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## **RIS** Discussion Papers

**Towards An Asian “Bretton Woods”  
for Restructuring of the  
Regional Financial Architecture**

**Ramgopal Agarwala**

**RIS-DP # 133**



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### **Acknowledgments**

The study was prepared by Dr. Ramgopal Agarwala, Senior Adviser, RIS under the overall guidance of Dr. Nagesh Kumar, Director-General, RIS and substantive inputs by Shri Priyadarshi Dash, Research Associate, RIS. Contributions were also made by Dr. Nagesh Kumar, Dr. Ramakishen Rajan, Adjunct Fellow, RIS and Shri Abhishek Maity, RIS Intern. The study incorporates the findings of RIS report “Regional Cooperation for Infrastructure Development in Asia: Towards a Regional Mechanism for Public-Private Partnership” prepared in March 2007 by an RIS team led by Dr. Ramgopal Agarwala and comprising Dr. Prabir De, Fellow, RIS; Dr. Sameer Pradhan, Research Associate, RIS; Dr. Nilanjan Banik, Consultant; and Dr. Vidhya Muthuram, Consultant. It also draws upon a study prepared at RIS for the Department of Economic Affairs, Ministry of Finance, Government of India. Excellent editorial work was done by Shri Tish Kumar Malhotra. The views expressed are of the author.

## **Towards An Asian “Bretton Woods” for Restructuring of the Regional Financial Architecture**

**Ramgopal Agarwala\***

**Abstract:** Despite a plethora of programs for increased financial co-operation in Asia, there has been very little real progress in developing a regional architecture for financial co-operation in Asia. While the risks of repetition of 1997-98 style financial crisis in Asia are not high today, there are new risks of financial turbulence originating from sub-prime crisis in the US and new opportunities for using the financial strength of the region for accelerated growth with equity. To guard against these risks and to exploit these opportunities, a bold new initiative in the region is needed. The idea of Asian Monetary Fund proposed by Japan in 1998 needs to be revived, perhaps with a different nomenclature and a different terms of reference. This paper proposes a Reserve Bank of Asia which will be a combination of IMF and the World Bank at regional level. In order to respond to the current crisis, the major players in the region should develop a consensus on the outline of a regional financial architecture and call a conference of EAS countries to prepare Articles of Agreement for the institution much as was done at Bretton Woods some sixty years ago.

### **I. CURRENT PROGRAMS OF FINANCIAL COOPERATION IN ASIA AND THEIR LIMITATIONS**

#### **I.1 Introduction**

Increasing integration with the global and regional economies has been a hallmark of Asia’s growth story. Unilateral and multilateral trade liberalizations within WTO framework have been supplemented (though only modestly) by regional trade liberalization programs and the intra-regional trade as share of the total trade of the region is high and rising

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(from 54.9% in 1995 to 58.7% in 2005). Such integration has been particularly marked for East Asia but is also rising in South Asia. Supported by trade integration and also promoting it, has been the growing integration in the area of investment. Cumulative FDI from the Asia region to itself as percentage of total FDI from the region to the world was 70.60% in 2002, slightly higher than in 2000 (69.61%) though lower than in 1995 (77.6%). Cumulative FDI from the region to itself as percentage of the total FDI to the region from the world was also high 50.36% in 2002, though lower than in 1995 (61.48%). Here again the integration has been most prominent in East Asia but increasing in South Asia.

Financial sector integration has, however, been lagging both in terms of regional cross-border asset holding and convergence of rates of return on assets. The financial crisis of 1997-98 was perhaps a rude reminder of the costs of non-cooperation in the financial sector. Starting with Thailand, the contagion of financial crisis spread in varying degrees to Indonesia, Republic of Korea and Malaysia. Singapore and Hong Kong also came under pressure but were managed better by the authorities. The dimensions of crisis were staggering. The exchange rate of local currency per US dollar depreciated from 2909.4 in 1997 (period average) to 10,013.6 in 1998 in Indonesia, from 951.3 to 1401.4 in Korea and from 25.3 in 1996 to 31.4 in 1997 and 41.4 in 1998 in Thailand. There was a massive outflow of capital and borrowing from IMF and other IFIs was resorted to on a large scale. However, unlike what was done in the case of Mexican crisis of 1994/95 and what is being done in the U.S. subprime mortgage crisis of today, funds were not provided with speed and volume to calm the markets. Instead, the crisis was seized by international community to impose on the affected countries a shock therapy in the financial sector, which involved sudden closure of many banks, sudden liquidity crunch, and sharp decline in stock markets. The decline in output and increase in unemployment and poverty was greater than anything experienced in Asia in the recent years. The most adversely affected was Indonesia where GDP declined by 13.1% in 1998 and was largely stagnant in 1999 (at 0.8 % growth). In Thailand, the decline in GDP was 1.4% in 1997 and 10.5% in 1998. Korea and Malaysia also suffered GDP declines of about 7% each in 1998.

The crisis led to much soul-searching in the region. There was a broad consensus that the crisis was in large measure due to currency mismatches and term mismatches in the financial sector of the countries but it was compounded by the mishandling of the rescue operation by the extra-regional forces. (For an account of the inside story of how the extra-regional forces compounded the Asian financial crisis see Box 1 based on Blustein (2001)).

### **Box 1. The Role of Extra-regional Forces in the Asian Financial Crisis of 1997/98**

Paul Blustein's book *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (Public Affairs, New York 2001) gives a riveting account of how the extra-regional forces compounded the economic debacle of the countries affected by the Asian financial crisis of 1997/98. The two key external players were what he calls "the High Command" and the "Electronic Herd" (a phrase he borrows from Thomas Friedman). In his definition, "High Command" includes not only the IMF but also powerful officials at the U.S. Treasury, the U.S. Federal Reserve, and other economic agencies among the G-7 who oversee IMF operations and steer international policy. In course of the narrative, Blustein clarifies that the "High Command" really meant the US. In his words, "The popular perception of the High Command was illustrated by an article published in *Time* in early 1999, titled "The Committee to Save the World." The magazine's cover displayed a photo of Robert Rubin, the secretary of the treasury, his deputy Lawrence Summers, and Alan Greenspan, chairman of the Federal Reserve Board, posing amid the marbled splendor of the Treasury with arms folded and faces cheerfully composed. As the photo and accompanying article suggested, these three men, working hand in glove with the IMF, were exercising extraordinary influence over the strategy for containing the crisis." No wonder as the solutions of the crisis were sought, the High Command put the interest of the US and its ideology above the interest of the country in crisis. The second player Electronic Herd represented the financial world moving billions of dollars across the borders in search of speculative gains though movements in values of currencies and portfolio investments across countries. This herd controlled huge amounts of funds which can move speedily at the touch of a button and the movements of these herds were not always logical or predictable. Unlike foreign direct investments which put money in physical capital and contribute to longer term increased in output and employment, these

*Box 1 continued*

portfolio investments often contribute to destabilization of currencies and economies. In the words of the former Malaysian Prime Minister Mohammed Mahathir these speculative flows are mostly “unnecessary, unproductive and immoral”. These two factors combined with the limited resources and bureaucratic and ideological rigidity of IMF set the stage well for causing economic havoc in the Asian countries (South Korea, Indonesia and Thailand) which, for at least two decades before the crisis, were routinely presented by the international community (including the World Bank and IMF) as role models for sound development policies.

The book graphically illuminates the human misery in these countries to which IMF contributed in no small measure. Thailand which had been following disciplined fiscal policies was forced by IMF to adopt a contractionary program just when the economy was heading for a down turn. In Blustein’s words, “The IMF demanded, as a condition for its loan, that the Thai government take several measures aimed at producing a substantial budget surplus, increasing the value-added tax from 7 percent to 10 percent. Altogether, the IMF’s conditions required Bangkok to raise taxes and cut spending by an amount equal to 3 percent of GDP. To put that in perspective for Americans, it’s as if the United States raised taxes or cut government benefits by \$300 billion in one year, or over \$1,000 for every man, woman and child in the country.” The result was predictable: “in 1998 Thai GDP would shrink by a whopping 10 percent; imports would shrivel so fast that the country ran a current account surplus of 12.7 percent of GDP in 1998.”

The IMF package for Indonesia was even more severe, with possible agenda of destabilizing the political leadership of the country. In the words of Blustein: “All the more stupefying ...was the disintegration that would befall the Indonesian economy over the next several months, amid a highly charged showdown in which the IMF was demanding that Suharto dismantle long-criticized monopolies and subsidies benefiting his children and cronies. The rupiah would sink to the rate of 15,000 per dollar in January 1998, 85 percent below the summer 1997 level of 2400 per dollar. ..Economic output would shrink by more than 14 percent in 1998, a rate of contraction that ranks among the most catastrophic suffered by any country in a single year since the Great Depression of the 1930s. Among Indonesian men who were working in 1997, 15 percent would lose their jobs by mid-1998, and millions of Indonesians would slip back into poverty they thought they had escaped

for ever, as median daily wages fell by about 30 percent (adjusted for inflation) in rural areas and 40 percent in urban areas. The economic slump would fuel social unrest that would force Suharto to resign in May 1998, amid bloodshed that would claim over 1000 lives.”

South Korea which had been the darling of international development community for more than a quarter century was suddenly due for punishment at the behest of the US working through the IMF. In the words of Blustein: “To Rubin, Summers, and their lieutenants, Korea’s crisis was the inevitable result of the country’s stubborn insularity and its slavish attempts to follow the Japanese economic model, with its system of cossetting banks to pump funds into industry. .. Lobbying by American financial services firms, which wanted to crack the Korean markets, was the driving force behind the Treasury’s pressure on Seoul. .. So as in Indonesia, United States wanted a program with conditions that surpass the Fund’s traditional boundaries.” With the combined pressures of the High Command, the Korean economic and financial system went through a wrenching which caused widespread unemployment in country accustomed to job security and under which a large part of the country’s assets came to be owned by foreigners who bought them at bargain basement prices.

Not that there were no voices contrary to what the High Command was trying to do. Blustein notes three powerful voices which were critical of the IMF approach but to no avail. Jeffrey Sachs argued that the Fund was fundamentally misdiagnosing the problem by putting so much of the blame on the Asian economies’ internal weaknesses. “Although Thailand, Indonesia, and Korea suffered from corruption, poorly supervised banking systems, and crony capitalism, these problems were long standing and could not explain why so many countries were hit all at once...the crisis was similar to a bank run in which depositors rush to withdraw their money for fear that no money will be left in the vault... it was such an overwhelming factor that the Fund’s traditional austerity-oriented remedies—budget cuts, tight monetary policy, and so on—would only exacerbate the problem.”

Stiglitz (1998) argued that the basic cause of the Asian crisis was not excessive government intervention in Asian countries:

“Many of the problems these countries face today arise not because governments did too much, but because they did too little—and because they themselves had deviated from the policies that had proved so successful over preceding decades. In several countries, for instance, poorly managed

financial liberalization lifted some restrictions, including restrictions on bank lending to real estate, before putting in place a sound regulatory framework.... The buildup of short-term, unhedged debt left East Asia's economies vulnerable to a sudden collapse of confidence. As a result, capital outflow, and with it depreciating currencies and falling asset prices, exacerbated the strains on private-sector balance sheets and thus proved self-fulfilling."

A third critic was Eisuke Sakakibara, the Japanese vice minister of finance for international affairs. Sakakibara championed the view that his country must cling to its cultural values and reject the socioeconomic model that Washington tried to press on Tokyo and other Asian nations. "The United States, Great Britain, and other individualistic, Anglo-Saxon societies might be ideally suited to the dog-eat-dog world of creative destruction in which forces of the profit motive constantly eradicate weak enterprises and spawn vigorous ones. But that was decidedly not true of Japan, .. because of the importance Japanese attached to social harmony and the group rather than the rights of the individual."

"From his perch as vice minister, which gave him membership in the G-7 deputies, Sakakibara registered discontent with the way the Asian crisis was being handled by the IMF and the rest of the High Command. The Fund was too quick to blame the Asian economic model, he contended, when the real fault lay with forces beyond Asians' control. Like Sachs and Stiglitz—with whom he conferred often—he strongly disagreed that the turmoil was attributable to cronyism and excessively cozy ties between business and government; this was, he repeatedly insisted, "not an Asian crisis but a crisis of global capitalism. .. A U.S.-dominated IMF, he complained, was trying to change the Asian system, without changing the international financial system."

These voices got nowhere because the agenda of the High Command was none other than to "convert" Asia to the western model. No less a person than Alan Greenspan in his 3 March 1998 testimony before the Senate Appropriations Subcommittee on Foreign Operations, argued: "My sense is that one consequence of this Asian crisis is an increasing awareness in the region that market capitalism, as practiced in the West, especially in the United States, is the superior model; that is, it provides greater promise of producing rising standards of living and continuous growth."

He explicitly referred to the International Monetary Fund (IMF) program as "this conversion to embracing market capitalism in all its details." The actual results of this "conversion" exercise completely belied the hopes of "rising standards of living and continuous growth." The affected countries suffered massive decline in income and rise in poverty and unemployment. Between 1997 and 1998, Indonesia's per capita income declined by 14%, Korea's by 8%, Malaysia's by 10%, and Thailand's by 11%. During the period, 1997-2005, there has been some recovery but the average annual per capita income growth in all these economies has been much below the rate (5% plus) experienced by them in the preceding two decades: these rates were 0.5% per year for Indonesia, 1.5% for Malaysia, 1.9% for Thailand and 3.5% for Korea.

An interesting thought experiment would be to imagine what the IMF-type reform program would have been for the US in its current financial crisis. The subprime crisis has exposed the weaknesses of the US financial system even more vividly than what happened to the Asian financial institutions. While the Asian financial crisis was largely a liquidity crisis, the US financial crisis is largely a solvency crisis, the result of the country living beyond its means for more than a decade. The IMF type program would have called for closing down financial institutions (like Bear Stearns) whose capital had been severely eroded. It would have called for a restructuring of the supervisory institutions such as Federal Reserve which have clearly failed in their regulatory and supervisory functions and might even have encouraged the real estate bubble by their excessively expansionary policies. In order to correct the basic problem of excess consumption in the economy the program would have called for sharply higher interest rates and reduced budget deficits (if not a budget surplus) through increase in taxes and cut in government expenditures. Such a program would have no doubt accentuated the recessionary tendencies in the US much as it did for Thailand, Indonesia and Korea and given the importance of the US economy for the world that would have led towards a world recession, if not depression. Fortunately, there is no High Command dictating the US policies. Wisely, at least for the short run, every thing is being done to stimulate the economy: interest rates have been cut, budget is giving a big tax relief even at the cost of widening fiscal deficits and every effort is being made to avoid closing down of weak financial institutions and minimize widespread foreclosures of household mortgages so that the

*Box 1 continued*

financial contagion does not spread. Financial support to weakened institutions is being provided by internal and external sources (among others by the much derided Sovereign Wealth Funds) which are not calling for fundamental changes in the system at the time of panic. There are some who are asking why the IMF is not preaching or practicing the austerity measures that it did in the Asian crisis. In our opinion, the US government is right now and was wrong at the time of the Asian crisis. And it is fortunate not to have to depend on IMF advice or support. That, however, does not preclude the need for reducing the profligacy of the US over the longer term but such restructuring should be done in a calmer atmosphere and with a long-term perspective and section IV of this report outlines one proposal to achieve that goal.

In the wake of this painful experience, it was agreed that a two-track approach was needed: improving the financial sector operations at national level and improving regional self-help programs to help in future crisis. These deliberations led to four main areas of activities:

- reserve pooling to provide balance of payments support,
- development of national and regional bond markets,
- greater cooperation among regional credit rating agencies, and
- regional mechanism for surveillance and policy dialogue.

A review of the current status of cooperation in each of these dimensions is presented below.

## **I.2 Mechanisms for Regional Balance of Payments Support**

Programs for providing regional balance of payments support in Asia have a long history. An ASEAN network of currency swaps and repurchase agreements set up in 1977 was to provide immediate short-term swap facilities to members with temporary international liquidity problems. Initially set at US \$100 million for 5 members with a maximum of US \$40 million receivable per member, it was raised to US \$200 million for US \$80 million per member in 1978. EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) was set up in 1991 with 11 members (Southeast Asian and Australasian members) and its objectives include

enhanced regional surveillance, exchange of views and information, and financial market developments. In 1994, a group was set up for four major Asian financial centers (Australia; Hong Kong, China; Japan; and Singapore) to review issues related to the stability of the region's financial and foreign exchange markets.

These arrangements, however, proved totally inadequate to help the affected countries during the Asian crisis of 1997. The money available (US \$200 million) was of course woefully inadequate and reportedly was never used. Immediately after the crisis, Japan came forward with a plan for an Asian Monetary Fund (AMF) so as to assist in bringing stability to Asian currencies and financial markets. It planned to raise US \$50-60 billion in contributions from participating countries and another US \$50 billion from the Japanese Government. It was to be independent of the IMF and function as a substitute for IMF activities such as regional surveillance. The original membership was to be China; Hong Kong, China; Japan; Korea; and Taipei, China. With lukewarm support from China and vehement opposition from the US and IMF, the plan was scrapped a few months later. It was argued that the AMF would enhance the moral hazard problem, create a double standard (IMF and AMF), and challenge the IMF leadership.

Probably the most concrete and currently active regional financial arrangement to come out of the Asian crisis was the Chiang Mai Initiative (CMI), on the sideline of Annual meeting of ADB in 2000. The CMI is a network of swap arrangements which was agreed among ASEAN plus Three (APT) countries in May 2000.<sup>1</sup> 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 increased again to US \$2 billion;<sup>2</sup> 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.<sup>3</sup> 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 six more months at most. The basic characteristics of the BSAs are as follows. Twenty percent of the liquidity

can be drawn automatically without conditionality for 630 days (90 days, renewable 7 times). Interest paid is LIBOR +1.5 percent for first 180 days, rising by 50 basis points for each renewal to a maximum of LIBOR +3 percent. Importantly the swap providing countries form their own individual opinions on the potential swap recipient. Drawing of more than 20 percent regional liquidity requires the country to come under IMF conditionality.<sup>4</sup>

The CMI is an important step in Asian monetary regionalism as it is the first time regional countries have pre-committed resources as a means of regional financial safeguard. However, it clearly remains a work in progress. A number of important details remain to be worked out if the CMI is to be an effective liquidity enhancing measure. First is the inadequate size especially of the liquid component. For instance, the current aggregate size of just over US \$80 billion (as of July 2007) among all 13 APT countries (Figure 1) still pales in comparison to the crisis packages offered to Korea, Indonesia and Thailand in 1997-98 (Chang and Rajan, 2001). Second is the

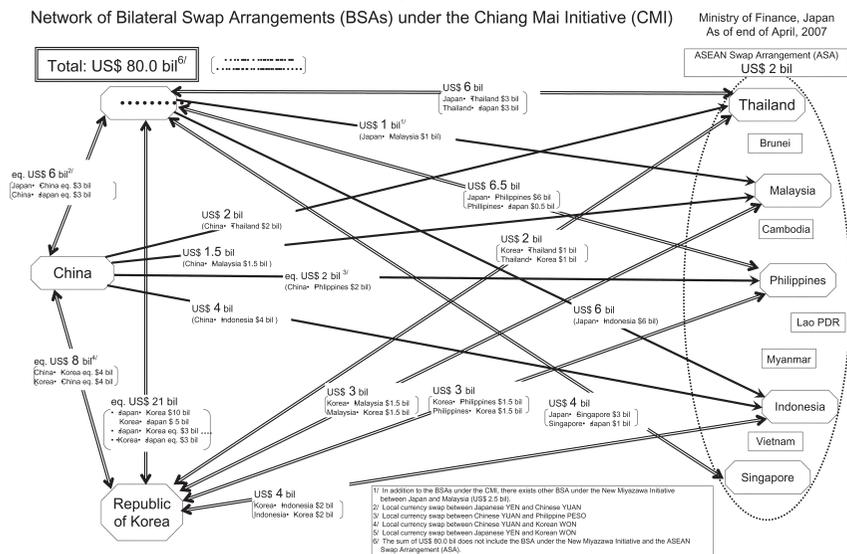
issue of how coordination between potential creditor countries is to be done. For instance, is the bilateral arrangement subject to regional approval? How is borrowing/lending to be distributed? Both these questions lead on to the key issue of how to regionalize (though more commonly referred to as “multilateralize”) the CMI, which is a series of bilateral and rather uncoordinated swaps. In fact in the Joint Ministerial Statement of 8<sup>th</sup> and 9<sup>th</sup> APT’s Finance Ministers’ Meetings in Istanbul and Hyderabad, respectively, there was an agreement to re-evaluate the process / possibility of multilateralizing the arrangements.<sup>5</sup> As part of this there was an agreement to look into developing a collective decision-making procedure to activate the swaps. There was also recognition of the need to improve on and link surveillance more closely and effectively to the CMI. Other issues relating to the CMI include raising the non IMF-linked share (what type of independent conditionality with teeth?) and making transparent and automatic the condition for withdrawal.

In Asia’s current conditions with large foreign exchange reserve build-ups, the risks of 1997-98 type financial crisis are minimal. However, if the balance of payments crisis does emerge in any major Asian economy, the support required will be large (in tens of billions of dollars) and the present provisions of CMI may be quite inadequate, particularly if only 20% of the funds can be utilized without IMF program. With world- wide disenchantment with IMF conditionality, the 20% limitation on use of funds under CMI seems anachronistic. Similarly, the voluntary nature of bilateral swaps creates an uncertainty which is the last thing a country needs in conditions of BoP stress. Basically the CMI is no better than the ASEAN currency swap agreements of 1977 which prove totally inadequate when the financial crisis struck the region in 1997. A meaningful BoP support mechanism has to be independent of IMF, large in size and truly multilateral (an example of which is provided in section 4 of this paper).

### I.3 Asian Bond Market Development

The financial crisis of 1997-98 made apparent significant gaps and weaknesses in East Asia’s financial sectors. The contagious nature of the 1997-98 crisis led many observers and policy makers to the view that there are positive externalities from cooperating to strengthen their individual

**Figure 1: The Chiang Mai Initiative: Progress to Date (as of July 2007)**



Source: Ministry of Finance, Japan website: ([http://www.mof.go.jp/english/if/CMI\\_0704.pdf](http://www.mof.go.jp/english/if/CMI_0704.pdf))

financial sectors, to develop regional financial markets, and to diversify their financial structures away from bank-based systems to bond markets.

Bond financing is considered a relatively more stable source of debt financing as bank loans are primarily illiquid, fixed-price assets in the sense that the interest rate - which is the price of the loan - does not vary much on the basis of changing market circumstances. Thus, almost all the adjustment has to take place via rises and falls in the quantity of bank lending, which in turn leads to sharp booms and busts in bank flows.<sup>6</sup> These sudden reversals in bank flows had calamitous and long-lasting effects on the domestic financial systems in the East Asian economies in 1997-98.

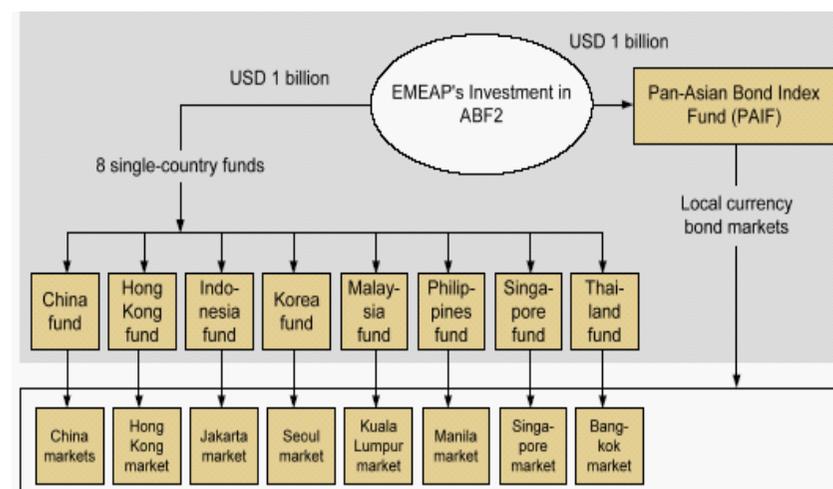
In this regard two main initiatives have been underway in East Asia. One is the Asian Bond Fund (ABF) established by the eleven members of the Executives' Meeting of East Asia-Pacific Central Bank (EMEAP), and the other is the Asian Bond Market Initiative (ABMI) by the APT economies. The EMEAP is a cooperative organization of central banks in the Asia and Pacific region. Its primary objective "is to strengthen the cooperative relationship among its members." The EMEAP currently comprises the central banks from eleven economies: Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand" (see <http://www.emeap.org/>). The ABMI — which was endorsed at the ASEAN+3 Finance Ministers Meeting (AFMM) in Manila on August 2003 — focuses primarily on developing efficient bond markets in Asia to enable the private and public sectors to raise and invest long-term capital. The activities of the ABMI are primarily concentrated on facilitating access to the market through a wider variety of issuers and enhancing market infrastructure to foster bond markets in Asia.<sup>7</sup>

The focus of the remainder of this subsection is specifically on the Asian Bond Fund (ABF) which was established on June 2, 2003. The first stage of the ABF essentially involved the regional governments voluntarily contributing about 1 per cent each of their reserves to a fund dedicated to purchasing regional sovereign and semi-sovereign bonds denominated in

US dollars. The initial size of the ABF was about US \$ 1 billion and the fund has been passively managed by the investment management unit of the Swiss-based BIS. The mandate is to invest in bonds in eight of the eleven member countries of EMEAP, the developed countries of Australia, New Zealand and Japan solely being lenders to the ABF. In a noteworthy next step, the ABF 2 (second stage of the ABF) was established in December 2004. The quantum of funds involved was doubled in magnitude (US\$ 2 billion), and its mandate is to invest in selected domestic currency sovereign and quasi-sovereign bonds in the eight countries.

More specifically, the ABF 2 comprises two components (US \$1 billion each): (a) a Pan-Asian Bond Index Fund (PAIF) and (b) a Fund of Bond Funds (FoBF). The PAIF is a single bond fund, while the FoBF is a two-layered structure with a parent fund investing in eight single market sub-funds (Figure 2). The International Index Company (IIC), a joint venture between ABN Amro, JP Morgan and Morgan Stanley, has created the benchmark indices for all nine funds. The funds will be passively managed to match the benchmark index. The seed money for single bond funds has been divided on pre-determined criteria and local fund managers have been appointed to manage the respective funds.

**Figure 2: Structure of Asian Bond Fund (ABF2)**



The specific criteria for market weights in each sub-fund (and distribution within PAIF) are based on: (a) the size of the local market; (b) the turnover ratio in that market; (c) the sovereign credit rating; and (d) a market openness factor. The market weights will be reviewed annually, with market openness being a particularly important factor in the allocation of weights (Ma and Remolona, 2005). The parent fund is limited to investments by EMEAP member central banks only. While the initial phase of PAIF was confined to investments by EMEAP central banks only (US \$1 billion), it was opened up to investments by other retail investors in Phase 2.

In broad terms, the objectives of the ABF are four-fold. First, to diversify debt financing from bank lending to bond financing by developing regional financial / capital markets by reducing supply side constraints and introducing low cost products and by raising investor awareness and broaden investor base on the demand side. Second, to encourage a convergence in financial and capital market policies and accelerate improvements in financial market infrastructures. Third, to recycle regional funds intraregionally and also reduce the region's vulnerability to "fickle" international investors. Fourth, to lessen the extent of currency and maturity mismatches (i.e. "double mismatches"). We elaborate on the latter two objectives below.

As is commonly noted, Asia as a whole holds the bulk of the world's savings. The excess of savings over investment along with quasi-managed exchange rates has given rise to large current account and overall balance of payments surpluses. Historically, the lack of sufficiently liquid financial instruments has led to much of Asia's savings being rechannelled outside the region, especially to the US. In relation to this, it is often noted that one of the reasons for the intensification of the regional financial crisis of 1997-98 was the fickleness of international investors, many of whom were extra-regional ones who did not have much knowledge about regional economies or differences in economic fundamentals between the economies. There was significant "panic herding" during that period as international creditors and investors chose to reduce exposures to all regional economies *en masse* once they were spooked by the crisis in Thailand and Indonesia, leading to a massive international bank run. Insofar as the ABF proposal promotes

greater intraregional financing, this might make the region somewhat less susceptible to extra-regional "investor ignorance" which is said to have contributed to an indiscriminate and disorderly withdrawal of funds from regional markets in 1997-98.

Another source of vulnerability made apparent by the 1997-98 financial debacle arose due to large-scale accumulation of uncovered external debt. To the extent that a relatively larger proportion of a country's liabilities is denominated in foreign currency vis-à-vis its assets (so-called "liability dollarization"), a currency devaluation could lead to sharp declines in the country's net worth, with calamitous effects on the financial and real sectors (so-called "balance sheet" effects).<sup>8</sup> On the part of the developing Asia-Pacific economies, the ability to issue bonds in domestic currencies mitigates the concerns about currency mismatches (i.e. borrowing and interest payments in foreign currency but assets and revenue streams in local currency) which in turn could negatively impact the project's solvency in the event of currency devaluation.<sup>9</sup> Thus, while the ABF 1 was solely focused on foreign currency bonds, the ABF 2 is notable in that it involves transacting solely in local currency bonds.

While the ABF is a welcome move for regional financial cooperation, it is important not to oversell the initiative. First and foremost is the quantum of funding available. The current US \$2 billion funding of ABF 2 is a drop in the bucket relative to the region's aggregate reserve holdings or infrastructural financing requirements. Second, if the supply of good quality sovereigns and quasi-sovereign paper is limited (which appears to be the case), it could merely crowd out private bond purchases, hence leading to no new net financing.<sup>10</sup>

#### **I.4 Association of Credit Rating Agencies in Asia (ACRAA)**

A part of the program of developing regional financial sector has been the program to improve co-operation among the credit rating agencies of the region. The Association of Credit Rating Agencies in Asia (ACRAA) was organized to exchange information, experiences, and skills among credit rating agencies in Asia, to enhance their role in providing reliable market information. Also, ACRAA aims to undertake activities to promote the

adoption of best practices and common standards throughout Asia, as well as to promote development of capital markets in Asia and cross-border investment throughout the region. To date, membership has expanded to include 23 credit agencies from 13 member economies which are: Bangladesh; People's Republic of China; India; Indonesia; Japan; Republic of Korea; Malaysia; Pakistan; Philippines; Taipei, China; and Thailand.

There is indeed a strong case for trying to develop regional/national rating agencies. At present the rating business is highly oligopolistic with three firms, Moody's, Standard and Poor (S&P), and Fitch accounting for more than 90% of the business. These agencies are owned by profit-seeking individuals and often paid by issuers rather than investors for their rating business. Even in developed countries, regulators are concerned about inadequate competition, risks of bias in the rating and possible overload with rapidly expanding rating business and shortage of skilled staff. The recent crisis in subprime mortgage markets has raised new concerns about the independence of rating agencies. For Asia trying to develop their own financial products, there are additional concerns in being overly dependent of these international rating companies. These companies may have inadequate knowledge of the local scene and there may be conflict of interest in promoting regional or national financial products.

However while the need for developing national/regional rating agencies is clear, the task is not easy. The challenges were well-articulated by Mr. Kazuo Imai, Chairman of Credit Rating Agencies in Asia in his paper "ACRAA and Harmonization under Asian Bond Market Initiative" on the occasion of 6th Tokyo Roundtable on Capital Market Reform in Asia September 28th, 2004.

Despite the advantages that are supposed to accrue to regional agencies, they seem to perform poorly in timeliness of their rating actions. Accuracy of domestic credit rating agencies (DCRAs) rating and quality of rating reports and analysis have not been found high. Developing cooperative efforts, such as common training programs, analyst exchange programs, regional industry studies and so on are essential for improving the capacity

of DCRAs. Another key issue is "harmonization" which faces many problems including the following: (1) different sense of urgency on the part of DCRAs and a desire to be independent; (2) different accounting standards being followed; (3) different legal frameworks prescribing legal requirements; (4) different levels of development of domestic capital markets; (5) varying business cultures which prescribe expectations on disclosure and norms of behavior and (6) different attitudes of Regulatory Authorities.

The bottom line is that despite several years of efforts, the regional/national agencies have not been able to provide credible alternatives to international credit rating agencies (ICRAs). Perhaps the fundamental problem is lack of political will on the part of regional leaders and lack of scale and sophistication required in these agencies to match ICRAs.

## **I.5 ASEAN+3 Policy Dialogue Forums**

The financial crisis of 1997-98 highlighted the risks of inadequate policy coordination among Asian countries when interdependence among these countries has increased and there are serious possibilities of "contagion" in the financial sector of Asia. It was also widely felt that the policy conditions under the IFIs support programs contributed to deepening of the crisis and there was a need for regional mechanisms that are more sensitive to and cognizant of the regional realities. Accordingly, a series of mechanisms have been developed in the region for regional policy dialogue and surveillance. Noted below are these new forums along with some earlier ones for similar purposes.

- a. ASEAN Surveillance Process (ASP)
- b. ASEAN+3 Surveillance Process
- c. Manila Framework Group
- d. Asia-Europe Meeting (ASEM)
- e. Asia Cooperation Dialogue (ACD)
- f. South East Asia, New Zealand and Australia (SEANZA)
- g. South East Asian Central Banks (SEACEN)
- h. Executive Meeting of East Asia and Pacific Central Banks (EMEAP)
- i. SAARC FINANCE
- j. Nongovernmental Regional Forums

The proliferation of regional institutions for policy dialogue and research presents another example of “noodle bowl” of regional cooperation initiatives. There is no central secretariat for coherent analysis and dissemination of findings. The limited number of staff available is scattered through multiple initiatives with overlapping membership. The capacity of the staff is nowhere near the level provided by the international institutions working on the same issues. The local culture of avoiding frank discussions of the common problems and the lingering trust deficit among the partners further limits the effectiveness of these forums. In practice, the “hub and spoke” situation prevails with each country and regional institutions relying more on dialogue with international institutions and external advisors than with each other or on regional advisers. There is no serious discussion in the regional forums on today’s major issues of global and regional finance such as insurance against disorderly unwinding of global imbalances, exchange rate policy in Asia including external pressures for appreciation of Chinese Yuan, better use of Asian savings for investment in Asia, financial assistance to weak and vulnerable states in the region and so on. The international forums reflecting the economic power equation of the mid-twentieth century rather than of the 21<sup>st</sup> century still dominate the regional financial dialogue.

## **I.6 Status on Financial Integration of Asia**

The limitations of the current programs of regional financial cooperation are reflected in the bottom line results on the degree of financial integration in Asia. This is evident both in cross-border flows of portfolio assets and liabilities and in convergence of major financial sector prices.

Intraregional portfolio assets as percentage of total portfolio assets held by the countries in the region increased marginally from 9.0% in 2001 to 9.7% in 2004 for Asia, though the increase was somewhat sharper in Southeast Asia (from 11.0% to 15.2%). Similarly, foreign currency bonds as percentage of GDP and the share of foreign currency bonds in total bonds outstanding declined in most Asian countries between 1997 and 2006, with the exception of Hong Kong and Singapore. Intra-regional holdings of Asian bonds were only about 3% of the total bond holdings in the region. These findings have been confirmed by UNCTAD analysis presented in its TDR, 2007, which concludes:

“Despite all these initiatives there has only been limited progress in the integration of regional financial markets. Between 1999 and 2005 the overwhelming majority of cross-border banking inflows to and outflows from ASEAN banks have been directed to other regions, in particular to Europe and North America. .. intraregional portfolio investment, which is investment in equity and debt securities held by ASEAN and ASEAN+3 countries, amounts to only 3.7% and 0.9 % of GDP respectively in 2005.” (p.129)

Evidence from price measures of financial integration also suggests that integration remains low albeit increasing (ADB Bond Monitor 2005). First although cross-border interest rate and bond yield differentials have narrowed in recent years, these differentials remain substantial, even after controlling for exchange rate movements. Co-movements in Asian interest rates and bond yields have increased in recent years, but this could also reflect increasing integration with global markets and/or improving fundamentals (such as lower inflation rates and differentials and improved sovereign credit ratings). Co-movements in equity market returns, even after controlling for global factors, suggest that stock markets are more integrated than money and bond markets.

## **II. EXCHANGE RATE POLICY FOR REGIONAL INTEGRATION**

### **II.1 Introduction**

Exchange rate policy can play a vital role in either facilitating or hindering regional integration. For example, an artificially undervalued exchange rate (as perhaps is the case with China in recent years) can neutralize the effects of tariff reductions for trade liberalization by making imports costlier while promoting exports. Instability in exchange rate movements with regional partners can discourage trade by creating uncertainties in prices received by suppliers. Similar uncertainties can occur when invoicing is done in a currency which is fluctuating in an uncertain manner. Lastly, when there are uncertainties about future value of partners’ currency, investment in assets denominated in that currency will be discouraged. Thus, for promoting regional integration, it is desirable to seek stable and predictable external

values of national currencies within the region which will facilitate intraregional trade, simplify economic decisions, and promote cross-border holdings of local securities.

## **II.2 A Common Asian Currency**

It is obvious that these benefits are achieved most fully when there is currency union and the history of Euro as a common currency for EU is a testimonial to what can be done. Accordingly, there is a considerable amount of literature in Asia is about optimum currency area and the benefits of common currency drawing upon pioneering work by R. Mundell , R. Mckinnon and others.<sup>11</sup>

However, common currency requires surrender of national authority on internal and external monetary policy and presupposes a degree of convergence on inflation target, symmetry of macro-economic shocks, labour and capital mobility, conditions which may not be there in the Asian context for the foreseeable future. The literature on common currency thus remains largely of academic interest and preoccupation with common currency can even be counterproductive in the short and medium term to the extent that it diverts attention from actionable issues in regional exchange rate policy. Among such actionable issues are: (a) creation of a parallel currency, (b) creation of regional currency as a unit of account or (c) exchange rate coordination for concerted action in response to internal and external shocks and/or changes in fundamentals affecting the national exchange rates.

## **II.3 A Parallel Regional Currency**

The case for parallel currency in Asia was made by Nobel laureate Robert Mundell<sup>12</sup> in several publications including his lecture at ADB in 2001. The idea was developed further in RIS discussion paper<sup>13</sup> which proposed creation of a Reserve Bank of Asia which will issue the parallel currency much like Bancor proposed by Keynes at Bretton Woods. It was also elaborated in Barry Eichengreen<sup>14</sup> in recent paper. Essentially this is an adoption of the idea of SDR as a supplementary currency mooted in the IMF many years ago which unfortunately did not take off because of the conflict of interest with veto-power holder in the IMF. <sup>15</sup>

An Asian Currency Unit (ACU) could be defined as a fixed number of units of each constituent currency. Weights could be determined by the share of the country in regional trade or exports, GDP and strength of the currency. In Asia's circumstances today, it may be reasonable to choose a few strong currencies such as Yen, Yuan, Won, Indian Rupee and Singapore Dollar and assign equal weights to them. Official ACUs would be created in exchange for swaps of a fraction of the international reserves of participating central banks. Participating central banks would agree to accept ACUs in transactions among themselves. Governments would agree to experiment with the issuance of ACU-denominated bonds. The existence of these benchmarks would make it more attractive for financial and non-financial firms to issue and accept ACU-denominated liabilities and assets, subject to standard prudential regulations. Apart from providing a reference currency such a parallel currency will allow seigniorage created by regional transactions to be available to the region for its developmental needs. And given the region's current foreign asset position such a currency can be created in near future provided the regional partners are not afraid of depriving the present beneficiary of reserve currencies of the windfalls due to seigniorage.

## **II.4 Links to Basket of Currencies, Extra-regional or Regional**

With or without a common/parallel currency, there are possible gains from linking of national currencies to some sort of basket of currency. One approach proposed by Williamson (1999)<sup>16</sup> is to link Asian currencies to three major world currencies, US dollar, Euro and Yen. Predictable exchange rates against the dollar, euro and yen would facilitate export growth. Common weights in the national currency baskets would also limit intraregional fluctuations in effective exchange rates. There could be a float of individual currencies within a band perhaps supported by a common pool of reserves. Critics of this approach note credibility issues related to adoption of "soft margins" in the target band as well as the political difficulty of re-aligning central parities when the under lying determinants of the equilibrium exchange rate change. Pan-regional political, economic and financial commitments required for such basket currency may also be absent in Asia.

Another approach is country specific trade-weighted basket peg. In principle, a system of country-specific basket pegs would insulate the trade relations of the region from outside disturbances (as the common-basket proposal does) but not fully eliminate intraregional instability in bilateral rates. Whether customized baskets would be superior in stabilizing real exchange rates depends on the relative variability of the external values of the constituent currencies. A further advantage of country-specific basket pegs is that they may be better suited to a context of evolving intraregional trade patterns and could represent an interim step towards the adoption of a common basket as real convergence among Asian economies proceeds.

## **II.5 Basket Currency as a Unit of Account**

Apart from the issue of using regional or national basket of currencies for exchange rate policy, such a basket may be useful just as a unit of account. In this form, SDR is being used at international level but that is heavily weighted by major international currencies. An Asian version could be created in the short run which would include major Asian currencies and that ACU could become a unit of account for invoicing, and financial assets and liabilities in the region. It can also be a benchmark which individual countries can take into account if determining its exchange rate policy. ADB proposal on ACU made in ADB Annual meeting in 2006 in Hyderabad was meant to serve that purpose. Indeed, the stated aim of the ADB at this stage is for the ACU to serve mainly as a means of benchmarking the extent of currency movements /deviations. However, the proposed ACU was not representative of the developing member countries of ADB. Nor was there adequate consensus-building among the members about the role and modalities of ACU before it was floated.

Despite more than ten years of discussion since the financial crisis of 1997, there is hardly any concrete progress on ACU in any form, as a unit of account, as a benchmark for exchange rate policy, for exchange rate policy coordination, not to mention parallel currency or common currency. Among the factors contributing are: lack of support from global institutions and dominant global financial players (who have a short-term conflict of interest with regional currency programs) and lack of appreciation in the Asian players of the costs of business as usual scenario partly because the

region is experiencing healthy growth with reasonable stability. We believe that a roadmap for launching ACU should be proposed and discussed among Asian countries. Such a roadmap may have the following elements:

- In the near-term (within one year), design an ACU as a unit of account which could be used for denomination of cross-border bonds and loans in the region and for trade price quotations.
- In the medium-term (over 1-2 years) use the ACU as a reference currency for national exchange rate policy and as an insurance against competitive devaluation policies in Asia in case of hard landing of the US dollar.
- Over the longer term (beyond 2 years), move towards issuance of ACU as a parallel currency to replace the US dollar as the main reserve currency in Asia.

Such a program can, however, be implemented only if there is a regional financial infrastructure to guide the process and our proposals in that regard are presented in Section IV of this paper.

## **III. NEW RISKS AND OPPORTUNITIES FOR ENHANCED FINANCIAL CO-OPERATION IN ASIA**

### **III.1 Introduction**

The post-1997 crisis performance of Asia measured in terms of select macroeconomic indicators presents a mixed picture. For the affected East Asian economies, the GDP growth rates for the period 1997-2005 were below 5% per year: 2.3% in Indonesia, 2.5% in Thailand, 4.0% in the Philippines, 4.1% in Malaysia, and 4.3% in Korea. GDP growth rates in these countries have improved in recent years but still far below the pre-crisis growth rates of these countries. Basically, so far as growth performance is concerned the crisis-affected countries have not regained their old dynamism.

On stability front, there is distinct improvement particularly in the crisis-affected countries. Most of the Asian countries have very large foreign exchange reserves, much more than what is required by rules of prudent foreign exchange reserve management. In most of the countries, exchange

rate is managed with some flexibility and intraregional instability in real effective exchange movements is now much lower than before the crisis. The banking systems in most countries are stronger with sharply reduced ratio of non-performing loans (with the exception of the Philippines). Current account deficits, budget deficits and inflation rates in most countries are low and manageable. However, with ample global liquidity and expanded investor base, capital inflows to the have increased sharply and in some countries such as China and Thailand, short term debt as percentage of total external debt has increased to 1997 levels of the crisis-affected countries.

However, as some of the old risks have diminished, new ones have risen along with new opportunities of accelerated and sustained growth. As noted in IMF's *World Economic Outlook*, April 2007, "Financial markets in the region, especially those that appear richly valued, also remain vulnerable to any unanticipated rise in global risk aversion. A related risk arises from the inflows into many regional markets stemming from the yen carry trade. These could unwind rapidly if investors were to revise their expectations of bilateral exchange rates and interest rate differentials, particularly in the context of rising volatility in foreign exchange markets". In addition there are new risks in the global environment and new opportunities in the region to accelerate its growth while maintaining stability. Among these are:

- Risks from US financial crisis;
- Losses from excessively high foreign exchange reserves;
- Infrastructure deficits; and
- Risks of policy disorientation.

In what follows we elaborate on these new risks and opportunities and argue that they make a case for a bold departure from the conventional programs of financial cooperation in the region.

### **III.2 Mitigating Risks from US Financial Crisis**

The risks of financial meltdown in the US are increasing by the day. The losses to the banking system from sub-prime mortgages and related crises are now being counted in trillions of dollars. The fall in net worth of households is also being counted in trillions of dollars. A combination of

these creates a serious risk of prolonged recession in the US. Coming as these tendencies do at the time that fuel and other commodity prices are rising, the risks of stagflation are also real. The dimensions of economic debacle that may follow hard landing of the US dollar should not be underestimated. Loss of confidence in dollar can lead to sharp decline in its value, sharp increase in the US interest rates and sharp decline of US output. In the protectionist atmosphere that now prevails in the US, this may lead to import restrictions, leading to decline in output and trade in major trade partners of the US, in particular Asia, further compounding the recessionary tendencies in the US. Thus the downward cobweb of protectionism and output decline that lead to the Great Depression of the thirties may not be out of the question.

The US monetary and fiscal policies are aiming at providing "whatever it takes" to avoid prolonged recession. Lowering interest rates, providing tax relief, opening up liquidity taps of the central banks to the financial institutions in liquidity/solvency crunch - all these and others are items of daily news. These measures may or may not fix the short-run stabilization problem but they are certainly inadequate to fix the underlying long-term problem. In fact, they are similar to what was done in the wake of tech bubble crash and risks created by 9/11 in 2001 and they may end up compounding the long term problem of external debt burden on the US economy.

The real factor behind the financial crisis is the macro-economic profligacy rather than imprudence or inefficiency at the micro-financial level. During the last ten years the US has spent \$6 trillion more than its income. Each year its over-consumption on "borrowed" money was more than the total consumption of a billion people in India. Today, as mentioned by eminent authorities like Fred Bergsten, the US dollar liabilities are at least \$20 trillion. Such profligacy was possible because the world has been on a dollar reserve system where the US can pay its foreign bills in its local currency without the adjustment mechanism that a normal economy may have when its external account gets out of balance.

The lack of balancing mechanism permitted an excess injection of demand in the system which seemed to be called for short term stabilization

purposes. The collapse of the tech boom in 2000 and atrocious attacks of 9/11 seemed to justify stimulation measures for the US economy. And the managers were lulled into complacency by the facile ideas of exceptionalism of the US. Strange theories of “dark matter” suggesting that the US economy can go on living beyond its means for ever (or at least foreseeable future) were concocted and taken seriously. There were many in the US and abroad (see Box 2 for three examples) who argued that such profligacy was neither healthy for the US nor sustainable but in the euphoria of unbounded consumerism, such warnings were ignored.

### **Box 2. Some Early Warnings of US Financial Crisis**

On the risks of global imbalances, a powerful presentation was made recently by Lawrence Summers (2006) in Mumbai and it deserves to be quoted at some length:

“The American current account deficit is unprecedented in our economic history or that of other major economic powers. Today, it is currently running at a rate approaching 7 percent of GDP. Barring some discontinuity, most knowledgeable observers expect it to increase. Most of the classic indicators for deciding how serious a current account deficit are worrying:

- First, 7 percent and growing is an unusually large deficit,
- Second, the current account deficit is financing consumption rather than investment as the U.S. net national saving rate is now at a record low level of under 2 percent.
- Third, investment is tilted towards real estate and the non-traded goods sector rather than the traded goods sector and away from exportables.
- Fourth, the net flow of direct investment is out of the United States and the flow of incoming capital appears to be of shortening maturity and coming increasingly from official rather than private sources.

This configuration, whatever its causes, raises obvious risks. There is the hard-landing risk. This is not just an American risk, but a global risk at a time when the U.S. external deficit is creating nearly an export stimulus demand approaching 2 percent of global GDP. And as we are seeing with increasing frequency, whether it is regarding ports or computers or automobile parts, the current situation is creating

*Box 2 continued*

*Box 2 continued*

substantial protectionist pressures. In addition, it is hard not to imagine that there are geopolitical risks associated with reliance on what might be called a financial balance of terror to assure continued financial flow to the United States. ...

To be sure the United States should be viewed differently from an emerging market and so there can be certain amount of complacent commentary- commentary that has gained strength as the U.S. current account deficit has continued without evident ill effect. In general, my view thinking about past experience with tech stocks in the United States or with the Japanese stock market or with a range of emerging market situations is that the moment of maximum risk comes precisely when those concerned about sustainability lose confidence in their views as their warnings prove to be premature and when rationalizations come to the forefront.

...Suffice it to say that intangible investment as well as tangible investment in the United States has also declined in the United States even as our dependence on foreign capital has increased. Even if home bias is declining, there are surely limits on the tolerance of foreign investors for increased claims on the United States. And while arguments about “financial dark matter” or the U.S. ability to issue debt in its own currency probably have some force in thinking about what level of external debt is sustainable for the United States, they surely do not make the case for indefinite continued expansion of debt (Summers 2006)”.

*World Economic Outlook 2006* (WEO) of IMF also mentioned as one of scenarios the risks of what it called “disruptive adjustment” in global imbalances. In this scenario, there is a worldwide reduction in appetite for US assets combined with a significantly increased interest rate risk premium. In this scenario, the current account deficits in the US contract rapidly to 2 percent of GDP, accompanied by a drop in the currency and a sharp increase in interest rates to combat inflationary pressures. US growth declines to around 1 percent for two years. There is a sharp real exchange rate appreciation in emerging Asia almost eliminating the region’s current account surplus by 2010, and bringing down growth rate to 4 per cent. The Euro area and Japan and the remaining countries experience similar effects but on a smaller scale. The WEO also admits that there could be even worse outcomes than above. A disorderly exchange rate adjustment and global recession could risk a severe disruption in financial markets, hurting

*Box 2 continued*

productive capacity, depressing access to credit and aggregate demand, and leading to asset price deflation. A downturn in activity could also trigger a wave of protectionism, causing substantial reduction in living standards across all countries.

In RIS Discussion Paper no. 46 (April 2003) “Towards a Multipolar World of International Finance” Ramgopal Agarwala and Gauri Modwel argued:

“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.”

Now it seems the party is over. Households, businesses and government have a huge debt overhang which needs external financing. The world needs a program for correcting the current account deficit of the US over the medium term. What is needed is to restructure the US demand away from consumption towards net exports, i.e. increasing exports and reducing imports to the extent of about \$700 billion per year over the adjustment period. That, in turn requires, three steps:

- Drastic depreciation of US dollar in relation to the currencies of the rest of the world.
- Hard external budget constraint on the US.
- Additional demand creation in the world economy to help augment US exports and compensates in global demand due to decline in US absorption.

First is the issue of smooth depreciation of the US Dollar. Like any other economy with large current account deficit, US must depreciate its currency (perhaps by 20-30% from its level in March 2008) to promote exports and restraint imports.<sup>17</sup>

A one-time quick and drastic devaluation will reduce speculation about further depreciation in dollar and restore the confidence in the dollar. Asian currencies are, by and large, undervalued and they must be allowed to appreciate in relation to the US dollar. However, this cannot be done by a single Asian country for fear of losing its competitiveness in relation to other Asian trading partners. Instead, Asian countries need a policy of concerted and steady appreciation in relation to the US dollar. US and the Asian governments need to work together to promote such an exchange rate policy in Asia.

The second step is to ensure that US can only borrow external funds to a specified limit. In this context the ideas on Substitution Account in the IMF first mooted in the seventies are relevant. In his article in *The Financial Times* of December 10, Fred Bergsten has proposed revival of the idea of substitution account (see Box 3). However, IMF with veto power of the debtor in trouble is hardly a credible agency from the point of view of the creditors. There has to be a mechanism for compensating the institution for further decline in value of dollar, an appropriate interest rate on the holdings of dollars and a program of redemption of dollars over time. Altogether

### **Box 3: Fred Bergsten on Substitution Account**

The world economy faces an acute policy dilemma that, if mishandled, could bring on the mother of all monetary crises. Many dollar holders, including central banks and sovereign wealth funds as well as private investors, clearly want to diversify into other currencies. Since foreign dollar holdings total at least \$20,000 billion, even a modest realization of these desires could produce a free fall of the US currency and huge disruptions to markets and the world economy. Fears of such an outcome have risen sharply in both official circles and the markets.

However, none of the countries into whose currencies the diversification would take place want to receive these inflows. The euro zone, the United Kingdom, Canada, and Australia among others believe that their exchange rates are already substantially overvalued. But China and most of the other Asian countries continue to intervene heavily to keep their currencies from rising significantly. Hence, further large shifts out of the dollar could indeed

push the floating currencies far above their equilibrium levels, generating new imbalances and a possibly severe slowdown in global growth.

There is only one solution to this dilemma that would satisfy all parties: creation of a substitution account at the International Monetary Fund (IMF) through which unwanted dollars could be converted into special drawing rights (SDR), the international money created initially by the fund in 1969 and of which \$34-billion-worth now exists. Such an account was worked out in great detail in 1978–80 during an earlier bout of currency diversification and free fall of the dollar that closely resembled today’s circumstances.

There was widespread agreement, including from influential private sector groups and congressional leaders as well as the IMF’s governing body, that the initiative would enhance global monetary stability. It failed only because the sharp rise in the dollar that followed the Federal Reserve’s monetary tightening of 1979–80 obviated much of its rationale and over disagreement between Europe and the United States on how to make up for any nominal losses that the account might suffer as a result of further depreciation of dollars that had been consolidated.

The idea of a substitution account is simple. Instead of converting dollars into other currencies through the market, depressing the former and strengthening the latter, official holders could deposit their unwanted holdings in a special account at the IMF. They would be credited with a like amount of SDR (or SDR-denominated certificates), which they could use to finance future balance-of-payment deficits and other legitimate needs, redeem at the account itself or transfer to other participants. Hence the asset would be fully liquid.

The fund’s members would authorize it to meet the demand by issuing as many new SDR as needed, which would have no net impact on the global money supply (and hence on world growth or inflation) because the operation would substitute one asset for another. The account would invest the dollar deposits in US securities. If additional backing were deemed necessary, the fund’s gold holdings of \$80 billion would more than suffice.

All countries would benefit. Those with dollars that they deem excessive would receive an asset denominated in a basket of currencies (44 percent dollars, 34 percent euros, 11 percent each yen and sterling), achieving in a single stroke the diversification they seek along with market-based yields.

They would avoid depressing the dollar excessively, minimizing the loss on their remaining dollar holdings as well as avoiding systemic disruption.

The United States would be spared the risk of higher inflation and potentially much higher interest rates that would stem from an even sharper decline of the dollar. Such consequences would be especially unwelcome today with the prospect of subdued US growth or even recession over the next year or so.

The international financial architecture would be greatly strengthened by a substitution account. In the wake of the dollar crises of the early postwar period, the IMF membership adopted SDR as the centerpiece of a strategy to build an international monetary system that would no longer rely on a single currency.

The move to floating exchange rates by most major countries in the 1970s postponed the need to pursue that strategy to its conclusion but also generated the extreme currency instability that triggered official consideration of an account. The global imbalances and large currency swings in recent years, and the accelerated accumulation of official dollar holdings by countries that have essentially reverted to fixed exchange rates, replicate the conditions that led to both the creation of SDR and the negotiations on an account.

A substitution account would not solve all international monetary problems nor would it suffice to restore a stable global financial system.

The dollar needs to decline further to restore equilibrium in the US external position. China, many other Asian countries, and most oil exporters will have to accept substantial increases in their currencies now and much more flexible exchange rates for the long run. But early adoption of a substitution account would minimize the risks of adjustment of the present imbalances and the inevitable structural shift to a bipolar monetary system based on the euro as well as the dollar.

*Source:* “How to Solve the Problem of the Dollar” by C. Fred Bergsten, Peterson Institute, *The Financial Times*, December 11, 2007

there would be a need for a “structural adjustment program” for the US economy which cannot be designed and implemented with the present IMF governance. Either the governance of IMF is drastically changed or a consortium of dollar holders is formed to manage the process of exiting

from dominant dollar reserve system and moving to a new system of multi-polar reserve currencies.

Third, the exchange rate policy in Asia needs to be supplemented by programs to create additional domestic demand in Asia which will help restructure the world demand away from US consumption to Asian investment and consumption. In the absence of such Keynesian packages for demand stimulation in Asia, the program of reducing net imports of the US of about \$800 billion which will lead to drastic reduction in net exports of Asia can cause serious recession in Asia.

Regional financial cooperation has now received an urgency that has been missing until now. No longer can Asian policy makers say that when the economies of Asia are doing so well with such limited cooperation why bother about new and politically difficult programs of cooperation particularly when they are not supported either intellectually or politically by the dominant player in the world economy, namely, the US. Now for avoiding the risk of serious recession in the US as well as in Asia, Asian leaders must explore avenues for financial cooperation which will allow drastic devaluation of the US dollar, reduction in net imports of the US and creations of alternative sources of demand in Asia. Fortunately Asia has financial resources as well as latent demand to launch such rescue operation. And it is to these strengths of Asia that we turn now.

### **III.3 Accumulation of Foreign Exchange Reserves in Asia**

The foreign exchange reserves of Asia are now more than US \$3 trillion and growing by nearly 10% per year. 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% in 2004-05 and 3.9% 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-leader 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% 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% of the reserves at the end of December 2006. Clearly Asia is in a position to take a more aggressive approach to management of its portfolio of foreign exchange reserves.

### **Serious Infrastructure Deficits**

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 % of GDP in low twenties. These investment rates are quite inadequate for achieving the traditional East Asian growth rates of about 7% 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% of GDP, from about 6% in mid-1990s. Even in India, where the overall investment rates are improving, infrastructure investment rate in 2004-05 was 4.9% of GDP, lower than that in the year 1991-92, a year of economic crisis. Estimates of regional investment needs vary between a range of US \$165-\$412 billion (about 6.2-7.3 per cent of GDP) per annum for the period 2007-2011) depending upon the regional and sectoral coverage of the studies.

*Investment Deficits are Particularly High in Cross-border Investments in Sectors such as Energy and Surface Transportation.* In Asia-Pacific, the regional distribution of energy resources in comparison to demand is such that a number of interconnection projects can be envisaged that would provide large regional benefits. Several resource rich economies tend to have relatively low demand, whereas neighbouring resource poor economies have high demand. In several cases, sectoral and seasonal complementarities exist, such as between Central and South Asia and between Eastern Russia and Northeast Asia, there are seasonal complementarities with excellent opportunities for power trading. Energy infrastructure networks among these countries can enhance the security, flexibility and

quality of energy supply among the interconnected economies. Moreover, transit economies, that are economies that provide facilities for the laying-out of the infrastructure in their territories, also benefit from the rights-of-way given to the energy transmission

Traditionally, most Asian countries have relied on maritime transportation for their export and import trade. With evolution of maritime containerization, regional and global production networks have received a boost thus further increasing the role of maritime transport. This process while welcome has its limitations. As the trade in Asia is set to more than quadruple over the next 20 years, sea-lanes are going to be increasingly congested with consequent increase in costs and risks. Over time, Asia has to increase the use of surface transport much along the lines of what happens in continental Europe and the U.S., which have a much more dense surface transport network than Asia. Road connectivity between Central, South and East Asia can dramatically cut down travel time and costs for large as well as small shipments within Asian countries. There is also a growing acceptance that rail has an important role to play in the national and international movement of goods. A number of factors speak in favour of a greater utilization of rail transport in Asia, and between Asia and Europe. Such factor include: (i) the long land transport distances within and across Asia and between Asia and Europe; (ii) the sustainability of the rail mode in terms of its reduced impact on the environment and its greater energy-efficiency; and (iii) the ability of rail to clear landside port areas quickly to avoid congestion. In addition to efficiency considerations, equity considerations also suggest the need for increased emphasis on surface transport. The sea-base transport has helped develop the coastal regions while the inland provinces in many Asian countries (in particular China and India) have become lagging regions. Equally the landlocked countries of the continent have been lagging in performance and are under considerable economic and political stress. Improved surface transport, in a way reviving the old “silk routes” of Asia, can make them “landlinked” and become instruments of revival of these lagging regions and countries.

Closing the gap in infrastructure funding is not, however, merely a matter of funding. Quite often it is institutional constraints that hamper the

implementation of infrastructure projects. And these institutional constraints are operative at both national and regional level. A regional program is needed to overcome the institutional constraints for cross-border projects. Moreover, for many of these cross-border projects there may be some gap in financial viability which the public sector may well be called upon to fill. Thus there is a need for substantial amount of concessional assistance which under current conditions cannot be provided by international institutions creating a need for regional institutions with substantial grant money.

## **IV. TOWARDS A NEW REGIONAL FINANCIAL ARCHITECTURE IN ASIA**

### **IV.1 Changing Economic Power Equation in the Global Economy**

There is now a growing consensus that the center of gravity of the world economy and finance is shifting rapidly from Europe and America to Asia and by 2030/2040, Asia is likely to account for more than 50% of the world income, trade and international financial assets.

Agarwala (2005)<sup>18</sup> demonstrated that even on conservative assumptions about growth performance in the next three decades, Asia is likely to form more than 50% of the world economy by 2030. Similar conclusion has been reached among others by Goldman Sachs.<sup>19</sup> In the paper “Dreaming with BRICs: The Path to 2050”, the authors projected that by 2050, GDP of China and India could be US \$72.25 trillion in 2003 US\$, about 33% more than that of G6 countries (France, Germany, Italy, Japan, UK, and US). China, U.S. and India will be the three largest economies in that order. In their more recent paper of 2007, Goldman Sachs upgraded India’s prospects and concluded that India’s GDP (in US\$ terms) will surpass that of the US before 2050, to make it the second largest economy.

However even more striking projections have been made by Nobel laureate Robert W. Fogel<sup>20</sup>, according to whom by 2040 the share of global GDP of the US and EU combined may be nearly half of China’s alone. (See Table 1)

**Table 1: The Global Distribution of Population and GDP in 2000 and 2040**

Country	Percent of population		Percent (PPP \$ of 2000) of GDP	
	2000	2040	2000	2040
(1)	(2)		(3)	
United States	5	5	22	14
EU15	6	4	21	5
India	16	17	5	12
China	22	17	11	40
Japan	2	1	8	2
6South East Asian Countries	6	6	6	12
Rest of the world	58	50	28	16

**Source:** Robert W. Fogel (2007)

It is noteworthy that the ratio of trade, saving and investment in relation to GDP (both in nominal \$ and PPP \$) in Asia is much higher than that in the U.S. and EU. Thus by 2040 or 2050, share of Asia in flows of trade, savings and stock of financial assets is likely to be even greater than in GDP.

Altogether, by mid-21<sup>st</sup> century, the world economy will be largely about Asia much as it was largely about the US and Europe in the second half of the twentieth century. And financial co-operation mechanisms should be seen as an integral part of this economic evolution.

The fact of changing power equation can perhaps be best illustrated by reviewing the prospective changes in the reserve currency status of the US dollar. Reserve currency status giving seigniorage benefits to the dominant economy is perhaps the best statement of the economic power of the dominant nation. This seigniorage has been accruing to the US for the last 50-60 years. However, with growing large and continuing current account deficits, external indebtedness of the US is increasing over time and in that situation, the reserve currency status of the US may not be sustainable.

There is a variety of views as to whether US is likely to lose its reserve currency status over the medium/long term and what currency could take its place. Two views illustrative of the debate are those by Avinash Persaud (2004) and Barry Eichengreen (2005). The former believes that the reserve currency status of US dollar may not last long, while the latter sees no alternative to US dollar as reserve currency in the foreseeable future.

In our judgment, on current trends, Persaud is likely to prove closer to the mark than Eichengreen. The latter's argument that it all depends on the US economic policy does not seem accurate. If what matters is the relative size in the world economy and quality of finance, even the best managed US economy could become marginalized if larger improvements take place elsewhere. If forecasts made by Fogel (2007) come close to reality, economies of both the US and the EU combined are likely to be smaller than that of China alone. With savings rate of China more than double those of US and EU, China's relative asset share position may be even stronger. In any case, the economic policies of the US do not seem to be on right track. The U.S seems to be saddled with long-term fiscal deficits and other structural impediments which reduce the chances of the US economy reducing size of its external debt any time soon. The current financial crisis in the US has highlighted systematic weaknesses in the US financial structure and even raised questions about the validity of global market capitalism as espoused by the US.

In our assessment, there is a serious possibility of the long-term decline in the US dollar as reserve currency and the assumption of that role by Yuan. However, it is not clear, if that situation will be in the best long-term interest of either China or the region. As the experience of other reserve currency status holders shows, that status leads to temptations of overspending which in the end forces some difficult adjustment. It may be better to create a system that minimizes such temptations. For the region too, it will be unfair if the most powerful economy in the region appropriates the seigniorage created by financing needs of regional and global trade. This situation may increase tension between China and its neighbours, which is not healthy for either side. It may be better to follow the European example where a regional currency is created

and the region benefits from the seigniorage rather than only one country. Prevention, rather than cure of currency hegemony of one country is the way going forward. And as argued above, this does not require a common currency. A parallel currency issued by agreement among the regional partners can serve the purpose. With start of ACU as a unit of account, it can gradually move toward a parallel currency issued by a regional institution. In allocation of this parallel currency, the developmental needs of weaker states in the region can be taken into account much as has been done so successfully in EU with allocation of large grants to the new and weaker members of the Union. Perhaps time has come for Asia to be bold and design a regional financial architecture consonant with its new economic power and responsibilities.

## **IV.2 Towards a Reserve Bank of Asia**

Time may have come to revive the basic idea of an Asian Monetary Fund proposed by Japan in 1998 but with appropriate modification to nomenclature and mandate to reflect the current needs of the region.

We propose that a new regional financial mechanism perhaps called Reserve Bank of Asia (RBA), be established in Asia with authorized capital of, say, \$300 billion, 10% of which may be paid up. A certain small percentage (say 10%) of the regional reserves (currently about \$3 trillion and increasing at more than 10% per year) may be lent by the central banks of Asia to at the rate that obtains on 30-year US Treasury Bills to RBA which will be authorized to invest these resources in global equity indices.<sup>21</sup> There is a high probability that RBA will be able to earn at least 5 hundred basis points above the cost of its funds and thus have about \$15 billion per year to assist development in Asia.<sup>22</sup> Its initial focus could be to correct the infrastructure deficits in a public-private partnership mode by filling the financial viability gap that the private sector may have in meeting the infrastructure (both physical and social) needs. Using the Indian example, this gap can be put at a maximum of 20% of the project cost. In addition, the RBA will be authorized to borrow from the markets and lend on projects under Public-Private Partnership (PPP) mode at rates and maturity patterns determined by a process of competitive bidding on the projects identified by RBA. With private and public sector enterprises utilizing the capital

markets for raising their basic fund requirements, the financial ability of RBA 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 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 RBA 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 ACU (much as many transactions of global financial institutions are denominated in SDRs) and this unit could be a weighted average of major regional currencies.

The proposed program 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 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 many of which (such as pipelines, and power grid) 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 programs, 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.

We believe that this mechanism will achieve the objectives of financial cooperation more effectively than is likely under the present initiatives. More specifically, it will:

- Facilitate orderly correction of the US financial crisis.
- Provide a large resource pool and a multilateral mechanism for meeting BOP needs, which is an objective of Chiang Mai Initiative.
- Give a boost to Asian Currency Unit (ACU) by first using it as a unit of account available for invoicing, secondly by using it as a reference currency and for denomination for regional bonds and transactions and thirdly by issuance of ACU as a parallel currency.
- Provide a mechanism for issuance of regional bonds by governments and intergovernmental organizations.
- Create institutional capacity for regional policy dialogue and regional surveillance.

First, the proposed institution will facilitate an orderly correction of US financial crisis by allowing a concerted appreciation of Asian currencies, diverting global demand towards Asian investment and by tightening the external budget constraint on the U.S. Additional investment demand of over \$100 billion per year together with their multiplier and accelerator

effects can be expected to create substantial additional effective demand, perhaps to the tune of one-quarter of the current excess demand of the U.S. (about \$800 billion per year). Similarly, with less of Asian savings available for purchase of US Treasuries, the U.S. authorities may be induced to make more serious efforts to reduce their fiscal deficits (in particular military expenditures) and the increase in interest rates and reduced liquidity may help U.S. households to reduce their excessive consumption. Since the whole process will be managed by regional public authorities rather than financial market forces which have a tendency to overshoot, it can be a gradual process of “belt-tightening” in the U.S. consistent the country’s social and economic stability and Asia’s ability to divert demand from exports to the U.S. to regional investment and consumption.

With US \$300 billion invested largely in equity indices that are liquid, RBA should be able to meet the balance of payments needs of Asian countries on a scale bigger than the IMF or CMI. In case of BoP needs, RBA will provide up to the contribution of the country to the Fund at interest rates higher (say, 100 basis points) than LIBOR. Higher tranches would attract higher interest rates and policy assurances.

On exchange rate, RBA can construct and publicize an ACU immediately. It can also take the second step of issuing and/or underwriting regional bonds issued by regional entities soon after its establishment. The third step of issuing a parallel currency is also becoming more timely as US dollar declines and Euro cannot take all the burden of appreciation. ACU could become a third reserve currency to which switch from US dollar can take place. If the idea of substitution account is implemented, RBA may play a role by accepting certain amount of US dollar and issuing ACU in exchange. As ACU becomes accepted as an international reserve currency, seigniorage generated thereby can help to fund development of Asia, including funding of adaptation and mitigation measures related to climate change.

The use of ACU as a unit of account for regional bonds issued by government backed regional enterprises and /or RBA will give a boost to regional bond market initiative and help use regional savings for regional investments. ACU-bonds could offer the benefit of currency diversification:

if one constituent currency lost value against say the investor's home currency, the impact would be limited by its weight in the basket.

The proposed RBA, with reserve capital of more than \$300 billion and supporting investment of more than \$100 billion per year, will be providing financial support bigger than all the current IFIs put together. Accordingly, it can also build up technical staff bigger than in the IFIs at present. With such sizeable staff capacity, RBA can become a central place for economic dialogue and surveillance in Asia more effective for Asia than has been the case with IMF, which, in any case, is facing sharply declining business opportunities and a need for downsizing. The RBA could help in articulation of an Asian Development Paradigm, which is different as much from the Soviet-inspired statist paradigm as from the US-inspired neoliberal paradigm (see Appendix 1).

#### **IV. 3 Leadership for Designing the Regional Financial Architecture**

The current international financial system was set up largely at Bretton Woods Conference in 1944 in barely three weeks time with preparatory work extending over months rather than years. This was possible because there was a clearly felt need and a clear leadership. The memories of 'beggar thy neighbor' "policies on exchange rate in the interwar period were a powerful stimulant to designing a system for exchange rate stability. The foreign exchange shortages facing many European countries called for balance of payments support mechanisms for the needy. And both required an agency for review of macroeconomic policies of the participating countries. The huge funding needs for reconstruction for war-ravaged Europe called for a bank for reconstruction to which the need for development of underdeveloped economies was added, though as an afterthought. But the whole exercise was possible mainly because of the leadership provided by the unquestioned economic power of the day, namely, the U.S. with some intellectual support provided by the U.K.

In the Asian context, we believe that the felt needs are there for a major regional financial institution. However, there is no clear leader comparable to the U.S. at Bretton Woods Conference to respond to the need by action.

Instead, Asia may look to the European example of shared leadership of a few major players in the region. The concept of JACIK (Japan, ASEAN, China, India, and Korea) which has been elaborated in several papers in RIS in the context of regional trade liberalization programs could also be relevant for financial co-operation. With the participation of all the JACIK countries, in addition to Australia and New Zealand, East Asia Summit has merged as an important forum for a dialogue on regional issues.

East Asia Summit (EAS) seems to be the most appropriate forum to carry further the program of financial co-operation in Asia. The subject should now be raised from academic to political level. A Committee of Senior Officials may be convened to review proposals for designing Asia-wide financial co-operation mechanisms, an illustration of which is provided in the study. This may be followed up by a meeting of Finance Ministers of EAS countries to design a new regional financial architecture in Asia. Once the broad outline of such a program is agreed an Asia-wide conference (an Asian Bretton Woods Conference?) may be convened to agree on the Articles of Agreement of the new regional financial architecture in Asia.

The question of the U.S. reaction to the proposal is of vital importance. As in the case of the proposal for Asian Monetary Fund proposed by Japan in 1998, a strong opposition from the US may make it difficult for several key players in the Asia to promote the proposal. We believe that the proposal made here is in the immediate as well as long-term interest of the U.S. The over-borrowings by the U.S. are clearly unsustainable for ever. The U.S. absorption has to come close to the U.S. output sooner or later: the U.S. economy has to land. The real choice is between "hard landing" and "soft landing". Unless something is done to reduce U.S. deficits gradually, a hard landing scenario is highly likely and that will do much damage to the US economy as well as the Asian economies. By gradually strengthening the external budget constraint on the U.S. and diverting demand from U.S. to Asia, the proposed scheme will reduce US deficits without reducing the global demand. What was done by the U.K in handling its sterling balances after the Second World War may also be an example to learn from.

## Endnotes

- <sup>1</sup> The ten ASEAN countries are Indonesia, Malaysia, Philippines, Singapore, Thailand and Brunei Darussalam, as well as the newer/transition members, viz. Cambodia, Laos, Myanmar, Vietnam, Timor-Leste (formerly East Timor).
- <sup>2</sup> There are also a series of repurchase agreements (repos) that allow ASEAN members with collateral such as US Treasury bills to swap them for hard currency (usually US dollars) and then repurchase them at a later date.
- <sup>3</sup> For more details on the CMI and monetary regionalism in Asia more generally, see Park (2004).
- <sup>4</sup> Japan and India have recently concluded a currency swap agreement to help counter investor speculation in their respective currencies.
- <sup>5</sup> See “The Joint Ministerial Statement of the 8th ASEAN+3 Finance Ministers’ Meeting” (Istanbul, May 4, 2005) (<http://www.aseansec.org/17448.htm>). In May 2006, finance ministers tasked their deputies to further study the possibility of multilateralizing the CMI or to create a post-CMI framework. At the 41st Annual Meeting of ADB’s Board of Governors in Madrid in 2008, agreement was reached among ASEAN+3 countries on several key elements of multilateralization of CMI.
- <sup>6</sup> For instance, see Ito and Park, eds. (2004) and Eichengreen and Luengnaruemitchai (2007). For an overview of Asian bond markets, see Hamada, Jeon and Ryou (2004). Also see a BIS symposium on Asian bond markets <http://www.bis.org/publ/bppdf/bispap30.htm> as well as resources available on the portal created and maintained by the Asian Development Bank (ADB) <http://asianbondsonline.adb.org/>.
- <sup>7</sup> Under the auspices of the ABMI, the APT has established a number of working groups to examine various aspects of capital markets, including creating securitized debt instruments and increasing the supply of local currency denominated, exploring possibilities of a regional settlement linkage and impediments to cross-border bond investment and issuance in the region, capacity building of local credit rating agencies in Asia, and enhancing comparability and harmonization. More information on all these and other initiatives is available on <http://asianbondsonline.adb.org/>. Also see the review of ABMI working groups by Kawai (2007).
- <sup>8</sup> The macroeconomic implications of these balance sheet effects have been explored by Rajan and Parulkar (2007), Rajan (2007) and Bird and Rajan (2006).
- <sup>9</sup> It is important to ask the question as to why some countries are not able to borrow overseas in domestic currencies (so called “Original Sin” hypothesis a la Hausmann, Panizza and Stein (2001). Logically, if there is a significant risk premium imposed on a certain currency and if interest rates are “sufficiently” high, there will always be some potential borrowers. While this is true, the concern is that a potential solvency risk will merely be converted to a liquidity risk (to the extent that revenues in the event of a negative shock are not sufficiently high to meet the high interest payments). See Jeanne (2000).
- <sup>10</sup> For a more detailed and forceful critique of such regional bond initiatives, see Eichengreen (2004).
- <sup>11</sup> Mundell, R.A. (1961). “A theory of optimum currency areas”, *American Economic Review*, 51(4) 657-65; McKinnon, R.I. (1963), “Optimum Currency Area”, *American Economic Review*, 53(4), 717-25. Ogawa, E. and Kawasaki, K. (2004) “Toward an

- Asian Currency Union” in Yoon Hyung Kim and Chang Jae Lee, eds. *Strengthening Economic Cooperation in Northeast Asia*, KIEP, Seoul, 311-347.
- <sup>12</sup> Robert Mundell’s presentation in “Defining an Agenda for Poverty reduction” in *Proceedings of the First Asian and Pacific Forum on Poverty (Vol.1)* ([http://www.adb.org/Documents/Books/Defining\\_Agenda\\_Poverty\\_Reduction/Vol\\_1/chapter\\_03.pdf](http://www.adb.org/Documents/Books/Defining_Agenda_Poverty_Reduction/Vol_1/chapter_03.pdf))
- <sup>13</sup> “Towards a Multipolar World of International Finance” Ramgopal Agarwala and Gauri Modwel, RIS-DP # 46/2003 April 2003.
- <sup>14</sup> Eichengreen, Barry (2006). “The Parallel Currency Approach to Asian Monetary Integration”, Mimeo (March), Asian Development Bank, Manila.
- <sup>15</sup> The case for and the history of resistance to universal currency unit by the US has been noted by Mundell (op.cit.) “Over most of recorded history the international monetary system has had the benefit of a universal currency based on gold, silver, or both metals. More recently, back in the days of Bretton Woods, the British Plan (also called the Keynes Plan) envisaged a world currency, a universal currency called “bancor,” and the American plan (also called the White plan) envisaged a universal currency, called “unitas.” In other words, the original planning at Bretton Woods made provisions for a world currency. However, it fell afoul of American interests. There is a nice passage in the diaries of (Lord) Lionel Robbins about how delegates were talking about the potential new world currency and then suddenly the Americans stopped talking about it because they had decided it was not in US interests. Gold or the dollar would suffice in the postwar world.  
The need nevertheless persisted, and persists to this day. An attempt to make up for the omission occurred in the 1960s with the creation of the SDR, a gold-guaranteed reserve asset that would have economized on gold. But in the 1970s, the gold guarantee was stripped away and it was transmogrified into a mere basket of 16, then five, and now four currencies: 39 percent dollars, 32 percent euros, 18 percent yen, and 11 percent pounds sterling.  
A country now has the option of fixing its currency to the dollar, euro, or yen, or even going the full distance and dollarizing (or “euroizing” or “yenizing”). It could also fix to a basket of these currencies or to the SDR. The SDR is becoming a viable option as a unit of account for the world economy. The more countries adopt it as the anchor for their own currencies, the closer it would approximate true international money, badly needed in the world economy. As Paul Volcker has put it, “A global economy needs a global currency.”
- <sup>16</sup> Williamson, John (1999). “The case for a common basket peg for East Asian currencies” in *Exchange Rate Policies in Emerging Asian Countries*, by S. Collongnon, J. Pisani-Ferry, and Y.C. Park (eds.), London.
- <sup>17</sup> In *Dollar Adjustment: How Far? Against What?* by C. Fred Bergsten and John Williamson (eds.), November 2004, Michael Mussa estimated that a 30% depreciation of US dollar in real effective terms (from the baseline of the period from mid-2000 to mid-2002) was required just to bring down the current account deficits of the US by 3% of GDP.
- <sup>18</sup> Ramgopal “Agarwala, “Asia’s Reemergence: When Can Asia Reclaim Its Place in the World Economy?” in *Asian Economic Cooperation and Integration: Progress, Prospects, and Challenges*, Asian Development Bank, Manila, 2005.

- <sup>19</sup> Goldman Sachs, “Dreaming With BRICs: The Path to 2050”, Dominic Wilson and Rupa Purushothaman, Global Economics Paper No.99, October 1, 2003 and “India’s Rising Growth Potential” Tushar Poddar and Eva Yi, Global Economics Paper No. 152, January 22, 2007.
- <sup>20</sup> Robert W. Fogel, “Capitalism and Democracy in 2040: Forecasts and Speculations”, Working Paper 13184, NBR, June 2007. <http://www.nber.org/papers/w13184>.
- <sup>21</sup> The significance of investment in equity indices should not be underestimated. In the wake of investment by China in Blackstone Company, there is now a widespread concern in the U.S. about the politicization of sovereign wealth management and there are calls for greater transparency of sovereign wealth management and for involvement of IMF and World Bank in the matter. Investment in equity indices by a regional financial institution will be fully transparent and minimize the risk of politicization of these investments.
- <sup>22</sup> The stock markets are of course subject to fluctuations. However, on any long term basis (say 30 year average) stock indices such as Standard and Poor’s have consistently shown about 10 per cent annual ROR or about 5 per cent higher than on US Treasury Securities). It is noteworthy that even if investment was made when the stock market index was high (for example 1972) and sold after 30 years in 2002, when the index was low, the 30-year average on equity index was 8.12, 3083 points more than that on 10-year Treasury bonds. This confirms the well-known finding in stock markets that for investors with capacity to hold for long, the timing of investment is not very important. If in the short-term, these investments do not turn in profits and even show losses, the cushion provided by the paid-up capital can be used to tide over these periods.

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**APPENDIX 1: Toward an Asian Development Paradigm**

Policy Issues	Soviet-inspired Statist Development Paradigm	Neoliberal Western Development Paradigm	Asian Development Paradigm
1. Role of Government	Dominant role of the Government. Economy-wide resources allocated according to the central plans devised by the Government. Private sector seen as speculator and profiteer to be kept within strict limits with licensing and other controls on its activities	Minimalist role of the Government. Development is private sector-led, with government interference withdrawn, particularly in economic sectors	Public-private partnership for development, with the Government playing a nurturing and developmental role in both economic and social sectors
2. Market failures/ government failures	Focus on market failures. Faith in the government capacity to determine appropriate allocation of resources to deliver on the plans	Rapid privatization when the Government is heavily involved in economic sectors Focus on government failures and neglect of market failures	Private sector development before privatization, which has to proceed cautiously Accepts both market failures and government failures and designs policies to correct both
3. Stabilization	Monetary and fiscal policies subservient to fulfilling planning targets. Controls to be used if macro-economic imbalances lead to pressures on prices, interest rates or foreign exchange	Stabilization program focuses on total fiscal deficit and the aim is to eliminate fiscal deficit irrespective of the level of development or phase in business cycle  The lower the inflation rate the better	Stabilization program focuses on eliminating current account deficit, not total fiscal deficit. Emphasis is on public investment (including that in physical and human development infrastructure) needed for development. Public investment could be as high as 10% of gross domestic product

*Appendix I continued*

Policy Issues	Soviet-inspired Statist Development Paradigm	Neoliberal Western Development Paradigm	Asian Development Paradigm
		Indiscriminate high interest rate policy for correcting overheating	(GDP) in early stage of development and financing the capital account deficit could be done in part by sharing in the seigniorage created by monetization of a developing economy. Role of deficit financing for correcting underutilization of capacity (Keynesian situation) is accepted. Moderate inflation (below 5% per year) is acceptable Caution on high interest rate policy is needed
4. Capital accumulation	Higher investment rate seen as critical for accelerating growth.	Savings and investment rates are determined by the market and are not regarded as important for growth	There is conscious public policy to increase savings and investment rates, which are regarded as key to growth and technology transfer. Investment rates of close to 30% of GDP are found essential for GDP growth rate of 7% per year, or above, on a sustained basis

*Appendix I continued*

*Appendix I continued*

Policy Issues	Soviet-inspired Statist Development Paradigm	Neoliberal Western Development Paradigm	Asian Development Paradigm
5. Financial sector	Financial sector to be subservient to resource allocation according to plans. Both interest rates and credit allocation guided by the government.	Rejection of directed credit  Bank closures based on net worth analysis  Emphasis on private sector banks, including foreign banks  Emphasis on creation of capital markets for raising capital for investment	Selective use of directed credit for encouragement of small and medium- size enterprises (SMEs), agriculture, industries, promoting human capital formation, and technology. Caution in closing banks because of their potential damage to confidence in banking. Development of local banks (including public sector- owned banks) with wide reach across the regions and enterprise size  Emphasis on banks (including investment banks) before relying heavily on capital markets for raising funds for development. Use of pension funds and small savings for funding investment in public sector and priority areas in the private sector
6. Trade policy	Import substitution a key policy. High tariffs and import controls key instruments. Import licensing to direct imports to preferred sectors.	Free trade	Strategic trade policy with selective import protection/substitution and export promotion

*Appendix I continued*

Policy Issues	Soviet-inspired Statist Development Paradigm	Neoliberal Western Development Paradigm	Asian Development Paradigm
7. Industrial policy	Strong support to strategic industrial sectors through direct governmental intervention	All sectors alike. No preference in public policy for particular sectors	Idea of lead sector is accepted, and public policy is geared to encourage preferred sectors through administrative guidance, import protection, tax incentives, subsidies, state-supported research and development, directed credit, and information
8. Development and entrepreneurship	Neglect of entrepreneurship and stigma attached to private sector.	Legal, regulatory, and competitive framework for development of entrepreneurship	In addition to property rights and competitive environment, preferential credit schemes for SMEs; also, development of housing markets and local contractors in publicly financed construction activities regarded as seedbed for entrepreneurs
9. Exchange rate policy	Exchange rate kept overvalued to supply cheap imports to preferred sectors including government agencies	Market-determined floating exchange rate	Market-responsive but not market-determined exchange rates; managed floats aimed at avoiding wide fluctuations in real effective exchange rates

Appendix I continued

Policy Issues	Soviet-inspired Statist Development Paradigm	Neoliberal Western Development Paradigm	Asian Development Paradigm
10. Foreign capital	Strong suspicion of foreign capital. Allowed in limited quantities under government supervision.	Free movement of capital. Strong emphasis on foreign investors' confidence. No distinction among type of foreign direct investment (FDIs)	Hot money flows discouraged. Selective capital controls. Preference for FDI that helps technology development and promotes exports. Foreign investors' confidence not a dominating public policy issue
11. Governance	Political leaders and bureaucrats are seen as working for national welfare and given power with minimal accountability.	Emphasis on representativeness, accountability, transparency and rule of law	Emphasis on prestige, high quality and competence of the administrative system and rule of law
12. Social capital	Sociological factors underplayed within a framework of deterministic and universalistic economic models	Emphasis on universalism and neglect of historicity and social capital.	Emphasis on particularism, historicity, and social capital. Roots-oriented development and importance of congruence of policies with the values of the society
13. Lead ministry	Predominance of the planning ministry.	Predominance of stabilization-oriented finance ministry and central bank, and abolition of planning ministry	Predominance of a comprehensive planning/economy ministry focusing on public policy in all aspects Monetary policy too important to be left to monetary institutions alone

Appendix I continued

Policy Issues	Soviet-inspired Statist Development Paradigm	Neoliberal Western Development Paradigm	Asian Development Paradigm
14. Social protection	Public sector funded social security systems	Private sector-oriented funds for social security with basic social safety net provided by public sector	Defined contribution-oriented social security system with public sector initiative and management
15. Pace of reforms	Impatience with old traditional systems and drastic intervention by the government to change the social and economic systems	Fast pace of reforms so that those adversely affected cannot get organized to block reforms.  Comprehensive set of reforms both by subject and by region to avoid emergence of relative price distortions	Gradualist pace of reforms to give time to those adversely affected to get adjusted to the new situation and for policymakers to learn from experience  Partial reforms by sector and by region (e.g., free trade zones) to keep the changes manageable and to learn from experience
			Careful sequencing of reforms e.g., agricultural reforms before trade/industrial reforms; development of the private sector through SMEs before large scale privatization of state-owned enterprises

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