

# A Bank for East Asian Settlements: A Win-Win Proposal for All

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# Outline

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- ◆ Introduction
- ◆ The Experience of the Bank for International Settlements
- ◆ The Use of Own Currency in International Transactions
- ◆ A Two-Country Example
- ◆ A Three-Country Example
- ◆ A Proposal for a Bank for East Asian Settlements
- ◆ Benefits for the World
- ◆ Benefits for China
- ◆ Benefits for the Other East Asian economies
- ◆ Benefits for the U.S.
- ◆ Benefits for Hong Kong
- ◆ Concluding Remarks

# Introduction

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- ◆ This is not a proposal to have the Renminbi replace the U.S. Dollar, or even to compete with the U.S. Dollar as an invoicing, clearing and settlement currency for international transactions.
- ◆ It is also not a proposal to establish an East Asian Monetary Fund.
- ◆ This is a proposal to enable East Asian economies to use their respective own currencies for the invoicing, clearing and settlement of their international trade transactions among themselves.
- ◆ In fact, before the U.S. unilaterally severed the link of the U.S. Dollar to gold and introduced the fluctuating exchange rate system in 1971, all member countries of the International Monetary Fund (IMF) were able to use their own currencies for their international transactions. This was the system established at Bretton Woods, at the founding of the IMF.

# Introduction

- ◆ However, the currently existing fluctuating exchange rate system, with its heavy reliance of the U.S. Dollar as the major anchor and the most important clearing and settlement currency, has a number of potential problems.
- ◆ First, there is a phenomenon known as the Triffin Dilemma or the Triffin Paradox, first pointed out by the economist Robert Triffin. As international transactions grow, the rest of world needs more and more U.S. Dollars to support their transactions. In order that the rest of the world can “earn and hold” more U.S. Dollar balances for transactions purposes, the U.S. will have to run a larger and larger current account deficit. (If the U.S. has no trade deficit, the rest of the world will not be able to earn any U.S. Dollars net.) While the strong foreign demand for the U.S. Dollar 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. Moreover, the strong U.S. Dollar makes matters worse by encouraging U.S. imports and discouraging U.S. exports, further enlarging the U.S. current account deficit and exacerbating the problem in the process.

# Introduction

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- ◆ Second, while the U.S., as the leading provider of the international medium of exchange, can enjoy the seigneurage that goes with it, it can only provide this international “money” by running chronic trade deficits. Some day, a point may be reached that the U.S. may not be willing to run a trade deficit with the rest of the world any more, or may even run a trade surplus. (Or the U.S. may turn isolationist and protectionist.) 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, possibly forcing a significant contraction in cross-border trade and investment.
- ◆ The U.S. may also be unable to provide the international liquidity. It 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 rescued the U.S. financial sector.)

# Introduction

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- ◆ Third, the freely fluctuating exchange rate system actually favours a strong currency like the U.S. Dollar, which has also become a safe haven currency. However, the freely fluctuating exchange rate system is subject to manipulation and predatory speculation, and can result in extremely volatile exchange rates, especially for many smaller economies.
- ◆ The currently existing system is therefore prone to crises and is not sustainable in the long run.

# The Experience of the Bank for International Settlements

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- ◆ The Bank for International Settlements (BIS) was instrumental in enabling intra-Western European international trade to be cleared and settled in local currencies in the immediate postwar economic recovery period of the late 1940s and early 1950s. At the time, the French would not accept the German Mark and the German would not accept the French Franc and neither of them would accept the Italian Lira. The recovering Western European economies did not trust one another's currencies.
- ◆ Under the BIS, the international transactions of the Western European countries with one another were cleared and settled on a multilateral Western Europe-wide basis, using their own local currencies. Any uncleared balances left over would be settled with the U.S. Dollar balances maintained by the BIS (obtained through a grant from the Marshall Plan).
- ◆ This BIS scheme helped to accelerate the economic recovery of the Western European countries by facilitating the international trade among them. As they recovered and their respective currencies gained in strength and reputation, by 1960, the BIS scheme was no longer necessary.

# The Use of Own Currencies for International Transactions

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- ◆ Currently, in order for two East Asian economies to trade, typically the exporter in the exporting country will quote and invoice in U.S. Dollars. The importer in the importing country in turn has to purchase U.S. Dollars with its domestic currency to pay the exporter when the goods arrive. Upon receipt of the U.S. Dollars, the exporter in the exporting country will sell the U.S. Dollars for its own domestic currency so that it can pay its workers, contractors, suppliers and rent as well as eventually a profit to its owners, most of whom are in the exporting country.
- ◆ What this means is that there are two foreign exchange transactions, one from the importer's currency into the U.S. Dollar, and one from the U.S. Dollar into the exporter's currency, leading to higher transaction costs. In addition, there are also two exchange rate risks during the period between the placement of the import order and the delivery of the exports to be borne by the importer and the exporter.
- ◆ If the importer can place its order in its domestic currency and the exporter is willing to accept it, then there is only a single exchange rate conversion and a single exchange rate risk, reducing both the transactions cost and the uncertainty.

# A Two-Country Example

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- ◆ We consider a simple two-country example. Consider two countries, A and B. If they do not trust each other's currency, they can do barter trade, that is exchanging goods with each other directly. Otherwise, no trade is possible, unless they have the currency of a third country that both of them trust. In most cases, this currency turns out to be the U.S. Dollar, or some other hard currency. The quantity of trade between them then depends on the amount of U.S. Dollars that they each have that can be used to support the trade between them. That is why for many economies, “generating foreign exchange (創匯)” is an important task for the government and its officials.
- ◆ An exception to this case is when trade between the two countries can be exactly balanced, in which case it is similar to barter trade as no clearing or settlement in a third currency is necessary.

# A Three-Country Example

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- ◆ Next, we consider a simple three-country example. Suppose there are three countries: A, B and C. Let us suppose that A has a trade surplus with B of US\$10 billion; B has a trade surplus with C of US\$10 billion; and C has a trade surplus with A also of US\$10 billion. In the absence of a BIS-like scheme, all three countries will have to run a trade surplus with respect to the U.S. in order to earn the US\$10 billion to pay for their trade deficits with one another. With a BIS-like scheme, no U.S. Dollars will be needed, because A can pay B in its own currency, B will pay C in A's currency, and C will pay A in A's currency. All trade transactions can be cleared and settled amongst the three countries.

# A Proposal for a Bank for East Asian Settlements

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- ◆ This BIS-like model can be applied to the clearing and settlement of international transactions among East Asian economies, with the formation of a “Bank for East Asian Settlements”. The Bank will have as its members the central banks or monetary authorities of East Asian economies. Participation is voluntary for central banks willing to commit to the clearing and settlement of the international transactions among their economies insofar as possible in own currencies. The resulting uncleared multilateral balance will always be smaller, and often much smaller, than the sum of all the uncleared bilateral balances.
- ◆ Any left-over uncleared multilateral balances can be cleared and settled through joint undertakings by the People’s Bank of China (the central bank of China), perhaps together with the Bank of Japan and the Bank of Korea (the central banks of Japan and the Republic of Korea) to exchange them for any hard currency desired by the holders of the left-over uncleared balances.

# Benefits for the World

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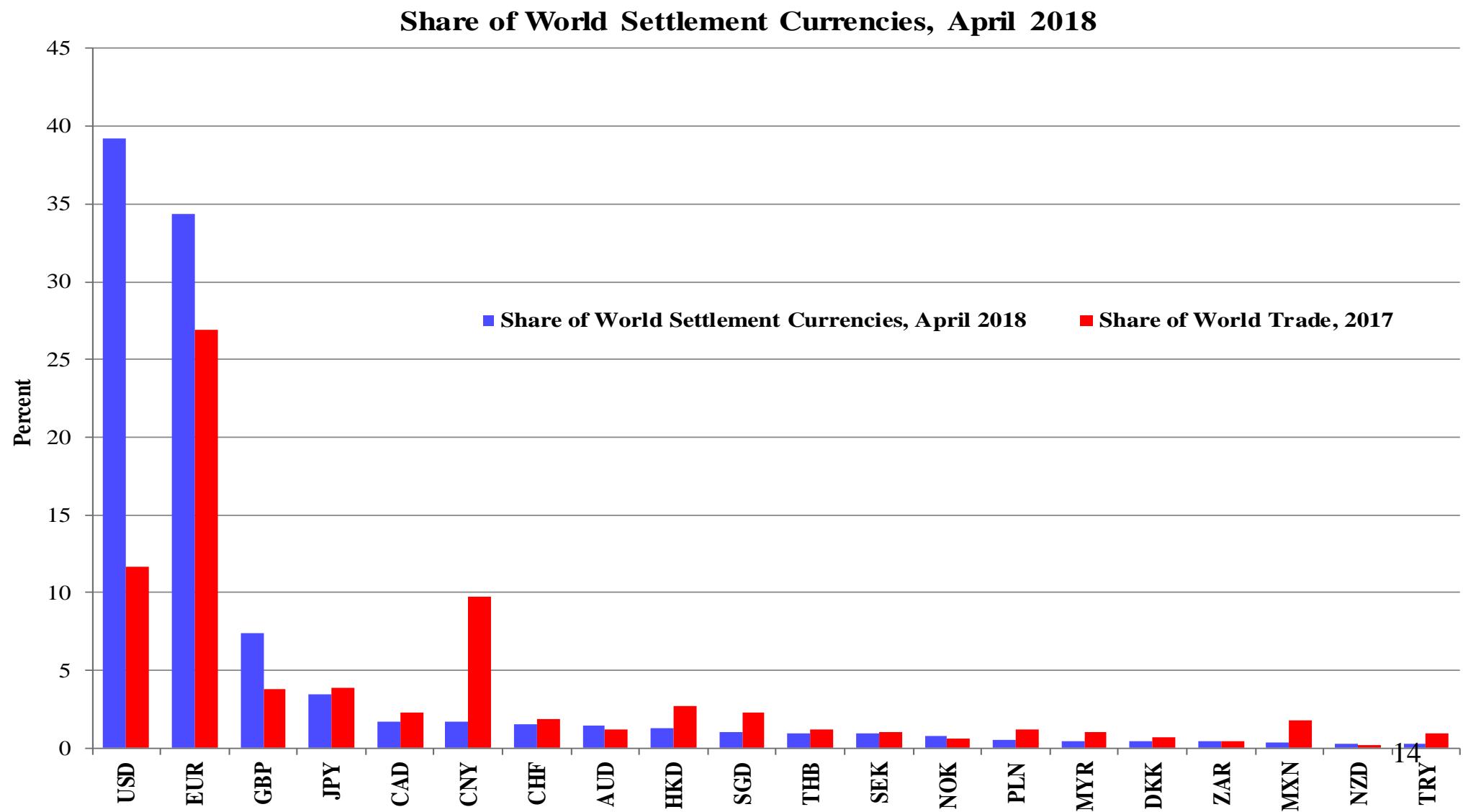
- ◆ Throughout the period 2010 to the present, the U.S. Dollar and the Euro combined accounted for more than 70% of world payments. (I personally believe that the Euro will survive, but it does look wobbly from time to time.)
- ◆ However, the world economy faces risks by relying exclusively on the U.S. Dollar as an international medium of exchange. Hence it is only prudent for the world as a whole to consider the diversification of the international monetary system away from its reliance on a single major currency as a risk remediation measure. The introduction of the Euro was such an attempt but it has not proved to be too successful outside the Euro Area.
- ◆ The Bank for East Asian Settlements will help reduce the reliance on the U.S. Dollars by enabling the use of own currencies for the clearing and settlement of international transactions among East Asian economies.

## Benefits for China

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- ◆ As of April 2018, the U.S. Dollar was the undisputed champion for world payments, accounting for almost 40% of world settlement, even though the U.S. itself accounted for only slightly more than 10 percent of world trade. The U.S. Dollar was followed by the Euro, which was used for 34 percent of world payments, while the Euro Area accounted for 27 percent of world trade. The Renminbi was in sixth place, behind the pound sterling, the Japanese Yen, and the Canadian Dollar, with less than 2 percent of world payments, even though China also accounted for more than 10 percent of world trade, just like the U.S (see the following chart).

# Distribution of World Trade Settlement Currencies versus World Trade, April 2018



# Benefits for China

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- ◆ Currently, only 17% of Chinese international trade is settled in Renminbi. The Renminbi is used for the settlement of international transactions to a much lesser extent than warranted by the Chinese share in world trade.
- ◆ In contrast, the Japanese Yen accounted for more than 3% of world payments as of April 2018 while Japan accounted for less than 4% of world trade. The proportion of international trade of Japan cleared and settled in Japanese Yen was 90%.
- ◆ If the Japanese experience is any guide, there is still a great deal of room for the Renminbi to grow in terms of its share of world payments. This would eventually mean even less need for the People's Bank of China to maintain a high level of official foreign exchange reserves for transactions purposes.

# Benefits for the East Asian Economies

- ◆ Two countries use the currency of a third country to invoice, clear and settle their trades because they do not trust each other's currency. However, if there is a way of settling their transactions in their own currencies through an intermediary that both of them can trust, such as the proposed Bank for East Asian Settlements, they both stand to gain. There are many advantages in being able to use an economy's own currency for invoicing, clearing and settlement of its international transactions:
- ◆ (1) Reduction of transaction costs—only one currency exchange is necessary;
- ◆ (2) Reduction of currency risks— at most only one of the transacting party is at risk;
- ◆ (3) Reduction in the need for the central bank to maintain large foreign exchange reserves if the own local currency can be used for clearing and settlement (the U.S. actually does not maintain any foreign exchange reserves because all the other economies accept U.S. Dollars readily); and
- ◆ (4) Expansion of the ability to import if the own local currency can be used for payment.

# Benefits for the East Asian Economies

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- ◆ China runs a trade surplus with all ASEAN economies with the exception of Singapore (which may be due to re-exports through Singapore). It can promote the use of own currencies for clearing and settlement by the ASEAN economies by encouraging Chinese exporters to ASEAN economies to accept the local currencies. The People's Bank of China can commit to the purchasing of the ASEAN local currencies earned by Chinese exporters at the prevailing exchange rates with Renminbi.
- ◆ The Bank for East Asian Settlements can promote, facilitate and enable the clearing and settlement of international transactions in local currencies among the East Asian economies.

# Benefits for the U.S.

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- ◆ There are significant advantages for the issuing country of a currency being used as a medium of international exchange between other pairs of trading countries. This is called seigneurage. They include:
  - ◆ (1) The issuing country can pay for real imports with pieces of paper (either money or bonds) which can be printed more or less at will at almost zero marginal cost. This is similar to the seigneurage enjoyed domestically by the central bank or the monetary authority that has the legal power to issue money.
  - ◆ (2) Because all other countries need to hold this currency as part of their official foreign exchange reserves for international transaction purposes, the issuing country can run significant trade deficits and enjoy low borrowing costs. It should be noted that without running trade deficits, the benefits of seigneurage is significantly reduced.
  - ◆ (3) Its currency is also likely to become a “safe haven” currency, so that at the first sign of any trouble in the world, capital will flee to that currency from all over the word. The issuing country will therefore benefit even when there is trouble in the world.<sup>18</sup>

# Benefits for the U.S.

- ◆ How much is the seigneurage worth to the U.S.? It is difficult to estimate the value of the seigneurage. What follows is a very rough attempt.
- ◆ The U.S. has been able to run a persistent trade deficit (US\$572 billion in 2017 and cumulatively US\$11.7 trillion since 1980). Based on the assumption of a 3% spread between short-term U.S. Treasury securities and the rate of return earned by U.S. assets abroad, the current value of the seigneurage may be conservatively estimated at approximately US\$350 billion (US\$11.7 trillion times 3%) a year.
- ◆ The U.S. provides a very valuable service to the world by its supply of an international medium of exchange that enables and supports international transactions. Without this international liquidity, many international transactions would not have been possible. The U.S. therefore deserves the seigneurage as compensation.
- ◆ Total world trade is approximately US\$40 trillion a year and the estimated seigneurage earned by the U.S. is less than 1%.

## Benefits for the U.S.

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- ◆ If the Bank for East Asian Settlements become a reality, what are the benefits and costs for the U.S.?
- ◆ First, the U.S. will have greater flexibility in its fiscal and monetary policies as its tightening and loosening will have less direct impact on the rest of the world.
- ◆ Second, the U.S. trade deficit is likely to decline as the demands for “earning and holding” U.S. Dollars diminish. It will no longer have chronic trade deficits.
- ◆ Third, the U.S. Dollar exchange rate will reflect more accurately its competitiveness in international trade in goods and services. It may well result in an increase in U.S. exports to the rest of the world and hence a higher U.S. GDP.

## Costs for the U.S.

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- ◆ However, to the extent that the use of own local currencies in international transactions becomes possible for the East Asian economies, the demands for foreign exchange (especially the U.S. Dollar) as part of the official reserves of the East Asian central banks will decline. The resulting reduction of seigneurage and the possible rise in the rate of interest of U.S. Treasury securities and hence in U.S. interest rates more generally may become costs to the U.S.

# Benefits for Hong Kong

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- ◆ The Hong Kong Dollar has been pegged at a fixed exchange rate to the U.S. Dollar (HK\$7.8 per US\$) since 1983. It is considered to be just as good as the U.S. Dollar (perhaps even better because Hong Kong has so little public debt) and is widely accepted all over the world. For this reason, it will benefit very little from the proposed Bank for East Asian Settlements directly.
- ◆ However, Hong Kong is the ideal location for a Bank for East Asian Settlements. Capital can flow freely in and out of Hong Kong without any restrictions. Its foreign exchange market is extremely active and deals in all East Asian currencies. It is traditionally a safe money haven for the Southeast Asians and more recently for the Mainland Chinese as well. Hong Kong also operates one of the most efficient real-time settlement systems which can be used by the proposed Bank for East Asian Settlements for clearing and settlement purposes.

# Concluding Remarks

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- ◆ If the proposed arrangement for the Bank for East Asian Settlements works out well, membership in the Bank can be expanded to include the central banks of the “Belt and Road” developing countries, again on a voluntary basis, enabling them to use their own currencies for the invoicing, clearing and settlement of their international transactions with other members of the Bank.
- ◆ Another possible development is for the East Asian economies to eventually begin to issue bonds denominated in their own currencies in the international capital market. Since their own currencies can be used for the settlement of international transactions under the Bank for East Asian Settlements, their bonds will have value internationally and will be marketable. (However, their longer-term bonds may need to be indexed to each country’s respective rate of domestic inflation.)

# Concluding Remarks

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- ◆ The ability to issue bonds in one's own currency should greatly reduce currency mismatch and also help to reduce maturity mismatch, the two major causes of financial crises in many economies.
- ◆ Hong Kong can greatly benefit from the formation of a Bank for East Asian Settlements because it can serve as the location of the headquarters of such a bank, become the international centre for the clearing and settlement of East Asian international transactions and the issuance and trading of East Asian own-currency-denominated bonds.