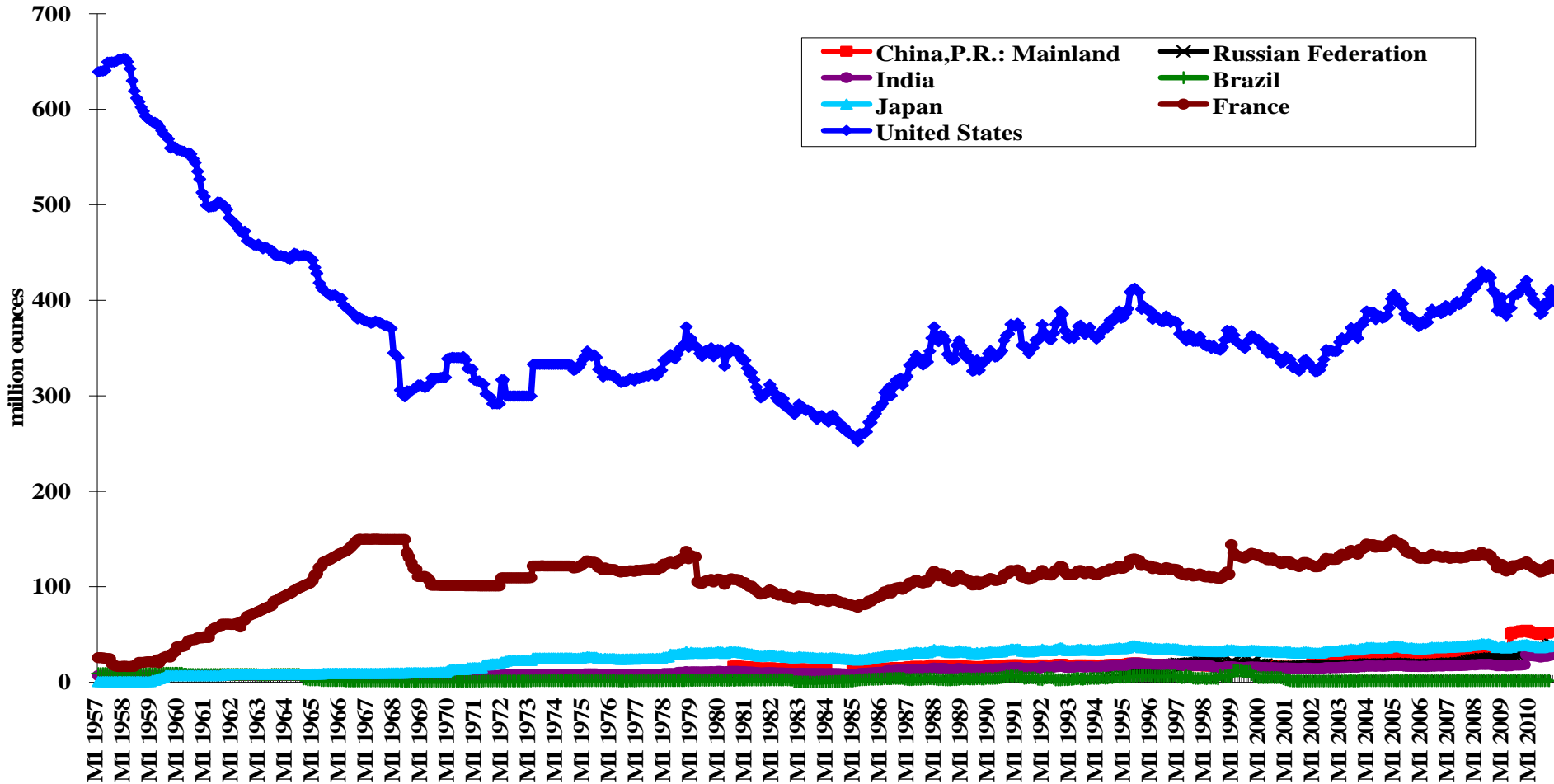
- ◆ Of course, under such a system, persistent trade deficits are not possible—an economy with large and persistent trade deficits must devalue relative to gold—it must be prepared to sell less gold per unit of its currency to other central banks with excess holdings of its currency. In so doing, its currency will also effectively devalue relative to other currencies which do not need to change their values relative to gold. Thus, it is hoped that such a trade-deficit economy will be able to reduce its trade deficit and perhaps even begin to run a trade surplus, and to earn back the gold that it sold to other central banks to settle the previous trade deficits.
- ◆ Thus, it would seem that there should be enough gold in the World to make the system work. Moreover, it is possible to have the gold-based settlement system apply only within a group of countries on the basis of voluntary participation rather than to the entire World.³⁵

Estimates of the Value of Gold Held by Central Banks

- ◆ The United States still holds the largest quantity of monetary gold in the World, with an estimated 400 million ounces, worth US\$560 billion at US\$1,400 per ounce. (These figures on gold may have a significant margin of error, but the order of magnitude is believed to be reliable.) By comparison, U.S. trade deficit in goods and services vis-à-vis the World in 2009 was less than US\$400 billion.
- ◆ The other large holders of monetary gold are probably European countries, e.g., France.
- ◆ China, Russia and India have all increased their holdings of monetary gold recently but they remain relatively small holders.

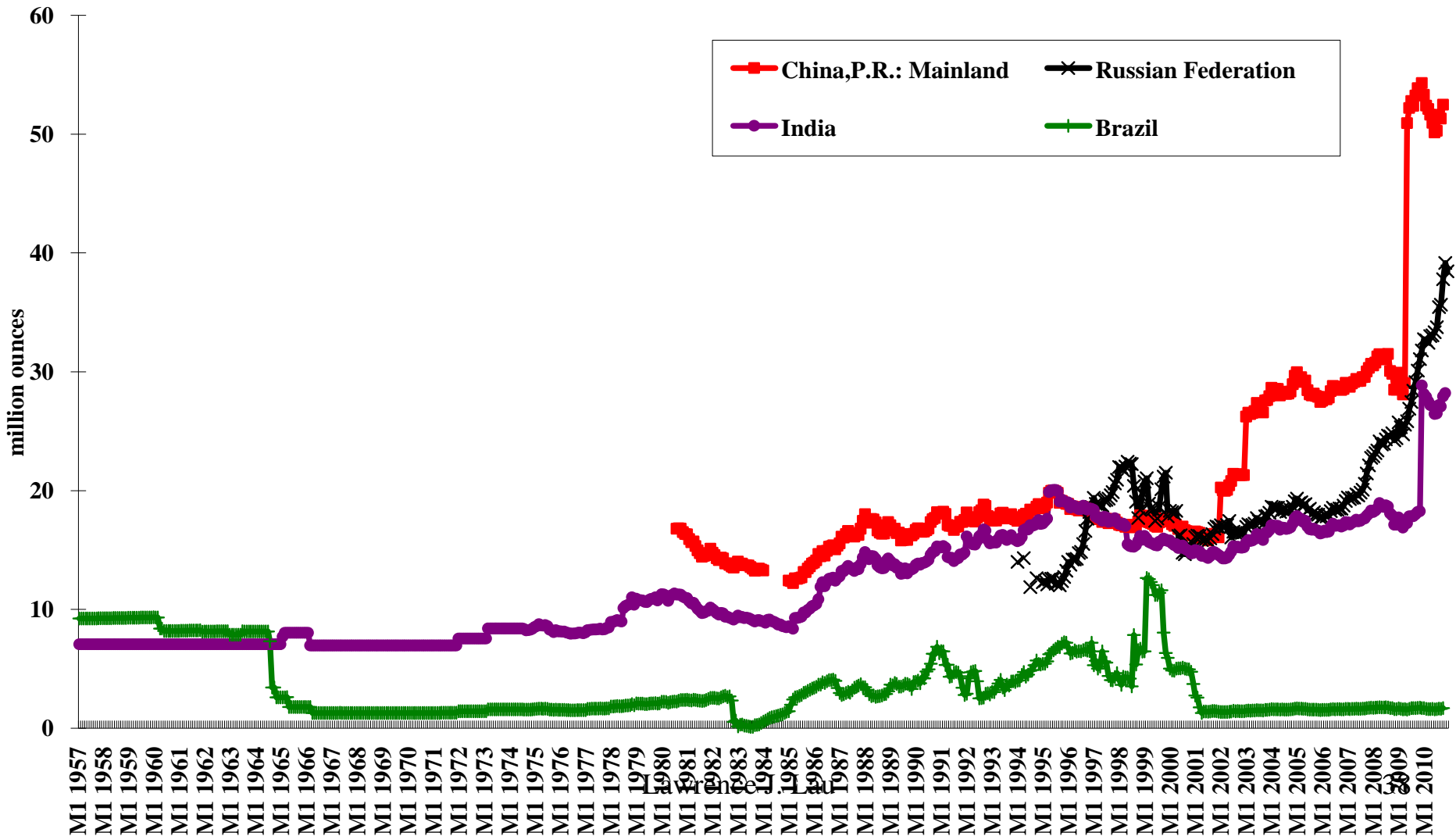
Estimated Holdings of Monetary Gold, Selected Economies, million ounces

Monetary Gold of Selected Countries, in million ounces



Estimated Holdings of Monetary Gold, Selected Economies, million ounces

Monetary Gold of Selected Countries, in million ounces



Arguments Against the Use of Gold

- ◆ It will benefit the gold producing countries (e.g., Russia, South Africa)—yes, the use of any standard will benefit some economies over others. The current de facto US\$ standard benefits the U.S. An oil standard will benefit the oil producing countries.
- ◆ However, with the return to a gold-based, or quasi-gold-based standard, the U.S., as the holder of the largest quantity of monetary gold in the World, will also benefit—it can probably buy back a significant proportion of its debt held by foreign central banks with its stock of gold at the price of say US\$1,400 per ounce.

Arguments Against the Use of Gold

- ◆ It will encourage speculation in gold—yes, the trade in monetary gold will have to be carefully monitored to prevent monopolisation or market manipulation in the gold market; perhaps private ownership of monetary gold can be forbidden.
- ◆ In any case, no central bank will be obligated to buy gold from the market at the market price—its only commitment, assuming that it subscribes to the gold-based standard, is to sell gold at a fixed price in its own currency to other central banks with what they consider to be excessive holdings of its currency. Such a commitment to redeem one's currency in gold should be only between central banks with signed agreements.

Concluding Remarks

- ◆ Further economic globalisation may require the compensation of groups hurt by globalisation within each economy by suitably redistributing its gains from the increases in international trade and investment. This would help prevent the rise of protectionism and reduce political opposition to further economic globalisation.
- ◆ Reductions in exchange rate volatility can also greatly facilitate the growth of international trade and investment and hence enhance further economic globalisation.

Concluding Remarks

- ◆ In the near term, exchange rate volatility can be reduced through measures discouraging and regulating short-term non-trade-related international capital flows and pure currency speculation. (Investment flows are generally longer-term flows.)
- ◆ In the intermediate term relative exchange rate volatility can also be reduced through exchange rate coordination among economies with close economic relationships (e.g., the “European currency snake” before the introduction of the Euro). For example, there can be an implicit understanding to maintain relative real parities among a group of economies, say, amongst East Asian economies. This would also facilitate the adjustment of exchange rates among East Asian economies with respect to other major currencies such as the Euro and the US\$ as no East Asian economy would be relatively advantaged or disadvantaged.

Concluding Remarks

- ◆ For another example, Prof. Robert Mundell has proposed stabilising the Euro-US\$ exchange rate within a range, say, between US\$1.2 and US\$1.4 per Euro by agreement between the Euro Zone and the United States, with each side being responsible for intervening when its currency becomes too high relative to the other. This would also reduce exchange rate volatility and hence currency speculation.
- ◆ In the long term, exchange rate volatility can be greatly reduced with a return to a quasi-gold standard—achieving flexibility without volatility.