PROCEEDINGS REPORT

Fireside Chat with Former Central Bank Governors on

Central Banking in an Evolving International Financial Systems

6 February 2024 at the Asia School of Business, Kuala Lumpur

Hosted by

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This proceedings report is prepared by FIDFE FORUM

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Central banking in an evolving international financial system. The discussion will be approached from three angles – the past, the present, and the near future. What might the international monetary system look like in the distant future? Having been in important policy where there have been challenging international developments in the financial markets and growing international integration of financial markets, leading to flows of capital across borders that sometimes lead to financial stress in the system. What were the lessons that can be drawn from these challenges that are relevant for the current cohort of central bank governors and future central bank governors?

Mr. Veerathai Santiprabhob, Former Governor, Bank of Thailand

2015 to 2020 was a period of unconventional monetary policies used by major central banks around the world. This is when the Federal Reserve brought down interest rates sharply and the European Central Bank (ECB) as well as the Bank of Japan had negative interest rate policies. In such an environment, there were two main challenges for the central banks of small open economies.

The first challenge is related to volatile capital inflows due to quantitative easing and aggressive monetary policies by central banks of major countries. Money was searching for yields all over the world. In Thailand, although economic growth was sluggish and faced a series of political challenges, it had sound macroeconomic conditions and a large current surplus. Thailand was considered a safe haven in the eyes of international investors and a lot of money was flowing into the country, affecting the exchange rate and exports significantly. Thailand then adopted a flexible exchange rate policy to allow the market to determine the value of its exchange rate. It was unavoidable for Thailand's central bank to intervene in the foreign exchange market. Thailand also ended up building large amounts of international reserves through foreign exchange intervention. International financial institutions may not like what Thailand did and some major governments also believed that Thailand was manipulating its currency. However, from the perspective of a small open economy, this was unavoidable. If Thailand allowed capital flows to dictate the value of its exchange rate, it could harm exports during a time when economic recovery was already sluggish.

The second challenge is related to financial stability. The search for higher yields comes with the problem of underpriced rates. This created financial stability challenges across different levels. The banks were competing and received very low-cost funding from abroad. Branches of foreign banks were also very active in offering funds to large conglomerates in Thailand. They were offering money market lending to finance long-term projects of Thai conglomerates. There was evidence of the underpricing of rates and the mismatching of maturity. All banks were racing to the bottom offering very affordable money market financing to large corporations. Corporates were also underpricing rates with many being issued short-term corporate debt instruments to finance long-term projects. Investors, in the search for yield, thought that they could be the first to exit large corporates in the first sign of trouble, but it is very difficult to be the first one to opt out.

This led to the development of shadow banking. There were mutual funds, large fixed-income mutual funds, and daily redemption fixed-income mutual funds. On the asset side, there were investments in long-term corporate debt. On the liability side, investors could redeem their unit trust on a daily basis. This is an emphasis on the mismatching of maturity. There were also financial stability challenges at the household level. Household debt increased significantly as people took out mortgages for multiple homes as they speculated on housing prices.

Financial stability requires central banks to view matters with a broader lens to deal with occurrences of shadow banking in the non-banking sector. While central banks are regulators of commercial banks, many of these sectors are outside the purview of the central bank. At the same time, central banks have to safeguard the stability of the whole financial system. Therefore, the Bank of Thailand had to work with other regulators to devise different sets of policies as preemptive measures to preserve financial stability. The market and government did not appreciate this move. This is typical as nobody acknowledges the efforts of the central bank when conditions are stable but is quick to blame when a crisis emerges. Such is a fact of life for central bankers.

There are several lessons that can be drawn from this context. Firstly, the central banks of small open economies and advanced economies can experience problems similar to those of emerging economies during times of volatile capital flows. Central banks need to be flexible and combine a wide range of policy measures such as interest rate policies, foreign exchange intervention, micro-credit policies (if the central bank is also a bank regulator), macro-credit policies, and preventive capital control measures. Lately, international financial institutions like the International Monetary Fund (IMF) have realised the need for an integrated policy framework. Prior to this, international financial institutions would advise that one policy should be tailored to a single objective at a time. There were many restrictions for the central banks of small open economies that limited their ability to exercise a combination of policies, particularly in matters of foreign exchange intervention or capital flow management measures.

The international financial system needs an improved system of burden sharing between the source countries of capital flows and recipient countries. Until now, recipient countries of capital flows had to bear the full burden of dealing with such flows which could impact financial stability. Instead, recipient countries should have the flexibility to deal with the unintended consequences of capital flows and be able to prepare for the possibility of capital flow reversals. During the COVID-19 pandemic, Thailand managed to use its additional reserves that it built to minimise disruption in the exchange rate and the financial markets.

Therefore, the ability and flexibility to combine different policy measures is key. Central banks need to ensure they have a full set of policy tools available to be able to deploy when needed.

Mr. Duvuri Subbarao, Former Governor, Reserve Bank of India

Three lessons can be learned in the context of financial globalisation. The first lesson is that no country is "an island". Whatever happens anywhere in the world affects countries everywhere. This was observed during the Asian Financial Crisis, the Global Financial Crisis, the Eurozone sovereign debt crisis, and recently with COVID. When the Lehman Brothers collapsed, there was much dismay, denial, and disbelief in India as people did not understand how they could be affected by the crisis. After all, Indian banks were safe and well-behaved, their markets had no toxic assets, and the Indian Reserve Bank was a responsible regulator. Yet, it was affected because India is part of the world and is integrated with it. Similarly, when the Eurozone sovereign debt crisis erupted, events took place in Greece.

When Mr Duvuri was governor of the Reserve Bank of India, a staff members called him at 9.00 pm and told him that something was happening in Greece which India should watch out for. Initially, Mr Duvuri was nonchalant as Greece was a small economy which India had no banking connection with nor traded much with. He was proven completely wrong the next morning when the markets opened when the Indian markets reacted to what was happening in Greece.

The second lesson is that it is a very unequal world. The rules of the game for international finance and international economics are set by wealthy countries and emerging economies have to play by the rules of the former. The Washington Consensus was a set of rules written in Washington and was adopted by the IMF, World Bank, and everyone else. It contains a set of guidelines advising how emerging economies can emerge and integrate with the world. This includes the use of tariffs, flexible exchange rates, and an open capital account. Emerging countries took on these guidelines in good faith and benefited, both rich and poor. It was a win-win situation and everything was good. However, when the tide turned during a crisis, the burden of adjustment fell entirely on these emerging economies. This should not have been the case, but they would not listen. Once

during a meeting of central bank governors, one governor told chairman Ben Bernanke that emerging economies took account of developments in the US, Europe, and Japan when they in their policies, and asked the former chair of the US Federal Reserve if major economies thought about emerging economics when they devise their policies. This question was met with sheepish silence. Hence, it is an unequal world.

Another example is IMF's Article 4 evaluation of every country, which is very important to emerging economies as what the IMF says matters. IMF's description of a country's compliance and performance matters to international investments coming into a country as it affects the confidence of foreign bankers. If on the other hand, the IMF says that a particular country is blowing public debt or is controlling exchange rates too much, it will then have an adverse effect on the country. This is why emerging economies are deeply concerned about Article 4. On the other hand, the US, a member of the IMF, has never had Article 4. They should, by rules, but they never had, which implies they do not need it. If America had gone through Article 4, the IMF would have identified a crisis was brewing before the Lehman Brothers collapsed. Such is an unequal world.

The third lesson – in an unequal world of emerging economies, each has to fend for themselves. They cannot depend on the generosity of rich countries. In many international forums, central bank governors of emerging economies have argued that the burden of adjustment must be shared. When the global financial crisis broke out, dollar liquidity dried up all over the world. America as the issuer of the dollar felt obligated to infuse the global system with dollar liquidity. However, they limited soft facilities to countries whose currencies were convertible. India also requested a soft facility. While the US did not decline, they were clearly disinclined to do it for India.

In order to defend themselves from the global system and capital flows, countries should build their insurance. The IMF stressed that emerging economies do not need their own "insurance" by building their foreign exchange reserves and has instead advised countries to approach it for support. However, in Asia, there is still a stigma attached to the IMF. Should India go to the IMF, everyone will speculate that India is getting into trouble. Therefore, emerging economies cannot go to the IMF and regional arrangements have not proven that they can stand the test of crisis. Bilateral arrangements can provide some solution, but ultimately a country's defence is its own foreign exchange reserves. There is a cost involved, but they have to bear the cost in order to protect themselves.

Mr. Masaaki Shirakawa, Former Governor, Bank of Japan

Japan's perspective of the 1997 and 2008 financial crises resulted in two lessons. During a G7 meeting with Finance Ministers and central bank governors on the weekend of the collapse of the Lehman Brothers, in a phone call, Henry Paulson said that the bankruptcy of Lehman Brothers was inevitable. This was unbelievable at the time due to the magnitude of the disaster to a point even at the last minute there were expectations for the US to step in to prevent disaster. This did not happen and a disaster situation unfolded due to the inaction of the Federal Reserve to act as a lender of last resort. While there were good reasons for the US not to do so, it was still unthinkable as what resulted was a very disastrous situation.

A lesson drawn from this is the importance of central banks as a means of last resort. Despite the financial systems being on the brink of collapse, eventually, the situation experienced in the 1930s was successfully avoided. That was due to the joint effort of central banks as a last resort. The major central banks had an agreement with the Federal Reserve Bank for it to act as a global lender of last resort. This way, the Bank of Japan could gain access to an unlimited amount of dollar liquidity. With such direct credit, the Bank of Japan could lend an unlimited amount of US dollars to Japanese banks to strengthen their reserves. That is how countries like Japan have been able to avoid a collapse of the financial system, showing the importance of central banks as lenders of last resort.

The second lesson is the importance of avoiding the bubble itself. After Japan's bubble collapsed in the early part of the 1990s, the Bank of Japan was frequently criticised by US academics who said that bubble burst would likely not have happened if central banks had been aggressive. Quantitative easing has been effective, but the reason why Japan is experiencing low growth is simply because the Bank of Japan is not aggressive in implementing quantitative easing.

In the case of the global financial crisis, many major central banks adopted a so-called quantitative or unconventional monetary policy. Nonetheless, low growth continued, and quantitative easing has not been very effective. If quantitative easing or unconventional monetary policies were truly effective, there would not have been a persistence of quantitative issues for many years. In the case of Japan, unconventional monetary policy has continued for the past 30 years, which is contractive.

Even if central banks were aggressive by adopting unconventional monetary policies, once the bubble burst, it would be challenging to return to the normal course of the economy. Hence, one must recognise the significance of avoiding a bubble.

Y.M Tan Sri Dr. Zeti Aziz, Former Governor, Bank Negara Malaysia

Malaysia emerged from the Asian Financial Crisis within a year with a V-shaped recovery. From an economic contraction of 7 percent in 1998, Malaysia grew to 6 percent by 1999. The crisis did only affect Malaysia as it also involved the whole of Southeast Asia. The biggest lesson is the need to build resilience to withstand shocks and the effects of policies taking place abroad. Some of these shocks were built up over a period of time, while some happened suddenly. No one could have predicted a health pandemic with all its consequences. Others occurred due to a buildup of excesses over time and were just waiting to happen. Within all this is the need to build capability, not only as a country, but also as corporations, financial institutions, and households. One needs to build up resilience to allow oneself to be in a position to withstand challenging times.

A decade later, a crisis occurred in the developed world that people tend to describe as a Global Financial Crisis. Yet, it cannot be called a “global” financial crisis as such an event involves total disruption where markets become dysfunctional and intermediation processes ceases to function. In the Asia Pacific, while the Lehman Brothers crisis had an effect, its financial intermediation continued to function and markets carried on. It did not only apply to Asia, but the Asia Pacific region, as Glenn Stevens once pointed out that New Zealand and Australia were affected as well. The Asian financial Crisis became the “AFC” and the Financial Crisis of 08-09 became the “GFC”. Instead, it should have been called the Great Financial Crisis.

To build resilience, Malaysia diversified its financial system which was bank centric with the concentration of risk on the banking sector and the development of the bond market. Other sectors such as the insurance industry became more diversified. When this came to be, risk was dispersed throughout the financial system, allowing it to better withstand the effects of these consequences that take place mostly in the developed world.

The second lesson is not to wait for a crisis to address vulnerabilities. Continually, environmental scans need to be conducted to watch out for other buildups of vulnerabilities that will explode when a crisis or shock occurs. This could be accesses of high indebtedness, large current account deficits, large fiscal deficits, rising inequalities, and other socioeconomic problems. It is important to put in place a national risk management framework, stress testing, and so on, to enable greater awareness of these vulnerabilities and address them during the good times.

The third important lesson is having a resolution infrastructure. Throughout the world with these financial crises, there has been much progress in dealing with the “too big to fail”. There are now resolution mechanisms in place and standards have been enhanced immensely. Since then, financial stability issues have been addressed quickly and contained. However, there is an uneven aspect involved as most of these resolution infrastructures and mechanisms focus on financial

institutions. It is equally important to focus not only on the lenders but also the borrowers. This involves having resolutions for large corporations with debt restructuring which mechanism has proved to be very useful. This also applies to small businesses and households, allowing them to avoid situations like the subprime crisis with great foreclosures and bankruptcies.

Larry Summers once attempted to respond to a Financial Times article where he argued that it is impossible to focus on the borrowers. That is why many lost their homes during the subprime crisis and went into bankruptcy. Having a policy framework that is reinforced by relevant communications capabilities is important due to the role of social media. That is one of the greatest challenges that is facing not only central banks, but also by corporations, governments, and just about everyone because of the instantaneous information that is available, which may at times not even be accurate. Yet, they influence consequences and impact of policies. This emphasises the importance of communication during challenging times. When Malaysia implemented its unconventional policies during the crisis, it had 30 hotlines that operated 24 hours and provided public updates explaining the rationale of its policies, its impact, and current developments. This resulted in a high payoff as Malaysia did not experience significant capital flight, despite the IMF thinking that it did. Building up trust in the policies that are being implemented to deliver results is very important.

Moderator: We have a situation now with geopolitical tensions in the world. To some extent, this is leading to a fragmentation in international trade. There is also the emergence of all sorts of digital money, some of them official such as central bank digital currencies (CBDCs) and others private such as cryptocurrencies. If you were still a governor, what would keep you up at night? What advice do you give to your successors?

Mr Masaaki Shirakawa, Former Governor, Bank of Japan

There are many challenges faced by central banks. The most worrisome is that central banks nowadays are asked to undertake many tasks to ensure stability. This includes price stability, financial stability, environmental stability, climate change, and so on. Additionally, central banks now are under constant pressure to act when the economy is not functioning adequately. There are three reasons why such trends have emerged in recent times. One, the economy and society themselves have become very difficult to cope with. For example, Japan has been experiencing demographic changes in the form of rapid aging and a shrinking population. These are the effects of decreasing growth rates, which is not a weakness but a result of certain factors. However, it is difficult to distinguish between weaknesses and low growth rates. Yet, central banks are under constant pressure to resolve these issues. Such expectations are problematic as issues differ from country to country.

The second reason is that central banks feel compelled to do something. While central banks are independent, they must possess some understanding of what is experienced by the general public. Should a central bank be regarded as an

institution that understands the hardships of general citizens, it can become quite difficult to retain independence. Even though the effects of certain actions on various issues are limited, the central bank feels it needs to do something. Such a mentality is problematic. A case in point is climate change, where the central bank's mentality is that it needs to be involved.

The third factor is that the balance sheets of central bank have become very large. In the case of Japan, the current ratio of the central bank's balance sheet to GDP is 120 percent. 30 years ago, the ratio was only 10 percent. This demonstrates the effect central bank behaviour has on credit and resource allocation.

Central banks should be focused on their core mandates which is to ensure stability and financial stability. Price stability and financial stability are just two sides of the same coin. Eventually, comes down to the stability of the currency. If central banks lose sight of their mandate, it risks the very basis of society.

Mr Duvuri Subbarao, Former Governor, Reserve Bank of India

Geopolitical tensions are dividing the world into finance blocks, trade blocks, currency blocks, and economic blocks, which are not good for us. This has been observed over the last two years. America is weaponising the dollar, which is acceptable as they are doing it for a larger good and has behaved quite well thus far. However, it is possible that America might weaponise the dollar for capricious reasons in the future.

Emerging economies are moving quickly with the development of cryptocurrencies and CBDCs. On the other hand, Bank of England, America, and Europe have been very outspoken on the matter, but have not made rapid progress. This is because cryptocurrencies are more likely to impair monetary sovereignty, financial stability, and capital account flows. Emerging economies are concerned that private cryptocurrencies will impair the basic functioning of the central bank. Hence, the reason why the central banks of emerging economies are looking into CBDCs is to use them as a defensive mechanism.

There are also concerns about digital finance. In 2023, Silicon Valley Bank collapsed. Normally, when a bank is collapsing, regulators act over the weekend. In the case of Silicon Valley Bank, it started acting immediately because a bank run in the digital age is different from a bank run of a traditional banking system. Social media can make a bank run happen.

The next worry is cybercrime with payment systems and the use of digital money. In a purchase off a counter, there is no way to be sure the cashier knows the funds moving from a customer's wallet or bank account are successfully transferred to the merchant's account, as payment systems can be attacked.

In the case of climate change, while climate change cannot be the core concern of central banks, they also cannot deny the existence of climate change due to the impact it has on monetary policy and inflation which then affects financial

stability. This makes climate change a matter central banks must be concerned about.

Whether central banks should expand their scope or focus only on core competencies, the answer is less definite. Central banks add value if they focus on their core mandate rather than do everything else. They can promote school education and basic health, but these efforts are not their core mandates, nor do they hold a comparative advantage. Instead, they should focus on price stability, financial stability, and macroeconomic stability, to an extent where other things that are happening in the world that affect their core mandate should be a matter of concern. This is the reason why the Reserve Bank of India is contracting its mandate, as it had a confusing mandate earlier on that was written in such a way it could do anything and get away with it. This led to changes in the last 15 years where the Reserve Bank of India's mandate has been given greater responsibility and focus.

Y.M Tan Sri Dr. Zeti Aziz, Former Governor, Bank Negara Malaysia

It is true that just about everyone expects everything from central banks. It has always been this way where central banks are expected to rise up to address some of the challenges countries are facing. It is important to have well-defined outcomes of what is expected of the central bank aside from their core mandates, whether it is a single mandate like the European Central Bank (ECB) or a broader mandate. This is certainly the case in emerging market economies where it is typical for central banks to expect broader mandates.

It is all about boundary management. For example, if central banks are asked to do something for small and medium-scale enterprises, they then must look at the outcomes required, set a timeline for it, determine channels of accountability, chart an exit of their role, and manage the boundaries. The reality is that central banks cannot say that they are not going to look into these issues as there are major implications.

While central banks tend to focus on the rate of inflation, it is not the rate of inflation in the current environment that may be the relevant area of focus and should instead be price levels. Price levels of food and energy make up the largest percentage of expenditure composition, particularly among households in the lower-income and middle-income groups. War, sanctions, and geopolitical tensions around the world have disrupted supply and affected daily living conditions.

One of the significant differences between a central bank and other policymakers is that central banks look beyond the immediate term. It is essential to address the issue of living conditions which can influence a country's choice of leaders. In Argentina, a person who wants to close down the central bank was elected as its leader. When Argentinians are interviewed, it is revealed that people were in such misery and pain they just wanted change. The political environment will show that people chose not because they feel that certain individuals would

bring about resolution, repair or growth, and development to their country, but because they simply feel a need for something different and want change. Addressing this issue by looking at levels of inflation, especially on certain widespread items, is important because it affects the overall well-being of people on this planet.

Central banks in emerging economies are also expected to shadow interest rates in the developed world. Instead, there should be a decoupling of such trends and markets should not apply pressure to emerging economies to shadow the interest rates of the developed world. There are two reasons why this is the case. During the 08-09 crisis, unconventional policies were introduced to bring interest rates to near zero levels and negative in some countries. While a deep depression was averted, these interest rates were held too low for too long. Inflationary conditions were recognised too late when they emerged. As a result, there had to be an over-adjustment of interest rates. The emerging world, including those in Asia, interest rates were not brought down to historic low levels. Instead, inflationary conditions were recognised which led to the adjusting and normalising of interest rates by raising the rates much earlier than the developed world. While the developed world experienced an over-adjustment, it was questionable why other countries should be punished by undervaluing their exchange rates, simply because they had not adjusted interest rates according to the adjustments in the developed world. There should be a decoupling of rates between the rest of the world and those who took too long to react.

The influence Wall Street has on policies is also worrying as it applies pressure on monetary authorities. Assessment should be based on the prevailing economic conditions rather than having interest rates required to shadow the interest rates in economies and financial systems that are totally different. This way pronounced adjustments in the financial market are not required as it can be destabilising.

Dr. Veerathai Santiprabhob, Former Governor, Bank of Thailand

There are three future challenges that central banks need to pay more attention to. The first is related to the issues of debt overhang. Low interest over long periods of time has resulted in increased leverage across various levels. At the country level, many emerging countries were able to enter global financial markets for the first time. This led to emerging financial markets incurring huge amounts of debt at the corporate and household levels.

When COVID came, economic activities halted, resulting in the disruptions or destruction of balance sheets across all levels as many countries fell into a debt trap. There was no clear solution for countries to enter debt restructuring as mechanisms that authorities had put in place did not measure up proportionately to the magnitude or scale of the problem. Significant amounts of debt overhang will continue indefinitely, affecting the rate of economic recovery which will happen at a slow pace. Consumption cannot be stimulated due to high amounts of household debts. Similarly, it will be difficult to stimulate investments with

high amounts of distressed assets in the market. Therefore, central banks should pay more attention to addressing debt restructuring and debt overhang issues.

The second challenge relates to the fact that inequality has widened in most countries, particularly after the COVID pandemic. Many SMEs went bankrupt and large corporations have gained more market dominance. Inflation has affected people at the bottom of the pyramid more than the people at the top or the middle. This has created a widening of income and wealth inequality. Lately, other developments in the global economy also suggest the presence of inequality of opportunity. These issues could have implications for the long-term stability of an economy. In the past, central banks tend to only look at macro indicators. Today, evaluating the macro indicators of most countries on its own tends to suggest that matters are fine, but a closer examination of the micro numbers could reveal more alarming issues. Therefore, central banks are required to wear a micro lens when analysing ongoing economic conditions and need to have their feet on the ground. In situations like this, the resources become much thinner, be it from government, corporates, or households, these buffers become less available, yet expectations remain high. If central bankers do not have their feet on the ground and understand the economy, particularly matters affecting inequality, the general public will assume central banks have abundant resources, leading the government and everyone else to rely on central banks. This will make it challenging to preserve the central bank's independence and authority if people feel that central bankers are disconnected from reality.

The third challenge is the rapid advancements in digital technology, particularly digital finance. Apart from addressing cyber security, new forms of deposit grants, and virtual banks, there are also many developments in the digital financial landscape. Central bankers need to play an active role in helping design financial landscapes that are appropriate for each country. If new technological developments are not handled well, large firms with access to modern technologies will gain more market dominance and comparative advantage, leaving the majority of society behind. Digital financial systems should not be creating a widening digital divide within an economy or society. Central bankers can play a role in helping design proper landscapes and market structures involving digital finance. For instance, in open banking, policies need to consider how "open" open banking needs to be to ensure that marginalised members of society also can benefit from banking services.

There is fragmentation in the payment system. Instead, such systems have to be interoperable and allow new competitors to enter. In the use of transactional data, the role of central banks becomes even more important when it involves digital finance. In the old days, the world operated on collateral-based lending, but today everyone has digital financial footprints. Information-based lending could be a solution in addressing access to finance for many people. This has been the case in India and China. Ultimately, it is up to central banks to design a data architecture, ensure interoperability, and provide open banking policies that ensure everyone can benefit from the development of digital finance.

Moderator: Do you foresee an increased importance of Asia in the financial systems or an end to the dominance of the dollar? What would you like to see and what do you think might happen? What is the role of central bank cooperation?

Mr Duvuri Subbarao, Former Governor, Reserve Bank of India

The dollar will continue to be the world's dominant reserve currency. This is because more than half of global trade is invoiced in dollars, more than two thirds of central bank reserves are held in dollars, and more than two thirds of international debt is denominated in dollars. In fact, Chinese loans to some of the African countries are still denominated in dollars. Such is the sphere of the dollar. What happens on Wall Street affects financial markets and what the Federal Reserve does affects global economies everywhere. However, it is not as if the dollar has been anointed as the global reserve currency by an international agreement. The dollar is the world's global dominant reserve currency because of the strength of the American economy, and the depth and resilience of the American financial markets under credible American institutions.

Nevertheless, resentment has been building against the dollar. One reason is weaponisation. The second is that the dollar, being the dominant reserve currency, has been a source of instability for the world. This was observed after the Global Financial Crisis as what happened was paradoxical because America was at the centre of the subprime crisis. The dollar is issued by America. If it were any other emerging economy, its currencies would have collapsed during a crisis. Yet, what happened in America was the opposite as the dollar appreciated. When the Lehman Brothers collapsed and the subprime crisis erupted, the dollar appreciated because the dollar is the world's reserve currency. Instead, other countries bore its consequences.

The third reason for the sentiment against the dollar is because America is having an exorbitant privilege while the rest are paying the cost for it. For example, if one keeps USD100 in one's pocket, the person is giving a hundred dollars of interest-free loans to America. This implies that many people within America and beyond are lending with America's privilege and are able to borrow at a very low cost because the rest of the world is willing to finance them. Therefore, America is an exorbitant privilege while the rest of the world is an exorbitant cost.

Some have tried to replace the dollar. First was the Euro when Nicholas Sarkozy appointed a committee under Joseph Stiglitz. It was a time when France was the chair of the G20 and was seeking to make the Euro an alternative to the dollar. The project collapsed even before it could take off due to the Eurozone sovereignty crisis. Whether the Renminbi can become a reserve currency is unclear as China has capital controls, controls its exchange rate, and the People's Bank of China (PBOC) is not an independent institution but a department of the Ministry of Finance. It is very unlikely that the world to move away from the dollar to the Yuan. Therefore, the Euro cannot replace the dollar and the Yuan is unlikely to replace the dollar. Interestingly, the Chinese have been internationalising the

Yuan for the purpose of trade. However, it is uncertain if they are interested in making it a reserve currency. They might hope it to be, but it is unlikely to happen.

On the question of countries getting together to establish a common currency, during the BRICS Summit in the summer of 2023, there was much talk about a BRICS currency. Yet, this topic was not discussed during the summit, with discussions centred on carrying out trading in local currencies. This is because it is a difficult proposition for emerging economies to build their own currency. To do so, their trade has to be roughly balanced and they need to have a good footprint of trade. Another problem is that China is part of BRICS. If BRICS has a common currency, it would be confronted with the issue of net balances. After netting out, there could be disputes in terms of which currency they would choose to settle balances and it is unlikely BRICS would agree to succumb to China. This is probably a reason why India and South Africa resisted a BRICS currency. Therefore, even if countries like the BRICS grouping attempt to establish an alternate currency, they are unlikely to succeed.

The world is beholden to the dollar. Money has three functions – a unit of account, a medium of exchange, and a store of value. While the dollar will lose some prominence as a unit of account and a medium of exchange, but as a store of value the dollar will survive.

Moderator: ASEAN countries have been discussing the idea and implementing invoicing and settling trade between the countries in local currencies. What is the latest on this discussion and will this likely lead to the abandoning of the dollar on a greater scale?

Dr. Veerathai Santiprabhob, Former Governor, Bank of Thailand

The US dollar will continue to be the dominant reserve currency of the world. However, central banks and the economies of many countries will begin to diversify currencies for transactions. Similarly, central banks will start to diversify reserve holdings away from the US dollar due to sentiment and concerns regarding the future of the dollar. There will be a diversification of asset holdings in other currencies, yet not inviting another reserve currency to replace the dollar, which will be very difficult. However, the share of the US dollar should be coming down as more central banks have diversified their international reserves holdings.

Initiatives by Bank Negara Malaysia and the Bank of Thailand have attempted to increase the usage of local currencies for settlements of trade. This has expanded into many countries with the development of technology as a factor. The introduction of central bank digital currencies (CBDCs) would see the bypassing of middlemen who use dollar accounts for settlement. Wholesale CBDCs would see central banks and commercial banks across different jurisdictions using distributed ledger technologies for payment and settlements to facilitate cross-border payments and settlements in local currencies. This would be an important development that may take some time to gain traction.

Yet this will have implications for the dominance of US dollars in international transactions.

Despite these developments, in the area of financial and payment technologies, many American firms are leaders of the field. While the Federal Reserve and the US government may be very sluggish in this space, as they do not even have a fast payment system in place, their private sector on the other hand owns the technology. American firms are leading introducing the likes of US Dollar Stablecoins and trade settlements like PayPal Dollars or the likes of Ethereum that introduced Stablecoin for financial market transactions. These developments need to be followed and monitored.

Apart from all the key criteria that economists recognise such as credible institutions and open capital account convertibility, one must also consider the technological aspects which will play an important role in determining the roles of reserve currencies.

Observation of the US dollar as a dominant reserve currency also must closely take account of the development of the treasury bill markets and the US government bonds markets. The US treasury bill and government bonds markets are considered risk-free assets. This essentially underpins the valuation of all asset classes in the world. Regardless of whether or not the US market is indeed risk-free, people today will have a lot more reservations than before as the size of the US government's budget deficit has expanded significantly. In the past, it was acceptable because the Federal Reserve was adopting unconventional monetary policies. Today, the Federal Reserve is reducing its balance sheet with quantitative tightening, causing demand for US treasury bills to decrease.

Due to geopolitical economic concerns, some central banks have decided to lower the holding of US treasury bills and US government bonds, which in turn is reducing demand. The US government will also have to face increasing financing costs because interest rates have been rising. In the past five years, the functioning of US treasury bill markets has seen various incidences where the Federal Reserve has intervened to ensure the proper functioning of the treasury bills market. With significantly more volatility being observed in US government deals, future developments in the US treasury bill market and the US government bond market will have an influence on reserves and the positioning of US dollars, questioning its ability to maintain its position as a dominant reserve currency.

Mr Masaaki Shirakawa, Former Governor, Bank of Japan

The current dominance of the US dollar will remain unchanged. However, since money is needed to facilitate exchange, transactions between monies still require the dollar. In the near future, the status of the dollar will not be changed and because there is no other alternative. The Euro has not taken this position because it is still not fully integrated. There also has not been a Pareto moment where a Euro-denominated current bond asset board exists.

Given these considerations, it is unthinkable for the Euro to replace the role of the dollar. The same is true for China. Its compatibility is not yet in place, making it impossible for many countries to adopt the Renminbi as a key international currency. However, with the US weaponising the dollar, many countries could be induced to make a gradual shift away from the dollar in favour of other currencies. This process is inevitable.

The current state of the matter does not provide optimal conditions. A case in point is the aftermath resulting from the US adoption of monetary easing. Emerging market economies experienced a huge inflow of capital which eventually led to the tightening of monetary policy. This then caused the outflow of capital. In the process, emerging market economies were faced with economic turbulence.

Japan experienced zero or low interest rates, which it had already experienced during the Global Financial Crisis occurred. Many countries, including the Federal Reserve, lowered interest rates. Because of the narrowing of interest rates differentials, Japan was unable to widen its own interest rate differentials which caused the Japanese Yen to appreciate. As Japan is unable to widen its interest differential, it will always face an appreciating Yen when its economy is weak. In that process, countries with lower interest rates can enjoy some positive effects due to depreciation. On the other hand, a country prolonging the adoption of monetary easing will eventually cause it to be faced with lower band interest rates. Eventually, this becomes a zero-sum game.

It is unrealistic for countries to adopt monetary policies that are aimed at global stability rather than domestic stability, the latter of which is their mandate. At the same time, should all countries pursue their own narrowly defined goals of domestic stability, it could lead to global suboptimal. It would be more realistic for countries to have a frank exchange of views with each other as efforts are needed to identify an enlightened set of interests. Central banks have to justify the limits of monetary policy. If, for instance, central banks recognise the limits of unconventional monetary policy, then it is unlikely that monetary easing will be taken up on this scale which has lasted for the past seven years. The current situation is unsatisfactory and requires a frank exchange of views.

Y.M Tan Sri Dr. Zeti Aziz, Former Governor, Bank Negara Malaysia

10 years ago, YM Tan Sri Dr Zeti Aziz wrote a paper on the international financial system which she described as uneven, unanchored, and unorganised. Since then, not very much has changed as the world is still over reliant on the US dollar.

Discussions have surfaced regarding the role of the US dollar in the international financial system because the structure and the configuration of the world economy has changed with a more prominent role of other economies, including emerging economies, in the global financial system. Therefore, the role of the US economy has, to certain extent, lessened in terms of trade and size. This change precipitates thinking towards the dominance of the main global currency as it is

used for trade settlement, cross-border investments, and international reserve holdings. As a result, the concentration of significant amounts of US dollars is a concentration of risk that can lead to destabilising consequences for the global financial system.

In discussing the unanchored nature of the international financial system, one finds no guidepost or automatic mechanisms facilitating adjustments. There are occasions when it is prone to perpetually facing disequilibrium conditions. Such conditions have been observed in Malaysia. Disequilibrium conditions in the international financial system can lead to a misallocation of resources and perpetuate disequilibrium conditions.

The current system is unorganised due to its inadequate response mechanisms. There is no effective platform or established frameworks with resolutions to deal with liquidity provision. The IMF's liquidity provision is insufficient despite its many enhancements. In terms of financial safety nets, the only two that exist in the world are the European Union and ASEAN as these are the two largest in the world aside from other international organisations. With fundamental changes taking place in the world economy, it is very likely that the world is transitioning into a multipolar world. The US dollar will still be important, but it will no longer be the number one currency as there will be significant use of local currencies for bilateral trade arrangements. This phenomenon is gathering momentum in ASEAN. The world will reflect on its multipolar economic configuration with investments and currencies that manage transactions across borders becoming multipolar as well.

The Yen did not emerge as an important reserve currency as it did not have a short-term treasury bill market like the US dollar. To become an international reserve currency, there is a need for short-term liquidity management potential of the currency. Hence, there is a possibility of other currencies emerging.

Bilateral payments in local currency will emerge. This is happening in many places where bilateral trade is growing. There could be risks and consequences moving into a third currency which countries need to bear as such a rift can be highly destabilising.

Regional blocks are likely to emerge. Asia, starting with ASEAN and ASEAN+3, will continue to become a block to be reckoned with due to its cohesiveness. Latin Americans and the Middle East want to examine how Asia has achieved such cohesiveness and integration. ASEAN never wanted a single currency as it does not have the preconditions for it. Instead, what it wants is financial integration because they are high savings economies. Its savings do not require it to go to developed financial markets and return as volatile capital flows. ASEAN should use some of its savings directly to finance investments in its region. Therefore, financial integration is the way to go within the international financial system.

CLOSING ADDRESS

By Datuk Kamaruddin Taib, Chairman, FIDE FORUM

Today's discussions illuminated critical facets of our evolving global landscape. We have dwelt into geopolitical tensions, the rise of cryptocurrencies, digital finance, challenges to US hegemony, as well as broader issues within the global financial system. These discussions are not just academic but also touch on the very core of how central banks can maintain monetary and financial stability. As we navigate these changes, the role of central banks becomes increasingly complex requiring adaptability and innovative financial tools. The emergence of digital finance, while presenting challenges, also offers new mechanisms for policy, implementation, and financial oversight. However, the potential of cryptocurrencies to circumvent traditional financial systems raises questions about regulatory efficacy and the future of monetary sovereignty. As central banks confront these challenges, these strategies must evolve to ensure stability in the new financial paradigm, balancing innovation with risk management. The path forward is uncertain. But one thing is clear – collaboration, both domestically and internationally, will be key to navigating the future of monetary policy and financial stability.

The panel discussion underscores the complexity facing central banks amidst geopolitical tension. the rise of digital finance, challenges to US dollar's dominance, and broader financial system shifts. It highlights the necessity for central banks to adapt, innovate, and collaborate internationally. As digital currencies gain traction, they present both opportunities and regulator changes, emphasising the need for a balanced approach to ensure monetary stability. This evolving landscape demands that central banks not only adjust their tools but also strengthen global cooperation to navigate the uncertainties of this new financial paradigm effectively.

Generative artificial intelligence (AI) is stirring both excitement and apprehension among many. It is pivotal in reshaping how central banks oversee the global financial sector, revolutionising oversight of finance, enhancing predictive and analytical capabilities for better decisions. While automating some tasks, AI primarily augments human roles, necessitating workforce adaptation in AI ethics and analytics, transforming jobs more than eliminating them in the evolving financial landscape.

Fireside Chat with Former Central Bank Governors on
Central Banking in an Evolving International Financial Systems

by Asia School of Business and FIDE FORUM

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