INTERNATIONALISATION OF CURRENCIES[1]

Against the background of calls by the Japanese authorities for a greater international role for the yen, this speech examines the benefits and disadvantages of the internationalisation of currencies, as well as relevant historical experience, before considering some specific issues concerning the role of the yen.

Introduction

I should like first to review a number of general issues relating to the internationalisation of currencies, then to examine some historical experience, and finally to consider various points concerning internationalisation of the Japanese yen in particular.

Perhaps I should begin by defining what I mean by internationalisation. I am not aware of any single, universally accepted, statistical measure, but as a concept I regard it as relating to the extent to which a currency is used as a vehicle for international trade, investment and financial management. A manifestation of more mature internationalisation is when the currency is used on a significant scale not only for transactions which are directly related to trade or investment flows to or from the issuing country itself, but also for transactions among third parties. One might also count as internationalisation the instances where one country's banknotes have to some degree displaced the local physical currency internally within another country.

Benefits of Internationalisation

What are the benefits that a country derives from its currency having become internationalised?

First, there may be enhanced status, but that is a rather ethereal concept. If it means simply enjoying more recognition as a country, it can do no harm, but equally may not result in any material benefit. More significant perhaps is the possibility that it may give the country a seat at various international negotiating tables which it might not otherwise have earned; but even then the benefits may be hard to discern in concrete terms.

Second, and more concretely, there are the benefits which might flow from having more of one's own international transactions denominated and paid for in one's own currency, because of savings on foreign exchange transactions and reduced foreign exchange exposures. It is difficult to know how much weight to attach to this factor. Some people argue that competition in banking ensures that the costs of transacting foreign exchange deals are minimal, and that the sophistication of financial markets and instruments nowadays is so great as to enable all foreign exchange risks to be readily hedged. However, switching currencies or hedging them will always incur some cost, even if only on a small scale, and in practice there may still be some circumstances when it is difficult or impossible to hedge in an optimal manner. Thus it is clearly advantageous at least to have the option of using one's own currency and so not having to worry about such things at all. I might note in passing that the elimination of such transaction costs is regarded as one of the principal benefits of the euro.

The *third* benefit is seignorage. In its purest form seignorage is simply the profit which accrues to the issuer from the physical currency issue (because the holders of currency are in effect holding obligations of the central bank or government on which no interest is paid). Internationalisation only adds to this in those cases where the currency itself circulates significantly outside the country. The United States is the prime example, with estimates that around two thirds of US banknotes may circulate outside the United States. The deutschemark has also seen significant external circulation in nearby countries of eastern Europe and the Balkans. And even Hong Kong earns some seignorage from the considerable circulation of its banknotes across the Mainland

1 This is an abridged version of an address by Tony Latter, Deputy Chief Executive of the Hong Kong Monetary Authority, to the International Finance Committee of Japan's Association of Corporate Executives (Keizai Doyukai) in Tokyo on 11 November 1999.

border. Of course, the profits from seignorage depend upon the level of interest rates, and have been lower on that score in the recent era of low inflation than they would have been had the higher inflation of some earlier periods prevailed.

All the examples of banknotes being used offshore are in cases where other countries have either been in economic turmoil or operate a non-convertible currency which makes the acquisition of a convertible foreign currency particularly attractive, whether legally permitted or not. The country issuing the desirable currency is just a passive supplier, since it does not determine the conditions which give rise to the demand for its currency. But the role is usually acquired only by the major currencies (overwhelmingly the dollar) and needs to be supported by adequate physical supply. It is notable that the US Federal Reserve goes to considerable efforts to ensure that there are sufficient quantities of US banknotes, of the right denominations, available for external shipment and that the distribution channels operate efficiently.

One could also count as seignorage, in a broader sense, any gains to the banking system from international usage of the currency, associated with additional demand for holding bank balances in the currency. Even in cases where many of the transactions relating to the internationalised currency occur offshore, there will be some final payments and settlements which can only be effected in the home country, through correspondent banks or similar channels. This reflects the fact that only the home central bank provides lender-of-last-resort liquidity to the money market, and finality of settlement in terms of central bank money can only be achieved there. Even if interest is paid on some or all of these bank balances, there will be a margin for profit which is akin to seignorage. And even if some of the banks involved are foreign-owned banks (which is not uncommon), the value added is still likely to benefit the local economy.

A final aspect of seignorage, also in its broader definition, is the lower interest costs on issued securities which the country may enjoy because of international demand for them that arises from the acknowledged status of the currency. This is most commonly viewed in terms of savings on servicing the government's own debt. For example, there is a fairly widespread presumption that the United States government has been able to fund the federal deficit over the years significantly more cheaply than might otherwise have been possible on account of the preference of international investors - foreign governments and private sector alike - for holding dollar instruments. However, the scale of any such saving defies measurement, since it is not possible to differentiate between the currency preference premium per se and other factors which may determine yields.

Disadvantages of Internationalisation

To set against those purported benefits, there are some potential negative aspects to internationalisation.

First, there is possible vulnerability. It is argued that because instruments denominated in an international currency are so widely held and traded, the exchange rate becomes vulnerable to shifts in international sentiment, which may not always have an entirely rational basis, with the result that the exchange rate and monetary policy become too much dictated by external considerations. A particular instance is where the currency is borrowed and sold short, thereby putting the exchange rate under downward pressure; the scope for such activity could be large for a freely convertible currency with plentiful liquid markets.

While I acknowledge that this argument has some validity, I think it is also possible to argue the opposite - that a broadly held currency attains stability through the large inertial mass of holdings that are acquired; on this argument it is the more narrowly held currency which is the more vulnerable to speculative pressures and the like. I don't think that one can reach absolute conclusions as to where the balance lies between these arguments. What is relevant is that a currency cannot become truly international until it is freely tradable, and at that point it becomes exposed fully to the vagaries of the market. Attempts to limit freedom in order to limit vulnerability will tend to impede internationalisation. And any perception that the authorities might be willing to impose restrictions at their own discretion to suppress vulnerability will have the negative effect - from the point of view of achieving or sustaining internationalisation - of limiting the attractions of the currency to international investors.

Second, a possible drawback of being in charge of a major international currency is that there may from time to time be pressures from various external sources, urging one to conduct monetary policy in ways which may not be in the best interests of one's own economy. The most obvious examples are the pressures which may have been felt, although rarely if ever conceded, by the US Federal Reserve on a number of occasions to hold down interest rates for the benefit of heavily dollar-indebted countries elsewhere in the world.

The Process of Internationalisation

Let me now turn to consider how internationalisation may occur or be nurtured, if that is what one wants. I believe there are three ingredients.

First, and rather obviously, the more prominent is one's economy in world output and trade, the more likely is it that the outside world has a transactional need for the currency and wishes to consider the currency when making portfolio decisions.

Second, at the microeconomic level, the financial infrastructure must be capable of supporting and encouraging usage of the currency. Under this heading fall numerous activities such as payment, clearing and settlement systems, communications, taxation, regulation, legal framework - in sum, all things which may contribute to speed, efficiency, reliability and user-friendliness of the currency and of instruments denominated in it.

Third, at the macroeconomic level, the currency must be set in a stable economic and political environment. This does not mean that the exchange rate or interest rates have to be fixed or even that they have to be predictable - few currencies can claim to have been in that position over the past thirty years. But it does mean that international businessmen and financiers should have confidence in the long-term stability and prosperity of the economy, and be confident that there will be no major directional changes in policy, such as imposition of capital controls or departure from the broad principles of market economics.

You might think that I should add a fourth ingredient for internationalisation, namely that there needs to be some innate desire on the part of central banks or other foreign investors to hold assets denominated in the currency. But in reality that sort of desire does not exist independently. Apart from instances where "desire" is in effect enforced by treaty or law, the desire of foreigners to hold a currency is determined endogenously by all the other factors which I have mentioned.

History of Internationalisation

Let me turn now to look at some of the history of so-called international currencies.

The *pound sterling* was the first currency in modern times to assume an international dimension, as a result of Britain's dominant position in international trade and investment in the nineteenth century. This economic strength both helped to develop London's role as an international financial centre, and was in turn aided by that development. In the first part of the twentieth century, the US dollar began to overhaul sterling, which was debilitated by the effect of two world wars. By 1945 the international reserve role of sterling could only be sustained by, in effect, locking in the sterling investments of Sterling Area countries, against the promise of privileged access to the London market to raise funds. Meanwhile there were severe restrictions in the United Kingdom on lending sterling to non-residents, and UK residents were prohibited from moving funds out of sterling unless such investment could be demonstrated as likely to generate a healthy and speedy return. There remained a market-determined international role for sterling as a vehicle for trade finance and as a home for voluntary investment by foreigners, but the overall standing of the currency was considerably diminished. Exchange rate crises of 1964, 1967, 1974 and 1976 were judged to be exacerbated or complicated by sterling's international role, so much so that an effort was then made actually to discourage other countries from adding to their official reserve holdings of sterling - in effect to de-internationalise the currency. But that policy did not last for long. Eventually, in 1979 all capital controls were abolished, since when sterling has been available to be freely bought or sold, borrowed or invested, by residents or non-residents alike. The UK authorities are nowadays largely indifferent as to what role the currency plays internationally. In fact, sterling now has only a very modest role as an international currency, compared to its dominant position a century ago.

What is significant, however, is that London has retained and expanded its role as an international financial centre throughout this period. This proves that you do not need to have a major international currency in order to perform as an international financial centre. There are other examples of this on a lesser scale elsewhere - such as Hong Kong. These centres have thrived because of the infrastructure, efficiency and expertise which they offer. At times they may have been helped by the slowness of other centres to modernise or by policies adopted in other countries which unwittingly drove business offshore - the prime historical example being "regulation Q" in the United States which placed a ceiling on deposit interest rates within the country and so led to the rapid development of the offshore dollar market - the eurodollar market - centred in London, during the 1960s and 1970s.

The *US dollar* owed its emergence as a major international currency initially to similar factors as did sterling - namely the strength of the US economy and its weight in global business. The position was consolidated when the dollar was the only significant currency to remain fully convertible after the second world war. Although other currencies became convertible over the subsequent years, the dollar has retained its dominant position, partly as a reflection of the continuing economic supremacy of the United States and partly because of the highly developed, liquid markets that exist in dollar instruments. Interestingly, usage of the dollar does not appear to have been discouraged by the quite wide swings which have occurred over the years in interest rates and in its exchange rate against other currencies; in the short term people have been able to use the liquid markets to profit from these movements as often as to lose, and in the long term the dollar has remained a secure investment and a universally accepted method of payment.

It is sometimes argued that the United States enjoys an unfair economic advantage because so much world trade, particularly in certain commodity markets, such as oil, is denominated in dollars. This is a position which the dollar has earned from its history as a highly respected currency. Yet the advantages of such a situation are less than those who envy it may claim. It does not follow that the United States somehow has control over these prices; they are set in real terms by the forces of supply and demand, and there is at most only some short-term inertia in dollar terms. And people from other countries who are entering into contracts based on these prices are usually able, through the financial markets, immediately to fix the prices in their own currencies, although there is, as noted earlier, a cost in so doing.

None of the currencies which have now merged to form the euro was previously a particularly significant international currency. The *deutschemark* was the most in demand for such a role, but the German authorities were never keen to facilitate it to any great extent. In fact their fiscal and regulatory regimes tended to discourage it. The euro, however, shows greater potential, since the Euroland authorities are happy to encourage such a role, and the combined market provides a certain critical mass of liquidity. Already, for example, international bond issuance in euro is running at a much faster pace than did the collective previous issuance in the component currencies. And the European Central Bank has put in place, in Target, a highly efficient real-time payments system. Investment in the different countries of Euroland is of course still subject to individual country credit risk, so there is not such a large, homogeneous, domestic base for the euro as there is for the dollar. Nevertheless, the euro seems set to take its place as a significant international currency, especially perhaps in the countries neighbouring Euroland or aspiring eventually to join the euro.

The one other currency which I ought to mention is the *Swiss franc*. Switzerland is a small country, but its currency was at one time disproportionately important as an international currency, albeit in the rather narrow sense of being a haven for savings, rather than as a major vehicle for international trade or fund-raising. Switzerland's record of political stability and economic prosperity was one factor behind the attractiveness of the Swiss franc, but so also was the tradition of banking secrecy, which eventually earned Switzerland a rather tarnished image. Moreover, the Swiss authorities found their domestic monetary policy frequently blown off course by inflows of funds, so much so that at one point in the 1970s they imposed taxes which effectively set negative interest rates on non-resident accounts. Nowadays the Swiss franc can hardly be described as a major international currency, but Switzerland has continued to have a thriving international financial services sector, including a focus on a number of specialist services such as private banking, while also being home to two of Europe's largest international banking groups.

It may not be possible to draw any firm conclusions from these experiences of other countries, but it is worth noting that none of them ever sought consciously to internationalise its currency and some of them actually took steps to discourage such a development.

Internationalisation of the Yen

Let me turn now to consider the internationalisation of the yen.

I find myself in agreement with most of the analysis and many of the conclusions of the Report[2]. It identifies a series of impediments, faced by non-residents in particular, to holding or managing yen-denominated instruments. Some of these have already been tackled, such as by reforms to withholding tax and the abolition of the securities transaction tax and the bourse tax, while others are being actively addressed, such as the mechanics of the repo market, real-time gross settlement and possible development of a strips market in government bonds. These and other recommendations, such as for further improvements to the bond market infrastructure and a review of accounting standards and bankruptcy laws, rightly - to my mind - put the spotlight on the fact that an efficient, modern, transparent and welcoming financial infrastructure is a pre-requisite for foreigners to make greater use of the local markets and the local currency. I would mention also the matter of information and transparency, which are relevant especially to foreigners contemplating investment in the corporate sector. There is a perception that corporate disclosure in Japan does not yet match the standards achieved in other leading markets; added to this, there is a language problem in that too little of the market-sensitive information that is released is available immediately in English. Consequently, international investors fear that they may miss important opportunities. This makes them hesitant to invest.

It is from improvements of this sort to the financial infrastructure that increased usage of the yen as a medium for trade and investment may follow.

The Report also raised important questions about macroeconomic balance, exchange rate stability and financial system restructuring in Japan, as preconditions for internationalisation of the yen.

From the point of view of prospective international holders of yen denominated assets, it is plainly important for there to be the utmost confidence in the banking system, not only because many investors will hold direct claims on individual banks as part of the liquid component of their portfolios and for transactions management, but also because all investors are at some stage dependent on certain key mechanisms for making and settling yen payments, which are in turn operated by and dependent on the banking system. The problems encountered by the banking system in recent years therefore need to be conclusively resolved before the yen can expect to realise its full potential on the world stage.

2 "Internationalisation of the yen for the 21st century - Japan's response to changes in global economic and financial environments"; Council on Foreign Exchange and Other Transactions, 20 April 1999.

As regards the exchange rate, I would not place so much emphasis as the Report does on yen stability, particularly if that were to involve holding the currency at some artificial rate which might be unsustainable in the long run. After all, international holders of US dollars have over the years seen quite marked swings in the exchange rate against their own domestic currencies or other major currencies, without having been deterred from holding on to, or adding to their dollar assets. What is, I believe, more important than the exchange rate is that there should be confidence in the economic management of the country for the long term. This means clarity of objectives, and consistency in the application of policy in pursuit of those objectives. If investors can, in consequence, be reasonably confident that the economy will grow steadily in real terms over time, without undue inflation, they will be sure of earning real returns, even if a positive return in any particular year cannot be guaranteed because of exchange rate movements.

As to the question of how to increase the usage of the yen for invoicing trade or for loans and investments, I believe that this should be left largely to market forces. The contribution of the authorities should be to facilitate the process by ensuring that the financial infrastructure and the macroeconomic environment are conducive, in ways which I have already enumerated. It is perhaps worth noting how this process has been developing for the euro. In Euroland many companies have been negotiating with their counterparties in non-euro countries to quote prices and settle accounts in euro; and usage is expanding because of the efficiency with which the euro can be used and because competitive pressures are steering parties in that direction. But the outcome is determined in each instance by commercial factors and negotiation, not by any formal regulations. The European Central Bank and national authorities may see themselves as facilitators of this process, but are in no way involved in forcing it.

A question has also been raised as to whether the yen could play a greater role than at present relative to the dollar in the foreign exchange market, through the development of more active bilateral trading of regional currencies, such as yen against Korean won. Once again, this is a matter for market forces to decide, but it must be acknowledged that the dollar enjoys an immense advantage as the long-established vehicle currency for the world's currency markets; the liquidity of the bilateral markets in the dollar is much greater (and hence spreads narrower) than the markets between pairs of non-dollar currencies; the dollar will not easily be dislodged.

Regional Issues

I should like to make two observations on east Asian regional issues. *First*, I doubt the suggestion implied by the Report that the Asian crisis of 1997 might have been less acute, if those currencies which had in effect been trying to sustain a peg against the US dollar had instead been pegged to the yen. My reasons are twofold. First, the crisis was not simply one about overvalued exchange rates, but about many other factors too, such as over-borrowing, weaknesses in the banking systems and lack of transparency. Secondly, to the extent that fixed exchange rates were responsible, it would have made little difference, except possibly as regards timing, if the fixing had been against the yen; it was weaknesses in the implementation of policies surrounding the pegged rates and not the particular choices of denominator which were largely to blame.

Second, a word or two about the idea of an Asian single currency. The preconditions for the establishment of the euro were that the component currencies were fully convertible and that the economic performance of the countries displayed very substantial convergence in terms of inflation, fiscal positions and interest rates. Assuming that a similar set of conditions would need to be satisfied in any move towards unification of east Asian currencies, I conclude that any such step is a very long way off, certainly beyond my working life. Even the conditions for operating a system of narrow bands of fluctuation amongst the currencies, which preceded the advent of the euro, do not yet seem to obtain in this region. Yet I am certainly not opposed to the principle of fixing exchange rates more closely as an eventual goal, provided that one is confident that alternative means of market-based economic adjustment in each economy are available. I need hardly add that constitutional questions regarding control of any proposed new system might also prove to be complex.

Conclusions

- There are some advantages (other than mere status) from one's currency being a major one on the international stage, but there are some potential disadvantages too.

- With regard to the internationalisation of the yen, I believe that most investors, fund-raisers, traders, etc around the world would welcome the prospect of another truly international currency, especially to redress some of the over-concentration on the dollar that exists at present.

- If the yen is to expand its role, this will come about as a result of institutional reforms at the microeconomic level - many of which are already being pursued - and by improved international confidence as to the coherence and stability of macro-monetary policy in the long-term context. The authorities can create the climate within which the currency's role can grow, but they cannot dictate whether, how or when it may happen. In any case, one may need to be patient: it takes time to build critical mass and to win the confidence of international investors who, as a group, are probably less adventurous than they are often portrayed to be.

- I would not expect or necessarily advise other countries in the region to hasten to relate their exchange rates more closely to the yen - or indeed to any other currency - but I would not rule out the possibility, years ahead, of moves towards narrow bands or even eventually a single currency; this might not be the yen itself, but in the same way as the deutschemark effectively formed the basis for the euro, so the dominant currency of the region would be likely to play a magnetic role in any move of that sort.

- Speaking for the Hong Kong Monetary Authority, we would welcome the evolution of more dynamic financial markets for the yen and a more prominent role for the yen on the world stage. There would then be increased effective choice available in financial decisions, and Hong Kong is a firm believer in market forces, competition and choice.