28/08/2023

Summary of the workshop on "Recent Developments and Future Prospects of the International Monetary System''

Hong Kong, 24-25 August 2023

Is the world moving towards a "multipolar" monetary system? This question came up repeatedly at the workshop organised by the Hong Kong Institute for Monetary and Financial Research in cooperation with AMRO, the ECB, the ESM and BOFIT. In his opening remarks, Eddie Yue, Chief Executive of the Hong Kong Monetary Authority, highlighted that the current international monetary system has been the foundation of globalisation of the world economy for several decades. Therefore, it is important to understand the benefits and risks of a move towards a more diversified global monetary system.

The different facets of the dollar's central role

Georgiadis at al.[1] demonstrated why the dollar plays a central role in the current global financial system. The different dimensions of dollar's international use, the 'dollar trinity', jointly shape and transmit the so-called Global Financial Cycle.[2] The dollar's role in safe asset supply, cross-border credit, and global trade invoicing act in tandem. Since the dollar denominates the largest share of safe assets globally, the dollar appreciates when global risk appetite drops and investors flight to safety. When the dollar appreciates, cross-border credit becomes scarcer, and global financing conditions tighten. As most of global trade is also invoiced in dollars, its appreciation presents a policy trade-off between stabilising output and consumer prices in other countries. Hence, the dollar emerges as the 'linchpin' of the global financial system that transmits the Global Financial Cycle to the world economy.

Sander and Bengui[3] show that there is a clear complementarity between a currency's dominance in trade and finance. Invoicing currency concentration shapes interest rates and currency risk premia. A currency's dominant role in trade invoicing generates strong demand for hedging in that currency and can explain why the issuers of the dominant currency pay lower interest rates on their risk-free bonds.

There are also complementarities between trade invoicing and bank lending. McQuade et al.[4] provide insights into the determinants of currency choice in cross-border bank lending, such as geographic distance, financial and trade linkages, and invoicing currency patterns.

In turn, Bippus et al.[5] show that global banking flows have a significant impact on exchange rates. Banks' risk-bearing capacity is also important for exchange-rate dynamics. When global banks' capital ratios are one standard deviation below average, the effect of capital flows on exchange rates can be nearly twice as large as in normal times.

[1] Georgiadis G., Müller, G. J., and Schumann, B., "Dollar trinity and the Global Financial Cycle".
[2] Miranda-Agrippino, S., and Rey, H. (2020), "U.S. Monetary Policy and the Global Financial Cycle," Review of Economic Studies, 87/6, 2754-2776.
[3] Sander, N., and Bengui, J., "Invoicing Currency Concentration and Currency Risk Premia".
[4] Emter, L., McQuade, P., Pradhan, S. K., and Schmitz, M., "Determinants of Currency Choice in Cross-border Bank Lending".
[5] Bippus, B., Lloyd, S., and Ostry, D., "Granular Banking Flows and Exchange-Rate Dynamics".

The impact on other countries

The dominant role of a reserve currency in trade and global financial transactions can generate unfavourable spillovers to other countries. For instance, according to Li et al.[6], in response to an unanticipated monetary policy tightening in the US, real GDP and exports of a typical small open economy fall, despite the depreciation of the local currency. The reason is that the financial channel of the transmission of monetary policy shocks across countries dominates over the traditional expenditure-switching effect.

Sun[7] finds that dollar funding stress can also adversely affect countries' GDP, bank dollar lending, imports, and exports. Industries that depend more on external dollar financing export significantly less than others in face of a dollar funding crunch.

The outlook for diversification

Against this backdrop, it is in vogue to talk about "de-dollarisation" these days, but the share of the dollar as the main currency of countries' external balance sheets has not decreased in recent years. Zhang et al. [8] report that the global usage of currencies other than the US dollar and the euro for cross-border payments also remains limited. A rapid switch into a multipolar system seems unlikely, but the outlook is uncertain. Technological change can accelerate the transformation of the global financial system towards multipolarity, while rising geopolitical tensions can exacerbate the risk of a more fragmented system.

In an increasingly complex global financial environment, Allen et al.[9] point out the importance of a nuanced analysis of countries' currency exposures. Since the 1990s, there has been a large improvement in currency composition across countries, with most countries moving from short to long exposures in foreign currency. However, exposures can differ across country groups, and the aggregate improvement masks vulnerabilities in emerging and developing economies. There has been an increase in local currency debt issuance by governments,[10] and the share of debt liabilities denominated in foreign currency had declined since the 1990s, but this trend has reversed since the mid-2010s. Emerging economies' debt liabilities are still predominantly denominated in foreign currency, primarily due to increases in foreign currency bank loans and debt issuances of the private sector. Taken together, these findings highlight that while aggregate foreign currency exposures have improved, looking at the currency exposures by item (debt, equity) on both sides of the balance sheet may be needed to assess risks and vulnerabilities.

The euro and the renminbi

When looking at alternatives to the dollar, the euro is clearly the second most important currency globally, but Temprano Arroyo[11] points out that the euro is still punching internationally below the euro area's economic weight. The Next Generation EU and SURE facilities represent an important step to increase the supply of euro-denominated safe assets, but they are unlikely to significantly boost the euro's global role on their own, partly due to

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[6] Cesa-Bianchi, A., Ferrero, A., and Li, Sh. "Capital Flows and Exchange Rates: A Quantitative Assessment of the Dilemma Hypothesis".

[7] Sun, M., "Dollar Funding Shortage - A New Database and New Evidence".

[8] Perez-Saiz, H., Zhang, L., and Iyer, R., "Currency Usage for Cross-Border Payments," IMF Working Paper 23/72.

[9] Allen, C., Gautam, D., and Juvenal, L. "Currencies of External Balance Sheets".

[10] Shin, H. S., and von Peter, G. (2022), "Overcoming Original Sin," Journal of Globalization and Development, De Gruyter, 13/2, 411-433.

[11] Temprano Arroyo, H., "The EU's Response to the COVID-19 Crisis: A Game Changer for the International Role of the Euro?" European Economy Discussion Paper 164.

their temporary nature. The EU should complement these efforts with other measures to strengthen the euro's global status.[12]

In the meantime, the last decade has witnessed China's push to accelerate the process of renminbi internationalisation. The use of renminbi remains small globally, accounting for only 3% of total cross-border payments, but Zhang and Perez-Saiz[13] find significant regional variations. While the renminbi is little used in some regions, it has gained traction particularly in the Asian-Pacific region, especially in countries geographically close to China in their trade with China. The renminbi's role in some countries is supported by policy measures of the People's Bank of China, including establishing bilateral swap lines and offshore clearing banks, given China's overall capital account restrictions.

Garcia-Herrero et al.[14] also show that economic variables, in particular trade and direct investment, are key factors behind the use of the renminbi as international currency. Liu et al.[15] argue that the dual-approach reform adopted by the Chinese government has been largely optimal. Due to the complementarity between different functions, combined policies that simultaneously address frictions in the international financial and goods' markets are more effective than policies with a single focus.

Crypto

The rise of cryptocurrencies and their growing role in banking and financial transactions also raises questions. Chan Lau et al.[16] find that the crypto space is only weakly connected to the banking system, and cryptocurrencies mainly affect each other. However, regulation is struggling to keep up the pace with the rapidly evolving crypto space. Copestake et al.[17] identify a "crypto factor" that explains 80% of variation in crypto prices, and caution about possible spillovers from crypto to equity markets if the participation of institutional investors increases.

Policy implications

The policy panel covered several policy aspects. The euro, the renminbi and other currencies can complement the dollar's international role rather than challenging it. The use of international currencies is driven by real economic transactions as well as by market forces, business and investment decisions. Therefore, diversification into different currencies which remain mutually compatible in a market-based system create "optionality for diversification" and can be beneficial.

At the same time, the speakers also warned that a more multipolar system bears risks if it reflects increasing fragmentation. The emergence of currency blocks commanded by different sets of rules can undermine financial stability and economic growth. Fragmentation will affect the cross-border allocation of capital, international payment systems, and asset prices. This limits international risk diversification opportunities and exacerbate macro-

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[12] Temprano Arroyo discusses the main elements of a comprehensive strategy to promote the euro´s international role. See also Hudecz et al. "The euro in the world," ESM Discussion Paper 16.

[13] Perez-Saiz, H., and Zhang, L., "Renminbi Usage in Cross-Border Payments: Regional Patterns and the Role of Swaps Lines and Offshore Clearing Banks," IMF Working Paper 23/77.

[14] García-Herrero, A., Amighini, A., and Mu, H., "The RMB as a trade settlement currency: An exploratory analysis of economic vs institutional determinants".

[15] Liu, Q., Luo, W., and Niu, J., "Dual Approach for One Goal: The Internationalization of Renminbi during 2010-2021".

[16] Chan-Lau, J., A., Quach, T. L., and Tang, L., "Crypto Currencies and Banking Sector Connectedness: Don't Worry, Be Happy . . . for Now".

[17] Che, N., Copestake, A., Furceri, A., and Terracciano, T. "The Crypto Cycle and US Monetary Policy".

financial volatility. At the same time, it leads to a less efficient allocation of capital, undermining long-term growth, or financing constraints affecting trade.

There is also the question about central bank digital currencies (CBDCs): How can different CBDCs connect to support the use of local currencies in cross-border payments? Though it is at an early stage of the debate and actual design of digital currencies, many central banks are already working on how to improve and ensure the interoperability between different CBDCs.

Overall, the global monetary system can reap the benefits of diversification if a move towards a multipolar system happens in a gradual and cooperative way — but risks on the way need to be carefully monitored and managed.