SMART

JOURNAL OF BUSINESS MANAGEMENT STUDIES

Vol.3 No. 2 July - December 2007

ISSN 0973 - 1598

Chief Editor

Dr. M. SELVAM, M.Com., Ph.D.,

Bharathidasan University,

India

SCIENTIFIC MANAGEMENT AND ADVANCED RESEARCH TRUST

(SMART)

TIRUCHIRAPPALLI (INDIA)

http://www.geocities.com/smartbard

MONETARY INTEGRATION IN SOUTH ASIA - EXPLORING THE POSSIBILITIES

R.Chandramohan and D.Ilangovan,
Professors, Dept. of Commerce, Annamalai University, India.

Abstract

The establishment of APEC (Asia Pacific Economic Cooperation) in 1989 promoted intra regional trade and investment amongst the 18 member economies, but there were only ancillary discussions on monetary cooperation. In February 1991, nevertheless, Asian monetary cooperation took a quiet but significant step forward with the creation of EMEAP (Executives' Meeting of East Asia Pacific Central Banks). The Bank of Japan initiated this 11-member group of central banks. The Asian financial crisis of 1997 demonstrates the need for a region-wide monetary architecture to forewarn the impending currency and balance of payment problems in Thailand, Malaysia, Indonesia and Korea. The emergence of regional initiatives – the proposed Asian Monetary Fund by Japan, the Chiang Mai Initiatives at the ASEAN+3 meeting in May 2000, the Kobe Research Project, and the currency swap agreements and surveillance mechanism at the Asian Development Bank Meeting in Honolulu in May 2001 (Peter Wilson,2002) support the view that an Asian Monetary Authority has a vital role in the promotion of regional monetary coordination, macroeconomic surveillance and future financial crisis prediction.

Introduction

Monetary integration can simply be stated as working together to the same monetary end. This then leads to the question as to what that same monetary end should be, who should be working together and the form in which they should best work together, particularly when one is talking about monetary integration across monetary systems on a global or regional dimension.

As to who should be working together, it is quite obvious that the interested parties would necessarily include the monetary authorities of economies facing or potentially exposed to monetary problems. The increasing realization of this need to work together has led to the formation of various, mostly regional, fora where monetary authorities gather to discuss issues of common interest.

The Asian Scenario

In the post-war period, many Asian central banks evolved from colonial currency boards, which practiced the virtue of stable money fixed to an international reserve currency. As a result of this monetary discipline, supported by sound fiscal discipline, Asia enjoyed stable growth with low inflation. As Asian economies gradually opened their markets to international trade and competition, with Hong Kong setting a good example of how free markets work, the existence of stable exchange rates, largely linked to the US dollar, formed the anchor of Asian growth. The need for monetary cooperation amongst Asian economies, therefore, did not matter much as long as each traded mainly with Europe or America using the US dollar as the main currency of trade.

This was the reason why the work of the principal forum for central bank discussions in the late 1950s called **SEANZA** (South East Asia, New Zealand and Australia) focused mainly on providing training for central bankers. The 18 members of this group cover a geographical area that spans the whole of Asia-Pacific from India to New Zealand.

In the 1990s, the number of Asia Pacific groupings increased, partly as a result of accelerating intra-regional trade. The establishment of APEC (Asia Pacific Economic Cooperation) in 1989 promoted trade and investment amongst the 18 member economies, but there were only ancillary discussions on monetary cooperation. In February 1991, Asian monetary cooperation took a quiet but significant step forward with the creation of EMEAP (Executives' Meeting of East Asia Pacific Central Banks). The Bank of Japan initiated this 11-member group of central banks. At the beginning, EMEAP concentrated on the exchange of information on market developments in the economies of members and was the forum for the Bank of Japan to brief others on G-7 discussions.

The Recent Developments

In this connection, the foresight of Bernie Fraser, then Governor of the Reserve Bank of Australia, who called for the establishment of a new regional institution - for want of a better name, an **Asian BIS** – is to be appreciated and suitably acknowledged for suggesting Asian monetary integration. Bernie saw quite rightly that **"globalization is elevating the international dimension of monetary integration"**. In response to his call, EMEAP convened a working group to study the proposals and at its first Governors' Meeting in Tokyo in July 1996, further established two working groups and a study group to share knowledge and expertise on financial market development, central bank operations and banking supervision issues respectively. The following are some of the attempts made:

1. A Feasibility Study on A Free Trade Agreement between India and Thailand
2. Relevance of Asian Bonds
3. Closer Economic Cooperation with Neighboring Countries
4. Intra-Regional Trade Liberalization in South Asia - SAPTA and SAFTA
5. Towards A Free Trade Area in South Asia: Charting A Feasible Course for Trade
6. Liberalization with Reference to India's Role
7. Economic Cooperation with Central Asian Republics
8. Economics of Regional Integration in Asia: A CGE Modeling Approach
9. Trade Complementarities and Potential for a Single Currency in JACIK
10. India-Sri Lanka Comprehensive Economic Cooperation Agreement
11. A Framework Agreement on FTA between India and Thailand
12. Monetary Cooperation in South Asia: Potential and Prospects
13. Towards A Bay of Bengal Economic Community (BoBEC)

Asian Monetary Problems:

It is perhaps one of the ironies of the post-Britton Woods era that the modern world is no longer generally short of liquidity, and indeed is arguably at present over-flush with liquidity. Yet amidst all this liquidity and prosperity, liquidity crunches can even test the solvency of nations. *The currency turbulence in Asia has prompted a realization of this irony and consequently much soul searching on the appropriateness of exchange rate and other monetary arrangements, macroeconomic and structural adjustment policies, the adequacy of financial market regulation and banking supervision, the pace of financial liberalization, etc.*

1. **Capital inflow** must be at the top of the list. At the beginning of the decade, net capital inflow to emerging markets was less than US$50 billion a year. By 1996, however, this has increased to US$245 billion. Asia has received roughly half of

this capital inflow thanks to the rather attractive basic economic fundamentals.

2. The next monetary problem concerns **current account deficits**. A number of Asian economies were able to run larger than normal current account deficits in the balance of payments because they were easily funded by capital inflows.
3. Then there is **asset price inflation**, which is a rather common consequence of capital inflows. In an open economic environment, capital inflows may not lead to consumer price inflation since imports would alleviate excess demand.
4. In addition, **growing competition at the low-wage end of industries came from other Asian and non-Asian economies**. In Europe, cheaper production came from the restructuring economies of Eastern Europe. Competition came from the revival of Latin American economies with improved access to the US market through NAFTA. In Asia, India and China are emerging as major exporters. As a result, exports in Asia suffered a downturn, while imports continued to rise, leading to growing levels of current account deficits.
5. Then came **problems on the exchange rate front**. The volatility of key exchange rates, particularly that of the yen against the US dollar, has placed the balance of payments of some Asian economies under considerable stress.
6. As we are all aware, this combination of Asian monetary problems has recently put **tremendous pressure on the financial markets, in particular the foreign exchange markets, in the region.** Speculators, who took advantage of these market developments to set up their attacks, resulting in the currency turmoil in Asian currencies that we have seen, compounded this.

The Case for Asian Monetary Integration:

These Asian monetary problems can seriously undermine the ability of Asian monetary authorities to deal with shocks, and when shocks do come, they will cause much agony in terms of economic disruptions and painful adjustments. The problems are also highly contagious, transmitted through sudden shifts in the same direction in the perception of risks by international investors, as they looked for worrisome similarities amongst Asian economies, as the recent turmoil in Asian currency markets has shown. The fall in one market may also lead them to look for liquidity in other markets, thus contributing further to the contagion.

The **Asian financial crisis of 1997 demonstrates the need for region-wide monetary architecture** to forewarn the impending currency and balance of payment problems in Thailand, Malaysia, Indonesia and Korea. The emergence of regional initiatives – the proposed Asian Monetary Fund by Japan, the Chiang Mai Initiatives at the ASEAN+3 meeting in May 2000, the Kobe Research Project, and the currency swap agreements and surveillance mechanism at the Asian Development Bank Meeting in Honolulu in May 2001 (Peter Wilson,2002) support the view that an Asian Monetary Authority has a vital role in the promotion of regional monetary coordination, macroeconomic surveillance and future financial crisis prediction. Monetary instability arising from financial liberalization, the proliferation of short-term capital flows, volatile currency trading and the lack of crisis response mechanism in Asia have led to the ASEAN+3 summit in November 2000 in Singapore to examine the various forms of financial cooperation (Chalongphob Sussangkarn, 2000) with respect to:

• The ASEAN surveillance process;

• Capital flow monitoring;

• Capital market development

• The promotion of ASEAN currencies for intra-ASEAN trade, including the use of a single ASEAN currency and exchange rate system.

Given the growing intra-regional trade, the on going banking and financial restructuring in the East Asian region, the acceleration of ICT and financial technology, and the region's awakening realization in efforts to mobilize high level of savings resources within the Asian region rather than investing domestic savings in OECD countries, the prospects of Asian monetary integration in the next two to three decades may no longer be a pipe dream but a distinct reality.

Asian Development Fund (ADF)

Notwithstanding increasing economic integration, one has to accept the reality of economies in Asia being a very diverse group. Given differences in the economic and financial structure on the one hand, and differences in policy objectives and approaches on the other, the monetary transmission mechanism of Asian economies and their monetary reactions to internal and external shocks are also quite different. The idea of an Asian Monetary Fund was proposed by Japan in 1997. The objection to an Asian Monetary Fund was almost hysterical because it meant that Asia could solve its own problems without as much as by your leave from Washington. The argument that an Asian Monetary Fund would be too relaxed in its attitude to monetary and fiscal mismanagement is ridiculous. Ultimately, the Asian Monetary Fund will succeed or fail based on its governance, its economists, its protocol of supervision and surveillance.

The prospects of Asian Monetary Fund

It is worth recalling that when the ADB was set up, besides Japan, India also played an important role. India's C. S. Krishnamoorthy helped to draft its constitution and financial structure. He ended up serving as an effective and well-remembered Vice-President of the ADB for many years. For an effective role in the new AMF, there is a need to formulate our own priorities clearly. Main questions are: "Does India want to invest a part of our reserves in the capital of the new institution? Does India need a strong presence on its governing board and management? What kind of relationship should the AMF have with the IMF, the World Bank and the ADB?" It is important that we think out clearly the various possibilities and arrive at a reasonable understanding of a consensus with our Asian neighbors as well as with the world powers, such as the US and the UK, which will undoubtedly desire to have a say in the new institution.

Whether the AMF will be a prelude to an Asian common market is a different question. The IMF did not lead to a common market for the world or to a common currency, although Keynes did desire both in some form. All the more, it is necessary to form a task force involving the Ministries of Economic Affairs, Finance and Commerce to deal with the new AMF initiative. Let it not be said that New Delhi let pass a golden opportunity to leave an imprint on the emerging new institution, the Asian Monetary Fund, the herald of the new Asian century.

Issues for Asian Monetary Integration:

There are five specific issues for Asian monetary integration. These are information exchange, resource provision, market infrastructure development, banking supervision and financial regulation, and policy consultations

Another important area for Asian monetary integration is the building of the market infrastructure. In trying to draw attention to this area, I have often said that while billions of dollars are spent in building highways and airports as part of the physical infrastructure in order to move people around efficiently and safely, there is by comparison very little money spent on building the financial highways and airports to move money around efficiently and safely. As a result, the money does not move, at least not as much as one would like to see.

There is no need for a centralized system or even a location. There is no centre for that network and so we do not need to get into the politically difficult question of where the network should be headquartered. Other central banks in the region have to establish similar linkages of payment systems. The next area for Asian monetary cooperation is banking supervision and financial regulation.

As financial markets are further liberalized and integrated, the growth of cross-border banking activities and other financial transactions is accelerating the risk of contagion. As ultimately monetary problems surface in the banking system, it is important for regulators in different economies to cooperate to safeguard the integrity of the banking and financial systems in the region.

Asian monetary integration concerns policy consultation. Clearly, there is scope for improving mutual understanding of each other's policy framework and priorities. This may or may not be a prelude to policy coordination, as the case has not yet been established. But a regular channel of communication on policy issues is still needed.

Conclusion

The road to international monetary cooperation has never been straight and smooth. The **European experience** suggests that there are many bumps along the way. With much more diverse needs and perspectives in Asia, we must allow Asian monetary cooperation to take shape gradually and in a flexible way, starting with less ambitious goals and proceed at a pace and with arrangements comfortable to all. I believe the approach of building an Asian monetary network capable of further linkages to form a global monetary network is the correct one. It is based on voluntary participation and accommodates each participant's unique circumstances.

References

1. Kraiwinee Bunyaratavej and T.K. Jayaraman, A COMMON CURRENCY FOR THE PACIFIC REGION: A FEASIBILITY STUDY, USPEC WORKING PAPER, Suva, Fiji Islands
2. Barry Eichengreen, **A Parallel Currency Approach to Asian Monetary Integration,** University Of California, USA
3. Peter B. Kenon, **Monetary integration in East Asia,** Council on Foreign Relations and Princeton University, USA
4. Won Leong Fee, FROM MONETARY COOPERATION TO MONETARY INTEGRATION?, Monash University Malaysia, Malaysia
5. Joseph Yam,J.P., **Asian Monetary Cooperation,** Hong Kong monetary Authority, China