

Options for a Post-Crisis Settlement System for International Transactions

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Outline

- ◆ Reliance on a Single or a Couple of National Currencies as International Reserve Currencies
- ◆ A Supra-National Currency Approach
- ◆ A Multiple-Currency Approach
- ◆ Concluding Remarks

Alternative Clearing and Settlement Mechanisms

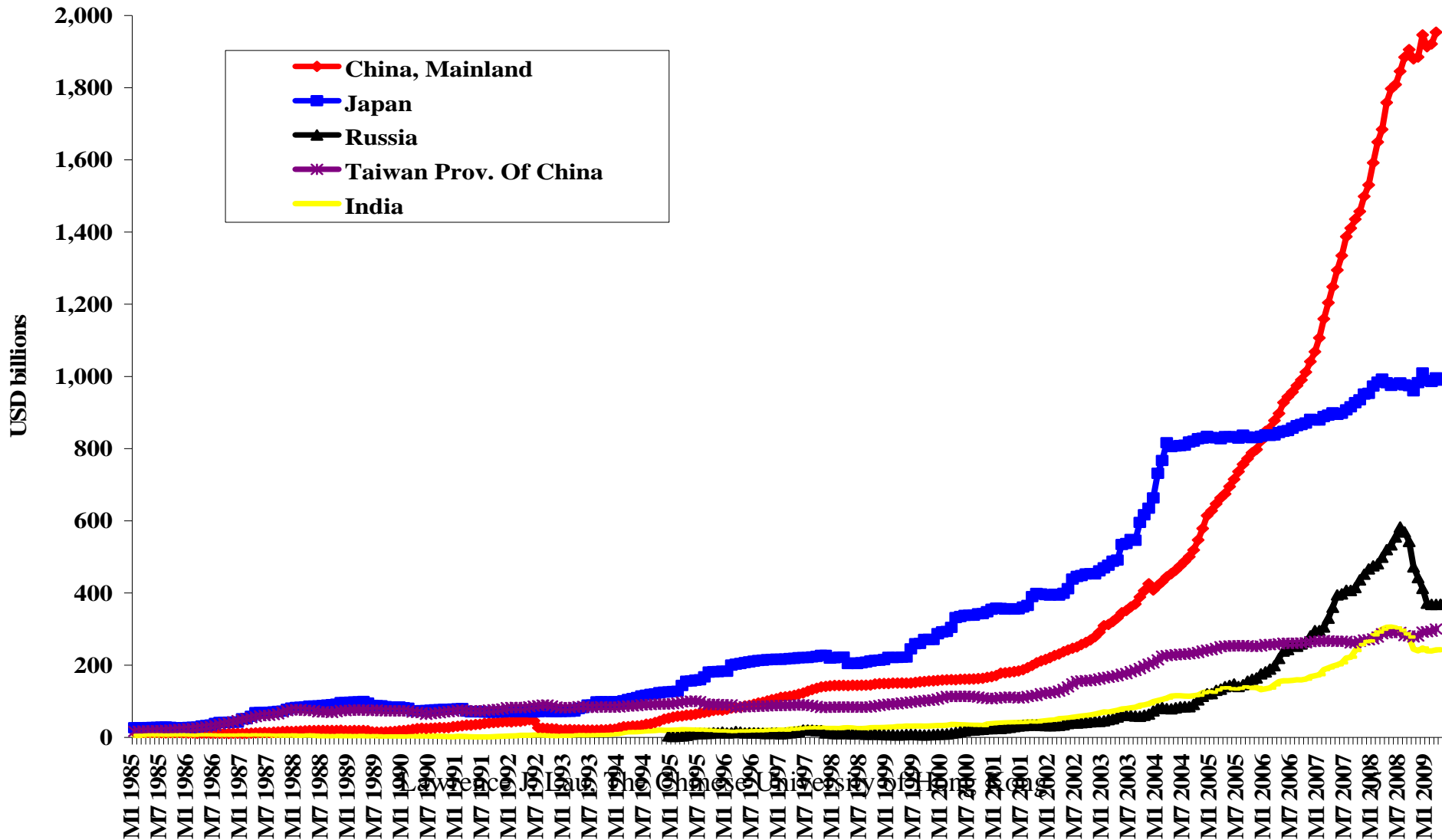
- ◆ We consider the important question of the method of settlement of international trade and other economic and financial transactions. In the immediate post-World War II period, the U.S. Dollar and the British Pound were the two major international reserve currencies used in the settlement of international economic and financial transactions. Some time in the late 1950s and early 1960s, the British Pound managed to lose its status as a major international reserve currency. Until the emergence of the Euro around 2000, the U.S. Dollar served as the sole major international reserve currency.
- ◆ Global trade, including trade in oil, is currently mostly denominated and settled in U. S. dollars. Most countries, other than the U.S. and outside of the Euro Zone, rely on the U.S.\$ to conduct transactions not only with the U.S. but amongst themselves. That is what has given rise to the huge foreign demand for U. S. dollar balances. The U. S. dollar reserves held by central banks and monetary authorities around the world provide in part the liquidity and transactions balances necessary to support the growth of their respective international trade and other transactions.

Alternative Clearing and Settlement Mechanisms

- ◆ The following two charts present the total foreign exchange reserves and the value of the stock of U.S. Treasury securities held respectively of selected countries and regions. The first chart shows that China has overtaken Japan as the country with the largest foreign exchange reserves in 2006. The second chart shows that up to 2006, Japan held a much higher stock of U.S. Treasury securities than China. Thus, to the extent that there exist global imbalances sustained by the purchases of U.S. Government debt, Japan was a much more important contributor than China until 2008. The U.S. Dollar is one of the major international reserve currencies used in the settlement of international economic and financial transactions. Some time in the late 1950s and early 1960s, the British Pound managed to lose its status as a major international reserve currency. Until the emergence of the Euro around 2000, the U.S. Dollar served as the sole major international reserve currency.
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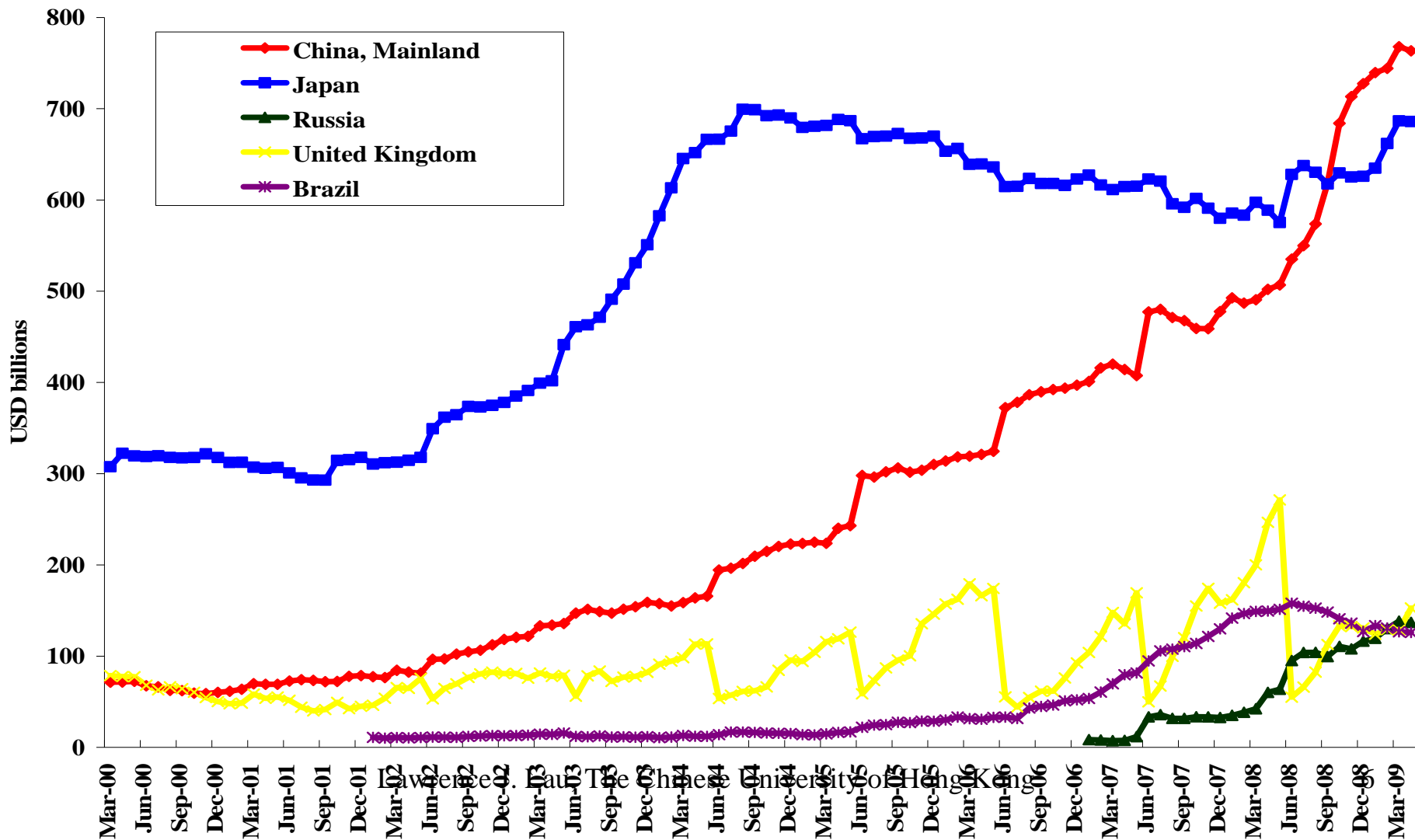
Total Foreign Exchange Reserves minus Gold, Selected Countries and Regions

Total Reserves minus Gold



Major Foreign Central Banks' Holdings of U.S. Treasury Securities

Major Foreign Holders of U.S. Treasury Securities



The Global Reliance on the U.S. Dollar for International Transactions

- ◆ The central banks and monetary authorities of many countries hold U.S. Dollars and U.S.\$-denominated assets as part of their foreign exchange reserves because the U.S. Dollar is almost universally accepted.
- ◆ Two countries trading with each other may not trust each other's currency, so that unless the bilateral trade is completely balanced and a straight barter is possible, they will need to use the currency of a third country which both of them trust. This currency often turns out to be the US\$.
- ◆ Thus, US\$ reserves held by these central banks and monetary authorities serve as the transaction balances for international trade and investment between countries which do not wish to accept and/or to hold each other's currencies.

The Global Reliance on the U.S. Dollar for International Transactions

- ◆ A normal way for a country to be able to acquire net US\$ balances is for it to run a trade surplus vis-a-vis the United States. Thus, it will receive more U.S. dollars for its exports to the U.S. than it will need to pay for its imports from the U.S. The net excess U.S. dollars will then be sold by the exporter to its central bank for local currency. The central bank will then retain the U.S. dollars in its foreign exchange reserves. It can, if it so wishes, purchase U.S. Treasury securities or other U.S.\$-denominated assets or other assets. To the extent that it purchases U.S. Treasury securities it will become a creditor of the U.S. (It can, of course, also acquire U.S. Dollars by running a trade surplus with a third country with U.S. Dollars.)

The Global Reliance on the U.S. Dollar for International Transactions

- ◆ The United States, on its part, will be able to import more than it exports, paying for the difference with U.S. Dollars and eventually with U.S. Treasury securities (which it can simply print with little cost).
- ◆ As international trade increases, the need for U.S. Dollar balances for transactions purposes rises. It has been estimated that the amount of transactions balances needed by a country can be six months or more of the value of its imports.

The Global Reliance on the U.S. Dollar for International Transactions

- ◆ The U.S.\$ balances held by the foreign countries, whether in central banks or in public and private firms, thus serve a useful function in making international trade and other economic and financial transactions possible. These balances have the same relationship to international economic transactions as the domestic money supply to domestic economic transactions.
- ◆ For its contribution to the facilitation of international trade, the U.S. has what is called seigniorage, that is, it can enjoy the benefit of being the issuer of the “international money,” of being the banker to the world’s trading nations. It can purchase goods and services internationally using only paper money or paper bonds which it can print more or less at will; in other words, it can purchase with “credit”.

The Global Reliance on the U.S. Dollar for International Transactions

- ◆ The recent scarcity of credit in U. S. dollars and the expected decline in the U.S. trade deficit in the future would potentially reduce the supply of U. S. dollars to the rest of the world and ought to add impetus to the consideration of alternative ways to settle trade and other international transactions.
- ◆ An obvious question is what happens if the United States stops running a trade deficit and even begins to run a trade surplus vis-à-vis the world. The aggregate US\$ balances in the world will no longer grow but may start shrinking. But this may constrain the growth of world trade, unless there is an alternative currency to enable international transactions or an alternative method of settlement of net balances. This is a question that needs to be addressed within the next couple of years.

Alternative Clearing and Settlement Mechanisms

- ◆ Another consideration is the fact that the U.S. Dollar and the U.S. Treasury securities have always been considered “riskless” assets. While they are still “riskless” from the point of view of U.S. dollar-based investors and consumers, they are no longer completely riskless for investors and consumers who are not U.S. dollar-based. In what currencies should a country’s foreign exchange reserves be held is a question that faces all central bankers. And that is also related to the question of which currencies to use in the settlement of international transactions.

Disadvantages of Being an International Reserve Currency

- ◆ What are some of the disadvantages of being an international reserve currency? Of course, to serve as an international reserve currency, a national currency must become fully and freely convertible. In addition, the following may be perceived as disadvantages:
- ◆ First of all, the country that supplies the international reserve currency in general has to be willing to run a trade deficit vis-a-vis the world—otherwise the other economies will not be able to acquire any of the international reserve currency. Countries that are protectionist or mercantilist want to run trade surpluses, not deficits.
- ◆ Second, if a country's currency is widely held around the world as an international reserve currency, there is a risk that the other economies may at some point decide not to hold this currency and dump the currency on the market, putting pressure on the currency to devalue and raising the rate of interest (especially if the country tries to defend the exchange rate). (Unless the country itself owes so much to the other economies that it is considered “too big to be allowed to fail.”)

Disadvantages of Being an International Reserve Currency

- ◆ These are some of the reasons why Japan did not want its Yen to become a major international reserve currency. If Japan were willing, the Yen could have become a much more important international reserve currency a couple of decades ago.
- ◆ Whether the Yuan should be allowed to become a major international reserve currency is a question that the Chinese Government will need to consider down the road.

What Options are There?

- ◆ What are some of the options if the international settlement system were to become less reliant on a single or a couple of national currencies as reserve currencies?
 - ◆ A return to the gold standard?
 - ◆ Alternative or additional international reserve currencies like the Yuan?
 - ◆ Special Drawing Rights (SDRs)?
 - ◆ Regional currencies?
 - ◆ A basket of currencies?
 - ◆ World currency?
 - ◆ Other possibly multi-currency arrangements?

Alternative Clearing and Settlement Mechanisms

- ◆ One obvious alternative would be to allow the importer of any country or region to pay for the imports in its own currency, provided that the exporter, or the exporter's country's central bank, is willing to accept and to hold the currency. For example, a Chinese exporter may be willing to accept payment in Thai Baht for its exports to Thailand, as long as he knows he can sell it to the People's Bank of China, China's central bank or to someone who needs Thai Baht such as a Chinese importer importing from Thailand. No U. S. dollar balances would then be necessary for such a transaction.
- ◆ To facilitate such a transaction, it would be helpful if the People's Bank of China could allow the Chinese exporter to sell forward the Thai Baht to it at the time a firm export order is received. These forward sales can be restricted to Chinese exporters of goods and services to Thailand that are invoiced in Thai Baht and only up to the value of the individual export orders.

Alternative Clearing and Settlement Mechanisms

- ◆ Of course, one may also allow an importer the choice of paying for the imports in the currency of the exporter, in its own currency, or in a third currency. For example a Chinese importer may pay a Thai exporter for imports from Thailand in Thai Baht, or in Renminbi, or in US\$, so long as they can agree between them.
- ◆ All of this can and should be done voluntarily, subject to mutual agreement between the importer and the exporter, and they may well agree to continue to use the U.S. Dollar. No change in the existing system is therefore required, except for the central banks in the respective countries being willing to buy and sell these additional foreign currencies. It is also not necessary for the central banks to buy and sell all currencies. There can simply be an eligible list.
- ◆ Over time, on a voluntary basis, the Renminbi may emerge as one of the currencies that firms, households and central banks and monetary authorities in other East Asian economies are willing to hold both for transaction purposes and as a store of value, just like the Japanese Yen.

Alternative Clearing and Settlement Mechanisms

- ◆ In our example, the People's Bank of China may decide to hold the Thai Baht as part of its foreign exchange reserves (after netting out the payments for imports from Thailand denominated in Baht). Eventually, the central bank may wish to consider holding the Thai Baht in interest-bearing assets such as bonds issued by the Government of Thailand, preferably indexed to Thai inflation to preserve the purchasing power of the central bank's Baht-denominated assets.
- ◆ Thus, gradually, and on a voluntary basis, the use of currencies other than the US\$ for international trade and other transactions will rise, thus easing the demand for US\$ for transaction purposes, and hence the need for the U.S. to supply such liquidity by running large trade and current account deficits.

Alternative Clearing and Settlement Mechanisms

- ◆ The arrangement described above is not so different from what has been made possible by the Chiangmai accords and the bilateral swap agreements between many East Asian central banks and monetary authorities, except for the possibility of inflation-protection feature of the foreign-currency denominated bonds to be held as part of the foreign exchange reserves. However, given the historical rates of inflation in some of the developing economies in East Asia, the nominal rates of interest on straight, non-inflation-indexed bonds may have to be very high in order to attract buyers and holders.

Alternative Clearing and Settlement Mechanisms

- ◆ Moreover, the issuance of inflation-protected bonds by the governments of developing economies has many advantages for these governments, among which is the possibility of borrowing abroad in its own currency. Foreign currency borrowing by developing countries and regions frequently leads to financial crises because of currency mismatch (revenue in local currency but liabilities in foreign currency) which is often also accompanied by maturity mismatch (borrowing short-term overseas but lending long-term locally). Thus it is a great advantage to be able to issue bonds denominated in one's own currency rather than a foreign currency.

The Creation of a Market in Bonds Denominated in Local Currencies

- ◆ Traditionally, local currency government bonds have little appeal domestically within certain developing economies themselves because of the high rates of inflation. They also have little appeal internationally. The result is that almost all developing economies can only borrow in foreign currencies and not in their own local currencies. Sooner or later, the foreign lenders would like to get their money back and hence would not roll over the loans, and a currency crisis would then ensue. For example, this happens habitually in Latin America, which has a currency crisis every decade or so.
- ◆ If the local-currency government bonds are indexed to the local cost-of-living indexes, they will have appeal both domestically and internationally. The purchasers of the bonds will be assured that they will receive a real rate of return in the local currencies, regardless of the movements of the relative exchange rates. They will always be able to purchase the same real quantity of goods that they could have bought at the time that they first purchased the local currency bonds (plus interest).

The Creation of a Market in Bonds Denominated in Local Currencies

- ◆ For example, suppose inflation-protected bonds are issued by the Government of Thailand. If the amount paid for the inflation-indexed bonds can purchase 20,000 tons of rubber today, the proceeds received from the bonds at maturity will still be sufficient to purchase 20,000 tons of rubber, plus interest, at that time, whatever happens to the exchange rate of the Baht in the interim. Thus, the risk of value erosion to a foreign central bank for holding Thai Baht-denominated bonds in its portfolio is greatly reduced.

The Creation of a Market in Bonds Denominated in Local Currencies

- ◆ Inflation-protected bonds can help developing economies overcome the problem of the “original sin”--that they cannot borrow in their own local currencies.
- ◆ These bonds can also be held by the local citizens, especially retirees, to preserve the purchasing power of their pensions and savings.
- ◆ They can be held by foreign central banks as part of their foreign exchange reserves, thus allowing them to diversify further the composition of their reserves and at the same time to preserve the underlying purchasing power.
- ◆ A country that issues inflation-protected government bonds has a built-in incentive to control inflation, and thus issuance of these bonds per se is an indicator of a credible commitment against high rates of local inflation.

The Creation of a Market in Bonds Denominated in Local Currencies

- ◆ A country that issues inflation-protected bonds will find that its currency will be accepted more widely. This is because, in part, those who receive their currency always has the option of using it to purchase inflation-protected bonds in the same currency, thereby protecting its purchasing power over time; and also because, in part, the issuance of inflation-protected bonds per se is perceived as a commitment not to let inflation run away.
- ◆ Thus, with the introduction of inflation-protected, or equivalently, cost-of-living indexed bonds, more and more currencies can potentially become reserve currencies and there is no need to rely on only a few major currencies. Of course, not all countries will have the required credibility to issue inflation-protected bonds.
- ◆ In the intermediate to long run, issuing bonds in one's own currency is preferred to issuing bonds in a foreign currency, be it US\$, Euro, Yen or even Renminbi denominated because the exchange rate is not directly affected by whether foreign investors are willing to buy and/or hold on the bonds if they are local currency-denominated.

A Supra-National Currency Approach

- ◆ Another option is to supplement and supplant the current system with a supra-national currency that is accepted by almost all countries.
- ◆ Gold (and silver) were used as supra-national currencies many years ago. However, the quantity of gold available in the world today and its rate of growth over time are not sufficient to support the growth in international trade and other transactions.
- ◆ The gold standard had supplanted the use of gold in international transactions but was abandoned soon after the onset of the Great Depression of 1929. The Bretton Woods agreement of 1944 provided for a system of fixed, but periodically adjustable, exchange rates.

A Supra-National Currency Approach

- ◆ The Euro is an example of a supra-national currency. It is legal tender in the Euro Zone, in the sense that all transactions, including the payment of taxes, have to be conducted in Euro.
- ◆ The “Special Drawing Right (SDR)” of the International Monetary Fund can in principle become a supra-national currency if the member countries are willing to make it legal tender in their respective countries, at least for certain purposes, for example, the payment of national and local taxes. The IMF must also be endowed with sufficient credible authority, power and resources to withstand a run on the SDR, in the event that some members demand redemption in terms of spendable national currencies. Otherwise, there is little incentive to hold SDR balances. (Is it possible to have such a world currency without a world government with some real power?)

A Supra-National Currency Approach

- ◆ With close exchange rate coordination among East Asian economies, it is possible that over time, a kind of East Asian monetary “snake” may emerge, anchoring on the Yuan and the Yen, which can become the basis for the evolution of an East Asian wide currency like the Euro.
- ◆ A world currency, as advocated by Prof. Robert Mundell, is of course also a possible solution. It can be created if major currencies, such as the U.S. Dollar and the Euro, are linked by fixed parities with one another. For example, if the United States and the European Union can agree to maintain a highly stable parity between the U.S. Dollar and the Euro, other economies will likely follow and more or less peg their local currencies to the U.S. Dollar-Euro. Then there is virtually a world currency.
- ◆ If the Yuan were to maintain a stable parity to the Euro, it may also induce other East Asian economies to maintain stable parities for their local currencies with the Euro, and this may encourage the U.S. to maintain stable parities (nominal or real) between the U.S. Dollar and the Euro.

The Importance of Protection of Purchasing Power

- ◆ Why do countries not trust the national currencies of one another? There are two major risks in holding another country's national currency: the first is the risk of devaluation relative to one's own national currency; and the second is the risk of a rate of inflation faster than that in one's home country (which can in turn trigger a devaluation, whether abrupt or gradual). The consequence is a loss of purchasing power of the currency held.
- ◆ These risks can be overcome if there is some form of exchange rate coordination among a group of countries such that either the relative nominal parities are maintained at stable levels, or better still, if the relative real parities are maintained at stable levels.

Exchange Rate Coordination within East Asia

- ◆ Thus far, the central banks of East Asian economies have been reasonably content holding on to their US\$ denominated assets, mostly in the form of U.S. Treasury and Agency securities. It is in the interests of the U.S. as well as in their own self-interests to do so. A flight from US\$-denominated assets by the East Asian central banks would have a disastrous impact not only on the U.S., through the rise in the rate of interest, but also on world financial markets, and ultimately would result in huge capital losses on the part of the East Asian central banks as well. It is therefore important that no one breaks rank, or others may follow, with predictable disastrous results.
- ◆ The East Asian economies collectively hold so much foreign exchange reserves (on the order of US\$4 trillion) that they are perfectly capable of stabilizing the relative East Asian exchange rates at reasonable, mutually beneficial and long-term sustainable levels as long as there is a common understanding and consensus.

Exchange Rate Coordination

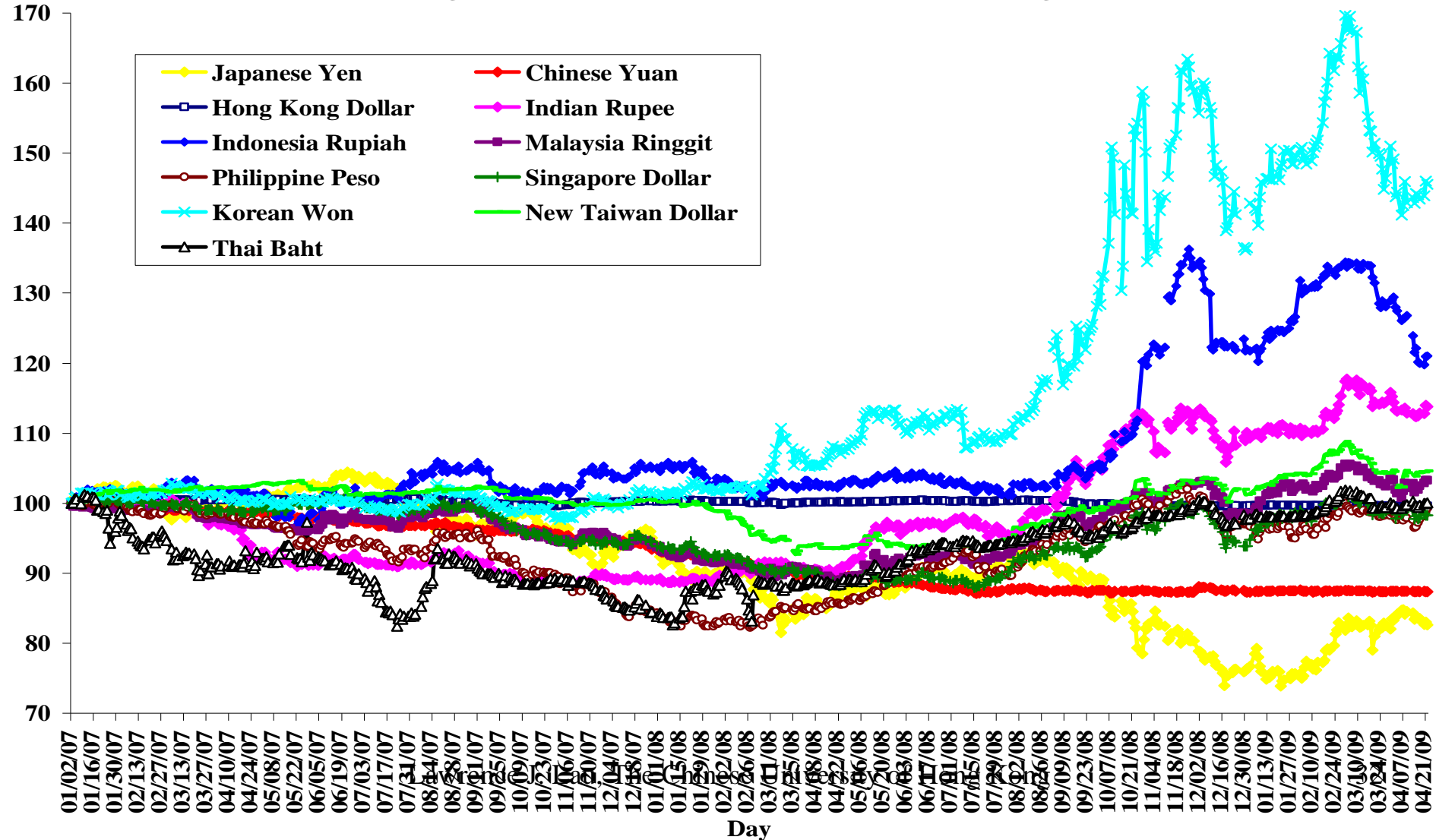
- ◆ There is also room for East Asian economies to coordinate their relative exchange rates for long-term mutual benefits. The basic principle is to maintain relative real parities, i.e., to maintain relative exchange rate levels after adjusting for the changes in the relative rates of inflation, so that in real terms, the relative competitiveness remains unchanged.
- ◆ Stable relative real parities facilitate international trade as well as international investments because they help to remove one major risk and enable long-term business development and planning.

Exchange Rate Coordination

- ◆ Without stable relative real parities among the exchange rates of currencies of different countries in a free trade area, the benefits of a free trade area will be quite limited, as for example in the European Economic Community prior to the birth of the Euro. Only with stable relative real parities can the benefits of a free trade area be maximized.
- ◆ One-time adjustments in relative exchange rates that are out of equilibrium due to special unique circumstances should be permitted. For example, the Japanese Yen is abnormally over-valued because of the unwinding of the carry trade and should be allowed to be adjusted downwards. The Korean Won is abnormally under-valued because of the withdrawal of foreign loans from Korea and should be allowed to be adjusted upwards.

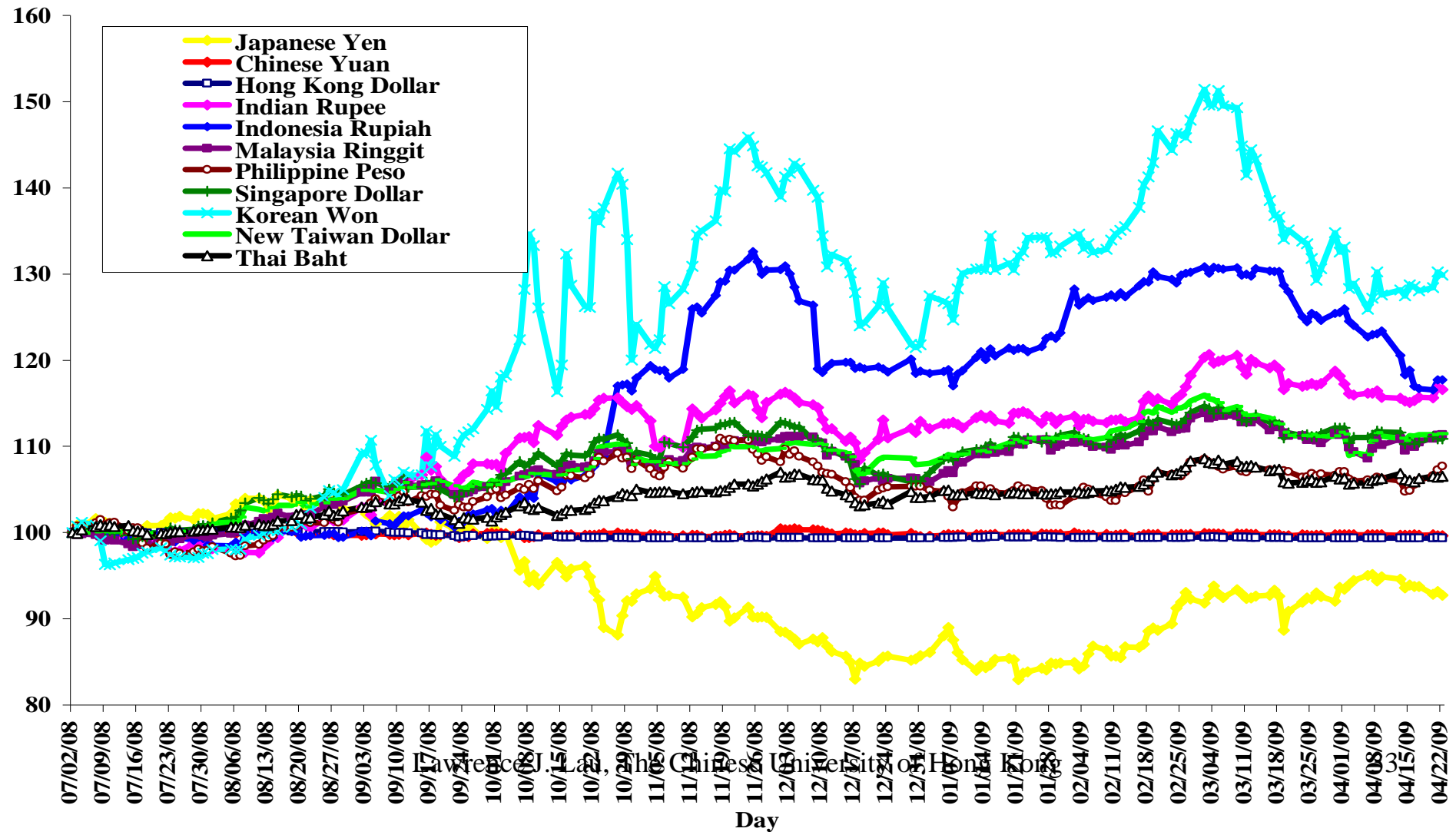
Exchange Rates of Selected East Asian Economies (1/2/2007=100)

Exchange Rate Index (1/2/2007=100) of Selected Countries/Regions



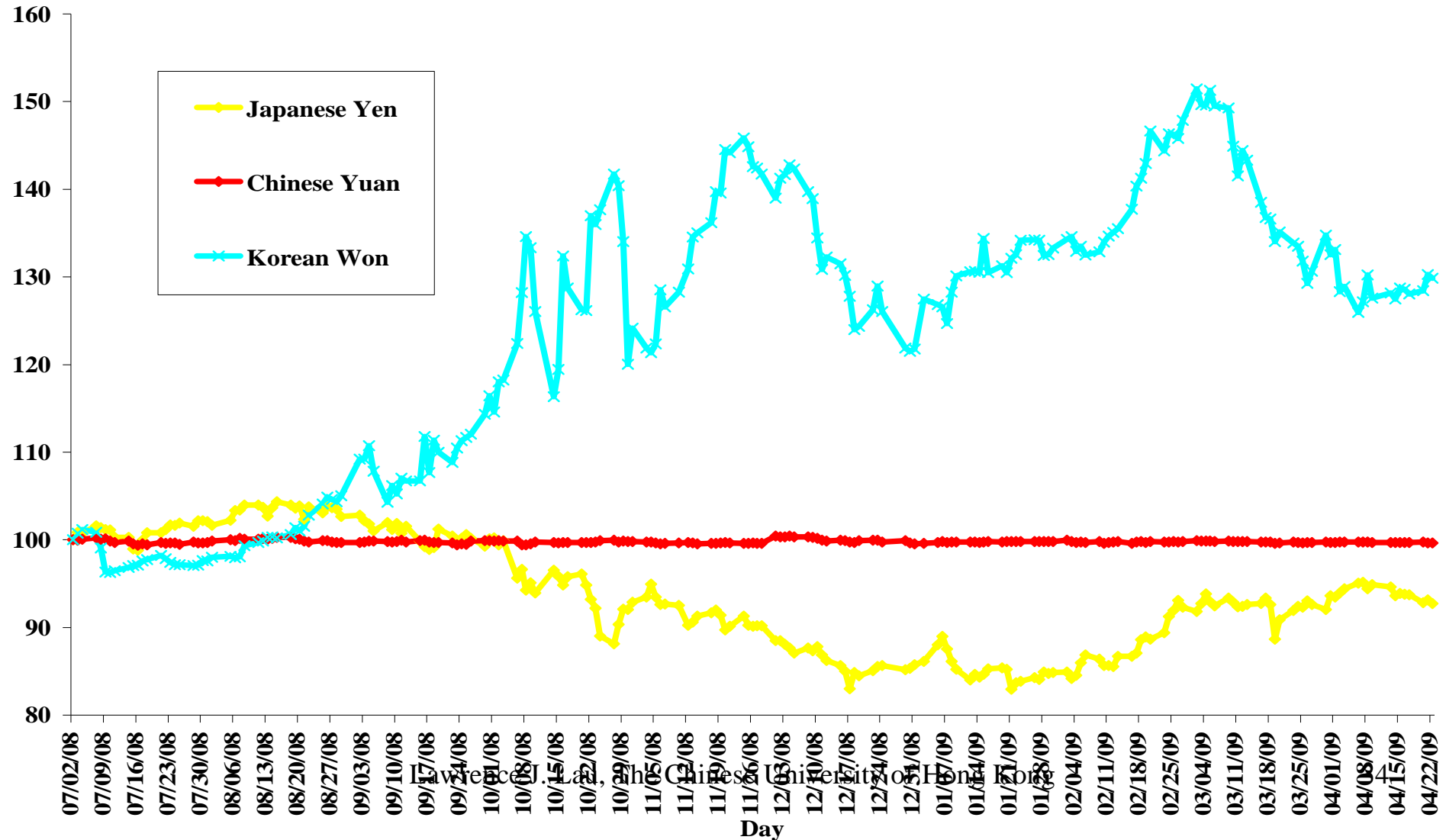
Exchange Rates of Selected East Asian Economies (7/2/2008=100)

Exchange Rate Index (7/2/2008=100) of Selected Countries/Regions



Exchange Rates of China, Japan and South Korea (7/2/2008=100)

Exchange Rate Index (7/2/2008=100) of Selected Countries/Regions



Exchange Rate Coordination

- ◆ Exchange rate coordination among East Asian economies, if successful, has one further advantage, that is, it facilitates the adjustment of the exchange rates of East Asian economies as a group vis-à-vis the U.S. Dollar or the Euro in the event of a serious disequilibrium.
- ◆ This is because individually and unilaterally, no one country will have the incentive to adjust the exchange rate vis-à-vis say the U.S. Dollar, either upwards or downwards.
- ◆ If a country devalues its currency, it knows and expects that every other country competing with it will also devalue and by at least the same percentage, so as to maintain relative competitiveness, and thus it will not gain any advantage in market share, but will wind up losing in terms of trade. So it will not devalue unilaterally.
- ◆ If it revalues unilaterally, it knows and expects that no other country will follow, so that it will lose in relative competitiveness and hence market share. So it will not revalue unilaterally either.
- ◆ The net result is that the existing relative exchange rate configuration is likely to persist for a long time, even though some adjustments may have become necessary or overdue.

Exchange Rate Coordination

- ◆ If there is a successful mechanism for exchange rate coordination, then the exchange rates of the entire group of countries can be devalued or revalued by the same percentage vis-à-vis the U.S. Dollar, so that the relative parities across the group of countries remain the same, and no one country gains or loses relative competitiveness. Such adjustments will be much more acceptable and can actually occur more frequently if needed.

A Multi-Currency Approach: An East Asian Bank for International Settlements

- ◆ Yet another option to a new global reserve currency is the introduction of new clearing and settlement mechanisms in the respective local currencies.
- ◆ The model is the Bank for International Settlements in the 1950s, when Western European countries were recovering from World War II and wanted to trade but did not want to accept and hold the currencies of one another.
- ◆ The Bank for International Settlements acted as a clearing and settlement centre where excess balances of other countries' currencies held by the member countries can be offset, using the Bank's own U.S. dollar reserves provided by the U.S. as its capital, if necessary.
- ◆ An East Asian Bank for International Settlements, backed by the central banks of China, Japan and Korea with capital and reserves, can be established to enable economies in East Asia to trade with one another in their respective national currencies.

The Near-Term Stability of the Renminbi-U.S.\$ Exchange Rate

- ◆ The near-term expectation is that the Renminbi—US\$ exchange rate will remain relatively stable—neither appreciating nor devaluing.
- ◆ Currently, everyone in the world has an interest in trying to restore stability in the markets—the fewer changes, the better.
- ◆ A revaluation of the Renminbi would require the selling of US\$ assets (including bonds and notes) and the buying of Renminbi by the People's Bank of China—such actions will help neither the U.S. nor China.
- ◆ However, as the Renminbi becomes much more widely acceptable, especially in East Asian economies, it may gradually supplement the U.S. Dollar as the currency of denomination in international trade in East Asia.
- ◆ China can play a significant role in this gradual evolution to an alternative sustainable framework for the conduct and settlement of international trade and capital transactions.

Concluding Remarks

- ◆ It is time to consider alternative clearing and settlement mechanisms that do not rely on the U.S. or for that matter any other country or countries running chronic trade deficits.
- ◆ In so doing, it is also possible to enable developing economies to begin borrowing (issuing bonds) in their own currencies, thus avoiding potential financial crises due to foreign investors or lenders withdrawing their capital.
- ◆ China can play a leadership role in these efforts by either providing guarantees, along with Japan and others, or maintaining a market for other currencies and bonds.