BANK FOR INTERNATIONAL SETTLEMENTS

More pluralism, more stability?

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Question, takeaways and roadmap

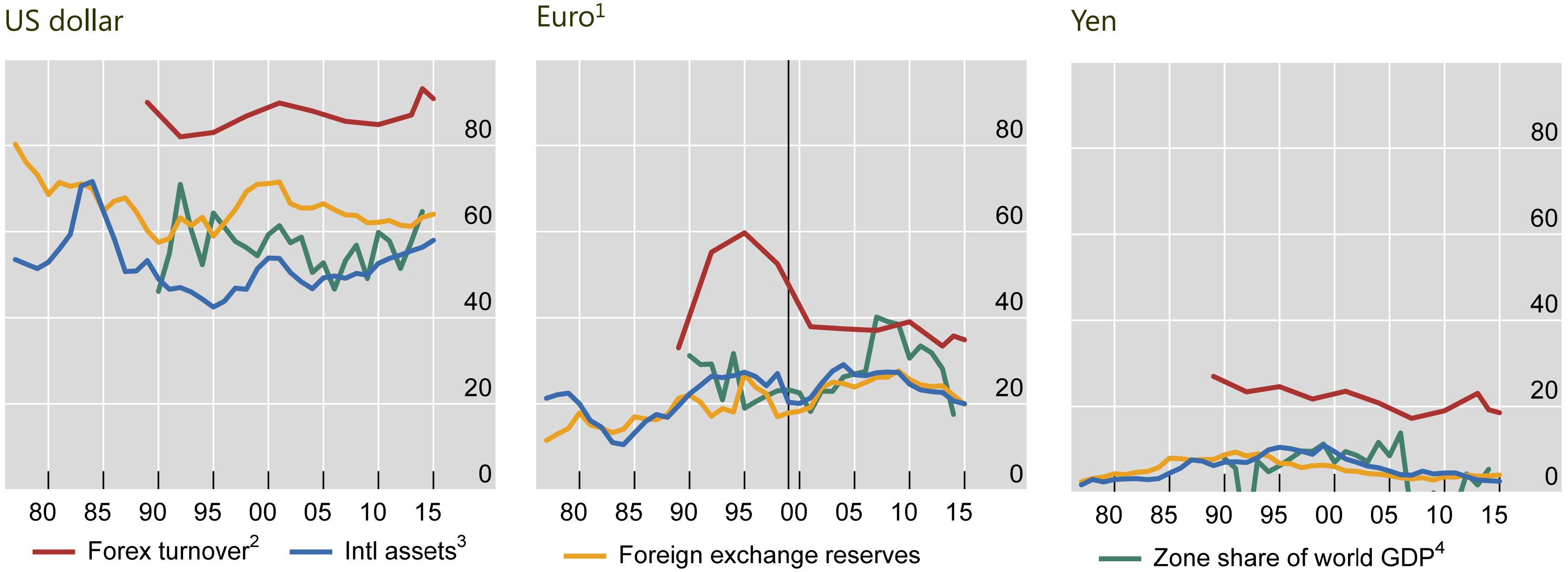
- Question:
  - Would more pluralism in international currencies strengthen the International Monetary (and Financial) system (IMFS)?
- Three takeaways
  - Dominance of one currency (USD) creates challenges
    - Imperfect coincidence of domestic and global interests
  - But not clear that more pluralist system would address IMFS key weakness
    - Inability to prevent the build-up and unwinding of hugely damaging financial imbalances (FIs)…
    - …thereby amplifying weaknesses in domestic policy frameworks
      - its "excess (financial) elasticity"
  - Progress requires stronger anchors at national and international level
    - We are quite a long way from that
- Roadmap
  - Document US dollar dominance in the IMFS
  - Consider the possible problems
  - Consider the possible solutions

I – The US dollar's dominance

- Not quite a monopoly, but US dollar's dominance is undisputable
  - Despite US's declining heft in world GDP
- Some facts
  - Close to 90% in FX trade; euro 33%; yen 23%; RMB some 2% (G 1)
  - FX intervention currency of choice, except for euro area's neighbours
  - Some 60% of FX reserves (2014); euro 20%; yen 4% (G 1)
  - Some 60% of "international claims"; euro 20% (G 1)
  - <u>About half</u> of non-US trade is denominated in USD; euro considerably less
  - Powerful gravitational force on other currencies
    - Dollar zone around 60%, euro 20% and yen distant third (G 2 & G 3)…
    - …influencing portfolio compositions (G 4 & G 5)
- This helps underpin asymmetric influence of US financial conditions on the RoW
  - US asset prices (eg, US bond yields) tend to lead those in RoW
  - US monetary policy (MP) strongly influences that elsewhere

Graph 1: The international roles of currencies: US dollar remains dominant

In per cent

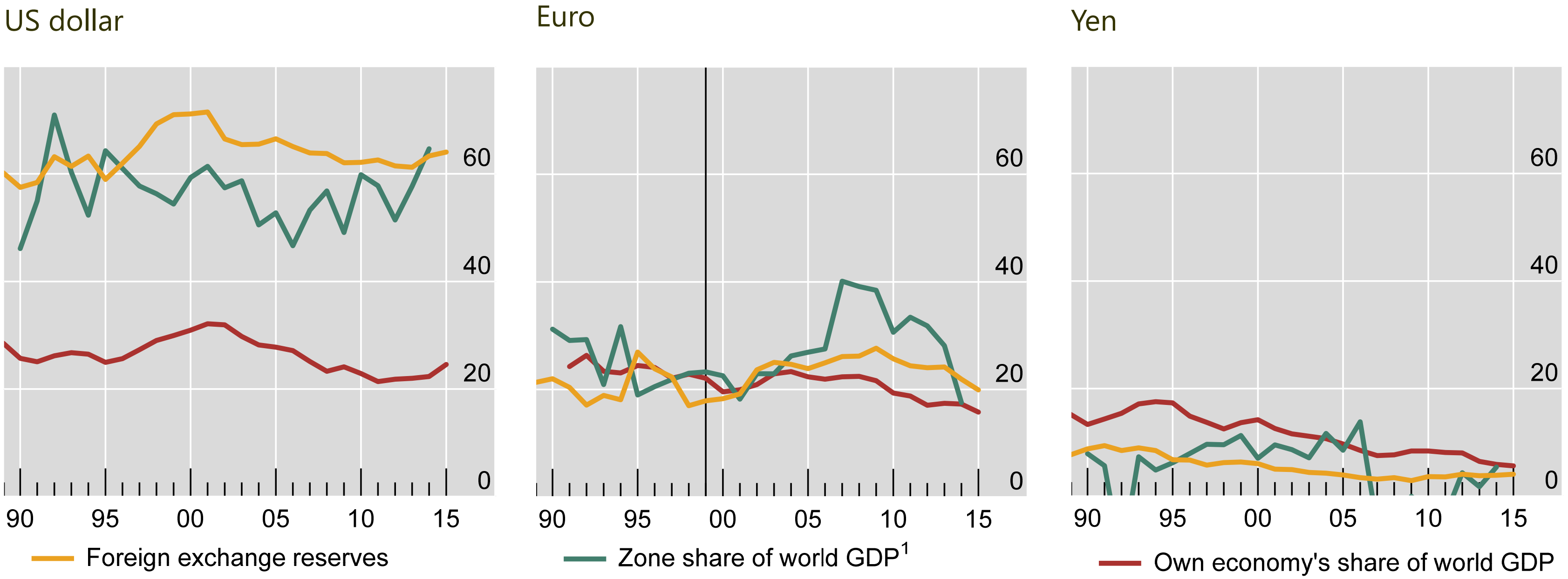


[1] Before 1999, "euro" aggregates available predecessor currencies. [2] The shares sum to 200% because each transaction involves two currencies. 2015 is estimated based on CLS trading data for February. [3] Includes bank deposits of non-banks and debt securities. Bank deposits are proxied by all bank liabilities before 1995. For the euro area, bank deposits exclude deposits vis-à-vis euro area banks. Debt securities are based on BIS international debt securities statistics before 1999 and the ECB's narrow measure of euro bonds since 1999, which excludes euro area residents' euro issues. [4] Estimated as each economy's share of PPP GDP, plus the elasticity-weighted share of all other economies' PPP GDPs.

Sources: ECB; IMF; CLS; Datastream; national data; BIS international debt securities statistics; BIS calculations.

Graph 2: Currency zones and global reserves composition: dollar punches above its weight

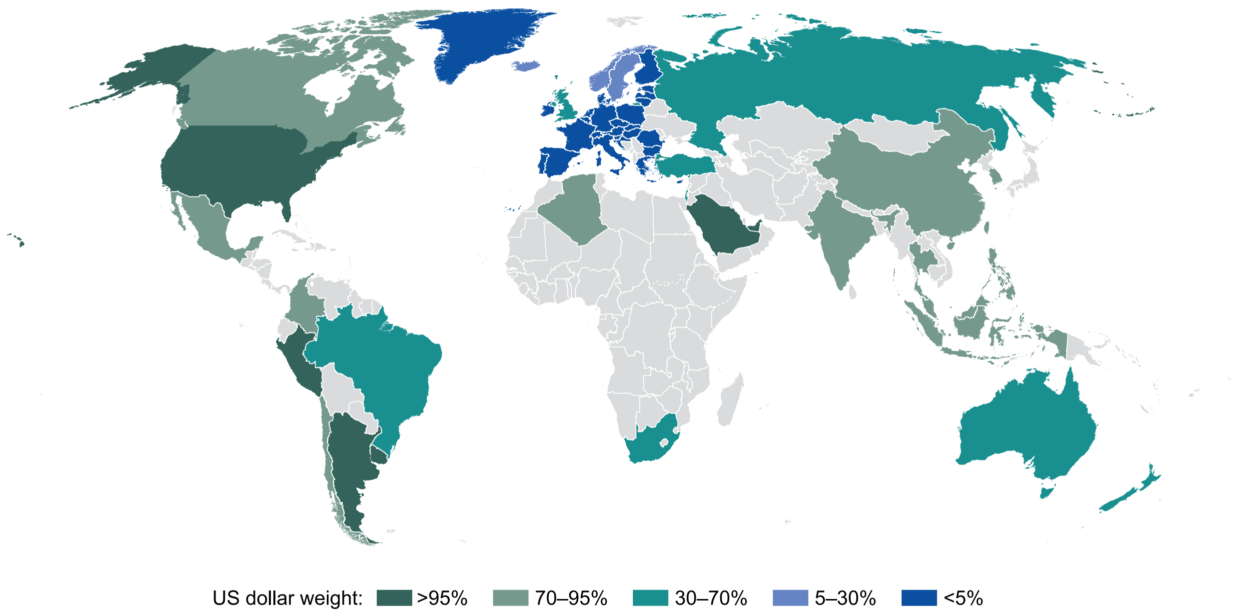
In per cent



[1] Zone share estimated as the own economy's share of PPP GDP, plus the elasticity-weighted share of all other economies' PPP GDPs. The elasticities are derived from a regression of weekly changes in the domestic currency/US dollar rate against a constant, and changes in the euro/dollar (prior to 1999, Deutsche mark/dollar), yen/dollar rates and the VIX, during the corresponding year. Negative values of yen bloc arise from negative coefficients on the yen that can be interpreted as reflecting use of the yen as funding currency in carry trades.

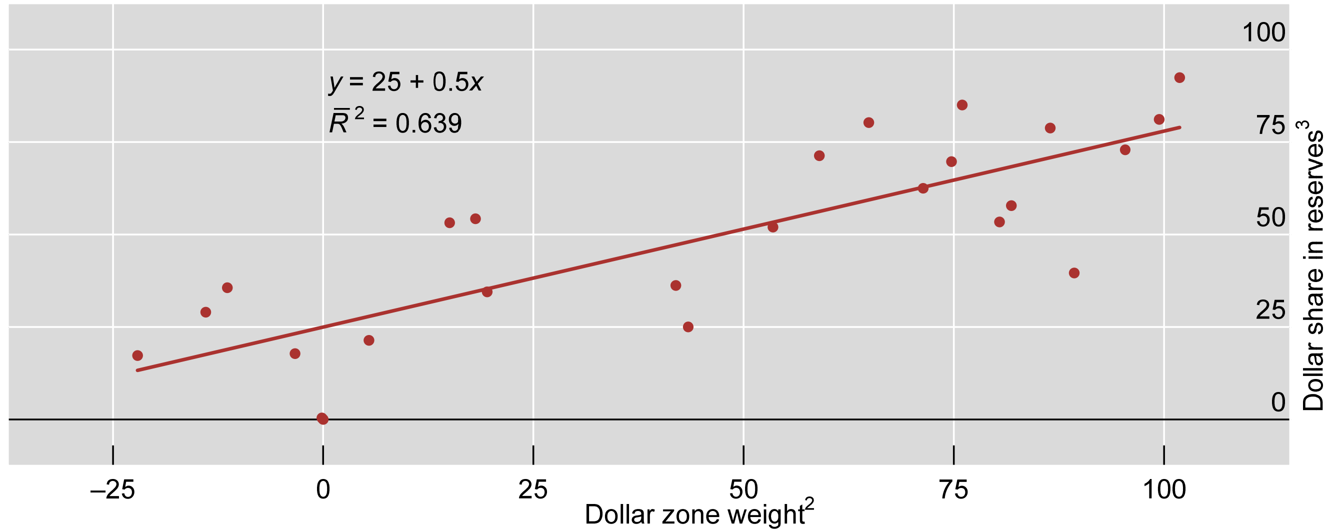
Sources: IMF; BIS calculations.

Graph 3: Shades of the dollar zone: more than half the global economy



Source: BIS calculation based on average elasticities of the national currency's dollar exchange rate with respect to euro/dollar and yen/dollar rates for 2011–14, inclusive.

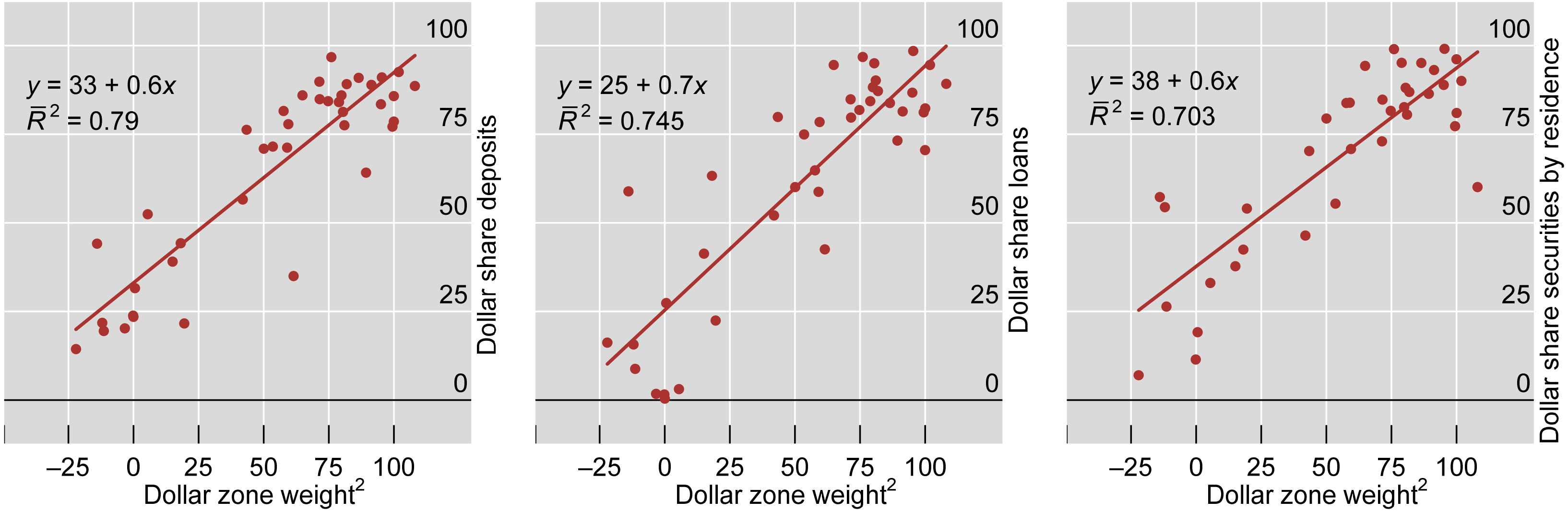
Graph 4: The dollar's pulling power influences FX reserves allocation[1]



[1] Country-specific dollar-zone weights plotted against the dollar's share in the country's FX reserves, 2014. [2] Average over four years. [3] For Colombia, New Zealand, Philippines and Turkey, earlier data used.

Sources: National data; BIS calculations.

Graph 5: The dollar's pulling power influences private sector portfolios[1]



[1] Country-specific dollar-zone weights plotted against the share of bank deposits, bank loans and resident's debt securities in the corresponding foreign currency totals, 2014. Includes the public sector. [2] Average over four years.

Sources: National data; BIS international debt securities; BIS locational banking statistics; BIS calculations.

II – Diagnosis: dominance, asymmetries and anchors

- Two concerns with dominance:
  - Country "projects" its influence on RoW, which cannot "insulate" itself
    - Given no coincidence of interests
  - (More specific) no effective anchor for macroeconomic stability
- **1. Variants of "Triffin dilemma"**: system's inherent contradictions ensure its demise and instability
  - Original Triffin: needed trade-driven growth of US short-term dollar liabilities (liquidity) eventually undermines confidence in USD convertibility into gold
  - Current account (C/A) version: C/A deficits needed to provide the RoW with dollar liquidity eventually make the US insolvent
  - "Safe asset" version: US fiscal deficits needed to provide internationally accepted "safe assets" eventually make US government insolvent
- **2. Variants of "exorbitant privilege"**:
  - High demand for USD-denominated debt weakens discipline…
    - Larger and more persistent fiscal and C/A deficits
    - Looser monetary policy
  - … which spread instability to the RoW

II – Diagnosis: three propositions

- **P1:** "Strong" forms of Triffin dilemma are debatable
  - Popular C/A version is incorrect
    - USD liquidity can be produced <u>regardless</u> of US C/A position
      - Growth in balance sheet size (assets and liabilities) – like any bank
      - Creation of USD claims occurs also entirely outside the US
        - What matters is soundness of corresponding balance sheets
  - "Safe asset" version points to a valid tension but goes too far
    - Overestimates precautionary motive in FX reserves growth
    - Underestimates possibility of reducing liquidity needs at source

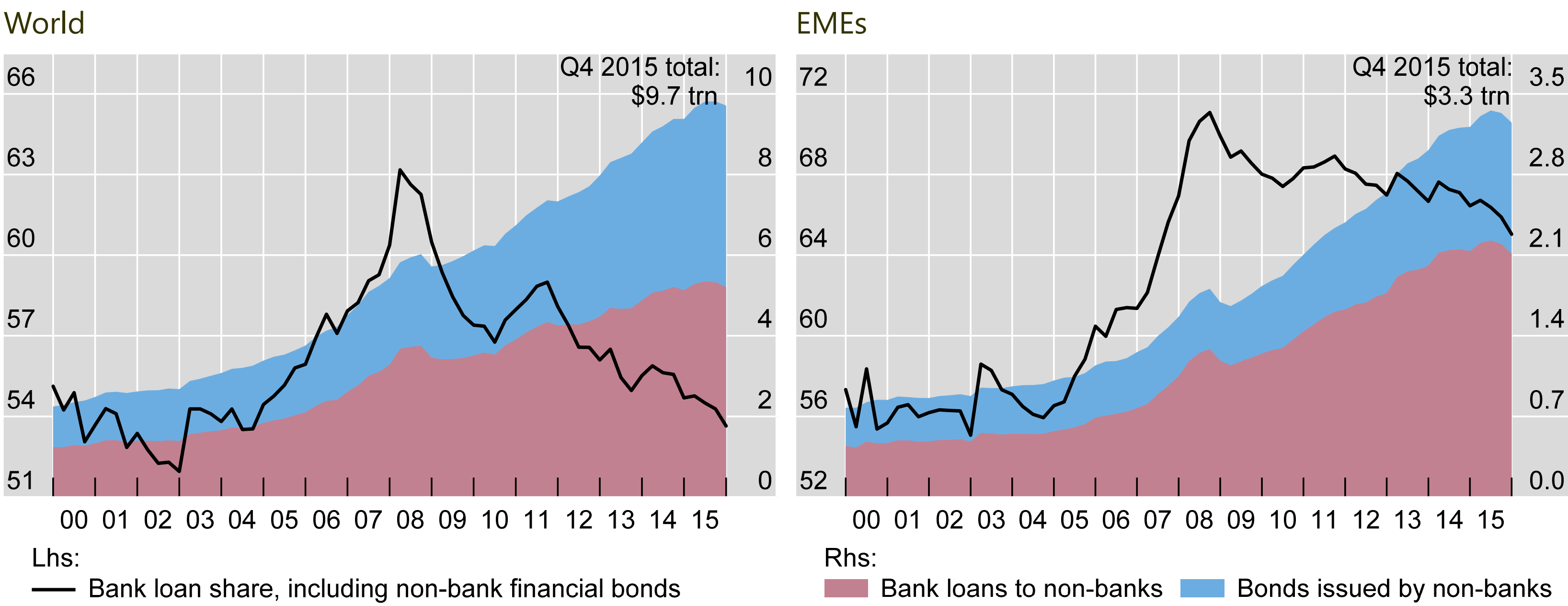
- **P2:** The privilege exists but is not at the root of the problem
  - Countries that borrow in domestic currency share some of US features
  - Main question is how to establish strong anchors in national economies
    - If countries individually follow the "right" policies, gains from global co-operation are less significant
    - But what would be adequate anchors?
    - Need to understand the Achilles heel of the IMFS

II – Diagnosis: three propositions (cont.)

- **P3:** The IMFS amplifies key weakness of domestic monetary and financial regimes
  - Inability to prevent financial booms and busts (financial cycles)
    - Leading to serious financial strains and macroeconomic dislocations
  - Domestic MP regimes pay little attention to the build-up of FIs
      - Easing bias spreads from the core economies to ROW
    - Directly: reach of international currencies – esp USD dollar – beyond borders
      - Huge expansion of USD credit to non-residents post-crisis (G 6)
    - Indirectly: through policymakers' resistance to unwelcome currency appreciation
      - Interest rates kept lower than otherwise & FX reserves balloon
        - Easing begets easing
        - Increase in reserves not so much precautionary but by-product
      - Hence global monetary conditions have ben exceptionally easy (G 7)
  - Interaction of financial regimes reinforces and channels these effects
    - Through free mobility of capital across currencies and borders
      - External funding typically amplifies domestic credit booms
      - Exchange rates tend to overshoot
- Bottom line: build-up of vulnerabilities in EMEs (and not only) post-crisis
    - Confluence of domestic financial booms and ample global liquidity
      - Signs that both may be turning

Graph 6: Dollar-denominated credit to non-banks outside the United States surges[1]

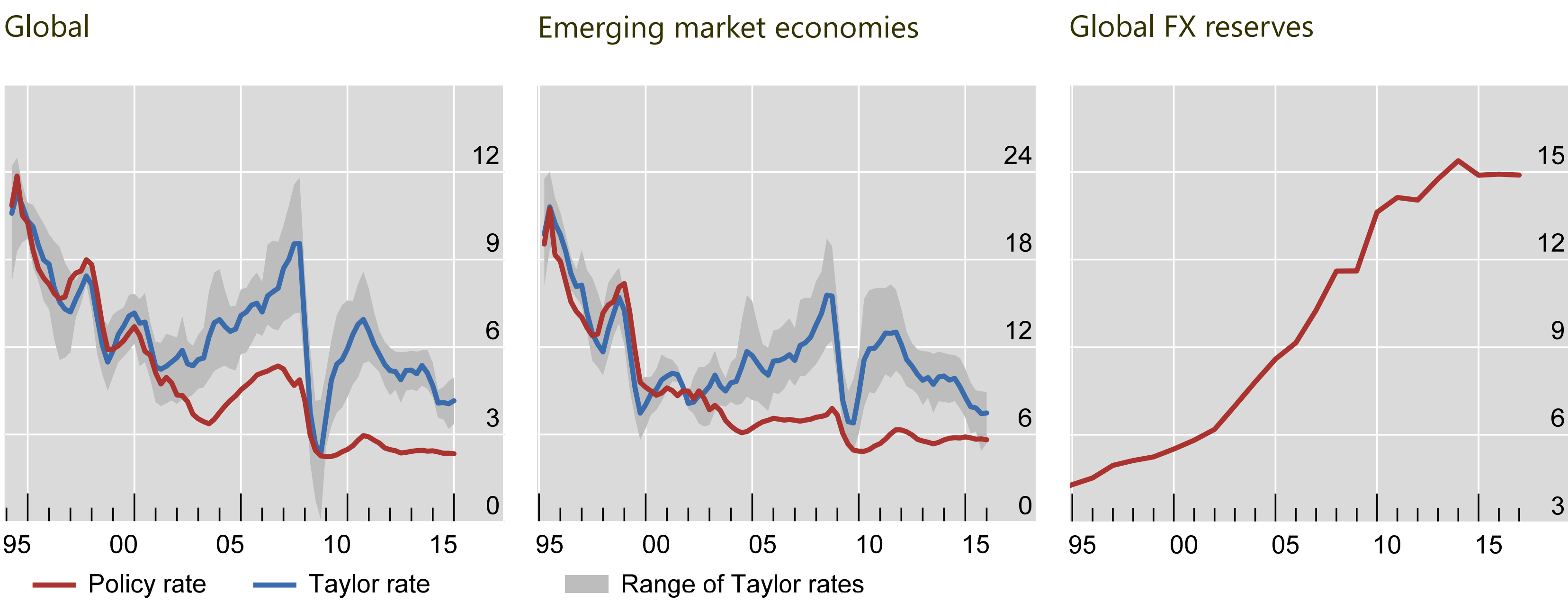
Amounts outstanding, in trillions of US dollars



[1] Non-banks comprise non-bank financial entities, non-financial corporations, governments, households and international organisations. [2] Loans by LBS-reporting banks to non-bank borrowers, including non-bank financial entities, comprise cross-border plus local loans. For countries that are not LBS-reporting countries, local loans in USD are estimated as follows: for China, local loans in foreign currencies are from national data and are assumed to comprise 80% USD; for other non-reporting countries, local loans to non-banks are set equal to LBS-reporting banks' cross-border loans to banks in the country (denominated in USD), on the assumption that these funds are onlent to non-banks.

Sources: Datastream; BIS debt securities statistics; BIS locational banking statistics.

Graph 7: Very accommodative global monetary conditions[1]



[1] Weighted averages based on 2005 PPP weights. "Global" comprises all economies listed here. Advanced economies: Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. EMEs: Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Singapore, South Africa and Thailand.

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*; Bloomberg; CEIC; Consensus Economics; Datastream; national data; BIS calculations.

III – Possible solutions

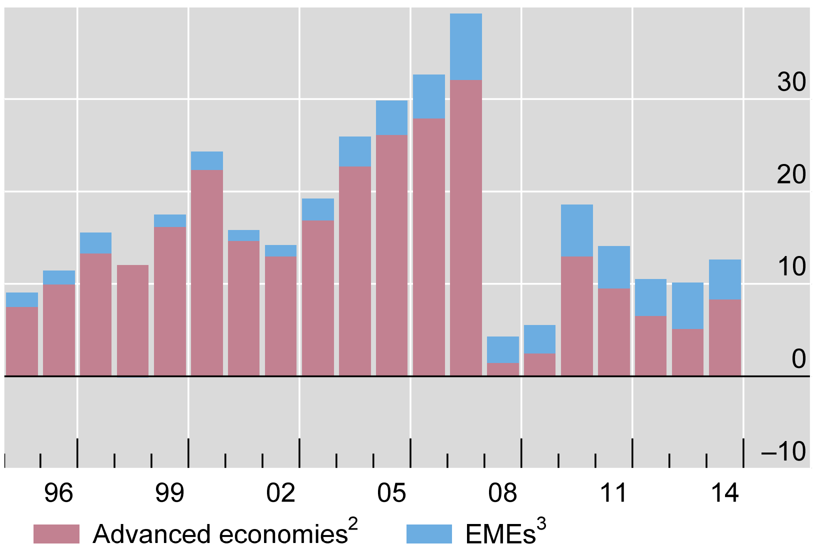
- **S1**: Not clear that greater pluralism is the key answer
  - Might induce greater discipline on dominant country
  - But would not address the problem of the global anchor
    - eg race to the top or race to the bottom?
    - eg putting the SDR at the system's centre would be no solution per se
      - Would still leave open question of what anchored the SDR

- **S2:** Solutions should focus less on addressing <u>C/A</u> imbalances and more on <u>financial</u> imbalances
  - Focus more on gross capital flows (and corresponding stocks) than net
    - Net are the tip of the iceberg (G 8)
  - In some cases, focus on C/As could even be counterproductive
    - Beware of recommending expansion in C/A surplus countries exhibiting FIs
      - eg Japan in late 1980s; China post-crisis

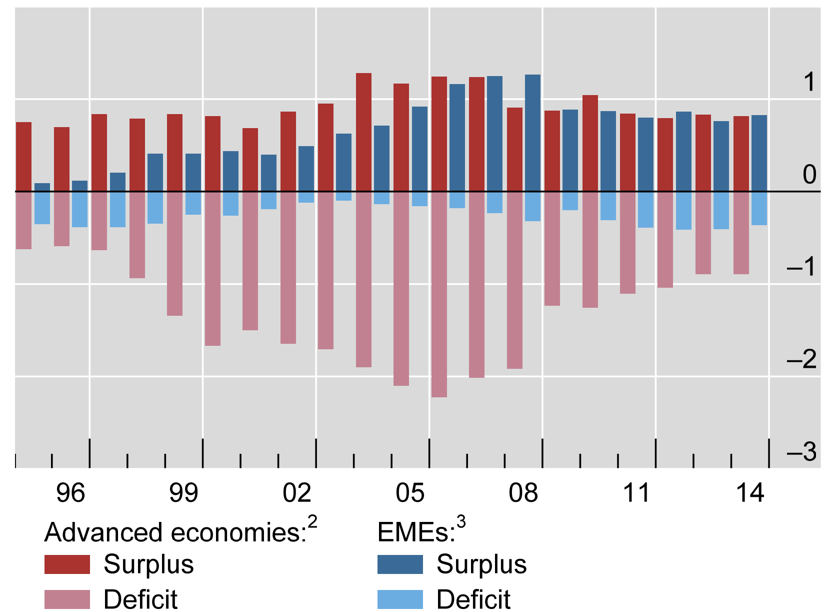
Graph 8: Gross capital flows dwarf current account balances

As a percentage of world GDP

Gross capital flows[1]



Current account[4]



[1] Gross flows equal the sum of inflows and outflows of direct, portfolio and other investments and change in reserve assets. [2] Australia, Canada Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. [3] Emerging Asia: China, Chinese Taipei, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. Latin America: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Other: the Czech Republic, Hungary, Poland, Russia, Saudi Arabia, South Africa and Turkey. [4] Both advanced and emerging market economies are sorted into surplus or deficit each by the signs (positive or negative, respectively) of their current account balances.

Source: IMF, *World Economic Outlook*.

III – Possible solutions (Ctd)

- **S3:** Solution requires stronger anchors for domestic regimes and their interaction
    - An ounce of prevention is worth a pound of cure....
  - Domestically: tackle more systematically financial booms and busts
    - Combination of monetary, prudential and fiscal policies
      - key: more symmetrical over booms and busts
  - Internationally: better internalise spillovers and spillbacks
    - Three possibilities (increasing degree of ambition)
      - Enlightened self-interest
      - Occasional coordinated measures
      - New rules of the game to ensure greater discipline at national level
- Where are we?
  - Still a long way from a satisfactory solution
    - Advanced in prudential policy but not much progress in MP
  - Pre-condition: greater consensus on diagnosis
    - Put FIs at the core of the issue
  - Stakes are high
    - Important to reach consensus on diagnosis and solutions

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