ADBI Working Paper Series

Regional Financial Arrangements and the International Monetary Fund

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No. 394
November 2012

Asian Development Bank Institute

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Suggested citation:

Eichengreen, B. 2012. Regional Financial Arrangements and the International Monetary Fund. ADBI Working Paper 394. Tokyo: Asian Development Bank Institute. Available: http://www.adbi.org/working-paper/2012/11/06/5328.regional.financial.arrangements.imf/

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Abstract

The rise of regional monetary arrangements poses a challenge for the International Monetary Fund (IMF)'s global surveillance efforts. This paper reviews how the IMF has responded to earlier regional initiatives, from the European Payments Union of the 1950s and the Gold Pool of the 1960s to the CFA franc zone and the European Monetary System. The penultimate section draws out the implications for monetary regionalism in East Asia.

JEL Classification: F30, F53, F55

Contents

1. INTRODUCTION

Regional and multilateral financial arrangements have always sat uneasily with one another, but the tension between them is especially evident in crises. A case in point is the Asian financial crisis of 1997–08: this led first to a Japanese proposal for an Asian monetary fund, which was quashed by the United States (US) government and International Monetary Fund (IMF); then to IMF programs for the Asian crisis countries, which were less than happily received in the region; and finally to the Chiang Mai Initiative (CMI), which was portrayed as a framework through which regional and multilateral lenders could work together. Participants in the CMI (since renamed the Chiantg Mai Initiative Multilteralization, or CMIM) can draw up to 20% of their swap lines prior to agreeing with the IMF on the terms of a program, but additional drawings are then contingent on reaching a program with the Fund. But when Asian countries feared severe liquidity shortages in 2008-09, they responded not by activating the CMI but instead by agreeing to substantial expansion of the IMF's New Arrangements to Borrow.[1] Thus, the relationship between the CMIM and the IMF remains, to put it politely, unclear.[2]

Similarly, in the current European crisis the relationship between the IMF and the organs of European regionalism—specifically, the European Commission and European Central Bank (ECB)—remains very much a work in progress. When Greece was forced to seek external financial assistance, the European Union (EU) turned to the IMF to spearhead negotiations, but without exactly distancing itself from the critical discussions. Understandably, some might say, since the assistance package was financed one third by the Fund and fully two-thirds by Greece's EU partners through their European Financial Stability Facility. Subsequent negotiations modifying the terms of the assistance and making additional policy adjustments intended to keep the program on track were negotiated between the Greek government and the "troika" of the IMF, the European Commission and the European Central Bank (ECB). There was also tension between the lenders, as when the crisis spread in the summer of 2011 and IMF officials called for swift bank recapitalization but European leaders initially rebuffed their recommendation. But at the same time that some critics complained that the IMF and Europeans remained too distant, others warned that they were too close, reflecting the dominance of Europeans in the Fund's management. Non-European members of the IMF's executive board questioned whether the Fund's continued commitment to Greece was consistent with its obligation to safeguard its assets and specifically with the statutory requirement that it only lend to governments with the ability to meet their payment obligations for the succeeding 12 months.

In sum, the relationship between regional and multilateral financial arrangements is fraught. This should not be entirely surprising, if only because the mess is not new. The uneasy relationship between regional and multilateral finance goes back to the origins of the current multilateral framework—that is, to the early days of the Bretton Woods System. A first goal of this paper is thus to provide a brief review of this early if understudied history: to trace the relationship between regional and multilateral financial arrangements from the European Payments Union of the 1950s and the Gold Pool of the 1960s to the regional exchange rate arrangements of the 1980s and 1990s. The paper then returns to the present in an effort to situate monetary regionalism in Asia and Europe and its relationship to multilateral financial institutions like the IMF in their historical context. A concluding section building on this analysis draws some implications for policy and offers speculations about the future.

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[1] And in two cases, those of Singapore and the Republic of Korea, to negotiate bilateral swap arrangements with the Federal Reserve System.

[2] For more on the CMIM see "Implications for East Asia" below.

2. REGIONAL-MULTILATERAL INTERACTIONS IN HISTORICAL PERSPECTIVE

This section presents three capsule histories of how regional and multilateral monetary and financial institutions have interacted over the years.

2.1 The European Payments Union

At the Bretton Woods Conference in 1944, policymakers from 44 countries sought to implement their vision of the post-World War II world as an open system. They created the IMF and the World Bank as multilateral institutions to guide and finance readjustment to a world open to trade and foreign investment and to provide assistance, both financial and technical, for economic development.

There was limited appreciation among those gathered at Bretton Woods that Western Europe would face special adjustment problems requiring a regional response at the conclusion of the war. That realization then dawned in 1945. The openness and interdependence of Europe's economies, it became apparent, made it impossible to restore economic growth without first reconstructing intra-European trade, but the exhaustion of gold and foreign exchange reserves created a hesitancy to open. Further, the scarcity of reserves constrained imports of essential capital goods and raw materials from the United States. There was lack of trust between the now-former belligerents and a consequent reluctance to lift ceilings on German industrial production. There were the political gains by communist parties openly hostile to the market system. And there was the advent of the Cold War, which made a vigorous and sustained economic recovery all the more urgent.

The response took the form of US bilateral aid, first through the United Nations Relief and Reconstruction Administration, which was largely wound down in 1947, and starting in 1948 through the Economic Recovery Program, or Marshall Plan. Western European countries were encouraged to pursue integration at the regional level. The recipient governments were required to coordinate their Marshall Plan budgets, which they did through meetings of the Organization for European Economic Cooperation.[3] They negotiated limited regional clearing arrangements with the goal of liberalizing and multilateralizing their trade. In 1950 they established the European Payments Union (EPU), a regional clearing union empowered to provide temporary credits to countries experiencing transitory payments problems when liberalizing their trade.

When agreeing to provide Marshall Plan funds, the US insisted that European countries should not be allowed to also borrow from the Fund, since a second source of official finance would limit the ability of the US to attach conditions to its aid. The decision was therefore taken in April 1948 that the IMF would not finance countries participating in the Marshall Plan.[4] The US was also skeptical about the EPU, which it saw as a vehicle for discriminating against US exports. Some American officials felt that Europe should move immediately to full current account convertibility, as anticipated in the IMF's Articles of Agreement, rather than pursuing the more gradual, phased strategy of the EPU. As the dominant shareholder in the IMF, the US used the Fund to convey its objections, creating tension between IMF officials and the European authorities.

[3] What subsequently became the OECD.

[4] James (1995): 109.

But since the Fund was not lending in Europe, there was little that it could do about the fact.[5] The Bank for International Settlements similarly favored a faster transition to current account convertibility and was critical of the EPU agreement even while providing banking services and technical assistance to the union.[6] But it was similarly unable to divert Europe from its preferred path.

By 1950, American officials were obliged to concede that phased liberalization was better than no liberalization. The US therefore provided $600 million of Marshall Plan funds to establish the EPU. With the outbreak of the Korean War, the importance of this facility became apparent. Germany, where industry relied on imported raw materials, saw its current account move into deficit as a result of sharply higher commodity prices.[7] The fear was that, lacking reserves, the German government would meet this threat by tightening import controls, forcing other European countries to respond in kind, or by hiking interest rates, thereby plunging Germany and the rest of Europe into recession.

In the end, the crisis was managed at the regional level and not by the IMF. The EPU managing board dispatched two economists, Per Jacobsson (subsequently managing director of the IMF) and Alec Cairncross, to Germany. They concluded that the problem was temporary: an exceptional EPU loan enabling Germany to finance its current account deficit would provide an alternative to import controls and tighter money, allowing the country's industrial production to expand and eventually eliminating the deficit. Germany received a special $120 million credit from the EPU in return for a commitment to continue down the path of liberalization. Things turned out as planned; German industrial production and exports expanded strongly, and by 1952 the crisis was history.

The IMF was no more than a spectator at these negotiations. Subsequently, however, it became more involved in EPU operations. Along with Germany's temporary deficit, the other big problem for the EPU was Belgium's chronic surplus. Belgium was a leading producer of iron and steel products in high demand during the reconstruction period. Consequently it regularly provided credits to other EPU members to finance their imports. To reassure the Belgian authorities that this would not create an excessive drain on their reserves, starting in 1952 the IMF provided the country with a $50 million standby credit. 1952, not incidentally, was the first post-Marshall Plan year. This was in fact the IMF's first-ever letter of intent. As a condition for extension of the IMF credit, the Belgian authorities committed to liberalizing their trade with the non-European world and thus moving in the direction of multilateralism. While the IMF credit was only drawn on in 1957, when Belgium and its neighbors were making final preparations for the transition to current account convertibility, its extension was important for cementing the liberalization process.

2.2 The Gold Pool

The Gold Pool, established in 1961 and wound down in 1968, was a North Atlantic effort to stabilize the dollar price of gold that served as the linchpin of the Bretton Woods System. It

[5] James (1995): 75–76.

[6] Toniolo (2005): 333.

[7] Given how current intra-European problems are compounded by Germany's chronic current account surpluses, this history is not without irony.

brought together the US and the United Kingdom, both of which were expected to run balance of payments deficits, with a handful of continental European countries expected to run surpluses (Germany, France, Belgium, the Netherlands, Switzerland, and Italy).[8] Involving only a limited number of countries, this agreement was not easily reconciled with an open multilateral system. Such reconciliation as occurred took place through the good offices not of the IMF but another multilateral institution, the Bank for International Settlements.

The Gold Pool was established at US impetus following the gold losses that the country suffered during the 1960 presidential-election campaign.[9] To prevent the market price of gold in London from rising significantly above the US' official price of $35 an ounce and creating an incentive for foreign holders to cash in their claims on the US, US Treasury Secretary Douglas Dillon and his Undersecretary for Monetary Affairs, Robert Roosa, proposed that the US and its European partners should share this burden equally. Germany, America's faithful ally and now a large holder of dollar reserves, agreed. The other Europeans, and especially the French and the British, went along reluctantly.

The Bank for International Settlements, the relevant multilateral institution in matters concerning the gold market, was a not-so-silent partner in these operations. Since it held gold in its Banking Department and undertook gold market operations on behalf of its members, it had the capacity to undo whatever support was provided by governments to the London gold market, either of its own volition or at the instruction of individual shareholders. In fact, once South African and Soviet gold sales fell off in the second half of the 1960s and the members of the pool were required to make significant sales in order to prevent the London gold price from rising, several European members attempted to undo those operations by cashing in dollar claims for gold, either directly in the US or via the BIS.

The BIS consequently became involved, along with the Bank of England, which acted as the pool's agent for transactions in London, in monitoring the gold-market transactions of the members of the pool. Its findings were then discussed at monthly BIS board meetings.[10] BIS staff provided detailed statistics on world gold production and consumption to the governors and technicians overseeing the operation of the pool. Finally, the BIS acted as a mechanism for reconciling this special arrangement among eight countries with the larger multilateral system. Over time, other concerned countries such as Sweden, Canada, and Japan were allowed representatives at the Basel meetings where the Gold Pool was discussed.

From the outset, BIS representatives expressed reservations about the gold-pooling operation. The basis for their skepticism was obvious enough. It would be incentive compatible for other countries to help cap the dollar price of gold at $35 an ounce, in effect temporarily reimbursing the US for half its gold losses, only if there was reason to believe that those losses were transitory and that, given time, the US would take steps to eliminate its balance of payments deficit. At the same time, there were good reasons to question whether the country would be willing and able to take those steps—and whether it would be willing to subordinate other goals of monetary and fiscal policy. Even then there were questions about whether the US would be able to eliminate its external deficit, given the constantly growing appetite of other countries for

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[8] Although the last member of this second group was not exactly a chronic surplus country. It is important to distinguish balance-of-payments deficits from balance-of-trade deficits (and surpluses) in this context. The US trade balance was in surplus all through the Gold Pool period, but the balance of payments—which was what mattered for gold inflows and outflows—was in deficit, owing a deficit on financial account.

[9] Specifically, there were worries that the Democratic candidate, John F. Kennedy, would follow the example of Franklin Delano Roosevelt and, on taking office, devalue the dollar against gold in order to jump-start economic growth. See Eichengreen (2000).

[10] Toniolo (2005): 377.

dollar reserves.[11] For those who doubted American resolve, the Gold Pool, by slowing US gold losses, only lessened the pressure to adjust. For those who doubted America's ability, an agreement to hold dollars rather than gold exposed the holder to capital losses, something that the BIS could not prudently recommend to its shareholders.

Over time, the BIS seems to have become more sympathetic to the operation of the Gold Pool. Once suspects that, once it became invested, it felt compelled to go along. This is not the only time in this chapter when we will observe the tendency for a multilateral organization to "go native" when it becomes involved in a stabilization initiative together with a subgroup of countries.

2.3 The CFA Franc Zone

The CFA franc zone grew out of the common monetary arrangements of France's former African colonies.[12] Over time it became centered on West and Central Africa, where two monetary unions, the West African Monetary Union and the Central African Monetary Area, issued common currencies linked to the French franc.[13]

The peculiarity of these monetary unions is that the participating countries (Benin, Burkina Faso, Ivory Coast, Mali, Niger, Senegal, and Togo in West Africa; Cameroon, the Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon in Central Africa) trade relatively little with one another, although each trades extensively with France.[14] Parities were fixed to the French franc from 1948 to 1994, at which point the African units were devalued against the French franc.[15] Full convertibility vis-à-vis the French franc meant, effectively, that monetary policy was dictated by the Bank of France. The lender-of-last-resort function was provided not by the Bank of France, however, but by the French Treasury, which allowed the African central banks to run overdrafts on its operating accounts at the finance ministry. In return, members of the zone reached agreements with the French Treasury concerning domestic policy rules (concerning, inter alia, fiscal policy) to which they must adhere.[16]

Given the economic size and resources of France relative to its African partners, for some years the IMF was little involved in this system. As international capital markets opened up in the 1970s, however, members of the CFA franc zone began borrowing heavily, sometimes financing substantial budget and current account deficits. Starting in 1977, sharply weaker commodity prices made repaying this debt difficult. The French Treasury, rather than negotiating the conditions attached to exceptional assistance itself, which would have been difficult in a post-colonial setting, turned to the IMF. Gabon entered into a stand-by arrangement with the Fund in 1978, the Central African Republic in 1979, Niger in 1983, and the Ivory Coast

[11] This was the dilemma of which Robert Triffin famously warned (Triffin 1960).

[12] And, indeed, Newfoundland, which is not exactly African.

[13] In addition, at one point Madagascar and Comoros were in a monetary union with one another, until Madagascar defected in 1973, leaving Comoros to issue a third franc-linked currency.

[14] See Yehoue (2007) for details. The actual membership history is more complex.

Guinea left the franc zone upon obtaining its independence, while Mauritania joined the zone and then left in 1973. Mali left following independence but rejoined in 1967. Togo first joined in 1963. Equatorial Guinea and Guinea-Bissau, which had not been French colonies, joined in1985 and 1997.

[15] Comoros' currency somewhat less than the others.

[16] Designed in turn to limit the need for lender-of-last-resort support.

in 1984.[17] In the 1980s five CFA franc countries also borrowed from the IMF through newly-created facilities designed to meet the needs of low-income countries.

The IMF's initial foray into the region was less than a resounding success. The recipient countries regularly missed their targets, and IMF disbursements were delayed and, in some cases, terminated. In the late 1980s and early 1990s, a number of franc-zone countries fell into arrears on their obligations to the Fund. Increasingly the view of both the IMF and World Bank was that the fixed peg to the French franc was part of the problem.[18] Sustained fiscal consolidation, which depressed domestic demand, would be possible only if accompanied by devaluation to boost competitiveness and encourage exports. But the IMF had little ability to sway this policy, given the opposition of both France and its African partners to tampering with the monetary union. Although the Fund provided a significant fraction of the finance, it could not dictate the recipients' exchange rate policies. In part this reflected the IMF's traditional position that countries should be permitted to adopt whatever exchange rate regime they preferred; its responsibility was only to determine whether other policies were consistent with that regime. But in addition there was a special problem in West and Central Africa in that the franc link also was strongly supported by the French government on grounds of prestige and financial influence.

The IMF's initial response was to curtail its involvement and leave Paris to sort out the problem. Successive French governments, rather than pushing African governments into a politically embarrassing devaluation and risking the splintering of the franc zone, financed their deficits at growing cost. Finally in the summer of 1993, with France's own exchange rate increasingly embroiled in difficulties, Paris had had enough. Again, the French government outsourced the hard bargaining to the IMF, announcing to its African partners, through the medium of Le Monde, that French financial support would continue only if the recipients reached agreements with the Fund. The result was the long-delayed devaluation of the CFA franc as a requirement for the negotiation of new extended arrangements.[19]

This experience, in which a group of countries' monetary union partner (France) provided financial assistance that only worked to delay adjustment until doing so became prohibitively expensive, at which point it outsourced the negotiation of structural adjustment measures to the IMF, is an illustration of the difficulties that multilateral institutions face when dealing with regional arrangements.[20]

3. RECENT EUROPEAN EXPERIENCE

The debt and banking crisis in Europe marks the latest attempt by regional and multilateral institutions to mount a coordinated response to financial dislocations. Awareness of the severity

[17] Ivory Coast previously negotiated an extended arrangement with the Fund in 1981.

[18] James (1995): 493.

[19] In the wake of the devaluation, the members of the Central African Monetary Union agreed to move over time to full economic and monetary union. In that context they established "convergence criteria" governing inter alia budget deficits, the level of public debt, government arrears, and inflation. The macroeconomic convergence criteria are specified in the treaty establishing the economic and monetary union, negotiated in conjunction with France. Thus, changes would require the consent of the French Government, creating further complications for multilateral surveillance.

[20] To which I turn below.

of the euro area's sovereign debt, banking and financial problems materialized in 2009.[21] By the year's final quarter, investors had developed serious doubts about the Greek sovereign's creditworthiness—doubts that were validated by the decision of the three rating agencies to downgrade the Greek government's obligations in December. The new PASOK-led government then unveiled an ambitious fiscal consolidation program early in 2010, but this was predicated on overly optimistic assumptions about economic growth and assumed political support that, in the event, was lacking. Strikes and demonstrations by public employees erupted in February, precipitating very sharp increases in Greece's borrowing costs that threatened to render the government's financial position unsustainable. This led three months later to the extension of a first joint euro area-IMF rescue package, with the Fund taking the lead in negotiating the conditions.

While this assistance offered a financial respite for the Greek government, strikes and unrest continued unabated. In the summer of 2010 investor doubts spread from Greece to Ireland, Portugal, and Spain, all of which experienced sharply higher borrowing costs. Doubts about the stability of the euro area fed back to Greece, where spreads soared to 800 basis points in September. The Irish government, having guaranteed the country's bank debt, was then forced to accept an IMF-EU assistance package in November. Portugal, after denying the need, followed six months later.

While the European Union had a spare pot of money lying around for use in funding the Greek and Irish packages (it had €60 billion in the European Financial Stability Mechanism, funded using the EU budget as collateral and intended originally for problems in Central and Eastern Europe, which could now be repurposed), the prospect of having to extend liquidity assistance to additional countries led the members to create the European Financial Stability Facility (EFSF) in mid-2010. The EFSF was created as a special purpose vehicle with paid-in capital and authorization to borrow amounting to €440 billion and enjoying joint and several guarantees from euro area members.

Not a minute too soon, for in mid-2011 the crisis spread to Spain and Italy. Slower growth in Europe and the US raised doubts about whether the adjustment plans tabled by the Spanish and Italian governments would suffice to stabilize their debt ratios. Greece undershot its fiscal targets as its recession proved even deeper than anticipated, and progress on privatization remained halting. On 21 July, following yet another emergency meeting, EU and IMF officials agreed to "re-program" their assistance to the crisis countries. The interest rate on EU loans was brought down in an effort to lighten their debt-service burdens. (The IMF lending rate remained unchanged, reflecting that institution's standard practice.) The Greek government accepted additional austerity measures. Institutional investors represented by the Institute of International Finance, the organ of the big international banks, proposed a debt exchange in which bondholders agreed to a limited reduction in the face value of their claims on the Greek government. The IMF and EU both issued statements supporting the terms of the debt exchange.

But with the global growth picture darkening and reforms still halting, doubts resurfaced almost immediately about whether limited liquidity assistance would suffice. It quickly became evident the actual amount of cash-flow relief made available to the Greek government under the terms of the July 21st deal was too little to make a difference.[22] In September it was announced that

[21] Why they failed to develop earlier is an interesting question that I leave for another occasion (see however Eichengreen 2011).

[22] See Eichengreen, Allen, and Evans (2011).

the country had again undershot its growth and deficit-reduction targets. With a deep debt restructuring for Greece now seemingly inevitable, the crisis spread to the European banking system, and specifically to three big French banks holding substantial positions in Greek bonds. In August the IMF's managing director, Christine Lagarde, called on European governments to recapitalize their banking systems, but European leaders initially rejected the idea. In October they finally acknowledged the need, committing to table a plan for coordinated bank recapitalization, for revisiting "private-sector participation" in Greece, and for ring-fencing the other euro-area countries by early November.

How well overall did European institutions and the IMF coordinate their response? As Henning (2011) notes, their initial reaction was vacillating and indecisive. The EU initially sought to resolve the Greek problem in-house, on the grounds that turning to the IMF would be an admission of Europe's inability to solve its own problems, but was unable to reach an agreement with the Greek government. The result was a damaging delay during which economic and financial conditions continued to deteriorate, making the problem that much more difficult to resolve when the response eventually came. The EU and IMF had to come up with a larger package for Greece than had they acted earlier, and contagion to other countries was correspondingly greater. That there was no consensus on the assignment of responsibilities thereby heightened the problem.

When the response finally came in the form of a €110 billion package spread over three years, financed two-thirds by the EU and one-third by the IMF, negotiations over conditionality were spearheaded by the Fund. The EU found that negotiating painful conditions was difficult in what was putatively a union of equals. The notion of Germany imposing conditions on Greece evoked memories of World War II. Hence the EU turned to the IMF, much as the French Treasury turned to the Fund to negotiate with its one-time colonies in the 1980s and 1990s..

At the same time, the IMF was constrained in its negotiations by the preferences of Greece's EU partners, who ruled out all talk of debt restructuring.[23] From the very day the Greek stand-by was announced, economists questioned whether adjustment without restructuring was feasible.[24] Yet, despite its on extensive involvement with "private sector burden sharing," the IMF went along.[25]

The ability of the EU to exercise veto power, in turn, flowed from the authority with which it could speak about European affairs and from the fact that it was putting up two-thirds of the money. This led some observers to suggest that the IMF should insist on putting up a majority of the finance whenever it negotiates a stand-by arrangement. This assumes, of course, that putting up a majority, as opposed to the entirety, of the finance would be enough to eliminate a regional power's veto. It assumes that the Fund would have sufficient resources to foot the bill. And it

[23] European officials felt restructuring was seen as an embarrassment, as a potential danger to European banks, and as a channel for contagion. Exactly how hard the IMF would have pushed for private-sector involvement in Greece, in the absence of pressure not to do so from Europe, is difficult to say.

[24] See for example Buiter (2010).

[25] The Fund and the European Commission had previously come to loggerheads in 2009 over whether Latvia should have been required to devalue its currency as a condition for receiving assistance. The country's prime minister has been quoted as stating that the Fund favored devaluation but that this was vetoed by the Commission (Lannin 2009). Asland and Dombrovskis (2011) show how opinion within the IMF was, in fact, less than monolithic. The Fund's mission chief in Riga was quite supportive of the Latvian preference to avoid devaluation (in, perhaps, another example of the tendency for area departments and country economies to "go native"). Other Fund staff saw considerably more merit in the devaluation option and pushed the Latvians and other Europeans to consider it. The difference of opinion is clearly evident in the December 2010 IMF staff report on the country (as Asland and Dombrovskis note). See IMF (2010c). Again, this resembles the situation in the franc zone in the early 1990s, when the IMF favored devaluation but the French Treasury was opposed.

has implications for other regional arrangements, such as the Chiang Mai Arrangement, where co-financing terms are less than definitive.

Subsequently, the IMF and the institutions of the European Union (the European Commission and European Central bank) learned to work together more smoothly, or so it would appear from the outside. Staff teams from the three institutions undertook their periodic review missions to Athens jointly. They issued joint statements summarizing their findings. But there is reason to believe that, while the IMF would have preferred faster action and more radical steps, it was still constrained by the European Union. IMF staff and some executive directors would have preferred more significant debt reduction for Greece than agreed to in July 2011, but the president of the ECB, an institution with significant amounts of Greek debt on its balance sheet and whose leaders were fearful of the financial-stability implications, went public with his opposition. In late August the managing director of the IMF made a strong statement of the need to forcefully recapitalize European banks (a point that was then reiterated in September with release of the Fund's *Global Financial Stability Report*), but, as noted above, EU governments rejected her call out of hand. By October European leaders were implicitly acknowledging that the Fund had been right, but not before several more precious months had been lost.

There was also the failure of the IMF to use its new financial tools in the crisis, perhaps reflecting Europe's unwillingness to act as a laboratory. The Fund considered extending a Flexible Credit Line to Spain in 2010 in order to help stem the spread of contagion, but did not pull the trigger.[26] The possibility of extending a Precautionary Credit Line to Italy was discussed in the midst of the turbulence surrounding the resignation of Prime Minister Berlusconi in late 2011, but again nothing came of it. The IMF discussed creating a special purpose vehicle to intervene directly in European bond markets but, as of the time of writing, did not proceed.[27]

While the record of multilateral-regional cooperation in Europe is checkered, there is reason to think that it worked better than would be the case in other regions. Europe is disproportionately represented on the IMF's executive board. It is generously represented in the highest levels of management; both managing directors in the period were former French economics and finance ministers. The fact that high EU and IMF officials have a history of regular communication and come from similar educational backgrounds means that they speak the same intellectual language, which presumably facilitates a meeting of the minds.[28] Cooperation is also easier insofar as the IMF already conducts regular surveillance exercises at the level of the euro area: it undertakes twice-yearly staff discussions with the institutions responsible for common euro-area policies, provides the board with an annual staff report on euro-area policies, and clusters its Article IV reviews of euro-zone countries together with its staff visits to euro-zone institutions.[29] It is relevant for what follows to observe that no similar arrangements have been devised for Asia.

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[26] Other explanations for this reluctance not inconsistent with that in the text include that the Spanish were worried about stigma effects and that the Fund was worried about depleting its financial resources.

[27] The idea was mooted by a member of IMF staff in the press conference introducing its Regional Economic Outlook for Europe in early October but then denied. Rajan (2011) had earlier suggested that the IMF should set up a special vehicle similar to its current New Arrangements to Borrow that would be capitalized by a first-loss layer from the EFSF and then a second layer of the IMF's own capital. This could then be used to provide large lines of credit to illiquid but fundamentally solvent countries.

[28] The implications for, inter alia, Asia are obvious.

[29] For details see IMF (2010a).

4. IMPLICATIONS FOR EAST ASIA

The other obvious place where these questions are prominent is East Asia. The Asian crisis of 1997–08 highlighted the dependence of Asian countries on short-term foreign funding and pointed up the value of dollar liquidity as protection against financial instability. Emergency liquidity was obtained from the IMF in what was perceived as a less-than-happy experience. The Fund was seen as demanding onerous conditions poorly attuned to the circumstances of Asian countries. (For example, it demanded high interest rates, which only aggravated the crisis given the high level of Asian corporate indebtedness.) The Fund was seen as using its leverage to pry open the markets of the crisis countries to foreign investment, in part because this was in the interest of its principal shareholders, notably the US.[30]

The Japanese government responded in 1997 by proposing an Asian Monetary Fund to provide an alternative source of emergency financing, but the idea was shot down by the US Treasury and IMF. Post crisis, Asian countries responded by redoubling their efforts to accumulate dollar reserves, but this only exposed them to capital losses from exchange rate changes and fed global imbalances. The Association of Southeast Asian Nations (ASEAN)+3, with US and IMF support or at least acquiescence, then responded by expanding the ASEAN Swap Arrangement, a limited arrangement dating to 1977, into the Chiang Mai Initiative of swap lines and credits. The initial value of bilateral swaps was limited to $30 billion, but the total was raised repeatedly, reaching $120 billion in 2009.

The significance of moving from the CMI to the CMIM was threefold.[31] First, the decision to disburse was now to be made collectively, in the manner of the countries represented on the IMF board, rather than by individual creditors, as had been the case with bilateral swaps.[32] Second, agreement was reached on the weights to be used in the weighted voting intended to guide that collective decision.[33] Third, the decision was taken to create an independent secretariat, what eventually became the ASEAN+3 Macroeconomic Research Office, in the expectation that this would evolve over time into a regional surveillance authority.

At the same time, the tension within the CMIM design manifested itself in the retention of an IMF link. The agreement initially provided that countries could draw more than 10% of their swaps only after negotiating a program with the IMF, this despite that one of the motivations for creating the CMI had been to free countries from dependence on the IMF. That 10% threshold was raised subsequently to 20%, but the IMF link and conceptual tension remained.[34] It is revealing that the Chiang Mai Initiative was not activated in 2008–09 following the failure of Lehman Brothers, in part one presumes because of the continuing reluctance of Asian governments to approach the IMF.[35]

The explanation for the IMF link is the difficulty that Asian countries have in conducting critical reviews (undertaking “firm surveillance”) of one another’s policies and imposing firm policy

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[30] The facts, such as they are, continue to be disputed, of course. But the perception is undeniable, and it was the perception that shaped and continues to shape the policy response in East Asia.

[31] While the multilateralization agreement was signed in late 2009, implementation occurred only in March 2010.

[32] That said, the reserves in question will remain “self managed” —they will not be placed in a common pool.

[33] With the People’s Republic of China (PRC) and Japan receiving equal numbers of votes (30% a piece), the Republic of Korea half that number, and ASEAN countries the residual.

[34] In May 2011 the PRC suggested raising the 20% threshold to 30% or 40%, but no action was taken.

[35] Instead the Republic of Korea and Singapore negotiated dollar swaps with the Federal Reserve System.

conditionality. East Asian countries have a tradition of noninterference in one another's affairs (a tradition sometimes referred to as "the ASEAN way").[36] This makes it hard for them to criticize their neighbors and demand policy adjustments. But this in turn renders governments reluctant to lend to one another, since, without assurance that adjustments will be undertaken, they lack confidence that they will be repaid. Much as in the case of Greece and the European Union, it is easier to outsource the negotiation of conditionality to the IMF. But that in turn raises questions about the *raison d'etre* for the CMIM.

ASEAN+3 has now created an entity charged with surveillance-like responsibilities with the implicit goal of relaxing and eventually eliminating the IMF link. But its establishment occurs against the background of the "ASEAN way," which has led governments to limit its authority and capacity. The new entity's mandate is limited to data gathering and analysis. Its limited remit is evident in its name: the ASEAN+3 Macroeconomic and Research Office, or AMRO. "Review" is more ambiguous than "surveillance." "Research," however useful, is not obviously central to the CMIM's lending function. Unlike IMF staff, AMRO will not have the authority to table policy proposals and programs. Wei Benhau, its founding director, comes from a country, the PRC, that is especially jealous of its policy autonomy and committed to the principle of noninterference. It is unlikely that AMRO will develop a specific set of indicators on which the lending process will be predicated; PRC, it will be recalled, watered down the surveillance provisions of the G20's Mutual Assessment Process.

With a professional staff of only ten, moreover, it is not clear how AMRO can undertake serious reviews of 13 separate countries' policies and problems. One suggestion is that AMRO should piggyback on IMF Article IV surveillance, joining the Fund's Article IV missions and utilizing its staff reports. Again, however, it is not clear how this represents a step toward breaking the IMF link. Alternatively, AMRO could form its own country teams and send them on independent missions. But meaningful staff reports presuppose a significant expansion of professional staff and the articulation of well-defined standards for acceptable country policy and adjustment strategy. The rationale for establishing the CMI (and for the Asian Monetary Fund proposal before it) was to create an Asian institution that understood Asian economies better than the multilaterals and offered policy advise better attuned to local circumstances. But making good on that promise requires AMRO to articulate those circumstances and that advice. All this is a tall order.[37]

Moreover, to issue hard-hitting reports AMRO would have to establish its independence from the governments that fund it. It would have to adopt IMF-like transparency practices. This would constitute a radical departure from the ASEAN way.

For the time being, then, the IMF link is destined to remain. The question under these circumstances is whether the CMIM can be more than simply a supplementary source of finance for IMF adjustment programs. One solution would be for ASEAN+3 to clarify whether the link would be satisfied by the Fund's extension of a Flexible Credit Line. Flexible Credit Lines are extended to countries with strong policies expected to be able to repay once temporary liquidity problems have passed; they therefore do not come with policy conditionality attached. Countries do not have to draw actual resources at the time of extension. Thus, a country could negotiate an FCL as a way of sending a signal of its fundamental credit

[36] On the ASEAN way, see Asian Development Bank (2011).

[37] It is a tall order for a small office in particular.

worthiness, draw no or only limited funds from the IMF, and draw more extensively on its ASEAN+3 credits.[38]

This would require harmonizing the term of flexible credit line (FCL) and CMIM credits. Qualification for an FCL is for a period of one to two years. Countries drawing their lines then have 3 ¼ to 5 years to complete repayment. CMIM credits, in contrast, are for two years. There would also have to be greater clarity about seniority. The IMF has traditionally insisted on the seniority of its loans. Would IMF loans be senior to CMIM swaps, or *pari passu*? This issue has not been addressed.[39]

In addition, relying on FCLs for activation would mean that CMIM credit would be extended only under restrictive circumstances and limited to countries with impeccably strong policies. Lightly-conditioned or unconditional lending should be provided only to countries with strong policies and, by implication, to countries with liquidity rather than solvency problems; loans to others should come with policy conditionality attached. At the same time, this two-tier process is not consistent with the Asian norm of regional solidarity. Whether or not such limitations were the intent of the initiative's architects is debatable. Be that as it may, under this solution other countries would be left to the tender mercies of the IMF.

Finally, there is the problem of stigma still attached to IMF programs in the region. Poland, Mexico and Colombia have negotiated Flexible Credit Lines, but no Asian country has done so. A solution would be for the IMF to unilaterally qualify countries for FCLs and to qualify them in groups so as to avoid sending a negative signal about their immediate prospects. This has been suggested as an element of the Global Stability Mechanism (GSM) currently under discussion, which would be designed to systematize the dollar swaps provided bilaterally and on an ad hoc basis by the Federal Reserve System. But whether the GSM will be created remains to be seen. And, again, ASEAN+3's low-income countries would not be included, since they would not qualify for credits not accompanied by conditionality.

An alternative, suggested by IMF staff, would be for the Fund to lend directly to the CMIM for purposes of providing credits to its members.[40] This would address the problem of IMF stigma by shifting the negotiations away from individual countries. But like the proposal that the IMF should lend to the European Financial Stability Facility, described in Section 2 above, doing so would require amending the IMF's Articles of Agreement. It would be tantamount to the IMF relinquishing control of its resources and of the associated conditions.

5. CONCLUSIONS AND POLICY IMPLICATIONS

From the establishment of the Bretton Woods institutions, there has been an uneasy relationship between multilateral and regional financial arrangements. The resulting tensions manifested themselves in the 1950s in the context of the European Payments Union, in the 1960s in connection with the Gold Pool, and in the 1980s and 1990s in the differing approaches of the IMF and French Treasury toward the CFA franc zone. The underlying issues, still unresolved, have again come to the fore with the crisis in the euro zone and establishment of the Chiang Mai Initiative Multilateralization. In Europe, the IMF and the institutions of the European Union have attempted to work together to provide assistance to the crisis countries,

38 Henning (2002) suggested this for the Contingent Credit Line (since abolished), but the idea has not been publicly embraced by officials in the region. Henning (2011) suggests that Japan is favorably inclined toward the idea.

39 The fact that CMIM swaps are shorter term at present indeed suggests that they might be effectively senior, making it all the more important to address the issue.

40 See IMF (2010b).

with mixed results. The CMIM, while conceived as an effort to free East Asia from dependence on the IMF, continues to require the negotiation of IMF programs by countries seeking to draw more than 20% of their financial entitlements.

Fundamentally, the limits to coordination between multilateral and regional financial arrangements reflect less than full agreement on the purposes and circumstances under which financial assistance should be extended. The IMF has long focused on providing loans to countries with adjustment problems—loans that therefore come with policy conditionality attached. With the opening of capital accounts and growth of financial markets, the Fund has also acknowledged the potential for liquidity problems, leading it to establish facilities like the Flexible Credit Line and Precautionary Credit Line (now the Precautionary and Liquidity Line) through which countries with strong policies are prequalified for lightly conditioned or unconditional loans.

How regional financial arrangements fit into this picture is unclear. Regional arrangements are ill-suited for addressing structural-adjustment problems. Neighbors find it hard, for reasons of history and geopolitics, to demand painful adjustments of neighbors as the price of emergency assistance. This has led them to outsource the negotiation of conditionality to multilaterals like the IMF. But regional powers have a special interest in the maintenance of stability and pursuit of adjustment in their own region, which provides motivation to put up additional funds. Herein lies the conflict. On the one hand, there is a desire to shift the onus of negotiating conditionality to the multilateral level, and multilaterals like the IMF for their part are obliged by their statutes to safeguard the resources of their members. On the other hand, there is the desire on the part of the members of a regional arrangement to influence the terms of that conditionality to meet their particular needs.

This is a recipe for disagreement and conflict. Resolving such disagreements requires, at a minimum, clarity about who is in the driver's seat when multilateral finance is supplemented by a regional arrangement. It requires the IMF to be transparent about the rationale for the conditions it negotiates, so that it is clear that it is representing the interests of its members equally. More ambitiously, the executive board could mandate that the IMF should enter into an agreement for supplementary finance from a regional member only when the Fund still provides the majority of the finance, in order to ensure that it has the loudest voice in the negotiation of conditions.

The other corner solution is for regions to develop their financial arrangements into self-standing monetary funds. Europe could create a European Monetary Fund out of the seed of the European Stability Mechanism to lend to crisis countries without IMF involvement. East Asia could transform the CMIM into an Asian Monetary Fund. Given the difficulty of neighbors demanding conditions of neighbors, the entities administering these regional funds would have to possess a high degree of independence, which would in turn require a high degree of specificity about the circumstances under which they were allowed to lend and the conditions they were entitled to require. It is clear that Asia and even Europe are still very far from that point.

The IMF has also moved to create facilities for providing liquidity assistance, as noted above, and it is contemplating further steps in this direction, through the establishment of a Global Stability Mechanism. These facilities are designed to provide unconditional or lightly conditioned financial assistance to countries with strong fundamentals but temporary liquidity needs. In this context an IMF link, where regional assistance is activated only when a country is authorized to draw on the relevant Fund facility, would be an adequate design. It outsources the decision of who has strong policies, conveniently for political reasons, while at the same time supplementing IMF liquidity.

The danger is that the IMF may be too generous about prequalifying members, since much of the money it puts up is not its own and that IMF funding has seniority over regional contributions (the Fund gets paid back first). A possible solution would be to mandate that IMF lending through these facilities is not senior to regional contributions. But, even then, Asian countries in particular would have to shed their sense of IMF stigma for any of this to matter.

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