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RIS Policy Briefs

Reserve Bank of Asia: Institutional Framework for Regional Monetary and Financial Cooperation

Limitations of the Existing International Financial System

The basis for the current system of international finance was laid at the Bretton Woods Conference in 1944 which is often described as one of the most successful conferences of the twentieth century and a landmark in world economic history. Among the key objectives of International Monetary Fund (IMF), that emerged from the conference were: to provide "the machinery for consultation and collaboration on international monetary problems", "to promote exchange stability", and to provide resources "to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" (quotes from Articles of Agreement of the IMF).

Over time, however, the system has changed dramatically. The current system is not based on true international consultations and collaboration. It is now led by the US. Most of the international trade is denominated in US dollar, most of the international reserves are held in US dollar, and the US can pay for its external deficits by printing dollars which it does not expect to have to redeem in the foreseeable future. The US dollar is now the vehicle currency in inter-bank and forward exchange markets and the main currency of denomination for most cross-border capital flows. The US-led private financial institutions intermediate a major part of international savings and investments and the US-led international financial institutions now play a decisive role in determining the macro-economic policies of many developing countries. Thus, as in political and military spheres, the world has become unipolar in financial matters.

In the unipolar world of finance, the US had a soft budget constraint in terms of external deficit. The US thus ran huge deficits in current account balance for nearly a decade. And it was able to combine these deficits with an appreciation in real exchange rates because of huge capital inflows which were in part due to the illusion of high profitability of investments in the US created to a significant extent by the boom in stock markets and by the creative accounting practiced by corporate America. The salient features of the international resource position of the US as it emerged by 2000 are presented below:

- Over the period 1993-2000, the US net debt position worsened by $2 trillion. At the end of 2000, the US was the largest debtor nation in the world.
- The current account deficits have been rising during the 1990s and were $ 445 billion in 2000.
- Unique in the world, external liabilities of monetary authorities and General government in the US in the form of bonds, currency and notes amounted to $1755 billion in 2000. The seigniorage earned on these was more than the aid given by the US.

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This Policy Brief is based on RIS Discussion Paper #46 on *Towards Multipolar World of International Finance* by Dr. Ramgopal Agarwala.

Under the unipolar financial system, the richest country in the world has been appropriating the seigniorage that is created by expanding world trade and that should be shared world-wide and preferably go to the poor. The system is thus clearly inequitable. The system is also inefficient because it is transferring savings from the less developed rest of the world to the richest country where the rate of return on foreign savings in real terns is not high particularly because a large part of these imported savings are used for private and public consumption. The system is also unsustainable. Over the medium and long term, the current account deficit of the US cannot keep on growing at the current rate. The US cannot continue to act as the locomotive of the world economy. Unless an alternative source of demand is found, the deflationary tendencies in the world economy could become highly pronounced. The problem will be particularly serious for Asia which has been running large trade surpluses with the US. Similarly, the overvalued exchange rate of US dollar is increasingly unsustainable and the dollar may well be heading for a hard landing. Unless alternative arrangements are made the instability in US dollar will have serious adverse effects on Asia.

Relevance of Regional Financial and Monetary Coopertion in Asia

The major economies of the world the US, EU and Japan are now facing the prospect of a prolonged slump. The situation is increasingly reminiscent of the Great Depression. The potential output lost in East Asia alone may be as high as one trillion dollars per year. As in the 1930s, it is unlikely that recovery can be brought about by private sector: much of the private sector is suffering from excess capacity and the household sector has become overly debt-laden and fearful of the unemployment.

The most promising source of recovery in the region is promotion of public sector-led investment. Domestic pump-priming will have to play the crucial role in revival of growth in the region. But in most of the major countries in the region, regional pump-priming can provide a useful supplement to the domestic efforts. For example, in Japan, domestic pump-priming efforts are running into difficulties partly because of the problem of finding worthwhile public works projects and partly because the public debt has already reached high levels and there is a political reluctance to allow public debt to increase much further. However, at a regional level there are many viable infrastructure projects which can help to increase utilization rate in Japanese manufacturing and construction sectors. And if a regional institutional mechanism could be developed to channelise Japanese excess savings into loans for these infrastructure projects, regional pump-priming can proceed without increasing public debt in Japan. Even if some concessional financing becomes necessary to make Japanese bidders for these infrastructure projects to be internationally competitive, the public resources required would be a fraction of what is required in domestic public works projects. Similar logic would apply to pump-priming in economies such as Hong Kong, China, Singapore, and Taipei, China where there is large excess capacity in sectors such as IT industry for which there is not enough potential domestic demand but there is potential regional demand which can be transformed into effective demand through regional financing mechanisms.

The risks of hard landing of the US dollar are particularly great for Asia, because despite its eminence in many other areas of economic policy Asia has been far from following optimal exchange rate policies particularly during the last two decades. Under the IMF approach of freely floating exchange rates in Asia have gone through large gyrations which clearly were not favorable to the development of the countries. In the current situation, the Chinese Yuan which was already undervalued is becoming further devalued because of its link with US dollar. The economic and political risks of irrational exchange rate movements are high in Asia today. There is now an urgent need for a new system to bring about some stability in exchange rates in Asia.

Need for a Bold Programme of Regional Monetary and Financial Cooperation

The discussions of regional co-operation for exchange rate policy usually focus on nominal exchange rates. Such co-operation requires co-operation for relative price movements and thus on monetary policy. That naturally bears on sovereignty of monetary management which is difficult to surrender for countries in Asia with widely different levels of development. This then usually leads to pessimistic conclusions about the political feasibility of monetary co-operation in Asia.

It could, however, be argued that co-operation for relative stability in real effective exchange rate (REER) policy is both *more relevant and more realistic*. It is more relevant because what matters for trade and investment flows are real rates more than nominal rates. It is more realistic because such co-operation does not require co-ordination of monetary policies in the region. Each country can pursue its own monetary policy but will try to adjust its nominal exchange rate so as to maintain relative stability in real effective exchange rates. The stability programme has to be agreed in broad terms with variation within a band and over a time period, thus avoiding the risk of speculation on the currency. Moreover, the real rates would not be rigid, but adjusted in response to external and/ or internal shocks which may cause a fundamental disequilibrium in the rate.

In Asia the inflation rates are not as divergent as they were in Europe in the 1970s when Europeans tried a similar system of relative stability in REER. Thus, Asia is better placed in that respect than was Europe. Of course, it will be necessary to have some broad understanding among the Asian countries regarding macro-policies so that sharp divergences in inflation do not emerge. But it will not be necessary to have tight rules on macro-balances as done under Maastricht Agreement among European countries which are neither feasible in Asia today nor desirable for flexible macro-management.

Reserve Bank of Asia: Institutional Modality for Regional Cooperation

For making regional monetary co-operation effective, it seems necessary to initiate institutional reforms which will be bolder than what has been attempted so far. We suggest establishment of a regional reserve facility, which we call Reserve Bank of Asia (RBA). RBA will have at least US$100 billion of capital contributed by the member governments, of which perhaps only 10 per cent need to be paid up. It will accept deposits from central banks of member countries and lend funds to the governments as needed to help the region achieve stability of real effective rates and help the countries in need of short-and medium-term BOP assistance. Minimum deposit levels and maximum borrowing levels in several tranches will be decided according to the economic weights of the member countries. It would develop its own form of policy dialogue and conditionality (preferably through higher interest charges for higher levels of borrowing) based on the regional realities. RBA will pay interest on the deposits close to rates of return currently obtained by Asian central banks on their deposits and will lend at rates with a reasonable margin (say 2 percentage points). It will issue an Asian Currency Unit (ACU) which will be a composite of currencies of member countries with weights in line with the respective value of trade. The ACU will be freely convertible into international currencies. The initial value of ACU could be made equal to 1 US dollar. Over time, the value of ACU will be maintained in real terms by adjusting the units of each currency by the index of inflation in the country of the currency. This feature of value maintenance should make ACU an attractive reserve asset much as gold was in the past. ACUs should be increasingly used as the unit of account, as unit for invoicing and as reserve currency by countries in the region.

Over time as ACUs become widely used as reserve currency in the region, RBA will be able to issue ACUs in multiple of its primary reserves and earn seigniorage which could be in tens of billions of dollars. These funds could be allocated to development agencies in the region at concessional rates to help build up the regional public goods and help development of the region in general. With concessional funds coming from within Asia, the tax payers of non-Asian countries would be relieved of the burden of financing development of the less developed countries in Asia on concessional basis and could devote these resources for raising the welfare levels of the poor within their economies or in poor African countries where the needs are clearly more acute.

Concluding Remarks

This Policy Brief argues that the existing international financial order is becoming unipolar and unjust and inefficient for Asia, while it brings tremendous short-term financial gains to the US. In this situation, the ideas of reform of international financial system to take care of their adverse effects on Asia (based though they are on the American principles of justice and pluralism) are politically unrealistic in the near-term. The only alternative for Asia is to set up a regional financial infrastructure geared to helping the regional economies much as Europe has done. The region has a strong case as well as financial and technical resources to accomplish the task of bringing pluralism to the world of finance.

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