Towards a Diversified International Monetary System

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Outline

- Flaws in the International Monetary System
- Possible Directions of Reform
- Currency Swap and Increased Settlement in Local Currencies between Asian and European economies

Flaws in the International Monetary System

- Excessive volatility of exchange rates
- Excessive short-term capital flows
- Excessive reliance on the U.S. Dollar
- The potential for contagion

Flaws in the International Monetary System: Excessive Volatility of Exchange Rates

- Volatility of the exchange rate is bad for exporters and importers, bad for long-term direct and portfolio investors, both outbound and inbound (especially under the existing mark-to-market accounting rules)—it is bad for the real economy.
- Excessive volatility of the exchange rates discourages international trade flows in goods and services and long-term direct and portfolio investment flows, both inbound and outbound.
- While some could argue that the volatility can be hedged, but this could normally only be done at a significant cost, especially for any period longer than 24 months. It is better and less costly to reduce the necessity for hedging by limiting unnecessary volatility, that is, volatility unrelated to the economic fundamentals.

Flaws in the International Monetary System: Excessive Volatility of Exchange Rates

- An economy with a completely open foreign exchange market, without any capital controls, can be subject to predatory speculation by foreign hedge funds and other similar short-term investors. For example, consider the successful attack of the British Pound by George Soros in the early 1990s as well as the speculative attacks on the East Asian currencies during 1997-1998.
- For most open economies, especially the smaller ones, the exchange rate is really too important a price to be left entirely to the currency speculators to determine. A responsible central bank must monitor the exchange rate of its currency carefully and vigilantly.

Flaws in the International Monetary System: Excessive Short-Term Capital Flows

- The key to the reduction of volatility of the exchange rate, without artificially repressing the market, is the reduction of short-term purely speculative capital flows, both inbound and outbound.
- Economic theory tells us that free international trade flows are beneficial to all trading partner countries. Long-term capital flows in the form of direct investment or long-term portfolio investment can also be shown to benefit both the investor and the investee countries. However, there is no theory to support the hypothesis that short-term capital flows are beneficial to either the economy of origin or the economy of destination.
- International trade flows are relatively stable. Foreign direct investment flows, both inbound and outbound, are basically long-term in nature and hence also relatively stable on the whole. The same is true of long-term portfolio investment flows.

Flaws in the International Monetary System: Excessive Short-Term Capital Flows

- However, short-term cross-currency international capital flows are susceptible to abrupt changes in magnitude and direction (e.g., hot money) that can greatly de-stabilize the financial markets of a country, including its foreign exchange market, credit market and capital market, impacting the real economy negatively.
- But the most compelling argument against such short-term cross-currency international capital flows is that, with the exception of short-term trade-related financing, they are not socially productive.
- Short-term cross-currency capital inflows cannot be usefully deployed in the destination country. When they are used to finance long-term investments in the destination country, they invariably lead to trouble because of the maturity mismatch, and further exacerbated by the currency mismatch. The 1997-1998 East Asian currency crisis is basically the outcome of massive maturity and currency mis-match in the loans taken out by enterprises in the East Asian economies.

Flaws in the International Monetary System: Excessive Short-Term Capital Flows

- Moreover, as short-term capital flows in and out of the destination country, they cause the exchange rate and/or the interest rate of the destination country to become excessively volatile, inhibiting not only the flows of its international trade and long-term investment but also the development of the domestic real economy.
- A foreign exchange market with participants that consist primarily of exporters, importers and long-term direct and portfolio investors will yield much more stable and reasonable exchange rates than one dominated by short-term speculators.
- Thus, it is desirable to be able to differentiate between long-term capital flows, which should be welcomed and encouraged, and short-term capital flows, which should be discouraged.

Flaws in the International Monetary System: Excessive Short-Term Capital Flows

- The average daily volume of foreign exchange transactions worldwide in 2013 was approximately US$5.3 trillion. This is equivalent to approximately US$1.325 quadrillion per year, on the basis of 250 working days per year. The total annual volume of international trade, including trade among countries and regions that do not require currency conversions such as within the Euro Zone, is approximately US$45 trillion in 2013, which is only 3.4% of the total volume of foreign exchange transactions.
- The bulk of foreign exchange transactions consists of short-term speculation, causing unnecessary fluctuations in the currency exchange rates, which generate no benefits to real economies but create large profits for banks handling these transactions. These banks are in effect operating "legal casinos", so to speak. Moreover, the volatility of the exchange rates caused by such speculation further increases the demand for foreign exchange hedging and hence generates even more foreign exchange transactions.
- However, this volatility in exchange rates actually benefits the U.S. Dollar as the dominant and only safe haven currency with sufficient liquidity.

Flaws in the International Monetary System: The Excessive Reliance of the U.S. Dollar

- The international monetary system relies almost exclusively on the U.S. Dollar as the numeraire currency. This is especially so since the European sovereign debt crisis.
- Some countries complain about the seigneurage earned by the U. S. as the provider of the international medium of exchange and the liquidity for international transactions. This view is not completely fair. The U.S. provides a valuable service to the World by its supply of an international medium of exchange that support international transactions. Without this international liquidity, many international transactions would not have been possible. The U.S. is therefore entitled to the seigneurage as compensation.
- However, the World economy faces two risks by relying exclusively on the U.S. Dollar as an international medium of exchange.

Flaws in the International Monetary System: The Excessive Reliance of the U.S. Dollar

- First, the U.S. itself may experience a financial crisis so severe that its banks may no longer be able or willing to continue to provide the liquidity needed by the rest of the World. (The collapse of Lehman Brothers in 2008 was such a moment and would have impacted the entire World economy in an even worse way had the U.S. Federal Reserve Board not stepped in and saved the U.S. financial sector.)
- Second, some day a point may be reached that the U.S. may not run a trade deficit with the rest of the World any more, or may even run a trade surplus. When this happens, the supply of U.S. Dollar liquidity to the World will begin to dwindle and may become insufficient to support international transactions worldwide, forcing a significant contraction.

Flaws in the International Monetary System: The Excessive Reliance of the U.S. Dollar

- There is a phenomenon known as Triffin's paradox, first pointed out by Robert Triffin. As the rest of World demands more and more U.S. Dollars to support international transactions, the U.S. will run a larger and larger current account deficit, so that the rest of the World can "earn and hold" the U.S. Dollar balances. While the strong foreign demand for the U.S. Dollars implies that the U.S. Dollar should appreciate relative to the other currencies, the large and increasing current account deficit suggests that the U.S. Dollar should devalue instead.
- Hence it is only prudent that one should consider the diversification of the international monetary system as a risk remediation measure.

Flaws in the International Monetary System: The Potential for Contagion

- The potential for contagion is real. There are many, many examples: the 1997-1998 East Asian currency crisis, the 2007-2008 global financial crisis, and the 2009-2010 European sovereign debt crisis.
- China was spared the worst impacts of these financial crises because its financial and capital markets were relatively insulated from the rest of the World.
- This is not to say that economic globalization should be rolled back, but that attention should be paid to limiting the exposure, especially the short-term exposure, of an economy to foreign transacting parties. This should include both direct and indirect (e.g., through financial derivatives) exposure.
- I have proposed elsewhere that the “Globally Systematically Important Financial Institutions (GSIFIs)” should be allowed to do only limited business with one another as a means of reducing potential contagion.

Possible Directions of Reform

- Introduction of additional major reserve currencies
- Greater use of the Special Drawing Rights (SDRs)
- A return to the Bretton Woods system
- Real relative parity-maintenance agreements
- Regulation of short-term capital flows

Possible Directions of Reform: Introduction of Additional Major Reserve Currencies

- While the introduction of additional major reserve currencies such as the Renminbi certainly diversifies the international monetary system, it is not at all clear or obvious that the addition of a major reserve currency will fix any of the flaws of the international monetary system named here. It may lead to even greater exchange rate volatility under the existing system of freely fluctuating exchange rates and unrestricted capital mobility as there is one more object available for gambling.

Possible Directions of Reform: Greater Use of the Special Drawing Rights (SDRs)

- It will be an uphill battle to persuade exporters and importers and cross-border investors to invoice, settle and clear their transactions in a quasi-currency that no one uses in real life—What can one do with the SDRs that one receives? In addition, the exchange value of the SDR may also have high volatility relative to the local currency. Moreover, using the SDR may also involve high transaction costs. It would probably be better to continue to use the U.S. Dollar for transactions purposes, because whatever flaws there may be, the U.S. Dollar has the advantage that it is widely and readily accepted. (It is the devil that one knows.) Only banks involve in foreign exchange trading would welcome the SDR as one more possible object for speculation.

Possible Directions of Reform: A Return to the Bretton Wood System

- A return to the Bretton Woods system is not a bad idea because under that system, all currencies are equal and exchange rates are relatively stable. The exchange rate of a currency is subject to periodic adjustment vis-a-vis all other currencies depending on its current and capital account surpluses or deficits. However, this is likely to be opposed by the United States, which is the principal architect and beneficiary of the existing system.

Possible Directions of Reform: Real Relative Parity Maintenance Agreements

- It is not unreasonable for a group of similar economies to enter voluntarily into explicit or implicit, nominal or real relative exchange rate parity maintenance agreements. The purpose is to reduce the potential for "beggar thy neighbor" devaluation and to facilitate exchange rate adjustments vis-a-vis another economy or group of economies.
- Relative exchange rates tend to be sticky among a group of similar economies because if one economy adjusts its exchange rate upwards, the other economies are unlikely to follow, and will instead benefit by taking away the market share of the economy with the appreciated currency. If one economy adjusts its exchange rate downwards, that is, devalues, every other economy that competes with it will follow suit. Thus, the devaluing economy can derive no real advantage from its devaluation. Hence the optimal strategy for such an economy is to stay put, to not adjust the exchange rate one way or the other.

Possible Directions of Reform: Real Relative Parity Maintenance Agreements

- Thus, it makes sense for a similar group of economies to coordinate their relative exchange rates and to maintain nominal or real (which is better) relative parities by agreement so that no one economy is advantaged or disadvantaged.
- The "European Snake" before the introduction of the Euro was an example of such a parity maintenance agreement.
- For example, if the group of economies runs a trade surplus with another economy or another group of economies with a common currency, they can collectively revalue their respective currencies at the same time and at the same rate, thus leaving intact their relative competitiveness. Such parity maintenance agreements can actually make exchange rate adjustments more frequent and more timely and hence more effective.

Possible Directions of Reform: Regulation of Short-Term Capital Flows

- Even the International Monetary Fund has now accepted the idea that capital control can be an useful policy instrument for macroeconomic and exchange rate management. Regulation of short-term capital flows in both directions can actually make the foreign exchange market more efficient by excluding short-term speculation.
- It is desirable to be able to distinguish between short- and long-term capital flows so as to discourage the former and encourage the latter.
- A Tobin tax, suggested by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, was originally proposed as a tax on all spot conversions of one currency into another. The tax is intended to put a penalty on short-term financial round-trip excursions into another currency.
- What is proposed here is a Tobin tax on capital account flows but not on current account flows. Foreign currency transactions related to the exports or imports of goods and services, all current account transactions, will be completely exempted from such a tax.

Possible Directions of Reform: Regulation of Short-Term Capital Flows

- Such a Tobin tax imposes a penalty on short-term purely financial round-trip excursions from a foreign currency into the domestic currency or vice versa, and thereby discourage short-term cross-currency capital flows.
- If every time a foreign currency is converted into a domestic currency or vice versa, a tax of say 1% is levied, then a round-trip within a month would amount to an effective cost of more than 24% per annum, whereas for a direct investment with a long time horizon of say 5 years, the tax will amount to only 0.4% per annum, virtually nothing.
- Thus, a Tobin tax on capital flows will help to discourage short-term capital flows without impacting on long-term capital flows, differentiating automatically between long-term and short-term capital flows.

Possible Directions of Reform: Regulation of Short-Term Capital Flows

- It is in the interests of every economy to encourage and promote long-term capital flows, in both directions (that is, both inbound and outbound direct and long-term portfolio investments), and to discourage and regulate short-term capital flows, which are not only socially unproductive but can actually be disruptive and cause great damages.
- There is in fact a continuum of rates that can be used--any rate between 0% (completely free capital flows) and infinity (complete capital control) is possible.
- Moreover, it is not absolutely necessary that the inbound and outbound rates of Tobin tax be identical at all times. They can be allowed to be asymmetric under some circumstances.

Possible Directions of Reform: Regulation of Short-Term Capital Flows

- A Tobin tax can also enhance the ability of a government to exercise macroeconomic control on an economy. It can actually make possible simultaneously the "Impossible Trinity".
- "The Impossible Trinity" is a trilemma in international economics which states that it is impossible to have all three of the following conditions holding at the same time:
  - A fixed (stable) exchange rate;
  - Free capital movement (absence of capital controls);
  - An independent interest rate policy.
- A Tobin tax introduces an interest rate differential between domestic capital and international capital, which enables a central bank to have some degree of flexibility in its monetary policy, in particular, in its interest rate policy even under conditions of unrestricted capital flows.

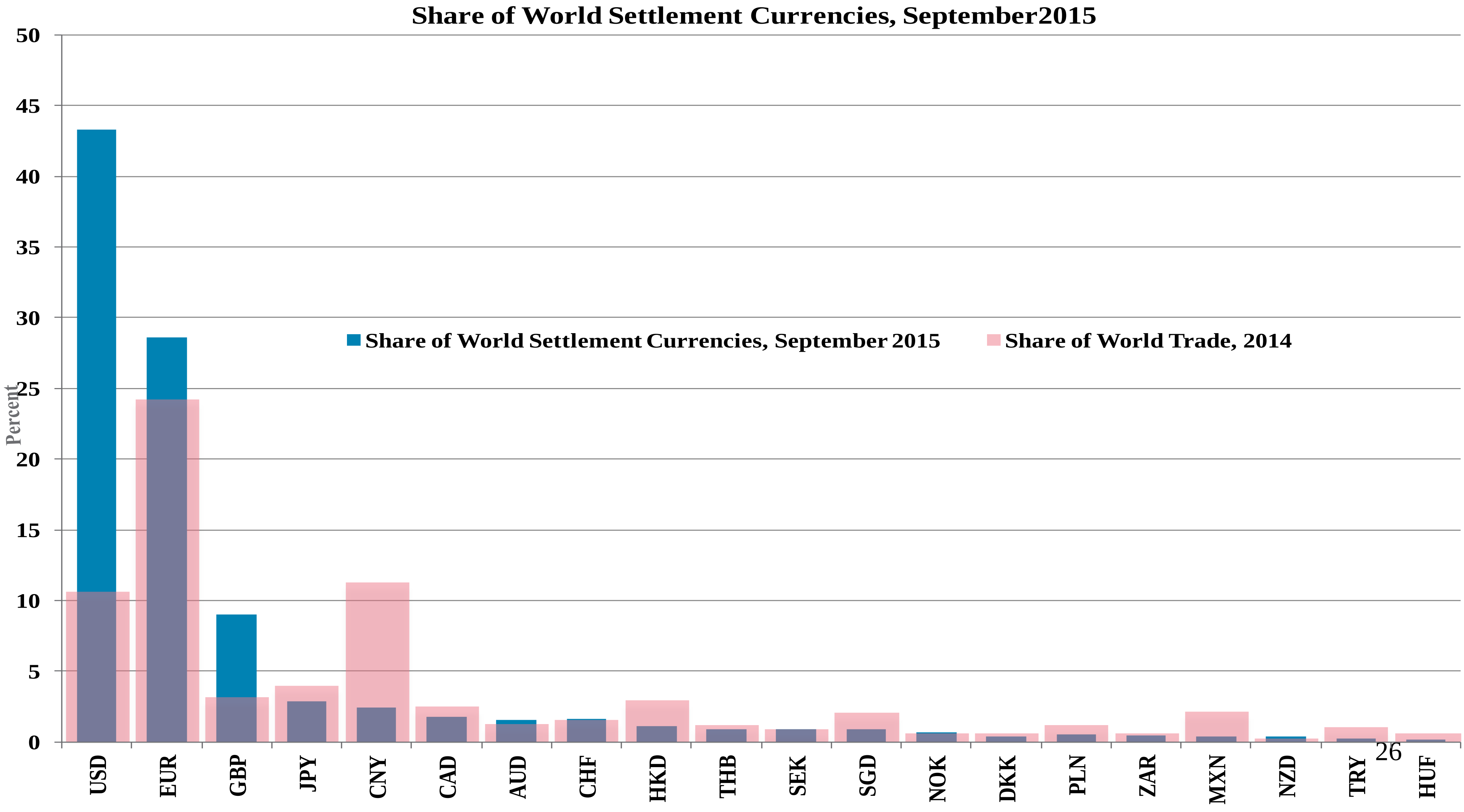
Increased Settlement in Local Currencies between Asian and European Economies

- The ability to invoice, settle and clear international transactions in local currencies is advantageous to all economies. There are the following three advantages:
- (1) Reduction of currency risks—only one of the transacting party is at risk;
- (2) Reduction of transaction costs—only one currency exchange is necessary; and
- (3) Reduction in the need for central banks to maintain large foreign exchange reserves as the local currencies can be used to settle and clear international transactions.

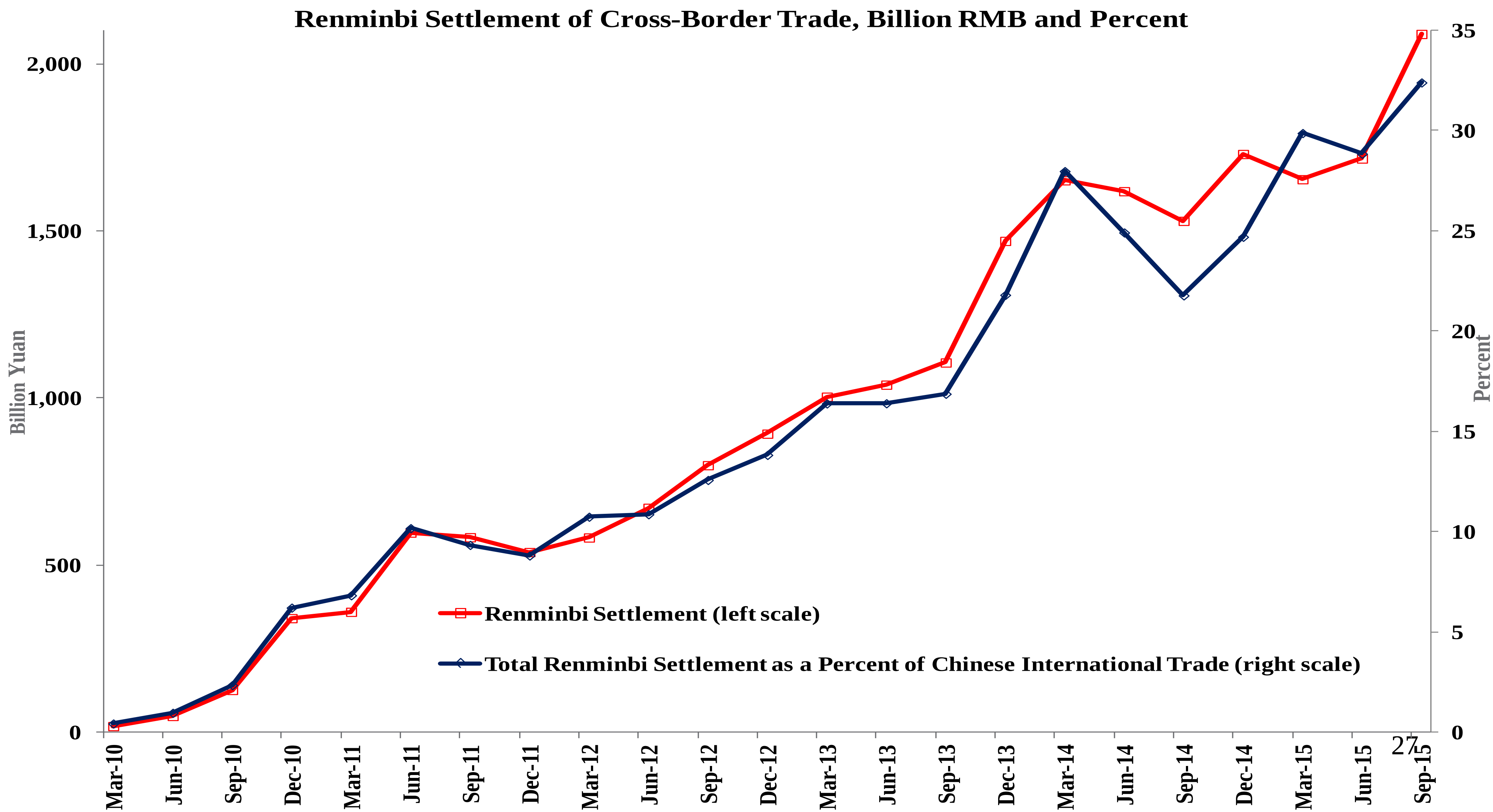
Increased Settlement in Local Currencies between Asian and European Economies

- The Renminbi is increasingly used in the settlement of Chinese international trade. Approximately 30% of Chinese international trade is now settled in Renminbi.
- If the experience of Japan is any guide, this percentage should eventually increase to 50%, or even more.
- What this means is that the Chinese demand for foreign exchange reserves for international transactions purposes will greatly diminish. The People's Bank of China will need to redeploy its excessive foreign exchange reserves.
- Almost all East Asian economies have trade surpluses with China and thus have ready access to Renminbi if they need it. They can certainly use their excess Renminbi for settlement and clearing purposes.

Distribution of World Trade Settlement Currencies versus World Trade, Sept. 2015



Renminbi Settlement of Chinese Cross-Border Trade, Billion RMB and Percent



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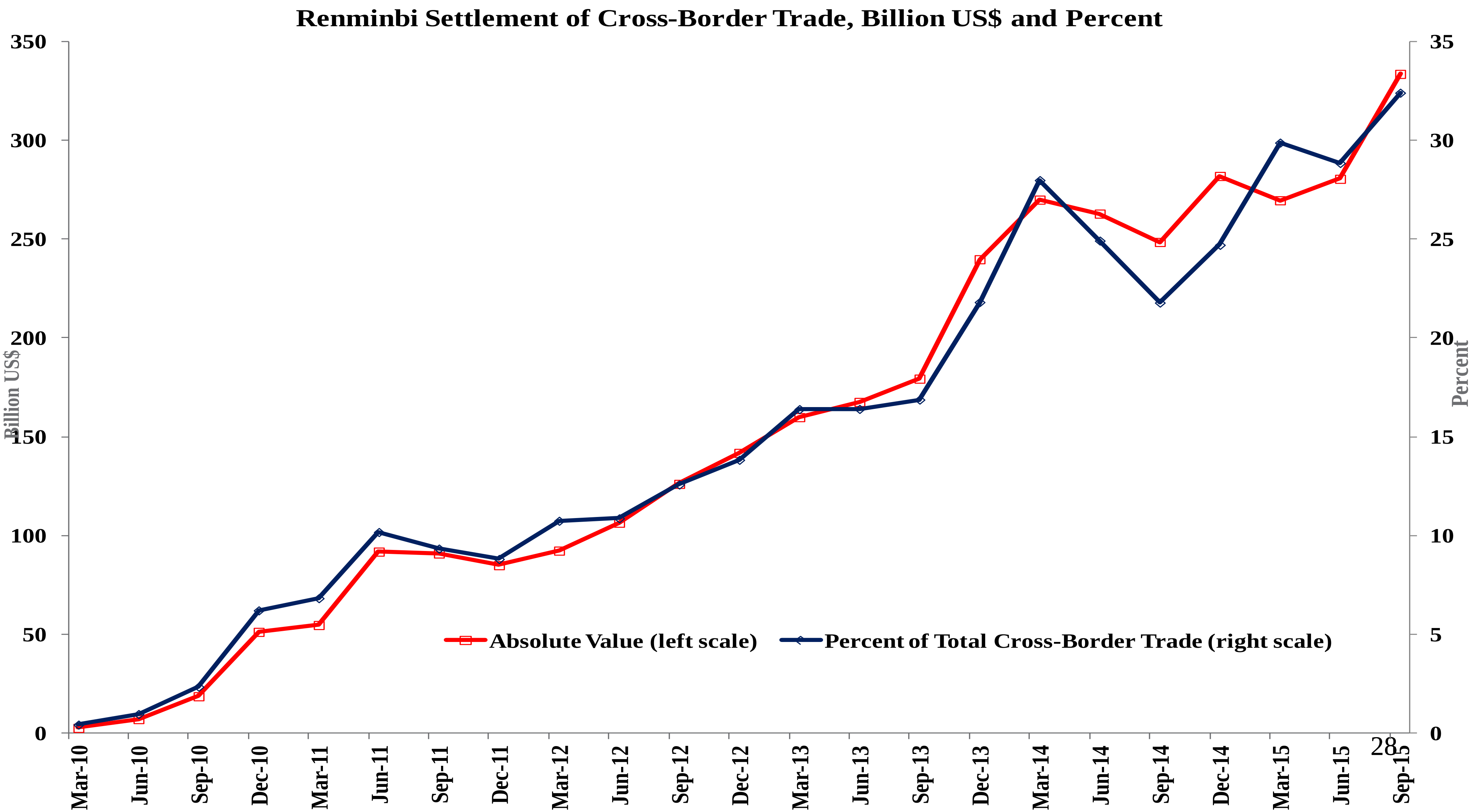

Increased Settlement in Local Currencies between Asian and European Economies

- The Bank for International Settlements (BIS) was instrumental in enabling intra-European international trade to be settled and cleared in local currencies in the immediate postwar period of the 1950s when the European economies did not trust one another's currencies. Under the BIS, their international transactions were settled and cleared on a multilateral (Western) Europe-wide basis, using local currencies. Any uncleared balances left over would be cleared with the U.S. Dollar balances maintained by BIS (obtained through a grant from the Marshall Plan). As the European economies recovered and their respective currencies gained in strength and reputation, the BIS was no longer necessary.
- Such a BIS model can be applied to the settlement and clearing of international transactions among East Asian and European economies, enabling them to do so in their own respective currencies. The left-over uncleared balances can be cleared with a "Bank for Eurasian Settlements" underwritten jointly by China, Japan, Korea and the European Central Bank (ECB).

Increased Settlement in Local Currencies between Asian and European Economies

- In the longer run, it is desirable that all economies should be able to not only settle and clear their current transactions in their own local currencies but also issue debt in their own respective local currencies. Again, an international platform may be necessary, with partial guarantees or undertakings by the major economies under appropriate conditions, e.g., by offering for sale non-transferrable credit default swaps on these bonds to bond purchasers (and only bond purchasers).
- The advantage for an economy being able to borrow in its own currency is that it is no longer subject to the difficulties of a currency mis-match as it is able to service and repay its debt in its own currency.
- However, in order to protect the purchaser of these bonds, the bonds should be indexed to the local inflation rate, so that whatever happens to the exchange rate, the purchaser will always have a real rate of return.
- These bonds should also be available in the borrowing economy so that there is local supervision and pressure by the local citizens against an intentional default on the part of the government.

Concluding Remarks

- Despite its flaws, the international monetary system has actually served the World economy reasonably well. There is therefore no need to make a revolutionary change.
- However, there is a need to enable settlement and clearing in local currencies in the long run, which was the situation under the original Bretton Woods system. Settlement in local currencies is not only beneficial to developing economies but also has the potential of enhancing the stability of the entire international monetary system.
- In the medium term, perhaps a prudently applied Tobin tax can reduce exchange rate volatility and excessive short-term capital flows and actually enable greater confidence in market-determined exchange rate mechanisms. China can lead the way for other developing and emerging economies by adopting a Tobin tax.