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RIS Policy Briefs

Towards an Asian Regional Mechanism for Addressing Excess Foreign Exchange Reserves, Infrastructure Deficits and Global Imbalances

I. The Triple Challenges

Foreign exchange reserves of Asia are now more than $3 trillion and increasing at more than 10 per cent per year. While such abundance of reserves is a cause for comfort in many Asian countries with recent memories of foreign exchange crisis, there are at least three major problems associated with it.

Foreign Exchange Reserves as Loss Leaders

First, these foreign exchange reserves are earning very low rates of return, much lower than the profits earned by those sending capital to Asia. For example, in India, according to the Reserve bank of India's Annual Report, 2005-06, the rates of return were 3.1 per cent in 2004-05 and 3.9 per cent in 2005-06 which meant negative rates of return in real terms. This is much lower than interest rates earned on foreign deposits and on capital inflows in India. Thus at this point the foreign exchange reserves have become the loss-leaders for the country: every dollar added to reserves is a cost to the economy. Assuming that we do not want to restrict the inflows of foreign capital, we must find ways of better portfolio management of our foreign exchange reserves.

By any calculation of transaction and precautionary needs, at least 50 per cent of these reserves are excess. Traditionally, reserves equivalent to 3 months of imports are regarded as adequate. Another rule is to provide for reserves equal to the short-term debt of the country. Even if we take a conservative approach and use the double the level suggested by these conventional rules, excess reserves in Asia are more than 50 per cent of the reserves at the end of December 2006 (see Table1). Clearly Asia is in a position to take a more aggressive approach to management of its portfolio of foreign exchange reserves .

Risks from Global Imbalances

Second, these reserves are to a considerable extent mirror image of the current account deficits and increasing foreign liabilities of the US The deficits of the US were $597.5 billion in 2005 and increasing. Many eminent economists including Larry Summers and IMF have argued that there is a serious risk of disorderly correction to these imbalances, which can bring about recession in the US as well as in the world economy. In its recent report on world economy, *World Economic Outlook 2006*, the IMF presents a "Strengthened Policies" scenario in which there is greater exchange rate flexibility in emerging Asia accompanied by *gradually reduced foreign exchange purchases by monetary authorities and by an improvement in productivity as an increasing share of wealth is invested in productive physical capital inside the region* (emphasis added). In view of the importance attached to the IMF views by the central bankers of the world, particularly in Asia, this recognition of the role of increased investment in Asia for correcting global imbalances is significant. Moreover, this approach can be linked up with the proposal from the US Treasury Secretary urging Asia to increase domestic demand

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This policy brief has been prepared by Dr. Ramgopal Agarwala, Senior Adviser at RIS on the basis of an RIS Report: *Regional Cooperation for Infrastructure Development in Asia: Towards a Regional Mechanism for Public-Private Partnership*. The Report was prepared by a team led by Dr. Ramgopal Agarwala under the overall guidance of Dr. Nagesh Kumar, DG, RIS and with inputs from other Faculty members in particular Dr. Prabir De, Dr. Sameer Pradhan and Ms Anindita Ghosh and Dr. Nilanjan Banik and Dr. Vidhya Muthuram, Consultants.

Table 1: Estimated "Excess" Foreign Exchange Reserves in selected Asia-Pacific Countries

	Foreign Exchange Reserves*at end of December 2006	"Excess" Foreign Exchange Reserves with reserves as 6 months of imports	Excess" Foreign Exchange Reserves with reserves required as twice the level of short-term debt
Japan	866.53	541.93	711.35
China	990.45	612.42	820.39
Taiwan, China	262.0	161.56	173.94
Hong Kong, China	130.24	58.39	69.31
Korea	228.14	55.53	54.65
India	159.10	86.62	84.93
Malaysia	79.22	15.76	27.95
Russia	258.70	164.06	141.91
Total	**3274.38**	**1696.27**	**2084.43**

Note: * International Reserves excluding Gold.
Source: RIS based on Joint BIS-IMF-OECD-World Bank Statistics on External Debt, IMF, BOPS, August, 2006, US Treasury, 2006.

[1] Statement by U.S. Treasury Secretary John Snow following the G7 Finance Ministers and Central Bank Governors Meeting September 23, 2005: "To maintain sustainable growth - and advance the goal of reducing poverty around the world we simply must see more domestic demand-led growth from other parts of the world. Rather than slowing U.S. growth to match that elsewhere, I emphasized the need for more growth from more countries and new reforms to boost potential growth rates appreciably."

(which can be interpreted to mean regional domestic demand as well).[1] The risks of neglecting the problem of global imbalances are indeed serious, particularly in view of the growing protectionism in the west, including the US If disorderly correction of the global imbalances leads to sudden decline of US dollar leading to a sharp increase in US interest rates, there could be serious recessionary tendencies in the US This could strengthen the protectionist sentiments in the country leading to a cobweb of declining output and increasing protectionism much as what happened during the 1930s when the collapse of the roaring twenties in the US led to a worldwide depression. The time for action is now before the financial correction starts which as experience shows often has a tendency to overshoot. The world community must now try and design proposals for increasing investment in Asia which along with other measures proposed by IMF can achieve a win-win solution for the problem of global imbalances while accelerating growth in Asia.

Serious Infrastructure Deficits

Third, Asia now suffers from the anomaly of excess savings in the aggregate with many countries, particularly in South-east Asia suffering from "investment drought" with investment as per cent of GDP in low twenties. These investment rates are quite inadequate for achieving the traditional East Asian growth rates of about 7 per cent per year which was crucial for the stellar record of East Asia in poverty reduction. Within the overall investment drought, infrastructure deficit is particularly prominent. In Indonesia, the situation is desperate with the infrastructure investment rates declining to about 2 per cent, from about 6 per cent in mid-1990s. Even in India, where the overall investment rates are improving, infrastructure investment rate in 2004-05 was 4.9 per cent, lower than that in the year 1991-92, a year of economic crisis.

Asia as whole has a large stock of economically viable infrastructure projects which can create additional investment of over $200 billion per year. Many of these investments are in cross-border infrastructure where pay-off can be very high. These can make the land-locked countries and regions landlinked and help growth in Asia become more inclusive. They can help achieve the objective of energy security high on the agenda in many Asian countries. Just as important as these supply side effects are the demand side effects. It should be remembered that in many of rapidly growing economies of Asia, demand generated by infrastructure investment provided an important basis for sustained growth. In fact, in China, where exports are often seen as the key stimulus of growth, increase in investment (including infrastructure investment) rather than net exports accounted for the major share of growth in the last five years.

Private sector for infrastructure investment did not live up to its promise of the mid-1990s. Except in telecom sector where technological developments helped the process, private investment in most sectors such as transportation, power and water and sanitation, in most of the countries in Asia has been declining from their peaks in the 1990s. The problems of governance, regulatory systems and risks faced by the private sector in infrastructure investment continue to be serious. At the same time, with continuing limited fiscal space in most countries, going back to investment by public sector is not a realistic option. Clearly, some sort of partnership between public and private sector is needed to increase infrastructure investment in Asia to accelerate growth and make it more inclusive, not only within countries but also between countries.

Some of these investments are also financially viable and private sector may well take them up provided the regulatory environment is improved. For

some others, there may be some gap in financial viability which the public sector may well be called upon to fill. Public policy support for increasing infrastructure investment may well be necessary to sustain growth in rapidly growing economies, improving energy security in the region and help the lagging regions by improving their connectivity. This additional investment stimulus (of about $200 billion per year) can also help improve production and export of capital goods from developed countries not only Japan and EU but also US and thus reducing the trade gap in the US. And if some to Asian savings are gradually diverted to Asian investments, the process may harden the external budget constraint on the US, which will also help to reduce the US consumption, both public and private. Moreover, the whole process will be gradual and even the most ambitious infrastructure programme in Asia, will achieve demand switching gradually providing a long period (say ten years) for gradual reduction in US deficits.

II. Some Promising Reforms in the Making

Public-Private Partnership for Infrastructure

Recognizing the needs for public-private partnerships (PPP) in infrastructure development, some special mechanisms are being set up in, for example, India and Korea. This approach recognizes upfront that there are many risks in infrastructure development that public sector can bear better than private sector. And there are externalities in infrastructure development which public sector can internalize better than the private sector. Many infrastructure projects have financial viability gaps that need to be filled by the public sector which, over the longer term, will earn additional revenues from exploiting the positive externalities created by infrastructure development. A Special Purpose Vehicle has been created in India, which with guarantee from the Government can borrow from capital markets and help funding of projects in PPP mode. The exact mechanisms of this approach are still at a formative stage but encouraging enough for wider experimentation and learning by doing on a larger scale.

In Republic of Korea, the government has been operating a scheme for Private Participation in Infrastructure (PPI) over the last ten years. A key factor in selecting the PPI over the traditional procurement method is Value for Money (VfM). By combining such responsibilities as design, building, financing and operating in a single contract and transferring part of the risks and responsibilities to the private sector, PPI projects realize VfM with less project costs and improved service quality compared to the conventional public procurement. PPI programme not only supports investment in infrastructure such as roads and railways but also investment in social infrastructure such as education, cultural, and welfare facilities. Government supports private sector through support for acquisition of land, construction subsidy, minimum revenue guarantee, foreign exchange risk mitigation, tax benefits, and infrastructure credit guarantee fund. As a result, the share of private investment in infrastructure in Korea has risen from about 1.2 per cent in mid-1990s to 14.4 per cent in 2005.

Better Returns from Foreign Exchange Reserves

On the issue of better management of foreign exchanger reserves too, there are some encouraging initiatives, breaking the old taboo among central bankers about investment only in risk-free government bonds. The Government of Singapore Investment Corporation Private Limited (GIC) was set up by the Government of Singapore in 1981 to manage Singapore's foreign reserves. Over a period of 25 years to March 2006, the annual rate of return on the foreign reserves managed by GIC averaged 9.5 per cent in US dollar terms. China has recently announced a programme of setting aside $200 billion of its foreign exchange reserves for active management. India has also put aside $10 billion for active management.

Developing Regional Bond Markets

Bond markets offer some distinct advantages in terms of longer maturities, tradability and back-weighted repayment structures that help to support long gestation projects. There are several initiatives to expand the role of bond markets in Asia. Eleven regional economies that are members of the Executives' Meeting of East Asia-Pacific Central Banks have set up Asian Bond Fund (ABF) to promote regional financial cooperation. In the first phase of ABF, the value of the Fund was $1 billion which was doubled to $2 billion in the second phase in 2004. Its mandate is to invest in selected domestic currency, sovereign and quasi-sovereign bonds in various countries. Another initiative is the ASEAN+3 Asian Bond Markets Initiative (ABMI), which was endorsed at the ASEAN+3 Finance Ministers' Meeting in Manila, the Philippines on 7 August 2003, and aims to develop efficient and liquid bond markets in Asia, enabling better utilization of Asian savings for Asian investments. It would also contribute to the mitigation of currency and maturity mismatches in financing. Activities of the ABMI focus on the following two areas: (a) facilitating access to the market through a wider variety of issues, and (b) enhancing market infrastructure to foster bond markets in Asia. These are welcome initiatives. During 2000 and 2004, size of the regional bond market grew by 18 per cent compared to the global market's growth by less than 2 per cent. However, the most of bond markets in the region remain small and have serious limitations in terms of liquidity, efficiency and growth.

III. The Way Forward

Outline of the Proposal

Building on the incipient initiatives in Asia, the RIS study proposes a bold initiative which can utilize the opportunities to tackle the challenges for achieving rapid and inclusive growth in Asia. Specifically:

- The study proposes that learning from the incipient reforms in Asia, a regional Special Purpose Vehicle (SPV) may be established with authorized capital of $300 billion, 10 per cent of which may be paid up. The SPV will use the excess foreign exchange reserves of Asia to help fill the financial viability gap of private sector investments in infrastructure. A certain small percentage (say 10 per cent) of the regional reserves (currently about $3 trillion and increasing at more than 10 per cent per year) may be lent by the central banks of Asia at the rate that obtains on 30-year US Treasury Bills to the regional SPV which will be authorized to invest these resources in global equity indices. There is a high probability that this SPV will be able to earn at least 5 hundred basis points above the cost of its funds and thus have about $15 billion to fill the financial viability gap, which, using the India example can be put at a maximum of 20 per cent of the project cost. In addition, the SPV will be authorized to borrow from the markets and lend on projects under PPP mode at rates and maturity pattern determined by a process of competitive bidding on the projects identified by SPV. With private and public sector enterprises utilizing the capital markets for raising their basic fund requirements, the financial ability of SPV should enable it to be a catalyst for more than $100 billion infrastructure investment per year in the region, thus meeting about half of the infrastructure funding gap.
- The new institution will also provide non-financial assistance to catalyze infrastructure projects in the region. More specifically, it will identify and formulate infrastructure projects for its clients: public sector, private sector, and public-private joint ventures (PPJV) of member countries. It will provide advice and assistance to member countries on infrastructure tariff fixation, working out strategies for risk mitigation and project financing including early development of construction planning to later stage arrangements for permanent financing including securitization, take-out financing and liquidity support. It will work with UNESCAP and other regional and subregional organizations for negotiating inter-country issues associated with formulation, implementation and financing of regional and cross-border projects. The funding ability of the SPV will give its technical assistance activities a coherence and relevance that is difficult to achieve otherwise.
- Private sector will raise its basic funding from the regional capital markets, in particular bond markets, which need to be developed further (among other things, by linking up with the growing pension funds industry in the region) to intermediate regional savings into regional investments. In order to minimize the risks to these bonds from fluctuations in regional currencies vis-à-vis US dollar and in relation to each other, these bonds may be increasingly denominated in an Asian currency unit (much as many transactions of global financial institutions are denominated in SDRs) and this unit could be a weighted average of major regional currencies with weights proportional to PPP adjusted GDP.

Win-win Outcome

The proposed programme would be a big boost to private sector in Asia and in the developed countries. First, it will provide financial and non-financial assistance for private sector investment. Second, it will facilitate raising of funds by private sector in Asian financial markets. Third, by switching investment of a part of reserves from Government securities to stock markets mostly in developed countries, it will help equity markets. Lastly by creating demand for supply of infrastructure investment (such as pipelines, and power grid) it will create demand for construction and manufacturing industries of sophisticated types, many of which will probably be supplied by developed countries including Japan, EU and US.

Additional infrastructure investments will benefit all countries through supply-side and demand side benefits noted above. Even for China which has a high rate of investment, these programmes, particularly in cross-border investments would be useful for increased inclusiveness of their growth and increased energy security. Many of these cross-border projects may be difficult to negotiate and implement by Asian countries individually, even for large countries such as China and India. The problem of asymmetry of power among neighbours often frustrates cross-border investments. The proposed mechanism can play an honest broker role which will help all Asian countries, big or small. Above all, the reduced risk of global turmoil emanating from global imbalances should be of interest to all major regional players including China, Japan, India and Russia.

IV. Some Questions Answered

Since the above regional mechanism was proposed in the UNESCAP/RIS Conference in March, 2007, there has been a lot of interest in the subject and a number of questions have been raised. We discuss below three important questions.

First, how serious are the risks of using foreign exchange reserves for infrastructure development with long gestation lags?

The scheme is risk-free for the central banks, who will just swap fixed interest instruments from the US

Treasuries to the Regional SPV. Since the proposed SPV bills are of 30-year maturity, the central banks will lose some liquidity, but at their current level of reserves, they can well afford that loss of liquidity. Moreover, since the foreign exchange reserves will not be directly invested in infrastructure investment but in a relatively liquid form of equities, countries in need of balance of payments support can withdraw a part of their loans from the SPV. In fact, the regional mechanism may allow the individual countries to borrow back more than their contributions under certain agreed rules for such borrowings.

The SPV and governments guaranteeing the borrowings of SPV will of course take some risks. But these are manageable risks with commensurate high returns. The whole point of Asia's new financial situation is that they are now affluent enough to take such risks and get higher returns that accrue to those who can take longer term view of their investments. As shown by the data of US Treasury Bills and stock market indices, on a long-term basis (thirty year moving average) over the last fifty years equities have earned about 4-5 per cent point more than on treasury bills. Even if an investment was made in equities in 1972 which was followed by a sharp decline in stock markets in 1973 and 1974, the thirty year average ending in 2002 (which was also a year of decline in stock markets) yielded 4 per cent point more than Treasuries. It is the strength of the Asian countries today that they can take these risks and make the long-term gains for region as well as for the individual countries.

Second, what if the equity investments by RSPV turn negative returns on inception?

In the proposed mechanism, only the profits of the RSPV will be invested in infrastructure. If there are no profits, RSPV will not support any new projects. In fact, it is highly likely that several years will go by before RSPV will be ready to finance the projects and it should have accumulated some funds which will act as cushion for fluctuations in the profits of the entity. In the initial years, the borrowings from the central banks can also be in the form of bullet bonds with no interest payment obligations for say 5 years during which the RSPV may establish its pool of resources. In the unlikely event of the RSPV running into deficits, the equity base of the SPVP and the callable capital is there to support the institution.

Third, why regional effort?

It is true that several countries are developing special mechanisms to earn better rates of return on their foreign exchange reserves and for supporting private sector in infrastructure. The proposed regional mechanism is to supplement not substitute for these country efforts. Among the reasons which support such a regional effort are the following:

First, the proposed mechanism will provide an instrument for risk pooling. The proposal allows for a the possibility that a country can run into balance of payments difficulties and may have to get back the loans of foreign exchange reserves it made to the SPV. Since it is unlikely that all the major players in Asia will run into such BOP difficulties at the same time, the regional programme will offer possibilities of borrowing back not only the contribution but even larger sums by the individual countries.

Second, the regional mechanism will allow greater focus on cross-country projects which are particularly neglected because there is no champion for them in national governments. A regional mechanism will be more acceptable than bilateral mechanism because in the situation of the asymmetry of power among big and small neighbours, a regional institution can play the role of an honest broker.

Third, in the current situation of Asia, there are several fragile states which can pose risks to the economic and political stability of the region. It is in the interest of bigger and stronger countries to help the fragile states in the neighbourhood. China, among others, is actively engaged in helping these fragile states. But as the experience of international assistance has shown, a multilateral mechanism may help to diffuse the tensions of smaller countries feeling dominated by bigger countries in the framework of bilateral assistance. A regional mechanism could thus be of interest, particularly to the bigger countries such as China, Japan and India.

V. A Proposed Institutional Set-up

The first option will be to have an expanded role of the premier financial institution in Asia, namely, the Asian Development Bank (ADB). Promoting regional co-operation for development is in fact the prime mandate of ADB. The primacy of this mandate is indicated by the fact that the very opening sentence of the Agreement establishing ADB emphasizes "the importance of closer economic co-operation as a means for achieving the most efficient utilization of resources and for accelerating the economic development of Asia and the Far East". Similarly, while defining the functions of ADB, the Agreement puts regional and sub-regional projects ahead of national projects and programmes in the following words: "To fulfill its purpose, the Bank shall…. utilize the resources at its disposal for financing development of the developing member countries in the region, giving priority to those regional, sub-regional as well as national projects and programmes which will contribute most effectively to the harmonious economic growth of the region as a whole...."

Despite this mandate, ADB for many years failed to contribute much to regional co-operation. However, recently it has taken an active role in this area and formulated Regional Cooperation and Integration (RCI) Strategy which puts forth an ambitious programme for ADB assistance for promoting regional co-operation. The strategy specifies four pillars, of which the first pillar is about improving infrastructure and can, in principle, fit in with the requirements of the initiative proposed.

There is, however, a question as to the form in which such an expanded role can be performed by ADB.

First, in the proposed mechanism, private sector will play a lead role in infrastructure development but as shown by the Indian and Korean experiences, there is often a need for funding financial viability gap in private sector led infrastructure development. In India this gap is put up to 20 per cent of investment. It is not clear if *the current charter of the ADB will allow provision of such "subsidy" to private sector*.

Second, even if such subsidy provision is allowed in principle, where will the large funds required come from? Grant funding for ADB from developed countries is neither large nor increasing rapidly. In the proposed mechanism, this free money will come from 'profits' generated by better management of excess foreign exchange reserves of Asia. The question arises as to whether *the current charter of ADB will allow it to borrow from central banks of Asia and invest in equities as proposed above.*

Third, there is the issue of scale of operations. The proposed scheme is intended to fill a substantial part of the infrastructure deficits in Asia and make a difference to correcting the global imbalances which are regarded as a serious threat to world economy today. The infrastructure deficits are more than $200 billion per year and global imbalances are over $700 billion per year. To make a difference to these problems, additional investments have to be large: we put $100 billion per year as a ballpark figure. That in turn requires, in our estimate, the borrowing capacity of the regional SPV of over $300 billion. The question arises as to whether with *ADB's current capital base of $50 billion and paid- up capital of $3.5 billion, it will be possible to borrow $300 billion from central banks to generate the profits needed to support the required level of infrastructure development.*

If the answers to the above questions are in the affirmative, the proposed scheme may be accommodated within the present structure of ADB. If not, consideration may be given to creating a financially and legally independent affiliate within the ADB much as International Finance Corporation (IFC) was created in the World Bank to meet the special needs of supporting private sector in developing countries.

If, however, it turns out that ADB within its present political and administrative structure cannot accommodate either of the above two options, a new institution may have to be created. Transaction costs of creating a new institution are indeed considerable. But that issue has to be seen in the context of a new Asia emerging in the 21st century with a new economic power equation in the world. The financial institutions created in the middle of the twentieth century will be increasingly unable to adjust to the power realities of the new century and sooner or later new institutions will have to be created. The proposed mechanism intended to address three major issues of today may be as good an occasion for such institutional development as any.

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