Y V Reddy: Monetary co-operation in Asia

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, at the IMF-MAS High-Level Seminar on Asian Integration, Singapore, 3 September 2005.

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Mr. Chairman and distinguished participants,

It is a privilege to be associated with the deliberations on Asian Integration. Singapore very vividly signifies both the diversity and potential for prosperity of the Asian region. We deeply appreciate the hospitality and excellent arrangements made by the IMF and MAS for this High Level Seminar. The discussion paper circulated by the MAS is of high quality and is a very useful document. This session is devoted to subjects of special interest to Central Banks, namely “Enhancing Regional Surveillance and Monetary Co-operation in Asia”. I intend focusing on one of the topics flagged for discussion in this session by the organizers, namely “Is there scope for co-operation or co-ordination on exchange rate policies over the long term?”

In this brief presentation, I propose to explore the following areas: First, changing dynamics of exchange rate regimes in Asia; second, importance of the Asian economies for global prosperity and stability; third, the Asian dynamics of financial integration, fourth, the scope for co-operation or co-ordination on exchange rate policies; and finally, some thoughts specific to the Indian situation.

Changing dynamics of exchange rate regimes in Asia

In the period prior to the 1997 crisis, many of the Asian economies followed an exchange rate regime of fixed but adjustable pegs. During the East Asian crisis, it was realized that such pegs were quite vulnerable to speculative attacks. Several East Asian economies have adopted different types of exchange rate regimes in the post-crisis period. While some countries continued with pegged regimes, others moved over to some kind of managed floats.

Thus, it appears that in most economies of Asia, the weight of experience seems to be tilted in favour of intermediate regimes, and post-crisis, the choice of the exchange rate regimes generally reveals a growing preference for relatively more flexible exchange rates than before. In this regard, given the current state of relatively benign international financial market conditions, it is possible to speculate that as the comfort level of forex reserves as self insurance is reached, and institutions and financial markets in Asian economies acquire further resilience, this shift in preference might grow stronger and wider. The recent moves by the Chinese and the Malaysian authorities would only substantiate such a notion.

An intermediate managed floating regime may not sound technically a perfect system but, prima facie, it has proven to be the most pragmatic which explains its popularity. The built-in flexibility allows the domestic currency to be responsive to market forces, while it meets the concern of the authorities for ‘basic stability’ and orderly movement in forex markets. In contrast to a pure float, this mechanism can prevent excessive exchange rate volatility that can have adverse impacts on external trade and investment. In other words, rather than being distracted by a quest for the ‘perfect system’, perhaps it is wise to focus on improving the working of any given float regime. The real issue in this regard relates to how much of a float is envisaged and the nature, magnitudes as well as instruments of its management. These would depend on several factors, especially the changing contours between flexibility and volatility in each economy.

The recent record of very impressive growth in Asia has been driven by trade and cross-border investment flows. The rapid strides achieved by China have provided a powerful stimulus for regional expansion. But it is the nature of trade flows as much as their impressive scale that is shaping economic relationships and prospects. While much of this trade involves production of goods, still ultimately destined for the North American and European markets, it also reflects an increased division of labour, product specialization and integration within the region. Together with this, fundamental shifts in economic relations are also taking place.

Many of the intra-Asia trade flows, which correspond to the international division of labour between Asian countries, are flows of exports of components and spares but not of finished goods for their end consumers. A crucial question for some countries in the region is the level of income that would enable domestic demand to become the main driving force of growth. As domestic demand, notably household sector demand, becomes the driver of growth, movement to a more flexible exchange rate policy would be feasible.

Similarly, as the corporates as well as financial intermediaries, especially banks equip themselves to manage movements in exchange rate, greater flexibility would be feasible, as forex markets also would tend to become less volatile. It is also necessary in this regard to recognize the ‘insurance’ in the form of foreign exchange reserves needed against potentially volatile capital flows which should be sufficient to take care of fluctuations in capital flows and ‘liquidity at risk’. It is generally felt that reserves would act as a circuit breaker for situations when unidirectional expectations become self-fulfilling. The swap arrangements among the Central Banks such as the one under Chiang Mai Initiative (CMI) add to the level of ‘insurance’ and hence to the comfort factor to the Central Banks in dealing with excess volatility in capital flows.

Recently there has been considerable expansion in global liquidity but this should not dilute the vigil of policy makers in regard to volatility in capital flows. Very often, it is difficult to assess, *ex ante*, whether capital flows are temporary or permanent. It is prudent for policy makers to assume that they are reversible till they are proven to be enduring. Impact on real economy of significant reverse movements over a relatively short period could be destabilizing with attendant serious welfare implications. We in Asia are acutely aware of these aspects. Recent sharp upward movements in oil prices in an era of heightened uncertainties is yet another reason for policy makers in Asia to be vigilant. The hikes in oil prices tend to have adverse consequences for growth and prices in several of our economies but they also have significant impact on external sector, encompassing both current and capital accounts. On current account, the trade deficit will tend to widen. On capital account, surpluses generated in oil exporting countries may add to global liquidity and lead to large capital inflows to emerging markets that are net importers of oil. Hence, a careful assessment of the medium term sustainability would be imperative.

Over the medium to longer term, the exchange rate regimes and related policies are likely to be influenced by (a) the confidence in the strength of Asian economies; (b) perceived resilience of their economic as well as financial systems; (c) growing economic and financial integration amongst Asian economies; (d) emerging significance of Asian economies in the global economy; (e) the state of international financial architecture and market conditions and (f) policy-induced measures for co-operation and co-ordination amongst Asian economies.

Importance of Asian economies and policies

The fact that the Asian economies have recovered swiftly after the crises of 1997 is an important consideration in viewing the future external developments. The growth rate of developing Asia, which had plummeted to 4.2 per cent in 1998, recovered quickly to 6.2 per cent in 1999, rising further to 6.6 percent in the year 2000. In the more recent period, the recovery in the output of the Asian economies has been robust with developing Asia growing by nearly 8 per cent in 2003 and 2004. It is widely recognized that the contribution of Asia to global growth has generally been very impressive in recent years, and may continue to be so, for several years in future. The current account on the balance of payments has been in surplus for many if not all Asian economies. The private capital flows to the emerging Asia have recovered from an outflow of US $ 52 billion in 1998 to an inflow of US $151 billion in 2004. At the same time, the reserve build up in the region has been significant.

In the backdrop of the resilience of the Asian economies and their ability to bounce back after a deep financial crisis, there is resurgence of confidence in their future. Strategies in the form of having mutual swap agreements under the Chiang Mai initiative, to guard against speculative attacks, could now be enlarged, and could also be supplemented by greater co-operation and co-ordination in the exchange rate regimes and policies.

Indeed, from a longer-term perspective, we must note that Asia is appropriately poised in terms of abundance in factors of production – labour and capital – particularly labour, as the demography is clearly in favour of Asia to sustain a long- term growth. The emergence of surplus factors of production in Asia combined with financial strength would impact prices, wages and exchange rates. Asian economies could explore strategies to evolve a system whereby they could not only prevent and, if necessary, manage financial crises on their own to the extent possible, but also play a more active role in co-ordinating policies with other major developed economies. These arrangements could be consistent with continued and an active role of IMF in international monetary cooperation.

It is useful to recall that the acute sense of interdependence aroused by the financial "contagion" in 1997 convinced the Asian economies of the importance of economic cooperation, one that reflected their common interests and priorities as well as strengthened their voice in the global arena. Among others, this led to two parallel movements – one in South Asia in the form of the SAARC Initiative and the other in East Asia reflecting the ASEAN+3 Initiative.

The idea of having an integrated financial system so as to provide viable 'safety net' in times of crisis germinated. As a result, the idea of "ASEAN + 3" Initiative[1] gained prominence. This, in turn, was reflected in two correlated developments. First, in 2000, ASEAN+3 countries mutually agreed to form a network of bilateral swap agreements to provide mutual protection from financial emergencies, popularly known as the Chiang Mai Initiative. More recently, there has been a resurgence in the debate on the formation of an Asian Monetary Fund and the adoption of an Asian Currency Unit. Concomitantly, reflecting the parallel developments under the ASEAN+3 Initiative, there has been wider discussion and debate on the formation of a South Asian Economic Union and a South Asian Development Bank[2]. Second, the Asian Bond Fund Initiative[3] was launched in 2003 reflecting the effort to develop a regional bond market for catering to the medium and long term financing needs of the Asian economies.

Asian dynamics of financial integration

It is useful to recognize that, there are several important factors that are relevant for considering greater financial integration in Asia. First, the wide diversity in the level of economic development across the region. Second, the divergent level of financial sector development across the region. Third, the limited scope of the existing intra-region resource-pooling mechanism and the lack of institutional frameworks. Fourth, the presence of asynchronous business cycles amongst the countries in the region. Such divergences are aptly reflected in the asymmetric transmission of demand and monetary shocks in the region.

There are significant developments that point to emergence of enabling factors for strengthening of economic integration in Asia. First, emerging Asia fares quite well in terms of factor mobility and wage and price flexibility. Second, the trade intensity ratios in emerging Asia, particularly the ASEAN region, are quite high and are likely to accelerate. Further, Foreign Direct Investment flows within the region are significant. Third, tariffs are being brought down rapidly. Fourth, the free trade agreements are expanding and deepening making the prospects of tariff-free and virtual trade integration in Asia sooner than later. Fifth, there is a strong commitment of political leadership in Asia to focus on economic issues. There are regular and frequent close interactions among Central Bank Governors in Asia which should strengthen the process of cooperation.

Scope for co-operation and co-ordination

The Chiang Mai Initiative is a good starting point to build on the various existing initiatives. Although under the present dispensation the CMI is complementary to similar IMF initiatives, it has an important symbolic value in as much as it can signal the markets a regional commitment to supporting any member country's currency that is under speculative pressures. It also recognizes that establishing swap arrangements does not obviate the need to address structural and financial sector weaknesses. It may also be added that while CMI might have contributed to the exchange rate stability in the

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1 The ASEAN + 3 was formed as a gathering of the governments of ASEAN members, China, Korea and Japan that were Asian members of ASEM, had its first leaders' meeting in December 1997.

2 The SAARC Council of Ministers meeting held in Islamabad during January 2-3, 2004, desired that the SAARCFINANCE should prepare a concept paper on the proposed South Asian Economic Union and a South Asian Development Bank.

3 The Asian Bond Fund is basically an arrangement for pooling of a portion of foreign exchange reserves of few East Asia and Pacific countries and the Fund portfolio is invested in the liquid US dollar denominated bonds of major Asian economies.

region, it has also contributed to closer regional economic and financial integration and co-operation. It is useful to discuss ways of carrying this process forward.

There are several fora already established for regional monetary cooperation. The Asian Clearing Union (ACU), which was established in 1974 at the initiative of the Economic and Social Commission for Asia and Pacific (ESCAP) has eight member central banks. The main objective of the ACU is to provide a facility to settle current international transactions among members on multilateral net settlement basis. The ACU mechanism also provides for a currency swap type mechanism amongst members for trade transactions. ACU aims to promote monetary co-operation amongst the members and has also resulted in closer relations across the banking systems of the member countries. During the last few years trade settled through ACU mechanism has grown at a rate higher than that of total international trade of the member countries.

Yet another forum for exchange of views and experiences, including through visits and training programmes, is SAARCFINANCE. Areas covered in recent months include communication policies and practices of Central Banks and Real Time Gross Settlement systems.

The recent policy shift in China from a pegged to a flexible exchange rate regime is a significant development in international finance. This step is a watershed in the financial sector reform process now underway in China. Going by the available indications, China has long-term plans for development of deep and liquid markets in financial assets, which would encompass foreign exchange, bonds, and equities, as also commodities.

Some thoughts on India's approach

It may be useful to recall our experience with exchange rate management in India. In September 1975, the Government of India proposed a system of determining the exchange rate based on a basket of five currencies, with weighting, based essentially though not entirely, on trade weights. The permissible range for the exchange rate was 2.25 per cent on either side. The currencies chosen were US Dollar, Pound Sterling, Deutsche Mark, Japanese Yen and SDR. The weights were revised in 1979, 1983 and 1984, though the currency composition broadly remained the same with only one change in 1984 when French Franc replaced SDR. The band, however, was extended from 2.25 to 5.0 per cent in 1979 and from 5 to 10 per cent in 1986. Soon after the devaluation of the rupee in July 1991, there was a move in March 1992 to a regime of partial convertibility (essentially a dual exchange rate). In March 1993 the regime changed to a uniform exchange rate of the rupee which was market-determined – a system which remains in place to date. In August 1994, India moved over to current account convertibility. From the latter part of 1997, India moved to a cautious and well calibrated move towards capital account convertibility. These developments tested the exchange rate regime which proved conducive to growth while maintaining stability.

India has been actively participating in the various initiatives in SAARCFINANCE and ACU arrangements. Exchange of views and co-ordination in policies through both formal and informal mechanisms have been the main characteristics of co-operation. India's trade links with Asia are growing at an unprecedented scale. The stated policy in regard to tariffs is to bring them on par with those of East Asia as soon as feasible. Policy on Free Trade Agreements with countries in Asia, including SAPTA point to the binding forces of greater integration of India into Asia. Launching of negotiations of Free Trade Agreements between ASEAN and India is of historic significance for carrying forward Asian Integration.

As part of our policy of communication and to aid researchers and analysts the Reserve Bank of India has been constructing a five-country and 36-country indices for Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER). We have decided to review the REER and accordingly we expect a new six-country index to replace the present five-country one. The new index is likely to include the U.S.A., Eurozone, the U.K., Japan, China and Hong Kong. The new index would in that case have two new currencies, both Asian, namely, the Renminbi and the Hong Kong Dollar. The 36-country index already includes the key Asian countries, but its review is likely to result in some enhancement of their weights. This reflects an increasing recognition of the Indian economy's rapidly growing integration with Asia.