Summary of summaries of Topic1 “Ways to promote foreign trade settlements denominated in local currencies in East Asia”

This study analyzes the factors limiting the use of local currencies in invoicing and settlement of foreign trade in East Asia and explores ways to promote their use.

(Costs and benefits of using a regional currency in invoicing and settlement)

Using a regional currency in invoicing and settlement brings the following benefits to the region: (i) trade competitiveness of Asian companies would be less impacted by the fluctuations of non-regional currencies (i.e., the dollar, euro); (ii) trade finance would become easier, as the impacts from liquidity conditions of non-regional currencies would become less; and (iii) settlement risk (such as Herstatt risk) would be reduced.

There are some pre-conditions to become a regional currency: (i) the currency has to provide adequate “liquidity” to nonresidents as well as residents; (ii) the currency has to be backed by a large domestic economy to absorb internal and external shocks; (iii) the central bank of the currency has to provide liquidity at times of crisis; and (iv) the currency has to be stable vis-à-vis other currencies in the region.

For the country whose currency becomes the regional invoicing and settlement currency, its businesses would be freed from currency risks in their trading, while its monetary policy might become more influenced by regional developments.

(Promotion of the use of a regional currency in invoicing and settlement)

Promoting the use of a regional currency in invoicing and settlement and facilitating the regional economic growth are mutually reinforcing. The role of inertia is significant and staying in an inferior Nash equilibrium may result. In order to break the inertia or a coordination failure, policy actions to promote a regional currency as invoice and settlement currency may be justified. However, whether the current situation warrants strong policy actions has to be examined carefully. Regional use of a regional currency is a first step to make Asian currency an international reserve currency.

(Theoretical and empirical studies on currency invoicing)

In the literature on invoicing currency for trade, three stylized facts are well-known: i) trades between developed countries tend to be invoiced in the exporter’s currency; ii) trades between a developed and developing country tend to be invoiced in the developed country’s currency; and iii) differentiated products tend to be invoiced in the exporter’s currency, while commodities, such as crude oil, are invoiced in an international currency, typically the US dollar. Theories on invoice currency show how the choice of an invoice currency depends on factors such as product differentiation, exchange rate volatility, market share, or the economic size of the exporter's country. Empirical studies, confirming theoretical projections, show that many factors, not only a country's macroeconomic and foreign exchange market conditions but also the nature of products and a firm's strategies affect the choice of an invoicing currency.

(The case of Japan)

According to official statistics, the breakdown of invoice currencies for Japanese trades in recent years is as follows. The share of the Japanese yen is around 40% for exports and between 20% and 30% for imports. The share of the US dollar is around 50% for exports and 70% for imports.

The share of the US dollar as the invoicing currency for exports is much higher in Japan than in other non-US developed countries. The high usage of the US dollar can be explained by the fact that Japanese exporters practice the PTM (pricing-to-market) behavior for exports to the US. It is more of a puzzle that they use the US dollar in their exports to Asia and the EU.

Our interviews with major Japanese exporters reveal the following findings: i) Invoicing in the currency of destination is prevalent among Japanese exports to developed countries; ii) Exports of electronics products tend to be invoiced in the US dollar even for exports to non-US markets; and iii) although Japanese firms have shifted their production bases to Asian countries, exports to and from these Asian bases (semi-finished goods) tend to be invoiced in US dollars as long as the final destination is the United States.

The major reasons why Japanese companies use the US dollar as a dominant invoicing currency within the Asian region are as follows: i) the headquarters in Japan rather than the foreign subsidiaries manages the foreign exchange risks due to the economies of scale and better skills in managing currency risk; ii) pricing-to-market when the final destination is the US and iii) high hedge costs for Asian currencies other than the yen.

(The case of Indonesia)

Data on Indonesia's international trade shows that the US dollar is the major invoicing currency for Indonesian exports. About 90% of total exports are in the US dollar. By destination, almost 100% of exports to the US are in the US dollar. Recent data shows that only 9% of exports to Europe are in the Euro and only about 10% of exports to Asia are in Asian currencies. The use of the Indonesian Rupiah (IDR) as an invoicing currency in all exports is very limited. It has never reached 2.5% in the last ten years. The data on Indonesian imports shows a similar situation; that the major currency used as the invoicing currency is the US dollar. Indonesian firms simply choose the US dollar in their foreign trade transactions due to history, hedging motives, and market rules. There is weak evidence of a relationship between the choice of the invoicing currency and product differentiation, whether the product is final goods or parts, and whether they are exported directly or through trading companies. From Indonesian perspective, the Japanese yen and the Chinese renminbi meet the requirements to play the role as a vehicle currency for international trade among Asian countries.

(The case of Thailand)

The US dollar is the most widely used currency in international trade transactions. Less than 7 % of exports are denominated in Thai Baht. The ratio varies substantially among industries. The ratio of imports denominated in Thai Baht is lower than that for exports. The increase in the use of the Euro stems from both increased trade with the EU member countries and its use as a vehicle currency (third country's currency). As a vehicle currency, the use of the U.S. dollar was more prevalent than the Euro, but the Euro's share increased in both export and import transactions during the period 2001-2008. The share of Thai Baht in Thailand's exports has grown with the increase in Thailand's trade with other ASEAN countries. It implies that increases in intra-ASEAN trade would encourage the use of local currencies, the Baht in the case of Thailand.

(The case of Singapore)

According to the interviews with 15 Singapore-based exporters and importers, although the US dollar is the dominant invoicing currency in exports and imports, the Japanese yen and Singapore dollar are also accepted. In addition, it seems that the trading country currency is more prevalent in imports to than exports from Singapore. The interviews also suggest a lukewarm attitude towards a greater use of the local currency, as the majority of the interviewees were of the opinion that the US dollar will continue to be the most relevant invoice currency in the future.

(Experience of the EU)

In Europe, a significant increase in intra-regional cross-border capital flows together with stable intra-regional foreign exchange rates due to the European Monetary System (EMS) contributed to a substantial reduction in the spreads of cross-foreign exchange rates among European currencies (cross foreign exchange transaction costs), and helped the West German mark to replace the US dollar as the vehicle currency in Europe in the 1980s. Since the launch of the Euro, it has steadily increased its share of the settlement and invoicing of trade, especially in the Euro zone as well as in the non-euro EU countries. This implies that regional monetary and financial cooperation could be effective in promoting the use of a regional currency.

(Action Plans)

Improve reliable data and statistics

Only a few countries currently release the data on currency choice in foreign trade invoicing and settlement, and the available statistics do not cover the whole of East Asia. Understanding the current situation would be critical in finding ways to promote the use of local currencies.

The following measures would be effective in increasing the volume and reducing the transaction costs of cross-foreign exchange transactions among East Asian currencies, and contribute to the increased use of local currencies as well as the growth and stability of the East Asian economy.

Remove capital controls

This should be done gradually and in a correct sequence. It would consequently increase the number of convertible currencies in East Asia. The capital controls of the member countries could be periodically reviewed in ERPD to support well-sequenced capital account liberalization.

Promote economic integration

Advancing the FTA/EPAs among the member countries and pursuing a regional FTA by integrating them would be beneficial as such developments would increase the size of the integrated economies and facilitate intra-regional trade, particularly that which is ultimately destined for the region, not outside the region.

Promote financial cooperation

The current CMIM, an effort to prevent a financial crisis, together with possible cooperation in the future for on intra-regional exchange rate stability should be effective.

Develop local currency capital markets

Further developments in the ABMI and ABF, CGIM (Credit Guarantee and Investment Mechanism), and the introduction of the Asian Local Currency Exchange Support Fund will contribute to the development of local currency capital markets, leading to the deepening and maturing of local currency foreign exchange markets.

Improve foreign exchange settlement systems in East Asia

In addition to the Bank of Japan, the Bank of Korea, the Hong Kong Monetary Authority, and the Monetary Authority of Singapore, other Asian central banks are urged to become CLS members. Moreover, a swift move toward the region-wide cross-border RTGS system is recommended.

Promote competitiveness of East Asian companies

Internationally competitive goods tend to be invoiced in the exporters' currencies. Measures for economic integration will strengthen the competitiveness of East Asian companies.