Glenn Stevens: Asian financial co-operation

Address by Glenn Stevens, Deputy Governor of the Reserve Bank of Australia, to the Asian Economic Panel hosted by the Lowy Institute for International Policy and the ANU Centre for Applied Macroeconomic Analysis, Sydney, 14 October 2005.

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It is a pleasure to take part in this Asian Economic Panel meeting, amid such a distinguished group of scholars and colleagues from the Asia Pacific region. For this brief session, I would like to offer a perspective on financial co-operation in Asia.

Following the financial crisis which engulfed east Asia in 1997-98, many observers concluded that the region lacked effective mechanisms for co-operative responses to shocks, and particularly lacked a set of regional institutional arrangements which could withstand the vagaries of international capital flows. There were some avenues for co-operation or regional channels for assistance – some regional partners contributed to packages to assist Thailand, Indonesia and Korea for instance. But these were generally organised on an ad hoc basis, and in the context of IMF programs rather than any regional framework. More importantly, they could not directly address the underlying vulnerabilities, such as under-developed local capital markets, small financial systems and economies relative to the potential size of capital flows, weak banking systems and the like.

That underlying dissatisfaction, coupled with disillusionment over the response of the global institutions, lies behind the attempts to do more to build up regional financial architecture since then.

With that background, I'd like to address three questions. First, what do we mean when we use the term 'regional co-operation?' Second, I will ask how much has been achieved? And third, where to from here?

What does 'co-operation' mean?

Strictly speaking, we should distinguish between co-operation, co-ordination and integration. These are, of course, not the same, though they arguably lie on a continuum of engagement: it is one thing to co-operate, but to *co-ordinate* involves, as well as co-operation, a greater degree of commitment to adjust policies, while *integration* involves, *in extremis*, a degree of co-operation and commitment sufficient actually to cede sovereignty over one or more arms of policy.

Taking that spectrum as a reference point, we can distinguish six, progressively stronger, degrees of financial co-operation between countries.

First, is the **sharing of information**. This sounds straightforward enough but it actually takes a lengthy period of regular contact among senior officials, policy-makers, academics and so on to develop the sort of constructive and frank sharing of information that is really the foundation for genuine engagement. Sharing of information is more than just the exchange of facts and figures; it is learning about how other economies work, about how other policy-makers think, and about which approaches in the other countries have worked, which did not, and why. In a crisis, there must be timely sharing of market intelligence. Most important, if there is ever to be any prospect of collective action in response to regional problems, there has to be a shared analysis of what the problem is. The capacity to form that sort of analysis does not exist naturally; it has to be developed.

The second degree of co-operation is having a set of arrangements to **lend money** in times of trouble. When one or more countries face the pressure of capital outflow, with associated downward pressure on their exchange rates, the idea is that these agreements provide a sense of mutual support which could increase market confidence. Generally, such arrangements increase the availability of resources to a country under pressure, though by a limited amount. Funds are usually available with conditions, at the discretion of the lender and with most of the risk remaining with the borrower.

Going the next step involves joint work on **improving the operation of local financial infrastructure**. This can be viewed as harmonisation (i.e. as a mild form of co-ordination) which facilitates people managing their affairs across national boundaries more efficiently. This could potentially involve everything from listing requirements, tax treatment, arrangements for supervision of financial institutions, and so on. But policies are still made at national level and it is not necessary to have a

goal of harmonisation per se to think this sort of work is useful: it might simply be an effective device for improving the functioning of the individual local economies.

The fourth degree of co-operation would be based on some agreed common goals, most likely some sort of regional effort to **stabilise exchange rates**. Here we are definitely talking about a form of policy co-ordination. In the pre-EMU European context, there was a mutual obligation to defend regional parities. This system was silent, notably, about the situation where all European currencies rose or fell together against the dollar.

In principle, this would leave monetary policy remaining focussed on domestic objectives. One can then distinguish a fifth degree, in which that constraint is dropped and it is explicit that domestic **policies will be adjusted** to help achieve exchange rate goals agreed between the countries – a stronger form of co-ordination. The gold standard was such an arrangement, under which domestic objectives were subordinated to the collective objective of maintaining external stability.

The sixth, and most extensive, form of co-operation is where individual countries **cede control over an arm of policy** to an international body, which conducts that policy in pursuit of a collective goal. In the monetary sphere, this would be monetary union, as in the Euro area, conducted by a regional central bank, and with a highly integrated payments system: a strong form of financial integration which, it is sometimes argued, could foster broader economic integration.

What has Asia been doing?

Within that framework, we can then ask: what has Asia been doing since the crisis of the late 1990s? The answer, essentially, is that it has been doing more of numbers 1 and 2 of the above, which were both occurring prior to the crisis. In addition, a lot more attention is being paid to number 3.

There were various exercises in **information sharing** already in operation before the crisis, but these have intensified. ASEAN has a history of several decades, and ASEAN+3 has built on that to become an important forum. In the central banking world, the EMEAP[1] group has been meeting regularly since 1991, but the scale of that work has grown significantly in recent years. There are regular meetings of finance ministry officials, numerous bilateral contacts, and of course meetings of the more academic variety, as you are having here today. There are more and more regional meetings and conferences. I simply re-iterate the point that the value of this will be maximised if we keep in mind the need to find, ultimately, a shared analysis of regional issues. That has to be a foundation of genuine co-operation.

On the second form of co-operation, **lending money** in times of trouble, there has also been progress. Prior to the Asian crisis, there was a network of US dollar repurchase agreements between the EMEAP central banks. This was basically a symbolic exercise in the early days of Asian financial co-operation, around 1996; the arrangements were not activated during the crisis. Prior even to that, there was the network of foreign exchange swaps between the ASEAN countries which dated back to the mid 1970s, though these were small in size and had not been used since 1992.

After the crisis there was, of course, the Chiang Mai Initiative, a series of bilateral foreign currency swaps of considerably larger size, under which a central bank would offer US dollars or its own currency to another central bank in exchange for a corresponding amount of that other country's currency. The nature of such swaps is that no foreign currency risk is run by either country in the swap itself: the rate for the reverse transaction is contracted in advance. Of course if the borrowing country sells the borrowed foreign exchange in order to support its own currency, it is then running a foreign exchange risk and the country initially supplying the funds is running a credit risk.

The CMI swaps are mostly quite conditional – only a small portion of the money can be accessed without there being an IMF program in place in the borrowing country. That proportion is to be raised, but even then the bulk of the funds will still be conditional. The overall size of the lines is being increased, and there is discussion about a collective activation arrangement, as opposed to the current one where the parties to each bilateral line presumably negotiate over activation.

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[1] Executives' Meeting of East Asia-Pacific Central Banks.

This is certainly a useful step towards financial co-operation, and has considerable symbolic value. But it remains exclusively a lending facility, where the additional resources available to a country under pressure can only be used by taking considerable risk. There is no obligation on the other countries to make market purchases of the weakening currency. Moreover, the CMI swap network has not yet been tested, and it is probably only workable when one or two countries come under pressure. If a number of countries are simultaneously experiencing pressure from capital markets, it would be only natural to expect a degree of reluctance to take on any additional obligations in defence of their neighbours. Hence, there still seems to be a perceived need for a large degree of self-insurance in the region (i.e. accumulation of large reserves of foreign currency).

Efforts have also been made to accelerate the **development of financial infrastructure**. Work under the banner of APEC (Asia-Pacific Economic Co-operation) is seeking to promote securitisation and credit guarantee markets. The ASEAN+3 group is working towards the issuance of local currency debt by the multilateral institutions, with some success so far.

The Asian Bond Funds 1 and 2, initiated by the regional central banks, have made good progress. The idea here is essentially to work out how to set up cross-border mutual-fund type structures to invest in bonds issued by regional governments and quasi-government authorities, and to show the way with a modest amount of central bank money. This is painstaking work. It involves such things as the development of customised bond market indexes, and efforts to remove the various small impediments that individual countries have managed, perhaps unintentionally, to put in the way of investors. As just one example, the Pan-Asia Index Fund component of the ABF2 is domiciled in Singapore, but listed in Hong Kong, the first time that has been done in Asia. This involved the relevant authorities working towards mutual recognition of their respective regulatory frameworks.

ABF2 is a good example of the way a regional initiative can put the spotlight on local barriers to well-functioning local markets and exert some pressure for their removal.[2] Indeed, to my mind, the value of these initiatives has been less the 'integration' aspect than the progress made in enabling eight local bond markets to function more effectively for foreign and domestic investors and, not least, for the governments and other borrowers of those countries. A well-functioning local-currency bond market allows a government much more economic policy flexibility than can be experienced when tied to foreign currency borrowing.[3] And eight well-functioning, modest-sized, local bond markets amount to the same thing as a 'regional market' for most practical purposes.

So in terms of developing the resilience of the region to the vagaries of international markets, there is value in increasing the capacity to provide financial support once a crisis hits. But I would argue there is more value in building financial infrastructure, through the activities in type 3 co-operation, which can make national systems more resilient in the face of shocks.

Where to from here?

What then of the future? In particular, what about steps 4 to 6? Is there any serious prospect of countries undertaking these higher levels of co-operation, or more correctly co-ordination and even integration, any time soon?

There have been various calls for a common exchange rate policy, usually based around targeting a common basket, though to my knowledge there is no action plan currently available. One problem is that the interests of the countries are in some respects still rather divergent, not least because of the very different levels of economic development around Asia. There are a number of countries – China not least among them – whose prospective rates of productivity growth over the decades ahead will surely mean a substantial increase in their real exchange rate. Yet there are some others, such as Singapore or Hong Kong, who have already largely completed their productivity catch-up with the

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[2] For a good discussion of this, see Guonan Ma and Eli Remolona (2005), 'Opening Markets Through a Regional Bond Fund: Lessons from ABF2', *BIS Quarterly Review*, June 2005, pp. 81–92 (at http://www.bis.org/publ/qtrpdf/r_qt0506g.pdf).

[3] Unhedged foreign currency debt, as was prominent in 1997, means that a fall in the currency pushes up debt servicing costs for the government, local corporates and banks, but a rise in interest rates to assist the exchange rate has the same adverse effect. Policy-makers can then face a currency crisis and a banking crisis simultaneously. A government which borrows in its own currency and encourages private borrowers to do the same has more options when its exchange rate comes under downward pressure.

advanced economies, and the associated real exchange rate appreciation. The idea that these two – who, of course, have very different exchange rate regimes at present, but both quite successful ones – would easily find an acceptable exchange rate linkage with the others is not one that is intuitively obvious. This point is strongest for these two cases, but I suspect it generalises further around the region.

Moreover, most countries appear to me to remain determinedly focussed on the US dollar exchange rate. In other words, Asia is unlike pre-EMU Europe. The prime motivation for the European countries' exchange rate policies was to build monetary and financial stability inside Europe, rather than to follow a particular export-led growth model. In Asia, it is still the other way around: countries want financial and monetary stability, but they seem to want this within a US dollar zone. Presumably this is because they still place primacy on the export-led, FDI-enabled, model of economic growth, with focus on exports to outside the region.

Another difference with Europe is that there is not a large bastion of economic stability within the region which is the obvious anchor for a currency arrangement. Until the mid 1990s, Japan might have been that country. But then Japan experienced a decade of stagnation, deflation, and concerns over financial sector solvency. Its government finances are also in a parlous state. Hence it seems unlikely that Japan could any time soon become the anchor currency of an Asian exchange rate system. The obvious potential candidate in the long run is China, but China does not presently maintain a convertible currency and does not have a forty-year record of economic and monetary stability the way Germany did by the end of the 1980s.[4] And, as noted above, China has its own adjustments to make for some time ahead, in which others in the region might not want to share.

Hence it seems unlikely, to me, that an Asia-wide exchange rate policy is likely any time soon. Most likely exchange rate policies will continue to be made with reference to the US dollar for a while yet. To the extent there is 'co-ordination' it will be accidental, as a result of similar activities by various countries directed towards managing exchange rates against the US dollar – with an eye, of course, on what their neighbours are doing. It would follow from this that the likelihood of a system of closer co-ordination in which domestic policies are allowed systematically to be affected by *regional* exchange rate concerns is pretty small.

It further follows that the prospect for monetary union is quite remote indeed. Apart from the likelihood that some countries' real exchange rates will need to move a lot over the next twenty years to an extent that could be painful under a system of irrevocably fixed nominal rates, monetary union is a political as well as an economic decision. Indeed, for Europe, it was *overwhelmingly* a political decision (which is not to say it was wrong). You would all be able to judge better than I but my guess is that Asia's political leaders are nothing like ready to make such a decision involving ceding sovereignty to a supra-national institution.

That is not to say that there is not a lot of worthwhile co-operative work to be done. On the contrary, I think that there is much value to be gained by pursuing type 3 co-operation: working on making the financial infrastructure reasonably consistent, well understood and easy to use for investors across the region. The reason for this is only partly to foster cross-border activity; it is also, in my view, because it is in the interests of each of these countries to have well-functioning (local currency-based) markets. This is much less glamorous than talking about regional exchange rate initiatives, but for some time ahead at least, is likely to have more pay-off.

I do not wish to speak against sensible thought being given to more ambitious ideas. Preparations for joint exchange rate policies or monetary union take a long time. To make an informed decision at some (distant) future time, then, a lot of work would have to be done in the interim, and there is little harm in doing some over the coming decade. But we should take care that such work does not draw too many resources away from efforts in some of the less exciting areas which will have a concrete and timely pay-off.

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[4] Germany’ s longer-run record, of course, was much more problematic: three hyper-inflations in the first half of the twentieth century was probably what seared into the collective German psyche the need for monetary stability.