

The International Financial Architecture and the Role of Regional Funds¹

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Turbulence in global financial markets, which has spiked to unprecedented heights in recent years, creates an understandable desire on the part of small (and not so small) open economies for balance-of-payments insurance. This has meant reserve accumulation. Since the turn of the century the total reserves of emerging markets and developing countries have risen from less than \$1 trillion to \$5 ½ trillion.² There is a considerable body of evidence that emerging markets and developing countries with more reserves did better in the crisis – they were better able to insulate themselves from the shock.³ But self-insurance in this form also has costs. There is the low yield on reserve assets. There is the prospect of accounting losses as emerging-market currencies appreciate against the dollar, the euro and the yen. There is the tendency for reserve accumulation achieved by running current account surpluses to feed global imbalances which are a potential source of financial fragility.

These observations have given rise to an extensive debate on alternative mechanisms for balance-of-payments insurance. There are proposals for regular issuance of Special Drawing Rights, either by the IMF or by a new Global Reserve Bank operating under United Nations auspices, as a mechanism for breaking the link between global imbalances and reserve adequacy.⁴ The IMF proposes expanded use of its Flexible Credit Line, the new facility through which countries with strong countries are able to borrow reserves without having to satisfy onerous conditions.⁵ There have been efforts by some countries, South Korea for example, to regularize the exceptional bilateral dollar swap arrangements negotiated with the Federal Reserve System at the height of the crisis. There is the proposal, under consideration by the G20, to create a global network of such swap lines (a “global safety net”). Finally, and of particular relevance to this conference, there is the possibility of establishing, expanding and regularizing regional reserve pooling arrangements.

Of these alternatives, only regional reserve pooling is likely to be feasible. The SDR will be unattractive as a form in which to use international reserves, beyond symbolic levels, so long as it is not used in private transactions. The SDR can't be used in market intervention because there are no private markets in SDRs. The SDR is not traded on foreign exchange markets. Governments and corporations have little appetite for issuing SDR-denominated debt. Institutional investors have little demand for SDR-denominated assets. If any of these entities

¹ Prepared for the fifth annual FLAR economic studies annual conference, Cartagena, Colombia.

² As of 2010 Q1, according to the most recent IMF COFER data.

³ Although there may have been diminishing returns to reserve accumulation beyond a certain point. See Reza Moghadam (2010), “Emerging Market Countries and the Crisis: How Have They Coped?” www.imf.org (19 April).

⁴ United Nations (2009), *Preliminary Report of the Commission of Experts on Reforms of the International Monetary and Financial System*, New York: United Nations (May).

⁵ See “Factsheet: The IMF’s Flexible Credit Line” (24 June 2010), at <http://www.imf.org/external/np/exr/facts/fcl.htm>.

want basket-based assets or liabilities, they can construct currency baskets of their own; there is no obvious reason why they should prefer the SDR's fixed weights. And so long as private demand is minimal, markets in SDRs will lack liquidity, which is an attribute that central bank reserve managers value above virtually all others.⁶

It would still be possible for central banks, seeking to intervene in the foreign exchange market or provide foreign-currency liquidity to domestic banks, to turn their reserves into dollars and other national currencies by converting them at the IMF. But this assumes that the Fund would have an adequate stock of dollars on hand, which is not to be taken for granted. The G20 countries at their April 2009 summit committed to increasing the Fund's resources \$750 billion to \$1 trillion (depending on what one counts). But even this would be small potatoes by the standard of emerging markets' \$5 trillion plus of reserves. One suspects that a number of national parliaments and congresses, not least the U.S. Congress, would be reluctant to accept a significant further expansion of the Fund's resources. They would be reluctant to authorize it to borrow freely on the market to fund its issuance of SDRs, fearing inflation, moral hazard, and inadequate political accountability.

Wider use of the IMF's Flexible Credit Line, for its part, is inhibited by the reluctance of countries, fearing stigma effects, to apply.⁷ There is now talk of the Fund unilaterally prequalifying countries, and of countries applying in groups to prevent any of them from being singled out as weak sisters. Even then, however, there would remain the problem of how to disqualify previously prequalified countries when policies deteriorate without precipitating the very crisis that the facility is designed to avert. Governments will hesitate to apply for fear that, down the road, renewal of their preferential status will be denied, with terrifying financial consequences. This gives grounds for worrying about whether access to the Flexible Credit Line can be scaled up to systemically significant levels.

The idea of a global safety net, under consideration by the G20, would be identical in its essentials to a generalized Flexible Credit Line with the IMF still in the picture, and impractical without it. Either way, there would be reluctance on the part of the reserve-currency issuers, such as the Fed and the ECB, to agree to the full panoply of credit lines. The four \$30 billion swaps extended by the Fed to Brazil, Mexico, Singapore and South Korea at the height of the financial crisis were criticized by the U.S. Congress as giveaways. While this criticism was misguided, it is an indication of the political obstacles. There is reluctance on the part of governments to deal directly with one another when conditionality is involved, as it often is. Recent European experience is a case in point: the idea of Germany setting conditions for Greece

⁶ In 1981 the IMF sought to jump-start private markets in SDRs by reducing the number of currencies making up the SDR from 16 to 5. Commercial banks seeking to test the market took out ads offering certificates of deposit in SDRs. Investment banks offered to underwrite SDR bonds on behalf of governments and corporations. But there were few indications of interest among investors. On the side of the borrowers, Sweden in fact obtained a syndicated credit in SDRs in early 1981, but the only other governments that followed its example, the likes of Ireland and the Ivory Coast, were small potatoes. It is easy to see why there was so little progress. The first private entity issuing an SDR bond or deposit incurred extra costs as a result of the instrument's illiquidity. The first private SDR, by definition, was not traded in a broad and deep market. Purchasers required additional compensation to hold it. And since liquid markets in claims denominated in national currencies already existed, private SDRs traded at a disadvantage.

⁷ It would be interesting to hear more about this – and whether such worries are unjustified – by representatives of our host country, which has been one of three countries to apply.

to borrow reawoke memories of the Germans' World War II occupation of their neighbor. Thus European Union, despite providing the majority of the funding when Greece needed emergency financial assistance earlier this year, relied on the IMF to negotiate the conditions.

This leaves regional reserve pooling, undertaken in conjunction with the IMF, as the only game in town. There are a number of existing arrangements: Europe's Medium Term Financial Assistance Mechanism, Asia's Chiang Mai Initiative Multilateralization, the NAFTA countries' North American Framework Agreement, the Arab Monetary Fund and, of course, FLAR. These are mechanisms for partially pooling the reserves of regional neighbors. Assuming that the neighbors don't all require additional reserves at the same time, which is plausible insofar as balance-of-payments shocks are imperfectly correlated even across countries in the same neighborhood, these arrangements enhance reserve adequacy.⁸ They reduce the need for reserves at the national level. As a form of mutuality, or risk pooling, they reduce the costs and risks of insurance.

How much can we expect of these arrangements? In attempting to answer this question, I build on the work of McKay, Volz and Wolfinger.⁹ I consider five attributes of regional reserve pools likely to shape their effectiveness as mechanisms for mutual balance-of-payments insurance. These are (1) the adequacy of the finance they are able to provide, (2) their capacity to undertake economic and financial surveillance, (3) the speed of their decision making, (4) their perceived legitimacy, and (5) their ability to work together with the multilaterals, notably the IMF.

Why are these attributes important? For adequate financial capacity, the answer is obvious. The pool has to be big enough to meet prospective needs. It has to be of the same order of magnitude as balance-of-payments shocks. Surveillance capacity matters because contributors to a pool will be willing to put money on the barrelhead only if they are confident that avoidable problems will be avoided and unnecessary drawings on the pool will not take place. They will have to be confident that other countries drawing on the pool are doing what they have to in order to eventually pay them back. Speed of decision making is of the essence because, as recent experience reminds us, shocks to financial markets hit suddenly. The arrangement has to be perceived as legitimate – those operating it have to be seen as accountable for their actions – if lending through the pool is going to occur in the first place. And, finally, the ability to work together with the multilaterals is important because it may be desirable to outsource the negotiation of conditionality and because it may be necessary to top up the pool.

How do the various regional reserve-pooling arrangements rate in terms of these criteria? Consider first Europe's Medium-Term Financial Assistance Mechanism, through which the European Union lends to non-euro-area member states. The EU borrows on the market to fund such loans. As of December 2008 the amount of money involved is €25 billion. This is a relatively small number: Hungary, Romania, and the Czech Republic all have more than €40 billion of reserves apiece. Note however that the EU has repeatedly shown willingness to raise this ceiling. Surveillance capacity is extensive, since the Commission regularly undertakes

⁸ See Barry Eichengreen (2007), "Insurance Underwriter or Financial Development Fund: What Role for Regional Reserve Pooling in Latin America?" *FLAR Review*.

⁹ Julie McKay, Ulrich Volz, and Regina Wolfinger (2010), "Regional Financing Arrangements and the Stability of the International Monetary System," unpublished manuscript, European Central Bank (January).

reviews of members and formulates so-called “Broad Economic Policy Guidelines” for euro-area outsiders. It is tempting to question the effectiveness of this surveillance, given the large deficits allowed to develop in the Baltic states and the extent of currency mismatches in Hungary and elsewhere.¹⁰ But the mechanism is relatively elaborate by comparative standards.

Decisions are taken by the ECOFIN Council on the basis of a recommendation by the Commission or at the request of a member state. In response to the events of November 2008 the Council and the Commission were very fast to come to the aid of Hungary, Latvia and Romania. That the mechanism is actually used – that €6 billion was lent to Hungary, €3 billion to Latvia, and €5 billion to Romania – is an indication that the arrangement possesses the legitimacy necessary for action. Finally, in terms of ability to work together with multilaterals, co-financing with the Fund and therefore signing an IMF Letter of Intent are standard practice.

While this European arrangement covers only a relatively small number of countries (and a shrinking number as additional countries join the euro area, Estonia being next, at the beginning of 2011), it thus rates relatively highly on a number of the relevant dimensions.

The Chiang Mai Initiative Multilateralization (CMIM) was created by the ASEAN+3 countries following the Asian financial crisis as an alternative to relying on the IMF. It is an outgrowth of the ASEAN Swap Arrangement, which dates from 1977. The \$120 billion of mainly bilateral swaps negotiated under the earlier Chiang Mai Initiative are now to be combined into a single pool (hence the second “M” in CMIM). While \$120 billion is a large number absolutely, it is not that relative to the reserves of the participating countries. South Korea alone had some \$250 billion of reserves on the eve of the 2008 crisis and in addition negotiated a \$30 billion swap with the Fed. That said, the ASEAN+3 countries have displayed a willingness to increase the size of the facility in the past and are likely to do so again in the future.

To address the need for strengthened surveillance capacity, the members have just agreed 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, shies away from giving it concrete oversight of national policies. These limitations are indicative of the continuing reluctance in Asia to criticize the policies of regional neighbors and thus of the obstacles to conducting firm surveillance.¹¹ This is probably the main obstacle to a more significant role for the CMIM.

Discussions of speed of decision making are hypothetical, given that the CMIM has never been utilized. Two positive signs are that explicit quotas/credit lines exist, obviating the need to negotiate these from scratch, and that the decision to disburse is now to be taken through a qualified majority vote of the members, avoiding the delays caused by unanimity requirements. The legitimacy of the arrangement rests on a voting formula that gives China and Japan exactly same weights, Korea half the weight of China and Japan, and the ASEAN countries a weight disproportionate to their financial contributions. In terms of ability to collaborate with the

¹⁰ Note that this is a quite separate matter from how financial problems were allowed to develop in Greece, which as a member of the euro area is not eligible for assistance through the Medium-Term Financial Assistance Mechanism and which is subject to a different set of surveillance procedures (whose adequacy can, quite similarly be questioned) in conjunction with the operation of the Stability and Growth Pact.

¹¹ This reluctance to engage in anything that can be construed as criticism of other Asian countries’ policies is known as “the ASEAN way.”

multilaterals, the good news is that there is an explicit formula for working with the IMF (the current rule is that a country must negotiate an IMF program in order to draw more than 20 per cent of its quota or credit line with the CMIM). The bad news is that approaching the Fund would be regarded as political suicide by any Asian government. The last observation suggests that the reserves ostensibly pooled through the CMIM may in fact be less than meet the eye.

Asia's aspirations for its regional reserve pool are ambitious; many regional policy makers see it as a stalking horse for an Asian monetary fund and as the first step toward an eventual regional currency. Outsiders tend to be more skeptical. They observe that the CMI was not activated even in the fall of 2008 in response to the most serious financial crisis in 80 years. They will want to see it used before they believe the ambitious claims made on its behalf.

The Arab Monetary Fund, while active, is small. It has just \$3 billion in paid-up capital and no ability to borrow. On the other hand, its technical staff of 50 conducts regular country reviews. Quotas and drawing rights are pre-specified. It has an explicit voting formula. Speed of activation is limited, however, by the fact that significant drawings require an application, a mission, a program and a letter of intent, all of which can take up to a month and a half to complete. Legitimacy is buttressed by the fact that the fund has existed for 35 years and that it has had quite a number of programs. There is no provision, however, for working together with the multilaterals.

The North American Framework Agreement is similarly very small. The three bilateral swaps for which it provides total just \$9 billion. They are dwarfed by Mexico's reserves, which exceed \$100 billion. The money available under the framework was already inadequate in 1994-5, when in response to the Mexican crisis much larger loans were provided through the U.S. Treasury's Exchange Stabilization Fund. More recently, when Mexico has needed access to foreign credits, it has utilized other channels, whether the IMF's Flexible Credit Line or bilateral swaps with the Fed.

This makes discussion of matters surveillance capacity a bit superfluous. For what it is worth, there exists a North American Financial Group (NAFG) that brings together officials from the three treasuries and central banks; also regular ad hoc and bilateral consultations. Disbursal in principle is relatively quick since this requires only bilateral agreement between a pair of participating countries. Legitimacy rests on the fact that the framework agreement is effectively a quid pro quo for NAFTA, which is viewed positively by policy makers in the U.S., Canada and Mexico alike.

This brings us to the main event, rating FLAR according to these same criteria. While this is a game that any number can play, my personal ratings are as follows. FLAR has roughly \$2 billion of paid-up capital and, in addition, some ability to borrow. To pick a country not entirely at random, Colombia's foreign exchange reserves are \$25 billion. Venezuela's are \$32 billion. Lending capacity is more significant when judged relative to the prospect balance-of-payments needs of the fund's smaller members. But, even then, Bolivia's reserves are \$9 billion. Ecuador's are \$8 billion. If these numbers are taken as measures of the magnitude of balance-of-payments shocks and the need for insurance, then the financial resources of FLAR could be better.

In terms of surveillance capacity, FLAR has an Economic Studies Division that provides regular country surveillance and monitoring. How much confidential country information this staff has access to is not clear, however. FLAR has explicit voting and disbursement formulae, enabling it to move fast in principle. Credit-disbursal decisions require the assent of at least five of the seven members. FLAR has been in existence since 1978, which is an indication of its perceived legitimacy. The fact that the fund has actually been used, as in the case of the \$500 billion loan extended to Ecuador in 2009, is a good sign. On the other hand, there is no formal link with the IMF.

So how can FLAR be strengthened to enhance its capacity to function as an effective regional reserve pool? Clearly, the pool needs to be enlarged. A modest start would be to follow the G20 decision regarding the IMF by tripling its resources. In terms of surveillance capacity, it would be important to ensure that the Economic Studies Division has access to not-yet-published national data. Decision making could be accelerated and streamlined by altering the voting rules for disbursing credit to require only a simple majority of members.¹² Finally, in terms of facilitating the negotiation of conditionality and topping up finances, it would be useful to establish an IMF link

Much, in other words, remains to be done. FLAR is a work in progress. But given the need for balance of payments insurance, the costs of obtaining it unilaterally, and the limitations of other mechanisms for providing it collectively, there is a strong argument for accelerating that work and developing it into a proper regional reserve pool.

¹² As has in fact been done in the case of the CMIM.