Closing Remarks at the Third Advanced Programme for Central Bankers and Regulators

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- The Risks of Short-Term Capital Flows
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The Settlement of International Transactions

- Cross-currency exchange rates were relatively stable under the Bretton Woods agreement, which governed the World's monetary system from 1945 to 1971. The Bretton Woods agreement provided for periodic adjustments in cross-currency exchange rates 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". It is not necessary to use a major international reserve currency for settlement purposes.
- 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.
- However, the Bretton Woods arrangement was unilaterally abolished by the United States in the 1971. It was replaced by a system of freely fluctuating exchange rates which is still in use today.

The Settlement of International Transactions

- Under the current system, relative exchange rates are no longer "fixed" or stable, foreign currencies that are not widely used have much greater volatility because of the thin transactions volume. Thus trading partner countries tend to settle in currencies that are more widely accepted for the settlement of their international transactions, and this means one of the major international reserve currencies. It is thus no accident that most international transactions are settled in U.S. Dollars and that most central banks and monetary authorities hold a large proportion of their foreign exchange reserves in U.S. Dollars.
- Since the Euro was introduced in 1999, international transactions within the Euro Zone, as well as some of the international transactions between the Euro Zone countries and their trading partner countries have been settled in Euros.
- A proportion of the Japanese international transactions have been settled in Yen.
- More recently, a proportion of the Chinese international transactions have been settled in Renminbi.

The Settlement of International Transactions

- 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.

The 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 for the settlement of any remaining balances necessary in terms of either the Yuan or the Yen or another major reserve currency such as the U.S.$ or the Euro.

The Risks of Short-Term Capital Flows

- What lessons can be learnt from the 1997-1998 East Asian currency crisis, the 2008 global financial crisis, the 2013 tapering crisis and the 2015 Swiss Franc crisis?
- Free and unregulated short-term capital flows can be greatly de-stabilising.
- Short-term capital inflows and outflows pose risks to developing economies because they unnecessarily increase the degree of volatility of the exchange rate and therefore discourage international trade and long-term international direct and portfolio investment.
- Moreover, short-term capital flows cannot be productively employed in the destination country because of a double mis-match: currency mis-match and maturity mis-match.
- Borrowing in a foreign currency when the potential revenue is in the domestic currency and borrowing short-term funds to finance long-term projects are formulae for an economic disaster down the road.

The Risks of Short-Term Capital Flows

- Even with the ending of the QE3 by the U.S. Federal Reserve Board, the quantitative easing policies being pursued by the European Central Bank and the Bank of Japan will continue to provide an immense amount of liquidity to the World capital markets—it can be as much as US$1.5 trillion in a year.
- Central banks and regulatory agencies should monitor regularly and if necessary adopt measures to discourage short-term capital inflows.
- They should be ready with instruments such as direct intervention in the foreign exchange market, capital controls, negative interest rates for non-resident deposits, a Tobin tax on capital account inflows, if necessary.
- At this time, they will do well to discourage short-term borrowing in foreign currencies and encourage repayment of short-term foreign-currency denominated loans.

Own Currency Bonds

- It is also in the interests of many economies to be able to borrow internationally in their own currencies, for example, by issuing 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, especially if the bonds can have a longer maturity.
- 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.
- In order to maintain a sufficiently liquid market for these own-currency bonds, it is best to have one market in which the bonds of all countries and regions can be traded.

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.

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. The establishment of a Bank for Intra-Asian Settlements can help to facilitate 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.
- Being able to borrow internationally in a country's own currency, for example, through the issuance of own-currency bonds, is advantageous to the issuing country.
- Real exchange rate coordination among a group of economies and stabilise relative exchange rates and can be beneficial to the entire group. Such coordination can also facilitate adjustment with respect to a major international reserve currency.
- Settlement of international transactions in own currencies, the issuance of own-currency bonds, possibly indexed to the rate of inflation, and real exchange rate coordination, are ideas worth pursuing by Asian economies.