Opening remarks

Már Gudmundsson[1]

Senior Deputy Governor Lee, dear colleagues, ladies and gentlemen

On behalf of the BIS, it gives me great pleasure to welcome you all to this seminar on currency internationalisation. We have organised the seminar jointly with our host here today, the Bank of Korea. I would like to express our deep gratitude to the Bank of Korea for the cooperation and the excellent arrangements they have put in place, especially Director General Yook and his team, but also Deputy Governors Rhee and Kim for their support and contribution to the programme. I would also like to thank my colleagues from the BIS Representative Office for Asia and the Pacific, Eli and Andy and their team, who have organised the event on our side. Professor Yung Chul Park and Bob McCauley also deserve credit. They got the ball rolling when Bob was still the BIS Chief Representative in the region.

As we told you when we invited you to this seminar, its purpose is to review experiences of economies with internationalised currencies in the Asia-Pacific region and to assess the prospects for further internationalisation. But we also asked the speakers to reflect on what they have learned about currency internationalisation since the outbreak of the international financial crisis. However, these are early days and it might be premature to expect us to be able draw the relevant key lessons in this seminar. First of all, the story is still being played out. We are in the process of collecting the data and analysing recent events. Secondly, and possibly more importantly, our vision might still be blurred by our pre-crisis views and assumptions, some of which might turn out to have been wrong.

Let me expand a bit on some of the questions that the crisis seems, to me, to have thrown up regarding internationalisation of currencies. In the immediate aftermath of the Lehman bankruptcy, cross-currency liquidity management of banks and other entities became very difficult as foreign exchange swap markets became severely impaired and there was a general scramble for dollar liquidity around the globe. The Lehman bankruptcy led to a major loss of confidence where concerns over protecting one's own solvency and liquidity led financial institutions around the globe to take action that, although rational from the standpoint of individual institutions, was disastrous for the system as a whole. Credit lines were closed, margin calls were made and all but the safest assets experienced fire sales. Emerging market assets experienced a sell-off as part of this process and funds were repatriated back to the United States in order to meet margin calls and repay debt.

In normal times, managing liquidity across currencies from countries with free movement of capital and relatively developed capital markets is not much of an issue. Foreign exchange swap markets can, in these conditions, be speedily used to change liquidity in one currency into another at spreads that closely reflect the differences in domestic money market rates in the two countries. In other words, the covered interest parity condition broadly holds. Vis-à-vis the US dollar, this relationship had shown periodic strain for most currencies since the financial turmoil broke out in late summer 2007, but broke down almost completely after the Lehman bankruptcy. There are probably several reasons for this, some of which have been analysed in BIS publications such as our *Quarterly Review*. Thus, for instance, we know that

[1] Már Gudmundsson was at the time of the conference the Deputy Head of the Economic and Monetary Department of the BIS but has since late August 2009 been the Governor of the Central Bank of Iceland.

European banks had, before the crisis, a structural imbalance where they had invested in longer maturity USD assets and financed them partly in USD interbank markets at shorter maturities. When these dried up, there was probably a scramble to get USD liquidity through foreign exchange swap markets with the result that they became dysfunctional as well.

This problem was significantly mitigated with the foreign exchange swap lines that the US Federal Reserve agreed with the ECB and other major central banks, especially after these became in some cases uncapped. But the problem was not confined to currency pairs involving the USD, and similar kinds of dynamics played out for smaller currencies in Europe vis-à-vis the euro, especially where banking systems had significant short-term foreign refinancing needs, or what can also be called rollover risk in terms of foreign currency. Similar stories can be told in this region.

In some cases, foreign exchange swap lines were granted vis-à-vis the dollar, the euro and the yen, and in some cases not. Where they were, it helped. And for some of the smaller players it might not have mattered that much which of the major international currencies they hooked onto in this sense, especially after the uncapped swap lines had been established.

In some sense, what we observed during this peak of the crisis was a run on cross-border banking operations. We know how to solve such problems domestically by letting central banks lend to markets and/or institutions through their almost unlimited short-run capacity to expand their domestic balance sheet. However, when it comes to foreign currency, your capacity to help banks to refinance the foreign liquidity that is being denied to them on the market is limited by the size of your reserves or the willingness of your big neighbour to help.

It seems to me that this experience raises several questions regarding the internationalisation of currencies, among which are the following:

1. What is the link between currency internationalisation and cross-border banking? It is clear, as pointed out by Professor Peter Kenen in his contribution to this seminar, that you can, in principle, have an international banking centre without having an internationalised currency. However, is that arrangement risky? In this regard, we have the extreme example of Iceland, where a cross-border banking system has collapsed, but it was built in a country whose currency could never become fully internationalised. However, it became partly internationalised for a while in the meaning that Hans Genberg gives to it in his paper, but has now been totally de-internationalised.
2. This raised the more general question of whether, as a consequence of the crisis and policy responses involving financial protectionism, we will see more widespread cases of de-internationalisation of currencies.
3. We have seen a kind of grading during the crisis. Cash is king, especially if it is USD cash. For a country in CEE, or Denmark, euro liquidity is almost as good. Does this mean that, even if it might be true in normal times that progress in payment technologies and such like makes it possible to have several fully internationalised currencies, at the time of reckoning we will always realise that they number less than four, even less than three, maybe less than two?
4. What does all this mean for the small- and medium-sized countries? Should they either encourage or at least not hinder the internationalisation of their currencies? Or is that risky, and should they rather consider whether to adopt an international currency through monetary union or to hook up with such a currency through some other means? What is the role of bilateral and multilateral foreign exchange swaps?
5. Finally, one of the underlying causes of the current crisis is the contradiction between globalised finance and national safety nets. If, as a result, banking retreats behind national borders, at least for a while, what might it mean for the

internationalisation of currencies? Or, put differently, what is the relationship between the global reach of your banking system and your currency?

Let us now get back to the agenda of the seminar. Even if we might not get a full grasp of the implication of the financial crisis, we will, in the course of the next day and a half, explore the issue of currency internationalisation from various angles through a line-up of excellent speakers. We will begin in the next session by getting a more general perspective of the issues involved. We will then proceed to analyse the cases of the euro and the yen before discussing the prospects for some of the other currencies in the region, in particular the renminbi, and the implications for regional cooperation. Tomorrow, we will first discuss some of the challenges for monetary policy of having an internationalised currency, and then discuss the lessons from the crisis and what the future might bring. I am very much looking forward to hearing what you have to say on all of these issues.

Thank you very much.