Closing Remarks

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Settlement of International Transactions Prior to 1971

- Cross-currency exchange rates were relatively stable under the Bretton Woods agreement, with periodic adjustments in response to persistent trade surpluses or deficits of individual countries vis-a-vis the World as a whole, in consultation with the International Monetary Fund.
- Under the Bretton Woods system, settlement of international transactions can be done in the own currencies of the trading partner countries because the relative exchange rates are "fixed".
- Own currency settlement between trading partner countries is preferred by both exporters and importers because it reduces transactions costs and exchange rate risks. It also makes it less necessary to maintain large official foreign exchange reserves.

Settlement of International Transactions Prior to 1971

- However, one cannot, in general, expect international trade to be bilaterally balanced for every pair of trading partner countries. Under own-currency settlement, some countries may wind up with an excess amount of another country's currency while others may have an insufficient amount of another country's currency. Thus pooled settlement makes sense, so that within a given group of countries, the excess foreign currency held by one country can be used to offset the shortfall of another country.
- This netting out should work well within a group, especially if every country in the group has more or less balanced trade with the rest of the group as a whole.

Settlement of International Transactions

- The Bank for International Settlements in Basel performed this group settlement function for the Western European countries in the 1950s and early 1960s as they recovered from World War II but had not yet developed the confidence in one another's national currencies. U.S. aid under the Marshall Plan underpinned the operation of the settlement system by providing U.S. Dollars to settle any remaining balance after netting out amongst the Western European countries.
- A similar Bank for Intra-Asia Settlements can be established to perform the same function for Asian economies on a voluntary basis, enabling them, if they so choose, to settle in their own currencies. China and Japan, with their large official foreign exchange reserves, can provide any remaining settlements necessary in terms of either the Yuan or the Yen or another major reserve currency such as the U.S.$ or the Euro.

Real Exchange Rate Coordination

- The real exchange rate between two currencies is the exchange rate after adjusting for the relative rates of inflation between the two economies.
- Stable real exchange rates are beneficial to the real economy. Exporters, importers, direct investors and long-term portfolio investors all prefer stable real exchange rates.
- In order to avoid "beggar thy neighbour" policies and potentially ruinous competitive devaluation, real exchange rate coordination can also be beneficial to a group of consenting countries and regions.
- Moreover, if there were effective real exchange rate coordination, it will facilitate the adjustment of the exchange rates en bloc vis-a-vis a major reserve currency because then no one economy within the group will be relatively advantaged or disadvantaged.

Own Currency Bonds

- It is also in the interests of many economies to be able to issue bonds denominated in their own currencies. (Borrowing in a foreign currency is always risky because of the currency mis-match.)
- Issuance of own-currency bonds is therefore much less risky to the issuing economy than foreign-currency-denominated bonds.
- However, in order to motivate foreign investors to buy these own-currency bonds, it may be necessary to index the principal of these bonds to the own rate of inflation, so that the foreign investors will still be able to achieve a real rate of return.

Concluding Remarks

- Most exporters and importers prefer own-currency settlement. Own currency settlement reduces transactions costs and exchange rate risks. Of course relatively stable exchange rates are essential for the wider use of own currency settlement.
- Most exporters and importers, direct investors and long-term portfolio investors prefer stable exchange rates. Stable exchange rates are also good for the real economy.
- Real exchange rate coordination among a group of economies can be beneficial to the entire group and can also facilitate adjustment with respect to a major international reserve currency.
- Settlement of international transactions in own currencies, real exchange rate coordination, and the issuance of own-currency bonds, possibly indexed to the rate of inflation, are ideas worth pursuing by Asian economies.