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## Regional financing arrangements and the stability of the international monetary system

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# Regional Financing Arrangements and the Stability of the International Monetary System

*Julie McKay  
Ulrich Volz  
Regine Wölfinger*



# Regional financing arrangements and the stability of the international monetary system<sup>\*</sup>

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<sup>\*</sup> The views presented in this paper are those of the authors and do not necessarily reflect those of the European Central Bank (ECB). Parts of this paper were written while the second author was visiting the ECB. The paper benefited from comments received at a conference on “Regional Economic Integration Beyond Europe” held at the German Development Institute, the 3rd Conference on “The Political Economy of International Organisations” at Georgetown University, as well as a seminar at the ECB. The authors are grateful to Graham Bird, Aldo Caliarì, Domenico Lombardi, Roberto Marino López, José Antonio Ocampo, Daniel Titelman and Kati Suominen for helpful comments on earlier drafts of this paper. All shortcomings of this paper are our own.

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## Abstract

Developments in regional financing arrangements, such as the strengthening of the Chiang Mai Initiative in East Asia, and the increased lending in the global financial crisis are increasingly raising questions about their contribution to the stability of the international financial system, and their relation to the International Monetary Fund (IMF) and its role in safeguarding that stability. Key questions concern the implications of regional financing arrangements for the lending and surveillance functions of the IMF and whether they could come to supplant Fund financing. Indeed, emerging market interest in regional financing arrangements may be attributed to perceptions of an undue burden of conditionality attached to IMF lending, and the dissatisfaction expressed by larger, dynamic emerging market economies over their lack of influence in the Fund's decision-making, as evident in their calls for representation commensurate with their economic significance. This issue has not yet been squarely addressed, and this paper seeks to fill that gap. It explores the argument that the contribution of regional financing arrangements to the stability of the international monetary and financial system depends on their design and operation. To gauge the quality of a regional financing arrangement, we establish a set of critical factors – “optimal financing criteria” – relevant for providing crisis financing, using a first principles approach. We then evaluate the frameworks for the IMF and the various regional arrangements in existence against these criteria. Results suggest that the design and operation of regional arrangements determine whether the extent to which they help alleviate crises. In essence, we find that those in existence can be expected to have superior information about the economy in crisis, and react more quickly to address a situation, but may lack the expertise to define the policy course towards external sustainability and the amount of funding necessary to reassure markets.

**Keywords:** Regional liquidity schemes; international financial architecture; the role of the IMF

**JEL classification:** F33, F55



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## Abbreviations

AAD	Arab Accounting Dinar
AMF	Arab Monetary Fund
AMRO	ASEAN+3 Macroeconomic Surveillance Office
ASEAN	Association of Southeast Asian Nations
ASEAN+3	ASEAN as well as China, Japan and South Korea
BIS	Bank for International Settlements
CMI	Chiang Mai Initiative
CMIM	Multilateralisation of the CMI
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs
EFF	Extended Fund Facility
EFSF	European Financial Stabilisation Facility
EFSM	European Financial Stabilisation Mechanism
EMEs	Emerging Market Economies
FAR	Fondo Andinas de Reservas (Andean Reserve Fund)
FCL	Flexible Credit Line
FLAR	Fondo Latinoamericano de Reservas (Latin American Reserve Fund)
GAB	General Arrangements to Borrow
GDP	Gross Domestic Product
HAPAs	High Access Precautionary Arrangements
IMF	International Monetary Fund
MTFA	Medium-term Financial Assistance
NAB	New Arrangements to Borrow
NAFA	North American Framework Agreement
RFAs	Regional Financing Arrangements
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
SRF	Supplemental Reserve Facility
USD	US dollar
VSTF	Very Short Term Financing Facility



## 1 Introduction

*“Developing countries [...] 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.”*

(Statement to the IMF’s International Monetary and Financial Committee by Guido Mantega, Minister of Finance of Brazil, Washington DC, 20 Oct. 2007)

The International Monetary Fund’s (IMF) handling of various financial crises over the past decade has given rise to a barrage of criticism. The Fund stands accused of providing unhelpful, even counterproductive advice (as in the Argentine and Asian crises); of being late to react (the Brazilian crisis); of providing insufficient finance to stabilise a situation and calm markets (the Asian crisis); of not identifying a looming crisis in time (the US sub-prime crisis); and of attaching excessive microeconomic requirements to its loans.<sup>1</sup> This led, in some cases, to a sense of humiliation in some afflicted countries as leaders perceived themselves forced to swallow bitter IMF medicine. To address their dissatisfaction with the Fund’s crisis financing, attempts have been made to bolster first and second lines of defence – foreign exchange reserves and regional financing arrangements, respectively.

In the wake of these crises, countries have recovered, learned from their mistakes, and gained strength and stature in the world economy. Due to a combination of prudent economic management and a long period of benign global monetary conditions that lasted until summer 2008, many countries have succeeded in building up large foreign exchange reserves, which can serve as a first line of defence in the event of a crisis. Others, such as East Asia, have gone further and developed regional financing arrangements (RFAs) that are becoming ever more sophisticated, in effect, strengthening a second line of defence.

In this paper, we define an RFA as an arrangement within which a group of countries pledges financial support to other members of that group that are experiencing balance of payment problems, either through a pool of contributed or borrowed reserves or through the swap of financial assets (usually foreign exchange reserves).

As emerging market economies (EMEs) rise up the ranks of economically important countries, the attractiveness of regional financing arrangements, not merely as a complement to IMF financing, but potentially as a substitute for IMF financing, has become intertwined with the issue of representation of EMEs in the Fund’s decision making processes. EMEs are seeking a greater voice in IMF governance in order to influence IMF policies. The Brazilian Finance Minister’s remarks made at the October 2007 Annual Meetings of the IMF quoted above made clear the demand of EMEs for a greater say in the governance of the IMF, and the role that RFAs could play in the future if IMF governance reforms are not deemed satisfactory by EMEs.

These developments give 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 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 is yes, do they provide a healthy dose of competition for

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1 See, for instance, the contributions in Vines / Gilbert (2004).

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 (e.g. Schäuble 2010; Gros / Meyer 2010; Suominen 2010).

The purpose of this paper is to investigate these questions and examine the extent to which the RFAs currently in existence are likely to complement or substitute IMF crisis lending. To this end, we develop criteria for optimal RFAs and evaluate existing RFAs, as well as the IMF, according to these criteria. Based on our results we consider the implications of RFAs for international monetary stability and evaluate ramifications for the IMF. The paper stops short of discussing the consequences for the existence of the Fund which is a subject rich enough for a separate paper.

The remainder of the paper is structured as follows. In section 2 we consider criteria for optimal financing arrangements and apply these to the IMF. In Section 3 we subsequently examine the performance of various RFAs as regards these criteria. Section 4 discusses the impact of RFAs on international monetary stability and the consequences for IMF crisis lending. Section 5 concludes.

## **2 Criteria for optimal financing arrangements and the benchmark IMF case**

### **2.1 Insights for optimal financing arrangements**

Take the hypothetical case of a country (A) that is facing an impending balance of payments crisis, but may make recourse to a financing arrangement, such as the IMF or a regional arrangement. On the one hand, it is important for country A that it is provided with sufficient financial resources to service its international obligations and restore confidence with its creditors; and that these funds are provided soon enough to prevent a worsening of the situation. On the other hand, the providers of crisis financing need a reliable estimate of the country's financing needs (which presumes timely access to relevant and reliable information, as well as the necessary analytical skills for its evaluation) and to ensure that the country repays the loan in order to safeguard the resources for further use. This implies having effective mechanisms for monitoring and enforcement of agreed conditionality.

From these considerations, six features can be identified that are 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 discuss each criterion in turn and evaluate the IMF's abilities as a crisis manager and lender according to these criteria as a benchmark case. Subsequently, section 3 examines how well existing RFAs meet these conditions.

*(i) Magnitude of the available finance*

First of all, for any lending arrangement to be relevant, it needs to be endowed with sufficient financial resources to provide credit in adequate amounts to countries on the brink of crisis. The optimal size of resources depends on the characteristics of the financing arrangement's membership and the likely constellation of drawers.<sup>2</sup> The susceptibility of members of a financing arrangement to crisis, and the amounts of emergency credit that might then be needed are a function of several factors. These include: a country's short term external (foreign currency) debt relative to Gross Domestic Product (GDP); its ability to generate foreign exchange through exports; the amount of liquid international reserves held by the government or central bank; its ability to borrow and mobilise finance in international credit markets; the average capital and current account balance in the recent past; the country's degree of openness; the size of foreign currency liabilities in the banking system; and the exchange rate regime (e.g. Edwards 2006; Calvo / Izquierdo / Mejía 2004). Moreover, the amounts needed in past crises might give an indication of the resources needed in possible future crises, although obviously every crisis is different in nature and magnitude. This multitude of factors influencing member countries' susceptibility to crises makes it difficult, if not impossible, to determine the optimal amount of reserves that a financing arrangement should have at its disposal. Nevertheless, consideration of these factors provides a rough guide to the amount needed to ensure effective policy responses.<sup>3</sup>

*(ii) Timely access to relevant information*

An important task of a financing arrangement is to engage in monitoring and analysis that are aimed at an early detection of vulnerabilities (ideally to prevent crises), and in the event of a crisis, to provide an adequate response. A good understanding of the economic, political, institutional and social background of countries is crucial in that respect. To fulfil this task, a financing arrangement needs to have timely access to all relevant data, including sensitive government data, which would need to be provided by the authorities of the member countries. Indicators of data comprehensiveness, timeliness, reliability and access granted to others include subscription to the IMF's General Data Dissemination System and Special Data Dissemination Standard; frequency and size of revisions in national accounts data; and disclosure of the currency composition of official foreign exchange reserves. The less open disclosure of information by a country, the more important it is that the providers of finance have good access to necessary information.

*(iii) Analytical expertise*

To make appropriate use of all available information, and to convincingly present the financing arrangement's analysis to the member countries, a body of highly skilled staff is needed. To help prevent crises from occurring or to respond adequately to mitigate the effects of an ongoing crisis, well-trained professionals are required that have the analytical

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2 Although this goes beyond the scope of this paper, attempts can be made at assessing the probable timing of withdrawals by considering the correlation of shocks (including terms of trade shocks and financial shocks) that affect the member countries of a financing arrangement. Machinea / Titelman (2007) do this for FLAR.

3 Attempts to quantify the optimal level of international reserve holdings have been made for individual countries, for instance by Olivier / Rancière (2008).

capacities and the country- or region-specific expertise that will enable them to estimate the size of the financing required and generate adequate policy recommendations. Indicators of a financing arrangement's analytical expertise are the size of permanent professional staff; the level of qualification of that staff (e.g., the share of trained PhD economists); the financing arrangement's ability to attract top staff; and the international exchange with other financing arrangements, international financial institutions and academic centres of excellence.

*(iv) Speed of decision-making*

Successful crisis management requires speedy responses. It is therefore important that the financing arrangement's crisis response mechanisms allow quick decision-making and approval by the governing authorities so that guarantees can be issued or funds disbursed swiftly. This requires a transparent evaluation and approval procedure, clear responsibilities within the financing arrangement for taking decisions. A proxy for a financing arrangement's speed in responding is the average time taken from the occurrence of past crisis situations (or the moment the financing arrangement receives a request for assistance) to disbursement of crisis financing. Where the financing arrangement has no history of crisis situations, the institutional procedures for dealing with a country in need can be evaluated to assess this criterion.

*(v) Impartiality in lending decisions*

For a financing arrangement to be a trusted partner of its member countries, and to be respected by market participants alike, it must be impartial in both its monitoring and policy advice in times of non-crisis, as well as in its lending decisions in times of crisis. A financing arrangement's policy decisions and advice should be based solely on good economic analysis; any interference in or dominance of decision-making by an individual member that might have vested interests will tarnish the financing arrangement's standing and its ability to resolve a crisis, and diminish its policy influence. In addition, it may reduce the "sense of ownership" of the less influential member countries, which might be important not only regarding the commitment to repay a loan but also for the willingness to ask for financial support in the first place. The transparency of decision-making procedures and the accountability of the financing arrangement's management are important aspects in this context. Further factors that may have a bearing on a financing arrangement's impartiality include the selection procedure for senior management, the concentration of voting power in the financing arrangement's governance structure, as well as the existence of veto rights of single members, which may allow them to block lending decisions or limit financing. To be sure, it is the behaviour of a dominant party/dominant parties that is decisive for the well-functioning of a financing arrangement, not the existence of a dominant position *per se*: a strong power or partnership of powers can provide leadership and impetus, helping to better profile a financing arrangement.<sup>4</sup> However, to simplify the operationalisation of this variable, we assume that the likelihood of inappropriate behaviour increases with dominance.

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4 We would like to thank Aldo Caliarì for nuancing this point.

*(vi) Monitoring and enforcement mechanisms*

The issue of mechanisms for monitoring and enforcing conditionality attracts disparate views. On the one hand, lending conditionality can be useful for ensuring that the debtor government addresses the underlying problems of the crisis<sup>5</sup> and that the financing arrangement will get repaid. If conditions are to be applied, a financing arrangement needs the capabilities to monitor implementation, so that performance can be evaluated to inform the release of further tranches. Often, the linking of tranche release to fulfilment of conditions serves as the primary enforcement measure.

On the other hand, a criticism that has been frequently applied to IMF conditionality is that it not only interferes with the member government's sovereignty, but that in several crisis instances conditions were flawed and counterproductive to crisis resolution. Moreover, attaching a string of conditions that need to be negotiated between the financing arrangement and the member country might stand in the way of a swift disbursement of funds. Depending on the nature (i.e. short- or medium-term) and the size of funds under discussion, and the type of crisis, facilities without stringent conditions might be more appropriate and helpful. In evaluating financing arrangements, the approach to conditionality and the quality of monitoring and enforcement should therefore be examined with these considerations in mind.

In order to make comparisons between existing financing arrangements, we operationalise these criteria by introducing a rating methodology. That is, we rank the six criteria for each financing arrangement on a scale from 0 to 10, where a higher score describes a better achievement of the respective criterion. Wherever possible, the scores are based on hard data, such as elapsed time between lending request and lending decision, or available funds relative to number of member countries and their potential borrowing needs. In practice, however, it is sometimes difficult to assess these criteria for financing arrangements. This might be because a financing arrangement is opaque and the modes of its functioning are not openly disclosed or only partially. For some criteria, one thus has to use approximations and take into account factors less than ideally warranted.

For this research, we used facts and hard evidence where available. We examined a wide variety of material including, but not limited to, information provided by the financing arrangement itself (either publicly accessible through publications or websites or material provided to us by the respective financing arrangement), as well as literature on the respective financing arrangements. It is however inevitable that some of the scores are based on our judgement of how different financing arrangements compare with each other. A criterion like "impartiality in lending decisions", for instance, unavoidably has to be appraised based on our understanding of the context of each financing arrangement. The comparison is obscured also because of the different forms of the respective financing arrangements. To ensure that our judgments are as objective as possible, we have discussed them with people who either work/ed for the respective financing arrangements or otherwise have been closely involved in their work, either academically or as practitioners. Although the judgements are inevitably subjective and in some cases controversial, we believe that they should nevertheless provide a good indication of the relative strengths and weaknesses of the respective financing arrangements.

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5 With respect to the IMF the argument has been often made that one of its role is that of a "bad cop", meaning that it shall take on the blame for harsh policy measures taken by the member government, which were "forced" by the Fund to implement these policies.



Having discussed the criteria for optimal financing arrangements, we now turn to an analysis of how the IMF fulfils these criteria.

## 2.2 Criteria applied to the IMF

### (i) *Size of the financing pool*

Over the past years, the Fund's resources were often judged to be insignificant compared to the amount of private capital flowing in the world economy (e.g. Buria 2006; Lachman 2006). IMF analysis confirms that the relative size of the Fund had fallen substantially against various relevant economic and financial metrics for the global economy since the IMF's last general quota increase in 1998 (IMF 2009a). As can be seen in Table 1, the size of IMF funds at the beginning of 2009 remained much below its previous levels in relation to global output, trade and capital flows. This prompted questions as to whether the IMF is sufficiently equipped to meet potential demand for IMF financing, a discussion which some considered to diminish confidence in the IMF's ability to carry out its lending mandate. However, recent developments, not least the decisions taken by the G-20 leaders in April 2009 to increase the New Arrangements to Borrow (NAB) and in the meanwhile to provide bilateral funds to beef up the available resources for lending, have led to a considerable boost of the Fund's resources and lending capabilities. In addition, the IMF membership has agreed to advance the next quota review, which is likely to lead to a considerable increase of the quota-based resources.

The amount that the IMF has readily available for new (non-concessional) lending is indicated by its one-year *forward commitment capacity*. This is determined by its usable resources, plus projected loan repayments over the subsequent twelve months, less the resources that have already been committed under existing arrangements, less a precautionary balance. As of April 2010, the Fund's one-year forward commitment capacity was SDR 163 billion, i.e. about USD 248 billion (IMF 2010a), which encompasses both quota-based resources and borrowed resources stemming from bilateral loans or notes programmes made available by several Fund members since 2009.<sup>6</sup>

In addition, in the event of unexpectedly large needs, the Fund can activate supplementary multilateral borrowing arrangements. The first and principal resort is the NAB, established in 1998, under which 26 countries agreed to lend SDR 34 billion (about USD 51.8 billion in April 2010). Alternatively, the General Arrangements to Borrow (GAB), established in 1962, enables the IMF to borrow up to SDR 17 billion (about USD 26 billion) from 11 industrial countries. The NAB and GAB cannot be used cumulatively, i.e. the maximum amount currently available to the IMF is SDR 34 billion (IMF 2010b). Following up to the London Summit on 2 April 2009 the Executive Board in April 2010 adopted a proposal on an expanded and more flexible NAB, by which the NAB would be expanded to SDR 367.5 billion (about USD 588.6 billion), which includes also 13 new participating countries. The expanded NAB will become operational after domestic approvals by the participating countries. Once the expanded NAB becomes operational, the bilateral loan and note purchase agreements will expire.

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6 SDR stands for Special Drawing Rights.

<b>Table 1: Size of the IMF and economic indicators</b>								
	Seventh Review 1978 1/ (1)	Eighth Review 1983 1/ (2)	Ninth Review 1990 1/ (3)	Tenth Review 1995 1/ (4)	Eleventh Review 1998 1/ (5)	Twelfth Review 2003 1/ (6)	Thirteenth Review 2008 1/ (7)	Post Quota and Voice Reform 2/ (8)
Size of Quota Increase, in Percent	50.9	47.5	50.0	0.0	45.0	0.0	0.0	11.5
1. Size of the Fund	61.1	90.0	135.2	146.1	212.0	213.7	217.6	238.3
Index (1998=100)	28.8	42.4	63.8	68.9	100.0	100.8	102.6	112.4
2. Economic Metrics (Index: 1998=100)								
a. GDP	33	52	77	88	100	120	177	177
b. Trade	26	42	64	82	100	132	258	258
c. Capital Inflows 3/	10	16	37	58	100	143	242	242
d. Capital Inflows to EMDCs 3/	26	28	41	119	100	138	527	527
e. Foreign Assets plus Liabilities 4/	9	19	47	65	100	165	311	311
f. Foreign Assets plus Liabilities EMDCs 4/	10	28	45	74	100	139	304	304
3. Ratio of line 1 to line 2 (Index)								
a. GDP	86.8	82.1	83.3	78.0	100.0	84.0	58.0	63.6
b. Trade	108.9	100.3	99.4	83.7	100.0	76.1	39.8	43.6
c. Capital Inflows 3/	299.5	258.4	172.2	118.0	100.0	70.5	42.4	46.5
d. Capital Inflows to EMDCs 3/	110.9	149.2	154.4	58.1	100.0	72.8	19.5	21.3
e. Foreign Assets plus Liabilities 4/	322.0	218.7	136.7	105.7	100.0	61.0	33.0	36.2
f. Foreign Assets plus Liabilities	288.0	153.7	143.1	93.4	100.0	72.3	33.7	37.0
Notes: 1/ Quotas approved under each review. Economic data based on the year the Board of Governor's Resolution on quota review was approved. 2/ 2008 data is used. Quotas as agreed under the Board of Governor's Resolution No. 63-2. 3/ Based on three-year moving average for overall capital inflows. Projections based on World Economic Outlook October 2008. 4/ Data from Lane and Milesi-Ferretti. Figures for columns 7 and 8 based on latest data for 2007.								
Source: IMF (2009b, Table 1)								

As a further response to the financial crisis, the normal lending access limit for member countries was doubled in spring 2009 from 100% to 200% of their quota annually. At the same time, the cumulative access limit to nonconcessional lending was doubled to 600% of quota.<sup>7</sup> The higher limits aim to give confidence to countries that adequate resources will be accessible to them to meet their financing needs.

<sup>7</sup> Lending above the access limits has been possible since the inception of the Fund, and since the early 1980s was exercised under the exceptional circumstances clause. The nature of the exceptional circum-

Although the global financial and economic crisis is still ongoing at the time of writing, a preliminary assessment would lead us to conclude that the IMF has been able to respond adequately so far, with lending commitments reaching a record level of more than USD 167 billion in April 2010 including a sharp increase in concessional lending to least developed countries. Taking into account the IMF's historical track record in lending, and the commitments made by the G-20 to expand the Fund's resources and triple its lending capacity to USD 750 billion, we rate this criterion with 9 out of 10.

*(ii) Timely access to relevant information*

According to Art. IV of the Articles of Agreement, member countries are obliged to provide adequate information to the IMF in order for the Fund to be able to exercise firm surveillance. Regular staff visits to the country are part of the Fund's routine surveillance. In addition, the IMF often has country representatives to ensure a steady exchange with the member governments, but also with civil society and academia in the respective countries. All this assures a constant flow of relevant information to the Fund.<sup>8</sup>

The Fund is widely recognised as a major collector and provider of economic intelligence, and as such the IMF fulfils this role reasonably well. The Fund, however, is restricted to the information the member countries are willing to provide, and in case the interests of the Fund are not identical with those of the member government – which might give priority to satisfying the domestic constituency instead of following the IMF's recommendation etc., it might not access all information that it would ideally receive. The Fund's strength, in terms of data, is in providing standardised data across its membership. At the same time, its depth of knowledge and speed of access to relevant information for any one country is resource-constrained and may not on the whole be as intimate as desirable (for formulating a programme) owing to its outsider status. We thus rank the IMF with an 8.

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stances that would allow access above the limits was left deliberately unspecified. When the exceptional access policy was established, the Board deliberately retained the option to grant exceptional access in situations other than capital account crisis making recourse to the exceptional circumstances clause. In such cases the procedures for exceptional access described above continue to apply, and the request has to be judged "in light of the four substantive criteria", but the approval of the request would not necessarily be conditioned on meeting those criteria. The annual limit applies to gross purchases under the credit tranches (normally through a Stand-By Arrangement-SBA) or the Extended Fund Facility (EFF) in any 12-month period. The cumulative limit applies to credit outstanding, less scheduled repurchases, plus scheduled purchases, over the period of commitment of resources. In September 2002, the Executive Board agreed that the policies on exceptional access needed to be strengthened to ensure that such access remains exceptional. Four criteria were laid down that would need to be met to justify exceptional access for members facing a capital account crisis: (i) the country is experiencing balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within the normal limits; (ii) a high probability that debt will remain sustainable established on the basis of a rigorous and systematic analysis; (iii) good prospects for the member to regain access to private capital markets within the time Fund resources would be outstanding; and (iv) a strong adjustment programme adopted by the member that provides a reasonably good prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment. In addition, the Board agreed on strengthening the procedures for decision-making to provide additional safeguards and enhance accountability.

- 8 The extent to which timely access to relevant information helps prevent a crisis is the subject of a perennial debate. In this context, it is worth recalling that a recent report by the Independent Evaluation Office (IEO 2009) found evidence of relatively less effective surveillance of advanced and large emerging market economies, despite greater divulgence of information. Moreover, Lombardi and Woods (2008) argue that surveillance activities need to be more member driven, less prescriptive and more open to peer participation if they are to invite learning and cooperation, and hence become more effective.

*(iii) Analytical expertise*

The Fund currently employs about 2,600 staff, half of whom are economists. It is generally acknowledged that the Fund has been able to attract highly qualified professionals. The IMF's Research Department is widely considered to be one of the outposts for research in international finance, comparable with top university departments. The large body of professional staff, which frequently visits the member countries and constantly follows the developments in their countries of operation, has enabled the IMF to develop profound expertise and carry out its mandate.

Despite this, the Fund has been condemned for its neoclassical focus and inappropriate policy advice. For instance, critics have blamed the Fund for giving flawed policy advice to Argentina in the run-up to the Argentinean crisis of 2001–02, or wrong policy prescriptions during the Asian crisis of 1997–98 (e.g. Radelet / Sachs 1998; Katz 1999; Stiglitz 2000). Moreover, the Fund largely failed to identify the accumulation of risks that were building up in financial markets and ultimately lead to the global financial crisis of 2008–09. (The Bank for International Settlements (BIS), which has a much smaller professional body, in contrast, fared better in detecting and warning of vulnerabilities in the markets. Similarly, United Nations (UN) agencies like United Nations Conference on Trade and Development (UNCTAD) and Economic Commission for Latin America and the Caribbean (ECLAC) repeatedly warned of the discrepancies between increasingly sophisticated and dynamic international financial markets and the lack of proper institutional framework to regulate them (Ocampo 2010).) Critics of the Fund argue that a large pool of orthodox trained PhDs and a lack of internal diversity were a major liability for the IMF and prevented the Fund from spotting the dangers to financial stability arising from weakly regulated, overleveraged financial markets.<sup>9</sup>

Nonetheless, there is widespread agreement that IMF surveillance produces highly useful general reports (such as the World Economic Outlook). The Fund has also proven capable of learning from crises and its own mistakes, which became evident in its policy prescriptions during the 2008–09 crisis. We thus proceed on the assumption that, notwithstanding this criticism, the Fund strives for the highest analytical standards, and is widely regarded as setting the benchmark, albeit until recently predominantly in orthodox economics, by which other economics institutions measure themselves. We hence rate the Fund with an 8 for this criterion.

*(iv) Speed of decision-making*

The Executive Board agreed to accelerated procedures for the consideration of financing requests as part of the Emergency Financing Mechanism in September 1995 following the Mexican crisis.<sup>10</sup> These procedures were designed to facilitate rapid approval of Fund support while assuring the necessary conditionality. In terms of timing, the procedures stipulate *inter alia* that once an agreement has been reached with a country on a programme, staff would circulate documents to the Executive Board within 5 days, and the Board

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9 Ocampo (2010) points out that the Bank for International Settlements (BIS) and the UN had been calling for a macro-prudential financial regulatory framework for a decade before it was adopted by the G-20 in 2008.

10 See “Summing Up by the Chairman, Emergency Financing Mechanism”, Executive Board Meeting 95/85, 12 Sept. 1995.

would be prepared to consider the request for an arrangement as early as 48 to 72 hours later.<sup>11</sup> This emergency procedure was invoked in the cases of Korea and Indonesia.

Notwithstanding these provisions for a swift crisis response, a criticism that has been applied to the Fund every so often, especially in the evaluation of the IMF's response during the Asian crisis, is that it acted too slowly to combat crises (e.g. Radelet / Sachs 1998). Indeed, the Fund's swift response to the Mexican "tequila" crisis of 1995 with a USD 17.8 billion standby programme (amounting to 688% of Mexico's quota in the IMF) that was matched with USD 20 billion from the US Stabilisation Fund and USD 10 billion from the G-10 (Bordo / James 2000, 33) contrasted sharply with the inert crisis support for Thailand, South Korea, and Indonesia.

The IMF has tried to learn its lessons from the Asian and other crisis. Among other things, it established new and more flexible facilities. The Supplemental Reserve Facility (SRF) was created in December 1997 to assist emerging market economies facing a sudden loss of market confidence, and was designed in such a way to facilitate swift negotiation and implementation. In practice, the emphasis was on accessing amounts above SBA limits rather than rapid responses, as recipient countries were all already on SBAs, i.e. with longer-standing problems. More recently, the Flexible Credit Line (FCL) was introduced in spring 2009 to provide large and upfront financing to pre-qualifying members, that is, those with very strong fundamentals and policies.<sup>12</sup> As a further response to the crisis the Fund also enhanced the preventive angle of its flag-ship SBA facility to provide flexibility in lending also to countries that do not qualify for the FCL but need similar "insurance". Like the FCL, the so-called High Access Precautionary Arrangements (HAPAs) provide large financial support on a precautionary basis, which can be frontloaded when the need arises.

The recent attempts at increasing the Fund's performance in terms of timeliness and speed can be expected to increase the overall appeal of IMF lending. While the time from agreement to Board approval and disbursement is short – only a matter of days – there is little evidence on the time from the request to the agreement. This may be lengthened by the competing interests of the needy country (seeking high and rapid access with minimal conditionality) and IMF staff (mindful of the need to safeguard resources and secure overall board approval). We hence assign a 7.

#### *(v) Impartiality in lending decisions*

The impartiality of the IMF's staff is to be assumed. However, lending decisions need to be approved by the Executive Board, which is criticised in some quarters as being influenced by geopolitical considerations. For instance, there has been criticism of dominant US influence to favour some Latin American countries or of EU members supporting

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11 In terms of conditionality, the procedures state that the member would need to be ready to engage immediately in accelerated negotiations with the Fund in order to agree on measures sufficiently strong to address the problems, that prior actions would be expected and that the member's past cooperation with the Fund would have a strong bearing on the speed with which the Fund could assess the situation.

12 The SRF was eliminated in the 2009 reforms along with other seldom-used facilities (the Compensatory Financing Facility and the Short-Term Liquidity Facility) to simplify the Fund's lending toolkit. Mexico, Colombia and Poland have so far used the FCL.

countries in the region.<sup>13</sup> Moreover, an often-made claim is that the Fund's lending decisions have been partially driven by the interests of the main shareholders.

Indeed, a major criticism of the Fund is that its governance structure is dominated by the US and European countries, which together hold 10 out of 24 Executive Directorships. As can be seen from Table 2, the voting rights in the Executive Board are concentrated among

<b>Table 2: IMF Quota and votes of largest shareholders</b>					
	Quota		Votes		GDP/World GDP
	Millions of SDRs	Percent of total	Number	Percent of total	2007
USA	37,149.3	17.09	371,743	16.77	25.11
Japan	13,312.8	6.12	133,378	6.02	7.97
Germany	13,008.2	5.98	130,332	5.88	6.04
France	10,738.5	4.94	107,635	4.85	4.72
United Kingdom	10,738.5	4.94	107,635	4.85	5.10
China	8,090.1	3.72	81,151	3.66	6.15
Italy	7,055.5	3.24	70,805	3.19	3.85
Saudi Arabia	6,985.5	3.21	70,105	3.16	0.69
Canada	6,369.2	2.93	63,942	2.88	0.03
Russia	5,945.4	2.73	59,704	2.69	0.02
Netherlands	5,162.4	2.37	51,874	2.34	1.41
Belgium	4,605.2	2.12	46,302	2.09	0.83
India	4,158.2	1.91	41,832	1.89	2.00
Switzerland	3,458.5	1.59	34,835	1.57	0.01
Australia	3,236.4	1.49	32,614	1.47	0.02
Mexico	3,152.8	1.45	31,778	1.43	1.86
Spain	3,048.9	1.40	30,739	1.39	2.62
Brasil	3,036.1	1.40	30,611	1.38	2.42
Korea	2,927.3	1.35	29,523	1.33	0.02
Venezuela	2,659.1	1.22	26,841	1.21	0.00
EU	70,403.6	32.38	710,786	32.06	30.78
Source: IMF quota and votes (as of July 24, 2009) from: <a href="http://www.imf.org/external/np/sec/memdir/members.htm#u">http://www.imf.org/external/np/sec/memdir/members.htm#u</a> GDP data from IMF World Economic Outlook Database (April 2009)					

13 The fact that the Fund permitted Latvia in 2009 to retain its currency peg despite a large current account deficit and intense market pressure to devalue the lats (in contrast to its advice during the Asian financial crisis) prompted Arvind Subramanian of the Peterson Institute for International Economics to remark that the impression given was “*not of an International Monetary Fund but a Euro-Atlantic Monetary Fund*” (Beattie 2009, 3).

a small group of industrialised countries. The five largest IMF shareholders (the US, Japan, Germany, France and the UK) hold 38.37% of IMF voting rights. The 27 EU members together hold 32.06% of total voting rights. The US and the EU together account for 48.77%, very close to the simple majority needed for lending decisions. Furthermore, given that many key issues require an 85% majority in the Executive Board, the United States – with 16.77% of total votes – effectively has a veto over major Fund decisions.<sup>14</sup>

While the Fund's governance structure as such does not imply that lending decisions are biased, anecdotal evidence suggests that lending decisions have been politicised at various instances in the past and dominated by the major shareholders. The IMF's Independent Evaluation Office criticises that accountability is “probably the weakest aspect of IMF governance” (IEO 2008, 7–8), pointing to difficulties induced by “the overlap of responsibilities between the Board and Management on the one hand, and between the Board and their political principals on the other [which] blurs the line of accountability and makes it difficult to identify a set of outputs for which the Board could be held accountable.” Of the Board's Executive Directors, five serve at the pleasure of an appointing member, while the remainder are elected for a two year term, with re-election possible in some constituencies. For management, it was long the practice that the Managing Director (who chairs the Executive Board meetings) was European and the First Deputy Managing Director was from the US, although this practice is set to be abolished. Given that voting shares diverge widely and the Board's decisions are, at least at times, influenced by political considerations, we opt for a 6.

#### *(vi) Monitoring and enforcement mechanisms*

IMF conditionality is “aimed at helping member countries solve balance of payments problems without resorting to measures that may put national or international prosperity in jeopardy while at the same time establishing adequate safeguards for the use of IMF resources” (IMF 2009b). A major criticism that the Fund has to live with is that the conditionality it has attached to its lending has been partly excessive and inappropriate. Feldstein (1998, 20), for instance, argues that the IMF's emphasis during the 1990s “on imposing major structural and institutional reforms as opposed to focusing on balance of payments adjustments” was misguided, and that the Fund “should stick to its traditional task of helping countries cope with temporary shortages of foreign exchange and with more sustained trade deficits”.<sup>15</sup> Buira (2003) criticises that the Fund has expanded conditionality well beyond its core areas of competence in the fields of monetary and fiscal policy and issues related to the exchange rate system to also encompass structural change in the trade regime, pricing and marketing policy, public sector management, public safety nets, restructuring and privatisation of public enterprises, the agricultural sector, the energy sector, the financial sector, issues of governance and others in which the IMF's expertise is limited. Saner and Guilherme (2007a, 2007b) maintain that the IMF's use of lending conditionality has stepped beyond its core legal mandate, particu-

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14 On the role of low-income member countries in the governance of the IMF, see the contributions in Boughton / Lombardi (2009).

15 Such conditionality, in the past an essential part of the IMF's mode of operations, has also been severely criticised by the International Financial Institutions Advisory Committee, also known as the Meltzer commission (Meltzer 2000).

larly causing harm to the least developed countries' economic development, for example by dictating their trade policies.

Against the backdrop of the continuing debate over the use and effectiveness of structural conditions, the IMF's Independent Evaluation Office (IEO) undertook an evaluation of the use of structural conditionality in IMF-supported programmes (IEO 2007), which focused on the effectiveness of structural conditionality at bringing about lasting economic change and the impact of the IMF's 2000 Streamlining Initiative to achieve greater focus in the use of conditionality in Fund arrangements. The study found that a significant number of structural conditions are very detailed, not obviously critical, and often felt to be intrusive and to undermine domestic ownership of programmes. According to the IEO, it was not evident why so many conditions, and at such a level of specificity, are needed to bring about the desired long-lasting reforms. The IEO also highlighted that compliance with structural conditionality, which stands at about 50%, is low compared to about 85 percent for macroeconomic conditionality.<sup>16</sup> It therefore concluded that it is difficult to see how structural conditionality contributes to ensuring adequate safeguards for the use of IMF resources or how it provides assurances to borrowing countries regarding the conditions under which the Fund's resources would be available to them.

In March 2009, the IMF modernised its conditionality framework as part of the reforms of its lending toolkit. The declared aim is to tailor structural conditions to member countries' different policies and backgrounds. This is to be achieved by using pre-set qualification criteria under the FCL and making traditional conditionality more flexible. In particular, monitoring of structural reforms is now conducted fully in the context of programme reviews, with the use of structural performance criteria discontinued in all IMF arrangements, including those for low-income countries. The newly introduced FCL for pre-qualified member countries allow for a quick disbursement of funds with hardly any strings attached. In line with this new approach, the conditionality, attached to recent Fund rescue programmes in the global financial crisis have been remarkably light.<sup>17</sup>

Although the Fund may not always have been the best at tailoring conditionality, the IMF has the capability and resources to monitor the enforcement of its lending conditions. The use of performance-based tranche release serves as a reasonably effective enforcement mechanism, despite the scope for waivers. We hence rank the IMF with an 8.

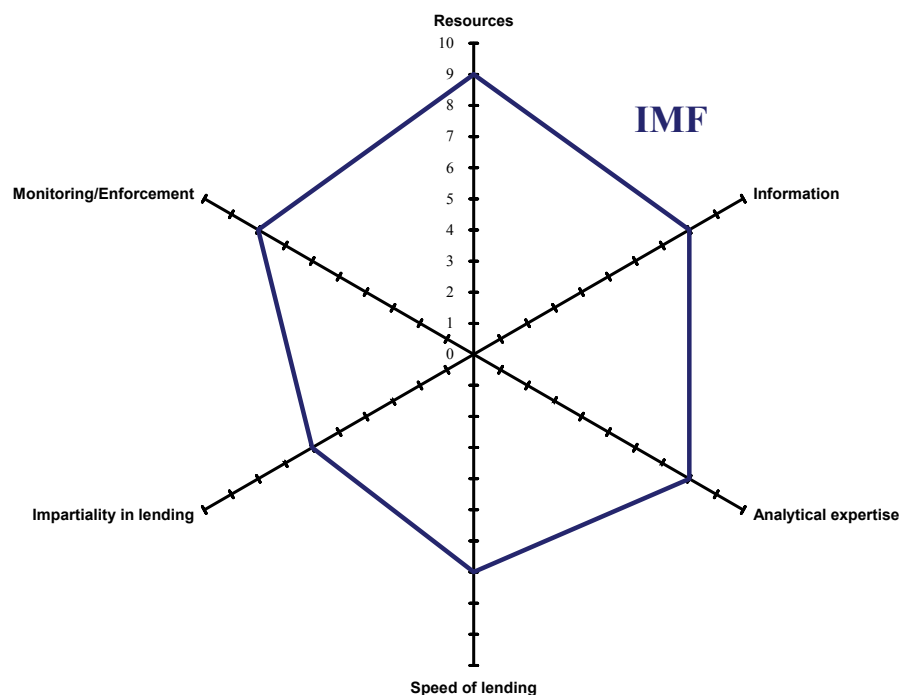
In sum, figure 1 displays the scores for the respective criteria for the IMF in a spider web chart. In the following analysis of RFAs, we will use this chart to compare their performance with the IMF's.

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16 Regarding the effectiveness and enforcement of Fund conditionality, Buira (2003) highlights that the rate of member countries' compliance with Fund-supported programmes showed a parallel and remarkable decline as the number of conditions, particularly structural conditions, increased gradually during the 1980s, and rapidly during the 1990s.

17 As the IMF's managing director Dominique Strauss-Kahn recently said, the use of conditionality attached to IMF loans has become more focused on *"fixing the crisis, not fixing the world"* (The Economist 2009).



**Figure 1: Criteria applied to IMF**

Source: Authors

### 3 How do regional pooling arrangements compare?

We now turn to an assessment of various existing RFAs. Among the most advanced and established RFAs are the European Union's Medium-term Financial Assistance (MTFA) Facility 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 (then under the name of Andean Reserve Fund-FAR) and today has six member countries; as well as the Arab Monetary Fund (AMF), which was founded in 1976 and which today has 22 member countries in the Gulf region.

#### 3.1 Financial assistance in Europe: Medium-term Financial Assistance (MTFA)

Community instruments to deal with balance of payments problems were established in the early stages of European integration. The relevant Article 143 of the Treaty on the Functioning of the European Union provides that if a member state is in "serious difficulties or is seriously threatened with difficulties as regards its balance of payments" and if such difficulties could "jeopardise the functioning of the common market", the Commission shall recommend to the Council the granting of mutual assistance and appropriate methods. Article 143 does not define the instrument to be used.

Two facilities were established in the 1970s, i.e. the MTFA of 1971 and the Community loan mechanism which was established in 1975. In 1988, the Economic and Financial Af-

fairs (ECOFIN) Council merged these two instruments into the MTFA. Moreover, whereas beforehand both member states and financial markets could be used to source financing for the facilities, the MTFA now relies solely on financial markets.<sup>18</sup>

The MTFA was originally designed for all member states of the European Community/Union. Since 1999 the facility is restricted to non-euro area member states only, that is, its members are all EU member countries which have not adopted the euro (Bulgaria, Czech Republic, Denmark, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Sweden and the United Kingdom).

The predecessors of the MTFA extended eight loans to member states between 1974 and 1993. The last loan in that period was granted to Italy in 1993. Since 1993, the MTFA remained unused until the outbreak of the global financial crisis (see below).<sup>19</sup>

In case funds are needed for liquidity support, the Commission borrows resources from the market and makes them available to a member state in the form of loans. The MTFA may be implemented by the Council at the initiative of the Commission or of a member state experiencing or threatened by balance of payments difficulties. The Council decides whether to grant a loan, its amount, the duration and the conditionality. The Commission is empowered on behalf of the EU to contract borrowings on capital markets or with financial institutions, while the European Central Bank (ECB) makes the necessary arrangements for the administration of the loans. The Commission together with the Council also monitors the implementation of the economic policy measures. Loans may be granted as consolidation to the support made available by the ECB under the Very Short Term Financing Facility (VSTF).

In light of recent experience, there have been additions to the lending framework to cover also euro area members. When a euro area member encountered solvency difficulties in 2010, EU members responded with loans for that country. Greece received bilateral loans totalling EUR 80 billion augmented by IMF lending of EUR 30 billion. Following this development, the European Council agreed on 9 May 2010 to set up a European Financial Stabilisation Mechanism (EFSM) for the support for all member states, which increases the remaining amount available under the MTFA to EUR 60 billion, and represents a modification of it. In addition, euro area members agreed to set up a special purpose vehicle – the European Financial Stabilisation Facility (EFSF) – specifically for other euro area members in need, given the collective interest in preserving the stability of the euro. With these two additional facilities, all EU members – whether euro area or non-euro area – now have recourse to EU finance under pre-defined circumstances, and envisage IMF co-financing. In this section, we continue to focus on the MTFA, since the operational specifics of the EFSF are still in formation.

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18 The relevant Council Regulation to date is the one adopted in 2002, which was amended twice – in 2008 and 2009 – to increase the ceiling for outstanding amounts to member states.

19 Every three years the ECOFIN Council has to assess whether the facility still meets the need which led to its creation. The first review took place in October 2005, when the ECOFIN Council on the basis of a Commission report and an Economic and Financial Committee (EFC) opinion was of the view that the principle and underlying rationale of the facility remain valid although the facility had not been activated since the adoption of the 2002 Regulation.

*(i) Size of the financing pool*

Until 2008, the maximum amount of loans to be granted to member states under the MTFA was limited to EUR 12 billion. In December 2008, this ceiling was increased to EUR 25 billion. The relevant Council Regulation argued that the large number of Member States currently outside the euro area affected the potential demand for Community assistance and therefore called for a significant increase of the ceiling. As a further response to the global financial crisis, the ECOFIN Council in May 2009 agreed on an additional enlargement of the MTFA ceiling to EUR 50 billions. The new EFSM for all member states, which is a modified MTFA, increases the amount that remains available for borrowing to EUR 60 billion and presumes that beneficiaries will also obtain an IMF loan. (The EFSF for euro area members has a total limit of EUR 440 billion, which the IMF is expected – but not legally obliged – to support by offering an additional 50% or more of the amount made available under the euro area facility.)

As of April 2010, three countries had been granted access to the MTFA: Hungary EUR 6.5 billion (November 2008), Latvia EUR 3.1 billion (January 2009) and Romania EUR 5 billion (May 2009). That is, EUR 14.6 billion out of the total amount available under the MTFA have been used. (Note that EU assistance has always been part of international packages which included loans from the IMF and the World Bank, plus sometimes loans from the EIB, the EBRD and bilateral sources.)<sup>20</sup>

The new EFSF makes available EUR 440 billion for euro area members only which, combined with the 60 billion from the EFSM, brings the total available to EUR 500 billion, excluding the special loans of EUR 80 billion to Greece.) Against this background, we rate the amount that can currently be made available with an 8.

*(ii) Access to relevant information*

Given the regular surveillance activities at the Community level in the context of European economic policy coordination, the Commission has detailed access to member states' economic and financial information. The Member State seeking assistance has to discuss with the Commission an assessment of its financial needs and submit a draft adjustment programme. Therefore, we consider that access to relevant information should not pose an obstacle for an efficient use of the European arrangement, although one can of course never rule out data problems, including false reporting. We hence rate the European arrangement with a 9.

*(iii) Analytical expertise*

The Commission is well-staffed, and the workforce is generally perceived as well-qualified. The same applies to staff at the ministries of finance and ministries of economics and central banks, including the ECB, that are preparing ECOFIN decisions. At the same time, European officials conduct such analysis less frequently than the IMF, which would suggest that the IMF has the edge. We therefore assign a 7.

*(iv) Speed of decision-making*

The recent crisis experience and the swift response of the ECOFIN Council and disbursement of MTFA support shows that decision-making in a pre-defined framework is relatively fast. We therefore assign an 8 for this criterion.

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20 According to the Council Regulation, a Member State calling upon sources of financing outside the Community, which are subject to economic policy conditions, must first consult the Commission and the other member states in order to examine the possibility available under the Community MTFA.

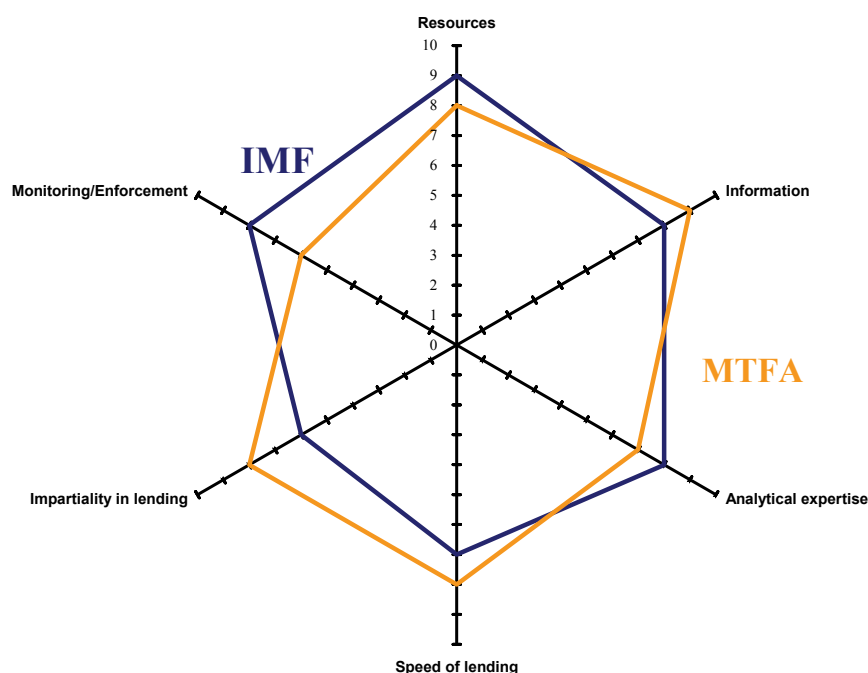
*(v) Impartiality in lending decisions*

While the influence of special historical, political or economic links within a subgroup cannot be ruled out, it is to be expected that all EU member countries have an equally strong interest in preventing a balance of payments crisis in any of the fellow member countries which could lead to contagion effects across the region. Given the close relations among EU members, assistance is likely to be granted even where the risk to the region is minimal, provided the member in difficulty is committed to undertaking the necessary reforms. Therefore, we assume that lending decisions will not be unduly swayed by a minority within the EU, rendering lending decisions relatively impartial. We therefore assign an 8.

*(vi) Monitoring and enforcement mechanisms*

Access to all three arrangements is subject to conditionality. Specifically for the MTFA (the only arrangement so far used), the regulations state that the Council shall decide the economic policy conditions with a view to re-establishing or ensuring a sustainable balance of payment situation. The Commission shall take the necessary measures to verify at regular intervals, in collaboration with the ECOFIN, that the economic policy of the member state in receipt of a Community loan accords with the adjustment or back-up programme and with any other conditions laid down by the Council. To this end, the member state places all the necessary information at the disposal of the Commission which, after the ECOFIN Committee has delivered an opinion, decides on the release of further instalments. Although the monitoring capacities as well as the means the Commission has at its disposal for enforcing conditionality through the Community budget would suggest a high score, there are numerous examples of peer group pressure and rules and procedures failing in the EU (e.g. in maintaining fiscal discipline). Hence, we rate this lower with a 6.

**Figure 2: Criteria applied to MTFA**



Source: Authors

### 3.2 The North American Framework Agreement (NAFA)

The North American Framework Agreement (NAFA) was established in April 1994 by Canada, Mexico and the United States as a parallel financial agreement to the newly established North American Free Trade Agreement (NAFTA). It is not a formal RFA, but a network of bilateral swaps that is designed to provide liquidity support to member countries' central banks to avert exchange rate pressure and financial instability in the context of increased economic integration under NAFTA.<sup>21</sup>

It is noteworthy that in the recent crisis, which was broad-based and did not solely afflict North America, the Federal Reserve set up swap arrangements with the Bank of Canada and the Banco de Mexico outside the NAFA. On 18 Sept. 2008, the Federal Reserve entered into a swap agreement with the Bank of Canada (as well as a number of other advanced economy central banks) for an amount of USD 10 billion to expire on 30 Jan. 2009. This agreement was augmented on 29 Sept. 2009 to USD 30 billion and the expiry date shifted to 30 Apr. 2009. On 20 Oct. 2008, the Federal Reserve agreed on a USD 30 billion swap with the Banco de Mexico (as well as a number of other central banks from large emerging market economies). On 3 Febr. 2009, and again on 25 June 2009, the expiry date for all the swaps, including Canada's and Mexico's was put back, and they expired on 1 Febr. 2010. On 9 May 2010, the swap between the Fed and the Bank of Canada was revived, along with those of some other advanced economies.

#### *(i) Size of the financing pool*

The three bilateral swap arrangements add up to just under USD 9 billion. The US-Mexico arrangement amounts to USD 6 billion, with the US Treasury and the Federal Reserve contributing up to USD 3 billion each. The Canada-Mexico swap is CAD 1 billion in size, and the US-Canada swap amounts to USD 2 billion. The parties to each of the swaps have reciprocal rights to draw on the swaps, but the agreements need to be renewed annually. Given the size of the economies involved, the amount of emergency financing through these swaps is rather negligible. For instance, the amounts available under NAFA proved to be insufficient during the 1994–95 Mexican crisis and were far exceeded by the magnitude of capital flows, necessitating a much larger financial rescue package.<sup>22</sup> As noted earlier, in the recent financial turmoil the Federal Reserve entered into swap agreements with both Canada and Mexico (along with a number of other advanced and emerging market economies) for far larger sums outside the framework of NAFA. We thus rate NAFA with a 3.

#### *(ii) Timely access to relevant information*

The establishment of a consultative mechanism parallel to NAFA, the North American Financial Group, brings together officials from treasuries and central banks to discuss financial and macroeconomic developments and policies on an annual basis. This high-level

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21 The bilateral swap arrangements among the US, Canada and Mexico predated the creation of NAFA, under which they were brought together and enlarged.

22 Following the initial provision of short-term liquidity by the US and Canada in Jan. 1995, the US-Mexico and Canada-Mexico swaps were temporarily augmented by 50%, but the additional liquidity was not drawn in the end and the short-term NAFA swaps were replaced by much larger medium-term loans from the US Treasury's Exchange Stabilization Fund and the IMF, exceeding USD 50 billion. This allowed the NAFA swaps to be fully reversed by Jan. 1996.

exchange is complemented by an exchange of timely information, so that we rate NAFA with a 9.

*(iii) Analytical expertise*

The participants in the NAFA and the staff of their respective institutions comprise high quality talent with a sound level of professional expertise. The size of the human resources is unclear as they are drawn from member governments, and is likely to vary depending on the importance of prevailing NAFA issues, but can be expected to be sufficient if not ample. For this reason we rate this criterion with an 8.

*(iv) Speed of decision-making*

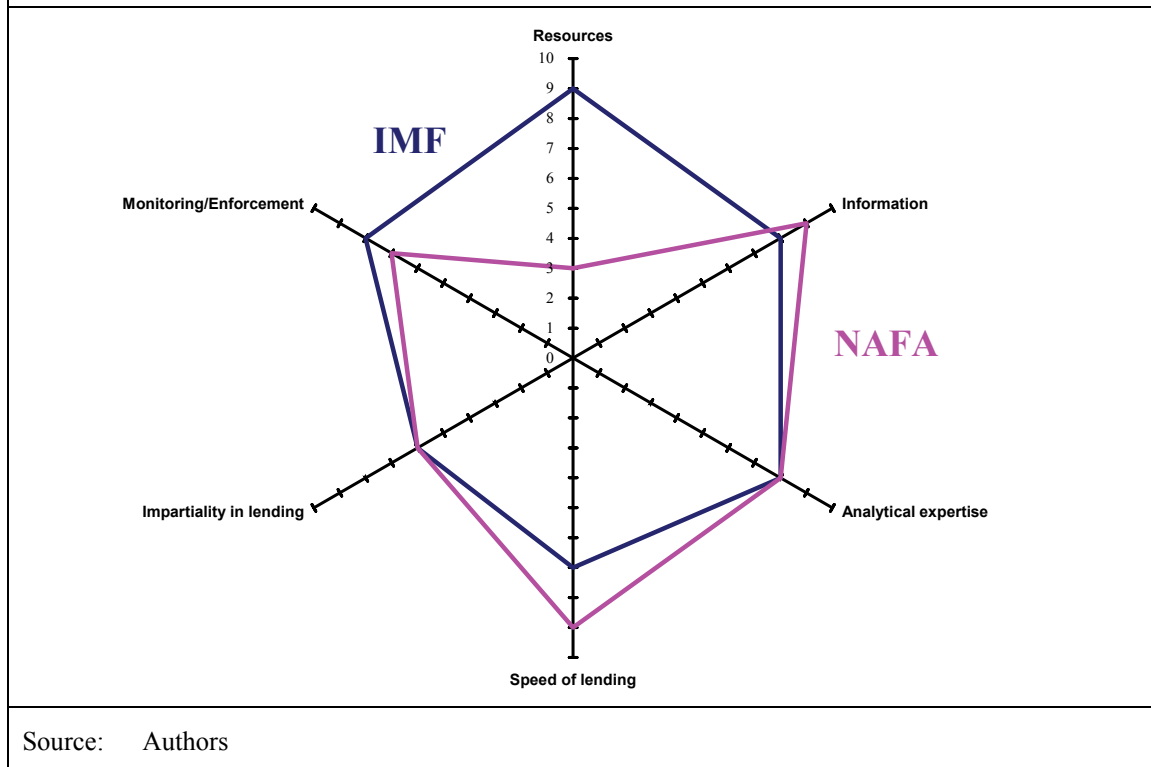
NAFA swaps are activated by approval of both sides to a transaction. On the side of the US, the funds have to be activated by both the Secretary of the Treasury and the Federal Open Market Committee of the Federal Reserve, which formally controls the activation of all Fed swaps, respectively. Depending on the size of the swap approved, there may be no conditionality, which simplifies the approval process. Yet even for large sums which require greater evaluation and negotiation, the experience during the Mexican crisis suggests that decision-making is fast. We assign a 9.

*(v) Impartiality in lending decisions*

Because lending decisions are taken at the highest political level, and the political power of three countries is unbalanced, lending decisions are likely to be influenced by considerations that go beyond purely technical analysis. At the same time, the relatively small amounts involved, the small number of parties to the agreement, and the high degree of integration of Canada and Mexico with the US, makes for aligned interests, which can be expected to support swap decisions, and downplay the importance of the concentration of power. We hence rate NAFA simply with a 6.

*(vi) Monitoring and enforcement mechanisms*

The provision of liquidity is not subject to formal conditionality or linked to a Fund-supported programme. However, the requirement of activation by mutual agreement effectively gives the creditor country the ability to insist on conditions for disbursement. In particular, participation by the US Treasury, which in practice establishes the conditions for activation on the US side, requires repayment assurances. For instance, when drawing on its Exchange Stabilisation Fund, as done during the peso crisis in January 1995, the US Treasury required that an assured source of repayment is identified and that the IMF managing director provides a letter stating his confidence in the economic policies of the borrower (Henning 2002). There are, however, no standardised criteria against which assurances of repayment are measured. We hence assign a 7.

**Figure 3: Criteria applied to NAFA**

### 3.3 The Arab Monetary Fund (AMF)

The Arab Monetary Fund (AMF) was founded in 1976 and started operations in 1977. It has 22 member countries.<sup>23</sup> The AMF aims at contributing to the achievement of the following objectives: (i) correcting disequilibria in the balance of payments of member States; (ii) striving for the removal of restrictions on current payments between member States; (iii) establishing policies and modes of Arab monetary co-operation; (iv) rendering advice, whenever called upon to do so, with regard to policies related to the investment of the financial resources of member States in foreign markets; (v) promoting the development of Arab financial markets; (vi) paving the way towards the creation of a unified Arab currency; and (vii) promoting trade among member states. It has a formal structure, with several elements adopted from the IMF. In the period from its establishment to end 2009 it made 146 loans benefiting 14 countries for a total value of USD 5.6 billion, of which around three-quarters was balance of payments related. In 2009, the AMF made two loans for stabilisation purposes, totalling around USD 140 million, the largest amount since 2001. It is interesting that several of its members are among the world's largest gas and oil producers, implying that most of these countries are not likely to experience balance of payments difficulties. Rather, the most vulnerable members are the net energy importers. This diversification of membership ought to promote confidence in the AMF to be able to offer the support needed.

<sup>23</sup> Jordan, United Arab Emirates, Bahrain, Tunisia, Algeria, Djibouti, Saudi Arabia, Sudan, Syria, Somalia, Iraq, Oman, Palestine, Qatar, Kuwait, Lebanon, Libya, Egypt, Morocco, Mauritania, Yemen and Comoros.

*(i) Size of the financing pool*

From the outset, the AMF's resource pool was limited, which precludes it from financing a large share of the balance of payments needs of member countries. This was reflected in the articles of agreement in its approach to making the AMF a complementary rather than a principal source for financing those deficits. As of December 2009 the paid-up capital of the AMF stood at AAD 596 million (of a total authorised capital of AAD 600 million) (AMF 2009), that is, roughly USD 2.8 billion.<sup>24</sup> It does not borrow. There are two types of facilities offered by the AMF, one for balance of payments needs and one for structural adjustments. We focus on the former,<sup>25</sup> of which there are four types; the automatic loan (granted up to 75% of paid-in capital); ordinary loans (granted up to 100% of paid-up capital and combinable with the automatic loan to reach 175%); extended loans (granted to 175% of paid-up capital and combinable with the automatic loan, to reach 250%) and a compensatory loan (up to 100% of paid-in capital). That is, the maximum amount that can be borrowed from the AMF by any member under normal circumstances is 250% of paid-in capital. Although there is no formal link to IMF lending, countries in receipt of ordinary and extended loans are expected to withdraw their reserve tranches from "similar regional and international organisations". In addition, in 2009, the AMF approved a new short-term liquidity facility, up to 100% of quota, designed to provide resources to countries with a good track record but having difficulty accessing financial markets due to global crises. On this basis we rate the AMF's financing capabilities with a 5.

*(ii) Timely access to relevant information*

The AMF maintains close relations with member countries, which provide the AMF with timely access to relevant information and a comparative advantage over the IMF when it comes to knowledge of regional economics and politics, so that we rate the AMF with a 9.

*(iii) Analytical expertise*

The AMF has a technical staff of around 50 out of a total staff of around 100. Staff are well-trained and conduct reviews of financing needs reasonably frequently, but are rather stretched for resources that can be devoted to country coverage. We therefore rate the AMF with a 7.

*(iv) Speed of decision-making*

The AMF has a number loan types that vary in the speed of processing. The fastest type is the automatic loan, which is without conditionality and can be granted up to a maximum of 75% of paid-up capital. A country in need applies by letter, a quick internal report is prepared and management takes the decision, with later notification to the Board. The other two main types (the ordinary loan and extended loan) take longer to set up. Once a country has appealed for assistance, a mission is sent, a programme devised, a letter of intention produced by the authorities and submitted to the Board for consideration. This process can take between one and six weeks as a rule. These two approaches to granting finance provide countries with some assistance swiftly. For this reason, we assign a 9.

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24 The Arab accounting dinar (AAD) is the accounting unit of the Arab Monetary Fund and is equal to three IMF special drawing rights.

25 Between 1998 and 2009, loans for balance of payments assistance amounted to 35% of total lending.



*(v) Impartiality in lending decisions*

The AMF's lending activity is governed by lending policies and procedures consisting of a body of rules, regulations and procedures. The lending policies and procedures enunciate a number of fundamental basis and principles which the AMF must take into consideration in discharging its lending function, such as the principle of fairness and the equal opportunity of access to AMF's loans by Arab countries. There are eight voting seats on the Board, of which three are single seat. These three are Saudi Arabia with 13.58%, Algeria and Iraq, each with 11.96%, and their combined shares (at 37.5%) are lower than their contributions to subscribed capital (40.8%). Of the five constituencies, the voting shares range from 7.05% to 19.96%. On the one hand, the explicit and formal framework of the AMF, and attempt to shift from basing voting shares strictly on contributions to paid-in capital are indicative of efforts to limit the scope for undue influence on Board decisions. On the other hand, it can be argued that three out of the 22 member countries nevertheless hold over one-third of the voting rights, which is quite a high concentration. Hence, we rate the AMF with a 6 for this criterion.

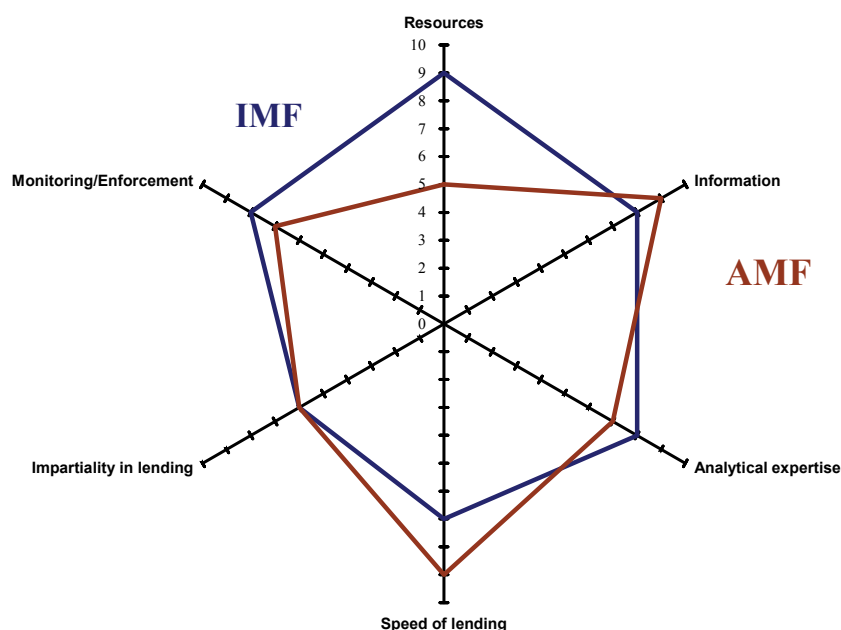
*(vi) Monitoring and enforcement mechanisms*

The AMF is required to ensure that the resources it lends are used safely by the borrowing members who must have the ability to meet their obligations towards it. Automatic loans have no conditionality attached, which removes a lever in disbursing tranches. The two types of loans offering the largest access to resources (ordinary and extended) require an agreement with the borrowing member on appropriate adjustment programmes. In both cases, the AMF undertakes consultations aimed at monitoring the effectiveness of the programmes in alleviating the member's balance of payments deficit during the loan's maturity period. It is evident that quite sizeable sums are recovered with a delay if at all (e.g. the 2009 Annual Report records USD 214 million in interest set-aside, USD 188 million in overdue interest, and USD 140 million in repayments and debt relief). To properly evaluate the extent to which these amounts indicate weak enforcement requires more detailed information, such as on the types of loans affected, the countries affected and possible security issues of those countries. In the absence of this information it would be inappropriate to pronounce on the implications for enforcement. Hence we choose a rating of 7 based on the procedures in place for monitoring and enforcement.

### 3.4 The Latin American Reserve Fund (FLAR)

FLAR was established in 1978 under the name of Andean Reserve Fund (Fondo Andinas de Reservas, FAR) for the five Andean countries (Bolivia, Colombia, Ecuador, Perú and Venezuela). It was renamed into Fondo Latinoamericano de Reservas (FLAR) when Costa Rica joined in 1989. Uruguay joined in 2008.

Originally, it was created to provide short-term liquidity support to its members' balance of payments. Besides providing external financing to central banks by granting credit and securing third-party loans, FLAR now also engages in improving the liquidity of international reserve investments; facilitating the restructuring of public debt; and helping to harmonise the members countries' monetary, exchange and financial policies (e.g. Titelman 2006; Eichengreen 2006). FAR was very active in the 1980s, supporting the external financing or short-term liquidity needs of Andean countries. Lending has been sporadic since then. In 2009, a large loan of USD 480 million was made to Ecuador.

**Figure 4: Criteria applied to AMF**

Source: Authors

*(i) Size of the financing pool*

FLAR resources come mainly from the paid-up capital of member countries (about 90%), which defines their debt capacity with the fund. In July 2009, members had paid up capital of USD 1.77 billion (of USD 2.34 billion authorised capital). These resources are supplemented by limited market borrowing. The level of access to credit lines is a function of paid-in capital as well as their stage of development. Bolivia and Ecuador are granted privileged access to FLAR and can borrow 350% of their capital, whereas other countries can use only 250%. The resources FLAR has available for emergency funding might seem rather small, but for Bolivia, Ecuador and Costa Rica, their debt capacity with FLAR is quite significant and markedly reduces their short-term debt to international reserves ratio when added to their international reserves. In the case of Bolivia and Ecuador, FLAR has loaned resources equivalent to 35% and 28% of the respective countries' reserves (Titelman 2006, 225). We hence rate this criterion with a 7.

*(ii) Timely access to relevant information*

The high degree of ownership of FLAR among the member countries and its designated role in supporting the coordination of member countries' macroeconomic and monetary policies ensures that FLAR is granted timely access to relevant information so that we rate it with a 9.

*(iii) Analytical expertise*

Besides its main functions as described above, FLAR also provides technical services, training and research services to members' central banks. When it comes to regional knowledge, it has a comparative advantage over the IMF. We thus rate it 7.

*(iv) Speed of decision-making*

FLAR funding is credited for its timeliness and speed, as well as anti-cyclical crisis lending (Titelman 2006; Ocampo / Titelman 2010). In some instances, FAR/FLAR was the only institution that provided emergency liquidity, such as during the Peruvian crisis of 1988. Short term lending for emergency liquidity needs – available up to 100% of paid in capital – is decided by the Executive President. Other lending decisions, as well as conditions and exceptions to access limits for balance of payments and debt restructuring credits, are taken by the Executive Board, which consists of members' central bank governors. This lending mode has given FLAR an operational advantage over the IMF in the timeliness of credits (Titelman 2006). We hence assign a 9 for this criterion.

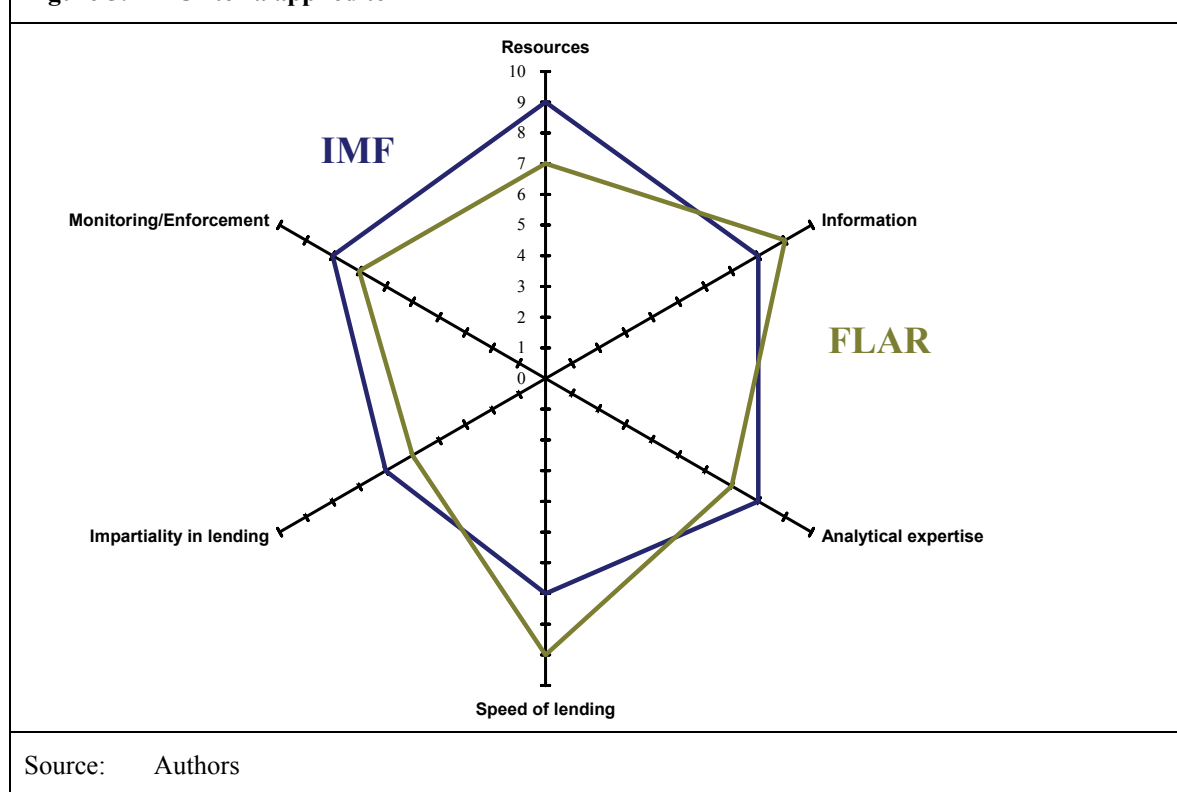
*(v) Impartiality in lending decisions*

Given FLAR's informal preferred creditor status and the strong sense of ownership among the small group of members that is characteristic of FLAR, its governing bodies maintain a benign and close relationship with member governments, which runs somewhat contrary to the aim of objective and impartial lending. Decisions are mainly by 75% majority of those present. Three countries (Colombia, Peru and Venezuela) each have 21% of the vote, and a further two (Bolivia and Ecuador) have 10.5%, while Costa Rica and Uruguay have 8.9% and 7.1% respectively. This affords the big three countries considerable weight in the decision. Indeed, for important decisions, not only is a 75% share of the votes of those present necessary, but votes cast against a proposal must not exceed 20%. This gives each of the three large countries a veto. We therefore assign a 5.

*(vi) Monitoring and enforcement mechanisms*

FLAR has a zero default record in its basic loan operations. Although it has no legal status as preferred creditor (where members would have to give priority to repayment of their obligations to FLAR over other creditors), it has de facto acquired such a status as member countries honoured their obligations even when defaulting to commercial creditors. This (informal) preferred creditor status is also reflected in the ratings of Moody's and Standard and Poor's.

FLAR has no conditionality for short-term credits, whereas credits for balance of payments support are conditional upon economic policy measures as determined by FLAR's Board of Directors. FLAR has no formal link between its own lending operations and the IMF's activities, but apparently assessment of macroeconomic performance by IMF staff has occasionally played an informal role in FLAR's lending decisions. (It is understood that FLAR can draw informally on the Fund's surveillance.) We hence rate it with a 7.

**Figure 5: Criteria applied to FLAR**

### 3.5 Regional financing assistance in East Asia: The Chiang Mai Initiative (CMI)

The CMI was launched in May 2000 in Chiang Mai, Thailand, by the finance ministers of the ASEAN Plus Three group (ASEAN+3), which consists of the ten member countries of the Association of Southeast Asian Nations (ASEAN) as well as China, Japan and South Korea. The idea was to provide short-term financial support for neighbouring countries which experience balance of payments problems. The CMI consists of an expanded ASEAN swap arrangement that includes the ASEAN countries and a network of bilateral swap arrangements among ASEAN+3 countries.<sup>26</sup>

Between 2000 and 2009, the CMI was developed further and the swap amounts augmented. On 3 May 2009, the ASEAN+3 finance ministers agreed in Bali on the governing mechanisms and implementation plan for the multilateralisation of the CMI (CMIM). That is, the bilateral currency swap agreements will be transformed into a single regional pooling arrangement. To date there have been no swaps, or drawings, under the CMI since its inception notwithstanding the global financial crisis, not least owing to the substantial own reserves of some of the member countries.

<sup>26</sup> On the creation of the CMI, see Henning (2002). On the multilateralisation of the CMI, see Volz (2009) and Sussangkarn (2010).

*(i) Size of the financing pool*

The ASEAN swap arrangement is now USD 2 billion in size, while some 16 bilateral swap arrangements have been successfully concluded among eight countries with a combined total size of about USD 90 billion. In February 2009, the ASEAN+3 finance ministers held a special meeting in Phuket in light of the global financial crisis and decided to increase the funds of the multilateralised CMI to a minimum of USD 120 billion. 20% of the funds are to be provided by the 10 ASEAN members and the remaining 80% by the Plus Three countries.<sup>27</sup>

While the amounts available to potential borrowers under the CMI are small in relation to most East Asian countries' foreign exchange holdings, the available facilities nonetheless exceed the region's less developed countries' quotas at the IMF by several multiples. (It is implicitly understood that the CMI would be drawn upon by the ASEAN countries, not by the Plus Three.) It should be noted, however, that the CMI currently operates under the so-called "IMF-link", which stipulates that only 20% of the credit lines can be disbursed without the borrowing country having a lending programme with the IMF. We hence rate the CMI with a 6 for this criterion.

*(ii) Timely access to relevant information*

So far the CMI has had no secretariat or other organisational entity that collects or processes information, as information was shared directly between governments. It is unclear how open the governments are with one another, especially given the historical hostilities between some members. Nevertheless, the frequency and coverage of meetings among ASEAN+3 has risen markedly over recent years.

The Bali agreement envisages the creation of a system for regional cooperation that is self-governed and goes beyond simple information-sharing or peer-review.<sup>28</sup> In particular, it entails the creation of an independent regional surveillance agency, the details of which were agreed upon by the ASEAN+3 finance ministers at their meeting in Tashkent on 2 May 2010 (ASEAN+3 2010). The ASEAN+3 Macroeconomic Surveillance Office (AMRO) will be located in Singapore and is supposed to be operational by early 2011. As such, the new reserve pooling arrangement under the CMIM – while stopping short of being a full-fledged Asian Monetary Fund – should be in a strong position to get timely access to relevant information from both the governments of member countries as well as financial markets.<sup>29</sup> For the time being, however, uncertainties remain about the access to data that AMRO will get from its members. In the CMIM negotiations some member countries have been apparently reluctant to share all information with the other ASEAN+3 countries, and a final agreement still needs to be found in this respect. Indeed, it is still subject to negotiations whether AMRO will get access to the same data

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27 With 32% each, China and Japan both contribute identical shares to the reserve pool. South Korea's share is 16% and ASEAN's 20%. To arrive at equal contributions by China and Japan, China's share comprises the contribution of Hong Kong, which will now join the CMI. China and Japan hence share joint leadership, while the smaller countries gain a larger weight in the governance structure of the CMI compared to their relative economic size.

28 As such, the multilateralised CMI goes far beyond previous initiatives like the Economic Review and Policy Dialogue that the ASEAN+3 established in April 1999.

29 The creation of an independent regional surveillance unit was already agreed upon at the ASEAN+3 summit in Phuket in February 2009.

that are provided to the IMF, and it is likely that disclosure of information to AMRO will be voluntary initially. On the basis of the current swap arrangements, we therefore award a rating of 5.

*(iii) Analytical expertise*

The envisaged regional surveillance agency should improve the level of dedicated professional resources and hence analytical expertise available within the CMI, which hitherto relied only on those of government officials. Nonetheless, to date AMRO has not been established, so that the CMI currently lacks its own expertise and human resources to conduct surveillance of regional financial markets and subsequently carry out analytical research on a level that would match the standards set by the IMF. We therefore assign a 5.

*(iv) Speed of decision-making*

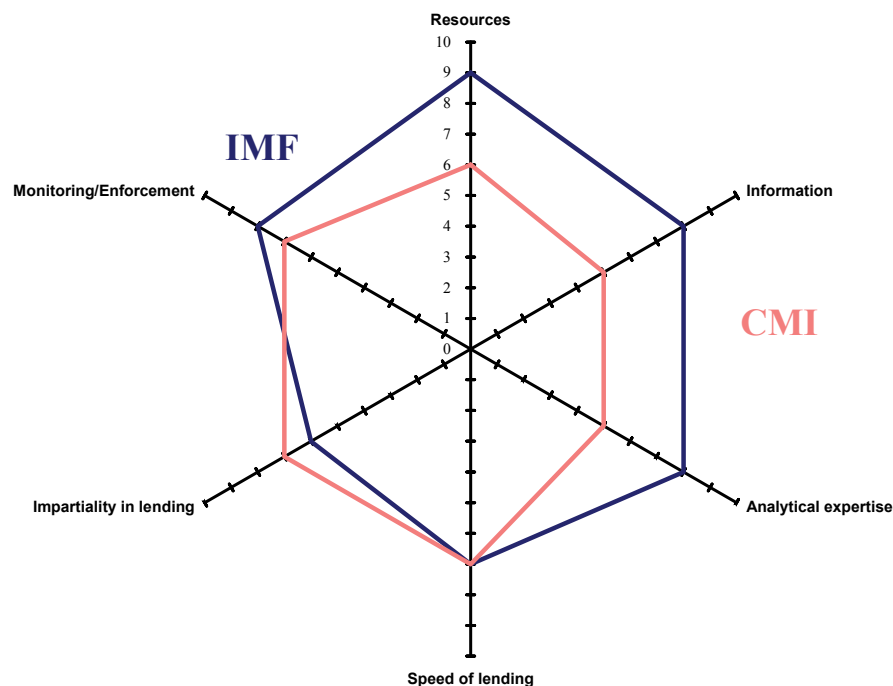
In Bali, the finance ministers agreed on the distribution of voting rights, which are allocated to prevent any of the Plus Three countries, or ASEAN as a group, from holding veto power. The types of decision were divided into two categories: fundamental issues, which require consensus among all ASEAN+3 countries; and lending issues, which are subject to simple majority ruling. As there is no experience with CMI lending so far, we can base our assessment only on the procedural structure that would come into force if a member country were to apply for assistance. In any case, given that due to the IMF-link only 20% of funds can be disbursed without the borrowing country having reached a lending agreement with the Fund, the speed of disbursement of the remaining 80% is dependent on an IMF decision. This potentially reduces the speed of CMI lending beyond the first 20%. We hence rate the CMI with a 7.

*(v) Impartiality in lending decisions*

Given that there has been no CMI lending so far, it is hard to assign a rating for this criterion. Given that no countries in the region have a veto and all have a vested interest in preventing a balance of payments crisis in any of their neighbouring countries, which could subsequently spill over to the rest of the regional or even the domestic economy, we assume that lending decisions should be impartial and assign a 7. This takes into account the dependency of 80% of loans disbursed on the existence of an IMF programme, and so is influenced by the rating of 6 given to the IMF.

*(vi) Monitoring and enforcement mechanisms*

As mentioned earlier, the CMI currently lacks the expertise and human resources to conduct surveillance of regional financial markets, which is one of the reasons why the IMF link has been maintained. Once the agreed mechanism for macroeconomic and financial monitoring under the CMI becomes fully functional and the CMI has created its own monitoring and enforcement apparatus within AMRO, the portion of CMI loans that can be disbursed without IMF lending will most likely be increased. For the time being, we rate the CMI's monitoring and enforcement mechanisms with a 7.

**Figure 6: Criteria applied to CMI**

Source: Authors

#### 4 Implications for international monetary stability and the IMF

Based on our review of how the IMF and the various RFAs fulfil the criteria for optimal lending arrangements we can 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, just on a smaller scale. This attests to certain elements being essential 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 emergency lender worldwide. Moreover, the way in which its programmes are designed is conducive to enforcement.

Third, a comparison with RFAs, however, shows that these also have their comparative advantages. In particular, RFAs have potentially quicker access to data, given their proximity to member governments, which in some cases feel a strong sense of ownership of the RFAs – something that is notably lacking among the IMF's developing and emerging market economy membership. The Fund, given its outsider status, may not get access as quickly as a 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, or the fewer 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, albeit this might be offset by more detailed regional or local knowledge. Also, RFAs may lack the expertise to define the policy course towards external sustainability and the amount of funding necessary to reassure markets.

Fourth, for impartiality in the lending decision, it is not obvious whether the universal lender or the regional lender has an advantage, since both leave something to be desired. Here, a case-by-case approach is clearly called for.

The existence and increasingly prominent role of RFAs give rise to a number of issues concerning the future and integrity of IMF crisis lending – one of the IMF's key roles. The key question is whether regional arrangements will supplement or supplant IMF lending to a country with a balance of payments crisis, and what implications this might have for international monetary stability. There are several risks that RFAs pose for international monetary stability, 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 provide time before a comprehensive programme with the Fund is 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 cooperation. 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. This may be one reason why the suggestion by Hugo Chavez, President of Venezuela, for a regional pool to provide unconditional, unlimited access to regional finance has not yet come to fruition.

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 start remedy measures early enough. 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.



The danger of conditionality shopping might also increase the risk of moral hazard because it is easier to tap funds.

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 (Imbs / Mauro 2007). (A counter example would be the Arab Monetary Fund, comprising net oil importers and exporters.)<sup>30</sup> 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 too small loan amounts to restore market confidence and 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.

Whether RFAs have the potential to replace the IMF as a major international lender, or become a serious competitor, ultimately depends on the resources made available to the respective RFA. While the large East Asian economies clearly have the resources to transform the multilateralised CMI into a fully-fledged Asian Monetary Fund that would make the IMF irrelevant in the region if they wish to do so, the situation appears different for other RFAs. An arrangement like FLAR is less likely to be conceived in isolation from global arrangements, given the limited resources of its member countries, even though the ranks obtained in specific criteria might be high.

It is quite clear that while RFAs can 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. Such adverse competition carries the danger of leading to a weakening of economic policy making standards through conditionality shopping. Undercutting Fund conditionality with an insufficiently rigorous economic management and lax lending requirements leaves open the risk of crisis exacerbation and contagion (assuming, of course, that Fund conditionality is appropriate).

Constructive competition for the Fund in the provision of crisis financing by RFAs should clearly be welcome, while an overt confrontation between the Fund and an RFA should be avoided. This points towards the need for clarifying existing lending procedures and a division of labour between the Fund and RFAs. Ocampo (2006) makes the case for a divi-

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30 For Latin America, Machinea / Titelman (2007) show that Chile and Colombia, both of which have a low reserve volatility, would not benefit from joining FLAR, since both would experience a decline in effective reserves as compared to self-insurance. Other Latin American countries such as Mexico, Ecuador and Peru, in contrast, would benefit from joining FLAR.

sion of labour in the provision of financing between global and regional organisations.<sup>31</sup> He proposes a federal network of the IMF and regional arrangements. In particular, Ocampo envisages that the IMF should play a central role in macroeconomic policy coordination at the global level, while RFAs should have a greater role on a regional and subregional level. While the Fund should manage the largest balance of payment crises to avoid regional and global contagion effects, he argues that RFAs could provide full crisis support to small and medium countries.

Like Ocampo (2006) and Henning (2006) demands a clearer division of labour between the Fund and RFAs, although he envisages a much more central role for the IMF. In particular, Henning (2006, 177–8) proposes a set of principles that regional facilities should adopt in order to guide their relationship with the Fund. In particular, Henning proposes that RFAs should (i) create no substantial conflict with members' obligations under the Articles of Agreement; (ii) be at least as transparent as the financial and monetary rules and operations of the IMF; (iii) adopt and pursue sound rules of emergency finance, to be understood as lending into liquidity shortfalls (as distinguished from insolvency) at premium interest rates and with assurance of repayment; and (iv) lend on sound conditionality, understood to mean policy adjustments that eliminate the financing gap in the medium term, or link lending to IMF conditionality directly.

Henning also suggests that IMF member countries engaged in regional facilities should agree (i) to report and disclose the details of their regional cooperative arrangements to the IMF; (ii) to submit their arrangements to the purview and assessment of the IMF's Executive Board; (iii) that regional financial facilities shall not undercut IMF conditionality; and (iv) that regional policies with respect to financial regulation and private-sector involvement must be consistent with stabilisation efforts on the part of the IMF. Such or similar rules would provide the basis for a successful collaboration between the IMF and RFAs and avoid the kind of unhealthy competition sketched out above. It would also be useful to assess the adequacy and usefulness of CMI-types of links for coordinating regional and global responses, both from the political and economic perspectives.

## 5 Conclusions

In this paper we examined the potential contribution of regional financing arrangements to the stability of the international monetary and financial system. The main conclusion is that whether RFAs *complement* the Fund or rather *complicate* the Funds work, that is, exacerbate or help alleviate crises, depends on their design and operation. To gauge the quality of an RFA, we established a set of “optimal financing criteria” relevant for providing crisis financing using a first principles approach. We then evaluated the frameworks for the various regional arrangements in existence against these criteria. Compared with the Fund, RFAs in general can be expected to have superior information about an economy in crisis, and react more quickly to address the situation. At the same time, RFAs may not have the expertise to define the policy course towards external sustainability and lack the amount of funding necessary to reassure markets. Moreover, there is a danger that, instead of being a second line of defence, RFAs might undercut Fund conditionality with an insufficiently rigorous economic management and lax lending requirements that

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31 See also Culpeper (2006).

will leave open the risk of crisis exacerbation and contagion to countries also beyond their membership. While a “competition for ideas” that leads to better policies and crisis responses should be welcome, a competition for the provision of public goods that will perversely lead to a deterioration of international monetary stability through conditionality shopping must be avoided. In contrast, it would be highly desirable to create or increase synergies between the various regional arrangements and the IMF.

An obvious extension to this work is to examine the growth of and recourse made to bilateral lines for the provision of liquidity, for example, via swap arrangements.<sup>32</sup> Why has more recourse been made to these than RFAs in the recent crisis? What does this reveal about the financing needs of countries, and what do they infer for international monetary stability? What gaps are they filling in the “market” for crisis financing; and how do they compare with other crisis financing arrangements?

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32 See the recent contributions by Aizenman / Jinjark / Parl (2010) and Obstfeld / Shambough / Taylor (2009).

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