

Closing Remarks at the Fourth Advanced Programme for Central Bankers and Banking Regulators

Lawrence J. Lau 刘遵义

**Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong
and**

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

Fourth Advanced Programme for Central Bankers and Banking Regulators

Institute of Global Economics and Finance

The Chinese University of Hong Kong

Hong Kong, 20 February 2016

Tel: +852 3943 1611; Fax: +852 2603 5230

Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl

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The Settlement of International Transactions in Own Currency

- ◆ 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.
- ◆ If a country ran a persistent trade surplus, the exchange rate of its currency would be adjusted upward, that is, revalued against all other currencies; if a country ran a persistent trade deficit, the exchange rate of its currency would be adjusted downward, that is, devalued.
- ◆ Under the Bretton Woods system, settlement of international transactions could be done in the own currencies of the trading partner countries because the relative exchange rates of all currencies were “fixed”. It was not necessary to use a major international reserve currency for settlement purposes.
- ◆ However, the U.S. Dollar was redeemable for gold at a fixed parity. Since all other currencies had a relatively fixed exchange rate with the U.S. Dollar, they also had a fixed parity with respect to gold.

The Settlement of International Transactions in Own Currency

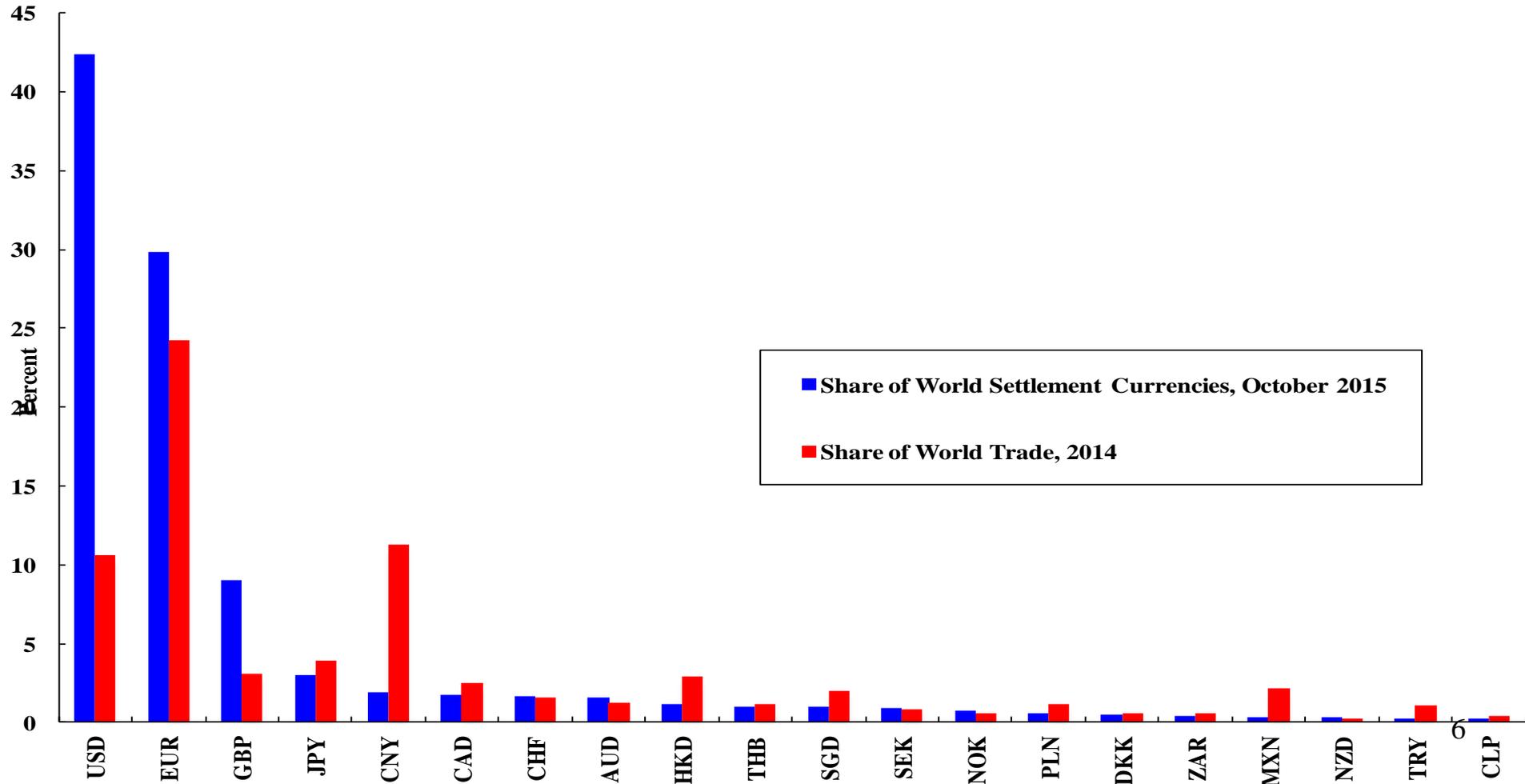
- ◆ Own currency settlement between trading partner countries is preferred by both exporters and importers because it reduces transactions costs and exchange rate risks. It also makes it less necessary to maintain large official foreign exchange reserves for international transaction purposes.
- ◆ Two trading partner countries use a third currency for invoicing, clearing and settlement only because they do not trust each other's currency. Under the Bretton Woods system, since all exchange rates were relatively fixed, all currencies were more or less equal.
- ◆ However, the Bretton Woods system 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 in Own Currency

- ◆ 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 prefer 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 (see the next Chart) 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.
- ◆ Since 2010, a proportion of the Chinese international transactions has begun to be settled in Renminbi (amounting to 26.4% of Chinese international trade as of the end of 2015).

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

Share of World Settlement Currencies, October 2015



The Settlement of International Transactions in Own Currency

- ◆ After the abolition of the Bretton Woods system, international transactions became much more complicated and as explained above, the currency of a third country would frequently have to be involved in the invoicing, clearing and settlement of a transaction.
- ◆ For example, if a Chinese exporter exports to India, it may not be willing to accept the Indian Rupee, and may demand to invoice and be paid in U.S. Dollars. This means that there are at least two currency conversions for this transaction, first from Rupee to U.S. Dollar, and then from U.S. Dollar to the Renminbi. The transactions costs are therefore higher.
- ◆ Moreover, there are also the exchange rate risks of the two currency conversions—the risk in the Rupee/US\$ exchange rate and the risk in the Yuan/US\$ exchange rate, which must be assumed by the respective transacting parties. Such risks exist because of the time lag between the placing of an exporter order and the arrival of an import shipment, typically months or longer.

The Settlement of International Transactions in Own Currency

- ◆ If the bilateral trade between two trading partner countries is always balanced, then as long as the exporters and importers in both countries trust each other's currencies, the invoicing, clearing and settlement of their bilateral trade transactions can in principle be done in their own currencies, since no one will be holding uncleared balances of the other currency.
- ◆ 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.

The Settlement of International Transactions in Own Currency

- ◆ As an example, consider a group of three countries, A, B and C. Suppose A runs a trade surplus with B, B runs a trade surplus with C and C runs a trade surplus with A. Further, suppose that all three countries individually have balanced trade with respect to the entire group. Under these circumstances, if there is pooled settlement for the group as a whole, then all three countries can use their own currencies for settlement purposes. Essentially, C's surplus with A can be swapped with B to pay for C's deficit with B, which in turn can be used to pay for B's deficit with A.
- ◆ 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. Even if the trade within the group is not balanced, the uncleared balance is likely to be relatively smaller and much more readily settled in a major international reserve currency acceptable to all.

The Settlement of International Transactions in Own Currency

- ◆ 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 East Asian Settlements can be established to perform the same function for East 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 international reserve currency such as the U.S.\$ or the Euro.

The Limits of Monetary Policy (Quantitative Easing)

- ◆ The experiences of the quantitative easing policies undertaken by the U.S. Federal Reserve Board, the Bank of Japan, the European Central Bank (ECB) and other central banks since late 2008 confirm what should have been well known—that monetary policy alone cannot overcome the negative expectations about the future. If expectations about the future of the economy are poor, then firms will not invest and households will not consume no matter how low the interest rates are, even if they are negative.
- ◆ The U.S., Japan and many of the European countries have been in a classic “liquidity trap”. As the saying goes: “One can pull on a string, but not push on a string”. Monetary policy or quantitative easing is powerless when faced with a low level of confidence about the future of the economy.
- ◆ What is needed is some real economic stimulus from real aggregate demand expansion.

The Limits of Monetary Policy (Quantitative Easing)

- ◆ The U.S. QE1, which was launched in 2008, did succeed in rescuing its financial institutions, restoring financial stability in the U.S. and driving up the exchange rates of almost all major currencies (with the notable exception of the Vietnamese Dong) because of the vast liquidity that it unleashed on the rest of the World. The Japanese Yen was at one time driven up to 75 Yen per US\$. Unfortunately, the U.S. QE1 and the subsequent QE2, which began in late 2010, did not succeed in stimulating additional real investment in the U.S. Nor did the QE3 which followed QE2 but was terminated in 2014.
- ◆ In response, the Bank of Japan unleashed its counter-QE, or “Qualitative and Quantitative Easing (QQE)” in late 2010, and succeeded in eventually driving down the Yen/US\$ exchange rate to 125 Yen/US\$, but otherwise was not able to increase domestic real investment significantly.

The Limits of Monetary Policy (Quantitative Easing)

- ◆ The Bank of Japan would have been better off by simply intervening directly in the foreign exchange market to lower the Yen/US\$ exchange rate. Then at least it would not have caused an asset price bubble in Japan, lowering interest rates to negative levels, hurting the aged and the retired. However, it was constrained from doing so because of opposition from the U.S. on purely ideological grounds—direct intervention is taboo whereas indirect manipulation, via quantitative easing, is fine.
- ◆ While the lowered Yen exchange rate did increase Japanese exports on the margin, the low Japanese interest rate did not lead to any significant increase in domestic real investment.
- ◆ The European Central Bank was no more successful with its quantitative easing in stimulating additional real investment within the Euro Zone.

The Limits of Monetary Policy

(Quantitative Easing)

- ◆ In retrospect, the U.S. QEs could have been much more effective in increasing real aggregate demand if instead of purchasing the federal government securities (Treasury and Agency securities), the U.S. Federal Reserve Board had offered to purchase the securities of individual states with the proviso that the all the proceeds must be used for either building new basic infrastructure or for repairing existing basic infrastructure within the respective states. This will inject significant aggregate demand in each of the states. The money would not have been wasted as U.S. basic infrastructure had become antiquated and under-maintained and ready for renewal over the years.
- ◆ The same could have been done by the Bank of Japan and the European Central Bank—to purchase local (in the case of the ECB, national) government securities to finance new or renovated basic infrastructure. It is still not too late for them to do so.

The Limits of Monetary Policy (Quantitative Easing)

- ◆ The truth is that monetary policy has not worked, and should have never been expected to work by itself alone.
- ◆ What is needed in every economy is an increase in real aggregate demand sufficient to change expectations about the future.
- ◆ As there is excess capacity almost everywhere, the social cost of an economic stimulus is small, especially compared to the lost output and employment.
- ◆ The World can really use a “simultaneous coordinated real economic stimulus” by all the major economies such as the U.S., China, Japan and the Euro Zone.

The Risks of Short-Term Capital Flows and the Tobin Tax

- ◆ 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, both outbound and inbound, can be greatly de-stabilizing to the foreign exchange market and the capital market of an economy.
- ◆ Short-term capital inflows and outflows pose particular 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.

The Risks of Short-Term Capital Flows and the Tobin Tax

- ◆ In fact, while economic theory tells us that voluntary trade between two trading partner countries always benefit both even though possibly to varying degrees. Also long-term direct investment benefits both the investor and the investee countries. However, there is no theory which says that short-term cross-currency capital flows are necessarily beneficial to the origin country or the destination country.
- ◆ 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 and the Tobin Tax

- ◆ 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 and outflows, 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. They should also limit the use of leverage in the buying and selling of currencies and their derivatives as well as stock indexes and their derivatives.

The Risks of Short-Term Capital Flows and the Tobin Tax

- ◆ One way to discourage and reduce short-term capital flows is the imposition of a Tobin tax on both inbound and outbound capital flows.
- ◆ The Tobin tax was first proposed by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, as a currency transaction tax. It can be applied to cross-border capital account currency exchange transactions.
- ◆ The Tobin tax can function as a device for discriminating between long-term and short-term capital flows. Suppose a Tobin tax of 1% is imposed on all capital flows. Then a one-month round-trip from U.S. Dollars into Renminbi and vice versa will imply a cost of 24% per annum, which should be sufficient to discourage most currency speculators.

The Risks of Short-Term Capital Flows and the Tobin Tax

- ◆ Moreover, a Tobin tax can enable the so-called “Impossible Trinity”. The “Impossible Trinity”, a concept due to Prof. Robert Mundell, Nobel Laureate in Economic Sciences, states that it is impossible for an economy to have all three of the following at the same time:
 - ◆ (1) A fixed exchange rate
 - ◆ (2) Free capital movement (absence of capital controls)
 - ◆ (3) An independent monetary (i.e. interest rate) policy
- ◆ However, the imposition of a Tobin tax makes it possible to maintain an interest rate differential between domestic capital and international capital, making it possible for the domestic central bank or monetary authority to have some degree of flexibility in its monetary, and in particular, interest rate policy.

Own Currency Bonds

- ◆ It is also in the interests of many economies, especially developing 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 neighbor” 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 East 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.
- ◆ The Tobin tax can be used to reduce short-term capital flows, both inbound and outbound, and hence to reduce the degree of volatility in the exchange rate.
- ◆ 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 because it is not subject to the exchange risk that arises from borrowing in another currency.

Concluding Remarks

- ◆ 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 East Asian economies.