

**Missing Link in FX Reserve
Management: Global Needs for
ACU-Denominated Reserve Assets**

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1. Reserve Management

- **Establishment of A3 Fund**
- **Increased use of A3 currency and/or A3 currency denominated assets in FX reserves**
- **Introduction of A3CU to issue A3CU denominated reserve assets: Increased use of A3CU denominated assets**

In addition to SWFs, other policy options for more active reserve management include:

- 1) transferring some excess reserves into national pension funds
- 2) transferring into exchange traded funds which are distributed among local investors.

These efforts would run into trouble when dollar assets become risky

Two stylized facts "Asia's export-led growth strategy and its fear of a recurrence of crisis" would strengthen both precautionary and mercantilist motives for IR

The region has long had an inclination toward rigid exchange rates with respect to the US dollar.

We need to pay more attention to make more diversified investment possible rather than simply managing assets more actively

Problems related to the long-term investment policy of these funds: 1) rigid asset allocation frameworks
2) over-reliance on government bonds and cash, and extreme home bias.

Resulting investment returns are simply too low to meet the future liability shortfall targets these funds were originally set up to address.

Transfer of excess FX reserves into the pension fund would be matched by a counter-transfer of local government bonds and cash of equivalent value to the local monetary authorities, who would then be able to shrink their balance sheet by the same amount.

The authorities can transfer FX assets in a special purpose vehicle, which can then be used as the basis for a newly launched ETF, denominated in the local currency and distributed among local investors.

OR we can think about sovereign investments in alternative assets, such as real estate and commodities. The local currency amounts raised through such a public offering can be used to retire some of the sterilization debt, helping shrink the public sector balance sheet further.

Establishment of A3 Fund

- Size: Needs to be greater than current CMIM – Minimum Total Size: 120 billion dollars, each A3 contributing min. 40bil.**
- Setup: Either a completely new institution or as a Trilateral Cooperation Secretariat**
- Function: Emergency credit facility, A3CU-bond, Regional A3-Mega Projects**

Increased Use of A3 Currencies in FX Reserves

- Currently, A3 currency assets are not actively held among international investors, except for Japanese Yen**
- Reserve holdings of A3 currencies among A3 central banks need to be raised above 1%.**
- At first, currency and government debts could be tried.**
- Later, A3CU-bond can be held as legitimate reserve assets**

Introducing A3CU

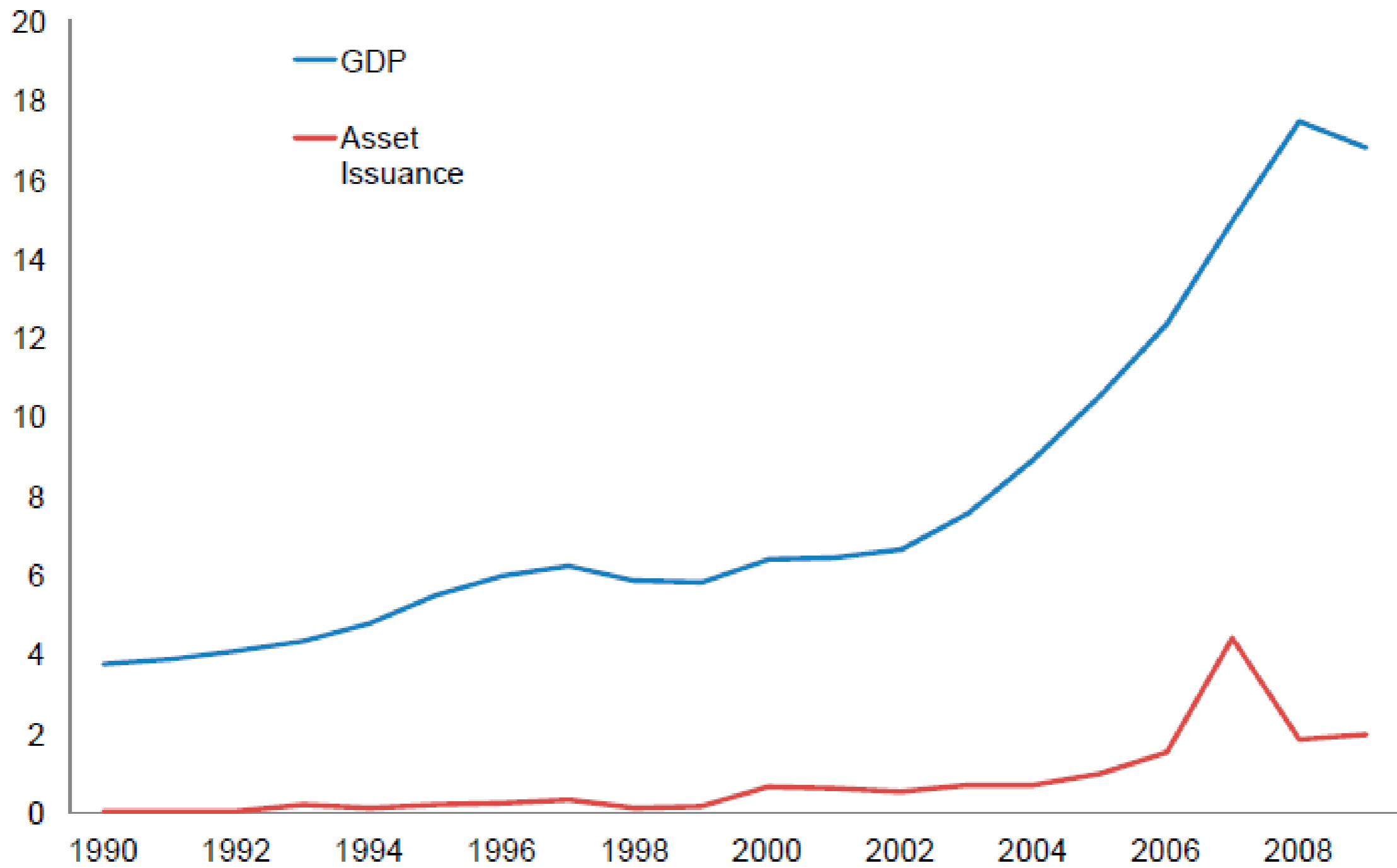
- **Absolutely necessary to introduce A3CU**
- **Equal representation of A3 currencies, resolving asymmetries**
- **Subsequent adjustment weights cap the max possible weight of a specific currency within 49%.**
- **Application: Divergence indicator for macro cooperation and monitoring**
- **Issuance of A3CU-bond: Valid reserve assets for reserve management**

Asset Shortage in EM:

TOO MUCH SAVINGS CHASING TOO FEW ASSETS

- Asset issuance as a share of GDP in EMs has not increased in parallel with GDP
- While EMs accounted for roughly 30 percent of global GDP in 2010, they accounted for only about 15 percent of global financial assets.

**Figure 1: GDP and Asset Issuance
(in trillion of US Dollars)**



Source: WDI and IBES

Root causes of many problems

- ***Low real interest rates***
- ***Lower economic growth.***
- ***Misalignment in the valuation of assets, leading to bubbles in extreme cases***
- ***Capital flows from emerging markets to advanced economies. Classical economic***

Asset Shortage Index

(Chen and Imam 2012)

S=domestic national savings, B=bond issuance in the domestic market, E=equity issuance in the domestic market, L=loan issuance in the domestic market, and S.D.= short-term deposits.

NPFA= net purchase of foreign financial assets by domestic residents, which reflects the position of domestic investors ' holdings of foreign assets (debt, equity, financial derivatives, other investments) minus the net position of foreign investors ' holdings of domestic assets

$$AS = 1 - \left(\frac{B + E + L + \Delta S.D. + NPFA}{S} \right)$$

Empirical Findings of *Chen and Imam*

- *The AS index has a significant and positive impact on the probability of a crisis.*
- *Asset shortages negatively affect growth, while an asset surplus has no discernible impact.*
- *Causality runs from asset shortages to economic growth, with the impact being negative.*
- *Strong positive link between asset shortages and asset bubbles*
- *Impact of asset shortages on the current account is positive and statistically significant*

Why isn't there a greater supply of domestic financial assets in EM?

- The answer is partly related to market size.
- At last, A3 need to get together

2. Roadmap for Regional Monetary and Financial Cooperation

Two Basic Principles:

- Gradualism and Time-Consistency**
- Start from the things that we can agree on**
- Build mutual confidence as we go along, strengthening self-sustaining integration dynamics**

Roadmap for Monetary and Financial Cooperation

	Stage I	Stage II	Stage III
Goals	Policy cooperation and infrastructure-building	Activation of A3CU and Introduction of a flexible exchange rate regime	Introduction of a single regional currency and financial integration
Policy Mandates	<p>Establishment of A3 Fund</p> <p>Introduction of emergency liquidity facility</p> <p>Institutionalization of Policy Dialogue</p> <p>Introduction of information-sharing system</p> <p>Introduction of A3CU : A3CU Based Bond Issuance and Infrastructure-building</p>	<p>Introduction of "Asian Exchange Rate Mechanism"</p> <p>Introduction of granting credit system for intervention : Using private A3CU</p>	<p>Introduction of a regional central bank</p> <p>Transition of National Currency to Common Currency</p> <p>Introduction of Macroeconomic Adjustment and Cooperation System</p>

Agenda for Institutionalization

- Institutionalization consists of two categories: 1) inter-governmental organizations that deal with topics of mutual interest 2) regional organizations**
- Inter-governmental organization differs with varying mixes of standing representatives, permanent institution**
- Currently, ASEAN+3 is an inter-governmental ad-hoc organization with no standing representative**

Inter-governmental Consultative Organization

- The Ministerial Meetings**
- Committee of Governors of A3 Central Banks (CGACB)**
- Committee of Exchange Rate Coordination**
- Council of Financial System Development**
- Council of Restructuring Policy**

A3 joint organization

- **General Administrative Body (A3 Commission): Utilization of existing TCS(Trilateral Cooperation Secretariat)**
- **Monetary and financial cooperation fund : Develop A3 Fund**
- **A3 High-Court: Monetary and Financial Cooperation as well as dealing with FTA-related disputes**
- **Other : Institutionalization of the Summit, Cabinet meetings, Parliamentary meetings, etc**

Key Issues

- **Practical approaches to improve Reserve Management**
- **Ways to utilize Reserves to formulate common FUND (Size of capital contribution, Type, Place and Organization Operating manager)**
- **Concrete Mandates (Emergency Credit Facilities, A3 currency index-denominated Bond)**

FX reserve management

- FX reserves have served A3 effectively**
- Huge accumulation begins to pose serious problems-capital loss, deadweight loss, stabilization costs-resources are tied up for the benefit of stability and competitiveness**
- Continuation is also problematic as we face tail distribution, yet diversification choice is limited**
- Common Pooling is suggested for regional rebalancing-SMEs, mega projects, GCF, etc**

How do we achieve stability with less dependence on IR?

- Setup different sort of funds**
- Provide anchor of confidence to foreign investors by dealing with regional issues**
- ADB mainly tackles development issues**
- Sovereignty cannot be a complete choice : lack of prerequisites for internationalization**
- Teaming up is necessary, but union proves to be infeasible, ineffective**
- Parallel currency approach seems the best choice for now**

Possible Solutions

- **Concretize our regional efforts: Common pooling and use are desirable, but needs to be rigged into regional base, not US base**
- **On the monetary side, develop a regional yardstick with which A3 start issuing EM-CDO or CB as an alternative form of reserve assets**
- **On the real side, some infrastructure building needs to be promoted**
- **For better cooperation, AMF is critically important-deal with region-wide financial uncertainty**

Common efforts to overcome common problems

- A3 institution, e.g. AMF needs to be established to specifically deal with issues related with regional concerns**
- Current tie-up of huge resources to redress regional issues, e.g., polarization and aging society can be eased with common efforts**
- Whom do you trust? AMF with an independent auditing can work!**

Key Issues

- **Tweaking the current country-specific financial system cannot help ease structural problems**
- **Core problem lies in excessive dollar dependence- short-term solution at the expense of long-term dependency**
- **Some rebalancing is necessary for the good of all**
- **Start supplying regional reserve assets**

Current dilemma stem from lack of regional financial stability

- Real side is simple to operate using sovereign control of competitiveness**
- Sovereign financial stability is increasingly costly since the real volume increase poses capacity issue on regional monetary system-Excessive capital flow volatility and limits of stabilization given polarization issues**
- Some of the volatile flows can be muted with partial internationalization of currencies**
- EM-CDO or CB can be tried**

Regional Reserve Assets

- **Sovereign approach has limited effect: Cross-holdings do not imply portfolio diversification against external shocks**
- **Common approach based on EM index is desirable**
- **EM index based Covered Bond is a preferred choice**
- **Instead of making matters worse over intermediate term, time consistent approach is preferred**

In short,

- **Setup an AMF to start activating the regional financial market**
- **Beyond CMIM, Asia badly needs diversification of capital flows (intra-regional vs. inter-regional)**
- **The only practical way to support this function is to establish AMF (Look what GCC countries are doing!)**
- **AMF needs to issue EM-CB or EM-CDO**