Comments on Yung Chul Park and Kwanho Shin's paper "Internationalisation of currency in East Asia: implications for regional monetary and financial cooperation"

Rizal A Djaafara[1]

I thoroughly enjoyed reading the paper by Professors Park and Shin, which not only reminds us of what qualifies a currency to be internationalised but also reviews the numerous costs and benefits of currency internationalisation as well as its implications for financial and monetary integration.

My comments on the paper are based on three elements, namely: the relationship between the internationalisation of a currency and domestic financial stability, particularly in emerging economies; the role of currency internationalisation as an external shock absorber; and, finally, I will touch briefly on the Indonesian experience in handling the issue of currency internationalisation.

The internationalisation of a currency and domestic financial stability

One conclusion drawn in the paper, with which I agree, is that the benefits of currency internationalisation remain uncertain and are often unquantifiable whereas the costs involved in increased domestic financial instability can be substantial. The latest fluctuations in the global financial market provide a stark illustration of the risk that could emerge as a result of currency internationalisation. The speculative element of exploiting financial innovation and imbalanced development among both financial and goods markets will exacerbate domestic financial market instability. Therefore, the clear priority of emerging economies, when considering a policy of currency internationalisation, is to fully prepare the market and domestic players beforehand. The benefits to be reaped from internationalising one's currency are not significant. In fact, it is clear that, in the short term, the currency would become an object of speculation.

The effects of currency internationalisation on the domestic money market have been well illustrated by a number of empirical studies regarding the influence of currency futures and options contracts in various countries. Jochum and Kodres (1998) argued that currency trading in futures and options contracts carries the risk of volatility in the spot market. In addition, studies such as those conducted by Clifton (1985), Chatrath et al (1993) and Crain (1995) demonstrated that currency trading in futures contracts spurs currency volatility in the spot market. A study by Kaziow and Arbaeus (2007) also showed that currency trading in the futures market leads to increased currency volatility, and that speculative trading on the futures market directly (day to day) raises currency volatility on both the spot and the futures market.

Such domestic financial instability risk is one of the primary considerations for Indonesia not to internationalise the rupiah. The domestic foreign exchange market in Indonesia is not yet mature and is vulnerable to speculation. Although pressures in the domestic foreign exchange market are not fully isolated, restricting currency internationalisation has helped to

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[1] Director of Center for Banking Education and Studies, Bank Indonesia.

minimise the fluctuations of the rupiah. I will discuss the development of rupiah internationalisation in more detail below.

The role of currency internationalisation as an external shock absorber

The risk of domestic financial market instability means that several areas would require strengthening before a currency could be internationalised. Professors Park and Shin argue that emerging economies should push forward to develop domestic financial markets that are broad and liquid enough to absorb external shocks before proceeding with currency internationalisation. In my opinion, their argument constitutes a step in the right direction.

However, lessons from the current global financial crisis have shown that broadening the domestic financial market does not fully absorb external shocks: the financial system is a shock amplifier rather than a shock absorber. It is true that sound financial system development contributes positively to economic activities. A more efficient financial system reduces the cost of capital for the corporate sector and improves household capacity in terms of consumption smoothing. But, on the other hand, financial innovation still has inherent risks and weaknesses. Jenkinson et al (2008) looked at five weaknesses that, in general, lead to market imperfection. These are: incomplete information; alignment of incentives; liquidity in financial markets; robustness of financial market infrastructure; and system dynamics. Such weaknesses can spark shocks in the financial market and quickly intensify strong pressures on macroeconomic stability, as can be seen occurring today.

The risk stemming from the financial system requires us to consider other qualifications to reduce the potential of the financial system acting as a shock amplifier during the introduction of currency internationalisation. I would argue that, in this regard, indicators of current account flows should be a complementary qualification in the pursuit of currency internationalisation. Conceptually, a dominant role of international trade in the balance of payment dynamics, and one which is elastically affected by the exchange rate, would optimise the role of currency internationalisation as an external shock absorber. This precondition strengthens the argument made by Professors Park and Shin that large volumes of goods and assets could facilitate the use of the currency as a unit of account.

Currency internationalisation and market integration

The success of currency internationalisation, determined by the more dominant role of trade volume in affecting externalities, is congruent with the idea of market integration. Currency internationalisation is, among other things, part of the necessary infrastructure in the implementation of market integration in East Asian countries. This infrastructure will supplement a number of other infrastructural aspects such as regional clearing and settlement systems, regional credit guarantee institutions, hedging facilities, and the establishment of regional credit rating agencies. This is clearly in line with Park and Shin's opinion that infrastructure construction will also need to be accompanied by the harmonisation of legal and regulatory systems, domestic clearing and settlement systems, market practices, rating standards, accounting and auditing practices, and withholding taxes on bond coupon payments across the countries in the region.

Regionally, currency internationalisation might be a future consequence of the establishment of the ASEAN Economic Community (AEC) in 2015. An ASEAN single market and production base will comprise five core elements: (i) the free flow of goods; (ii) the free flow of services; (iii) the free flow of investment; (iv) the freer flow of capital; and (v) the free flow of skilled labour. The accomplishment of these targets has far-reaching implications for

currency internationalisation in ASEAN because a solid infrastructure that facilitates the five core elements must be created. Although this economic union does not currently include monetary integration, the rise in regional trade/investment volume may require ASEAN countries to use their respective currencies as a regional medium of exchange, or at least to internationalise currency in the region.

The issue of currency internationalisation in Indonesia

Following the 1997 crisis as well as a series of short-term exchange rate shocks that could have led to unwanted macro and financial instability, the acceleration of Indonesia's economic integration in the global financial market has become a policy concern in Indonesia. As you might already know, the rupiah is freely convertible for capital account transactions as well as current account transactions and concomitantly permitted currency internationalisation. As a consequence, the rupiah has become a tradable currency in the international market. Ironically, the international use of the rupiah for export and import payments, however, has never been significant. Export and import invoices are primarily denominated in the major world currencies, including the US dollar, the yen, the Singapore dollar and the euro. For example, those four currencies have accounted for around 98% of Indonesian export and import payments in the past three years; thus, the internationalisation of the rupiah has been confined mostly to the financial market.

Our experience suggests that, in a liberal financial system, financial markets can be subject to self-fulfilling panic, especially in the presence of highly leveraged positions. In a segmented and thinly traded foreign exchange market, exchange rate movements are extremely reactive to any change in sentiment – especially negative issues – and are subject to manipulation and herd behaviour. Many episodes of excessive overshooting and extreme rupiah volatility cannot be explained by the domestic macroeconomic situation. Rupiah internationalisation provided an opportunity for non-residents to take advantage of this loss of confidence and to speculate on the offshore rupiah market. Speculative activity in the rupiah caused excessive exchange rate volatility and made it difficult for monetary policy to maintain rupiah stability, which had a negative impact on the overall macroeconomic situation.

Because of these problems, in 2001 Bank Indonesia designed policies to reduce the volatility of the rupiah exchange rate originating from foreign exchange trading without underlying economic transactions, while maintaining its commitment to a free foreign exchange regime. This regulation aimed to stabilise the rupiah by reducing the impact of rupiah trading by offshore players, without sacrificing real economic transactions and foreign investment.

The regulation consisted of two main parts, namely restrictions on certain transactions by banks to non-residents and limitations on derivatives transactions for non-residents with some exceptions. The regulation:

- prohibits banks from extending loans and other sources of rupiah funding to non-residents;
- limits banks from conducting derivatives transactions without underlying transactions for non-residents;
- prohibits banks from transferring the rupiah to non-residents without underlying economic activities in Indonesia.

We recognised that these restrictions do not automatically contain exchange rate fluctuations. There are many factors, including non-economic factors, that affect the value of the rupiah. As in most segmented and thin markets, as well as in the context of Indonesia's small, relatively open economy, the rupiah exchange rate is largely driven by external shocks. The ongoing global financial turmoil is an example of this condition. The

deleveraging process amid increasingly risk-averse behaviour on the part of global investors has triggered a capital reversal, exaggerated by the slowdown in export revenue.

Let me conclude by saying that, in the future, policy must heed efforts to deepen the financial market, cautiously, and must be mindful of the relative preparedness of institutions and domestic players. Preparations towards currency internationalisation are also required in Indonesia, in particular taking into consideration the prevailing direction of regional economic integration, which is the commitment of ASEAN.

References

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