

# **Progress towards internationalisation: the Korean and Singaporean experiences – comments on Kyungsoo Kim and Young Kyung Suh’s paper “Internationalisation of the won” and Luke Goh’s paper “Singapore dollar’s evolution away from non-internationalisation”**

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## **Introduction**

Thank you for the invitation to comment on the views shared today by both our Korean and Singaporean colleagues. At first glance, both countries share important similarities – namely, they are relatively small and open economies which are highly dependent on trade. But particular attributes of each country’s trade differ remarkably. Korea’s relatively large share in international output stems from its sizeable real manufacturing and industrial base. Singapore, on the other hand, relies heavily on trade – imports and exports.

Both countries, however, have opposing views on internationalisation. The Korean stance is one favouring an active approach towards internationalisation. In fact, Kim and Suh (2009) state that “internationalisation of currency may be a strong instrument to cushion the adverse effect of external financial shock and should be considered as one of the top priorities in small open economies like Korea”. The Korean paper also states that “currency internationalisation is essential to a small open economy like Korea”.

At the opposite end, Singapore’s view on this issue has been clear: its long-standing policy of not encouraging internationalisation of the Singapore dollar stems from the Monetary Authority of Singapore’s use of the exchange rate as the principal tool of monetary policy. This reflects the view that, for a small open economy with a structure like Singapore’s, exchange rates play an important role in determining domestic inflation dynamics.

However, this policy has been revised numerous times to keep it updated and relevant, with greater liberalisation where warranted. The gradual lifting of restrictions, or removal of “speed bumps”, ultimately means that there is no longer a non-internationalisation policy per se, except for a remaining lending restriction on SGD to non-resident financial institutions.

The opposing views of the two countries – both small and open economies – and their respective policy choices raise numerous questions in terms of policy for countries with similar attributes, such as Thailand. A question that instantly comes to mind is whether a small and open economy with less than fully mature financial markets can have an internationalised currency.

The issue of currency internationalisation for emerging market economies immediately raises a number of important questions. First, assuming that it is indeed possible for a small and open economy to have an internationalised currency, how can we balance the costs and the benefits of internationalisation, particularly given that the benefits are uncertain?

And given this balance, are small and open economies willing to give up controllability of the exchange rate for the sake of the benefits which can be derived from internationalisation?

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Arguably, many of the costs mentioned in Kim and Suh (2009) may be less relevant if that country's currency is well accepted as an internationalised currency. But the road to such an end goal is long and uncertain. During that time, the country may become even more vulnerable to shocks which may arise from global capital flows, giving greater weight to potential costs in the meantime.

And, learning from these experiences, what does this imply for other small and open economies given this complete divergence in views?

Is it possible for a small and open economy to have an internationalised currency?

## **Feasibility of currency internationalisation**

The first question, therefore, is whether it is even possible for small and open economies – with relatively immature financial markets – to have an internationalised currency.

Kim and Suh concede that a country with an international currency should have a large share of world trade and world output. That implies that there should be widespread use of the currency outside the country's borders. Economic size gives a country market power, allowing it to dominate its trade in its own currency, thus forcing foreigners to take on exchange rate risk.

In terms of denomination of exports in local currency, there is a higher likelihood of exports being priced in an exporter's own currency the higher the exporter's share in that industry, and the more differentiated the export products are relative to competing foreign firms' products (ie a lower price elasticity of demand).

In addition, a larger economy is likely to support a larger domestic financial market, which should also be broader, in that it contains a large assortment of financial instruments, and deeper, in that it has well developed secondary markets. This also supports the use of domestic currency in pricing exports, given that the choice of currency as a medium of exchange will depend on the ease of buying, selling and hedging that currency for example, all of which is supported by a large financial market.

A factor related to size is the demand for that country's currency outside its borders, which in turn depends on market confidence and willingness to hold the currency. This is partially determined by the structure of trade – namely, how large a share that country's trade in goods and services has, as well as its financial presence, in international transactions. And, in addition to that country's own transactions, whether or not the volume of transactions denominated in that currency reaches a critical mass sufficient to push down transaction costs to make it competitive with other major currencies is a key factor in determining whether that currency is cost-effective in its use as a third, or vehicle, currency.

Another important aspect is the ability of the currency to serve as a store of value for non-residents. That ability depends on the confidence of non-residents in the value of the currency, namely its ability to keep its value in terms of other currencies and in terms of purchasing power over goods. This, in turn, is determined by a track record of low exchange rate volatility and a history of low and credible inflation, which themselves are supported by a credible central bank.

Finally, financial markets should be open, deep and broad. This implies institutional support for internationalisation, such that there are no institutional restrictions on foreign exchange trading and financing, while the breadth and depth of the financial markets may come about with a larger economy, as mentioned above.

Table 1

**Country share of world trade and world output**

Relative size of economy and financial markets compared to the United States

	<b>GDP</b>	<b>Bank credit/ GDP</b>	<b>Non-bank credit/ GDP</b>	<b>Stock capitalisa- tion/GDP</b>	<b>Bond capitalisa- tion/GDP</b>	<b>Trade/ GDP (%)</b>	<b>Capital flows/ GDP (%)</b>
<b>United States</b>	100	100	100	100	100	23	24
<b>United Kingdom</b>	18	336	68	93	28	39	155
<b>Japan</b>	33	225	46	55	116	29	16
<b>France</b>	17	200	41	61	64	45	54
<b>Germany</b>	22	257	52	32	51	74	42
<b>Netherlands</b>	5	364	74	73	71	115	86
<b>Switzerland</b>	3	357	72	165	43	93	167
<b>Korea</b>	7	202	58	42	48	75	18
<b>China</b>	20	...	...	30	19	65	13
<b>Singapore</b>	1	230	57	113	37	345	116
<b>Hong Kong SAR</b>	1	334	68	368	18	344	256
<b>Indonesia</b>	3	48	10	19	15	47	7
<b>Malaysia</b>	1	216	56	116	57	175	30
<b>Philippines</b>	1	66	15	23	18	74	13
<b>Thailand</b>	2	168	44	55	25	112	12

Sources: World Bank Financial Development Indicators; IMF, *IFS*.

Note: Table taken from Kim and Suh (2009).

Table 1 shows the relative size of regional economies compared to countries with major internationalised currencies. It also shows the relative size of financial markets and each country's trade and financial openness. We see that countries in the region generally satisfy only some of these conditions relative to developed countries.

**Desirability of an internationalised currency: benefits and costs**

The question that arises is how Asian economies rate in practice, in terms of the feasibility of internationalising their currencies. One important condition for an international currency to be well accepted is that it needs to be more competitive than existing international currencies, in terms of transaction costs in its use as a vehicle currency. In addition to volume of transactions, this also depends on the level of financial development, which rules out many regional economies with less than fully mature financial markets.

Other factors that increase a country's market power include the exporter's share in that industry and the degree to which the export products are differentiated, relative to competing foreign firms' products (ie a lower price elasticity of demand). If the above conditions hold, there is a higher likelihood that exports can be priced in an exporter's own currency.

In addition, a country that plans to pursue internationalisation needs to find a balance between the potential future benefits of internationalisation (and free capital flows) and current risks. These include risks to stability, given the level of financial development at present. At the same time, financial market openness entails a lifting of restrictions on capital account transactions and deregulation of the domestic financial system.

This also depends on the extent to which the country needs to maintain influence over the exchange rate, given the exchange rate's role in cushioning against external shocks. Such influence may range from minimising volatility to, as in the case of Singapore, having an exchange rate target. Moving towards internationalisation may lead to increased exchange rate volatility – not to mention increased speculation on the currency – complicating management of monetary policy. And in practice, exchange rates still play an important monetary policy role, particularly in emerging markets.

Assuming that it is feasible to pursue the path towards internationalisation, what then are the benefits of having an international currency? Kim and Suh lay out four important benefits.

The first benefit arises from the elimination of exchange rate risk in external transactions, ie the ability of exporters to denominate their exports of goods and services in local currency. The ability to do so will depend on factors mentioned above. But even if the internationalised currency catches on, exchange rate risk will only really be eliminated in the short term, in the form of the short-term elimination of “transaction exposure” to foreign exchange risk.

Over time, however, if the denomination currency is volatile and leads to exchange rate risk for the importing country, new transactions can and will always be repriced to reflect actual costs, including costs arising from exchange rate volatility, even if priced in domestic currency.

The second important benefit is the country's ability to access international financial markets without exchange rate risk – in other words, to issue debt denominated in domestic currency. This means overcoming “original sin”, the inability to borrow externally in domestic currency.

One possible downside arises if exposure to foreign capital flows leads to increased vulnerabilities to financial shocks from abroad. This, in part, depends on how confident investors remain about the country's prospects, and how fickle capital flows can be. Such downsides mean that the benefits of an internationalised currency may be less apparent in the case of emerging market economies.

A third benefit implied by the paper comes from the reduced incidence and severity of economic volatility arising from external shocks. Recent Korean experience has shown a withdrawal of foreign currency financing from emerging markets, which has led to heavy pressure on exchange rates and asset prices in those markets. This was particularly significant in Korea given its heavy reliance on external transactions. The incidence and severity of such shocks would undoubtedly be mitigated if debt could be issued in local currency, for instance.

Before full internationalisation takes place, however, incidents of this kind are likely to result in excessive volatility in the currency, which in turn places pressure on exchange rates and asset prices. This can be seen in Table 2, which shows that volatility in the Korean won has recently been high compared to the rest of the region.

Table 2  
**Actual volatility (%)**  
 (compared to USD)

Currency	Jan–Dec 2007	Jan–Dec 2008	Jan–Feb 2009
KRW	4.39	20.05	23.53
PHP	6.35	8.02	9.06
INR	4.81	8.16	10.04
JPY	8.78	14.85	16.63
MYR	4.17	6.32	7.62
THB	3.89	5.10	4.27
SGD	3.39	6.78	9.74
IDR	6.14	9.09	18.39
TWD	2.25	4.84	5.69
CNY	1.53	2.15	1.59

Sources: Bloomberg; Bank of Thailand calculations.

Finally, a fourth benefit identified by the paper is the reduced reliance on the central bank in its potential role as lender of last resort, as internationalisation eliminates the likelihood of a financial crisis caused by a sudden stop of foreign capital flows or external drains (capital flight, given risk aversion), which could otherwise place extraordinary demands on a central bank's funds. That would require massive amounts of foreign exchange reserves. Whether or not internationalisation would lead to a reduction in reserve holding in practice would depend on whether central banks are able to justify holding smaller reserves, given that their prime motive for holding massive amounts of reserves is caution and prudence.

On the other hand, an internationalised currency may mean costs for that currency's domestic economy. The most prominent cost of internationalising a currency is restrictions on the ability to conduct an independent domestic monetary policy, as monetary policy becomes less effective in controlling the exchange rate. This has implications for domestic activity and inflation, particularly in countries where the exchange rate plays a major role in determining inflation dynamics, such as Singapore.

Another cost arises from vulnerabilities to financial shocks from abroad, particularly for countries undergoing financial liberalisation. In this regard, Kim and Suh (2009) note that "in its early stages, internationalisation of the won may hinder rather than help the stabilisation of the domestic capital market". This risk is particularly relevant for emerging market economies with immature capital markets, which may face enormous risks in the process leading up to internationalisation of their currency by being fully exposed to global capital flows.

A country whose currency is internationalised may be at greater risk from the whims of foreign capital, thus exposing domestic investors to harm. For example, a sudden deleveraging (such as a systemic sudden stop) of foreign capital can cause drastic fluctuations in domestic asset prices.

This also applies to countries whose financial markets have been, or are being, liberalised. Recent crises that led to severe stress in financial markets in major currencies also resulted in sharp withdrawals of foreign currency financing from emerging markets and exerted heavy

pressure on exchange rates and asset prices in those markets. Korea has been one of the most affected emerging market economies given its heavy reliance on external transactions.

An internationalised currency's role as a reserve currency for other countries may also conflict with the desired exchange rate path for that currency. In particular, where the currency is used as a point of reference for other countries' exchange rates, other countries intervening in the reference currency usually take an opposite position to that of the domestic central bank (which is trying to prevent excessive appreciation of its currency).

Finally, another downside stems from concerns that lending to non-residents can lead to potential crowding-out of domestic borrowers, particularly during phases such as the current financial turmoil, which has placed strains on financial market liquidity.

The Korean paper raises an important question about the appropriate strategy towards internationalisation. It mentions that "it is important for developing countries to find a possible strategy for pursuing currency internationalisation that maximises the advantages while minimising the risks". But the underlying question is whether it is actually possible to actively pursue currency internationalisation, or whether countries can only encourage internationalisation.

For example, this distinction is clearly demonstrated in the difference between the Singaporean and Korean cases. In the case of Singapore, demand for the domestic currency internationally is a result of financial liberalisation and development, even though there was a clear policy of non-internationalisation. On the other hand, the Korean paper suggests that Korean authorities are making internationalisation of the won an explicit policy goal.

## **A regional approach to currency internationalisation?**

The Korean paper raises another interesting issue: given that the Korean won may not be easily internationalised in the short term, would it be possible to encourage regional use of the won – what the paper calls "regionalisation"? It is unclear whether financial markets would support a "regionalised" currency, given that such a currency would no doubt imply international linkages in any case. As a result, those linkages with international financial markets would place such a "regionalised currency" – the Korean won in this case – in competition with other established, major international currencies such as the US dollar and the euro, in terms of transaction costs and their role as a third (vehicle) currency. Even within the region, players would continue to use the US dollar, for example, if it was the more competitive currency.

This may reflect the fact that the world can have only a limited number of international currencies, given the critical mass required for transaction costs to be lowered to such an extent as to be extremely competitive. This implies that pursuing currency internationalisation is unlikely to be a strategy for all countries. Moreover, it may not be successful if a small open economy decides to go ahead with it alone, given that market forces will tend to favour established major currencies.

As an extension, a more successful option may be for the region to follow the path towards regional economic monetary integration in order to establish a regional currency. While this would not guarantee that the regional currency would be used internationally, it would draw upon many of the benefits of internationalisation mentioned above, such as helping to reduce foreign exchange volatility and costs of transactions within the region.

## Reconciling the Singaporean and Korean views

How, then, do we reconcile the two countries' opposing views? Both countries, having the characteristics of small open economies, may need to minimise risks arising from the exchange rate in order to facilitate international trade. At the same time, they should be able to reap some of the benefits that currency internationalisation should bring them, such as access to international financial markets in their own currency.

With regard to minimising exchange rate risks, the main difference is the way of minimising those risks, whether it is via control over the exchange rate, as in the case of Singapore, or by reducing the effect of exchange rate fluctuations on trade, as in the case of moving towards an internationalised currency.

At the same time, some flexibility may need to be accorded to exchange rates in order for them to play a role as a shock absorber for the economy.

Small open economies inevitably experience shocks of a real or nominal nature every now and then. The sources of these shocks can range from commodity prices to foreign capital markets and erratic domestic factors. In modern economies where the degree of trade and financial openness are continually increasing, the flexible exchange rate is believed to be an effective absorber of the unfavourable consequences of idiosyncratic shocks, as well as real shocks such as terms of trade shocks, productivity shocks and real interest rate shocks.

Internationalised currencies, on the other hand, rely on the widespread use of the currency to minimise exchange rate risks but allow exchange rates to be excessively volatile, given that exchange rate controllability is sacrificed for the currency's international role. The assumption is that the internationalised currency allows the country to command payment in domestic currency, hence cutting out the exchange rate entirely.

Box 1 Reconciling the Korean and Singaporean views		
Exchange rate target	Flexible exchange rate	Currency internationalisation
<ul style="list-style-type: none"> <li>Exchange rate as monetary policy tool</li> <li>Gradual liberalisation of "speed bumps" against lending to non-residents</li> <li>Emphasis on stability; compatible with financial liberalisation and robust financial and capital market development</li> </ul>	<ul style="list-style-type: none"> <li>Financial liberalisation</li> <li>Exchange rate allowed to act as shock absorber, but managed to prevent excessive volatility</li> </ul>	<ul style="list-style-type: none"> <li>Restricted ability to conduct monetary policy</li> <li>Exchange rate may be more volatile</li> </ul>

A possibility which reconciles both views, as reflected in the box above, is one where the exchange rate is allowed to move somewhat flexibly to act as a shock absorber but is managed by the central bank to prevent excessive volatility (while not resisting the trend). However, that arrangement may imply that all-out internationalisation may not be an option.

In order to reap some of the benefits of an international currency, however, increased financial liberalisation may allow improved access to international financial markets, without going to full currency internationalisation. As in the case of Singapore, financial liberalisation can be gradual, with the gradual lifting of restrictions against lending to non-residents, or the gradual removal of so-called "speed bumps", for instance. At the same time, there needs to

be an emphasis on stability, particularly with regard to financial liberalisation and ensuring robust financial and capital market development.

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