Options for a New International Monetary Order in East Asia

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Introduction

- Most of the international trade, investment and loan transactions of the World today are denominated and settled in U.S. Dollars. The U.S. Dollar is widely used, insofar as international economic activities are concerned, as a unit of account, a medium of exchange, and a store of value.
- However, this has not always been the case. For example, trade of goods and services across borders, can from time immemorial be conducted on a barter basis. Goods and services simply change hands, more or less simultaneously, and no currency or payment is involved. The questions of the credit-worthiness of the traders and the strength of the currencies do not arise. Of course, barter has its well known limitations.

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- At a later stage, precious metals, such as gold and silver, which were and still are widely accepted in many societies, were used as media of exchange and stores of value. Silver, for example, was used as a medium of exchange in China until the Twentieth Century. The degrees of purity of the gold and silver were often an issue.

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- When paper, or "fiat", money was introduced by different countries as legal tender, international traders began to be concerned about the strengths of the different currencies and about their respective ability to preserve exchange value or purchasing power. The redeemability of the paper currency in gold or silver then became an important issue. Eventually, the Gold Standard was evolved under which central banks of countries undertook to redeem their currencies held by other central banks in gold at pre-agreed parities.

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- After World War II, the Bretton-Woods system was put in place, under which the exchange rates of the currencies of different countries which subscribed to the system were fixed relative to one another. Countries had the obligation of redeeming their currencies held by other countries in gold, or in equivalent acceptable currencies such as the U.S. Dollar. Countries with persistent trade deficits would devalue their currencies relative to gold; countries with persistent trade surpluses would revalue their currencies relative to gold. United States was committed to redeem U.S. Dollar balances for gold at a pre-agreed price. Thus, the U.S. Dollar was considered to be "as good as gold."

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- However, after 1971, the U.S. Dollar was no longer redeemable in gold. Nevertheless, for many countries, the U.S. Dollar remained the risk-free safe currency that they would prefer to use for their international transactions. For example, two countries may wish to trade with each other, but neither has confidence in the currency of the other. The only way for them to trade is to have settlement in U.S. Dollars. Without U.S. Dollars, the trade might not have taken place.
- Thus, the U.S. Dollar provides a useful service to the World as a widely accepted international medium of exchange and a store of value. For providing this international liquidity, the U.S. is also rewarded with seigneurage, that is, the ability to mint (print) money (and bonds) and use them to purchase real goods and services around the World.

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- More recently, whether the U.S. Dollar is able to continue to fulfill the role of provider of international liquidity has come into question, for two reasons.
- First, the potential supply of U.S. Dollars for international transactions purposes depends in part on the U.S. running a significant trade deficit, and to the extent that the U.S. begins to run a smaller trade deficit, or even a trade surplus, the rate of increase of U.S. Dollars held by the rest of the World will decline and perhaps even become negative.
- Second, the willingness of the rest of the World to continue to hold U.S. Dollar balances has begun to decline, due to a not so optimistic outlook for the U.S. economy, especially on the fiscal side, and the expectation of a significant devaluation of the U.S. Dollar in the medium to long term.

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- Moreover, since 1971, exchange rates of currencies are no longer fixed relative to one another but fluctuate daily. However, it is also not clear that this “market system of exchange rate determination” has been effective in the reduction of persistent trade surpluses and deficits, especially when compared to the Bretton-Woods system.
- The exchange rates themselves have become excessively volatile and unpredictable, driven by short-term speculative capital flows. And the uncertainty of relative exchange rates has become a deterrent to the growth of international trade and long-term cross-border investment.

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- Thus, the time has come for us to consider the possibility of a new arrangement for the settlement of international transactions and for adjustment to persistent trade imbalances.

Alternatives for the Settlement of International Transactions

- (1) Additional reserve currencies—the use of other currencies such as the Yen or the Yuan as alternative major reserve currencies;
- (2) A return to the gold standard, or the gold-exchange standard, under which one or more currencies may be redeemable in gold at a pre-agreed parity by the respective central banks;
- (3) The introduction of a super-sovereign currency such as the "Special Drawing Rights (SDRs)";
- (4) The introduction of a multilateral settlement mechanism similar to what the Bank for International Settlements did for the Western European economies in the 1950s for East Asia.

Alternatives for the Settlement of International Transactions

- All of these alternatives have their pros and cons. In this lecture, we shall describe an arrangement under which two East Asian trading-partner countries can settle their international transactions in their own currencies, on a voluntary basis, without using the currency of a third country.

Option for East Asia: Trade Denomination and Settlement in Own Currencies

- Recently, the Ministers of Finance of China, Japan and South Korea, meeting on the sidelines of the Asian Development Bank annual meeting in Hanoi, issued a statement to the effect that they would study the use of their own currencies in trade settlement with one another.
- China, Japan and South Korea, if they so wish, can denominate and settle international trade among themselves in their own respective currencies. For example, on an entirely voluntary basis, Chinese exporters to Japan can quote their prices and invoice in either Chinese Yuan or Japanese Yen, as may be mutually agreed individually between them and the Japanese importers. The same applies to Japanese and Korean exporters—each of them can choose to invoice in the own currencies of either the exporting or the importing country.

Option for East Asia: Trade Denomination and Settlement in Own Currencies

- Japanese importers will then pay the Chinese exporters in either Japanese Yen or Chinese Yuan. They should have no problem paying in Yen. They can also acquire Chinese Yuan at the market exchange rate from the Bank of Japan, Japan's Central Bank, which is also committed to buy Chinese Yuan at the market exchange rate from Japanese exporters who have chosen to be paid in Chinese Yuan.

Option for East Asia: Trade Denomination and Settlement in Own Currencies

- It is possible that the Bank of Japan may wind up with more Yuan than it desires to hold, in which case it can present the excess Yuan balances to the People's Bank of China (China's Central Bank). The People's Bank is committed to "buy" back these excess Yuan from the Bank of Japan. It will first of all use its own excess Yen balances to do so; and if these are not enough, it can buy back the excess Yuan with gold at a pre-agreed parity, or U.S. Dollars, or other "hard" currencies, or inflation-protected Yuan bonds, as have been mutually agreed before hand and subject to the choice of the Bank of Japan.

Option for East Asia: Trade Denomination and Settlement in Own Currencies

- Thus, under this arrangement, when China, Japan and South Korea trade internationally among themselves, they will not require the use of a third currency for the settlement of the transactions, saving the currency conversion costs and reducing the levels of foreign exchange reserves required to be maintained for international transactions purposes.
- Such an arrangement will reduce the demand for U.S. Dollars as foreign exchange reserves on the part of the East Asian central banks. The Central Banks of the three countries will most likely maintain balances of one another’s currencies as part of their official foreign exchange reserves.

Option for East Asia: Trade Denomination and Settlement in Own Currencies

- Chinese exporters and importers in selected regions in China have been permitted to settle their international trade in Renminbi since 2009 on a voluntary basis, by mutual agreement between the exporter and the importer in each case. The practice will be extended to the whole nation in 2011.
- Japanese exporters and importers are free to choose their invoicing currencies, and subject to mutual agreement between the Bank of Japan and the People's Bank of China on swapping the two currencies, can also proceed to denominate and settle their trade transactions with China in either the Yen or the Yuan.
- A currency swap agreement is already in place between the Bank of Korea and the People's Bank of China. A similar currency swap agreement between the Bank of Japan and the Bank of Korea will complete this three-way arrangement.

Option for East Asia: Maintaining Relative Real Parities

- Volatility of relative exchange rates is a serious impediment to international trade and long-term cross-border investments, including both direct and portfolio investments, much more so than tariffs and other protectionist measures. With volatile exchange rates, one does not know whether one should export or import, or where to locate one's production facilities.
- Volatile exchange rates also tend to destabilise the real economies and reduce their real rates of growth.
- A stable exchange rate contributes to the orderly 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.
- If the exchange rates were not so volatile, it would not matter so much in which currency trade is denominated and settled.

Option for East Asia: Maintaining Relative Real Parities

- Timely interventions and the creation and maintenance of stable and sustainable expectations in the foreign exchange markets are therefore both necessary and beneficial.
- During the 1997-1998 East Asian currency crisis, the Chinese Government kept the Yuan/US$ exchange rate unchanged despite strong market sentiments and speculation that it should/would devalue. The Chinese decision was an important factor in the subsequent stabilisation of the crisis and the speedy recovery of the East Asian economies.

Option for East Asia: Maintaining Relative Real Parities

- More recently, in the aftermath of the Tohoku Earthquake and Tsunami, the Group-of -Seven (G-7) countries have seen it fit to intervene in the Japanese Yen market to stabilise the Yen/US$ exchange rate—a recognition that excess exchange rate volatility is harmful not only to Japan but also to the World and moreover, it is too risky to leave it to the market "to take care of it."

Option for East Asia: Maintaining Relative Real Parities

- Stable relative exchange rates, especially relative real exchange rates, among economies can enhance the international trade and investment flows among them significantly, much more so than a free trade area or a common market among them.
- The introduction of the Euro as a single currency for countries in the Euro Zone is a good example—intra-Euro Zone trade tripled to approximately 3 trillion Euro (or US$4 trillion) after the introduction of the Euro in the late 1990s even though there had been no tariffs among the major countries in the Euro Zone since the 1960s.

Option for East Asia: Maintaining Relative Real Parities

- The volume of foreign exchange transactions in the World is huge—currently it may be estimated at approximately US$1.5 quadrillion annually. The total annual worldwide international trade flows amount to US$20 trillion in 2010, or approximately 0.5% of total annual foreign exchange market turnover in 2010.
- The volume is far too large than can be justified by the "real" international transactions, that is: international trade, foreign direct investment, and foreign portfolio investment.

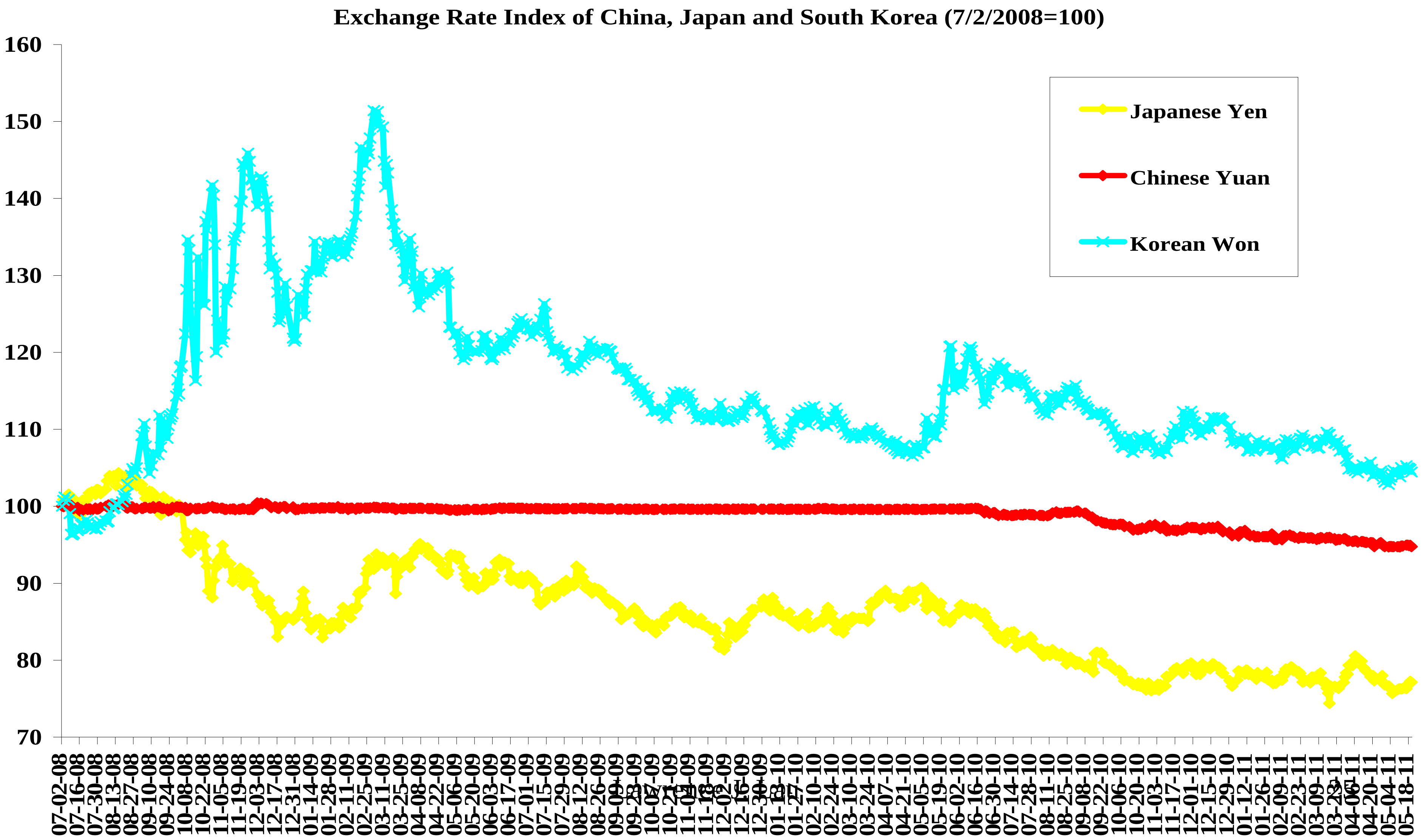
Option for East Asia: Maintaining Relative Real Parities

- Moreover, exchange rate volatility, as opposed to exchange rate flexibility, does not benefit anyone except the currency speculators. The economic benefits of a daily fluctuating exchange rate freely determined in the market are exaggerated. In any case, the foreign exchange markets are also subject to manipulation by the banks and currency speculators who dominate the markets.

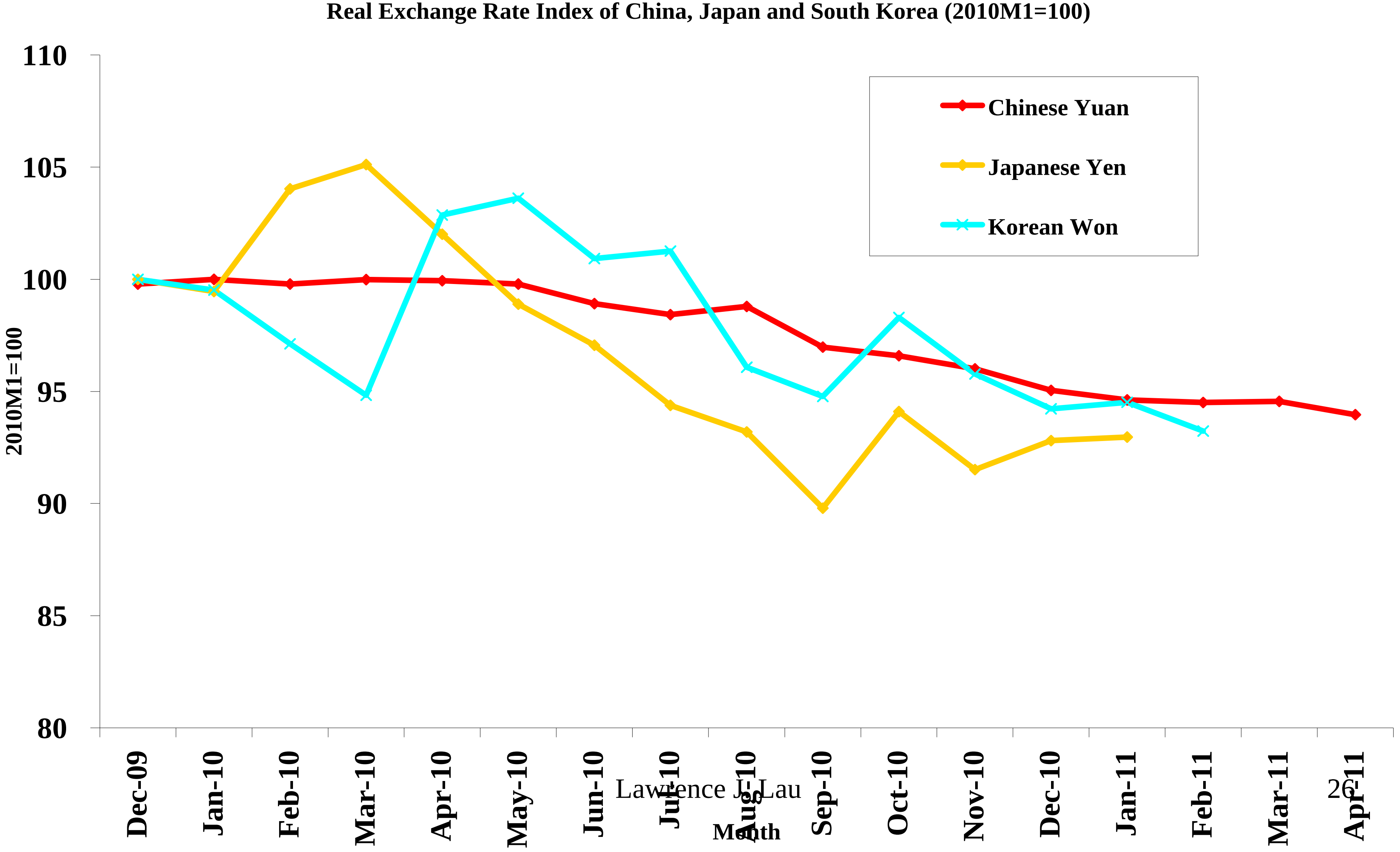
Option for East Asia: Maintaining Relative Real Parities

- It may be beneficial for the three economies to maintain the relative real parities of their exchange rates—in other words, to maintain the relative real purchasing power of each currency in the other currency so that 1 Yuan will always purchase the same quantity of real goods in Japan and South Korea (and similarly for 1 Yen and 1 Won).
- In fact, the real (as opposed to the nominal) exchange rates of China, Japan and South Korea tend to move together in the time frame of a year (see the next two Charts), so that maintaining relative real parities makes sense.

Exchange Rates of China, Japan and South Korea (7/2/2008=100)



Real Exchange Rate Indices of Selected East Asian Economies (2010M1=100)



Option for East Asia: Maintaining Relative Real Parities

- If the three countries can come to an agreement to maintain relative real parities of their currencies, but allowing them to be collectively flexible with respect to other currencies, that will greatly enhance international trade flow, long-term cross-border investment as well as international division of labour.
- The central banks of the three countries can intervene in the foreign exchange markets to maintain relative real parities in a way that is incentive-compatible with the interests of their exporters. For example, if the real Yuan/Yen exchange rate rises too much from the agreed relative parity, Japanese exports to China will be disadvantaged, in which case the Bank of Japan should intervene by selling Yen and buying Yuan. If the real Yuan/Yen rate becomes too low, Chinese exports to Japan will be disadvantaged, then the People's Bank of China should intervene by selling Yuan and buying Yen. The same mode of behaviour should also be followed by the Bank of Korea. This way, the relative real parities of the three currencies can be kept within relatively narrow bands.

Option for East Asia: Regulating Short-Term International Capital inflows

- The observed exchange rate volatility today is unrelated to international trade flows or to direct investment flows, which have been quite stable on the whole. It may, however, be related, in part, to short-term portfolio investment flows. However, it is mostly caused by the volatile short-term (defined as less than 12 months) speculative international capital flows.
- Moreover, exchange rate volatility in itself also in turn attracts further speculation, and hence may lead to even more short-term international capital inflows or outflows from hedge funds and other speculators taking advantage of the volatility to speculate on short-term exchange rate changes.

Option for East Asia: Regulating Short-Term International Capital inflows

- 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 international 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 long-term foreign portfolio investment.

Option for East Asia: Regulating Short-Term International Capital inflows

- However, there is no similar argument in favour of short-term international capital movements, with the exception of short-term trade-related financing. It is simply an article of faith that the freer the movement of capital, the better.
- Moreover, short-term non-trade related capital inflows that can be withdrawn at a moment's notice do 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 further exacerbated by currency mismatch.

Option for East Asia: Regulating Short-Term International Capital inflows

- It is also not clear what good short-term capital outflows 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 can benefit the U.S. economy.)
- Thus, through taxation, sequestration, or other means, short-term capital inflows should be discouraged at the same time that long-term capital flows, both inbound and outbound, are welcomed.

Concluding Remarks

- As China, Japan and South Korea are also contemplating the establishment of a Free Trade Area amongst themselves, they should also consider the following possible options:
- (1) Denomination and settlement of the international trade in goods and services as well as other international transactions such as investment and loans among themselves in their own currencies, with any balance settled in inflation-protected securities in their own currencies;

Concluding Remarks

- (2) Maintenance of relative real parities among the three currencies so as to promote long-term trade and cross-border investment and division of labour among themselves. (Such an arrangement will also facilitate a common adjustment to imbalances outside the three economies, since no country will be disadvantaged by a simultaneous adjustment with respect to a fourth currency.)
- (3) Formulation and implementation of a common policy regulating short-term capital inflows originating outside the three economies so as to reduce their potentially destabilising effects on the foreign exchange, credit and asset markets, but welcoming long-term cross-border capital inflows as well as outflows.