

## Leeds University Business School – Research and Innovation Podcast

Episode 28: What is currency internationalization and why does it matter?

Speakers: Dr Annina Kaltenbrunner and Dr Bianca Orsi

**Nina:** [00:00:00]

Hello everybody, to this episode of the Research and Innovation podcast. My name is Dr Nina Kaltenbrunner. I am an associate professor in the economics division at Leeds University Business School. And I'm joined by my good friend and colleague Dr Bianca Orsi, teaching fellow in the same division. Hi Bianca!

**Bianca:** Hello.

**Nina:** Good to be here. So we would quite like to talk a bit about our research on currency internationalization, particularly in the context of emerging markets, which is our area of expertise and particularly in the context and case of Brazil, which is Bianca's home nation. And I have fallen in love with.

So, what we would quite like to do is to tell you a bit about what currency internationalization is, how it is defined, how it matters. And then we would quite like you to tell, tell you a bit [00:01:00] about the research which we have been doing on the internationalization of the Brazilian Real for, and in collaboration with, the Brazilian central bank.

And we're going to conclude a bit about on what policy recommendations come out of this. And well, what's going on in the currency space at the moment, which Bianca has been following. So I'm going to kick things off, just telling you a bit about what currency internationalization is. And so far I haven't mispronounced it, which I'm very proud of.

And then Bianca is going to tell you a bit about so why it matters. So currency internationalization in its simplest form of definition is just the use of a domestic currency either by non-nationals or by non-residents. So what does that mean? That means that let's say in our context, the British pound could be used either by people outside the [00:02:00] UK, so non-residents, for example, could be traded or held by American investors outside the UK or in a narrow definition could be held by American investors or issued by American agents in the, within the borders of the UK.

So in both cases, depending on how we define it, we're talking about currency internationalization, which means domestic currencies either traded or held by non-UK, non-nationals, or held or traded offshore outside the UK borders. So that is the traditional definition of currency internationalization and the way it has been analyzed in the literature now what Bianca and I, and also in collaboration with colleagues from the University of Liverpool have been developing, is that actually, rather than these definitions, what really matters, isn't so much, whether but how currency internationalization takes place and comes [00:03:00] about.

So what we are arguing is that this currency internationalization is not a linear process, but it's actually a variegated one, depending on what type of functions currencies assume in the international economy.

And I want to hand over to Bianca. Bianca maybe you can tell us a bit more about what different types of currency internationalization there are, and what we've been investigating and maybe what different implications, these different types of currency internationalization have, particularly in the context of emerging markets, which we are so concerned with and which have their own policy challenges, if you want.

**Bianca:** [00:03:42] Thank you very much, Nina. So when we study currency internationalization, we are not only looking at the degree to which a currency is internationalized, but we are mainly looking, uh, at which nature these currencies are [00:04:00] internationalized. And in this literature, we usually use the traditional functions of money, which essentially is means of payment.

You need to have account and store value. But a question that arises with this is this: Why does it matter? Why does it matter that we study currency internationalization? Well, currency internationalization, not only the degree, but particularly the nature has a lot of implications for the domestic economy.

So if we take as an example, the US dollar, the US dollar is a highly internationalized currency across all the three functions, functions of money that we just mentioned. Um, and that has a lot, of course, a lot of implications for the US economy. For example, given that the US dollar is widely accepted all over the world, it means that for, uh, people [00:05:00] in the US that transactions, international transaction costs would be much smaller because they don't need to access a foreign currency to be able to make international payments. They can just use the US dollar, for example.

Another very important implication, uh, you know, of being the economy, that issues the most important currency, the key currency of the system is that the exchange rate volatility of this currency is much smaller than in other, in the case of other currencies. And of course this has a lot of impact on the domestic economy. Like for example, we have lower impact on inflation, you won't damage economic growth and so on and so forth.

However, this is not the case with less internationalized currencies. It has, you know, being at the bottom of what the so-called, currency hierarchy, where we have the dollar at the top of this hierarchy. And at the bottom we [00:06:00] have these less internationalized currencies in that they, for example, lose their monetary sovereignty.

So if we take as an example at the beginning of the pandemic, last year around April time, some of these emerging market countries, had their currencies devaluated in about 20%, which is a huge impact in a very short period of time. So that's why it's really important for us when we are studying economics that we pay attention to not only the degree, but like we said, the nature of currency internationalization and in that sense, Nina and I have

conducted a very, very interesting research about the Brazilian Real. Nina - would you like to talk a little bit about that?

**Nina:** [00:06:50] I'd love to thank you, Bianca. So. So based on that research about these different types of functions of money and how money is used to an international [00:07:00] economy and how that maps onto different types of currency, internationalization, Bianca and I together with those, with the colleagues at Liverpool, which I've already mentioned, have been asked by the Brazilian Central Bank to investigate the process of the internationalization of the Real and also formulate policy recommendations as to how to govern this internationalization process. And so based on the basis of extensive empirical research, which included both semi-structured interviews, interviews with foreign exchange market participants and economic metrics, we found that the Brazilian Real is indeed one of these cases of if you want so support in monies or let's put it differently - monies on the lower level of the currency hierarchy, which internationalized in a very specific and potentially quite volatile way, which we call short-term [00:08:00] investment currency internationalization.

So rather than internationalized thing, like the US dollar, which Bianca has just described a lot across all kinds of money functions, like as a medium of exchange of value, actually the Brazilian Real if and when it's used for non-nationals and non-residents is primarily used as a short-term speculative investment or as a short-term investment currency. Now in that we show has quite substantial implications, both for exchange at the economics and consequently monetary policy as takes the Brazilian Real is relatively volatile compared to developed currencies, but also its peers, which in its turn complicates monetary policy.

It's also very vulnerable to what happens on international financial markets. So as we say, whenever, whenever the Fed sneezes, the Brazil Real gets a cold. So the contagion effect from core economies on the [00:09:00] Brazilian Real being such a short-term investment currencies, are very strong and very immediate.

And so on the basis of this analysis and the characterization of the Brazilian Real and the characterization of these different types of currency internationalization, we've recommended to the Brazilian Real, as strategy of regional currency regionalization or trade-related currency regionalization.

So we recommended that in order to internationalize the Brazilian Real in a sustainable and positive way, it would be beneficial to on the one hand focus on trade operations, so support the Brazilian Real as a medium of exchange in trade. And in the first instance, focus on regional operations in the Mercosur - Argentina, Paraguay and Uruguay, and to some extent, Chile, rather than going or enhancing a full-fledged [00:10:00] global internationalization process. And in order to achieve this, we specifically recommend the enhancement or the use, or increased support to an existing local currencies payment and settlement system, which is the so-called SML.

And I think Bianca is going to tell you a bit more about the SML and what we found there, as being one of the experts on local payment systems.

**Bianca:** [00:10:31] Yeah, thank you Nina. So, like Nina said, the main, the broad recommendation, of our research is that the Brazilian Central Bank should promote the internationalization of the Brazilian Real as a trade currency in order that you get away from this, short-term use of the Brazilian Real. But the question here is that how, how can we even do that?

[00:11:00] And one of the main conclusions of our, of our research is that we recommend the, not only the expansion, but also the development of a local currency payment system called SML - in Portuguese, Sistema de Pagamentos em Moeda Local. And essentially the SML is an initiative from the Brazilian central bank.

And the SML essentially allows trade to be done in local currency, which in a way helps to reduce the dependency that these economies have in, in, in the region from the US dollar. However, when we were studying the SML, we noticed that the SML is used is still very limited. And when we dig into that, we found that, you know, some of our initial results show that [00:12:00] the main causes for this limitation in the use of the SML is, first, lack of credit in local currency.

And the second one is the, lack of advertisement by banks because they don't really profit from these kinds of operations. And finally, we also came to the conclusion that promoting the Brazilian Real only as a trade currency is not really enough. So we need to promote different types of currency internationalization at the same time in a complementary and simultaneous way in order to go, move towards a more, stable and positive kind of currency internationalization, as opposed to the short-term use of the Brazilian Real only for speculative investments, for example.

**Nina:** [00:12:57] Brilliant. Thanks so much Bianca. Now, when we [00:13:00] were preparing for this podcast in a way we've come to the end of our, of our main topic - currency internationalization of Brazil and the importance of developing regional systems and regional payment systems and other functions. Now, one question though, was, so when we present this research, we always get all kinds of questions about, well, you know, how does international monetary system looks like now? What is happening? So we thought maybe at the end, we finish up on a few thoughts or one on a few questions, which we, which we get asked most. And, I want to give back to, to Bianca who had kind of like, some, some interesting thoughts on, you know, where are we? What's the future of the dollar is the Chinese renminbi really rising and, you know, are central bank digital currencies, making a difference to it all.

Bianca, can you look into Pandora's box and tell us what's going to happen?

**Bianca:** [00:13:52] Yeah. Yeah. So despite the fact that, Nina's research and in [00:14:00] mind is mostly focused on the Brazilian retail. We also have a broad look in terms of,

currencies issued by emerging market economies. And one question that, you know, we keep, we keep getting all the time is that, “are we moving towards a multipolar system” in the sense that nowadays we have a bipolar system, very clear where we have essentially the US dollar and perhaps, uh, the Euro being mainly used at the international markets, but are we moving towards a multipolar system with more currencies to be, to be used, for international transactions.” And I guess we would say not really, at least not in the short term. What we have been observing more recently is that the Chinese renminbi is being growing a very fast pace in the international market, but currency internationalization is [00:15:00] by nature, a very, very slow process.

So if we think about the key currency of the international monetary system before the first World War was the British pound. And essentially took two World Wars, plus the Bretton Woods for the US dollar to replace this position of the British founders the key currency and become the key currency.

We also have the Euro, which is, you know, has a very relevant participation in the international market, but the US dollar is still the key currency of the system and it will continue to be so in the short-term. Another question that we also get many times is about central bank digital currencies, because I think this is a very hot topic at the moment; it is on the news all the time.

But in terms of research, we, we still think that it's too early to discuss that or to draw any [00:16:00] conclusions about that. But our main thought here is that we don't really see this as a threat to the use of national currencies at the international level, at least not in the near future.

**Nina:** [00:16:15] Brilliant. Thank you, Bianca. I could not, I mean, we've discussed it, but I couldn't agree more with you. And I think actually quite to the contrary, I think the dollar has just been strengthened through the recent COVID crisis and the active action of the Fed now and how it has supported other currencies in the system.

So there's definitely no end in sight to the dominance of the dollar. And with that, I guess we will leave you all. If you have any questions, then we're here and we're always very happy to discuss currencies.

**Bianca:** [00:16:44] And if you'd like to know more information about our research, we also have the reports that we are preparing, for the central bank about currency internationalization in particular, the internationalization of the Brazilian Real - it's available on the page.

[00:17:00] So, thank you very much for listening. And we are more than happy to take any further questions if you want to via email.

**Nina:** [00:17:07] Thank you very much.