

Taking Stock of Monetary and Financial Regionalism in Asia

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1. Defining Asia?

- Various classifications:
 - 52 members of ESCAP (Asia-Pacific).
 - 45 members of ADB.
 - 21 members of Asian Cooperation Dialogue (ACD).
- If membership is too broad initially it leads to a “convoy problem”.

- Smaller groups:
 - EMEAP (11 members).
(Australia, HK-SAR, Indonesia, Japan, Korea, Malaysia, NZ, PRC, Philippines, Singapore, Thailand).
 - BIS-ACC (12 members).
(Australia, India, Indonesia, HK-SAR, Japan, Korea, Malaysia, NZ, PRC, Philippines, Singapore, Thailand).
 - SEACEN (13 members).
(Indonesia, Korea, Malaysia, Mongolia, Myanmar, Nepal, Singapore, Sri Lanka, Thailand, Philippines, China, Taipei).
 - ASEAN plus Three (APT)
(ASEAN-10, China, Japan, Korea).
 - ASEAN plus Four (JACIK)
(APT plus India).
 - ASEAN plus Six (APS).
(JACIK plus Australia and NZ).

- If regionalism is too narrow and excludes large players looking to integrate with regional and global economy it may result in overlapping and untidy patchwork of sub regional “Asian alliances”.

- An explicit set of criteria participation in first East Asian Summit (EAS) in Kuala Lumpur:
 - Full dialogue partner of ASEAN.
 - Substantive existing links with ASEAN.
 - Signatory to Treaty of Amity and Cooperation.
- Initial participants in EAS are the APS countries.

- EAS is an evolving process and questions abound:
 - Should expansion of EAS be supported? – *qui pro quo* – India's membership in APEC and EMEAP.
 - Declaration termed it a “forum for dialogue on broad strategic, political and economic issues”.
 - If EAS is broadened and becomes a talk shop while intra APT cooperation is deepened, how can India enhance functional regionalism with APT?

2. Types of Functional Regionalism?

- From a functional perspective four dimensions of regionalism:
 - Monetary and Financial.
 - Trade and Investment.
(Issue of sequencing is important analytically but probably less so from a policy perspective).
 - Cross-border infrastructure and related software.
 - Regional public goods.

- *Focus here is on de jure Monetary and Financial regionalism (MFR).*

3. Why Asia's Interest in MFR?

- External developments in regionalism, particularly deepening and broadening of European Union (EU).
- Financial crisis of 1997-98 and perceived inadequate response to it from extra regional players.
- Concerns about under-representation of Asia in IMF quota distribution and general lack of voice in international monetary affairs along with the belief that Asia has ample resources for regional self-help.
- Growing *de facto* economic interdependence and regional nature of spillovers ("contagion").

- Beyond the need for “sound” macro policies, the *capital account nature of crises* has emphasized the following:
 - Ensure availability of sufficient liquidity in the event of a bust.
 - Diversify sources of funding / channels of intermediation to minimize intensity of busts.
 - Minimize balance sheet mismatches (both maturity as well as currency).

4. Types of MFR in Asia

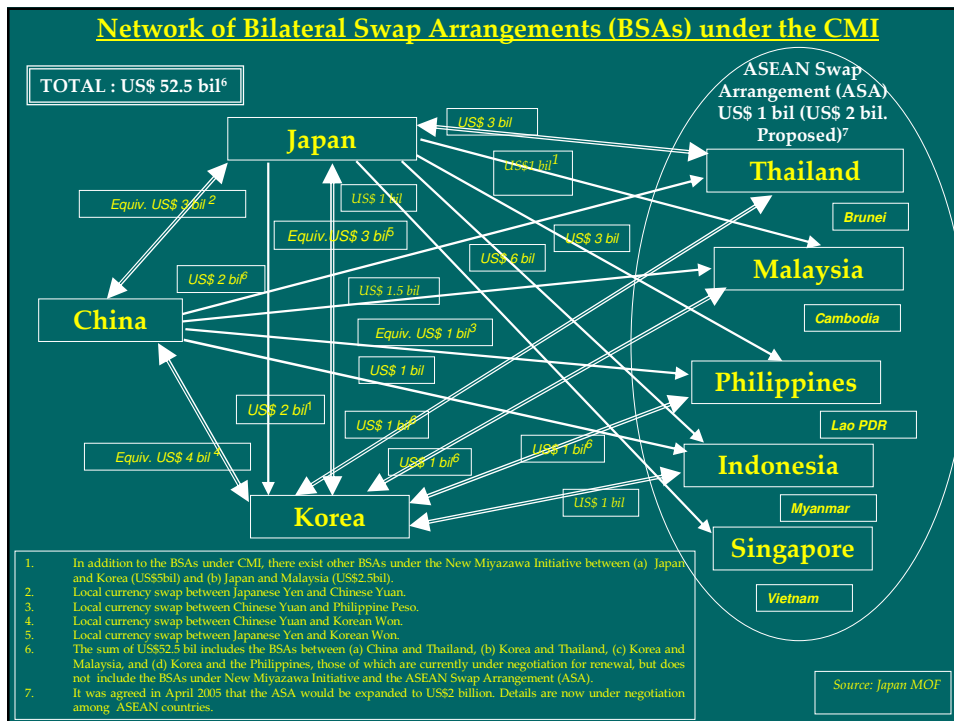
- Gradations of cooperation or policy initiatives.
 - *Weak form*: Policy dialogue, surveillance (*APT Economic Review and Policy Dialogue*), common early warnings signal and monitoring of capital flows.
 - ***Medium form*: Development of regional liquidity arrangements and regional financial markets.**
 - *Strong form*: Exchange rate and monetary coordination and eventual monetary union.

5. Regional Liquidity Arrangements

- Chiang-Mai initiative (CMI).
- CMI which is a network of swap arrangements was agreed among APT countries in May 2000.
- CMI is *not* a fund for exchange rate stabilization or crisis management but more crisis prevention.

- Stylized preventive steps in the event of crisis of confidence:
 - Raise interest rate to reduce capital outflows.
 - Cushion impact via currency depreciation.
(*Paper looking at these issues analytically*).
 - Talk up the market.
 - Ensure availability of sufficient liquidity.
 - ✓ Own resources (reserves).
 - ✓ Liquidity arrangements like CMI.
- Aim of CMI is to provide countries under pressure with short-term hard currency liquidity and supplement existing global financial arrangements.

- CMI has two components:
 - ASEAN swap arrangement (ASA) which was expanded from 5 to 10 countries, and from US\$ 200 million to US\$ 1 billion.
 - Networks of bilateral Swap arrangements (BSAs) among the three North Asian countries (Japan, China, Korea) and one of the three and one of the ASEAN countries.
 - A series of BSAs have been agreed upon with an aggregate size of US\$ 52.5 billion.



- Basic characteristics of the BSAs:
 - 10% (20%) can be drawn automatically without conditionality for 630 days (90 days, renewable 7 times).
 - Interest paid is LIBOR + 1.5% for first 180 days, rising by 50 basis points for each renewal to a maximum of LIBOR + 3%.
 - Swap providing countries form their own individual opinions on potential swap recipient.
 - Drawing of more than 10% (20%) requires country to come under IMF conditionality.

How Effective is the CMI?

- Inadequate size especially liquid component.
- How is coordination to be done?
 - E.g. is bilateral arrangement subject to regional approval?
 - How is borrowing/lending to be distributed? -- How to multilateralize it?
 - Limited duration of individual agreements.

- In the *Joint Ministerial Statement of 8th AFMM+3*
 - CMI is to be doubled in size.
 - Unconditional liquidity share has been raised to 20%.
 - Bilateral swaps are being made two-way and further discussions on multilateralizing the arrangements.
 - Collective mechanism to activate swaps. (*This is critical*).
 - Recognition of need to improve on and link surveillance more to CMI.

6. Developments in Financial Cooperation in Asia

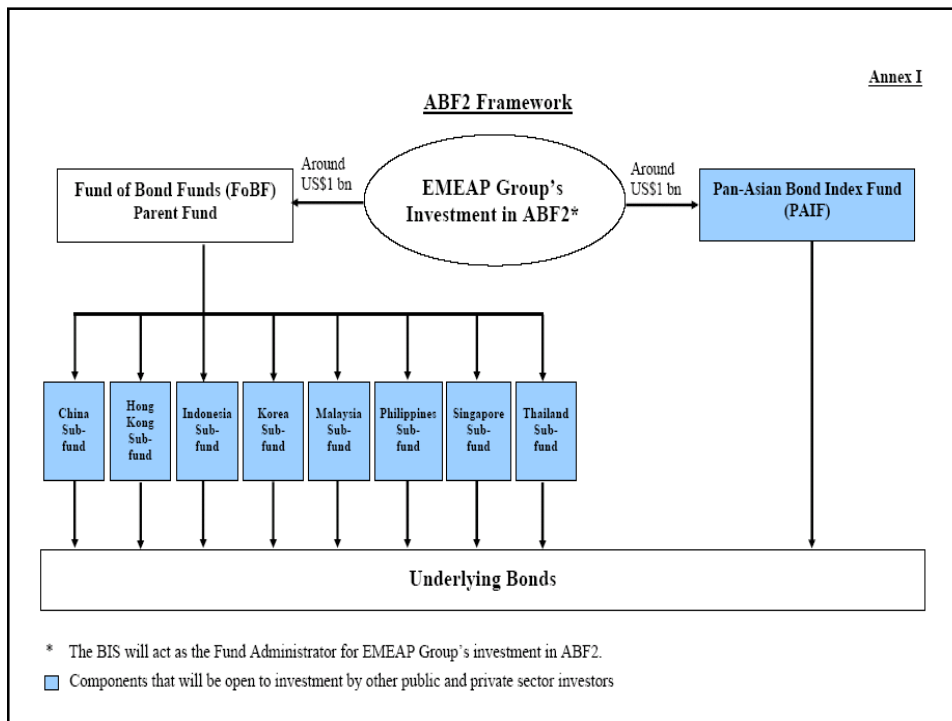
- Primary focus on the bond market.
- According to the World Bank (2004):
(c)ompared to the bank market, bond markets offers some advantages in terms of longer maturities, tradability, and back-weighted repayment structures that help support equity returns (p.157).

- Two main initiatives:
 - Asian Bond Fund (ABF) by 11 EMEAP members.
 - Asian Bond Market Initiative (ABMI) by APT.
 - Other initiatives at the APEC and ACD levels as well as private sector (Asian Bond Market forum).

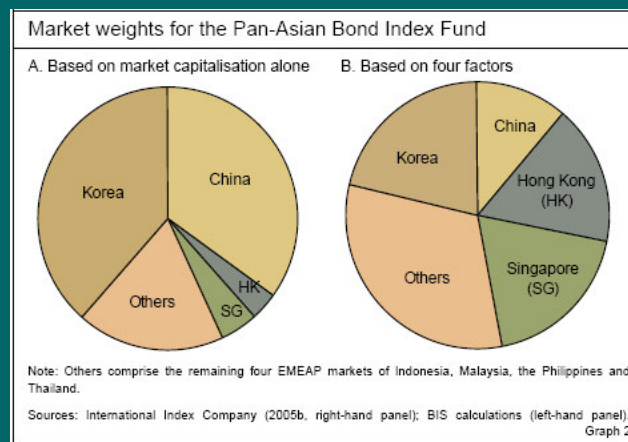
ABF 1 and 2

- ABF 1 (June 2003) -- passively managed by the investment management unit of the Swiss-based BIS.
- Mandate is to invest in a basket of liquid US dollar sovereign and quasi-sovereign debt issued by 8 developing member economies (excluding Australia, Japan and New Zealand).
- ABF 2 (December 2004) -- expanded in magnitude (US\$ 2 bn) includes selected domestic currency sovereign and quasi-sovereign bonds in the 8 countries.

- ABF 2 comprises two components (US\$ 1 bn each):
 - (1) A Pan-Asian Bond Index Fund (PAIF) -- The PAIF is a single bond fund.
 - (2) A Fund of Bond Funds (FoBF) -- The FoBF is a two-layered structure with a parent fund investing in eight single market sub-funds.



- Seed money for single bond funds divided on *pre-determined criteria* and local fund managers appointed to manage the respective funds.
- Criteria for market weights in each sub-fund (and distribution within PAIF) based on:
 - the size of the local market,
 - the turnover ratio in that market,
 - the sovereign credit rating, and
 - a market openness factor.
- Market weights will be reviewed annually, with market openness being a particularly important factor in the allocation of weights.



- Parent fund is limited to investments by EMEAP member central banks only.
- While initial phase of PAIF was confined to investment of EMEAP central banks only (US\$ 1 bn) it was recently opened to investments by other retail investors in Phase 2.

- Objectives of the ABF:
 - Develop regional financial / capital markets:
 - ✓ By reducing supply side constraints and introducing low cost products (ABMI).
 - ✓ By raising investor awareness and broadening investor base on demand side).
 - Lead to a convergence in financial and capital market policies and accelerate improvements in financial market infrastructures.
 - Recycle regional funds intraregionally including into infrastructure.
 - Reduce maturity *and* currency mismatches.

- Concerns with ABF:

- If the supply of good quality sovereigns and quasi-sovereign paper is limited will it crowd out private investors?

- Will it lead to premature capital market liberalization in some countries (*of concern given that weights dependent on openness*)?

7. Going Forward on MFR

Financial Regionalism

- Persist with attempts to develop well-functioning financial markets and institutions.
- Deepening and upgrading national and regional government and corporate bond markets as a means of reducing the region's heavy reliance on banks.
- ABF initiatives are modest steps in the right direction – expansion of size and membership.
- Discussions underway about creation of regional financial infrastructure (clearing and settlements systems, credit agency) as well as harmonization of withholding tax policies and capital account policies.

- Recent suggestion floated about is for an Asia Basket Currency (ABC) Initiative:
 - Member countries issue local currency bonds.
 - The ABC corporation creates and issues basket currency bonds (weighted combination of regional currencies of the underlying national bonds) backed by regional sovereign bonds.
- If successful, ABC could provide a fillip for eventual creation of an Asian Currency Unit (ACU).

Monetary Regionalism: Medium form

- Enhancement of liquidity arrangements.
 - **Further augmentation of CMI:**
 - a) Expand size further and enlarge to include India.
 - b) Multilateralize swap arrangement further.
 - c) Raise non IMF-linked share (what type of independent conditionality with teeth?).
 - d) Make transparent and automatic the condition for withdrawal.

➤ **Consider transforming CMI into a regional reserve pooling mechanism (ADB)?**

Cost of reserve build-up -- Opportunity costs (alternatives being proposed include reserve diversification and using funds for non-liquid purposes) and fiscal costs.

Regional reserve pool:

- Owned reserves offer the highest degree of liquidity and have zero conditionality but are costly.
- Second tier: Sub-divided into country's own reserves placed with regional pool and other members' reserves with the pool.
- Third tier: Conventional IMF lending.
- With such a structure the degree of liquidity could be inversely related to the degree of conditionality.

- But no forward movement until there is a considerable strengthening of the regional surveillance mechanism with well worked out policy conditionality.

7. Implications for India

- ADB's President has suggested a "horses for courses policy" towards membership:
 - India and ANZ should be included in an Asian-wide FTA (akin to proposal of PM).
 - Monetary and financial regionalism should be limited to APT – *argument made is limited Indo-APT financial integration.*
 - If this allowed to happen India may be relegated to be a secondary member -- even less than ANZ as latter two participate via EMEAP and APEC.

▪ India needs to hard sell its interest in and willingness to participate in weak and medium forms of MFR (*strong form is another issue...*) :

➤ Size and relative stability of India's reserve holdings.

➤ Vast experience in financial market reform and regulations.

➤ Growing *de facto* financial links between India and APT. – *Need for more research in this area...*

Thank you!