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AGENDA GUIDE

1. THE NEED FOR FINANCIAL COOPERATION

Enhanced financial cooperation is a nebulous concept, which may include a variety of steps. These include but are not limited to the following:

a) Policy measures to reduce frictions among capital markets of different countries;

b) Financial cooperation through institutional frameworks, especially during times of financial strain; and

c) Promotion of stable investment regimes in order to elicit foreign investments from foreign investors.

Financial cooperation including the above facets has several advantages.

- A system that facilitates frictionless movement of capital across countries allows for the most efficient allocation of resources. For instance, under such a system, investors across Russia-during times of low returns to investments in their domestic markets-can invest in other fast-growing economies (such as India, China, etc.). Yet, free mobility of capital also poses some downside risks. This is exactly why financial cooperation (point b) mentioned above) is critical during times of economic and financial crises.

- Economic factors and speculative movements within capital markets can lead to sharp reversals of capital movements, thereby jeopardizing financial stability. Over the last 8 years, we have seen multiple such instances where emerging economies have borne the brunt of factors concerning advanced economies (Eg. The financial crisis of 2008, Ben Bernanke's Taper Tantrum in 2013) or other geo-political factors that may or may not directly affect economic outcomes (Eg. The Russian invasion of Ukraine in early 2014). Opponents of free capital mobility cite such ficklemindedness of international investors as the primary justification behind capital controls. Yet, the same financial system, which might allow for such whimsical movement of capital, can also provide avenues for international financial cooperation. In the aftermath of the 2008 financial crisis, for instance, central banks across advanced economies offered unconditional supplies of foreign currencies (primarily US Dollars) to each other in order to stave off the liquidity crisis.

- Apart from cooperation among nations at the international level, there are multilateral institutional frameworks that have been specifically designed for such purposes. The International Monetary Fund (IMF), for instance, has played a pivotal role in the crisis surrounding Greece and its ability to repay international creditors in the aftermath of the 2008 crisis. The BRICS Bank has been mooted by the BRICS nations as an alternative to the IMF but with a specialized focus on the Economic South.

- Finally, stable investment regimes are critical to retain the faith of foreign investors and avoid unexpected capital flight out of the country. A very pertinent case is that of the Vodafone Tax Dispute and the accompanying retrogressive tax amendment that the Government of India enacted in 2012. Ever since, foreign investors wishing to enter India with massive fixed investments have been wary of the Indian tax regime. Similar issues related to P-notes- financial instruments used to invest in Indian capital markets- have kept foreign investors on tenterhooks. The Government has since been trying to instill confidence within the international investor community.

Figure-1 shows the levels of outward portfolio investment (only reported) from source nations within the SCO to nations within the SCO (data was available for only 3 of the current 6 full members, plus India and Pakistan). It suggests that levels of capital movement within the SCO can be much higher than current levels. The figure, for instance, suggests that of all investments out of Russia, less than 0.5% of the capital flows into the 4 destination nations captured in this graph: China (Hong Kong), Kazhakstan, India and Pakistan.

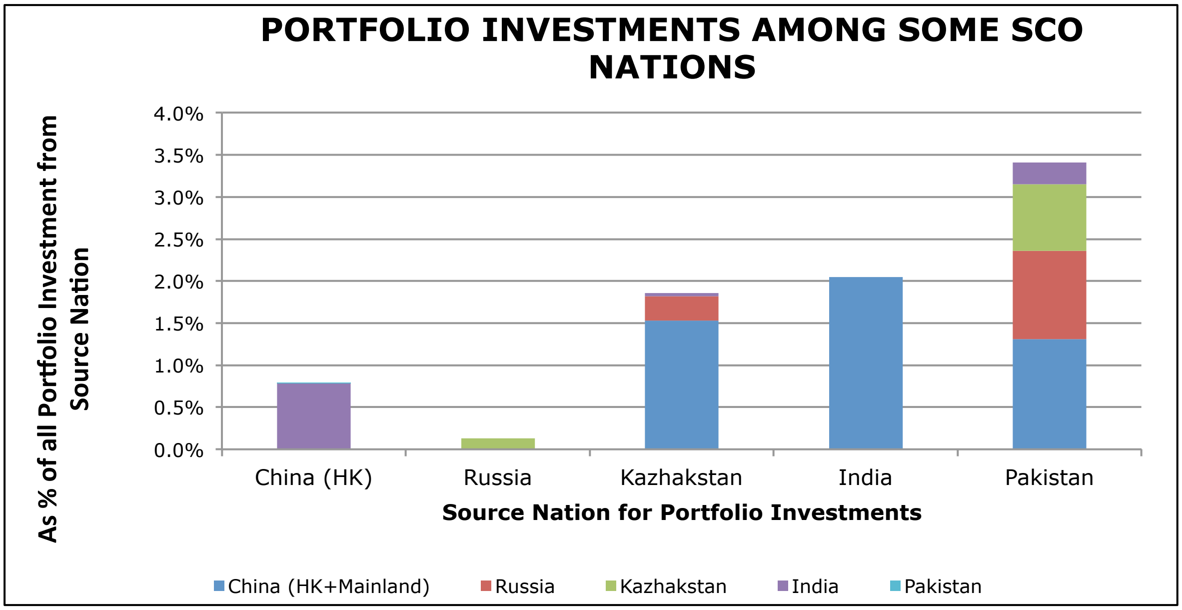

Figure 1 - Source: IMF Coordinated Portfolio Investment Survey; Author's Estimates

1.1. A new institutional framework for financial cooperation?

As mentioned above, despite its shortcomings, the IMF remains the gold standard for an institutional framework for international financial cooperation. However, the proposed BRICS Bank will challenge the IMF's monopoly. Under the circumstances, the SCO may want to consider its own version of such an institution in order to bolster financial integration and cooperation.

In fact, China pitched the establishment of an inter-SCO Development Bank in 2010 as a smaller, regional version of the World Bank and the International Monetary Fund. Though the final document from the 2015 Ufa summit did not address the status of the bank, there are indications that member nations may be willing to move forward.

2.TRADE WITHIN THE SCO REGION: CURRENT SCENARIO[1]

Despite the region's immense potential for intra-regional trade, the current picture doesn't look too satisfactory. The Intra-Regional Trade Intensity Index[2] for the CAREC[3] nations (used as a proxy for the SCO because of its almost similar composition) has remained almost unwavering since 2010 at 0.28, which reflects a trade flow that is much smaller than expected. However, the Intra Regional Trade Share for the CAREC has grown slightly from 2.98% in 2010 to 3.47% in 2014.

Quite dismally, the annual rate of growth in trade within the CAREC region has dipped sharply from 33.25% in 2010 to -1.82% in 2014. Of the total trade that the region's countries engage in, only 3.47% occurs within the region, leaving considerable scope for improvement at the intra-regional level. Notably, China's share of trade with the SCO comprises only 1.62% of its total trade, while that for the smaller economies is much higher.

While a combination of various reasons- ranging from economic hardship to geo-political factors - may have forced the reduction in trade over the last few years, there is definitely a case for greater institutionalization of trade within the SCO region, which can act as a facilitator in the long-run.

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[1] Source: Shanghai Cooperation Organization; available at https://aric.adb.org/initiative/shanghai-cooperation-organization

[2] The trade intensity index (T) is used to determine whether the value of trade between two countries is greater or smaller than would be expected on the basis of their importance in world trade. It is defined as the share of one country's exports going to a partner divided by the share of world exports going to the partner. It is calculated as: $T_{ij} = (x_{ij}/X_{it})/(x_{wj}/X_{wt})$

Where x_{ij} and x_{wj} are the values of country i's exports and of world exports to country j and where X_{it} and X_{wt} are country i's total exports and total world exports respectively. An index of more (less) than one indicates a bilateral trade flow that is larger (smaller) than expected, given the partner country's importance in world trade.

[3] Program consists of Afghanistan, Azerbaijan, the People's Republic of China, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.

2.1 Existing framework for intra-regional trade in the SCO

A Framework Agreement to enhance economic cooperation was signed by the SCO member states on 23 September 2003. At the same meeting the Chinese Premier, Wen Jiabao, proposed a long-term objective to establish a free trade area in the SCO, while other more immediate measures would be taken to improve the flow of goods in the region. A follow up plan with 100 specific actions was signed one year later, on 23 September 2004. On 26 October 2005, during the Moscow Summit of the SCO, the Secretary General of the Organization said that the SCO will prioritize joint energy projects; such will include the oil and gas sector, the exploration of new hydrocarbon reserves, and joint use of water resources. The creation of an Inter-bank SCO Council was also agreed upon at that summit in order to fund future joint projects. On 30 November 2006, at *The SCO: Results and Perspectives*, an international conference held in Almaty, the representative of the Russian Foreign Ministry announced that Russia is developing plans for an SCO "Energy Club". On 16 June 2009, at the Yekaterinburg Summit, China announced plans to provide a US$10 billion loan to SCO member states to shore up the struggling economies of its members amid the global financial crisis. The summit was held together with the first BRIC summit, and the China-Russia joint statement said that they want a bigger quota in the International Monetary Fund. Following are some examples of trade agreements that exist and are in operation in the region.

- The **Asia-Pacific Trade Agreement (APTA)**, previously known as the **Bangkok Agreement** was signed in 1975. It is the oldest preferential trade agreement between countries in the Asia-Pacific region. Its aim is to promote economic development and cooperation through the adoption of mutually beneficial trade liberalization measures. APTA is open to all members of the United Nations Economic and Social Commission for Asia and the Pacific.

- The **ASEAN Free Trade Area** (**AFTA**) is a trade bloc agreement by the Association of Southeast Asian Nations supporting local manufacturing in all ASEAN countries aiming to increase ASEAN's competitive edge as a production base in the world market through the elimination, within ASEAN, of tariffs and non-tariff barriers and attract more foreign direct investment to ASEAN. The primary mechanism for achieving such goals is the Common Effective Preferential Tariff scheme. The ASEAN has also signed seven FTAs with different nations.

- The **South Asian Free Trade Area** (**SAFTA**) is an agreement reached on 6 January 2004 at the 12th SAARC summit in Islamabad, Pakistan. It created a free trade area of 1.6 billion people in Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka (as of 2011, the combined population is 1.8 billion people). The seven foreign ministers of the region signed a framework agreement on SAFTA to reduce customs duties of all traded goods to zero by the year 2016. The SAFTA agreement came into force on 1 January 2006 and is operational following the ratification of the agreement by the seven governments. SAFTA requires the developing countries in South Asia (India, Pakistan and Sri Lanka) to bring their duties down to 20 percent in the first phase of the two-year period ending in 2007. In the final five-year phase ending 2012, the 20 percent duty will be reduced to zero in a series of annual cuts. The least developed nations in South Asia (Nepal, Bhutan, Bangladesh, Afghanistan and Maldives) have an additional three years to reduce tariffs to zero.

- The **Eurasian Economic Union** has an integrated single market of 183 million people and a gross domestic product of over 4 trillion U.S. dollars (PPP).The EEU introduces the free movement of goods, capital, services and people and provides for common transport, agriculture and energy policies, with provisions for a single currency and greater integration in the future. The union operates through supranational and intergovernmental institutions. The Supreme Eurasian Economic Council is the "Supreme Body" of the Union, consisting of the Heads of the Member States. The other supranational institutions are the Eurasian Commission (the executive body), the Eurasian Intergovernmental Council (consisting of the Prime Ministers of member states) and the Court of the EEU (the judicial body).

- The **Eurasian Customs Union** (**EACU**) is a customs union which consists of the member states of the Eurasian Economic Union. It came into existence on 1 January 2010. Its founding states were Belarus, Kazakhstan and Russia. The member states continued with economic integration and removed all customs borders between each other after July 2011. On 19 November 2011, the member states put together a joint commission on fostering closer economic ties, planning to create a Eurasian Economic Union by 2015.

Besides the above arrangements that are already in place, the **Regional Comprehensive Economic Partnership (RCEP)** is a **proposed** free trade agreement (FTA) between the ten member states of the Association of Southeast Asian Nations (ASEAN) and the six states with which ASEAN has existing FTAs (Australia, China, India, Japan, South Korea and New Zealand). RCEP will cover trade in goods, trade in services, investment, economic and technical co-operation, intellectual property, competition, dispute settlement and other issues. The agreement will encompass trade in goods and services, economic and technical issues, intellectual property and investments, and dispute settlement mechanisms.

2.2 Strengthening institutions for boosting intra-regional trade in the SCO region

Given the success of Free Trade Areas in various regions of the world, established by and for different regional organizations, there is a strong case for the establishment of an SCO Free Trade Area**.** An issue that has often come up in relation with the setting up of such an agreement has been over the principle of 'Most Favored Nation' established by the WTO which doesn't allow countries to normally discriminate between their trading partners: Grant someone a special favor (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members. MFN is also a priority in the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO.

However, it is true that, according to WTO itself, some exceptions are allowed. For example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside. Or they can give developing countries special access to their markets. Or a country can raise barriers against products that are considered to be traded unfairly from specific countries. And in services, countries are allowed, in limited circumstances, to discriminate. Hence, the setting up of Free Trade Areas is not as ridden with red tape as seems to be on the surface. Setting up of an FTA for the SCO would not only boost intra-regional trade which seems to be not so thriving at the moment, but would also help consolidate the SCO as a bloc.

3.QUESTIONS TO CONSIDER

The Committee, during the course of the conference, will deliberate on the following questions. The following list is only illustrative and not exhaustive.

- Is there any room for economic integration within the SCO region?
- If so, what steps can be taken to improve international trade and enhance financial integration?
- Will such enhanced economic cooperation benefit all member nations?
- Alternatively, will such an order create winners and losers? Will enhanced economic cooperation promote hegemonic control of the SCO?