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Regional and Global Liquidity Arrangements

Ulrich Volz / Aldo Caliari (Editors)

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Abbreviations

ACU	Asian Clearing Union
	Asian Currency Unit
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
AFTA	ASEAN Free Trade Area
AIB	Asian Investment Bank
AMF	Arab Monetary Fund
	Asian Monetary Fund
AMRO	ASEAN+3 Macroeconomic Research Office
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
ASEAN+3	Association of Southeast Asian Nations plus China, Japan, and South Korea
CFF	Compensatory Financing Facility
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralisation
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EMEAP	Executives' Meeting of the East Asia-Pacific Central Banks
EMF	European Monetary Fund
EMU	European Monetary Union
ERPD	Economic Review and Policy Dialogue
ESCAP	United Nations Economic and Social Commission for Asia and the Pacific
EU	European Union
FAR	Andean Reserve Fund
FCL	Flexible Credit Line
FLAR	Fondo Latinamericano de Reservas – Latin American Reserve Fund
FTAA	Free Trade Area of the Americas
G7	The Group of Seven
G20	The Group of Twenty
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
HAPA	High-access Precautionary Stand-by Arrangement
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
LIC	Low Income Country
MDGs	Millennium Development Goals
Mercosur	Mercado Común del Sur – Southern Common Market

MTFA	Medium-term Financial Assistance
NAFA	North American Framework Agreement
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
PCL	Precautionary Credit Line
RFA	Regional Financing Arrangement
SBA	Stand-by Arrangement
SDR	Special Drawing Right
SPV	Special Purpose Vehicle
SUCRE	Sistema Unitario de Compensación Regional – Unified System for RegionalCompensation
UN	United Nations
UNASUR	Unión de Naciones Suramericanas – Union of South American Nations
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

Introduction

Aldo Caliari and Ulrich Volz

In the 1990s a new generation of what can be called capital account-driven crises hit developing countries. Ever since these crises, the East Asian financial crisis in particular, issues related to the modalities, speed and terms of access to liquidity for affected countries have dogged the international community. Arguably, they have not been successfully resolved.

Given its mandate to provide short-term financing to countries suffering balance-of-payments crises, the International Monetary Fund (IMF) was clearly the pre-eminent international organisation for dealing with such crises.

However, the Fund's role in the handling of the financial crises of the past decades, the perceived lack of even-handedness of IMF surveillance, and the perceived lack of ability, in spite of successive reforms, to appropriately provide emergency financing are factors that have fuelled distrust of the Fund among developing and emerging country members. Dissatisfaction with the Fund's governance has also contributed to this situation.

As a result, policy makers in developing and emerging countries have increasingly contemplated alternatives to Fund lending. Many countries have sought to build up foreign exchange reserves as first lines of defence. Pretty much every country that has been able to do so has accumulated ever-growing amounts of reserves intended to serve as self-insurance and thus prevent the need to resort to the IMF.

Moreover, there have been efforts to establish or expand existing regional financing arrangements (RFAs) as a second line of defence. As a result, RFAs have gained increasing weight over the past decade. While several RFAs have co-existed with the Fund for quite some time,[1] new developments, especially the creation of the European Financial Stability Facility (EFSF) and the current multilateralisation of the Chiang Mai Initiative in East Asia, highlight the need for rethinking the roles that RFAs play in the safeguarding of financial stability. Moreover, their increasing size and importance have important ramifications for the future and integrity of the IMF's crisis lending and raise questions regarding the relationship between RFAs and IMF lending.

The Fund has tried to address the criticisms directed towards it, including that of excessive and inappropriate lending conditionality, to overcome the stigmas it has been living with for some while. In particular, the Fund has been revamping its lending policies, which has included a broadening of contingent financing. In March 2009, the Fund introduced a new Flexible Credit Line (FCL), *"designed to meet the increased demand for crisis-prevention*

1 The European Community created the Medium-Term Financial Assistance Facility in 1971 and a Community loan mechanism in 1975; the Arab Monetary Fund was founded in 1976, and the Latin American Reserve Fund dates back to 1978. For an overview of different regional arrangements see McKay / Volz / Wölfinger (2010).

and crisis-mitigation lending from countries with robust policy frameworks and very strong track records in economic performance" (IMF 2010a). It also started reforms of its concessional lending instruments for low-income members and introduced a new form of contingent protection through the Precautionary Credit Line (PCL), aimed at *"countries with sound fundamentals and policy track records, but facing moderate vulnerabilities that may not yet meet the high FCL qualification standards"* (IMF 2010b).

Together with the Korean G20 presidency, the Fund has set out ambitious plans for establishing a *"Global Financial Safety Net"*. To this end, it has launched proposals for a *"Global Stabilisation Mechanism"* (IMF 2010c); however, these have not received enough support to move them forward among its membership. In response to the increasing importance of RFAs, the Fund has also started *"working on establishing synergies in terms of lending and surveillance with key regional financing arrangements"* (Moghadam 2010), aiming to create a multi-layered financial safety net.

Acknowledging the role of RFAs, the IMF hosted for the first time a high-level meeting at the 2010 Annual Meetings in October 2010 to which it invited representatives of various RFAs, including the European Financial Stability Facility, the Arab Monetary Fund, the Latin American Reserve Fund, and various East Asian governments involved in the Chiang Mai Initiative Multilateralisation process (see IMF 2010d).

This multiplicity of activities shows what a long way the Fund has come from being the institution that vehemently opposed the idea of creating an Asian Monetary Fund, as proposed by the Japanese government after the outbreak of the Asian financial crisis. Cynics would retort, though, that the Fund's change of mind has not been one of choice, but one imposed by the need for change in order to avoid irrelevance, as well as a changing world in which crisis lending can no longer be conceived of as a function exercised by a global, central institution alone. Be it one way or the other, it is a fact that many of these reform ideas still have to materialise, and uncertainties remain concerning what form the interplay between the Fund and RFAs could and should take, and whether the Fund's embrace of RFAs can help it overcome the stigma it still has in much of the developing world.[2]

Against this backdrop, the contributions in this publication address a wide range of topics dealing with regional and global liquidity arrangements, including reform proposals for IMF lending facilities; experiences with, and reform proposals for RFAs; the relationship between the IMF and RFAs, including overlaps or complementarities that exist or may emerge among them; comparative advantages and/or disadvantages in the relationship between regional arrangements and the Fund; and guidelines for ensuring an efficient division of labour between regional arrangements and the Fund.

2 The fact that the system for liquidity provision has to work, by necessity, in the absence of any international framework for sovereign bankruptcy means that even when liquidity is provided, questions arise as to the fairness of the resulting distribution of the burden between the public and private sectors. Moral hazard questions are not only unavoidable, but their solution also depends on addressing questions exogenous to the liquidity mechanisms themselves.

Graham Bird sets the current debates about the international reserve system and the provision of international liquidity in historical perspective and highlights the fact that a new liquidity arrangement for the world economy is only one item on a holistic agenda for international monetary reform. In Bird's view, such an agenda should also incorporate measures to encourage economic adjustment and a more broadly symmetrical distribution of the adjustment burden. A larger and more reliable international lender of last resort facility may help to reduce the incidence of financial crises associated with international capital volatility. Bird also proposes the establishment of a link between the occasional creation of Special Drawing Rights (SDRs) and the provision of development assistance.

Ted Truman recommends that the G20 leaders endorse a series of steps to move the IMF closer to becoming an international lender of last resort. He calls for an expanded tool kit for financing and for the further elaboration of the Global Stabilisation Mechanism proposed by the IMF. To address systematically the moral hazard problem facing all lenders of last resort, Truman demands that an enhanced capacity to lend must be embedded in a broader policy framework, tying IMF lending more tightly to ongoing surveillance and supervision of members' policies. The objective would be to combine the availability of different IMF facilities to IMF members into a range of possible circumstances with the IMF's role in bilateral, and potentially multilateral, surveillance via comprehensive prequalification.

Pedro Páez Pérez argues that yearly issuances of SDRs by the IMF could enable the provision of policy space for national stimuli and the reduction of debt. His contribution also explores the new frontiers that SDRs could bring to RFAs. For instance, SDRs could support regional stabilisation funds and swap mechanisms, without the need for members to convert them into hard currencies. Moreover, regional SDR equivalents could become the cornerstones of lender of last resort schemes for regional arrangements. Additional SDRs would also limit the need for accumulation of reserves while directing resources to productive investment and helping donors to meet longstanding aid commitments.

Comprehensive IMF reform and further expansion of the Fund's resources, including new issuances of SDRs, however, might be difficult to achieve. *Raj Desai* and *James Vreeland* argue that the Fund is in a bind: if it does not make governance more inclusive, it will (continue to) lose the interest of emerging market countries. But if it does away with US power, Congress may indeed be less likely to approve future increases to contributions. Either way, the global institution risks irrelevance, which is perhaps the signature of a multipolar world in which no one is strong enough to dominate at the international level and regional hegemons emerge. Desai and Vreeland therefore argue that the Fund needs to recognise the growing strength of regional organisations and find ways to engage and work with them.

The argument *José Antonio Ocampo* develops is that the best global monetary arrangement would be a network which includes the IMF, regional reserve funds, and swap arrangements among central banks; this could also serve as a framework for a multilayered macroeconomic policy dialogue and policy co-ordination. According to Ocampo, the IMF of the future should be at the apex of such a federal network, playing a central role in macroeconomic policy co-ordination at the global level, while RFAs should have a greater role on a regional and subregional level. The benefit of a federal structure would be twofold: first, it would bring more stability to the world economy by supplying essential services that can hardly be provided by a few international institutions, owing both to the heterogeneity of the international community and to the dynamic processes of open regionalism which are currently under way. And second, it would be more balanced than a system based on a few world organisations, since it would broaden in particular the participation of small countries.

In their contribution, *Julie McKay* and *Uli Volz* discuss whether regional arrangements are likely to supplement or supplant IMF lending. While RFAs can make important contributions to international financial stability by providing an additional layer of defence against crises, McKay and Volz also point to several risks that RFAs pose for global financial governance. While a healthy competition for surveillance and ideas between the Fund and RFAs could well contribute to overall international financial stability, unhealthy competition – where RFAs erode the Fund's standing by undermining its authority and allowing countries in balance-of-payments crises to bypass the Fund entirely – has the potential to undermine the stability of the international system. They consequently argue for efforts on the part of the Fund and RFAs to create or increase synergies between the various regional arrangements and the IMF.

In a similar vein, *Kati Suominen* argues that regional "rapid-reaction", "first responder" funds could help the Fund weather crises beyond its means and reduce competing claims on its resources. RFAs could also serve as laboratories and incubators of new practices, the best of which could then be multilateralised. However, Suominen emphasises that a global economy requires global institutions and global co-ordination, and calls for the G20 to fashion a clear set of principles to guide the relationship among the IMF, regional financial facilities and any bilateral arrangements in lending to troubled economies. The G20 should also encourage the IMF and regional financial authorities to agree on formal channels and partnerships on surveillance and economic analysis so as to ensure two-way information flows and to avoid duplicating some of the more menial efforts, such as data collection.

Randy Henning discusses the case for co-operation between RFAs and the IMF, underscores the importance of this co-operation being organised on an *ex ante* basis, and offers suggestions for doing so. He argues that the member countries of organisations at both levels, especially those represented in the G20, should mandate RFAs and the IMF to organise co-operation on an *ex ante* basis with respect to several areas, including surveillance, co-financing, transparency, review, and representation. Henning suggests that these points be adopted as a formal code of conduct by all IMF members. Such a code could leave considerable room for accommodating the substantial differences among RFAs and thus the comparative advantage of the IMF. Considerable progress can nonetheless be made under less formal conventions between regional arrangements and the Fund.

Barry Eichengreen critically reviews what role RFAs may play in the future. The attraction of RFAs is that they can help avoid the potential embarrassment of borrowing from the IMF, while being less costly and more efficient than a system in which each country relies on its own accumulated reserves. But he also argues that regional arrangements may offer less than meets the eye in terms of actual insurance. Eichengreen gives three reasons why RFAs are not a serious alternative to national reserve accumulation on the one hand and IMF facilities on the other: limited size; limited regional surveillance capacity; and limited likelihood of meaningful conditionality attached to lending with, consequently, no assurance that the borrower will make required policy reforms. Eichengreen therefore argues that if countries are serious about establishing regional funds that make a meaningful contribution to regional and global financial stability, they will have to ante up real money. They will have to create stand-alone institutions with the capacity to engage in meaningful surveillance, and they will have to give these institutions the power to set the conditions that will be attached to emergency loans. Unless these conditions are met, Eichengreen predicts, RFAs will merely remain "paper tigers".

In the view of *Daniel Gros*, regional financial safety nets make sense whenever regional financial integration is particularly strong. The best example is the euro area, where he deems the creation of a regional safety net essential. But Gros points also to the danger that a proliferation of regional safety nets might create co-ordination problems and might leave important areas of the world that are not part of highly integrated regions without a safety net. Like Ocampo, Gros therefore recommends that the global financial safety net should be built like a pyramid with the IMF at its apex. Regional systems could take care of their own members who could pool their resources and IMF membership, while countries that are not members of any regional scheme would continue to have the IMF as their main provider of a financial safety net as before. Gros exemplifies this with the case of the recently established EFSF and makes a proposal on how the European financial safety net may be integrated as a building block into the global financial architecture. This would involve a (perhaps temporary) pooling of the IMF quotas of euro area member countries, which could transfer "use" of their quotas to the EFSF.

K. S. Jomo looks into regional financial and monetary co-operation in East Asia. He endorses regional arrangements as offering an intermediate alternative between national and global levels of action and intervention. To be successful and effective, such regional arrangements must be flexible but credible, and capable of effective counter-cyclical macroeconomic management as well as crisis prevention and management. In Jomo's view, the two main regional financial co-operation projects that East Asia has embarked on thus far – the Chiang Mai Initiative for liquidity support and the regional bond market initiatives – hardly threaten global hegemonic interests. According to Jomo, a major problem in East Asia is a relatively poor understanding of and little agreement on past successes as well as failures. Jomo also laments that there is far too little meaningful regional co-operation in East Asia and too little cognizance of the region's diversity, characteristics and environment.

In a second contribution on East Asia, *Masahiro Kawai* reviews the progress of recent financial co-operation in East Asia – including the launch of CMI Multilateralisation (CMIM) and the decision to set up an ASEAN+3 Macroeconomic Research Office (AMRO) – and explores the challenges in strengthening the region's liquidity and surveillance arrangements. Kawai argues that a strengthening of the CMIM and the region's Economic Review and Policy Dialogue (ERPD) would not only enhance regional financial stability but also contribute to the stability of the global financial system. Kawai calls for the ASEAN+3 finance ministers and central bank governors to work closely together and take decisive action to strengthen the CMIM and ERPD. To help transform the ERPD from the "information sharing" to the "peer review and peer pressure" stage, and then to a stage of "due diligence", AMRO needs to become an effective surveillance unit with sufficient resources and expertise. Kawai also argues that the CMIM needs to be expanded in size, de-linked from IMF programmes, and must start offering more instruments including precautionary credit lines. A strong ERPD and CMIM would eventually lead to the *de facto* creation of an Asian monetary fund (AMF). While strengthening the CMIM, East Asian countries should also explore how an independent CMIM (or a future AMF) should work with the IMF.

Rather than focusing on improving the mechanisms for liquidity supply, *Aldo Caliari* concentrates on the oft-overlooked relevance of mechanisms for reducing liquidity demand. In this regard, he explores the potential of systems for regional cross-border payments in domestic currency, accompanied by clearing unions and regional units of account – the latter composed of baskets of regional currencies. He further examines how these mechanisms could have important positive consequences for regional exchange rate stability, intra-regional trade and diversification of markets and products, trade finance and global financial stability.

In the final contribution, *Oscar Ugarteche* argues that the origins of the trend towards regional co-operation can be traced back to seeds present in the post-war Bretton Woods system and the incapacity of its institutionality to respond to emerging developments. One of these seeds was the system of fixed exchange rates whose implosion brought about extreme levels of volatility among reserve currencies. Countries have thus an incentive to search for ways to keep exchange rates stable, at least, within a limited, common economic zone. A second seed was the limited opportunity that reserve currencies issued by countries with growing indebtedness offer to developing and emerging economies looking for more profitable opportunities to invest their trade surpluses. This happens at a time when such economies are accumulating high levels of reserves. Finally, Ugarteche discusses the growing role of intra-regional trade in total trade, with the imperative of finding ways to detach such trade from the volatility generated at the centre. This has made the 21st century's regionalisation processes something that, rather than following a pre-determined plan by governments, follows and seeks to respond to corporate and trade needs that take place in each region, in highly specific ways.

While it is unlikely that financial crises will stop happening, the challenge is to conceive an international financial system where they can be reduced in number and intensity, and their impacts distributed in more equitable ways. The modalities, speed and terms of mechanisms for accessing liquidity in times of crisis have to be a key part of the system.

At a time when the post-war framework for liquidity provision in times of crisis is in flux, the momentum to enhance the system through profound reforms is probably at its highest point since its inception. The contributions in this publication cover a great deal of ground and offer a spectrum of ideas, from the visionary to the very pragmatic. It is our hope by laying out those ideas that this publication will make a useful contribution to the ongoing debate and will help in utilising that momentum for reforms.

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The world's liquidity arrangements: The easiest item on a holistic agenda for international monetary reform?

Graham Bird

Introduction and background

In the mid 2000s some commentators claimed that there were similarities between contemporary international monetary arrangements and the old Bretton Woods system, in the sense that countries with balance of payments surpluses stood ready to give financial support to countries in deficit in an attempt to prop up a particular configuration of exchange rates. The suggestion was that the world was experiencing a Bretton Woods II era. Whatever one's views on this idea, there are grounds for claiming that current debates about the international reserve system and the provision of international liquidity also have antecedents in the 1960s.

At that time, the principal weakness of the Bretton Woods system was seen as relating to the quantity of international liquidity – deemed inadequate – and the composition of international reserves – with excessive reliance on the US dollar. Almost all the reform plans focused on these issues (Machlup 1962 / Williamson 1973). While suggestions for increasing the official price of gold were resisted, schemes for increasing the IMF's lending capacity via quota increases and the General Arrangements to Borrow, making use of the Basle Facility, setting up a system of bi-lateral swaps, and ultimately introducing Special Drawing Rights (SDRs) were adopted. These were seen as creating a range of mechanisms for systematically increasing the quantity of international reserves when there was a global need, shifting away from relying on the US dollar as the principal international reserve asset, and providing additional financial support to individual countries that were under balance of payments duress.

The fundamental issue was that in circumstances where global economic imbalances arose, and adjustment tools did not allow them to be speedily corrected, there had to be some means of financing payments deficits. The ineffectiveness and inefficiency of adjustment eventually contributed to the collapse of the Bretton Woods system. In the post Bretton Woods era the liquidity issues that had dominated discussions in the 1960s went away. In principle, flexible exchange rates allowed countries to adjust to payments disequilibria more quickly, and increased international capital mobility provided a financing option that permitted adjustment to be cushioned in the short (or even not so short) term. Academic interest shifted to theories of exchange rate determination, and the focus of policy was on the surveillance of exchange rates.

Now, once again, issues related to international liquidity are firmly back at the top of the reform agenda. Why? The basic reason is that the system of flexible exchange rates, as it has functioned, and the use of policies aimed at managing aggregate demand have failed to correct global economic imbalances, while international capital markets have proved to be an unreliable source of payments financing. The Achilles heel of financial globalisation has been the volatility of international capital movements and the distinct possibility that their procyclicality make them part of the problem of financial and economic crises rather than part of the solution. If there is a market failure, it is natural to explore the potential contribution of international and regional financial institutions in overcoming or offsetting it.

Lessons from the past

A central message that emerges from the brief historical overview given above is that issues pertaining to the adequacy of international liquidity are intimately and inexorably related to the efficiency of international adjustment. Ideally, international policy needs to address both elements. Starting from a situation in which international liquidity is viewed as being inadequate, improvements may be made either by increasing the amount of liquidity or by lowering the need for it by reducing the incidence of balance-of-payments disequilibria or by making the adjustment mechanism more effective. Doing the last of these, however, is likely to be constrained by problems associated with the asymmetrical distribution of the adjustment burden and the fact that, within any financial system, it is much harder to exert adjustment pressure on surplus units than on deficit ones. Surplus countries generally seem much more willing to provide financial support to deficit countries than to allow their surpluses to be eroded. At the same time, it is much more difficult for deficit countries to adjust if surplus ones are not willing to accommodate the adjustment.

Thus it is that in 2009 and 2010 attention has shifted to liquidity issues (United Nations 2009; IMF 2010). The switch in part reflects the difficulties that have been encountered in correcting global economic imbalances by attempting to apply appropriately co-ordinated monetary, fiscal and exchange rate policies. The harsh reality is that political economy considerations suggest that it is likely to be easier (but not necessarily easy) to make headway in terms of international monetary reform by seeking to alleviate liquidity constraints. This is one of the lessons of the Bretton Woods system, but it is also illustrated by other episodes in the history of the international monetary system. It is against this background that current proposals for reform need to be seen.

Issues for the future

Reforming international liquidity and the global reserve system involves a number of interrelated elements. First, there is the question of the principal international reserve asset and the mechanism through which changes in the quantity of reserves may be brought about. While there are strong analytical reasons for aiming to move away from a system based on the US dollar or multiple reserve currencies in favour of the SDR or an equivalent international reserve asset, the practicalities of achieving this, for example in terms of creating a substitution account through which dollars can be swapped for SDRs, as well as the politics of getting agreement on such a systemic change, are daunting (Bird 2010a). This having been said, a more feasible objective might be to establish an "inorganic link" between the occasional creation of SDRs and the provision of development assistance. Such a scheme could help to alleviate the financing constraints encountered by many low income countries and intensified by the global financial crisis, and thereby minimise the distance by which the Millennium Development Goals (MDGs) will be underachieved in 2015 (Bird 2010b). Low income countries do not in general have the scope for establishing regional liquidity arrangements, and the accumulation of owned reserves by them carries a high opportunity cost. Low income countries are therefore likely to remain reliant on IMF-related resources.

Second, there are the questions of the IMF's lending capacity and the range of facilities through which loans are made. The demand for IMF resources is difficult to forecast with any degree of precision, and it would be problematic to design an automatic formula upon which the Fund's resources could be based (Ghosh et al. 2008; Bird / Rowlands 2010). An option worth exploring is to exploit the idea of direct IMF borrowing from international capital markets to supplement its quota-based resources (Bird / Rowlands 2006). This would enable the Fund to respond to global liquidity needs reasonably quickly. In the circumstances in which such borrowing would be necessary, it is unlikely that the Fund would crowd out direct lending by international capital markets to individual countries. Relying on IMF programmes to catalyse private capital flows is unjustified according to both the underlying analysis and the available empirical evidence (Bird / Rowlands 2002).

The Fund's range of lending windows has proliferated since the early 1950s, when stand-bys were the only form of IMF lending. To the uninitiated – and even the initiated – the demarcation between different facilities has often been quite difficult to discern. For example, empirical investigation has failed to discover significant differences in the economic circumstances in which the Extended Fund Facility has recently been used, as opposed to stand-bys (Bird / Rowlands 2007). Prior to the 1980s, low conditionality facilities such as the Compensatory Financing Facility (CFF) could be differentiated from the high conditionality ones. However, during the 1980s and 1990s low conditionality was abandoned, except perhaps in the context of the Systemic Transformation Facility, and conditionality was expanded to include structural as well as more conventional macroeconomic components. The "streamlining" initiative of the 2000s, followed by the "major overhaul" of conditionality during 2008/09, has sought to reduce conditionality as a way of improving "ownership" and, as a result, the implementation of IMF programmes (Bird 2009). The issue is whether the Fund's current range of facilities is appropriate to the differing circumstances in which member countries might seek assistance. Key components relate to the amount of finance provided, the speed with which credits can be arranged, and the nature of conditionality incorporated (and the division between *ex ante* and *ex post* conditionality). Low conditionality IMF lending – albeit incorporating a form of pre-qualification – has made a comeback under the umbrella of the Flexible Credit Line. Structural conditionality has been relegated in terms of institutional importance.

But just because structural adjustment has proved difficult to achieve within the context of IMF conditionality, this does not make it unimportant. It may yet prove to be unwise for the Fund to reduce the pressure on countries with structural economic problems to deal with them. Light conditionality may carry with it a moral hazard problem. It is a matter of getting the right balance. Excessive conditionality can certainly raise the perceived costs of IMF programmes to users. Indeed, there is empirical evidence to suggest that the perceived costs – both economic and political – of having an IMF programme may have been a significant factor in encouraging countries to build up their owned reserves as a means of self-insuring against future crises (Bird / Mandilaras 2010). While it is wise for countries to hold adequate owned reserves, one of the original purposes of the IMF was to pool reserves and reduce the need for countries to hold their own reserves. Reform needs to address this, not least because of the implications that reserve accumulation has for global economic imbalances. Key reform elements relate to the amount and nature of conditionality and the amount of resources available from the Fund.

Finally, there is the question of the relationship between IMF-based and regional liquidity arrangements: are they substitutes or complements? As stated earlier, the answer to some extent depends on the particular region being discussed, since in some areas of the world regional liquidity arrangements will not be feasible. Where they are, it is important that the respective roles be clarified. Where do the comparative advantages lie? Once again, however, what is feasible may be constrained by regional politics. In the aftermath of both the East Asian crisis in 1997/98 and the Eurozone crisis of 2010, political factors limited the scope for a regional (or at least exclusively regional) approach. Apart from political factors, the details of the mix between regional and IMF-based liquidity would appear to depend on: the extent of regional co-variance, the amount of resources that can be arranged, whether regional arrangements offer a net addition to resources available from the IMF, the relative speeds at which financial support can be arranged, and the nature of pre-qualification and conditionality.

In principle, one might envisage three tiers of liquidity (Bird / Rajan 2002), with owned reserves possessing the characteristics of immediate availability and zero conditionality, regional arrangements offering a slightly slower response speed and a higher degree of conditionality, perhaps based on pre-qualification, and the IMF offering an even more delayed response (requiring the negotiation of an IMF-supported programme) and more detailed contemporary and ex post conditionality. But in practice this is not how things have panned out. In the case of the Chiang Mai Initiative, conditionality has been linked to the IMF, and in the case of Europe, negotiating a regional deal was made contingent on IMF support with some regional creditors expressing concern that IMF conditionality would be inadequate. Are regional neighbours going to be better equipped than the IMF to identify relevant reforms and in a better position to enforce them?

Concluding remarks

It is unsurprising that increased attention is being paid to liquidity-related issues in the context of international monetary reform. While the issues raised are important, it is also important not to lose sight of a more holistic approach to reform. This approach should incorporate measures for encouraging economic adjustment and a more broadly symmetrical distribution of the adjustment burden while also reducing the incidence of financial crises associated with international capital volatility. A larger and more reliable international lender of last resort facility might help in this respect. The current focus on international and regional liquidity reflects the lack of progress achieved in these other areas. Historical evidence suggests that it may offer a somewhat easier reform path.

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The IMF as an international lender of last resort

*Edwin M. Truman**

The G20 leaders' meeting in Seoul should endorse a series of steps to move the IMF closer to becoming an international lender of last resort. The classic lender of last resort has the capacity (1) to lend unlimited amounts of funds to solvent institutions (2) on appropriate terms. Thus, to transform the IMF into a more effective international lender of last resort involves two components: design of the appropriate terms and financing.

With respect to the design component, a number of elements of an improved global financial safety net are at various stages of approval. They are: (1) a further relaxation of the amounts available from and terms of access to the Flexible Credit Line (FCL) for countries with very strong economic and financial policies; (2) the establishment of a Precautionary Credit Line (PCL) for countries which do not qualify for the FCL but have sound policies; this would be accompanied by limited, streamlined conditions (*ex post* conditionality) on their policies; and (3) a global stabilisation mechanism, through which, in a crisis, the IMF temporarily could use an expanded tool kit. That expanded tool kit could include the unilateral offer by the IMF of FCLs for multiple qualifying countries as well as other special facilities and relaxations of existing facilities. The first two elements have already been approved by the IMF executive board, and a moderate version of the third may be approved before the Seoul summit. The G20 leaders should endorse this progress and call for the further elaboration of the global stabilisation mechanism.

However, this enhanced capacity to lend must be embedded in a broader policy framework that would address systematically the moral hazard issue facing all lenders of last resort. When central banks lend to solvent financial institutions, they in principle combine essentially unlimited access to funds with close supervision and regulation of the potential recipients of those funds; those are the "appropriate terms". The aim is to limit the potential for a financial institution to add excessive risk to its portfolio and then turn to the central bank for liquidity support when the institution is in fact insolvent or close to that condition. For the IMF, this involves not only appropriate conditions attached to its loans but also tying IMF lending more tightly to ongoing surveillance and supervision of members' policies. The objective would be to combine the availability of different facilities to IMF members in a range of possible circumstances with the IMF's role in bilateral, and potentially multilateral, surveillance via comprehensive prequalification.

* This paper is based on E. M. Truman (2010): The G-20 and international financial institution governance, Washington, DC: Peterson Institute for International Economics (Working Paper 10–13).

Comprehensive prequalification would work as follows. Every member of the IMF is obligated to have an annual Article IV consultation and review of its economic and financial policies by the IMF staff and executive board. As an integral part of these reviews, the IMF staff should in the future indicate on what policy terms every member country would be potentially eligible to borrow from the Fund. For a country with very strong policies and a track record of policy performance, the staff would state its judgment that the country would be eligible to borrow under the FCL. For a country with sound policies, the staff would state what changes in policies or policy commitments would be necessary to qualify it for lending under the PCL. For a country with weak policies or a weak track record of policy performance, the staff would outline the changes in policies that would be necessary as part of a traditional stand-by arrangement (SBA), or perhaps a high-access precautionary SBA (HAPA).

This framework would apply to all countries. The IMF executive board could comment on the staff recommendation, as it now does on the staff policy assessment, but the board would not be required to act on the staff recommendation. Implementation of the approach should be supported by a commitment to make these staff reports public promptly and without significant modification. Under this framework, it would also be necessary to link the Article IV consultations more closely to financial sector assessments and to the work of the Financial Stability Board.

For example, the staff report on the US Article IV consultation might state that in the staff's judgment the United States would only be eligible for a PCL, not an FCL, and a PCL would be subject to policy conditions with respect to a longer-term fiscal plan to place U.S. public debt on a sustainable path, further concrete actions to control healthcare costs, and implementation of planned and additional financial sector reforms. Each of these topics was covered in the staff report for the US Article IV consultation. What would be necessary would be to make those recommendations more concrete and link them to a staff judgment about where US policies put the United States and the spectrum from FCL to PCL to SBA.

The multilateral consultation process would be introduced into the proposed framework via assessments of the global economic and financial environment. These assessments could lead to a staff recommendation with respect to support for a group of countries as with the multilateral lending facility or global stability mechanism.

The comprehensive prequalification approach as a whole should help to reduce the stigma problem of borrowing from the IMF. Countries would be responding to what in effect would be an invitation from the IMF staff to borrow on specific terms.

A softer and more limited version of this approach was presented to the IMF executive board in March of this year, and most executive directors reportedly were not enthusiastic. They did not like the feature that in having a positive list of countries qualifying for an FCL there would also be a negative list of countries that did not even qualify for a PCL. This reluctance to accept supervision and regulation in the form of IMF surveillance illustrates the moral hazard problem with a more expansive approach to IMF lending. The two aspects – financing and supervision – must be tied together.

There is also the issue of insolvency or illiquidity. Here countries are different from banks. Most countries' problems involve inadequate access to international liquidity and weak economic policies. Establishing the insolvency of a sovereign government is technically as well as politically challenging. This is a fact underappreciated by those excessively concerned about the moral hazard associated with IMF lending who want to rush countries into bankruptcy type solutions in order to punish the countries' political leaders and investors.

Turning to the financial component of the IMF's lender of last resort role, the challenge is that unlike national central banks the IMF cannot issue its own liabilities in unlimited amounts. It relies upon quota subscriptions from members and its ability to draw from the New and General Arrangements to Borrow or on *ad hoc* borrowing arrangements. These *ex ante* financial resources are roughly US$ 750 billion at present. However, the IMF requires the availability of financing on a much larger scale if it is to be credible in its role as the international lender of last resort. To that end, the G20 in Seoul should endorse a doubling of IMF quotas. In addition to providing the Fund with at least US$ 250 billion in new financing, bringing its total *ex ante* lending capacity with the enlarged New Arrangements to Borrow to US$ 1 trillion, a doubling of IMF quotas would have other advantages.

Doubling IMF quotas would rebalance the IMF toward its traditional structure of a quota-based international financial institution. It also would provide each member of the IMF in 2012 at the earliest, when the increase in quotas would most likely take effect, with an increase in its quota for the first time since 1998 – a period in which global GDP is projected to have increased by more than 125 percent, global trade more than 200 percent, and global financial transactions by substantially more than that. This would just match the historical average annual rate of increase of IMF quotas – 5 percent. But the IMF needs more financial resources if it is to enhance its role as the international lender of last resort.

Therefore, in addition, the G20 leaders in Seoul should encourage the IMF to put in place its ability to borrow in international capital markets, which is permissible under the Articles of Agreement. They should also endorse an amendment of the IMF Articles that would allow the IMF to approve a special, temporary allocation of SDR in a crisis, perhaps subject to endorsement by the International Monetary and Financial Committee (IMFC) and prior to action by the executive board, without requiring an 85 percent weighted majority vote of IMF governors. A reduced supermajority of, say, 60 percent might be required. The subsequent cancellation of the SDR over a five-year period would follow a declaration of the end of the crisis and might require only a majority vote.

Finally, the G20 leaders in Seoul should endorse an amendment of the IMF Articles of Agreement that would authorise the IMF temporarily to exchange specially allocated SDR to the central banks that issue the international currencies included in the SDR basket in exchange for their currencies, which the IMF would use to lend to other central banks specifically to support their financial institutions. This specific proposal has four advantages: (1) The mechanism would temporarily augment the IMF's financial resources as an international lender of last resort. (2) It would help to centralise in the IMF this type of lender-last-resort lending. At the height of the recent crisis, this type of support amounted to more than US$

600 billion via the swap lines of the Federal Reserve, principally, and the European Central Bank. It is at best uncertain whether the Federal Reserve will be comfortable in repeating such operations on a comparable scale in the future. (3) The mechanism would permit the issuing central banks to use the SDR to obtain foreign currencies if they need them to offset exchange rate pressures resulting from the liquidity support operations. (4) The mechanism along with the other features of my proposals would enhance the role of the SDR and hopefully limit somewhat the precautionary demand for increases in international reserves.

Regional and global liquidity arrangements for a more democratic and human world: The potential of SDRs

Pedro Páez Pérez

The new phase of the global crisis reinforces the urgent need for a different world monetary system. Without substantial reforms not only the possibilities of recovery are blocked but the deleterious forces and behaviours that led to the crisis will be strengthened. The deepening of that type of logic among the world's commanding heights could open a long period of degradation of civilisation by exacerbating the existing trends for more wars, conflicts, exclusion and social polarisation, waste, and environmental crisis.

The US dollar's monopoly of international liquidity helps to sustain global imbalances and, combined with financial deregulation, forces all non-hard-currency-issuer countries to accumulate reserves in a defensive way – thus nourishing the same dollar monopoly and sacrificing resources of productive investment, job creation, and wealth and welfare generation. The reinforcement of asymmetric macro and microeconomic responses in an overproduction scenario, besides the unfair anti-competitive outcome, further nuances the climate of international co-operation and fosters pressures for trade wars (under the form of currency wars, for example, with further parity misalignments).

The massive bailouts deployed by certain governments in favour of huge financial institutions contrasts with the technical, legal and even self-imposed restrictions created by the majority of countries. In the face of reduced investment opportunities and with growing concerns clouding confidence on the structural situation, those resources do not result in more credit, more jobs or more capabilities to create wealth, but in a metastasis of infectious assets and business practices and the multiplication of bubbles.

The deployment of these processes has triggered ferocious vectors that affect the basic mechanisms of market functioning. On one hand, crucial relative prices become structurally decoupled from the evolution of, for instance, reproduction costs or seasonal scarcities. In combination with the currency misalignment, the misleading effects on enterprises' and countries' investment perspectives and specialisation could result in large and painful future corrections with no guarantee of viable and sustainable allocations in the aftermath. On the other hand, the magnitude and capillarity of financial transnationalisation opens new sources of vulnerability due to moral hazard, lender of last resort, "creative accounting" and pervasive deregulation issues. The risks for financial and macroeconomic stability could compromise peace and democracy.

This essay proposes that in order to foster the construction of global public goods and a climate of co-operation, the global liquidity arrangements should incorporate the yearly issuance of special drawing rights (SDRs), without any austerity conditionality (except, perhaps, some "everything but weapons" condition) and at zero financial cost.

This is a technically viable option – should the political will be found – and one that would provide additional resources that would support policy space for national stimuli and reduction of debt acquisition.

The issuance of SDRs would also open up new perspectives for deploying South-South co-operation initiatives. For example, with small changes in the IMF's normative procedures, regional stabilisation funds and swap mechanisms could be supported with part of the members' SDR quota without the need to convert these SDRs into hard currencies.

Complementarily, the capabilities of such funds and swap mechanisms could be improved with a new repertoire of reserve assets like innovative schemes of natural resources management, as in the Ecuadorean proposal of "keeping the oil under the soil" for the Sarayacu and Yasuní regions. With such additional oxygen, it would be possible to reallocate national central bank reserves to define a regional system of hard currency cushions and the derived portfolio of regional reserve alternatives.

Moreover, the issuance of regional equivalents of SDRs (like the Latin American SUCRE) would be a complementary means of payments. Ideally, the "global" SDRs would be institutionally defined as part of a lender of last resort scheme for these regional arrangements. In turn, the regional arrangements could include also, *inter alia*:

- financial safety networks like that proposed for Latin America, directly connecting the national central banks through the electronic systems of payments, making available a technological platform for new services like a matrix of multilateral swap mechanisms among central banks (a departure from the Chiang Mai Initiative);
- the deployment of regionally-focused markets of liquidity (both for public and private agents) in order to eliminate the stigma still pending upon some open market operations and fiscal debt issuances in the South and to recycle the massive amounts of regional savings which usually fly with low nominal returns and high risks towards financial markets that are the epicentre of the structural insolvency crisis;
- the creation of new emergency credit facilities as insurance for fiscal and balance-of-payments needs.

With the adequate harmonisation of prudential regulation in banking as well as in the financial and exchange markets, these regional arrangements could have enough power and credibility to allow for a gradual convergence towards fixed but adjustable exchange rate systems in line with the long-term equilibrium of the trade balance, isolating the effects of capital account volatility. Several phases of convergence should be negotiated according to the economic and political conditions of each region, including dynamic macroeconomic policy co-ordination, potentially evolving into a system akin to the old European Monetary System.

Even with the same stochastic dynamic optimal control model and the same parameters of risk aversion and environmental uncertainty, the optimal accumulation of international reserves for each country must be reduced with these types of regional arrangements, freeing resources for productive investment and addressing goals of long-term regional, environmental and social sustainability through a new kind of development bank like the *Banco del Sur* Initiative for UNASUR (South American Union of Nations), with alternative priorities (regional sovereignty in food, energy, health care, science and technology, physical connectivity, financing of the heterogeneous popular economy, etc.) and new practices, including the use of domestic and regional currencies.

For the Northern countries, an allocation of SDRs is less important, since they can usually issue their own fully-convertible hard currency. In most cases, restrictions for macroeconomic and financial sovereignty are imposed by Northern countries from within rather than from without. New contents in the European construction in prioritising full employment policies could complete a different scenario of multi-polar, more democratic global governance.

Issuance of SDRs could open new types of North-South relationships, too, e.g. the donation of the North's quota of SDRs in order to fulfil the promise of increasing official development assistance to 0.7 percent of GDP. Few technical and normative changes are required to achieve this without financial cost, inflationary pressures or budgetary disputes (no country in the North has used the SDRs to finance the deficit). This would free funds in the order of US$ 150-200 billion per year that could be used for addressing the most pressing challenges, including support during humanitarian emergencies and natural disasters; achievement of the Millennium Development Goals such as the eradication of extreme poverty and hunger; and measures to counter environmental crises and mitigate climate change.

In sum, this alternative scheme that combines regional and global liquidity arrangements with the support of yearly issuances of new SDRs will open a new horizon of stability. But this also raises the prospect that it will be politically opposed by very powerful speculative interests that are currently profiting from the deepening of the crisis. Thus, several additional regulatory measures must be taken in order to make these efforts towards a New Global Financial Architecture politically viable. Among them, I would suggest:

- In order to immediately block the restoration of the blackmailing powers of the Old Financial Architecture (the IMF has given much more credit since autumn 2008 than in all previous decades), we need to channel all new resources that have been already promised or given to the IMF through a new window. This new window would operate in emergency terms (cheap and agile), without the neoliberal adjustment conditionality and with an alternative directory that would reflect a more democratic representation of the regions. A precedent to study in this regard is the Global Environment Facility within the World Bank.
- Provide developing countries with real capabilities for deploying counter-cyclical policies. It is urgent, in this regard, to create fiscal policy space through measures such as immediate external debt moratoria as proposed by UNCTAD and the generalisation of debt auditing processes (such as done in Ecuador) and the introduction of an International Debt Arbitrage Tribunal.
- Universally ban short-selling and other speculative mechanisms like specific credit default swaps, especially in the global food provision chain (seeds, products, inputs, etc. both in spot and future markets).
- Implement a universal definition of efficient and transparent capital regulations and raise a global, though nationally-collected, Financial Transaction Tax.

A suggestion for the IMF: Embrace regionalism

Raj M. Desai and James Raymond Vreeland

It is no secret that the governance of the International Monetary Fund (IMF) does not match economic reality and that the vote shares of emerging market countries do not reflect their economic strength. If the IMF does not make its governance more inclusive, it will (continue to) lose the support of emerging market countries. But if the power of the United States and Western Europe is diluted, they may be less inclined to support the IMF with additional funding in the future. Perhaps this is the signature of a multipolar world, where no one is strong enough to dominate at the international level – and regional hegemons emerge. If this is so, one potential solution for the Fund is to recognise the growing strength of regional organisations and find ways to engage and work with them.

Note that the need for change in IMF governance is recognised by those who dominate its Executive Board of Directors, but acceptable solutions have evaded them for years. The United States wants smaller Western European countries to accept smaller vote shares and to give up their Executive Directorships. Western Europe has called for the United States to give up *de facto* veto power over major decisions by reducing its vote share below the 15 percent threshold (major decisions at the IMF require an 85 percent majority). Yet the US Congress would not likely approve increased contributions to an IMF in which the United States has less say over the use of such funding. Western European countries would likely be in a similar bind. Would Belgium, the Netherlands, and Switzerland be able to generate domestic financial support for an IMF where they did not have seats on the Executive Board?

Any reduction in Western political and financial support would have to be met by an increase from the emerging market world. Certainly, emerging market countries have the foreign currency reserves to meet the task. But do they have the political will – or even the political interest to do so?

Emerging market countries have lamented for years the fact that they are underrepresented in voting power at the IMF – and rightfully so. China – the second largest economy in the world (having overtaken Japan) – has a smaller vote share than France (3.65 percent vs. 4.85 percent).[3] Belgium (GDP = US$ 470 billion) has 2.08 percent of the votes, while Brazil (GDP = US$ 1.6 trillion) has only 1.38 percent of the votes and India (GDP = US$ 1.2 trillion) has only 1.88 percent of the votes. Other factors beyond GDP definitely matter when it comes to "economic weight," but there is no realistic weighting that could support vote share apportionments in which France is stronger than China, and Belgium stronger than both Brazil and India – at least not without political machinations. But because an 85 percent majority of the current votes is required for any change to the voting structure, ma-

3 Small shifts in the vote shares that are occurring as we write notwithstanding.

jor shifts have been easily thwarted. Still, there have been incremental changes throughout the past decade. Slowly, the vote shares are coming into line with economic realities (see Vreeland 2007).

But are these changes too little too late? Do emerging market countries really even care about having a greater say in the IMF? Let us consider their actions when it comes to competing in the Executive Board elections, and contrast them with the actions of Western European countries. Every two years, the 187 member-countries elect the 24-member Executive Board of Directors. There is a kind of free market for Directorships.

By teaming up with other countries, Italy, which has 3.2 percent of the votes at the IMF by itself, ends up controlling 4.1 percent of the votes on the IMF Executive Board. This is more than China, which teams up with *no one*, and controls only 3.7 percent.

Belgium, which has 2.1 votes at the IMF by itself, teams up with several countries and ends up controlling 5.1 percent of the votes on the Executive Board, more than either the United Kingdom or France (which have 4.9 percent each). Up until this weekend, Belgium represented Austria, Belarus, the Czech Republic, Hungary, Kazakhstan, Luxembourg, Slovak Republic, Slovenia, and Turkey.

The Netherlands bloc includes a group of non-obvious partners: Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Macedonia, Moldova, Montenegro, Romania and Ukraine.

And then there is Switzerland. Since joining the institution in 1992, Switzerland has put together a coalition of states from Central Asia, Western Asia, Eastern Europe, and Southern Europe. This turns out to be important for global representation, since no Director comes from Central Asia or Eastern Europe.

Countries like China, which claim to want a stronger voice at the IMF, could have competed for the support of smaller countries – like Kazakhstan, for example. But what happened? Well, Kazakhstan's votes were up for grabs – Belgium lost them. But they were not picked up by a bloc led by an emerging market country. Rather, Kazakhstan joined the Swiss bloc. Instead of giving up its seat, as urged by the United States, Switzerland solidified its position.

How does Switzerland do it? Research indicates that foreign aid might be helping (Vreeland 2010), allowing money to be traded for political influence. Rich countries provide foreign aid to developing countries that offer political support at the IMF.

Why do the emerging market countries remain aloof from this game? We suspect that they simply do not care. Recent changes in vote shares may partially address the question of emerging-market representation, but not of the loss of confidence in the institution. In fact, since the global financial turmoil of the late 1990s and early 2000s, emerging markets have largely avoided IMF borrowing – partly due to collective memories of economic contractions and growing inequality during the periods of heavy borrowing in the 1980s and 1990s, and partly because most of these middle-income countries have been able to borrow from private capital markets. Since 2007, the IMF has concentrated the bulk of its lending on

European countries in distress. Of the US$ 90 billion in IMF current standby arrangements, over-three quarters of the money is committed to six countries: Greece, Hungary, Iceland, Latvia, Romania, and Ukraine.

Meanwhile, emerging market countries have been exploring regional alternatives to the IMF (and World Bank).[4] Last year, for example, Prime Minister Vladimir Putin called for concerted action to break the stranglehold of the US dollar and create a new global structure of regional powers (see Desai / Vreeland 2010). In East Asia, the Chiang Mai Initiative of the ASEAN+3 (the Association of Southeast Asian Nations plus China, Japan, and South Korea) may be a precursor to an Asian Monetary Union. Although much newer, the Union of South American Nations (UNASUR) – born from the convergence of MERCOSUR and the Andean Community, as well as President Hugo Chavez's proposed Banco del Sur and the Latin American Reserve Fund (FLAR) – are considered by many in the region to be necessary counterweights to the Bretton Woods Institutions. More recently, the African Union has proposed the establishment of an African Monetary Fund.

These regional options, however, still leave a constructive role for the IMF. Consider the European Union (EU), by far the most advanced regional organisation. Faced with issues of debt, the governments of the EU have turned to the IMF. They do not need the money – they need the institutionalised mechanism whereby liquidity is provided in return for policy reforms.

Similarly, the Chiang Mai Initiative does not obviate the need for the IMF: if a country needs to borrow more than 20 percent of the available swaps, it must submit to IMF guidelines on economic reform – a *de facto* "conditionality" intended to deter lax economic policies (see, e.g., Woo 2007). Unlike the Chiang Mai Initiative, the Banco del Sur designers insisted on a "no conditionality" clause, indicating that the Banco del Sur will determine the capacity of its members to borrow and will not place any restrictions on repayment beyond the established terms of the loan (McElhinny 2007). We are not convinced, however, that creditor-states, like Brazil, are going to be willing to contribute to a pool of funds that can be lent with absolutely no strings attached. If they do, they will be inviting moral hazard and inflationary pressures.

How will regional organisations navigate between providing liquidity and avoiding moral hazard? One avenue is to work explicitly with the IMF. There are various arrangements that one can imagine. One possibility would be for regional funds to set lending terms and conditions, while leaving monitoring and enforcement to the IMF. Alternatively a two-tiered system could be developed, where countries turn first to their regional organisations for short-term liquidity, and subsequently submit to IMF conditionality for longer-term lending (Johnson 2009; Subramanian 2010). Regional organisations are likely to have greater local knowledge of the financial and fiscal constraints and prospects of regional economies, yet

4 For a more thorough review of regional monetary funds, see Desai / Vreeland (s. a.). Also see McKay / Volz / Wölfinger (2010).

may be less willing to impose strict conditionality on their regional partners under stress than the IMF.[5] Ultimately, it may be incumbent upon regional monetary regimes to acquire the capacity to devise their own stabilisation programmes, conduct their own monetary co-ordination and surveillance, and to impose their own system of sanctions. The record of such regional arrangements – even in the most advanced case of the EU and its monetary arrangements – has been disappointing. But the regionalisation of the financial architecture is inevitable, both because financial regionalisation is demanded by emerging market economies, and because of the diminished relevance of global institutions such as the IMF to fast-growing regional economies.

In a multipolar world, current institutions of global governance are losing ground to regional organisations. A potential path for the old institutions is to recognise the growing strength of regionalism and find ways to engage with these regional counterparts.

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5 Particularly those that are politically important. See Kilby (2006) and Lim / Vreeland (2010).

The case for and experiences of regional monetary co-operation

*José Antonio Ocampo**

Most proposals on how to improve the global monetary architecture underestimate or altogether ignore the possible role of regional institutions. This is surprising in many ways. First, it ignores the fact that the new wave of globalisation is also one of "open regionalism." Second, Western Europe is widely recognised as a successful example of regional co-operation, which in the monetary area extends from the European Payments Union to the euro. Third, in the area of development financing, regional development banks have been recognised as an important part of the world institutional landscape since the 1960s.

In contrast to the tendency to overestimate the role of regional institutions, I argue here that the best global monetary arrangements for the world is a *network* of the IMF and regional reserve funds and swap arrangements among central banks, which can also serve as frameworks for a multilayered macroeconomic policy dialogue and eventual policy co-ordination.

The case for regional financial co-operation

Four major arguments can be made for a more active use of regional monetary arrangements. The first relates to the fact that the current globalisation process is also one of open regionalism. Intraregional trade and investment flows have deepened as a result of both policy and market-driven processes of regional integration. This calls for a world institutional architecture that takes into account this basic fact, as well as the heterogeneity of the international community.

A second argument is that regional reserve funds or swap arrangements could provide not only most of the exceptional financing for smaller countries within a region, but also part of the financing for larger countries, and thus help (at least partly) deter would-be speculators from attacking individual countries within a region. These forms of co-operation can equally serve as the framework for macroeconomic dialogue or stronger forms of regional surveillance and policy consultation that could internalise, at least partially, the externalities that national macroeconomic policies have on regional partners.

The third is an argument for competition, particularly in the supply of services to small and medium-sized countries. Owing to their small size, the power of these countries to negotiate with large organisations is very limited, and their most important defence is therefore competition in the provision of financial services to them.

The final argument, which regards a political economy order, relates to the fact that regional and subregional institutions enjoy a greater sense of ownership because member states, particularly small ones, feel that they have a strong voice in these organisations. This creates a special relationship between them and member countries. The "preferred-creditor status"

* This paper draws from J. A. Ocampo (ed.) (2006): Regional Financial Cooperation, Washington DC.: Brookings Institution and ECLAC.

that results from this fact reduces the risks that regional reserve funds face, further encouraging the virtues of risk pooling.

Of course, regional co-operation also faces significant challenges. The two most important ones are the capacity of a given group of developing (particularly low-income) countries to supply the relevant services; and the need to build strong professional institutions to manage such co-operation.

What this implies is that in designing a better global monetary architecture and, more broadly, a global financial architecture, it is unclear whether we should rely on a few global institutions. Rather, in some cases the organisational structure should be one of networks of institutions providing the required services on a complementary basis, while in others it should function as a system of competitive organisations. The provision of services required for financial crisis prevention and resolution should probably be closer to the first model, whereas in the realm of development finance, competition should be the basic rule (including competition with private agents as well). But purity in the model's structure is probably not the more desirable characteristic: it may be better for parts of the networks to compete against one another (for example, regional reserve funds or swap arrangements with the IMF in the provision of liquidity financing) and for rival organisations (development banks) to cooperate in other cases.

This implies that the International Monetary Fund of the future should be better viewed as the apex of a *network* of regional and subregional reserve funds and swap arrangements, an idea that I have defended for a over a decade. This model could be extended to the provision of macroeconomic surveillance and dialogue, as well as to the surveillance of national systems of prudential regulation and supervision, and to the development of the infrastructure for domestic and regional capital markets.

An institutional framework such as this would have two positive features. First, it would bring more stability to the world economy by supplying essential services that can hardly be provided by a few international institutions, owing both to the heterogeneity of the international community and to the dynamic processes of open regionalism under way. Second, from the point of view of the equilibrium of world relations, it could be more balanced than a system based on a few world organisations, as it would broaden in particular the participation of small countries.

The experiences of regional monetary co-operation

The best known case of regional monetary and, more broadly, macroeconomic policy co-operation is, of course, that of Western Europe. This process has been closely linked to trade and deeper economic integration, and has been accompanied by a strong emphasis on institution building, albeit in a gradual and pragmatic way. The major objective of macroeconomic co-operation was historically real exchange rate stability, which has been seen as the only way to create a level playing field for intraregional trade.

Since the breakdown of the Bretton Woods parities, this has generated a sequence of regional exchange rate arrangements, which eventually led to the European Monetary Union

(EMU) and to the creation of the euro. Prior to the euro, the defence of agreed parities implied the unprecedented commitment, if necessary, to defend the agreed parities with unlimited interventions. This rule implied that no explicit reserve pooling was necessary. The commitment to exchange rate stability implied that capital mobility was subordinated to that objective. This meant that capital controls were in place for decades, and were re-established when necessary. They were multilaterally removed only in 1990. This step was followed by a major crisis in 1992, along with the decision to move to a full-fledged monetary union. This was combined with the Stability and Growth Pact, which established explicit fiscal rules, a far less successful arrangement.

Contrary to Europe's history and equally rich background in the area of regional co-operation in development financing – particularly regional, subregional and interregional (Islamic Development bank) development banks –, there is a dearth of experience in the area of monetary co-operation in the developing world. This is despite the fact that, aside from the reasons that justified European monetary co-operation, two additional rationales are present in the developing world: building stronger walls of defence against global financial shocks, and avoiding distorting competition among export-oriented economies.

Experience with monetary unions has not been abundant, nor has it been always successful. The Eastern Caribbean Currency Union and the Rand Monetary Area have been relative successes, whereas similar arrangements in Western Africa have had a chequered history. Other arrangements have been in place for some time: particularly regional payments agreements, which reduce the need for foreign exchange to settle intraregional transactions and are thus particularly useful in mitigating the effects of foreign exchange scarcity on intraregional trade during crises. Initiatives have been abundant in recent years, involving macroeconomic dialogue and balance of payments financing. The most interesting initiative is, of course, the ASEAN+3 (ASEAN plus China, Japan and Republic of Korea) Chiang Mai Initiative. Pre-existing arrangements in this area are the Latin American Reserve Fund (FLAR for its Spanish acronym) and the ASEAN Swap Arrangement.

One way to view recent initiatives is that they break up monetary co-operation into its basic components: macroeconomic policy dialogue and eventual policy surveillance, liquidity support during crises, and exchange rate co-ordination. Given the frequency of shocks faced by developing countries, they generally eliminate (or, at least, significantly postpone in time) the desirability of the third component – which, as we have seen, was the major objective of European macroeconomic co-operation. This is even true in the case of those regions committed to some form of monetary union: the Gulf countries, the Caribbean Community, and the West African Economic and Monetary Union.

The two most successful experiences are in the area of liquidity financing: FLAR and the Chiang Mai Initiative. The experience of FLAR, made up of the five Andean countries plus Costa Rica and Uruguay, demonstrates that even a modest fund (with a subscribed capital of slightly over US$ 2 billion) can make essential contributions to the balance-of-payments financing of developing countries. Since 1978 FLAR has provided financing to member states which has exceeded that of the IMF for its smallest members throughout its history, and for the members as a whole during specific critical conjunctures (1982–1985 and 1998–2005). Its financing was clearly countercyclical, speedier than that of the IMF, and its preferred-creditor status has been reflected in its healthy portfolio, even in the face of two major crises in the region, when some member countries accumulated arrears in their public sector obligations. It also shows that the fear that "soft conditionality" would result in major losses by an institution providing emergency liquidity financing is exaggerated.

The most ambitious project of this kind is the Chiang Mai Initiative. The agreed mechanism was originally the negotiation of bilateral swap arrangements among the central banks of member countries. To do this, it built on the modest ASEAN Swap Arrangement, which had been created in 1977. Aside from liquidity financing during crisis, the mechanism has provided an instrument of policy dialogue. Surveillance is also deemed essential by net contributors, particularly Japan, and counts with the precedent of the ASEAN surveillance process. The decision to fully multilateralise this arrangement and increase its size in 2009 was a major step forward. If it leads to some form of reserve pooling, it could be used to back a common reserve currency that would be certainly be demanded as a reserve currency in other parts of the world.

Conclusions

The global financial architecture should rely more broadly on regional institutions. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions will provide a better system of governance than arrangements based on a single global organisation. This in turn is based on the well-established principle that regional institutions give a stronger voice and a sense of ownership to smaller countries, and are more likely to respond to their demands. This has already been recognised in some areas, such as the system of multilateral development banks.

The creation of such an institutional network is particularly urgent in the monetary arena, where regional institutions remain limited in scope and have not been recognised as central to the international financial architecture. The IMF should therefore make more active use of regional institutions, such as FLAR and the Chiang Mai Initiative, and support their creation in other parts of the developing world. Indeed, the IMF of the future should be positioned at the apex of a network of regional reserve funds and swap arrangements rather than remaining the unique global institution it currently is. To encourage the development of regional reserve funds, incentives could be created giving them automatic access to IMF financing or a share in the allocation of Special Drawing Rights (SDRs) proportional to their paid-in resources, or both.

It could be added that, in an era when developing countries have large foreign exchange reserves and have called for greater South-South co-operation, financial co-operation should be placed at the top of the agenda. These countries could use those reserves more actively for swap arrangements among central banks, pooling them in reserve funds, or using them to support the development of regional bond markets, among other things.

Rivals or allies? Regional financing arrangements and the IMF

*Julie McKay and Ulrich Volz**

Regional and bilateral financing arrangements have gained increasing importance over the past decade, not least during the recent global financial crisis. This has important consequences for the role of the International Monetary Fund (IMF) as a crisis lender and also raises questions regarding the relationship between these arrangements and Fund lending.

At the 2007 Annual Meetings of the International Monetary Fund (IMF), Guido Mantega, the Brazilian Minister of Finance, made clear the demand of emerging market economies for a greater say in the governance of the IMF, and the role that regional financing arrangements (RFAs) could play in the future if IMF governance reforms are not deemed satisfactory by developing and emerging market economies: *"Developing countries"*, he said, *"would go their own way […]. We will seek self insurance by building up high levels of international reserves, and we will participate in regional reserve-sharing pools and regional monetary institutions. The fragmentation of the multilateral financial system, which is already emerging, will accelerate."* (Mantega 2007, 3)

In the three years that have passed since 2007, the word economy has been rocked by the global financial crisis. The Fund, which had been written off by many, has re-emerged as a vital multilateral institution. Since 2007, its lending capacity has been expanded from US$ 250 billion to US$ 900 billion, and its outstanding credit has ballooned from US$ 2 billion to US$ 195 billion. However, even though the Fund reacted quickly and decisively during the crisis and its lending policy differed markedly from the prescriptions it gave during previous crises, it is still struggling to regain trust and credibility among its developing country members.

Since the series of crises in emerging markets over the last three decades, in which many countries had to undergo painful adjustment programmes, these countries have sought to avoid a situation where the Fund has to be called to the rescue by bolstering first and second lines of defence – foreign exchange reserves and regional financing arrangements, respectively. Due to a combination of prudent economic management and a long period of benign global monetary conditions that lasted until summer 2007, many countries succeeded in building up large foreign exchange reserves as a first line of defence in the event of a crisis. East Asia has gone further and developed an RFA that is becoming ever more sophisticated, in effect, strengthening a second line of defence.

The growing importance of regional and bilateral financing arrangements gives rise to a number of issues concerning the future and integrity of IMF crisis lending, one of the IMF's key roles. The overarching question is whether regional arrangements will supplement or

* The views presented in this paper are those of the authors and do not necessarily reflect those of the European Central Bank (ECB). This paper is based on McKay / Volz / Wölfinger (2010).

supplant IMF lending to a country with a balance-of-payments crisis. Will RFAs augment Fund financing by making larger sums available for disbursement? Or will they enable countries in balance-of-payments crises to bypass the Fund entirely? If the answer to the latter is yes, do they provide a healthy dose of competition for the Fund in the provision of crisis financing, or do they have the potential to undermine the very stability of the international monetary system by undercutting Fund conditionality with an insufficiently rigorous economic management and lax lending requirements, which leave open the risk of crisis exacerbation and contagion? Could they lead to a weakening of economic policy, making standards through conditionality shopping? Such questions addressing the roles of RFAs and their relation with the Fund have become even more important in the face of recent discussions about the creation of a European Monetary Fund as a reaction to the Greek debt crisis.

In a recent paper (McKay / Volz / Wölfinger 2010), we investigate these questions and evaluate the RFAs currently in existence. We define an RFA as an arrangement within which a group of countries pledges financial support to members of that group that are experiencing balance-of-payments problems, either through a pool of contributed or borrowed reserves or through the swap of financial assets (usually foreign exchange reserves).

We consider six features to be of particular importance to RFAs in providing effective crisis financing: (i) the size of the financing pool or resources accessible; (ii) timely access to relevant information; (iii) high quality analytical expertise; (iv) speed in decision-making; (v) impartiality in lending decisions; and (vi) mechanisms for monitoring and enforcing conditionality. We assess various existing RFAs against these criteria, as well as the IMF as the benchmark case. Advanced country arrangements include the European Union's trilogy of the Medium-term Financial Assistance (MTFA) Facility, European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), and the North American Framework Agreement (NAFA). We also scrutinise the Chiang Mai Initiative (CMI) that was launched in 2000 by 13 East Asian countries; the Latin American Reserve Fund (FLAR), which was created in 1978 (under the name of Andean Reserve Fund, FAR) and today has seven member countries; as well as the Arab Monetary Fund (AMF), which was founded in 1976 and has 22 member countries in the Gulf region.

Based on our review of how the IMF and the various RFAs fulfil the criteria for optimal financing arrangements we make some tentative observations. First, some arrangements bear striking resemblances to the IMF in terms of organisation, governance structure, decision-making processes and lending facilities, but on a smaller scale. This attests both to the key importance of certain elements for crisis financing, and the quality of the model employed by the IMF, notwithstanding its imperfections and lack of appeal in some regions.

Second, the IMF can be described as the best all-rounder, combining a huge body of professional staff for analysis and monitoring, as well as (recently increased) resources that will enable the Fund to continue to assume a major role as an emergency lender worldwide. Moreover, the way in which its programmes are designed is conducive to enforcement.

Third, a comparison with RFAs shows that these also have their comparative advantages. In particular, RFAs have potentially quicker access to data, stemming from the stronger sense of ownership that members often feel with the RFAs – something that is notably lacking in the IMF's developing and emerging market economy membership. The Fund, given its outsider status, may not get access as quickly as an RFA. Moreover, RFAs can be expected to have superior information about an economy in crisis and react more quickly to address the situation. Due to less formalised or rigid lending procedures and the smaller number of parties involved, RFAs are potentially faster in their lending decisions, although the Fund has taken measures to improve in this area, too. On the flipside, RFAs often have at their disposal smaller lending amounts. Compared with the IMF, RFAs tend to be less well equipped with technical expertise, although this might be offset by more detailed regional or local knowledge. Also, RFAs may lack both the expertise to define a policy course which targets external sustainability and the amount of funding necessary to reassure markets.

The existence and increasingly prominent role of RFAs has potentially important implications for international monetary stability. Based on the evaluation of RFAs, there are several risks that RFAs pose, as well as benefits.

Regarding the benefits, RFAs can provide quick support in case of liquidity shortfall in a country facing a crisis, which could help prevent a crisis from deepening and spreading. Augmenting Fund financing through speedy disbursement by RFAs can help in preventing or combating crises. In some cases RFA lending might suffice to ward off a fully-fledged crisis; in others it might buy time for a comprehensive programme with the Fund to be negotiated, i.e. the lending would complement the Fund's assistance.

Furthermore, RFAs can help improve a regional policy dialogue and improve incentives for strengthened regional co-operation. RFAs can also contribute to global stability by promoting a "put your own house in order" strategy at the regional level as well as through improving country and regional surveillance.

Regional peer considerations under the framework of an RFA may better safeguard resources due to a mix of peer pressure, strong sense of ownership and smaller information asymmetries at the regional level. To the extent that RFAs do not lend out "other people's money" but the region's own resources, this might reduce moral hazard problems and create stronger incentives to act responsibly in the prevention and management of crises. If conditionality is attached to lending, RFAs might be able to convey a stronger ownership for necessary reforms.

Last but not least, RFAs might contribute to greater international stability by providing alternative approaches to crisis management. That is, a "competition for ideas" between the RFAs and the IMF might lead to better overall policies.

There are, however, also potential risks for stability stemming from a prominent role of RFAs. First of all, the lack of distance between lenders and borrower might create a situation where not enough pressure will be created on the borrowing government to address structural weaknesses. (The decision by European countries to bring in the IMF as part of the Greek rescue package may be seen in this light.)

Governments of crisis countries might be inclined to "conditionality shop", that is, borrow from the financing arrangement that attaches the weakest conditionality to its loan (or none at all). This might lead to a deferment of necessary reforms and increase the danger that the crisis will eventually lead to even bigger problems. Owing to the greater risk of symmetric shocks among countries of the same region, risk-sharing gains may be smaller when membership is constrained to a regional basis. (A counter example would be the Arab Monetary Fund, comprising net oil importers and exporters.) Indeed, regional contagion effects may be too swift and overwhelm an RFA. Moreover, evaluating the risk and containing potential spillover effects of an initially local or regional crisis to other regions might go beyond both the mandate and capabilities of an RFA. Since extra-regional externalities that are not adequately addressed by an RFA have the potential to cause problems in other regions, the "global public good" of global macroeconomic and financial stability might be better safeguarded by an institution whose mandate is not limited to just one region. Also, a lack of credibility of RFAs or loan amounts which are too small to restore market confidence, along with a lack of clout with outside private sector institutions, might backfire and delay crisis resolution. Getting the IMF involved too late might make it harder for both the Fund and the RFAs to deal with a deeper crisis.

While RFAs can clearly be constructive in preventing or combating financial crises, the main dangers for financial stability arise if an RFA operates against the Fund rather than with or alongside it. Whether RFAs will *complement* the Fund or rather *complicate* the Fund's work depends on how they are set up. A healthy *competition* for surveillance and ideas could well contribute to overall international financial stability. In contrast, unhealthy competition – where RFAs erode the Fund's standing by undermining its authority and allowing countries in balance-of-payments crises to bypass the Fund entirely – has the potential to undermine the stability of the international monetary system. Consequently, it would be highly desirable to explore how to create or increase synergies between the various regional arrangements and the IMF. This is a promising avenue for further research and policy formulation.

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Policies to bridge regional and global financial arrangements

Kati Suominen

The G20 placed the International Monetary Fund (IMF) at the centre of its efforts to tame the global financial crisis, tripling the Fund's lending capacity and refurbishing its mission and instruments. However, as the world economy recovers, the Fund is facing difficult questions about its legitimacy and effectiveness. One of the main challenges is a spectre of disintegration of the global financial architecture into regional and bilateral arrangements – right when globalisation of the world economy and crises alike calls for system-wide management.

The epicentre of the issue is Asia. Amid the 2008-09 global crisis, the 13-member Chiang Mai initiative conceived in the wake of the 1997-98 Asian financial crisis was expanded to a total of US$ 120 billion, and it was "multilateralised" – a step expected to lead to the construction of an Asian Monetary Fund. But Chiang Mai is hardly *sui generis*; there are a number of other, even if not as prominent and/or widely discussed regional funds in Europe, the Americas, and the Middle East,[6] and Europeans and Latin Americans have recently discussed deeper regional financial integration. In addition to regional efforts, crises have frequently spawned bilateral, *ad hoc* lending arrangements. For example, in the latest crisis, Korea and Singapore turned to Japan and China for emergency lines outside the Chiang Mai system, and Korea performed its largest, US$ 30 million swap arrangement with the US Federal Reserve.

Thus far, Chiang Mai has had a link to the IMF: borrowers can draw up to 20 percent of their bilateral or multilateral swaps, but then need to agree on an IMF programme, including prescribed policy adjustments, to access the remaining 80 percent. As such, Chiang Mai is much more tightly referenced to the Fund than European and US regional rescue schemes – Europe's balance-of-payments facility, Medium-Term Financial Assistance, and the Treasury's Exchange Stabilisation Fund employed mostly within the Western Hemisphere – ever were.

But given US and European powers in the Fund, their schemes have had a built-in consistency with the IMF. Asians, with less weight at the Fund, do not necessarily agree on the body's policies, and may be more eager to go it alone. Yet, a divorce between the IMF on the one hand, and Chiang Mai and/or other such regional schemes, on the other, would risk conflicts and gaps between Fund and regional responses to crises, an outcome problematic for global financial stability. Furthermore, regional or bilateral rescues not predicated on similarly rigorous conditions for good macroeconomic governance as demanded by the Fund would perpetuate poor policies in the borrower nations and increase moral hazard. More generally, relying on regionalism alone would compel the Fund members to forego the benefits unique to the Fund as a genuinely multilateral instance:

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6 See McKay / Volz / Wölfinger (2010).

- The IMF economises sovereign insurance. Pooling insurance multilaterally among the Fund's 187 members is more efficient than accumulating reserves unilaterally or even pooling resources regionally.
- The Fund's surveillance and research of the global economy is something regional funds would not and could not replicate.
- The Fund's global expertise and accumulated experience in shepherding crisis-struck economies is practically impossible to match at the regional levels.
- The IMF provides global policy leverage to its members, something regional funds delinked from the Fund would not give to the outsiders. Conversely, the Fund can provide members to a regional arrangement with access to outside policy advice and credible enforcement mechanism.

Building complementarities between regional and global arrangements

Regional funds can be a force of good. They can serve as the first line of defence in regional crises, and their surveillance can supplement the Fund's analyses and alleviate its propensity for group-think. The division of labour is desirable as long as it leads to prompt crisis management and policy recommendations based on common international principles and aimed at national and global financial stability. Regional "rapid-reaction", "first responder" funds would also help the Fund weather crises beyond its means, reduce competing claims on its resources, and turn down some of the political heat for IMF rescues incurred by one administration after the next in the United States, the Fund's largest shareholder.

At the same time, a global economy requires global institutions and global co-ordination. Assets and policies need to be aligned, and spreading thin avoided. How to best reconcile the rise of regional arrangements with the need for a global financial architecture? The G20 should consider four immediate, complementary steps:

- The G20 needs to fashion a clear set of principles to guide the relationships among the IMF, regional financial facilities, and any bilateral arrangements in lending to troubled economies. The principles should address both money and policy – i.e. sequencing of the allocation of the funds from the different instances and potential cost-sharing among them, as well as co-operation between the Fund and regional authorities in designing country programmes and enforcing policy conditionality. Such principles are imperative for ensuring fluid and prompt co-ordination in the most testing of times. Granted, reforms to Fund quotas and board can help enhance emerging markets' buy-in for a complementary relationship between the IMF and regional funds. But crises afford little time to define what that relationship exactly is. Formal, *ex ante* specification is needed.
- The G20 should recommend that the IMF study and make recommendations on a range of further, less formal mechanisms to foster synergies between Fund and regional financial mechanisms and enhance a sense of ownership among regional economies – ad-

vanced or developing – of policies impacting their part of the world. For example, the members of a regional fund could be given committee status to set the agenda or pre-approve IMF packages for the regional economies.[7] Or, they could gain voting shares in proportion to their contributions to the regional fund in IMF decisions concerning their region.

- The G20 should encourage the IMF and regional financial authorities to agree on formal channels and partnerships on surveillance and economic analysis so as to ensure two-way information flows and to avoid duplicating some of the more menial efforts, such as data collection. (However, overlap is useful on surveillance and analysis.)
- The G20 should instruct the IMF to explore ways in which any future bilateral financial arrangements could be co-opted to the Fund. Truman (2009) proposes that the Fund charter be modified to allow the Fund to enter into short-term arrangements with national central banks to swap SDR for key national currencies in the global financial system – the US dollar, the euro, yen, pound, and Swiss franc. The currencies would then be used to fund the IMF's short-term lending facility. Such a centralised system would replace bilateral lending operations of national central banks, reducing uncertainties and enhancing consistency in approaches in the event of crisis, and lowering risks to all nations.

Incubating best practices globally and regionally

In the longer-run, the G20 needs to effect reforms to make the IMF into a more effective shock absorber and stabiliser in the global economy. For most of its lifespan, the Fund has served as a tool for global economic surveillance and crisis insurance. But today, financial markets dwarf governments, and the elusiveness, frequency, cruelty, and global reach of crises overwhelms governmental and multilateral bodies' capacities to respond. At the same time, expanding the Fund much further is politically difficult and would risk increased moral hazard. These considerations point to three more paradigmatic reforms:

- The Fund should prioritise crisis prevention or containment by explicitly rewarding good behaviour. One way to do that is by providing tangible rewards, such as technical assistance and support for countries' international lending operations, for national policies conducive to financial stability.[8] Such policies include not only good rules and sound economic management, but greater financial openness, an instrument of financial development.[9] While decidedly political, such a reward system could incentivise good behaviour around the world and pre-empt moral hazard.

7 See, for example, Lipscy (2009).
8 Truman (2009) makes a rather similar argument.
9 For a discussion, see Hufbauer / Suominen (2010); Fischer (1998) and Summers (2000). Even if controversial, the Fund could very usefully be made to promote open capital accounts. See Truman (2009).

- The Fund should be made into a bridge between private and public insurance markets, a notion already explored by Fund staff.[10] The Fund is in a unique position to overcome market failures that have kept private actors from insuring sovereigns. For example, it can perform rigorous surveillance on country risk, including any one country's susceptibility to external shocks, to inform private markets. It could also pool country-specific risks in a diversified portfolio, reducing pricing and creating economies of scale that lower underwriting costs.
- In particular, the Fund could readily provide advice to its members on ways to use hedging instruments employed in private markets (Mateos y Lago et al. 2009). Such fresh insurance strategies would not only keep the Fund relevant for furthering stability without placing heavy demands on its lending capacities; they could also help depoliticise the Fund and future rescues, and even make reserve hoarding less palatable.

All such reforms can be applied also at the regional levels. Indeed, regional funds could serve as laboratories and incubators of new practices, the best of which could then be multilateralised. Multilateralising regionalism is a major topic in global trade matters, where regional trade agreements have proliferated in the past two decades in an *ad hoc* fashion alongside, yet uncoordinated by, the GATT/WTO system. However, multilateralising the countless regional trade agreements now in place, or even somehow converging them into broader integration areas, is proving extraordinarily thorny. The G20 has a chance to avert such a development in global finance by systematising and institutionalising the relationship between the multilateral architecture and incipient and future regional and bilateral financial arrangements.

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10 For this and an overview review of other proposals, see Mateos y Lago / Duttagupta / Goyal (2009).

Regional financial safety nets and the IMF

*C. Randall Henning**

Regional financial facilities have been increasing in size and importance over the last several decades. The question as to whether the emergence of these facilities reinforces or undermines the multilateral efforts to defend financial stability has been the focus of considerable scholarship and policy analysis. The creation of new facilities and the reinforcement of existing ones in the wake of the 2008–2010 global economic crisis, however, establishes that regional financial arrangements and the IMF will coexist for some time to come. From the policy standpoint, the more immediate question is how to ensure that the Chiang Mai Initiative Mulitlateralisation (CMIM), European Financial Stability Facility (EFSF), and other regional financial arrangements (RFAs) cooperate effectively with the IMF, and vice versa, in future crises.

This chapter discusses the case for co-operation between RFAs and the IMF, underscores the importance that this co-operation be organised on an *ex ante* basis, and offers some general and specific suggestions for doing so.

The fundamental case for co-operation between RFAs and the IMF rests on four basic rationales.[11] First, the existence of multiple institutions lends itself to forum shopping and institutional arbitrage. Competition among institutions might be desirable in some areas, but this does not extend to specification of the adjustment measures that might be necessary in country programmes. Co-ordination is necessary to prevent institutions attaching conflicting conditions to their financial support. Second, while some redundancy might be desirable in the international financial architecture, duplication should be deliberate and minimised. Third, multiplicity of financial facilities raises the possibility that what one contributes might be removed by another facility. Inter-institutional co-ordination is necessary to ensure that resources provided at one level are additional rather than substitutes for resources provided at the other level.

Finally, there are mutual gains to be derived from division of labour and specialisation along lines of comparative advantage at the two levels. Whereas regional institutions might have better local knowledge and ownership, for example, multilateral institutions might be less vulnerable to backlash against austere conditionality. For a region that relies on unanimous approval of members by popular referenda for projects of integration, imposing domestically unpopular policy conditions might be politically risky however necessary they might be in economic terms. In such cases, the IMF might have a clear comparative advantage in specifying macroeconomic conditions as well as in expertise.

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11 See, among others, IMF (2010, paragraphs 34–6); Eichengreen (2006, 32–33); McKay / Volz / Wölfinger (2010); Henning (2002).

While most analysis would probably agree with this fundamental case, however, there might be lingering disagreement over whether co-operation should be organised on an anticipatory, *ex ante* basis or can safely be left to *ad hoc* design after a country encounters a sudden stop. The informal, flexible conventions that have guided IMF-European co-operation in recent cases in Central and Eastern Europe worked reasonably well. But it would be risky to continue to rely on *ad hoc* arrangements in the future; a more systematic, *ex ante* set of principles and procedures is needed, for four reasons. First, the size and number of RFAs in increasing, as noted above. Second, the frequency and severity of crises is unlikely to abate. Third, domestic political resistance to large financial packages increasingly constrain policymakers, who would otherwise be predisposed to cooperate.

Finally, the successful co-operation between the Fund and the European Union in the crises in Central and Eastern Europe and Greece is not likely to transfer easily to other regions. East Asia, Latin America and the Middle East, for example, (i) are not as well represented in the IMF as Europe, and (ii) do not have in the person of the Managing Director someone with knowledge of the inner workings of the region as that is as intimate as the present Managing Director's knowledge of Europe and the euro area. Both of these factors greatly facilitated co-operation in these recent cases.

Note that, as successful as Europe's co-operation with the IMF has been, the region also offers a chastening example of the possibility of co-operation failure. At the outset of the Greek funding problems, European authorities had no regional instrument with which to respond to financial crises within the euro area. When the Greek crisis struck, European authorities struggled over whether to respond on a regional basis alone or jointly with the IMF. The delay in turning to the IMF during February-April 2010 was expensive: the size of the Greek package required to calm the markets rose from the neighbourhood of € 30 billion to €110 billion and a TARP-sized package became necessary to stem contagion to other countries in the Southern tier. The episode illustrates the potential costs of co-operation failure and the value of ex ante arrangements among institutions.

The member countries of organisations at both levels, especially those represented in the G20, should mandate RFAs and the IMF to organise co-operation on an ex ante basis with respect to several areas, including the following five.

1. **Surveillance.** The IMF can (a) brief regional bodies on the outlook and vulneratibilities, (b) provide technical assistance in setting up regional surveillance mechanisms, and, perhaps more ambitiously, (c) include officials from regional secretariats in Article IV missions.
2. **Co-financing.** Lending terms and conditions should be coordinated in joint programmes and the machinery for doing so articulated in advance. Regional facilities that link explicitly to IMF programmes can deem Flexible Credit Line (FCL) and Precautionary Credit Line (PCL) qualification to satisfy that link.

3. **Transparency.** To facilitate public understanding, market credibility and inter-institutional co-operation, regional financial facilities should adopt a level of transparency that is similar to that of the IMF (see Henning 2006).
4. **Review.** In order to identify any potential conflicts between these arrangements and the IMF, all members of the IMF should agree to present their regional facilities to the IMF Executive Board.
5. **Representation.** RFAs should create clear and coherent mechanisms for representing themselves to the IMF and other third parties. For its part, the IMF (and other international financial institutions) should create clear channels through which to receive the representation of regional bodies.

I have earlier suggested that these points be adopted as a formal code of conduct by the members of the IMF. Such a code could leave considerable room for accommodating the substantial differences among RFAs and thus the comparative advantage of the IMF. Considerable progress can nonetheless be made under less formal conventions between regional arrangements and the Fund. Officials from the Fund and European and Asian institutions, among those of other regions, are discussing the modalities of their co-operation. They deserve the active support of their members for expeditious progress on this agenda.

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Regional funds: Paper tigers or tigers with teeth?

Barry Eichengreen

Balance-of-payments insurance is all the rage. The Asian financial crisis of 1997-8 and more recently the global financial crisis of 2008-9 impressed upon policy makers the advantages of ample foreign-currency reserves and ready access to foreign currency lines of credit as protection against volatile capital flows and balance-of-payments shocks. Emerging markets have accumulated reserves hand over fist. And given recent instability, who can blame them?

But reserve accumulation is expensive, while arranging foreign currency credit lines through the obvious source, the IMF, is potentially embarrassing. Herein lies the attraction of regional reserve pools. Reserve pooling is less costly and more efficient than each country relying entirely on its own war chest of reserves – so long, as seems plausible, that the participants do not all need to tap the pool at the same time. And as partnerships among neighbours, regional reserve pools are agreements among equals; in particular, one can imagine that accessing them would not force anyone into the embarrassing position of having to approach the IMF.

Invoking this logic, East Asian countries are continuing to elaborate the Chiang Mai Initiative (now the Chiang Mai Initiative Multilateralisation, or CMIM). The Latin American contributors to the Fondo Latinamericano de Reservas (FLAR) are contemplating how to turn their fund into a proper regional reserve pool. One suspects that similarly discussions are underway, or soon will be, among the members of the Arab Monetary Fund (AMF).

Yet one worries that these arrangements are just paper tigers – that, in terms of balance-of-payments insurance, they offer less than meets the eye. The amount of lending in which they engage ranges from slim to none. Hence countries, when seeking insurance, continue to turn to other sources. When South Korea desperately sought dollar liquidity following the failure of Lehman Brothers, it arranged for a US$ 30 billion credit with the Federal Reserve rather than requesting activation of the Chiang Mai Initiative. Colombia, rather than seeking to significantly enlarge the FLAR, has signed up for a Flexible Credit Line with the IMF.

It is no mystery why these regional arrangements are not a serious alternative to national reserve accumulation on the one hand and IMF facilities on the other. First, they are undersized. The US$ 120 billion of swaps available under the CMIM is not to be sneezed at, but it is small relative to the reserves of China, Japan or even South Korea. And it is not clear that a substantial fraction of the pool would, in fact, be available to any one participating country. And the AMF and FLAR's US$ 3 billion and US$ 2 billion of paid-up capital, respectively, are mere drops in the bucket. For regional reserve pooling to be a consequential alternative or even to meaningfully supplement other forms of insurance will require considerable scaling up.

Second, creating a pool without creating regional surveillance capacity is a recipe for a pool that will never be used. Governments will be willing to lend to their regional neighbours only if they have a reasonable expectation of being repaid. This will require ascertaining whether the borrower's problems are the result of illiquidity or insolvency. It will require determining what policy adjustments are required on the part of the borrower and monitoring their implementation.

FLAR has an Economic Studies Division that could, in principle, develop into such a surveillance bureau. But developing it will require more staff, more independence, and more access to confidential information. The AMF has a professional staff as well, but its existing surveillance capacity is subject to the same limitations. The most significant step in this direction is the agreement by the members of CMIM to establish an ASEAN+3 Macroeconomic Research Office (to be known as AMRO) in Singapore. This is a start, but AMRO's staff is small, and its remit is limited. Even the name, which refers to the new entity as a "research" office, indicates a tendency to shy away from giving AMRO concrete oversight of national policies.

Finally, lending requires conditionality in all but the most exceptional circumstances of a pure liquidity crisis. The expectation of being repaid, which is a prerequisite for lending, will require policy adjustments on the part of the borrowers, which the lenders will want to see specified at the outset. This is delicate business. There is understandable reluctance on the part of neighbours to impose painful conditions on one another. There may be a history of border conflict. There may be ethnic tension. Or the country setting down the conditions may just worry that it will be next.

In Southeast Asia, the resulting hands-off approach to regional co-operation even has a name, "the ASEAN way". While it may not glorified by a name, there is no question but that the same attitude prevails in Latin America and among the Arab countries. Can you imagine the Venezuelan government imposing conditions on Colombia, or vice versa?

But while this light-touch approach may suffice to support co-operation on other issues, it is not adequate for the maintenance of confidence in the cooperative approach when large amounts of cash are on the barrelhead.

This is a problem even in Europe, where co-operation is most extensively and deeply institutionalised. There the realisation that EU loans to Greece would come with painful conditions reawakened memories of Germany's World War II occupation of its neighbours, with the result that the negotiation of conditions was outsourced to the IMF. But this is no solution in Asia, where approaching the Fund remains tantamount to political suicide for any democratically-elected government.

There is no finessing the point. If countries are serious about establishing regional funds that make a meaningful contribution to global financial stability, they will have to ante up real money. They will have to create self-standing institutions with the capacity to engage in meaningful surveillance. And they will have to give the independent directors of those institutions, or someone else, the power to set the conditions that will be attached to emergency loans. Then we would have regional funds with teeth and not merely paper tigers.

"EMF in IMF" instead of "EMF versus IMF"

Daniel Gros

A simple proposition

Regional financial safety nets make sense whenever regional financial integration is particularly strong. The best example for this is the euro area. In this case it makes eminent sense to create a regional safety net. But a proliferation of regional safety nets might create coordination problems and it might leave important areas of the world that are not part of highly integrated regions without a safety net.

The global financial safety net could thus be built like a pyramid with the International Monetary Fund (IMF) at its apex. Regional systems would take care of their own members who could pool their resources and IMF membership. For countries not members of any regional scheme, the IMF would continue to provide a financial safety net as before.

The purpose of financial safety nets is to provide its members with access to credit during times of systemic crisis and thus avoid a race by everybody to insure the home country against adverse financial shock by running current account surpluses and accumulating reserves. The purpose of the official European safety is net is somewhat different: funding from the European Financial Stability Facility (EFSF) will be available only as a last resort, i.e. when the government of the country in difficulties has lost access to credit markets. Moreover, the creditor countries in the euro area are determined to make the conditions for access to the funding from the EFSF as tough as possible to minimise moral hazard problems. The European approach is thus completely different from the one taken by the IMF which has tried to make its facilities as attractive as possible to minimise any "stigma" attached to having recourse to these facilities.

The real safety net in the euro area is de facto the European Central Bank (ECB) which through its normal monetary policy operations has provided banks in countries like Greece or Ireland with financing amounting to over 30 percent (at a very favourable interest: 1 percent). This function of the ECB as a de facto regional safety net constitutes a further argument in favour of the set up proposed below.

How could the European financial safety net be integrated into the global system?

The eurozone should be close to the stage at which its own financial safety net could be integrated as a building block into the global financial architecture. The euro area has now an explicit financial safety net and it has common institutions which should enable the euro area to be effectively represented at the IMF.

The rough framework for the proper representation of the euro area in the IMF in the long run is well known: in the end the only sensible long term solution would be for the euro area countries to pool their IMF quotas (see Table). The euro area would then have one seat on the Executive Board. The representation could be split between the political level, with the Executive Director nominated by the euro group, and the alternate (in effect the deputy of the Executive Director) nominated by the ECB. In this way, both the fiscal and monetary authorities of Europe would be forced to cooperate in shaping their input into IMF decisions. Many countries (including Germany) have followed this "double headed" approach.

Table: IMF quotas of euro area member countries

Member	Millions of SDRs	Millions of EUR	Percent of total
Austria	1,872	2,203	0.86
Belgium	4,605	5,418	2.12
Cyprus	140	164	0.06
Finland	1,264	1487	0.58
France	10,739	12,634	4.94
Germany	13,008	15,304	5.98
Greece	823	968	0.38
Ireland	838	986	0.39
Italy	7,056	8,301	3.24
Luxembourg	279	328	0.13
Malta	102	120	0.05
Netherlands	5,162	6,073	2.37
Portugal	867	1,020	0.40
Spain	3,049	3,587	1.40
Slovenia	232	273	0.11
Slovak Republic	358	421	0.16
Total euro area	50,393	59,286	23.17

Source: IMF

However, given the scant interest of member countries to transfer further competences (and juicy international positions) to the EU level, this long run proposal seems indeed rather remote. Is there something that could be done even given the current political environment?

Until recently the euro area countries did not have a vehicle to pool their quotas at the IMF (assuming they wanted to avoid entrusting the ECB with an essentially fiscal task). However, Europe now has a "Special Purpose Vehicle" (SPV, a formally private sector entity with a legal seat in Luxembourg, but under the control of euro area finance ministers), which is to finance itself by issuing debt on the capital market. This debt will not constitute "euro bonds" since it is not guaranteed jointly and collectively by member countries. Instead each member country will guarantee only its share of the total debt of the SPV.[12]

12 To be precise: each member country guarantees a share of the total borrowing of the SPV which is equal to its share in the ECB multiplied by 1.2. In this way the total borrowing of the SPV would be "over-collateralised" by about 20 percent. This was necessary to achieve a AAA rating for the debt by an institutions not all of whose backers are themselves AAA rated. In essence the debt of the SPV will be a sort of rudimentary CDO.

In principle the EFSF should obviate for the need for financial support from the IMF for euro area member countries. However, when the EFSF was created over a dramatic weekend last May, the main creditor country insisted on IMF involvement because it feared that the European institutions would not be able to impose tough conditionality on their own. This is something that could and should be changed, for example by entrusting conditionality either to an independent arm of the Commission; or by creating a European Monetary Fund as proposed by Gros and Mayer (2010). Moreover, the SPV would probably have to be transformed from a private law company into some official body of the EU.

Moreover, the magnitudes of the IMF involvement in the Greek package (and the contribution to the EFSF pencilled by the Europeans) are much larger than one could justify if the IMF were to use its usual limits[13] and criteria for emergency lending.[14] In Europe the IMF is really not providing balance of payments support, but provides emergency financing to governments who have difficulties refinancing themselves on market, which is not the core mandate of the IMF.[15]

There is thus a priori no fundamental reason why the IMF should be involved in intra-euro area rescue operations. However, the euro area could still rely on IMF financing if member countries agree to transfer "use" of their quotas to the SPV. In the case of Greece, for example, euro area member countries could have agreed to "lend" Greece the use of their quotas.

This (perhaps temporary) pooling of the quotas of euro area member countries when needed would have one big advantage also for the European creditor countries: In an emergency the SPV could then rely not only on the funds it can raise in the markets. It could also call for IMF loans, which could be proportional to the joint quotas of the euro area members. IMF loans could be contracted by the SPV or go directly to the country in need and would be subject to the usual conditionality. Given that the joint quotas of the euro area member amount to roughly € 60 billion, there would thus have been no problem in mobilising the about € 110 billion needed by Greece. Even the € 220 billion pencilled in for the IMF by the EU would not be impossible observing the multiples of the quota normally applied by the IMF and given the huge increase in quotas that is currently being discussed, which might increase the combined quota of euro area countries to about € 120 billion. Details of the coming quota increase should be agreed soon.

13 The amount that a country can borrow from the Fund, known as its access limit, varies depending on the type of loan, but is typically a multiple of the country's IMF quota. This limit may be exceeded in exceptional circumstances. The Flexible Credit Line has no pre-set cap on access. See IMF (2010).

14 *"The FCL is for countries with very strong fundamentals, policies, and track records of policy implementation"* (IMF 2010). The last condition was certainly not fulfilled in the case of Greece.

15 From the IMF (2010) website: *"When can a country borrow from the IMF? A member country may request IMF financial assistance if it has a balance of payments need – that is, if it cannot find sufficient financing on affordable terms to meet its net international payments".*

A euro area member country that needs to go to the SPV (which would then refinance itself via the IMF, as discussed above) would then agree that its voting rights at the IMF would be exercised by the Eurogroup. This would represent a first, perhaps temporary, way in which the representation of the euro area at the IMF could be unified.

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Regional financial co-operation in East Asia

*K. S. Jomo**

In the aftermath of the experiences of the 1997-98 East Asian crises, there is growing appreciation of the desirability of regional monetary co-operation in the face of growing capital mobility and the increasing frequency of currency and related financial crises. Co-operation among governments in the region is considered more likely to be effective than national actions in the face of the larger magnitude and velocity of capital flows. However, there is no single formula or trajectory for fostering such co-operation, and it is unlikely that such co-operation can be successfully promoted independently of co-operation on other fronts.

Background

Soon after the crisis broke out, in September 1997, the Japanese Ministry of Finance proposed a US$ 100 billion Asian monetary fund or facility – dubbed the AMF – to help cope with the crisis. The initial official Chinese response seemed negative, as Beijing had not been consulted and may have been wary of Japanese intentions of strengthening regional hegemony. But the Chinese authorities have since been very keen on enhancing such regional co-operation. Japanese Finance Vice-Minister for International Affairs Sakakibara had presumed US support for the scheme after briefing his counterpart, Summers, but instead faced rebuffs from the US as well as the IMF. In November 1997, the US convened, but offered few resources to, its preferred Manila Framework Group; these resources had little perceptible effect as conditions continued to deteriorate.

Only in mid-1998 did the Clinton administration call for a "new international financial architecture", to better avert and manage the increasing frequency of currency and financial crises following international financial liberalisation. The Russian crisis of August 1998 moved the US to action. Besides the need to prop up the Yeltsin regime, there was a palpable fear that the East Asian crisis was spreading westward and threatening other economies closer to home.

US Fed co-ordination of the ostensibly private sector "bail out" initiative to contain the collapse of the Long Term Capital Management hedge fund following the Russian crisis was awkward to explain after the preceding criticism of Asian bail-outs as evidence of cronyism. Soon after, the Fed lowered interest rates, encouraging funds to flow back to the region, stabilising its currencies, and facilitating a sharp V-shaped recovery, except in Indonesia where new political dynamics compromised the economic recovery effort.

* The views expressed here are those of the author and do not necessarily represent those of the United Nations. They have been revised from "Whither the East Asian Flying Geese? Prospects for Regional Integration in East Asia", my Sir Patrick Gillam Lecture at the London School of Economics, 28 November 2005.

By the time of the annual IMF-World Bank meetings in October 1998, Japanese Finance Minister Miyazawa's new initiative for Asia was warmly welcomed by the US as the prospect of Latin American crises loomed large. The *quid pro quo* was for Japan to fund a new short-term IMF facility to bail out Latin American countries as the US Congress appropriated US$ 18 billion for an IMF capital increase. The Miyazawa initiative offered bilateral assistance of up to US$ 30 billion in the form of loans and credit guarantees to help revive the region's crisis-hit economies. Most importantly, it complemented IMF assistance and was not linked to any alternative multilateral institutional framework for regional co-operation on monetary and financial matters. In the following year, the Japanese extended currency swap backup facilities to the South Korean and Malaysian central banks.

Regional responses to the 1997-98 financial crises may actually have reflected growing nationalism in the region inasmuch as the absence of helpful responses by the West caused consternation and resentment.

Regional diversity and co-operation

Southeast Asia is more culturally diverse than East Asia, with national boundaries defined largely during the Western colonial period. The Association of South East Asian Nations (ASEAN) was set up in 1967 to promote economic and cultural co-operation, though it has little to show in the latter regard. The first ASEAN industrial projects were Japanese-financed after a spate of anti-Japanese protests in the region in the mid-1970s, while agreement to create the ASEAN Free Trade Area (AFTA) only came in 1992, with implementation uneven and partly delayed since then.

Ironically, ASEAN has become less relevant even as it became more regionally inclusive by allowing Vietnam, Laos, Cambodia and Myanmar to join its ranks. By the late 1980s, following the yen appreciation, the East Asian region was poised for greater regional co-operation despite lingering resentment of Japanese hegemony due mainly to Japan's unwillingness to atone for its wartime record. Following the failure to conclude negotiations at the Uruguay Round of GATT (General Agreement on Tariffs and Trade) in December 1989, Malaysian Prime Minister Mahathir famously called for an East Asian Economic Grouping. Earlier, Japanese Prime Minister Nakasone's proposal for East Asian economic co-operation had been referred to the US for approval by the Australian government. The US response was to insist on "Pacific rim" co-operation in the form of APEC (Asia-Pacific Economic Co-operation), which, critics claim, has little to show for itself besides colourful annual "photo ops" after a start in the mid-1990s.

The decline of APEC has been apparent since the second half of the 1990s. The Western, especially American, response to the 1997-98 regional financial crisis only served to deepen the Pacific gulf. East Asians even perceived some western glee at the end of the Asian miracle following the Japanese slowdown after its financial "big bang" less than a decade earlier, as both IMF and market responses quickly blamed the East Asians themselves for the debacle.

The experience of the 1997-98 East Asian regional financial crisis and the international responses to it reshaped the region. This is apparent not only in the greater official interest in East Asian – as opposed to Asia-Pacific or Pacific rim – regional co-operation in recent years. As noted earlier, ASEAN itself may have lost some of its earlier relevance and dynamism following its expansion inasmuch as AFTA has failed to deliver on the unrealistic expectations it generated earlier.

Yet the seemingly awkward "ASEAN + 3" East Asian regional arrangement – including the ten ASEAN members, China, Japan and the Republic of (South) Korea – has quickly attained an unexpected political as well as economic relevance.

Regional monetary co-operation

From 1999 on, the ASEAN+3 finance ministers began meeting annually in conjunction with the Asian Development Bank (ADB) Board of Governors' meetings. At their second meeting in Chiang Mai in May 2000, the ministers announced new arrangements to increase liquidity in the event of future currency crises by expanding the pre-existing ASEAN Swap Agreement and setting up a bilateral currency swap network involving Japan, China and South Korea. Efforts have also been made to enhance related monitoring, surveillance and training. However, countries need to have an IMF-supported programme in place before they can avail themselves of more than 10 percent of the available funds. Hence, there are fears that the funds actually available are even less, and can barely be expected to withstand concerted speculative attacks.

Most importantly, the arrangements have remained formally bilateral, rather than multilateral, with many bilateral currency swap agreements still not actually signed yet! In May 2005, the ASEAN+3 finance ministers finally agreed to multilateralise the arrangement to enable the relevant bilateral agreements to be collectively activated more promptly in case of emergency. They also increased the disbursement permitted without an IMF programme from 10 to 20 percent. In May 2007, the finance ministers of Japan, China and South Korea agreed to accelerate multilateralisation of the arrangement and to increase the available funds. The Chiang Mai Initiative Multilateralisation (CMIM) was officially endorsed by the ASEAN+3 finance ministers in March 2010, with a total amount of US US$ 120 billion. Moreover, an agreement was reached to create an ASEAN+3 Macroeconomic Research Office (AMRO), which will be set up in Singapore.

The memory of the Asian crisis has encouraged several East Asian economies to develop "self-insurance" – or more accurately self-protection – arrangements against the threat of currency crisis by accumulating huge foreign exchange reserves, mostly held in the form of US Treasury bonds. Such self-insurance is undoubtedly very expensive, not only because of the low interest rates accruing to such bonds and the continuing decline of the greenback in recent years, but also because it diminishes funds which might be better deployed for more productive purposes. Recognition of the continuing problems of global and regional hegemony has animated recent debates about possible alternative arrangements.

The Asian bond market was launched in mid-2003 by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). They launched a one billion dollar Asian Bond Fund to invest in US dollar sovereign and quasi-sovereign bonds issued in EMEAP countries except Japan, Australia and New Zealand. Later that year, the ASEAN+3 launched the Asian Bond Market Initiative to provide the necessary infrastructure for a well-functioning regional bond market. Subsequent developments suggest slow, but steady progress in local currency bond market development. Further development of the Asian bond market will broaden financial intermediation within the region, encouraging the recycling of funds within the region, while reducing vulnerability to "currency mismatch" problems.

The two main regional initiatives thus far – the elaborate bilateral currency swap arrangements for liquidity support and the regional bond market – hardly threaten global hegemonic interests. In fact, development of the regional bond market has secured support from those outside the region who are eager to benefit from its expected by-products, including financial liberalisation and reform in ASEAN+3 economies. After all, the US dollar remains the anchor currency for most Asian monetary authorities which still maintain currency pegs.

However, governments in the region are mindful of the possibility of certain powers using regional initiatives to their own advantage, thus impeding greater regional co-operation. During 2001-2, for example, there were claims that Japanese Finance Ministry officials were trying to use the ASEAN+3 cooperative framework to promote a yen-centred regional exchange rate regime. The promotion of the yen as the region's common currency was seen as an attempt to revive Japanese financial markets, i.e. to promote regional integration through the prism of Japan's national interests rather than through the prism of greater regional collective interests.

There have also been other regional financial co-operation initiatives. In early 2005, the Executive Secretary of the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) proposed the creation of an Asian Investment Bank (AIB), patterned after the European Investment Bank, to more effectively mobilise private funds to finance the region's annual infrastructure financing needs, then estimated by the Japan Bank for International Co-operation at around US$ 200 billion but since revised over three-fold upwards. The ADB currently provides a small fraction of that amount on concessionary terms. The AIB proposal has been recently discussed at the G20 among other places. Such a regional infrastructural investment financing facility – drawing on private sector funds, but available to sovereign borrowers on better terms than otherwise available on commercial financial markets – can also increase financial intermediation within the region besides helping to recycle funds for more productive uses.

Concluding remarks

The existence of regional arrangements offers an intermediate alternative between national and global levels of action and intervention and reduces the otherwise likely exclusive global authority of multilateral institutions or arrangements. To be successful and effective, such regional arrangements must be flexible but credible and capable of effective counter-cyclical macroeconomic management and crisis prevention as well as management.

A major problem in East Asia is the relatively poor understanding of and little agreement on past successes as well as failures. This has meant that post-crisis economic liberalisation policy reforms have sometimes continued despite increasing international criticisms of the Washington Consensus. There is also far too little meaningful regional co-operation in East Asia in cognizance of the region's diversity, characteristics and environment.

East Asian financial co-operation and the role of the ASEAN+3 Macroeconomic Research Office

*Masahiro Kawai**

Introduction: Key issues

The Asian financial crisis of 1997-1998 and its spread across the region revealed several important points: financial systems and economic conditions were closely linked across East Asia; Asians should not rely solely on the International Monetary Fund (IMF) for crisis management; and a regional self-help mechanism needs to be created to effectively prevent and manage financial crises.

Recognising this, the finance ministers of ASEAN+3 countries – the ten Association of Southeast Asian Nations (ASEAN) members, plus China, Japan, and Korea – embarked on several new initiatives for regional financial co-operation in 2000:

- regional economic surveillance (Economic Review and Policy Dialogue – ERPD);
- a regional liquidity support arrangement (Chiang Mai Initiative – CMI); and
- Asian bond market development initiatives.

The global financial crisis of 2008–2009 again demonstrated the need to strengthen East Asia's regional financial co-operation. Although the crisis affected many East Asian countries mainly through the trade channel, it created shortages of international liquidity in some countries, such as Korea and Indonesia. Korea encountered significant capital flow reversals in the aftermath of the Lehman collapse in September 2008 and saw a rapid loss of foreign exchange reserves and sharp currency depreciation. Unwilling to go to the IMF or the CMI for liquidity support, the Korean authorities chose to secure a US$ 30 billion currency swap line from the United States (US) Federal Reserve System. This had an immediately positive, stabilising impact on the financial and foreign exchange market.

In this paper I summarise the progress of recent financial co-operation in the region – including the launch of CMI Multilateralisation (CMIM) and the decision to set up an ASEAN+3 Macroeconomic Research Office (AMRO) – and explore the challenges in strengthening the ERPD, CMIM, and exchange rate policy co-ordination. I argue that a strong ERPD and CMIM would eventually lead to the de facto creation of an Asian monetary fund (AMF; see, for detail, Kawai 2010).

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Progress on East Asian financial co-operation

Economic Review and Policy Dialogue and AMRO

The ERPD is a regional economic surveillance process designed to contribute to the prevention of financial crises through the early detection of irregularities, vulnerabilities and systemic risks, and the swift implementation of remedial policy actions. It is intended to facilitate: analysing economic and financial conditions of the global, regional, and individual national economies; monitoring of regional capital flows and financial market developments; and providing policy recommendations for undertaking necessary national policies as well as joint actions on issues affecting the region. The expectation was that countries would implement more effective macroeconomic and financial sector policy at the national level as a result of peer pressure, and would pursue policy co-ordination if needed.

Without strong institutional support for such surveillance, however, the ERPD process has not been as successful as initially expected, although gradual improvements have been made over time. The quality and depth of ERPD discussions at the deputies' level have indeed improved partly thanks to the economic reviews provided by international financial institutions – such as the ADB and IMF – and by external experts. But the ERPD has not achieved much beyond simple "information sharing". Another problem is the absence of central bank governors in the process,[16] even though central bank deputies have been participating in ASEAN+3 finance deputies' meetings. Recognising these problems, the ASEAN+3 finance ministers decided to create a surveillance unit in charge of regional economic surveillance, AMRO, in Singapore. The AMRO is expected to: (i) monitor, assess, and report on the macroeconomic situation and financial soundness and vulnerabilities in any of the ASEAN+3 countries, (ii) provide assistance in timely formulation of policy recommendations to mitigate macroeconomic and financial vulnerabilities, and (iii) ensure compliance of swap requesting parties with the lending covenants under the CMIM agreement.

Chiang Mai Initiative Multilateralisation

The CMI is a regional liquidity support facility which is intended to reduce the risk of currency crises and manage such crises or crisis contagion. After establishing a network of bilateral swap agreements among the key ASEAN+3 countries, the authorities began to enhance the functioning of CMI – and ERPD – and to multilateralise the CMI. After step-by-step agreements, the CMIM was officially implemented in March 2010, with the total size of US$ 120 billion. Member contributions, borrowing limits and voting powers were decided (see the table on page 52); Japan and China would contribute 32 percent each, Korea 16 percent and ASEAN 20 percent. China, Japan and Korea would be eligible to borrow up to US$ 19.2 billion each; Indonesia, Malaysia, Philippines, Singapore and Thailand up to US$ 11.38 billion each; Viet Nam up to US$ 5 billion; Cambodia up to US$ 0.6 billion;

16 Central bank governors in the region have been collaborating through the Executives' Meeting of East Asia Pacific Central Banks (EMEAP), which is separate from the ASEAN+3 finance ministers' process.

Table: Financial contributions, borrowing agreements, and voting power under the Chiang Mai Initiative Multilateralisation (CMIM)

	Financial contributions		Borrowing agreements			Voting power			
								Total	
Members	Amount (US$ bn)	Share (%)	Multiplier	Maximum borrowing amount (US$ bn)	IMF de-linked portion (US$ bn)	Basic votes (no.)	Votes based on contributions (no.)	Votes (no.)	Share (%)
Plus Three Countries	**96.00**	**(80.00)**	**0.60**	**57.6**	**13.20**	**4.8**	**96.0**	**100.8**	**(71.59)**
China	38.40	(32.00)	0.5	19.2	5.52	1.6	38.40	40.00	(28.41)
PRC[(a)]	*34.20*	*(28.50)*	*0.5*	*17.1*	*3.42*	*1.6*	*34.20*	*35.80*	*(25.43)*
Hong Kong[(b)]	*4.20*	*(3.50)*	*0.5*	*2.1*	*2.10*	*0.0*	*4.20*	*4.20*	*(2.98)*
Japan	38.40	(32.00)	0.5	19.2	3.84	1.6	38.40	40.00	(28.41)
Korea	19.20	(16.00)	1.0	19.2	3.84	1.6	19.20	20.80	(14.77)
ASEAN[(c)]	**24.00**	**(20.00)**	**2.63**	**63.1**	**12.62**	**16.0**	**24.0**	**40.0**	**(28.41)**
Brunei Darussalam	0.030	(0.025)	5.0	0.15	0.030	1.6	0.030	1.630	(1.158)
Cambodia	0.120	(0.100)	5.0	0.60	0.120	1.6	0.120	1.720	(1.222)
Indonesia	4.552	(3.793)	2.5	11.38	2.276	1.6	4.552	6.152	(4.369)
Laos	0.030	(0.025)	5.0	0.15	0.030	1.6	0.030	1.630	(1.158)
Malaysia	4.552	(3.793)	2.5	11.38	2.276	1.6	4.552	6.152	(4.369)
Myanmar	0.060	(0.050)	5.0	0.30	0.060	1.6	0.060	1.660	(1.179)
Philippines	4.552	(3.793)	2.5	11.38	2.276	1.6	4.552	6.152	(4.369)
Singapore	4.552	(3.793)	2.5	11.38	2.276	1.6	4.552	6.152	(4.369)
Thailand	4.552	(3.793)	2.5	11.38	2.276	1.6	4.552	6.152	(4.369)
Viet Nam	1.000	(0.833)	5.0	5.00	1.000	1.6	1.000	2.600	(1.847)
ASEAN+3	**120.00**	**(100.00)**	**1.01**	**120.7**	**25.82**	**20.8**	**120.0**	**140.8**	**(100.00)**

Source: The Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers' Meeting, 2 May 2010, Tashkent, Uzbekistan.

Notes: (a) PRC refers to the People's Republic of China.
(b) Hong Kong's borrowing multiplier is 2.50, but its borrowing limit is the IMF de-linked portion, that is, US$ 2.1 billion (=US$4.2*2.50*0.20) or 50 percent of the financial contribution (=2.50*0.2), because Hong Kong is not a member of the IMF.
(c) ASEAN refers to the Association of Southeast Asian Nations.

Myanmar up to US$ 0.3 billion; and Brunei Darussalam and Laos up to US$ 0.15 billion each. One may note that these borrowing limits are not necessarily large in comparison to the individual countries' potential needs.[17] In particular, Indonesia's borrowing limit under the CMIM turns out to be less than the borrowing limit set under the former CMI bilateral currency swap arrangement.

Another important feature of the CMIM is that a crisis-affected member requesting short-term liquidity support can immediately obtain financial assistance up to an amount equivalent to 20 percent of the total borrowing limit,[18] with the remaining 80 percent provided to the requesting member under an IMF programme. Linking the CMIM to an IMF programme and its conditionality was designed to address the concerns that the liquidity shortage of a requesting country may be due to fundamental policy problems, rather than a simple liquidity shortage, and that the potential moral hazard problem could be significant in the absence of rigorous conditionality. Essentially, the CMIM is generally intended for crisis lending and hence requires conditionality. The lack of the region's capacity to formulate and enforce effective adjustment programmes in times of crisis was a reason for requiring the CMIM to be linked to IMF programmes.[19]

One of the reasons Korea did not go to the CMI for liquidity assistance in the fall of 2008 was that the amount of funds needed for the country would have triggered a link with IMF programmes. This would have created political problems within the country due to the negative perceptions of the IMF stemming from its operations in the 1997-1998 financial crisis. Another reason was that the Korean authorities neither considered the turbulence in the fall of 2008 to be a crisis – meaning that the CMI could not have been used, since it was designed for only crisis situations – nor regarded the size of possible CMI funding as adequate for the country. Korea was fortunate in being able to secure a US Federal Reserve currency swap line, but Indonesia was rejected by the Federal Reserve.[20] This illustrates the importance of strengthening the regional financing arrangement that is accessible to countries that are fundamentally sound.

17 At the time of the Asian financial crisis of 1997–1998, Indonesia, Korea and Thailand borrowed US$ 21.2 billion, US$ 35 billion, and US$ 17.2 billion, respectively, excluding the second lines of defence. CMIM borrowing limits are much smaller than these amounts.

18 Initially the IMF-de-linked portion of the CMI was 10 percent and it was raised to 20 percent in May 2005.

19 Some ASEAN+3 members, such as Malaysia, believe that the CMI/M should not be linked to IMF programmes.

20 Although Indonesia did not face a currency crisis in the aftermath of the global financial crisis, it had some difficulty funding its fiscal needs internationally and the rupiah depreciated sharply. In order to cope with potential financial turbulence, the country obtained US$ 5.5 billion in 2009 through a "standby loan facility" – or "deferred drawdown options" – with the funds provided by Japan, Australia, the Asian Development Bank, and the World Bank. Thus, multilateral development banks and bilateral agencies played a critical role in helping Indonesia to secure financial resources for budgetary support.

Policy challenges

There are several key policy challenges required for ASEAN+3 policymakers to make the ERPD and CMIM more effective.

Strengthening the ERPD and CMIM

An important challenge is to strengthen the CMIM and ERPD in order to reduce, and ultimately dismantle, the IMF link so that emerging East Asian countries can use the CMIM in crisis or near-crisis situations. The key is to create conditions to promote further IMF delinking. For this purpose, the newly established surveillance unit, AMRO, should be given adequate resources so that it can conduct effective regional economic surveillance (ERPD) and eventually become a strong permanent secretariat for CMIM that would provide liquidity support to member economies at times of financial and currency turmoil. The AMRO should acquire the capacity and credibility to formulate its own lending conditionality – independent of IMF programmes – in the event of CMIM activation.

Although the ERPD has clearly passed a simple "information sharing" stage, it is still in its infancy stage of "peer review and peer pressure" in comparison to the renowned "peer review" mechanisms developed by the Organisation for Economic Co-operation and Development (OECD) – such as the Economic Development Review Committee, the Economic Policy Committee, and Working Party 3. The region must make a concerted effort to move to a more rigorous "peer review and peer pressure" stage. Further, if the CMIM is to be significantly enhanced, the ERPD process must take an additional step into a "due diligence" stage which would involve assessment of a potential borrower from the perspective of potential creditors (see Kawai / Houser 2008).

More concretely, the following actions are needed:

- Enlarge the size of CMIM so that a sufficient amount of liquidity is provided to countries in need;
- Introduce new instruments, such as precautionary credit facility for a near-crisis situation;
- Clarify rules for activating CMIM lending, including the possibility of providing precautionary (or non-crisis) lending and eschewing policy conditionality in the event of externally- or herd behaviour-driven financial turbulence or crisis;
- Establish a joint forum for finance ministers and central bank governors to intensify policy dialogue;
- Provide adequate resources to AMRO in order to make it a strong professional secretariat, with the analytical expertise and policy experience which it requires to enable it to support regional economic surveillance (ERPD), activate the CMIM, and formulate conditionality independently of the IMF; and
- Strengthen ERPD by moving beyond the simple "information sharing" stage to a more rigorous "peer review and peer pressure" stage, and eventually to a "due diligence" stage, in order to improve the quality of economic surveillance.

Once these actions are taken, a new *de facto* AMF would emerge capable of conducting effective surveillance, providing international liquidity in the event of a crisis or near-crisis, and formulating and monitoring policy conditionality.[21] However, it may take some time to achieve these objectives and, during a transition period, a flexible use of CMIM for precautionary lending should be provided without conditions should a country face the type of financial turbulence that Korea experienced in the fall of 2008.

Exchange rate policy co-ordination

Growing economic integration that has strengthened macroeconomic links across East Asia suggests the increasing importance of intraregional exchange rate stability. Furthermore, given that East Asia – comprising mainly the ASEAN+3 countries – is projected to become the world's largest economic bloc by 2020, it is natural to expect this region to eventually develop its own monetary system.

The impetus towards regional exchange rate policy co-ordination may come sooner rather than later – should the US dollar depreciate sharply against East Asian currencies. With its robust economic recovery from the global financial crisis, the prospect of monetary policy tightening in East Asia, and the abundant liquidity injected by advanced economy central banks, large amounts of capital are already flowing into Asia. To maintain macroeconomic and financial stability in the face of persistent capital inflows, an economy should mobilise necessary policies, including stringent macroprudential measures, fiscal policy restraint, and a certain degree of exchange rate appreciation. If currency appreciation vis-à-vis the dollar and the euro is to be accepted in East Asia, this had better be done collectively, while maintaining intraregional rate stability, so that the costs of adjustment can be spread among the regional economies and kept to a minimum for each.

To facilitate such co-ordination, the region's authorities must become more serious about policy dialogue concerning capital flows, exchange rates and macroeconomic management. The AMRO must support this dialogue by using a set of economic and financial data, including Asian currency unit (ACU) indexes. Greater convergence of exchange rate regimes would be needed 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 type of policy co-ordination has the potential to form the basis of a future East Asian monetary zone.

21 A full-fledged AMF can be said to be created if a large part of the CMIM financial resources is centrally administered – rather than self-managed by individual authorities – and the AMRO becomes a more structured secretariat with a staff size commensurate with the economic size of East Asia.

Conclusion

East Asia can contribute to the stability of global finance by achieving sustainable economic growth and financial stability through a strengthening of regional liquidity (CMIM) and surveillance (ERPD) arrangements. The objectives of CMIM are: (i) to address short-term liquidity problems in the region; and (ii) to supplement the existing international financial arrangements.

Progress in strengthening the CMIM and ERPD would require more co-operation and decisive action. ASEAN+3 finance ministers and central bank governors need to work closely to strengthen their policy dialogue and co-operation. AMRO should become an effective surveillance unit with sufficient resources and expertise so that it can help transform the ERPD from the “information sharing” to the “peer review and peer pressure” stage, and then to the next stage of “due diligence” – a more rigorous scrutiny of a potential debtor economy. The CMIM needs to be expanded in size, should be de-linked from IMF programmes, and must offer more instruments − including precautionary credit lines − so that it can be activated in times of near-crisis.

The next challenge would be to explore how an independent CMIM (or a future AMF) should work with the IMF. Some of the collaborations between the two would include: a joint article IV surveillance; a joint Financial Sector Assessment Program (including also the ADB); and a joint liquidity support operation when considered appropriate. But for the last type of collaboration to become realistic, significant governance reform of IMF would be necessary in order to gain the trust of Asian economies towards the institution.

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Regional financial cooperation: Its role in supporting intra- and inter-regional South-South trade

Aldo Caliari

Regional liquidity arrangements cannot only take the form of improved mechanisms for liquidity supply. In fact, regional mechanisms for reducing the demand for liquidity, particularly for intra-regional trade operations, may be just as important. It can be argued that this aspect warrants more attention than it currently receives in international policy discussions. This is particularly so in the light of the side-benefits that such forms of cooperation can bring, and even more if they are put into perspective of the relative simplicity and limited resources that they need to be put in place, compared with liquidity supply arrangements.

One of the important insights that the global financial and economic crisis drove home is, undoubtedly, the high benefits that redoubled work on regional monetary and financial cooperation arrangements carries for developing countries.

Although the global financial and economic crisis affected developing countries in very uneven ways, to the extent that it affected them, the main channels at work were trade and trade-related, rather than directly financial ones. This is not surprising considering that the financial crisis brought a sharp contraction of world trade, the largest seen since the 1930s Great Depression, and the fact that developing countries exports-to-GDP ratio increased from being about a quarter of their GDP in 1995, to being more than half of their GDP in 2007.

The structure of trade, its diversification in terms of markets and products has been an important factor explaining the impacts of the crisis in developing countries. In terms of the export base, countries that had more diversified export profiles were better able to weather the crisis than countries dependent on few products. In terms of markets, countries that were less exposed to the markets of industrialised countries were also better positioned to weather the impacts of the crisis than those that were highly reliant on the export to the US and Europe.

This has important consequences for the future. The latest projections show that the recovery is going to be slower in the advanced countries than in the developing and emerging markets. This means that increasing South-South and intra-regional trade continues to be an advisable path for developing countries in the near term.

It is against this backdrop, that furthering regional financial and monetary arrangements acquires a new relevance. One form of regional cooperation whose potential would be important to explore is the establishment of systems for regional cross-border payments in domestic currency, accompanied by clearing unions and regional units of account – the latter composed of baskets of regional currencies, rather than traditional reserve or “hard”’ currencies. Such systems allow importers and exporters to price and pay their transactions in local currency, with central banks compensating the operations carried within a certain period and settling the remaining debt in hard currency at a pre-specified date.

Regional exchange rate stability

While obviously this form of regional cooperation would not solve exchange rate stability issues at the global level, it would support the relative stability of exchange rates within a region, and as far as regional trade is concerned.

A disturbing pattern that remains unaddressed in the international monetary system has been the emergence of extreme and growing fluctuations of the exchange rates among the main reserve currencies. Because intra-regional trade tends to also be denominated in hard currencies, oftentimes the trends among major currencies get imported into intra-regional trade.

To the extent that settlements in regional cross-border payments in domestic currency can be made with reference to domestic baskets of currencies, they offer the potential to delink intra-regional trade from hard currencies, thereby contributing to preserve relative stability of prices, and currencies, in a region.

Intra-regional trade and diversification of markets

The existence of mechanisms for payments in domestic currencies also provides an incentive for diversification of destination markets. Cutting the need to use hard currency reduces transaction costs for exporters and importers, and the stability of prices facilitates planning and investment. As a result, the mechanisms for regional cross-border payments can boost intra-regional trade, simply by virtue of their capacity to make such trade easier and simpler.

Diversification of products

In turn, the diversification of destination markets is likely to also lead to a diversification of products and the potential for developing non-traditional export sectors. Indeed, intra-regional trade exhibits greater shares of exports of manufactures, including higher proportions of high skill and technology products, so incentivising more intra-regional trade seems to offer a ready path to also increase the diversification of the export basket.

Trade finance

The sharp contraction of trade finance that was suffered under the recent financial crisis acted as a quick transmitter of the financial shock into developing country economies. The systems for cross-border payments in domestic currency also act as a mechanism for trade finance, but without the costs of obtaining trade finance lines from commercial banks, and without the exposure to sudden shocks that may be motivated in factors exogenous to the region in question.

The important role that clearing unions as alternative mechanisms for providing trade finance can play in times of need was in evidence in the Asian Clearing Union (ACU), where transactions among members increased by 32 percent from 2007 to 2008. The Governor of the Bangladesh Central Bank attributed this increase to the fact that *"ACU member central banks standing behind their commercial banks in each and every intraregional trade settle-*

ment under ACU eliminate settlements risks, with no need for expensive credit confirmation lines from international banks" (Rahman 2009). The increase, however, was from a very low base, which begs the question of what is the actual potential of these mechanisms beyond emergency times, a question on which more research is needed.

Contribution to global monetary stability

By suppressing the need for hard currency in a number of trade transactions, systems for cross-border payments in domestic currency can also help address another important shortfall of the current international monetary system, that is, the problem of global imbalances.

The reliance on the currency of one country, the US, as the main reserve and trading currency has led to ever-increasing levels of demand for such currency, with the consequent need for the US to run ever-increasing trade deficits. The phenomenon, termed the "Triffin dilemma", is at the source of the global imbalances that current global financial architecture reforms seem unable to put an end to. To the extent that alternatives that reduce the demand for the US dollar in the performance of trade transactions emerge, thus, a contribution can be made to reducing the pressure towards the build-up of such large imbalances.

The contribution to global financial stability is also apparent insofar as the emergence of a network of systems of regional units of account could, ultimately, offer a more sound, stable and development-friendly, basis for the design of a global one. They could, thus, become the stepping stones towards an alternative that should be factored into ongoing debates on the redesign of the international monetary system and the adequacy and features of Special Drawing Rights.

Conclusion

As important as discussing the contribution of regional arrangements for the supply of liquidity is the potential of regional arrangements that focus on lessening demand for it. Building and strengthening systems for regional monetary cooperation, in particular cross-border payments in domestic currency, with clearing unions and regional units of account, would make an important contribution to strengthening financial resilience in developing countries, mitigating the impacts of global financial crises and contributing to the maintenance of global financial stability.

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The international and the regional financial institutionality: Some perspectives

Oscar Ugarteche

In its latest communiqué, the International Monetary Fund's International Monetary and Financial Committee makes reference to the ongoing discussion on what has been termed the "global financial safety net", that is, broadly, a lending mechanism to contain risks arising from a systemic shock. While the global financial safety net would have, traditionally, been placed in the IMF, the communiqué also calls for the Fund to *"cooperate with […] regional financial arrangements."*

The fact that reference to cooperation with regional financial arrangements needs to be made in a proposal for a global financial safety net is probably the clearest indicator of how relevant regional financial arrangements have become. This essay reflects on the historic evolution of the process of financial regionalisation – tracing it back to the evolution of the global financial institutions established in the 1940s – and the different forms financial regionalisation has adopted in the 20th and 21st centuries.

The international financial architecture which emerged from the Second World War came as a way to protect the world economy from a depression with deflation and from the reintroduction of beggar-thy-neighbour currency policies and protectionist policies. The reason for this was the blame that leading countries put on economic factors for the detonation of the Second World War.

The architecture designed at the time had an economic logic and relied on one solid leading economy which gave backup and support to it. The entire international financial architecture was built around Fordism and Keynesianism, now both dead for about thirty years. The nation which designed the architecture in 1943 retained veto power and demanded that 50 percent of international reserves be kept in its currency. At the time, all international reserves that were not held in gold, were held in one major currency. This meant that international trade was quoted mostly in that currency, paid for in that same currency, and that international financial law relates to the economy which issues that currency.

As it stands in the first decade of the 21st century, the reasons for the creation of the architecture remain. As a currency war develops and as the leading currency has already lost a major part of its international value in the middle of what is considered the most significant crisis after 1929, the capacity of the existing institutionality to respond to what is happening has not been adequate.

In a post-Fordist world beyond Bretton Woods, and with international value chains and a still dominant neoclassical approach to economic theory, what is evident is that the leading economies are debtors to developing nations at the same time that Millennium Development Goals agreed at the UN are being pursued. Developing countries are financing the over-consumption of the rich economies instead of attending their own needs. This is not only unethical, but it also does not make economic sense. The international reserve system transfers all world external savings into bonds denominated in four currencies – which happen to be the currencies of four highly indebted economies.

One of the major economies is in fact a regional economy, with the inclusion of 15 countries plus 12 new ones in the process of adhering to it. The process of European monetary integration has shown that it may be convenient to aggregate reserves and keep stable exchange rates within the economic space while floating against all other currencies. The stability within the region has brought about very fast intra-regional trade growth.

The relative weight of the G7 economies has decreased as a proportion of the total world economy as others have progressed in their GDP and world trade participation. The world of the beginning of the 21st century has evolved from what existed in the second half of the 20th century.

The development of a perfectly unregulated and unsupervised international financial market which dominates the economic scene in what is considered a stage of financialisation of the economy has led to major shifts. Currencies revalue and devalue not because their real economic growth rates are different when adjusted by inflation but because they are subject to currency speculation in both directions. This is often related to interest rate differentials and to the evolution of stock markets in stable currency economies. The instability of the world economy is not primarily due to real factors but mostly to speculative factors.

The existing international financial institutions believed that markets would adjust automatically but it turned out that the markets made money and did not adjust. The lesson is that large investment banks can gamble all and will never pay the price of their losses. The existing international financial architecture has no role to play in this. In fact, as events evolved from the middle of 2007 no multilateral financial institution was looking at the main actors and or warning the rest of the world of what was happening. Only recently, in a seaside change, has the IMF started warning about the problems associated with the free flow of short term capital.

The regional processes started when the Bretton Woods agreement of fixed exchange rates collapsed. The initial consequence, in regional terms, was that those countries trading amongst themselves decided to trade their currencies directly and not through a third currency. The currency transaction costs were high given the instability of the currency market. That, in brief, led to the creation of the European Monetary System of exchange rate and macroeconomic policy coordination. Eventually and overcoming many problems, European countries eventually decided to create one single currency. This was perhaps a bit too soon as a single currency requires a highly coordinated fiscal policy, and that does not exist in Europe as yet. One of the lessons learnt from the current crisis by other regions undergoing similar processes is that it is better not to have a single currency but to keep exchange rates stable within the region in order to foster trade. The second lesson is that when there is a credit crunch in the currency through which international trade passes, international trade credit ceases, bringing international trade down and expanding a recessionary effect around the world.

Regional integration in the 21st century is different from regional integration in the second half of the 20th century. The latter was built around an international division of labour agreed upon by governments. However, since 1990 integration agreements have been market-driven. Mercosur in 1991 is the first, NAFTA is the second, the failed Free Trade Area of the Americas (FTAA) was the third, Chiang Mai is the fourth. There are similar schemes in the Emirates and in Western Africa and the Southern Horn of Africa. Governments, in this order of things, accompany and facilitate what are ongoing real integration processes. This means not all integration schemes are analogous.

This explains why after the initial shock, some large countries in different regions of the world, with strong currencies, decided to denominate international trade in their own local currencies. The dynamics of the crisis relating to intra-regional trade had to be put at bay and reactions came to foster trade which eventually meant that trade reduction was less severe than in cross-regional trade. The old saying that when the United States catches a cold, the world catches pneumonia, was not proven at all. Mexico caught pneumonia, as did Venezuela, both for their concentration in a single market. Others developing economies fared reasonable well, including those in the Middle East, South East Asia and South America. What was proven was that when the US experienced a credit crunch, the latter adversely affected international trade because trade credit ceased. China began international trade in renminbi and advanced very quickly to open Bank of China desks in commercial banks around the world to foster direct currency trade. Brazil and Argentina started trade in local currencies although they still compensate at the end of the day in US$.

In the first decade of the century, ASEAN+3 has developed balance-of-payments support swap agreements that became multilateral in 2009 and amount to US$ 120 billion. This accompanies the currency agreements amongst themselves that have served to keep their exchange rates relatively stable inside the ASEAN+3 region – excluding Japan. China has moved towards a complete exchange rate market (spot, futures, swaps, forwards), and entered the Euroclear system as well as the Reuters currency trade system.

In South America there is some macroeconomic coordination in the Mercosur subregion, and, for the first time, technical assistance from one country to another on inflation control. Lessons learnt by some central banks are being passed on to other central banks and equally the ministries of finance. Evidence shows that 7 out of 10 currencies in South America revalued by more or less the same proportion between October 2002 and June 2010. That is the result of some information exchange that could lead to more formal institutional coordination. Designs are made for an Asian currency unit and a South American currency unit, in the spirit of the European Currency Unit that preceded the euro. The creation of regional institutions that would use such units of account is open.

The new regional financial architecture being designed and implemented very fast thus far seems to complement existing international institutions. The Bank of the South concept complements existing development banks while helping to recycle regional savings. The region that seems to be advancing dynamically is the ASEAN region, which envisions the creation of a fully integrated ASEAN Economic Community by 2015. It is not clear who benefits in Asia from extra-regional institutional conditionality and it remains to be seen if, as in Europe, extra-regional institutions are called in for their conditionality while the money comes from within the region, like in the recent Greece-European case, or if this may be different. What is unquestionable is that these regional integration processes are progressing.

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