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Asian Currency Settlement System

Hajime Shinohara
Managing Director, IIMA

It has been a year and a half since Asia was hit by the economic crisis. The tumultuous situation, which began in Thailand, has spread in different degrees to different countries in the region. If we try to assess the scope of the crisis by naming the countries that asked the IMF for foreign liquidity capital, they are Indonesia and South Korea. But if we talk about countries which suffered drastic falls in exchange rates, even though they had enjoyed relatively stable exchange rates until then, or about countries which had been showing high economic growth relative to countries in other regions and are now experiencing drastically slower growth, in some cases negative growth, we must include Malaysia, the Philippines and most other East Asian countries.

Many writers have offered their analysis of the crisis. The sheer number of papers that have been written is perhaps evidence of the intellectual stimulus the crisis offers—the unbelievable gap between what was praised as the East Asian miracle and the present situation. In the early days of the crisis, when Thailand began to be exposed and Bahts began to fall forcing Malaysian Ringgit and other currencies to adjust their exchange rates, the analyses tended to see the culprit as the dollar pegged exchange rate policy and the various dollar centered systems that inevitably were associated with it.

During the following stage, when even Indonesia and South Korea went on the IMF's list of customers, everything that could be defined by the keywords "crony capitalism" was labeled "Asian", and it was explained that the crisis was the inevitable outcome because Asia was "Asian". Then approaching mid-1998, the Russian situation began to arouse serious anxiety and concern developed as to whether even the Latin American countries would be hit by the tumultuous wave. At that time, irresponsible investment activities led by hedge funds—in other words, the drastic movement of international short term funds—came to be blamed.

Leaving aside the question of which analysis was correct for another occasion, it is quite intriguing that the arguments had shifted so much in so short a time. It is worth noting that attitudes have changed so much that the Americans, who gave a definite no to the Asian Monetary Fund scheme, are now saying that it was a mistake that the United States objected last year.

Since last year, there have been active discussions concerning the first culprit, the dollar‑pegged exchange rate policy and the dollar centered system, among the intellectuals of the crisis ridden countries. In these discussions they first acknowledged their misjudgment in applying the policy. Then beyond that, there are various implications.

The first is that these countries will not measure the stability of their currencies by using the dollar from now on. If the dollar weakens close to 80 yen to the dollar, these currencies will be revalued against the dollar. If the dollar strengthens to nearly 2 marks to the dollar, these currencies will inevitably devalue. In such circumstances, these countries will now not pay attention to journalists and economists who criticize the adjustments that occur at such times.

The fact that they will no longer follow a dollar centered policy means that some foreign currency financing may now be in yen and yet more may be in euro. This will have the effect of encouraging Europe to be more aware of the international role of the euro and also of forcing Japan to make rapid and basic adjustments on various issues that have been discussed under the banner of the internationalization of the yen.

Above all, the most significant message of these discussions is that there needs to be stabilization of exchange rates between the currencies of the leading industrialized countries, i.e. the yen, dollar and euro, which tend to go up and down drastically at their convenience without any regard to others. At the logical end of these arguments lies Mahathir's question, “Why are exports from Malaysia to Thailand dollar denominated and must be settled through New York? Why don't we use our own currencies more?" This is quite logical and perhaps not surprising, but it is certainly refreshing to the ears of those who are accustomed to dollar denominated trade and dollar denominated settlements.

In Asia, foreign exchange transactions have been carried out for many years as a way to settle trade. Since about 40 years ago, when the price of the major primary commodities began to be quoted in dollars, dollar transactions have come to dominate foreign exchange transactions. Exchange between other currencies were made in cross transactions, calculating the exchange rates through the dollar. This custom was followed fully until the 90s, even between neighboring currencies like the Singapore dollar and Malaysian Ringgit. Direct foreign exchange with European currencies continued, though only to a small extent, because of traditional ties with the former colonial powers. However, since the mid 70s yen transactions have developed extensively in the Singapore and Hong Kong markets. But these, too, concentrated on the yen‑dollar exchange, and direct exchange between yen and other Asian currencies did not develop in any serious degree. After the Plaza Accord in 1985, yen transactions increased as the dollar devalued. This is the brief development of foreign exchange up to this day.

I would like to remind here that even exchanges between currencies of neighboring countries are still partly cross transactions, not to speak of exchanges between non‑neighboring currencies. Exchange rates are quoted, for example, as 115.30‑40 yen to the dollar. 30‑40 shows the difference between the selling and the buying rates, and is called the transaction margin. Using this example, the dollar can only be sold at the cheaper rate (buying rate for the market) in the market, and vice versa, can only be bought at the higher rate (selling rate of the market), paying the margin to realize a transaction. Two transactions must be made in each cross transaction, which means that there are two transaction margins in one cross transaction. When a bank is requested to make a cross transaction, it must carry out two transactions with the market to cover one such cross transaction in order to adjust its position. For each cover transaction, the bank pays the transaction fee, so there are two transaction fees included in a cross transaction. Consequently, the exchange rate for the cross transaction can be much worse than the rate that could be applied if the exchange could be made directly. Take a look at the rates offered by the foreign exchange dealers called the money changers in major cities of the Southeast Asian countries, and the difference becomes evident. They have their own network and they will offer a direct exchange rate by calculating the flow of cash. So though the difference may not be great, they can offer a better rate than the commercial banks. When I was a banker, I remember meeting a number of money changers of Indian origin who proudly said “Come, compare my rate with the rate at your bank."

If it becomes the norm to make direct transactions between Asian currencies, the exchange rates at banks can compete with those rates, at least in cash transactions. This will also mean that the transaction fees, though perhaps not large, that are included in foreign exchange transactions will be cut in half, and will certainly influence exporters and importers of a country if the rate is applied to trade settlements. Although such a benefit was known, there was no serious development of direct transactions worth mentioning before the crisis, except for some between the Singapore dollar and Malaysian Ringgit in the Singapore market. Coupled with the fact that more than 30% of ASEAN's trade is within Asia, I think it is time to create some means to develop direct transactions between Asian currencies.

Creating a Central Settlement System in Asia

Foreign exchange transactions are settled when transfers are made between accounts at the central bank of the currency of settlement. Settlements for small amounts are done with cash issued by that central bank, but this also means that the settlement is done through the accounts at the central bank, if we go back to the basics of the settlement system. A settlement is complete when a debit entry is made for the payer and a credit entry is made for the receiver in their accounts at the central bank.

Settlements between institutions within a country are made through the network of head office and branches of the central bank. Foreign exchange settlements across national borders are carried out at the central bank of the respective currency. For example, for a dollar - yen transaction, the dollar settlement is made at the Federal Reserve Bank in New York and the yen at Bank of Japan in Tokyo. If the settlements at the central banks are carried out within the same calendar day, the foreign exchange settlement is regarded as being completed on the same day regardless of the time difference—in this case, of 14 hours.

However with regard to risks involved in settlement, the 14 hours time difference can be a source of risk. Considering the complexity of transactions, the increasing size of each transaction and the increase in the number of transactions, the risk inherent in time difference cannot be ignored. As a result, in the past 20 years or so, various measures have been applied in order to decrease the risk. An example is the settlement of dollar - yen transactions. There is now a system where the banks hold accounts at the Tokyo branch of Chase Manhattan Bank and carry out dollar settlements temporarily in Tokyo, and settle the final balance 14 hours later at the head office of Chase Manhattan Bank in New York. This is a significant development devised and sustained by private institutions. Another measure is the longer hours of settlement the Federal Reserve Bank in New York maintains (running the computers for extra hours) in order to overlap with the operating hours of Tokyo.

A measure that was developed mainly among European currencies is the ECHO system. (The name ECHO has changed with its diversification but I will use the name ECHO for convenience in this paper) ECHO is a settlement system created with investment from private financial institutions. Because the system is indirectly connected to the accounts at central banks —the settlements are called netting—it is similar to the mechanism at the Chase Manhattan Bank's Tokyo branch mentioned above.

When a foreign exchange transaction is carried out, there are two parties involved. If both parties are members of ECHO, they first confirm that they will carry out settlements through ECHO. From that moment on, the counterpart for settlements becomes ECHO, not the other party to the transaction. In other words, ECHO comes in between all transactions and becomes the counterpart to both parties. When these arrangements add up, all transactions between members in currencies dealt with by ECHO end up being settled with ECHO.

I must point out here that ECHO is a function that cuts between settlements which means that ECHO receives from one and pays to the other, and the balance is always zero at ECHO as a whole. It also means that members can carry out transactions without concern for who the counter party is, i.e. without concern for the credit risk of that party. If there are a substantial number of settlements, the individual settlement fee becomes minimal and banks will be able to cut their administrative costs.

Although ECHO as a whole keeps the balance at zero, individual members may end up with net payment to ECHO after booking (others will have net receipt). This is settled through a managing bank which is designated for each currency, and transfers are made between the ECHO account of the respective currency at the managing bank and the member banks.

I am sure you have noticed that the main objective of this system is decreasing the final settlement amount. Although there are hundreds of payments and as many receipts, because the counterpart is the same, all transactions are netted and the final settlement amount is a very small portion of the total of transactions, which substantially decreases the risk as regards the settlement amount.

As you have seen, ECHO is a system that can function simply with the help of a computer. It is a for - profit private organization with above - mentioned managing banks designated for currencies as the core. This is not unique in the sense that there are other arrangements where the settlement system cuts in between settlements in order to carry them out smoothly. An example is the clearing system at commodity futures exchanges. In financial transactions, such a system has taken root at financial futures markets in Chicago.

Even without the comments of Prime Minister Mahathir, it is clear that if Asian countries intend to enhance the use of their currencies in the future, it is necessary to start considering a settlement mechanism among these Asian currencies. I believe the ECHO settlement system can be an excellent example.

However, even if such a system were to be created in Asia for Asian currencies, there is unlikely to be any large amount of transactions making the cost for each transaction too high and preventing it from being cost effective for a for - profit private organization. Although the credit risks of counter parties become nil, there is still a possibility that a member bank may go suddenly under. Since this can break down the whole system, the qualifications for member banks should be quite strict. Viewing the banks in Asia from this standpoint, it is difficult to see enough banks joining the system spontaneously to make it worth creating. With these various conditions in mind, I would suggest the following as the realistic picture of the Asian version of ECHO.

First, the investors in this computer operating organization should be the central banks of the participating countries in the region. The organization will, in effect, be semi－public, not putting profit as the first priority. The banks that are allowed to participate in this system will be chosen from among qualified banks within the financial circles of their respective countries by the central banks, which are the investors as well as the managing banks of the currencies they oversee. This would seem to be the most acceptable arrangement even from the point of view of the Basel Treaty which states that the central banks have the responsibility for financial oversight and to be the last lender to the banks established in their country (including the subsidiaries of foreign banks).

The rest can follow the ECHO structure. The final balancing of the currency holdings of members will be carried out at their accounts at the central banks of respective currencies, which are the managing banks, and the settlements will be complete. For foreign financial institutions that cannot directly hold an account at the central bank of a foreign country, settlements will be made through accounts held at a co－managing bank for the currency which will be named among commercial banks of each country. Since there is hardly any time difference among Asian countries, the operating hours overlap to an extensive degree, and the benefits of this system will be demonstrated quite effectively.

The operating cost of this system can easily be covered by one of the two transaction fees that will be eliminated compared to the present settlement system of paying the transaction margin twice.

Coming back to the Asian Monetary Fund scheme, I have already mentioned that the United States and the IMF, which were initially beside themselves to stifle it, had changed their attitude at the beginning of this year. Latin American countries had experienced their economic crisis in the 80s, have taken 10 years to recover and were thought to be finally on the right track, only to find shadows casting over them again. In Asia, measures must be taken so that the same currency turmoil and economic crisis, the kind of crisis that spreads immediately throughout the region, will not be repeated. This is an additional reason why the Asian Monetary Fund scheme should be prudently planned in detail, and I believe the Asian currency settlement system should be considered as part of this scheme.

The whole discussion is quite technical and does not have a flashy attractiveness, but what is inherent in the system is quite promising and meaningful. In the medium term, this system can become responsible for the settlement of a single numeraire (equivalent of ECU in Europe) which can be born in Asia. Such a possibility strengthens the significance of the system.

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Address: 2‐2, Nihombashi Hongokucho 1‐chome, Chuo‐ku, Tokyo 103‐0021, Japan
Telephone: 81‐3‐3245‐6934, Facsimile: 81‐3‐3231‐5422
〒103‐0021　**東京都中央区日本橋本石町**1‐2‐2
電話：03‐3245‐6934**（代）ファックス：**03‐3231‐5422
e‐mail: admin@iima.or.jp
URL: http:／／www.iima.or.jp