# Muhammad bin Ibrahim: The dollar, the renminbi, and the evolution of the international monetary system

Welcoming remarks by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the SEACEN-OMFIF Policy Dialogue "The dollar, the renminbi, and the evolution of the international monetary system", Kuala Lumpur, 31 May 2017.

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Welcome to the SEACEN-OMFIF Policy Dialogue. I am privileged to be here as we assemble to exchange views, insights and perspectives on an interesting and contemporary issue. Indeed, the theme on "*The Dollar, the Renminbi and the Evolution of the International Monetary System*" not only has regional importance but also global implications.

The rules, institutions and conventions of the international monetary system are far-reaching. They shape the actions and behavioral responses of players in the global economy. It is for this *very* reason that I look forward to the diversity of views that will enrich our discussion on this topic today.

I shall provide some perspectives on the existing landscape of the international monetary system, the shift that is taking place and the possible implications for Asia. Although there are various elements of the international monetary system, I will focus on the interaction of currencies, particularly as the title indicates, on the dollar and the renminbi.

## Dollar Dominance

The US Dollar (dollar) is unequivocally the dominant currency in the international monetary system. Its influence is, no doubt, prevalent.

a. Firstly, in international trade, more than 40% of international trade settlement is invoiced in dollars despite the United States making up only approximately 20% of the global trade;
b. Secondly, for financial markets, more than 88% of foreign exchange trading involves the dollar;
c. Thirdly, on safe assets, more than 63% of the world's central bank reserves are held in dollars.

These three figures represent the present. However, the dollar has only been dominant over the last 70 years. To understand the present and to form expectations about the future, let us first take a look at the past.

Peering into history, numismatic records indicate that a few national currencies played important roles in enabling international trade. Ancient Athens issued the silver drachma in the 5th century B.C. It became the first currency circulated widely outside its issuing state's borders. This was followed by the Roman aureus and the Byzantine solidus coin in the 6th century; the Arabian dinar in the 7th century; and the Mediterranean currencies between the 13th to the 15th centuries.

From the 16th century onwards during the Age of Exploration, the Dutch, Portuguese, Spanish and British empires expanded their trading colonies, and with it, their currencies. It was not until the 19th century that national central banks and treasuries began holding gold as reserves. This development coincided with Britain's rise as a lead exporter and importer between the 19th and 20th centuries. Consequently, the British pound sterling became the de facto international currency of the modern age.

In recent decades, however, the prime position of the dollar has been unchallenged. Its surpassing of the sterling occurred in the 1920s, although many historians would ascribe the pre-eminence of the dollar as coming to the fore with the Bretton Woods agreement in 1944. Since then, the "dollar dominance" continued unabated despite the US experiencing various challenges, including the breakdown of the Bretton Woods system in the 1970s and the recession in 1981. Closer to present times, the dominance of the dollar continues to hold even after the Global Financial Crisis, the most damaging crisis since the Great Depression.

Although the privileged position of the dollar was not in question, the magnitude of its influence certainly varied across time. It was not linear, consistent nor smooth-sailing. In fact, over the past few years, it was a favorite past time of market commentators to call time on the 'reign' of the dollar as the world's reserve currency. A few candidates were cited to supplant the role of the dollar in the past, including the yen, the euro and recently, the renminbi.

## Necessity for Economic Rebalancing

In 1971, the US Treasury Secretary John Connally, famously said to the European finance ministers that the "dollar is our currency, but your problem". This statement had validity then, as it does now. For emerging markets in Asia, this braggadocio or arrogance rings true. This reality was starkly demonstrated during the Asian Financial Crisis in 1997/98, where the emerging Asian economies were at the mercy of "original sin". With the relatively cheaper dollar being the vehicle currency of the world, these economies became reliant on the dollar for its borrowings, despite proceeds being largely in local currency. The corresponding currency mismatch, evident during the AFC, made these economies vulnerable to shifts in capital flows. The impact of sudden stops were amplified, causing the currencies to devalue and the cost of servicing the external debt to escalate, leading to a vicious cycle of default and instability. Capital flows to the region went from a USD93 billion inflow in 1996 to a USD12 billion outflow in 1997. As a consequence, growth of the economies in this region contracted between a range of 16% and 10%, a big contrast to the robust growth of 7% in the period before 1998.

Since then, emerging Asian economies have learnt their lesson. The reliance on external financing was reduced. Sources of domestic financing were diversified through the development of the domestic bond market. Regional bond markets have expanded significantly. The region has replaced foreign currency borrowings with local currencies and addressed the inherent weaknesses in currency mis-matches in funding.

However, there are unintended repercussions. An open and well-developed bond market attracts non-resident participation and the diversity of market players is said to enhance market liquidity. However, we have discovered that beyond a certain threshold the presence of non-residents participation is a source of instability. The higher the participation of non-residents in the bond market, the more vulnerable the market is to volatile portfolio outflows.

So it is said that with history, if we learn it well, will not repeat itself. Nevertheless, sometimes lessons in history are cloaked in apparent success.

The 2008 Global Financial Crisis and corresponding policy responses by major central banks caused risks not seen before. In the periods after, unconventional monetary policy and a prolonged period of low interest rates had negative spillovers to emerging markets. This was notably evident through the waves of volatile capital flows in large magnitude. These flows were drawn by the search for yields, and ironically coincided with a significant expansion and development of our financial markets, a key reform measure following the AFC. The region was once again at the mercy of global easy money, flattered with an overvaluation of asset prices and domestic financial market exuberance. As these capital inflows mainly originated from the advanced economies, regional financial markets became increasingly exposed to their vagaries. Take the Taper Tantrum for example, which exemplifies how fragile the region's fate is when just a hint of the US Fed possibly tapering its asset purchases was sufficient to trigger massive capital outflows from the region.

Time and again, a clear policy lesson has come to the fore – the importance of diversification and the need to reduce reliance on the *de facto* reserve currencies to manage negative spillover effects.

The aftermath of the shifting economic tectonics spurred countries to strengthen regional and bilateral cooperation. The impetus for regional integration in ASEAN deepened, and efforts were made to strengthen the regional safety net through bilateral currency swap arrangements and the Chiang Mai Initiative Multilateralisation. At the global level, the G20 was made the premier forum for international economic cooperation and the leaders involved have indicated their commitment to reforming the international financial architecture.

Collectively, countries in this region are resilient with strong domestic savings, current account surplus and high international reserves. The strength and stability of this region could be further enhanced with increased regional cross-border investments, supported by a wide network of regional banks. While some central banks and sovereign wealth funds have taken the lead to invest regionally, the size of these cross-border investments in local currencies pales in comparison with investments in the dollar markets. Nevertheless, re-channeling savings into the region, albeit still small, is a welcome start.

## China: Roaring Dragon

The story of China's rise in the global economy is a remarkable one. Its integration and increasing influence in the global economy is becoming more pronounced. In 1990 its size was only 1.9% of the global economy. Now it constitutes close to 15%. Rapid growth of a staggering 9.4% between 1978 and 2012 led to this rise. In fact, if one measures the size of the economy by purchasing power parity terms, China is already the largest economy in the world.

China's ascent was in part due to its integration with the global economy, signified by its membership in 2001 to the World Trade Organization. It opened itself to the world, embracing globalisation. This new phase of openness to the global markets was evidenced by the shift from goods export to capital exports, the move up the global value chain by producing high-tech products, new business models such as cross-border e-commerce, and over the last few years, an evolution from being a net capital importer to a net capital exporter. All these further strengthened China's transformation from a manufacturing and investment based economy, to one based on services and consumption.

Economically, China is introducing a bold strategy to enhance connectivity within this region and beyond. The clearest example of this is the 'One Belt One Road' initiative that is adding to previous initiatives such as the establishment of the Asian Infrastructure Investment Bank and the New Development Bank.

The consequence of China's economic rise is the increasing use of its currency. This was further spurred by China's gradual internationalisation of the renminbi in 2009. Renminbi hubs have been established around the world, including in Malaysia, and a global payment, clearing and settlement platform for renminbi, namely the Cross-border Interbank Payment System (CIPS) is in the development stage. Six years on, an estimated one-third of all Chinese trade is settled in renminbi, making it the third most traded currency in the world after the euro and the dollar. It is also now ranked 5$^{th}$ as the world FX currency in trading value and 6$^{th}$ as a payments currency in value.

Given the steady internationalisation of the currency, the renminbi is expected to be on a gradual path to become a fully convertible currency, along with the emergence and expansion of major Chinese cities such as Shanghai, as formidable truly global financial centres. The ongoing accessibility to the domestic financial markets, if further accelerated, will set forth a virtuous cycle of development that will facilitate greater use of the currency.

Thus, should the internationalisation of the renminbi continue as expected, it will further cement its role as the influential currency for trade and investment, and some say, a path towards becoming one of the more significant global reserve currencies.

### What are the implications for Asia?

Using an analogy is apt in describing the implications for Asia. Japan, a country experiencing approximately 1,500 earthquakes a year, is finding innovative ways to support its structures. Instead of using steel and concrete, traditional materials to strengthen its structure, a Japanese textile firm is experimenting with carbon fibre rope-curtains, which are tough and pliant to earthquake-proof a building.

This will allow the building to realign itself when it is quivering during an earthquake. This company, Kengo Kuma and Associates, realising the potential risks from stress, also planted anchors around the structure to prevent the ground from rising up when the carbon-fibre curtain is activated.

Likewise, Asia should ensure it has its own ‘carbon-fibre curtain’ of policy adaptability and flexibility to manage destabilising movements in the financial system. Despite the inevitable diversification of de facto reserve currencies, the dollar will remain a significant force to facilitate global trade and cross-border capital flows.

Thus, it is of primary importance for Asia, in particular the emerging markets, to ensure that economic fundamentals are strong and financial markets are resilient with adequate buffers. At the same time, we need to continuously improve the necessary infrastructure for corporates, businesses and financial institutions to transact in a multi-currency environment.

Currently, cross-border trade within the ASEAN region are transacted and settled mostly in dollars despite almost half of ASEAN trade being intra-regional. It makes economic and business sense, that transacting in local currencies would enhance the efficiency of trade and investments, with strong probability of reducing the cost of doing business. In an environment of volatile market conditions, businesses will have more options to choose the currency to transact, providing flexibility and insulation from exogenous shocks. Greater usage of local currencies would be an impetus for the development of the region’s financial markets, consistent with ASEAN’s collective vision for an integrated cross-currency market.

Malaysia has been forward-looking in preparing for the inevitability of a multi-currency market:

i. We have diversified our international reserves into emerging market currencies in early 2000, including into renminbi assets. We were confident in the diversification benefits given the strength and sustainability of China and emerging markets’ economic growth. These new asset classes serve to reduce vulnerabilities and recycle some of the regional savings for the development of regional financial markets;

ii. Putting in the necessary supporting infrastructure is critical to facilitate the development and readiness of our markets to accept multi-currencies. This is the basic idea behind the signing of the currency swap arrangements with the People’s Bank of China and Bank of Korea to promote greater usage of renminbi and korean won ; and

iii. In December 2016, Bank Negara Malaysia signed Memorandum of Understanding (MoUs) with Bank Indonesia and Bank of Thailand to promote the settlement of bilateral trade and direct investment using domestic currencies. An established Operational Framework will pave the way for wider usage of local currencies in support of closer integration under the ASEAN economic community.

## Conclusion, the need to re-engineer the international monetary system

The current international monetary system needs to be re-engineered. Our past experiences have proven that the current system is unstable, prone to shocks and broken. Stakes in the international monetary system are far too high to be beholden to conventional thinking and status quo. Like Japan and its buildings, we must continue to find innovative ways to strengthen the structure of the international monetary system. Such re-engineering efforts may unseat us from our comfort zone. It will certainly invite resistance and may even cause some temporary disruptions. But standing still is the costliest option, as we would be stumbling from one crisis to another. In a sense, the work is cut out for us, we need to distrust the status quo or we will continue to live in a decaying, sub-optimal and dysfunctional system, punctuated with frequent financial crisis. The needed reform will mean less disruptive capital flows, more robust financial safety nets and most relevant of all, greater impetus for diversification that will lead to greater resilience. Now is as good a time as any to begin.

I wish all of you a productive dialogue. Thank you.