

The dollar, currency convertibility and Asian dollar settlement

Questioning the dollar as a reserve currency

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Weakening of the dollar and the US economy through the course of the current financial crisis has created some concern about the dollar's continued dominance as the primary currency of international business. Officials in China, Russia, and India have all recently spoken of diminishing the dollar's prominent position in their economies. In addition, the availability of intra-Asia dollar settlement systems and proposed settlement of trade transactions in other currencies have raised issues of the future of dollar-based settlements in Asia.

QUESTIONING THE DOLLAR

Dmitry Medvedev, the Russian president, said recently that the dollar system is "flawed" and that his nation's central bank was reducing its holding in dollars.

In May, Chinese president Hu Jintao and Brazilian president Luis Inacio Lula da Silva discussed plans to settle trade between the two countries in local currencies, bypassing the intermediary exchange to dollars. And The People's Bank of China (PBOC) has spoken numerous times of creating a new global currency and making the Chinese yuan totally convertible. PBOC governor Zhou Xiaochuan has argued that the continuation of the dollar as the de facto global currency will only exacerbate global trade imbalances, and that the dollar's status as the world reserve currency allows America to borrow too cheaply.

Zhou proposed replacing the dollar with the SDR (Special Drawing Rights), the currency composed of a variety of countries' currencies, created by the IMF in 1969. This



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plan would further allow for the creation of an IMF-managed, SDR-denominated fund into which dollar reserves could be exchanged for SDRs to allow nations (notably China) to reduce their dollar exposure. Brazil, India, and Russia have all spoken in favour of the idea, although who would govern and manage such a programme and the underlying currency is unclear.

Most of these initiatives and the accompanying rhetoric are coming from within the ongoing financial crisis. What will happen as Western economies recover?

HOW REALISTIC ARE THESE PROPOSED CHANGES?

A shift away from the dollar is seen by many as unrealistic in the foreseeable future, as to replace the dollar requires a viable alternative.

Given China's massive holdings in dollars and US treasuries, China has reason for concern, but globally, even in the current crisis, the dollar is seen as a safe haven and as the currency to purchase when liquidity is needed. And, although many predict that

intra-Asian trade will increasingly be settled in yuan in the next decade, it would take a major shift in Chinese policy to forgo its current control of the country's monetary and credit policies through the yuan by making it totally convertible. Further, the yuan has no bond or futures markets through which international traders and bankers could offset or hedge yuan currency risks. SDRs today account for only 1% of total global reserves.

Is the euro an option? While currently benefiting from the dollar weakness, and hence being the wrong time to register such a change, most observers of the euro cite the challenges of applying large country fiscal management to an assembly of struggling economies with wildly different challenges. So the short-term strength and medium-term issues imply the euro is not an appropriate reserve investment vehicle for a major part of national reserves.

Similarly, the current strength of the Japanese yen is in question for the medium-term due to the severe demographic issues in that country.

CAN THE MAJOR TRADING CURRENCY BE CHANGED?

Asian economies seem to be rebounding from the current crisis faster than, and somewhat independent of, Western economies. Asian domestic spending and investment appears sufficiently vigorous to offset the drop in spending on Asian imports in the US and Europe. Such market independence adds at least rhetorical weight to the idea of non-dollar trade. While consensus opinion has been that there will be no movement away from the dollar as the world's reserve currency any time soon, the persistence of the slowed

economy allows for at least the possibility that things could change more quickly than many anticipate. Already, some portfolio managers, even in the absence of a viable alternative, are beginning to advise investors to diversify away from the dollar in their holdings, noting a slip in its status.

The Chinese have begun to allow cross-border settlement in yuan on a very restricted basis in designated areas in China. And, earlier in the year, China enacted a series of currency swaps with central banks in a number of Asian and Latin American countries that would, theoretically, allow for trade that bypassed the dollar. Whether such initiatives signal serious change is not yet determinable, and major trading companies express the opinion that any material change will be slow.

Not least, most major commodity prices have been quoted in dollars for years, and partial change would be difficult to accommodate.

IS CHANGE IN RESERVE CURRENCIES FEASIBLE?

Even if there were viable alternative reserve currencies, Asia remains awash with dollars. Further, there is no way for Asian nations such as China to sell off any significant percentage of their dollar holdings without diminishing the value of those they continue to hold, making their own currency appreciate and their exports more costly on world markets. It is partly as a way around this problem that China proposes conversion of dollars into SDRs, but it is difficult to know what sort of timeframe is envisioned. One Chinese official stated that the yuan could be a reserve currency by 2020, a date that would coincide with China's plans for Shanghai to become an international financial centre. Many commentators fall in line with this, citing 10 to 15 years.

THE DOLLAR FOR THE FORSEEABLE FUTURE?

BNY Mellon believes the dollar will remain the single worldwide reserve and trade currency into any foreseeable future, even should there be undisrupted growth of the Chinese economy. We can imagine the yuan becoming a convertible, tradeable currency in Asia within a decade or two among China, the

Asean countries, and the other Plus countries, but, it is unlikely that it could replace the dollar or even serve as a second reserve currency within the next 20 years. Despite the financial crisis, and despite criticisms of the US around the world, the stability of the US - its 200-year history of peaceful democracy, and its history of predictable jurisprudence - remain salient points. Similarly, the separation of the Federal Reserve from the elected government has been shown to be a strength. In comparison, the yuan or the euro are untested currencies and seem improbable candidates to replace the dollar any time soon.

INTRA-ASIA SETTLEMENT

Several intra-Asia dollar settlement systems have been promoted, initially as a means to secure rapid processing of intra-Asia payments. These could be seen as a first or interim step toward non-dollar settlement. The ability to make local settlement might be viewed by some as a key element for cities such as Hong Kong, Singapore and Shanghai that hope to transform themselves into global financial centres. Also, Asian nations such as the Philippines want to control trade and currency issues on their own terms, in their own regions, and by their own rules.

However, the initial impetus for these systems – their speed to process payments – has already been removed by extending the opening hours of the US-based systems and accelerating their processing. A typical intra-Asia dollar payment can now be settled by CHIPS within seconds. Further, the commercial banks they rely upon to provide dollar clearing may face financial, structural, and other external challenges that supersede their ability to support provision of real-time gross settlement and provide payment finality. These issues could become increasingly acute as the number of dollar clearing systems increases. Instead of using the advantages of centralised clearing organisations (such as FedWire and CHIPS) with many participants, continual technology refinement and proven contingency support, and finality based on funds placed with the Federal Reserve, liquidity for both banks and corporations could become fragmented among multiple, distinct settlement systems and exposure and settlement risks amplified accordingly.

The real issue is the strength, reliability, and predictability of the governments, systems, financial institutions and infrastructures that will provide the means of settlement across multiple countries in Asia. One foresees risks associated with systems and infrastructure failures, inconsistencies of local laws and regulations and liquidity burdens placed on settlement institutions.

Also, money laundering standards vary across the region. Intra-Asian settlement on the books of a single institution or consortium might not be subject to the equivalent of the Office of Foreign Assets Control sanctions and scans, increasing the risks related to money laundering and other illegal uses of foreign currency exchange and decreasing world intelligence on these activities, as well as exposure to penalties by non-compliant banks.

Against this, CHIPS provides direct access to the international marketplace within seconds, global processing hours, a 96%-plus straight-through processing (STP) rate, and certain and effective risk management, backed by funds on deposit at the Federal Reserve and a consortium of reliable financial institutions across the globe. Recent, real-life stress tests have confirmed the capabilities of this system. CHIPS also provide value-added services such as remittance information, universal identification numbers, and the latest web-based management tools.

In short, we expect the dollar to remain as the primary reserve currency for the foreseeable future and dollar clearing through CHIPS as continuing to offer the safest and most efficient international settlement system, even for intra-Asia dollar payments. ■

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