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The Future Global Reserve System—An Asian Perspective

Edited by Jeffrey D. Sachs, Masahiro Kawai, Jong-Wha Lee, and Wing Thye Woo

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The Future Global Reserve System—An Asian Perspective report and full individual papers can be downloaded at http://aric.adb.org/grs/

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Message from ADB's President

Today we are seeing the economic recovery gain traction in some parts of the world—most notably developing Asia. But recovery has been mixed in the more developed economies like the United States. And it is still uncertain in some of the fiscally stressed European Union states.

It is certainly welcome that a dynamic Asia is leading the world back to robust growth. However, that may well spur a resurgence of capital inflows, causing exchange rate instability and exacerbate previous trade and other imbalances. All that will add further pressure on a global reserve system already scored with fault lines.

That means, more than ever, we need to work together both globally and regionally to find solutions—however gradually implemented—that will bring about a workable reform of the global reserve system.

A well-functioning global reserve system ensures a commonly accepted source of liquidity that the world economy needs in order to flourish. It facilitates balance of payments adjustments and provides an international framework for constructing sound national economic policies. Its key elements include exchange rate determination, payments, adjustment required, and management of international liquidity requirements.

Our current global reserve system, unfortunately, is not functioning too well. Exchange rate systems, to cite one example, vary widely in flexibility. The use of the US dollar as an international reserve currency only heightens the problem of simultaneously using a currency as a domestic and as an international currency. It creates tension between national and global monetary policy making.

Going forward, the critical issue is simple to ask but difficult to answer: what are the alternatives, and who would want to take on that responsibility?

Many believe the euro is a serious rival to the US dollar as a reserve currency. However, the Greek debt crisis has made it clear that the euro is not yet a currency with a solid sovereign backbone. Given Asia's large and growing weight in the world economy, there is a growing opinion that the region should have its own reserve currency.

The yen is the Asian currency most used internationally, but its reserve currency status has weakened in the last 20 years. The yuan is a possible candidate—but a long-term candidate given the

People's Republic of China's relatively under-developed financial markets. There are also some proposals for a system based on special drawing rights or a regional currency basket. The key challenge here would be how to make this super-sovereign currency commercially viable.

In sum, the consensus seems to be that the US dollar will likely remain dominant for the foreseeable future. But it will be increasingly challenged.

Policy coordination, both at the global and regional levels, is the key to reforming the global financial architecture. Asia is no longer a minor player. It must take a more active global role. At the same time, Asian countries must continue to strengthen policy cooperation. Greater exchange rate cooperation will promote both intraregional exchange rate stability and extraregional exchange rate flexibility.

In conclusion, a reconsideration of the global reserve system is in everyone's interest. The ongoing debate on the issue is both healthy and necessary. Asia has led the world out of recession. We did not go overboard financially—we learned our lessons from 1997–1998 well. But now, we must also accept our responsibilities as active members of a global economic community that is now different from just a decade ago.

I sincerely hope that this report will stimulate constructive debate—both within and beyond Asia—on how we can move to a more stable, efficient and equitable global reserve system that will better facilitate global trade and capital flows.

H. Kuroda

Haruhiko Kuroda
President
Asian Development Bank

Contributors

International Monetary Advisory Group

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International Monetary Working Group

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[2] Daniel Gros co-authored his paper with Cinzia Alcidi, Anton Brender, and Florence Pisani.

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An inception workshop was conducted at Columbia University, New York, United States in September 2009, followed by another conference at Tokyo, Japan in March 2010 that was jointly organized with the Asian Development Bank Institute (ADBI). Josephine Duque-Comia, Ruby Grace Santiago, and the staff at the Earth Institute at Columbia University provided administrative and technical support in organizing the inception workshop. Doo Yong Yang, Yuzuru Nagai and the staff at the ADBI organized the Tokyo conference, with technical support from the Videoconference team of the ADB. The following experts provided valuable comments during the workshops: Charles Adams (National University of Singapore), Takatoshi Ito (University of Tokyo), and Wang Xianlei (China Center for International Economic Exchanges).

Executive Summary and Recommendations

Jeffrey D. Sachs, Masahiro Kawai, Jong-Wha Lee, and Wing Thye Woo

The financial crash of 2008 and subsequent global economic downturn has led to a major reassessment of the global monetary and financial system. When the crisis broke, both advanced and emerging economies resorted to frenetic macroeconomic measures to avert financial catastrophe and assure global confidence in the international financial system could return. These globally coordinated policies may have contributed to the ensuing worldwide recovery. But what is needed now is a better regulatory environment that reduces the probability it could happen again.

The crisis was rooted in lax monetary policies and inadequate financial oversight. This was most prominent in the United States (US) and led to serious financial excess. It helped create an over-abundance of global liquidity, partly an off-shoot of widening global imbalances. These originated from both excessive consumption in the US and an unprecedented accumulation of foreign reserves by emerging economies, especially in Asia. Partly a response to the 1997–1998 Asian financial crisis, foreign reserve accumulation was “insurance” against another crisis—when borrowing costs sky-rocket just when emergency financing is needed the most. Yet, hoarding international reserves can be extremely costly and inefficient when effective external debt management is lacking.

Thus, the global crisis ignited a well-timed debate among academics and policy makers about the current global reserve system.

Is the current system unstable and inefficient? Did the dollar-dominated regime contribute to the global crisis? And how should we manage the evolution of the current reserve system? An effective global reserve system supplies the international liquidity needed by a growing global economy, facilitates balance-of-payments adjustments, and provides an international framework for sound national economic policies. Unfortunately, the current system has fallen short of fulfilling its promise.

Reforming the global reserve system has huge implications for developing Asia. The region holds close to half of the world's total foreign exchange reserves and is highly dependent on international trade and capital flows for its growing prosperity.

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The Asian Development Bank, in partnership with the Earth Institute at Columbia University, initiated a joint research project on "The Future Global Reserve System—An Asian Perspective." The project aims to enrich the current debate by examining the issue from an Asian perspective, empowering Asia's policy makers to better deal with the issue and participate in the global dialogue, while informing the public on its importance.

The study was led by the International Monetary Advisory Group (IMAG), assisted by a Technical Working Group. Eleven internationally renowned monetary experts are members of the advisory group, chaired by Earth Institute Director Jeffrey Sachs. Each member contributed a paper on the future of the international monetary system and worked on finalizing a set of recommendations. The technical working group included 3 ADB staff and 6 technical experts from academia and the private sector, chaired by ADB Chief Economist Jong-Wha Lee. They prepared seven technical background papers on research topics identified by the advisory group. These reports and essays were the substance of two international workshops—in New York City in September 2009 and in Tokyo in March 2010.

The 11 IMAG papers discuss the future of the global reserve system; the optimal path for recovery following the global financial crisis; ways to rebalance the world economy; the need to create medium–term macroeconomic frameworks nationally and regionally; how to better manage global capital flows; and the future of Asian integration given the rapid growth of the region's two economic powerhouses—the People's Republic of China and India.

Nirupam Bajpai discusses India's response to the global crisis. He argues that the process of fiscal consolidation needs to be accelerated more through qualitative adjustments to reduce government dis-savings and ameliorate price pressures. Maria Socorro Gochoco-Bautista points out that capital flows need to be regulated because unfettered trade in financial assets in the presence of distortions does not improve social welfare. Willem Buiter considers what needs to be done to better coordinate fiscal stimulus globally, and argues the case for future fiscal tightening. Barry Eichengreen argues that the world is headed to a multiple reserve currency system and calls for sound and stable policies on the part of the reserve-issuing countries to ensure a stable system.

Masahiro Kawai suggests that given the difficulty of a global agreement, deepening regional reserve pooling, strengthening formal institutions, and creating a regional currency basket—or an Asian currency unit—in Asia is a practical alternative. Felipe Larrain B. argues that the US dollar will remain the main reserve currency but will face competition from other major currencies, including the euro, BRIC currencies, and a supranational currency such as the IMF's special drawing rights (SDR). Joseph

Stiglitz argues for a wider use of a supranational currency such as the SDR as a reserve currency. And Wing Thye Woo argues that a feasible architecture for an Asian Economic Union would be a free trade and open investment zone with a regional financial facility and its own surveillance mechanism.

Charles Wyplosz suggested that if exchange rate cooperation and limited intra-regional fluctuations are desirable, pegging to external currencies is more coherent than limiting deviations from an Asian monetary unit based on a regional currency basket. Yongding Yu indicates that US budget deficits would undermine the dollar's role as global reserve currency, and argues that the US government will likely be unwilling to sacrifice domestic objectives to preserve the global sanctity of the dollar.

The Technical Working Group produced seven papers. Joshua Aizenman and his co-authors suggest that Asia may benefit by deepening international reserve pooling and advancing regional swap arrangements. Daniel Gros and his co-authors argue that reform of the current *de facto* reserve system should aim to better make use of savings accumulated in emerging market economies.

Yiping Huang suggests that the People's Republic of China can facilitate a smooth and orderly adjustment of the global currency system by gradually increasing its exchange rate flexibility and diversifying foreign reserve investments. Jong-Wha Lee argues that an eventual move to a multi-currency system is desirable and that the renminbi would gradually emerge as an alternative international reserve currency.

Donghyun Park and Andrew Rozanov argue that sovereign wealth funds could play a crucial role in reforming the global reserve system. Kanhaiya Singh argues that the international monetary system has undergone substantial change and a fresh approach is needed—one more neutral and encompassing. Shinji Takagi analyzes the surveillance mechanism of the IMF and emphasizes the importance of effective regional surveillance in the Chiang Mai Initiative Multilateralization.

Recommendations

The Asian Development Bank and the Earth Institute at Columbia University jointly convened the International Monetary Advisory Group (IMAG) to create a comprehensive reform agenda for the global reserve system. The IMAG reform agenda is pragmatic, bolstered by concrete proposals on how best to implement policy.

1. Regional-level recommendations

With the quick rise of new, rapidly growing, economic powers, the Advisory Group sees the global reserve system evolving into a multi-currency reserve system. Regional initiatives that increase economic integration and policy coordination will help facilitate this process. Given Asia's growing economic clout, it is therefore natural to strengthen efforts to establish a coordinating mechanism—at an existing or new regional institution—to help the region's leaders better understand the complexities of this challenge, and identify new mechanisms to enhance policy cooperation.

1.1. ***Ensuring global liquidity.*** The past two decades have shown clearly the severity of economic damage when liquidity abruptly freezes. New arrangements must be made to enable the region's reserves to play a more central role in stabilizing the global financial system. This includes allowing greater access to swap lines, SDRs, or other types of borrowing. It includes reform of the IMF and increased cooperation among the regional monetary funds.

1.2. ***Exchange rate coordination and cooperation.*** Asia is home to a plethora of exchange rate regimes. And the complicated dynamics of cross-rates has likely reduced the benefits of the production chains that have been the backbone of integrating Asia. Most statistical analyses show that currency-basket pegs by Asian currencies can increase stability in intra-regional cross-rates than pegs to the dollar. In practice, country-specific currency-baskets appear to provide as much bilateral stability as a common pan-Asian basket.

1.3. ***The use of monetary policy and the extent of monetary cooperation.*** Regions, especially East Asia, should embrace regional monetary coordination more seriously. However, due to great differences in economic size and structure, the wide diversity in stages of economic development, and the general reluctance to permit free movement of labor within Asia, a common Asian currency is currently not a realistic target. Moreover, regional monetary coordination in general should stop short of efforts to peg currencies within the region—

Europe's crisis in 1992 and the 1997 Asian financial crisis are reminders that weak pegs are a recipe for disaster.

1.4. ***Unilateral and multilateral capital controls—their use and effectiveness.*** Short–term, volatile capital movements can clearly destabilize the global economy. Well-designed temporary capital controls—as opposed to permanent capital controls—are tools that can strengthen growth-oriented macroeconomic management. These controls on the flow of capital tend to be more effective when done on a coordinated basis across countries that are targets of rapid capital movements, rather than individual countries reacting unilaterally.

1.5. ***Internationalization of the renminbi and the Chinese economy.*** One of the biggest changes in the world economy has been the rise of the Chinese economy, now a dominant economic and political power in East Asia. However, the renminbi has yet to become an international currency. It could become one much more quickly than many anticipate. The internationalization of the renminbi has the potential to become an alternative to the US dollar—as did the euro—and help nudge the global reserve system toward a multi-currency reserve structure. Asian countries may also consider to develop a basket of Asian currencies as the region's anchor currency.

1.6. ***Surveillance and conditionality.*** In a multi-polar world with strong and effective regional economic institutions, country-specific economic surveillance and adjustment conditionality must inevitably evolve. Formal mechanisms for consultation between regional and global institutions will be needed to define the menu of policy choices—to prevent a race-to-the-bottom in conditionality-based lending.

1.7. ***Sharing seignorage.*** Given the failure of the international community to develop globally-binding agreements on climate change, the Group feels that, potentially, a portion of the revenue a country receives through *seignorage* could be shared regionally to tackle the climate change as a regional public good. As this is an ethically contentious issue as well as a technically complicated one, international working groups should be convened by the G20 and the United Nations to draw up policy options.

2. International-level Recommendations

2.1. ***Strengthening prudential capital market regulations.*** Given the obvious failure of the financial system to effectively police itself—the slew of financial derivatives as an example—and the gross inadequacies of current regulatory standards. The IMF, BIS, and new regional economic institutions can play an important role in helping standardize regulatory frameworks across regions and countries.

2.2. ***Convening a brain trust of independent international monetary experts.*** Chronic current account imbalances and varying exchange rate regimes, for example, can cause unnecessary friction between and across countries. Independent, expert analysis could provide a useful tool in ameliorating any disputes over alleged exchange rate manipulation.

The Future Global Reserve System
An Asian Perspective

Summaries of papers of the

International Monetary Advisory Group

Bajpai, Nirupam
Bautista, Maria Socorro Gochoco
Buiter, Willem
Eichengreen, Barry
Kawai, Masahiro
Larrain B., Felipe
Stiglitz, Joseph
Woo, Wing Thye
Wyplosz, Charles
Yu, Yongding

1. Global Financial Crisis, its Impact on India and the Policy Response*

Nirupam Bajpai

India could not insulate itself from the adverse developments in the international financial markets, despite having a banking and financial system that had little to do with investments in structured financial instruments carved out of subprime mortgages, whose failure had set off the chain of events culminating in a global crisis. Economic growth decelerated in 2008-09 to 6.7 percent. This represented a decline of 2.1 percent from the average growth rate of 8.8 percent in the previous five years.

To counter the negative fallout of the global slowdown on the Indian economy, the federal government responded by providing three focused fiscal stimulus packages in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets. India's central Bank – the Reserve Bank of India (RBI) took a number of monetary easing and liquidity enhancing measures to facilitate flow of funds from the financial system to meet the needs of productive sectors. This fiscal accommodation led to an increase in fiscal deficit from 2.7 percent in 2007-08 to 6.2 percent of GDP in 2008-09. The difference between the actual figures of 2007-08 and 2008-09 constituted the total fiscal stimulus. This stimulus at current market prices amounted to 3.5 percent of GDP for 2008-09. These measures were effective in arresting the fall in the growth rate of GDP in 2008-09 and India achieved a growth rate of 6.7 percent.

From all accounts, except for the agricultural sector as noted above, economic recovery seems to be well underway. Economic growth stood at 7 percent during the first half of the current fiscal year and the advance estimates for GDP growth for 2009-10 is 7.2 percent. The recovery in GDP growth for 2009-10, as indicated in the advance estimates, is broad based. Seven out of eight sectors/sub-sectors show a growth rate of 6.5 percent or higher. The exception, as anticipated, is agriculture and allied sectors where the growth rate is estimated to be minus 0.2 percent over 2008-09. Sectors including mining and quarrying; manufacturing; and electricity, gas and water supply have significantly improved their growth rates at over 8 percent in comparison with 2008-09. When compared to countries across the

* Full paper available at http://aric.adb.org/grs/papers/Bajpai.pdf

world, India stands out as one of the best performing economies. Although there is a clear moderation in growth from 9 percent levels to 7+ percent, the pace still makes India the fastest growing major economy after the People's Republic of China (PRC).

Considering the current inflationary strains, the as yet excessive pre-emption of the community's savings by the government, the potential for crowding out the requirements of the enterprise sector, and rising interest payments on government debt, it is extremely essential to reduce the fiscal deficit, and more aggressively, mainly by lowering the revenue deficit. Correction of these deficits would, inter alia, require considerable refocusing and reduction of large hidden subsidies associated with under-pricing in crucial areas, such as power, irrigation, and urban transport. Food and fertilizer subsidies are other major areas of expenditure control. Be that as it may, the process of fiscal consolidation needs to be accelerated through more qualitative adjustments to reduce government dissavings and ameliorate price pressures.

The step-up in India's growth rate over much of the last two decades was primarily due to the structural changes in industrial, trade and financial areas, among others, over the 1990s as the reforms in these sectors were wide and deep and hence contributed significantly to higher productivity of the economy. Indeed, there is potential for still higher growth on a sustained basis of 9+ percent in the years ahead, but among other things, this would require the following: 1) revival and a vigorous pursuit of economic reforms at the center and in the states; 2) a major effort at raising the rate of domestic savings, especially by reducing government dissavings at the central and state levels through cuts in, and refocusing of, explicit and implicit subsidies, stricter control over non-developmental expenditures, improvements in the tax ratio through stronger tax enforcement, and strengthening incentives for savings; 3) larger investments in, and better performance of, infrastructural services, both in the public and private sectors; and 4) greater attention to, and larger resources for, agriculture, social sectors and rural development programs to increase employment, reduce poverty and for creating a mass base in support of economic reforms.

If India does attain and sustain growth rates of around 9+ percent that it had achieved prior to the crisis, this itself is likely to push up its domestic savings in the next few years. Besides, stronger growth should attract more foreign savings, especially foreign direct investment, and thus raise the investment rate.

2. To What Extent Should Capital Flows be Regulated?*

Maria Socorro Gochoco-Bautista

Stylized facts regarding capital flows in the last two decades show that the potential for crisis is great, given pro-cyclical capital flows. The global crisis and the resulting recession and low interest rates in advanced economies will increase the potential for more pro-cyclical carry trade flows to emerging market economies (EMEs). Both the volume and volatility of capital flows have increased, with "sudden starts" of capital outflows becoming more prominent in the recent period, in contrast with "sudden stops" of capital inflows which characterized crises in the past. Emerging market economies have become important players in international banking and capital markets as financial globalization proceeds. But they have become more vulnerable to changes in investor appetites and portfolio changes from mature economies as equity flows and short-term flows become more important than banking flows as was the case in the past.

Capital flows need to be regulated because unfettered trade in financial assets in the presence of distortions is not necessarily welfare-improving. To what extent they need to be regulated depends on the degree of distortions present in an economy and whether it is easier to remove these distortions and allow capital flows versus the difficulty of dealing with the distortions which makes such regulation necessary. It also depends on complementary policies that can be adopted to make capital more productive in an economy to increase welfare obtainable from capital flows. The fact is that many EMEs today are running current account surpluses rather than deficits as in the past means that there is less of a need for external finance. There remains the problem of recycling such surpluses to advanced economies such as the US that need them, which then return to EMEs in search of higher returns.

Having embraced economic liberalization, however, should not preclude efforts to find ways to reduce the potential damage from pro-cyclical capital flows through their regulation. Unfortunately, while capital regulation has worked in some cases, for example, to lengthen the maturity of flows, there is little evidence that such regulation alters the composition of flows nor work over extended periods of time. There is also little evidence that EMEs can be spared the effects of a large externally-initiated financial crisis no matter what they do. The lack of success in regulating capital flows by individual countries underscores the need for international cooperation in the design and implementation of such regulation

* Full paper available at http://aric.adb.org/grs/papers/Bautista.pdf

of capital flows.

Under the current predominantly US dollar standard, there is a huge incremental demand for “safe” dollar assets that are reflected in perverse flows from the EMEs to the US and advanced economies. There is also little incentive for the US to weaken the dollar to correct its large deficit. However, as the reserve currency of the world, authorities in the US need to, and the rest of the world expect them to, maintain the strength of the dollar. The dollar standard also exacerbates pro-cyclical capital flows to EMEs such as those under carry trade. The adjustment burden tends to be shifted onto surplus countries to either continue to recycle their surpluses to the US and advanced economies and maintain the status quo, or to take on riskier assets for global adjustment to occur.

The radical solution to the problems of pro-cyclical capital flows and systemic crises would be to reform the global reserve system through the adoption of a supranational global reserve currency. Absent this, regulating capital flows may be regarded as a second-best solution. To be effective, such regulation should try to increase the policy space for countercyclical policy and requires international cooperation to raise the chance of success of measures adopted to regulate capital flows. To the extent that reforming the global US dollar-based reserve system could take time, and given continuing financial globalization, regulating capital flows becomes a necessary collective challenge.

3. The Case for a Further Global Coordinated Fiscal Stimulus*

Willem Buiter

The paper considers the conditions that must be satisfied for another internationally coordinated fiscal stimulus to make sense and tallies these against the circumstances prevailing in the advanced industrial countries during the late 2009-early 2010 period.

First, there must be idle resources – involuntary unemployment of labour and unwanted excess capacity. Output and employment are effective demand-constrained. These conditions were undoubtedly still satisfied throughout the industrial world.

Second, there should be no more effective way of stimulating demand, say through expansionary monetary policy. With short-term nominal interest rates at or near the zero lower bound and with quantitative easing, credit easing and enhanced credit support of doubtful effectiveness except when disorderly financial market conditions prevail, this conditions is also satisfied

Third, expansionary fiscal policy should not drive up interest rates, either by raising the risk-free real interest rate or by raising the sovereign default risk premium, to such an extent that the fiscal stimulus is emasculated through *financial crowding out*. This condition is only satisfied for relatively few industrial countries, those with low public debt to GDP ratios, low primary (non-interest) deficits as a share of GDP and significant scope for raising future taxes or cutting future public spending. Political economy considerations such as the degree of polarisation of the polity, the effectiveness of key political and economic institutions and the quality of the incumbent political leadership are the key drivers here. A few countries have extraordinary buffers that protect them from the normal working of market discipline through the 'bond market vigilantes' and similar channels. The most important are the US, protected for the time being by the global reserve currency status of the US dollar and Japan, protected by its large stock of net private financial assets and the very high degree of passive domestic ownership of its public debt.

Fourth, at given interest rates, the expansionary fiscal policy measures are not neutralised by *direct*

* Full paper available at http://aric.adb.org/grs/papers/Buiter.pdf

crowding out (the displacement of private spending by public spending or of public dissaving by private saving at given present and future interest rates, prices and activity levels). Such direct crowding out can occur in the case of tax cuts (strictly speaking, cuts in lump-sum taxes matched by future increases in lump-sum taxes of equal present discounted value) because of Ricardian equivalence/debt neutrality. In economies with very highly indebted households, debt neutrality can occur when taxes on households are cut, because of what the author calls 'Minsky equivalence'. Increases in public spending on real goods and services ('exhaustive' public spending) can fail to boost aggregate demand because of a high degree of substitutability (in the utility functions or the production technology) between private consumption and investment on the one hand and public consumption and investment on the other.

There is little if any empirical support for Ricardian equivalence. Minsky equivalence is untested but, the author argues, plausible in a world with highly indebted and suddenly highly risk-averse households. If it is present, it would be good news for those countries that have to tighten fiscally to meet the demands of skeptical markets that doubt their fiscal sustainability.

Fifth, there must be cross-border externalities from expansionary fiscal policies that cause decentralised, uncoordinated national fiscal expansions to be suboptimal. This is bound to be satisfied in a world of imperfectly competitive producers and employers operating under conditions of inadequate effective demand.

It follows that the conclusions on the scope for further conventional expansionary fiscal policy now is rather discouraging in nations with high and rapidly rising public debt burdens, unless there is scope for political realignments that support coalitions in favour of significant *future* fiscal tightening through tax increases or public spending cuts. The paper also outlines some unconventional fiscal/financial policies that may be effective in their own right and may help to enhance the effectiveness of conventional expansionary fiscal policy. Collectively, they can be characterised as the *equitization of debt* – household mortgage debt through the issuance of 'Islamic mortgages', bank debt through mandatory conversion of unsecured debt into common equity, and public debt through the issuance of instruments like GDP growth warrants or floating rate debt with the 'interest rate' indexed to the growth rate of nominal GDP.

4. Managing a Multiple Reserve Currency World*

Barry Eichengreen

It is the thesis of this paper that a multiple reserve currency system is coming. The system for which we need to prepare is one in which the dollar, the euro and the renminbi will be consequential international and reserve currencies. The international monetary system is growing more multipolar because the world economy is growing more multipolar. After World War II, when the United States accounted for the majority of the industrial production of the non-Soviet world, it made sense that the dollar was the principal unit in which exporters and importers invoiced and settled their trade, in which international loans were extended, and in which central banks held their reserves. But this situation makes less sense today when the US accounts for only some 20 per cent of the combined output of countries engaged in international transactions. Because habits die hard, the dollar continues to play a disproportionately important role. But simply because this is true today does not mean that it will be true tomorrow. Countries that trade with and borrow from the euro area will increasingly seek to hold euros as reserves. Countries that trade with and borrow from the People's Republic of China will similarly seek to hold renminbi, if not today then in the not-too-distant future.

Some warn that a multiple-international-currency system would be dangerously unstable. With dollars, euros and (eventually) renminbi all being substitutes for one another, their exchange rates will become dangerously volatile. Substitutability will create the temptation to shift erratically between them. Even a limited loss of confidence in the policies of one of the reserve-currency countries could cause central banks to rush out of its currency, aggravating financial difficulties in the problem country. The consequences for other reserve-issuing countries, which will see their currencies appreciate sharply, will be equally undesirable. A multiple-reserve-currency system, it is argued, would be an engine of instability.

This view is based on a mischaracterization of the behavior of central bank reserve managers. Reserve managers do not seek to maximize the return on their reserve portfolios in the manner of hedge-fund managers. They do not have the high-powered financial incentives of hedge fund managers – reserve managers are not compensated on a 2+20 scheme. They have less incentive to sell a currency simply because everyone else is selling. They can adopt a longer horizon because, unlike private fund

* Full paper available at http://aric.adb.org/grs/papers/Eichengreen.pdf

managers, they do not have to satisfy impatient investors. They do not have to exceed their previous high-water mark in order to draw a paycheck.

What can be done, in terms of policy, to stabilize a multiple international currency system? Sound and stable policies on the part of the reserve-issuing countries would be the most important contribution. Chronic budget deficits, lax supervision and regulation of financial markets and institutions, and bubble-denying monetary policies could set the system up for a painful fall. An International Monetary Fund that refuses to pull its punches and exercises firm surveillance of large-country policies would help to prevent this.

5. From the Chiang Mai Initiative to an Asian Monetary Fund*

Masahiro Kawai

Following the 1997-98 Asian financial crisis, the ASEAN+3 finance ministers launched several initiatives for regional financial cooperation: (i) the Economic Review and Policy Dialogue (ERPD) to support regional economic surveillance; (ii) the Chiang Mai Initiative (CMI), a regional liquidity support arrangement; and (iii) the Asian Bond Markets Initiative. In this paper the author evaluates the progress of such initiatives—particularly the CMI and the recent launch of its multilateralization (CMIM)—and explore the possible evolution of the CMIM toward a regional monetary fund, called the Asian Monetary Fund (AMF).

The paper argues that for an AMF to emerge, ASEAN+3 authorities need to strengthen regional surveillance and upgrade their capacity to formulate credible conditionality in the event of crisis lending so that the CMIM can be delinked from IMF programs. Specifically, the paper offers the following recommendations:

- Clarify rules for activating CMIM lending, including the possibility of providing precautionary (or precrisis) lending and eschewing policy conditionality in the event of externally- or herd behavior-driven financial turbulence or crises;

- Establish a joint forum for finance ministers and central bank governors to intensify policy dialogue among them;

- Make the newly established ASEAN+3 Macroeconomic Research Office (AMRO) a strong professional secretariat, with the required analytical expertise and policy experience, to enable it to support regional economic surveillance through the ERPD, activate the CMIM, and formulate conditionality independently of the IMF;

- Enlarge the size of the CMIM facility so that a sufficient amount of liquidity is provided to member countries in need; and

* Full paper available at http://aric.adb.org/grs/papers/Kawai 5.pdf

- Move beyond the simple "information sharing" stage to a more rigorous "peer review and peer pressure" stage, and eventually to a "due diligence" stage, to improve the quality of economic surveillance.

The paper also argues that there is a case for more flexible use of the CMIM—for precautionary lending without conditions—if the type of external shock that affected the Republic of Korea in the fall of 2008, following the Lehman collapse, were to hit Asia again in the future.

Finally, the paper emphasizes the need for the CMIM—and a new AMF—to work with the IMF to promote Asian financial stability, but this would require the IMF to undertake significant operational and governance reforms so that it regains credibility and trust in Asia. On the operational side, the IMF should focus on macro-financial surveillance of large, systemically important economies—like the United States and the European Union—and to hold them to the same standard as smaller economies. On the governance side, the choice of the IMF managing director—who has always been a Western European—should be based on merit and qualifications and not on nationality. Were such fundamental changes undertaken, then the IMF would likely successfully grasp the opportunity to regain the trust of emerging Asian members, provide them with a sense of ownership, and be regarded as their partner for macroeconomic and financial stability in Asia.

6. An Asian Currency Unit for Asian Monetary Integration*

Masahiro Kawai

In recent years East Asia has seen rapid advances in market-driven economic integration through international trade, investment, and finance. Growing economic integration has strengthened macroeconomic links across East Asia, suggesting that it is increasingly important for the region's economies to achieve intraregional exchange rate stability. Furthermore, given that East Asia—comprising mainly the ASEAN+3 countries—is expected to become the world's largest economic bloc by 2020, it is natural to expect this region to eventually have its own globally accepted, international currency.

In reality, however, the region remains characterized by diverse, uncoordinated exchange rate regimes. Japan and the People's Republic of China (PRC), the two largest economies in East Asia, respectively adopt a pure float and a tightly managed US dollar-based regime. Other economies—except for the small open economies of Hong Kong, China and Brunei Darussalam—adopt intermediate regimes of managed float with the US dollar as the most important anchor currency.

In this paper the author argues that East Asia needs a framework for exchange rate policy coordination. An obvious regional anchor currency that leads this coordination might be the yen or the yuan, given the large size and spillover impacts of Japan and PRC in the region. However, the yen's power waned in the 1990s and 2000s—due to both Japan's lost decade following the bursting of asset price bubbles and population aging—though it is fully convertible internationally and still has the potential to play a critical role. With PRC's strong growth, the yuan's international role will inevitably rise over time, but the usefulness of the yuan will long remain limited for international settlement, clearance, financing, and liquidity holding due to the lack of full convertibility. These two factors suggest that there is a need for introducing a basket of appropriately weighted East Asian currencies—called the Asian Currency Unit (ACU) where the weights of the yen and the yuan are relatively large—as the region's common reference. An ACU could facilitate various types of regional exchange rate policy coordination.

An important policy challenge for the region today is to manage large and rapid capital inflows. With the robust economic recovery and the prospect of an imminent tightening of monetary policy, large amounts

* Full paper available at http://aric.adb.org/grs/papers/Kawai 6.pdf

of capital are already flowing into Asia. To manage even larger capital inflows and maintain macroeconomic and financial sector stability, any economy should allow greater exchange rate flexibility but without damaging the country's international price competitiveness. The best policy strategy for the region is to allow collective currency appreciation vis-à-vis the US dollar and the euro, while maintaining relatively stable intraregional rates. Such collective exchange rate appreciation of the East Asian currencies would require a coordinated approach to exchange rate regime choice. Here an ACU index should prove useful, as it measures collective changes of East Asian exchange rates against the US dollar and the euro and allows analysis of the divergence of regional currencies from the ACU.

The immediate step for such coordination would be for the region's authorities to discuss exchange rate issues as part of enhanced regional economic surveillance and policy dialogue, for which an ACU index will be a useful instrument. The next step would be to promote convergence of exchange rate regimes in East Asia in order to achieve some degree of intraregional rate stability; the most realistic option is for emerging East Asian economies to adopt similar managed floating regimes. This can be done through, for example, the adoption of a common SDR-plus currency basket regime based on the SDR (which is a basket of the US dollar, the euro, the pound sterling, and the yen) plus emerging East Asian currencies. Use of the ACU for foreign exchange reserve holding, bond issuance, and bank deposits and loans would further promote the role of the ACU.

More formal mechanisms for intraregional exchange rate stability based on the ACU could be developed in the future by reducing the weights of the US dollar, the euro, and the pound in the SDR-plus basket. But this step would require substantial convergence across economies in the region in terms of political, economic, institutional, and social conditions.

7. The International Monetary System at a Crossroad*

Felipe Larrain B.

In the most likely scenario the US dollar will remain as the main reserve currency in the foreseeable future, but will face growing competition over the medium term from other national currencies, such as the euro, the BRIC (Brazil, Russia, India, and the People's Republic of China) currencies, the yuan, etc., and a supranational currency such as the SDR. Therefore, the dollar will probably lose weight in time as a share of international reserves. However, this process is likely to be slow and gradual, particularly due to lingering doubts about the future of the euro following fiscal problems in several countries of the Euro area.

The SDR is likely to gradually win greater importance as a reserve currency if it can play a larger role in trade and financial transactions in the global economy, and if it can substantially increase its liquidity and use as an international lender of last resort (ILLR) currency. The increase in 2009 of the SDR allocations and the flexible credit line go in that direction.

* Full paper available at http://aric.adb.org/grs/papers/Larrain.pdf

8. Towards a New Global Reserve System*

Joseph Stiglitz

The economic crisis has resulted in renewed attention to the creation of a new global reserve system. Some of the reasons should be obvious. The dollar-based reserve system has been fraying for years. At least since the beginning of the decade, the dollar no longer seemed a good store of value; its value was volatile and seemed to be subject to secular decline. But the crisis further undermined confidence in the US economy and its management

The choice facing the international community is whether to create, systematically, a new global reserve system, or to "muddle through," moving from the dollar-based system to a two- or three-currency reserve system, which could be even more unstable and volatile.

This paper argues that a new global reserve system is absolutely essential, if we are to restore the global economy to sustained prosperity and stability. But achieving this, too, will not be easy. In the interim, the countries of Asia have an opportunity to strengthen existing regional arrangements. Doing so would not only contribute to the strength of the Asian economies, but possibly also be a critical building block in the creation of a new global reserve system.

* Full paper available at http://aric.adb.org/grs/papers/Stiglitz.pdf

9. A Realistic Vision of Asian Economic Integration*

Wing Thye Woo

In thinking about Asian economic integration, it is noteworthy that most attempts at regional economic integration have been failures. Beside the European Union (EU), the only other case that has been meaningful enough and durable enough is the North American Free Trade Area (NAFTA). Unlike the EU, NAFTA allows only limited labor mobility across countries; has no plans to coordinate exchange rate policies; and does not envisage an eventual political union.

Our conclusion is that the feasible architecture for an Asian Economic Union would be a free trade and open investment area that has a regional financial facility. For the medium run, an Asian Financial Facility (AFF) would operationally be a large Asian swap facility that has its own surveillance mechanism to pre-qualify members for emergency loans. The primary mission of AFF is to reduce the cost of bad luck and not the cost of bad policies. AFF would evolve according to the progress of reforming the IMF, and to the needs created by an increasingly integrated Asia. Given the large size of East Asian foreign reserves, the AFF should take on the additional task of designing a pooling scheme where part of the East Asian reserves could be safely used to finance sound infrastructure projects in the poorest Asian countries. It is important that the AFF does not suffer from the institutional inertia that is characteristic of the present global organizations like the Security Council of the United Nations, the World Bank and the International Monetary Fund. The leadership structure of the AFF should be designed to avoid simply locking in the balance of economic power that existed at the time of its founding.

Given the great disparity in the present and future distribution of economic power in East Asia, and the greater restrictions on labor mobility within the (commonly proposed) Asian Economic Union, a NAFTA-type of Asian Economic Union would be preferable to an EU-type of Asian Economic Union. Exchange rate coordination might occur sporadically but it is unlikely to be the norm in the medium term, and most possibly even in the long term. East Asia should therefore be focusing its energy on creating as wide a free trade area as possible (i.e. be geographically unrestricted), and forgo the unrealistic goal of a common Asian currency. However, if an Asian common currency is still adopted, then the lesson from the Greek crisis in early 2010 is that it is necessary for the Asian Financial Facility to become the Asian Monetary Fund.

* Full paper available at http://aric.adb.org/grs/papers/Woo.pdf

10. An Asian Monetary Unit?*

Charles Wyplosz

Formally, the proposed Asian Monetary Unit (AMU) is a basket composed of the currencies of the 13 countries that form the ASEAN+3 grouping. Its usefulness has been examined by various study groups set up by Finance Ministers, with no formal conclusion so far. A basket of currencies is of no particular interest unless it is being used for particular purposes.

Proposals for the AMU follow the example of the European Currency Unit (ECU). ECU served as a unit of account, as a basis for computing exchange rate divergence indicators and was briefly used by private markets to issue debt instruments. Obviously, the proponents of the AMU aim as using it to foster exchange cooperation and possibly to create a regional bond market.

In Europe, the ECU never played any role but could an AMU meet a more brilliant fate? The ECU was superseded by the elaborate Exchange Rate Mechanism, which imposed many obligations on member countries. The East Asian countries have shown that they are not ready to accept the same restrictions on their monetary policies, but at the same time they are concerned that exchange rate movements affect their external competitiveness. In addition, they are open to currency mismatches, mostly in US dollars, which were at the root of the 1997-98 crisis.

The AMU proposal represents one more attempt at squaring the circle of greater exchange rate cohesion without giving up total control of monetary policies. The Chiang Mai Initiative has evolved towards an ERPD (Economic Review and Policy Dialogue) which covers exchange rate arrangement. It also dovetails with the Asian Bond Market Initiative. Yet, exchange rate policy coordination has remained elusive and progress on bond market integration at the regional level remains modest. Adopting the AMU is unlikely to change the situation.

A key reason is that, in and by itself, the AMU – with its associated divergence indicator – is not conducive to exchange rate arrangements because it requires choosing one regional currency (or a sub-regional basket) to act as anchor. The two regional giants, the People's Republic of China and Japan, are the only ones whose could see their currencies play that role, but the floating yen and the tightly controlled RMB are not well suited for the task.

* Full paper available at http://aric.adb.org/grs/papers/Wyplosz.pdf

This is why basket peg proposals for the area are typically defined in terms of external currencies, in some cases including the yen as Japan is unlikely to join an exchange rate policy cooperation arrangement. Basket pegs directly address the intention of limiting intra-regional exchange rate fluctuations. In contrast, the AMU only suggests such an objective, the implicit idea being that interested countries could tie – to various degrees – their currencies to the Unit. This would require agreeing on the list of currencies to be included in the basket and on their corresponding weights. An alternative is to bypass these discussions altogether and let each country choose its own basket. If the weights are based on trade volumes, the difference between common and own-baskets is trivial.

11. Will US fiscal Deficits Undermine the Role of the Dollar as Global Reserve Currency? If So, Should US Fiscal Policy be geared to Preserving the International Role of the Dollar?*

Yongding Yu

Any international monetary system has to perform two basic functions: providing liquidity for international transactions and facilitating the adjustment of current account imbalances. Since the end of the Second World War, the dollar has been used as the single most important medium of exchange, shore of value and unit of account in the international transactions. In other words, the dollar has played the role of the global reserve currency. However, the use of national fiat money as global reserve currency inevitably causes confident problem. As a result of persistent current account deficits, US net international investment position (NIIP) - to- GDP ratio has been increasing steadily over the decades. The doubt about US' ability of honoring its debt obligation has been increasing significantly since the turn of the century.

The recent global financial crisis and the policy responses by the US government towards the crisis and its aftermath have further shaken the confidence in the dollar. Among the policy responses, the dramatic increase in US fiscal deficit stands out as the most worrying aspect of US government policy. The increase in fiscal deficit and the consequent increase in the NIIP-to- GDP ratio inevitably will produce negative impacts on current account balance and hence will pose serious threat to the role of the dollar as global reserve currency. However, currently, the priority of US macroeconomic policy is to maintain the momentum of recovery. US fiscal policy should not be geared at preserving the role of the dollar as reserve currency. This is because dollar's role as global reserve currency depends on a wider range of factors and the impact of the increase in fiscal deficit on the dollar can be limited in the short run. Furthermore, in the short-run, the negative impact of the increase in fiscal deficit on the dollar can be offset by other policies such as trade policy.

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* Full paper available at http://aric.adb.org/grs/papers/Yu.pdf

The Future
Global Reserve System
An Asian Perspective

Summaries of papers of the

International Monetary Working Group

Aizenman, Joshua
Gros, Daniel
Huang, Yiping
Lee, Jong-Wha
Park, Donghyun
Rozanov, Andrew
Singh, Kanhaiya
Takagi, Shinji

12. International Reserves and Swap Lines: the Recent Experience*

Joshua Aizenman, Donghyun Park and Yothin Jinjarak

The global crisis has witnessed an unprecedented rise of swap agreements between central banks of larger economies and their counterparts in smaller economies. This chapter explores whether such swap lines can reduce the need for reserve accumulation. The evidence indicates that there is only limited scope for swaps to substitute for reserves. For one thing, swap lines are extended only to fundamentally sound emerging markets, and to important trade partners. Crucially, sound fundamentals include ample foreign-exchange reserves. The highly selective nature of swap recipients means that only a small minority of developing countries will have access to swap facilities. Moreover, large central banks provide liquidity support only when it is in their self-interest. When market confidence is shattered, as happened in the case of the Republic of Korea during the 4th quarter of 2008, reserves fail to perform their precautionary function, even if the economy has sound fundamentals. The timing of market movements suggests that the Bank of Korea's swap agreements with the US Fed played a pivotal role in calming down market hysteria over a possible dollar shortage.

Although overall there is only limited substitutability between swap lines and reserve accumulation, deepening swap lines and regional reserve pooling arrangements such as the Chiang Mai Initiative may weaken the precautionary motive for reserve accumulation. The Chiang Mai Initiative requires more concrete and specific governance structure and implementation details. Formalizing and institutionalizing swap lines will help transform them from temporary anti-crisis measures to more long-term mechanisms for liquidity support. These measures will make it less likely that Asia will gravitate toward the dollar standard.

* Full paper available at http://aric.adb.org/grs/papers/Aizenman.pdf

13. The Future of the Global Reserve System*

Daniel Gros, Cinzia Alcidi, Anton Brender, and Florence Pisani

In the de facto reserve system from 2000-09, emerging countries with a high savings propensity exported huge amounts of savings through the accumulation of reserves. The reserve currency country has been the main importer of those savings and hence, the main supplier of the accumulated reserves. The transatlantic financial system provided a complex web of risk-taking chains which assumed most of the risks arising from the fact that while ultimate borrowers (US households) supplied risky assets, savers required safe assets. The excess risk-taking that took place in the Western financial system is thus closely related to the accumulation of reserves observed during this period.

The authors also explore the prospects for the next decade by asking the following questions: will reserves continue to grow and will the mismatch between assets supplied and demanded be overcome by the huge expansion of public debt? What are the obstacles to currency diversification by reserve accumulators? They conclude that reserve-accumulating countries can help the reserve system to work better by providing more information about the nature of the assets they accumulate and by diversifying into risky assets. Reform of the reserve system should aim at making better use of the excess savings in emerging market economies.

* Full paper available at http://aric.adb.org/grs/papers/Gros.pdf

14. Renminbi Policy and the Global Currency System*

Yiping Huang

The global currency system is likely to change significantly after the global financial crisis, but decline of the US dollar may be a gradual process. These would impact the People's Republic of China's (PRC) renminbi policy, which, in turn, may generate feedbacks on the global system. PRC may be able to help achieve a smooth and orderly adjustment of the global currency system, through steps such as gradual increase in exchange rate flexibility and gradual diversification of foreign reserve investment. It could also promote IMF's SDR by linking renminbi to it.

The global crisis is likely to accelerate, not to slow, renminbi policy liberalization. And an internationalized renminbi may play very important global and regional roles, provided that PRC successfully improves monetary policy mechanisms.

* Full paper available at http://aric.adb.org/grs/papers/Huang.pdf

15. Will the Renminbi Emerge as an International Reserve Currency?*

Jong-Wha Lee

This paper argues that the world needs a greater role for alternative currencies in order to strengthen the global reserve system. A gradual evolution to a multi-currency system is desirable because it reduces the ever-growing balance of payments deficit pressure on a single reserve currency issuer and provides alternatives for countries to diversify their foreign exchange currency holdings.

This paper focuses on the role of an Asian currency in the global reserve system. Given the continuing strong growth of the People's Republic of China (PRC) and its expanding influence in the world economy, it is quite natural that the renminbi emerges as a new international currency. This is however, contingent on PRC authorities' acceptance of a more convertible capital account and development of an efficient financial system.

The current global financial crisis has hampered the long-term prospects of both the US dollar and the euro as reserve currencies. The crisis has compromised both currencies as safe-haven stores of value. The renminbi is not a significant international currency yet. But simulations show that once the currency were to become more convertible, the renminbi can gradually grow to become an international currency within the region and beyond—sharing from about 3% to 12% of international reserves by 2035. As other major currencies stagger, however, the renminbi may rise more quickly as an international currency than many anticipate.

Creating a more efficient, stable, and equitable global reserve system is a vital priority for emerging economies, which depend heavily on international trade and capital flows for their growth and development. The internationalization of the renminbi will offer an alternative to the US dollar and the euro. The well-functioning multi-currency system with an expanded role for the renminbi as an international currency can play an important part in maintaining global financial stability and sustained growth.

* Full paper available at http://aric.adb.org/grs/papers/Lee.pdf

16. Asia's Sovereign Wealth Funds and Reform of the Global Reserve System*

Donghyun Park and Andrew Rozanov

Developing Asia's foreign exchange reserves have grown explosively since 1990. The reserve growth mirrors the transformation of the region from a current account deficit region to a surplus region since the Asian financial crisis. The region's reserves now comfortably exceed all plausible estimates of what the region needs for traditional liquidity purposes. The emergence of excess reserves has led to widespread calls for more active reserve management. This, in turn, has resulted in the creation of new sovereign wealth funds (SWFs) such as China Investment Corporation (CIC) and Korea Investment Corporation (KIC) in the region. The establishment of SWFs and, more generally, reorientation of excess reserve management from passive liquidity management to active profit-seeking investment will dilute the dominant role of the US as a global reserve currency and thus speed up the reform of the global reserve system. This is because dollar-denominated assets enjoy a much more dominant position in the global market for reserve assets – i.e. US government bonds – than they do in the global market for riskier assets – i.e. equities and corporate bonds.

At the same time, SWFs can help redesign and restructure reserve portfolios to make them more robust and resilient to the reform of the global reserve system. That is, by exposing reserve managers to a more diverse mix of currencies and asset classes, SWFs and more active reserve management will better prepare them for the less dollar-centric global reserve system of the future. In addition to SWFs, other policy options for more active reserve management include transferring some excess reserves into national pension funds or into exchange traded funds which are distributed among local investors. Regardless of the exact form of returns-oriented reserve management, it will require that countries build up a critical mass of skills and expertise in wealth preservation and managements.

* Full paper available at http://aric.adb.org/grs/papers/Park.pdf

17. Reforming International Monetary System*

Kanhaiya Singh

The global economy is faced with unprecedented imbalances where huge reserves mostly denominated in US dollar have been accumulated in non-reserve currency countries and income velocity of the global reserves is decreasing with random-walk.

In this paper, global data with respect to world economy and the United States (US) have been analysed in Vector Error Correction and Unconstrained Vector Auto Regression frameworks to understand the changing dynamics of economic relationship between US and other nations through Granger Causality and impulse responses. In particular, the economic relationships between US and groups of other economies of the World has been examined with respect to real GDP, domestic money market rates, and international interest rates respectively to demonstrate the prevailing dichotomy in international economic structure.

The dynamics of analysis indicates that the US does not cause growth in real GDP of other countries (taken in groups of high income, upper middle, lower middle and low income countries) but it continues to affect the money market of major economies. Such possibility is argued to be plausible only because of the dual use of the US dollar, which is both the national currency of the US and major currency of international transaction. A dichotomy of this kind is inherently unsustainable as it creates distortions in conducting monetary and fiscal policies of all nations including the US. We also estimate a simple model of consumer price inflation in the US and demonstrate the prevailing rigidity and supply side dominance. It is then argued in particular how the inflation targeting regime in the US has been misplaced, volatile and destabilising for the entire global economy through linkages provided by dual use currency system while preferred policy regime should be characterised by low level low volatility interest rate.

Under these contradictions the global stability cannot be achieved without making the international currency neutral. The economy of the US would also be better off with a neutral currency of international reserve, which decouples its current account deficits from the holding of international reserve of other countries. Several proposals have been floated to reform international monetary

* Full paper available at http://aric.adb.org/grs/papers/Singh.pdf

system (IMS). However, world appears to be divided in three very broad groups: (1) Replace the current dual use currency with an international currency, (2) Replace current dominant dual use currencies with a basket of currencies, and (3) Leave the current currency as it is but develop regional currencies to provide completion. We believe, in the long run only first option is sustainable because other option will lead to similar situation as the one being faced today. There is no guarantee that the multi currency System would remain flexible and competitive.

We have attempted a modest proposal as follows. (1) We propose that there should be neutral currency say SDR-Money (SDRM) for international transaction, which can provide stable store of international value by virtue of expanded basket based valuation system and such currency needs to be managed by a banker of last resort say IMF-Bank, where excess reserve can be deposited and lent at pre-decided benchmark rates just like any central bank but with a provision of transaction off the bench mark rate. (2) There should be arrangement of bilateral negotiations between depositor central bank and borrowing central bank to make a deal off the bench mark rate where discounted deposit of surplus country can be transferred to borrower country in the mutual interest of trade. Such benefits can be provided by the surplus country to avoid tariff barriers from deficit countries which in a sense are supporting employment in exporting country. (3) The transition from US dollar-based IMS to SDRM based system should be done in an agreed timeframe with a period of coexistence followed by complete transition to SDRM. (4) With increasing share of other nations in world real economy, the demand for greater participation is legitimate and it would act as stabilising force. Therefore, more and more currencies need to be added to current SDR basket before adopting SDRM; and finally (5) the monolithic monetary fund may be decentralised with an arrangement of central office and several autonomous regional offices looking after surveillance, monitoring, and advisory with respect to the member countries, and management and distribution of fund at the regional level. The central office could concentrate on currency management, Policy making, surveillance of regional offices and fund allocations to regions. Such a system as proposed here would not only bring more confidence among smaller countries but it would be more robust, knowledgeable and effective.

18. Designing a Regional Surveillance Mechanism for East Asia: Lessons from IMF Surveillance*

Shinji Takagi

The process is underway in East Asia to establish an independent surveillance unit to support decision-making in the Chiang Mai Initiative Multilateralization (CMIM). The paper reviews the principles of surveillance, discusses how they have applied to IMF surveillance in practice, and draws lessons for designing an effective regional surveillance mechanism. The need for such a mechanism in East Asia is both immediate and evolving. For the immediate need, surveillance must meet the operational requirements of the CMIM. At the same time, it must also respond to East Asia's evolving need for a formal framework of policy dialogue and cooperation.

A review of the rich literature on IMF surveillance has identified at least five organizing principles for an effective regional surveillance mechanism, including: (i) clearly define the purpose of surveillance, (ii) centralize surveillance activities in a single organizational unit, (iii) use objective indicators to inform analysis, (iv) design the governance structure to ensure independence, and (v) provide analysis and recommendations directly to senior policymakers in order to exploit peer pressure.

Of these, defining the purpose of surveillance may be the most fundamental requirement for effective surveillance because agreement on the purpose presupposes the surrender by member governments of part of national sovereignty essential for successful policy cooperation. Peer pressure as the primary channel of influence does not preclude active engagement with the public because it is after all through the political process that policymakers are motivated to take action. The surveillance unit should therefore operate with the presumption that it makes a full and complete disclosure of any analysis, view, or information it possesses to the public except when privileged information is involved. To the extent that the quality of the people ultimately determines the quality of the outputs, it is paramount to staff the unit with competent professionals on the basis of merits alone.

* Full paper available at http://aric.adb.org/grs/papers/Takagi.pdf