Monetary Regionalism in Asia Revisited

Given the divergence in economic and institutional structures in the region, any attempt to create a common currency absent macroeconomic policy coordination and mechanism for automatic intra-regional fiscal transfers is far too risky and premature and will in all likelihood be a failure, setting back prospects for other forms of economic integration.

Ever since the currency crisis of 1997-98 there has been a great deal of interest in enhancing regional economic cooperation in Asia. It is important to keep in mind that economic regionalism is multidimensional nature. Economic regionalism can be categorized into four types, viz. trade and investment, monetary and financial, infrastructure development and related software, and cross-border public goods (cooperation with regard to avian flu etc, pollution etc). The focus here is on policy initiatives underway in Asia to enhance monetary regionalism and the analytical bases for these initiatives.

There are a number of factors that have motivated monetary regionalism in Asia. First has been the financial crisis of 1997-98 and perceived inadequate response to it from extra regional players. Second are the ongoing 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. Third have been external developments in regionalism, particularly the deepening and broadening of European Union (EU). To be sure, while many economists may have remained circumspect about the potential benefits of deeper monetary integration in Asia (do the microeconomic benefits outweigh the macroeconomic costs arising from loss of monetary policy sovereignty?), and there are signs of emerging tensions within the EU regarded the net benefits of a single currency, there is no doubting the influence European regionalism has had on policy makers in Asia. Fourth has been the growing *de facto* economic interdependence (so-called "market driven regionalism), as well as the regional nature of spillovers ("contagion").

There are many gradations of monetary and financial regional, ranging from the weak form involving regional policy dialogue and surveillance, on the one hand, to exchange rate and monetary coordination, on the other. The emphasis here is on "medium form" of monetary and financial regionalism, broadly defined as the development of regional liquidity arrangements and regional financial markets. The specific rationale for such "medium form" of monetary and financial regionalism arises directly from the "capital account nature" of crises. These new-style crises have in turn made apparent the need (beyond "sound" macro policies) to ensure availability of sufficient liquidity in the event of a bust; diversify sources of funding / channels of intermediation to minimize intensity of busts; and minimize balance sheet mismatches (both maturity as well as currency).

The CMI is a network of swap arrangements which was agreed among Asian plus Three (APT) countries in May 2000. The CMI is neither a mechanism for inappropriate currency pegging in the region nor a mechanism for managing a crisis after it erupts. Rather, it is aimed at preventing a crisis from erupting in the first instance. But what is the analytical basis for pursuing such a regional liquidity arrangement? Stylized preventive steps in the event of crisis of confidence include: (a) raising interest rates to reduce capital outflows; (b) cushioning the impact via currency depreciation; (c) talking up the market to try and instil confidence; and (d) ensuring availability of sufficient liquidity. It has long been recognized that inadequate liquidity can threaten the stability of international financial regimes. Illiquidity can create crises even when economic fundamentals are sound, or it can make a bad situation worse when the fundamentals are weak. Moreover, once it becomes a problem,

illiquidity further undermines the confidence of international capital markets. Capital outflows increase, thereby reducing liquidity still further. The speed and intensity of economic adjustment following a crisis is largely dictated by the scarcity of liquidity. It is the extreme shortage of liquidity that called for rapid current account adjustment in East Asia in 1998 that took place via a sharp domestic contraction.

Having appreciated the importance of ensuring adequate liquidity as a safeguard against future financial crises, many Asian countries have consciously attempted to build up reserves immediately after the crisis partly as a precautionary motive. As of mid 2006 Asia as a whole has accumulated more than $2,500 trillion of reserves. However, it is recognized that reserve accumulation (so-called "floating with a life-jacket") is costly on many fronts. In addition, there is the additional question of what the appropriate size of reserve holdings are; against what yardstick should reserve adequacy be measured. Since international reserve holdings have been found to be a theoretically and statistically significant determinant of creditworthiness, depleting them as a way of cushioning the effect of capital outflows on the exchange rate may make matters worse by inducing further capital outflows. If capital outflows reflect a perception within private capital markets that a country is illiquid, reducing international reserves and therefore, curbing liquidity further is hardly likely to be an effective strategy. The reversibility that makes reserve depletion credible in the context of trade deficits is often absent in the context of capital outflows.

In view of this, it is recognized that countries need to buttress their own reserve holdings with external liquidity arrangements. The need to provide adequate liquidity to help forestall a crisis in a distressed economy and prevent its spread to other countries took centre stage in the reform of the financial architecture immediately after the crisis. The International Monetary Fund's (IMF's) response was to create the Contingent Credit Line (CCL) so as to act as an 'insurance lender'. To quoe from the IMF Annual Report (p 37:2001):"The CCL was conceived as a precautionary line of defence to help protect countries pursuing strong policies in the event of a balance of payments need arising from the spread of financial crises". The idea here was to establish a precautionary line of credit for countries with 'sound' policies that might be affected by contagion from a crisis, and to finance this from outside the Fund's quota-based resources by new arrangements to borrow (NAB). The negotiation of conditionality with potential users of the CCL would therefore take place before the country needed to draw on the Fund. But no country negotiated a CCL. Consequently the facility has had to be re-evaluated and it was eventually shut down. The CCL has not been replaced by another similar liquidity arrangement.

Against this background and in recognition that financial stability has the characteristics of a regional public good, it is understandable that Asian countries have shown eagerness in promoting regional monetary cooperation. The CMI has taken centre stage in this regard. The CMI has two components, viz. (a) ASEAN swap arrangement (ASA) which was expanded from 5 to 10 countries, and from US$ 200 million to US$ 1 billion; and (b) 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.

The expanded ASA is to be made available for two years and is renewable upon mutual agreement of the members. Each member is allowed to draw a maximum of twice its commitment from the facility for a period of up to six months with the possibility of a further extension of not more than six months. The basic characteristics of the BSAs are as follows. One, 20 per cent can be drawn automatically without conditionality for 630 days (90 days, renewable 7 times). Interest paid is LIBOR +1.5 per cent for first 180 days, rising by 50

basis points for each renewal to a maximum of LIBOR +3 per cent. Importantly, the swap providing countries form their own individual opinions on potential swap recipient. Drawing of more than 20 per cent requires the country to come under IMF conditionality.

While the CMI is an important step in Asian monetary regionalism, being the first time regional countries have pre-committed resources as a means of regional financial safeguard, it clearly remains a work in progress. A number of important details remain to be worked out / altered if the CMI is to be an effective liquidity enhancing measure.

First is the inadequate size especially liquid component. For instance, the current aggregate size of $58.5 billion among all 13 APT countries pales in comparison to the crisis packages offered to Korea, Indonesia and Thailand in 19987-98. Second, there is the issue of how coordination between potential creditor countries is to be done. For instance, is the bilateral arrangement subject to regional approval? How is borrowing/lending to be distributed? Both these questions lead on to the key issue of how to regionalize (though more commonly refereed to as 'multilateralize') the CMI which is as of now a series of bilateral and rather uncoordinated swaps. In fact in the Joint Ministerial Statement of 8th APT's Finance Ministers' Meeting in Istanbul in May 2005, there was an agreement to look into the process / possibility of regionalizing the arrangements. As part of this, there was an agreement to look into developing a collective mechanism to activate the swaps. There was also recognition of need to improve on and link surveillance more to the CMI. Overall, it would be fair to say that until these issues are sorted out, the best thing that has happened to the CMI is that the region has not been faced by a crisis to test its effectiveness.

Apart from issues relating to regionalizing of the CMI, raising non IMF-linked share (what type of independent conditionality with teeth?) and making transparent and automatic the condition for withdrawal, there is a need for further augmentation of CMI in terms of expanding the size of the CMI and enlarging it to include other countries in the Asia-Pacific such as India, Australia and New Zealand, all of which are part of the East Asian Summit.

Over time consideration should be given to transforming the CMI into a regional reserve pooling mechanism / facility. Which could involve three tiers of liquidity. The first tier would be owned reserves that offer the highest degree of liquidity and have zero conditionality but are costly. The second tier would be sub-divided into a country's own reserves placed with regional pool, and other members' reserves with the pool. The third tier would be conventional IMF lending. With such a structure the degree of liquidity could be inversely related to the degree of conditionality.

Overall though, there can be no significant forward movement until there is a considerable strengthening of the regional surveillance mechanism with well worked out policy conditionality. The same goes for deeper forms of monetary regionalism such as a common currency. Indeed, given the divergence in economic and institutional structures in the region, any attempt to create a common currency absent macroeconomic policy coordination and mechanism for automatic intra-regional fiscal transfers is far too risky and premature and will in all likelihood be a failure, setting back prospects for other forms of economic integration.

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