An Option for a New International Settlement System in East Asia

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Santa Colomba Conference 2011
Siena, 10-11 July 2011

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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 (except for transactions occurring within the same common-currency areas). 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, the 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 payment, and hence no currency 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, are 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 abilities to preserve exchange value or purchasing power. The redeemability of a 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.

Introduction

- 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, initially at US$35 an ounce. 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, trade between them 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, just as a central bank of a country that issues money is rewarded with seigneurage domestically.

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- Of course, ultimately, these U.S. Dollar balances (and bonds) accumulated by the different countries can be used by the recipient countries to purchase goods from the U.S. as well as from other countries willing to accept U.S. Dollars. So, in principle, their trade with the U.S. can be balanced intertemporally.
- Moreover, under some circumstances, it may actually be beneficial for a trade-surplus country to accumulate and hold U.S. Dollar-denominated assets (or for that matter, other foreign-currency assets). For example, it may currently have a relatively young population so that it consumes less than it produces and the foreign assets accumulated at the present time will eventually enable it to consume more than it produces as its population ages and dependency ratio rises.

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- The basic uncertainly lies in the real value of the U.S. Dollar-denominated assets in the future. Can the purchasing power of these assets in the U.S. be preserved over time? If so, then holding U.S. Dollar-denominated assets long term would be quite attractive. If not, then holding U.S. Dollar-denominated assets long-term may be risky.
- That is why long-term Treasury Inflation-Protected Securities (TIPS), issued by the U.S. Treasury, should prove to be particularly attractive for central banks of other countries holding U.S. Dollar-denominated assets as part of their official foreign exchange reserves.

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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 major 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. (Of course it also depends in part on how fast the U.S. Federal Reserve Board increases the U.S. money supply.)

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- Second, the willingness of the rest of the World to continue to accumulate and 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. (Of course, if the U.S. Dollar balances could be inflation-protected long-term, it would be a different matter.)

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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 in the meantime become excessively volatile and unpredictable, driven by short-term speculative capital flows. The uncertainty of relative exchange rates has become a deterrent to the growth of international trade and long-term cross-border investment, both direct and portfolio.

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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 imbalances.

Alternatives for the Settlement of International Transactions

- (1) Additional major reserve currencies—the use of currencies other than the U.S. Dollar and the Euro, such as the Japanese Yen or the Chinese 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 Asian economies.

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, for example, China and Japan, can settle their international transactions in their own currencies, on a voluntary basis, without using the currency of a third country (generally a major reserve currency).

Renminbi as an International Reserve Currency

- There are both pros and cons for a country's currency to be used by other countries as a major international reserve currency.
- There are at least two principal considerations: first, in order for a country to derive benefit from the seigneurage that comes from being a major international reserve currency, it will have to run a trade deficit or to be a net long-term purchaser of foreign assets, and second, as its currency becomes widely held by the central banks of other countries, it is subject to the risk that foreign central banks holding its currency and assets denominated in its currency may decide to stop holding them all of a sudden for economic as well as non-economic reasons, impacting its exchange rate, interest rate and asset prices.

Renminbi as an International Reserve Currency

- The Japanese Yen is fully convertible but the Japanese Government has not promoted its use by other countries as a major international reserve currency.
- Whether the Renminbi will eventually become a major international reserve currency remains to be seen. There are both pros and cons for a country's currency to be used by other countries as a major international reserve currency.
- At the present time, Hong Kong, Singapore and South Korea have all been considering investing part of their foreign exchange reserves in Yuan-denominated securities to diversify its portfolio, even though the Yuan (Renminbi) is not yet fully convertible.

A Super-Sovereign Currency

- A real question that faces a super-sovereign currency is whether it will be accepted widely, not the least by the men in the street. One super-sovereign currency, the Euro, is accepted and used widely, but it is legal tender in the Euro Zone, and is acceptable by everyone as a medium of exchange in the Euro Zone. A non-European can also use a Euro to buy goods and services, at least within the Euro Zone, and hence is also willing to accept and hold it. Where can someone with a new world currency such as the SDR use it and what can this person buy with it? This goes back to the acceptability question.

A Super-Sovereign Currency

- A more difficult question is which organisation controls the quantity of the new world currency to be issued and its initial allocation among the different countries.
- In the case of the Euro, the European Central Bank is the controlling organisation for the issuance of the Euro designated by treaty among the countries in the Euro Zone.
- In the case of the Special Drawing Right (SDR), which is constituted as a basket of sovereign currencies, the subsequent adjustments in the composition of the basket as well as the allocations of newly issued SDRs are additional problems.

A Super-Sovereign Currency

- For the Special Drawing Right (SDR), or a new super-sovereign currency, the question of exit must also be considered. If one country opts out of the system, and presents the SDR or the new currency for exchange for say the underlying constituent currencies, can the issuing organisation perform? Can the issuing organisation demand that the issuing countries of the constituent currencies come up with the amounts of the respective currencies? Can the issuing organisation enforce its demands if one or more of the issuing countries balk? Without a super-sovereign organisation with legal authority, like the European Union, it would be very difficult for the SDR or a new world currency to succeed.
- It is probably easier to go back to the gold standard. After all, gold is widely accepted.

A Super-Sovereign Currency

- It is probably more likely that the world will be entering a period during which multiple currencies are used and held, especially since relative exchange rates are so volatile.
- Relative exchange rates can only be stabilised if short-term international capital flows are appropriately controlled or at least reduced. But if relative exchange rates are reasonably stable, there is really no need for an artificial super-sovereign currency.

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 transactions 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 even inflation-protected Yuan bonds, as have been mutually agreed before hand and subject to the choice of the Bank of Japan.
- Similarly, if the People's Bank of China winds up with more Yen than it desires to hold, it can use these Yen balances to purchase, for example, inflation-protected Yen bonds.

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 fourth 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 official foreign exchange reserves on the part of the Central Banks of the three countries. They 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 have been settling their international trade transactions in major foreign currencies such as the U.S. Dollar, Euro and Yen. In addition, 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 by the end of 2011.
- For the three-country own-currency settlement to work, Chinese exporters and importers need to be able to settle their international trade with the Republic of Korea also in Won.

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

- 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: Trade Denomination and Settlement in Own Currencies

- A commitment by the central bank of a country through mutual agreements to redeem its currency held by other central banks in terms of other hard currencies (e.g., US$ or Euro), gold, or its inflation-indexed bonds will go a long way to reassure the central banks of surplus countries that they will not lose out in terms of purchasing power, which is ultimately what really matters.
- Of course, the attractiveness of holding inflation-indexed bonds of a foreign country by a central bank depends on whether the index chosen accurately reflects the degree of inflation of the prices of goods and services in the foreign country.

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

- It is probably too difficult for a central bank to monitor the accuracy of the index of inflation of a foreign country. However, if inflation-indexed bonds are also widely held by the domestic citizens of a foreign country, one can count on these citizens to monitor the accuracy of the inflation index because they have every incentive to do so as well as the political power to ensure that inflation is measured accurately in that country.
- If trade settlement in own currencies turns out to be a widespread and durable arrangement, it may eventually supplant the use of the U.S. Dollar as the principal international trade settlement currency.

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

- Approximately 35% of Chinese international trade is conducted with East Asian economies. Chinese exports to East Asia except Japan amount to more than US$300 billion a year. Similarly, Chinese imports from East Asia except Japan also amount to US$300 billion a year.
- If the Renminbi were to be used as a settlement currency by Chinese exporters and importers with their trading partners in East Asia, it would greatly reduce the Chinese demand for U.S. Dollars for the purposes of settlement of international transactions, and the People's Bank of China, China's Central Bank, would no longer need to hold such a large quantity of foreign exchange reserves.

Option for East Asia: Maintaining Relative Real Parities

- Volatility and long-term instability 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 one's production facilities should be located.
- Volatile exchange rates also tend to destabilise the real economies as well as reduce their real rates of growth.

Option for East Asia: Maintaining Relative Real Parities

- 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 a cross-border investor- or an investee-country.
- If the exchange rates were not so volatile, it would not matter so much in which currency international trade is denominated and settled. (Whether a currency will be used as a store of value is a different matter.)

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.

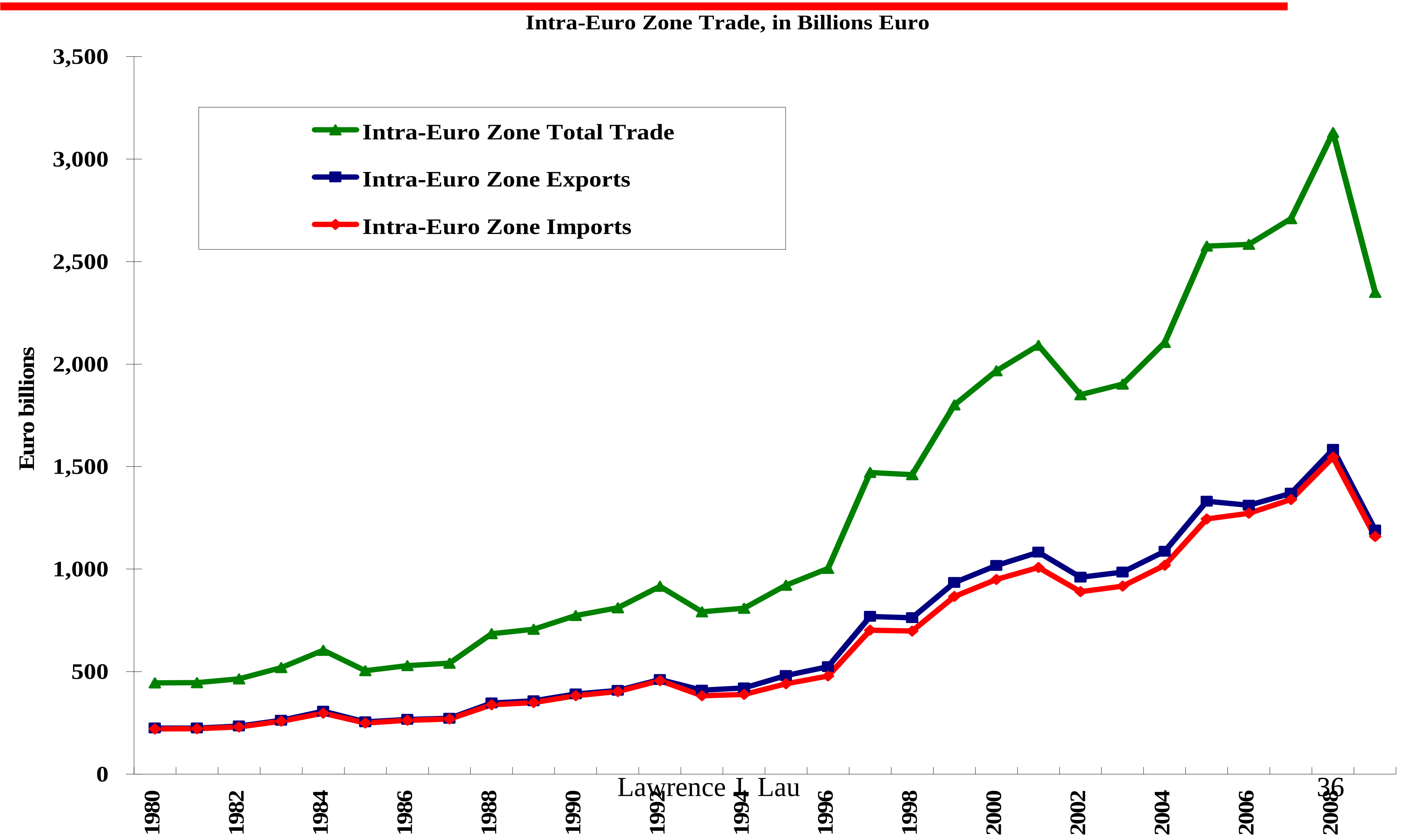
Option for East Asia: Maintaining Relative Real Parities

- More recently, in the aftermath of the Tohoku Earthquake and Tsunami in Japan, 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. This is certainly true among China, Japan and South Korea.
- The introduction of the Euro as a single currency for countries in the Euro Zone (due to Prof. Robert Mundell) 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.

Intra-Euro Zone Trade, Billions Euro, Pre-and Post the Introduction of the Euro



Option for East Asia: Maintaining Relative Real Parities

- Relative exchange rates have been extremely volatile in recent years. No one disputes the usefulness of exchange rate flexibility in the adjustment of persistent trade imbalances, but it is hard to see how such a high degree of volatility benefits anyone except the currency traders and bankers.
- The fluctuations in the relative exchange rates are largely unrelated to the 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 back again to 1.4 a couple of times. Did this reflect the relative economic fundamentals between the United States and the Euro Zone? Could this have been good for the Euro Zone, for the United States, or for the World?

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.
- This volume is far too large than can be justified by the "real" international transactions, that is: international trade, foreign direct investments, and foreign portfolio investments (even if we take into account that the stocks of the direct investments and portfolio investments can be much bigger than the annual flows and that they may possibly require hedging).

Option for East Asia: Maintaining Relative Real Parities

- The total annual worldwide international trade flows amount to US$20 trillion in 2010, or less than 1.5% of total annual foreign exchange market turnover in 2010.
- Of the total annual worldwide international trade flows, only those conducted in a different currency from either the exporting country or the importing country need to be funded in foreign exchange or hedged.
- For example, intra-Euro Zone international trade, amounting to some US$4 trillion in 2010, will be conducted entirely in Euros and does not generate any demand for foreign currency or hedging.
- If the intra-common currency area international trade is netted out, the total annual worldwide international trade flows that require currency conversion may be estimated at approximately US$15 trillion.

Option for East Asia: Maintaining Relative Real Parities

- If we assume two currency conversions per international trade transaction, and in addition, two currency hedging transactions, that is, by both the exporters and the importers invoicing and settling in a third currency, the total volume of such foreign exchange transactions should not exceed four times the total annual international trade flows among countries not using a common currency of US$15 trillion or US$60 trillion.
- However, because traders in the U.S. and the Euro Zone will settle the trade in their own currencies and do not need to exchange or hedge twice, the total volume of such foreign exchange transactions should be less than US$60 trillion, which is only 4% of the total annual global foreign exchange market turnover.

Option for East Asia: Maintaining Relative Real Parities

- Worldwide total international foreign portfolio investment outflow reached a peak of US$3 trillion in 2006 and currently runs at a rate of US$1.5 trillion a year. Cumulative worldwide foreign portfolio investment outflows since 1994 amount to approximately US$16 trillion.
- Worldwide total international foreign direct investment outflow reached a peak of US$2.5 trillion in 2007 and currently runs at a rate of a little more than US$1 trillion a year. Cumulative worldwide foreign direct investment outflows since 1994 amount to approximately US$24 trillion.
- The stock of total foreign investments, both direct and portfolio, may require one-way hedging to the extent that they are investments in a currency other than the currency of the investment-originating country.

Option for East Asia: Maintaining Relative Real Parities

- If we add up all of the above—that is, the foreign exchange transactions that are generated by the flows of international trade and the stocks of foreign portfolio investments and foreign direct investments—we obtain US$100 trillion, which is less than 7% of total annual global foreign exchange market turnover.
- There is therefore far too much "pure" speculation in the foreign exchange markets, by investors who purchase spot, forward or future foreign exchange purely for its capital gain potential and not for settling any underlying current or future transaction or hedging the value of any underlying asset or liability.
- It is fine if people like to gamble, but it is not fine when such gambling have major real effects impacting on third parties.

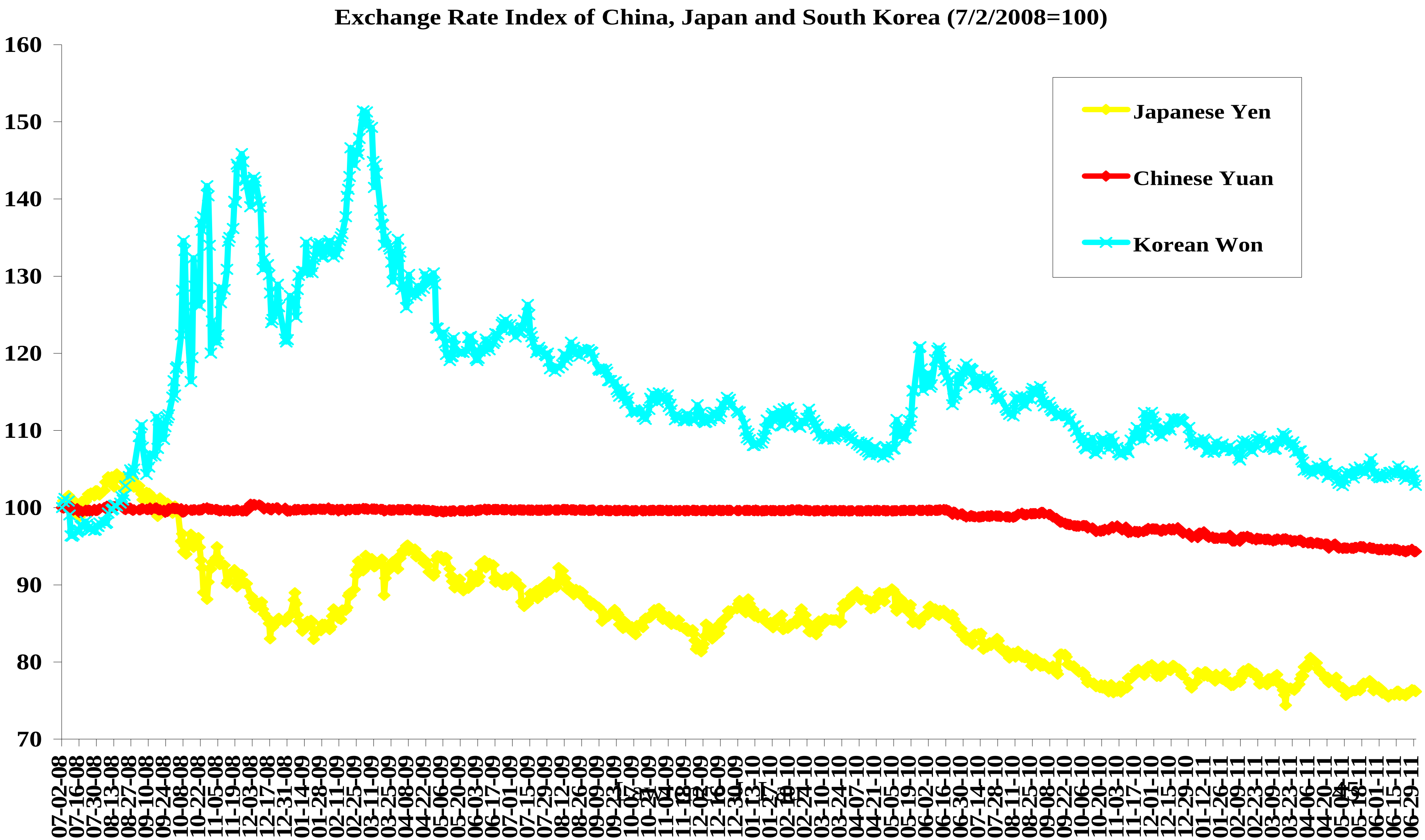
Option for East Asia: Maintaining Relative Real Parities

- 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 major banks and currency speculators who dominate the markets.

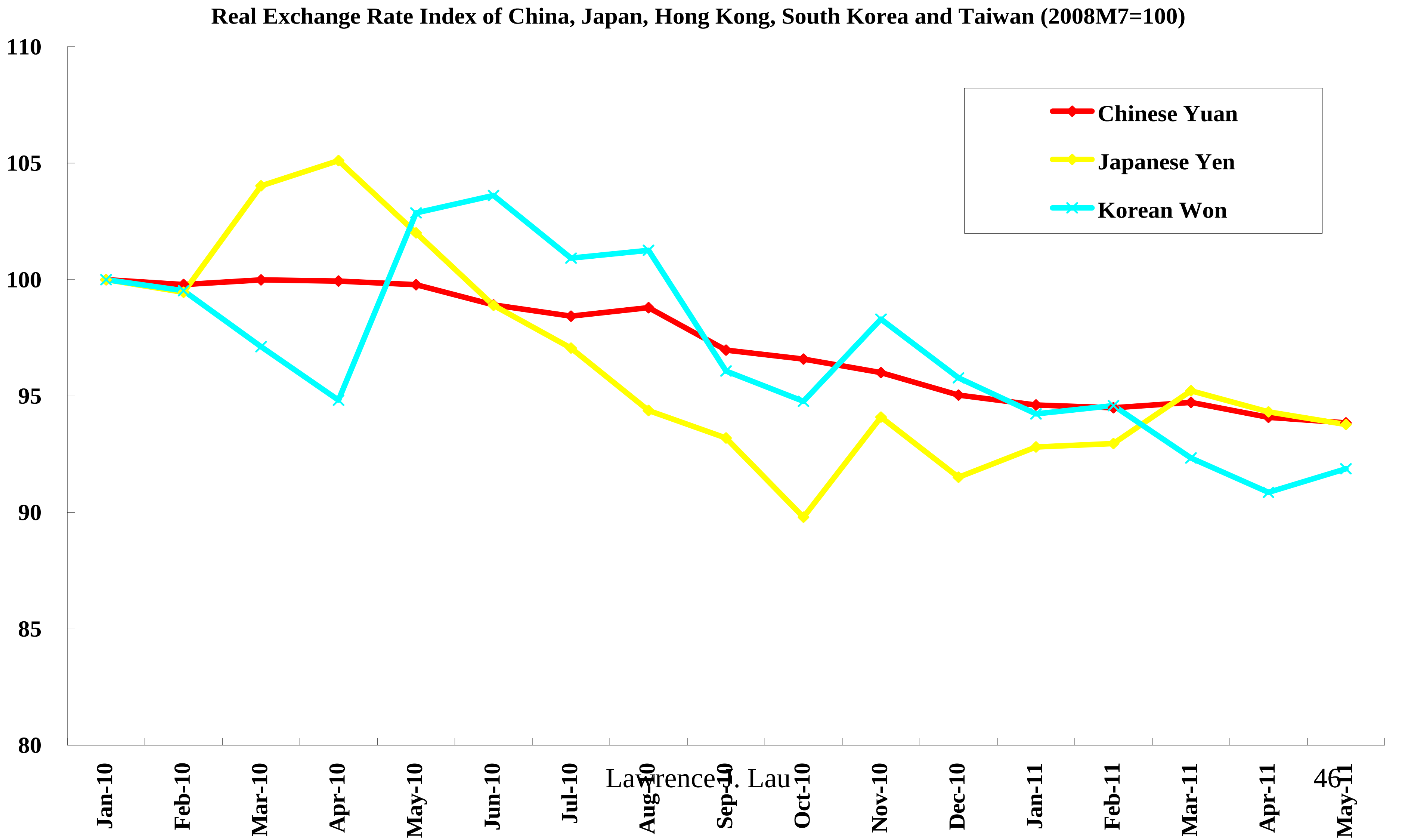
Option for East Asia: Maintaining Relative Real Parities

- It will be beneficial for China, Japan and Korea 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 currencies 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 is not inconsistent with the actual behaviour of the exchange rates.
- A common policy of maintaining relative real parities would have smoothed out the fluctuations and reduced the unnecessary volatility in the relative exchange rates.

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



Real Exchange Rate Indexes of China, Japan and South Korea (2010M1=100)



Option for East Asia: Maintaining Relative Real Parities

- The central banks of the three countries can intervene in the foreign exchange markets to maintain relative real parities within relatively narrow bands in a way that is incentive-compatible with the interests of their respective exporters. (This is an idea due to Prof. Robert Mundell.)
- The principal instrument used for intervention by each central bank is the purchase of the currencies of the other two countries with its own currency in the foreign exchange markets. Note that such interventions are not macroeconomic in nature and do not imply nor are they implied by nominal or real exchange rate targeting or inflation rate targeting for the economy as a whole.

Option for East Asia: Maintaining Relative Real Parities

- For example, if the real Yuan/Yen exchange rate, that is, the Yuan/Yen exchange rate adjusted for the relative rates of inflation of the two countries, rises too much from the agreed relative real parity, Japanese exports to China will become more expensive in China relative to domestic Chinese goods and hence be disadvantaged. In this case, the Bank of Japan should intervene by buying Yuan with Yen, driving up the Yuan relative to the Yen, so that each Yen will be worth fewer Yuan.
- Similarly, 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 buying Yen with Yuan.
- The same mode of behaviour should also be followed by the Bank of Korea. This way, the relative real parities among the three currencies can be kept within relatively narrow pre-agreed bands.

Option for East Asia: Maintaining Relative Real Parities

- Of course there is a question of which index of inflation should be used in the calculation of the real exchange rate parities. I believe either the GDP deflator or the Consumer Price Index would work. But all three countries should agree to use the same type of deflator. Ideally, it should be the same index of inflation used to index inflation-protected bonds issued by the countries concerned, if any.
- 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 not only greatly enhance international trade flow, long-term cross-border investment as well as international division of labour among themselves, but will also facilitate adjustment of their exchange rates vis-a-vis other currencies, such as the U.S. Dollar and the Euro, in response to persistent imbalances.

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

- The observed exchange rate volatility today is largely 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 from hedge funds and other speculators taking advantage of the volatility to speculate on short-term exchange rate changes, and hence may lead to even more short-term international capital inflows or outflows and even greater exchange rate volatility.

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 for the investor 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 short notice do not really benefit the destination country. On the contrary, they may do it significant harm, as the East Asian currency crisis of 1997-1998 and numerous Latin American currency crises amply demonstrated.

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

- The problem with short-term capital inflows is that they cannot be usefully deployed in the destination country. When they are used to finance long-term investment in the destination country, they invariably lead to trouble because of maturity mismatch which is further exacerbated by the currency mismatch.
- However, as they flow in and out of the destination country, they cause the exchange rate of the destination country to become excessively volatile, inhibiting the flows of cross-border trade and long-term investment.

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 created by the U.S. Federal Reserve Board, if it had stayed in the U.S., might have done the U.S. economy some good; but since most of it flowed out of the U.S., it is not clear whether and if so how it benefitted the U.S. economy.)
- Thus, through taxation (for example, a “Tobin” tax on cross-border and cross-currency area financial transactions), a period of sequestration or “quarantine”, or other means, short-term capital inflows should be discouraged at the same time that long-term capital flows, both inbound and outbound, should be encouraged.

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

- By minimising unnecessary short-term capital flows, the volatility of relative exchange rates can be reduced. It will therefore also facilitate the maintenance of relative real parities, for example, among China, Japan and South Korea. Stable relative real exchange rates can in turn encourage the growth of international trade, long-term cross-border direct investment and division of labour among the three countries.

Concluding Remarks

- As China, Japan and South Korea contemplate the establishment of a Free Trade Area amongst themselves, they should also consider the following possible measures as alternatives to the current system of settlement of international transactions. These measures will help make the Free Trade Area potentially an even greater success:
- (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 net surplus/deficit settled among their central banks in terms of inflation-protected securities in the currencies of the respectively deficit countries;

Concluding Remarks

- (2) Maintenance of relative real parities among the three currencies within relatively narrow pre-agreed bands so as to promote long-term trade and cross-border investment and division of labour among the three countries. (Such an arrangement will also facilitate a common adjustment to imbalances outside the three countries, since none of them will be relatively disadvantaged by a simultaneous adjustment in their exchange rates with respect to a fourth currency such as the U.S. Dollar.)

Concluding Remarks

- (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 of the three countries, but welcoming long-term cross-border capital inflows as well as outflows. Reduction of short-term speculative capital movements will also facilitate the maintenance of relative real parities among the three currencies.

Concluding Remarks

- If such economic collaboration and cooperation prove to work well, then the same arrangement can be extended to include other East Asian economies, especially the members of the ASEAN group in the future.