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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, and Regine Wölfinger

## Abstract

This article examines the potential contribution of regional financing arrangements (RFAs) to the stability of the international monetary and financial system. To gauge the quality of an RFA, we establish a set of “optimal financing criteria” relevant for providing crisis financing using a first principles approach. We then evaluate the frameworks for the main regional arrangements for emerging markets in existence against these criteria. The results suggest that the design and operation of RFAs determine the extent to which they can help prevent and alleviate crises and thereby contribute to global financial stability.

**KEYWORDS:** regional liquidity schemes, international financial architecture, the role of the IMF

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## 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, 20 October 2007 (Mantega, 2007: 3)

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 subprime crisis); and of attaching excessive microeconomic requirements to its loans. 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 (RFAs), respectively.

In the wake of these crises, countries have recovered, learned from their mistakes, and gained strength and stature in the world economy. Against a backdrop 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 an important line of defence in the event of a crisis. Others, such as East Asia, have gone further and developed RFAs that are becoming ever more sophisticated, in effect, strengthening a further line of defence.

In this article, 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 RFAs, 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? Do they provide a healthy dose of competition for the Fund in the provision of crisis financing, or do they have the potential to undermine the very stability of the international monetary system by undercutting Fund conditionality with an insufficiently rigorous economic management and lax lending requirements, which leave open the risk of crisis exacerbation and contagion. Could they lead to a weakening of economic policy making standards through conditionality shopping? Such questions addressing the roles of RFAs and their relation with the Fund have become even more important in the face of the recent discussions in the G20 and the IMF about strengthening global financial safety nets.<sup>1</sup>

The purpose of this article 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 article 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 article 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.

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<sup>1</sup> See the contributions in Volz and Caliarì (2010).

## 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 then 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 GDP; its ability to generate foreign

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<sup>2</sup> Although this goes beyond the scope of this article, 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 and Titelman (2007) do this for FLAR. See also Agosin (2001).

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 et al., 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> It should be noted, however, that some financing arrangements have an implicit understanding that funds would be tapped only by smaller or less affluent members, while large or affluent members take on the role of the lender. In such cases, the funds available – which may be small relative to the size of the largest economies, but large relative to the small ones, which may at the end be the main borrowers – should be evaluated accordingly.

*(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.

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<sup>3</sup> Attempts to quantify the optimal level of international reserve holdings have been made for individual countries, for instance by Jeanne and Rancière (2008) and IMF (2011a).

*(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 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 or 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. However, to simplify the operationalisation of this variable, we assume that the likelihood of inappropriate behaviour increases with dominance.

*(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>4</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. Arguably, in some liquidity crisis situations lending without any conditionality may well be appropriate. In evaluating financing arrangements, the approach to conditionality and the quality of monitoring and enforcement should therefore be examined with these considerations in mind.

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<sup>4</sup> 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.



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.

## **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., Buira, 2006; Lachman, 2006). IMF (2009) analysis confirmed 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, and that 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 have led to a considerable boost of the Fund's resources and lending capabilities. In an immediate reaction to the crisis, G20 leaders in April 2009 at the London Summit committed to increase the New Arrangements to Borrow (NAB) and in the meanwhile to provide bilateral funds to beef up the available resources for lending.<sup>5</sup> The IMF Executive Board in April 2010 adopted a proposal on an expanded and more flexible NAB, by which the NAB was expanded to SDR 367.5 billion (about USD 584.4 billion), including also 13 new participating countries. The expanded NAB became operational in March 2011, after domestic approvals by the participating countries, and was activated shortly after for a period of six months, in the amount of SDR 211 billion. In addition, the IMF membership in December 2010 has agreed to double quotas from approximately SDR 238.4 billion to approximately SDR 476.8 billion. This quota increase is expected to enter into force after the Annual Meetings 2012.

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 July 2011, the Fund's one-year forward commitment capacity was SDR 246.7 billion (IMF, 2011c), which encompasses quota-based resources, borrowed resources stemming from bilateral loans or notes programmes made available by several Fund members since 2009 and the recent activation of the NAB.

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>6</sup> The higher limits aim to give confidence to countries that adequate resources will be accessible to them to meet their financing needs.

Overall, it appears that the IMF has been able to respond adequately to the lending requirements that resulted from the global financial crisis, with lending commitments reaching a record level of more than SDR 172.6 billion in July 2011 in non-concessional lending, and SDR 2.8 billion in concessional lending to least

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<sup>5</sup> Under the NAB, which was established in 1998, 26 countries agreed to lend SDR 34 billion (about USD 54 billion in July 2011). The General Arrangements to Borrow (GAB), established in 1962, enables the IMF to borrow up to SDR 17 billion (about USD 27 billion) from 11 industrial countries. See IMF (2011b).

<sup>6</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.

developed countries (IMF, 2011c). Taking into account the IMF's historical track record in lending, and the recent changes to considerably increase the Fund's resources, we rate this criterion with 9 out of 10.

*(ii) Timely access to relevant information*

According to Article 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>7</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 may 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.

*(iii) Analytical expertise*

The Fund currently employs about 2,400 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

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<sup>7</sup> 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 IMF's Independent Evaluation Office (IEO, 2009) found evidence of relatively less effective surveillance of advanced countries and large EMEs, 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.

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 and Sachs, 1998; 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.<sup>8</sup> Critics of the Fund argue that a large pool of orthodox trained PhDs and a lack of internal diversity were a 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 (IMF, 1995). 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 would be prepared to consider the request for an arrangement as early as 48 to 72 hours later (cf. IMF, 1995).

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

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<sup>8</sup> The Bank for International Settlements (BIS) fared better in detecting and warning of vulnerabilities in the markets. Similarly, UN agencies like UNCTAD and 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).

<sup>9</sup> Ocampo (2010) points out that the BIS and the UN had been calling for a macro-prudential financial regulatory framework for a decade before it was adopted by the G20 in 2008.

the IMF's response during the Asian crisis, is that it acted too slowly to combat crises (e.g., Radelet and 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 G10 (Bordo and James, 2000: 33) contrasted sharply with the crisis support for Thailand, South Korea, and Indonesia.

The IMF has tried to learn its lessons from the Asian and other crises. Among other things, it established new and more flexible facilities. The Supplemental Reserve Facility (SRF) was created in December 1997 to assist EMEs 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 the limits of Stand By Arrangements (SBA) 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 March 2009 to provide large and upfront financing to pre-qualifying members with very strong fundamentals and policies.<sup>10</sup> As a further response to the crisis the Fund also enhanced the preventive angle of its flag-ship SBA facility in 2009 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. Moreover, in August 2010 the IMF created the Precautionary Credit Line (PCL) to bridge the gap between the FCL and the HAPA for those members with sound fundamentals and policy track records that nonetheless face moderate vulnerabilities that may prevent them from meeting the FCL's high qualification requirements. Members that qualify under the PCL have frontloaded access of up to 500% of quota, and can access up to 1,000% of quota after 12 months upon satisfactory progress in reducing their vulnerabilities.

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

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<sup>10</sup> 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, which works as a renewable credit line without cap on access to IMF resources, the need of which is assessed on a case-by-case basis. The FCL was overhauled in August 2010 to encourage further members to seek qualification.

(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 European members supporting countries in the region. 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, while developing and emerging economies are underrepresented, both in terms of voting shares and chairs on the Executive Board.<sup>11</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." 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 are harmful to national or international prosperity. At the same time, the measures are meant to safeguard IMF resources by ensuring that the country's balance of payments will be strong enough to permit it to repay the loan." (IMF, 2011d) A major criticism often

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<sup>11</sup> On the role of low-income member countries in the governance of the IMF, see the contributions in Boughton and Lombardi (2009). A major reform of "the IMF's quota and governance that will help deliver a more effective, credible and legitimate IMF and enable the IMF to play its role in supporting the operation of the international monetary and financial system" (G20, 2010: 2) has been committed by the G20 at the Meeting of Finance Ministers and Central Bank Governors in Gyeongju in October 2010 and agreed by the IMF Board of Governors in December 2010.

heard in the past was that conditionality attached to Fund lending was partly excessive and inappropriate.<sup>12</sup>

Against the backdrop of the continuing debate over the use and effectiveness of structural conditions, the IMF's Independent Evaluation Office 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% for macroeconomic conditionality.<sup>13</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 was to tailor structural conditions to member countries' different policies and backgrounds. This was to be achieved by using pre-set qualification criteria under the FCL and making traditional conditionality more flexible. In particular, monitoring of structural

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<sup>12</sup> 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". 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). Buirra (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, particularly causing harm to the least developed countries' economic development, for example by dictating their trade policies.

<sup>13</sup> Regarding the effectiveness and enforcement of Fund conditionality, Buirra (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.

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 several Fund rescue programmes in the early stages of the global financial crisis were relatively light.

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.

### **3. How do regional arrangements compare?**

We now turn to an assessment of various existing RFAs. Among the most advanced and established RFAs are the European Union's facilities (up until 2009, the Medium-term Financial Assistance Facility, MTFA) and the North American Framework Agreement (NAFA), which includes the US, Canada and Mexico. RFAs that consist mainly of developing and emerging economies include 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 seven 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. Due to space constraints to this article, we will only present our assessment of the last three RFAs, given that these are dominated by developing and emerging economies, some of which have expressed their discontent with IMF policies and governance. The interested reader can find a description and assessment of the EU facilities and the NAFA in the working paper version of this article (McKay et al., 2010).

#### **3.1 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 initial CMI consisted of an expanded ASEAN swap



arrangement between the ASEAN countries and a network of bilateral swap arrangements among ASEAN+3 countries. Between 2000 and 2009, the CMI was developed further and the swap amounts augmented. In 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 transformation of the bilateral currency swap agreements into a single regional pooling arrangement.<sup>14</sup> To date there have been no swaps, or drawings, under the CMI/M since its inception notwithstanding the global financial crisis, not least owing to the substantial own reserves of some of the member countries.

*(i) Size of the financing pool*

The ASEAN swap arrangement is now USD 2 billion in size, while until 2009 some 16 bilateral swap arrangements were 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 CMIM to a minimum of USD 120 billion. 20% of the funds are provided by the 10 ASEAN members and the remaining 80% by the Plus Three countries.<sup>15</sup>

While the amounts available to potential borrowers under the CMIM 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 CMIM would be drawn upon by the ASEAN countries, not by the Plus Three.) It should be noted, however, that the CMIM 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 CMIM with a 6 for this criterion.

*(ii) Timely access to relevant information*

The CMI had no secretariat or other organisational entity to collect or process information, as information was shared directly between governments. It is unclear how open the governments are with one another, especially given the

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<sup>14</sup> On the creation of the CMI, see Henning (2002). On the CMIM, see Volz (2009), Kawai (2010) and Sussangkarn (2010).

<sup>15</sup> 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.

historical hostilities between some members. Nevertheless, the frequency and coverage of meetings among ASEAN+3 has risen markedly over recent years.

The Bali agreement envisaged the creation of a system for regional cooperation that is self-governed and goes beyond simple information-sharing or peer-review.<sup>16</sup> In particular, it entailed 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 in May 2010 (ASEAN+3, 2010). The ASEAN+3 Macroeconomic Surveillance Office (AMRO), located in Singapore, became operational in May 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>17</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 were apparently reluctant to share all information with the other ASEAN+3 countries. Indeed, it is not clear whether AMRO will get access to the same data 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 arrangements, we therefore award a rating of 5.

*(iii) Analytical expertise*

The regional surveillance agency should improve the level of dedicated professional resources and hence analytical expertise available within the CMIM, which hitherto relied only on those of government officials. Even so, it is unlikely that AMRO will have anywhere near sufficient 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

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<sup>16</sup> As such, the CMIM goes far beyond previous initiatives like the Economic Review and Policy Dialogue that the ASEAN+3 established in April 1999.

<sup>17</sup> The creation of an independent regional surveillance unit was already agreed upon at the ASEAN+3 summit in Phuket in February 2009.

experience with CMI/M 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 CMIM lending beyond the first 20%. We hence rate the CMIM with a 7.

*(v) Impartiality in lending decisions*

Given that there has been no CMI/M 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 CMIM 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 CMIM becomes fully functional and the CMIM has created its own monitoring and enforcement apparatus within AMRO, the portion of CMIM loans that can be disbursed without IMF lending will most likely be increased. For the time being, we rate the CMIM's monitoring and enforcement mechanisms with a 7.

### **3.2 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.

*(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 and 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. We hence rate it with a 7.

### **3.3 The Arab Monetary Fund (AMF)**

The Arab Monetary Fund was founded in 1976 and started operations in 1977. It has 22 member countries.<sup>18</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.

#### *(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>19</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>20</sup> of which there are four types; the automatic loan (granted

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<sup>18</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.

<sup>19</sup> The Arab accounting dinar (AAD) is the accounting unit of the Arab Monetary Fund and is equal to three IMF special drawing rights.

<sup>20</sup> Between 1998 and 2009, loans for balance of payments assistance amounted to 35% of total lending.

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.

*(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.



## **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, e.g with the release of tranches subject to the approval of reviews, 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, though 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.

### **4.1 Benefits and risks of a higher profile for RFAs in crisis financing**

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, which could also (but need not) include exchange rate cooperation aimed at moderating exchange rate fluctuations that could derail regional trade. RFAs can also contribute to global stability by promoting a "put your own house in order" strategy at the regional level as well as through improving country and regional surveillance.

Regional peer considerations under the framework of an RFA may better safeguard resources due to a mix of peer pressure, strong sense of ownership and smaller information asymmetries at the regional level. To the extent that RFAs do not lend out "other people's money" but the region's own resources, this might reduce moral hazard problems and create stronger incentives to act responsibly in the prevention and management of crises. If conditionality is attached to lending, RFAs might be able to convey a stronger ownership for necessary reforms. Last but not least, RFAs might contribute to greater international stability by providing alternative approaches to crisis management. That is, a "competition for ideas" between the RFAs and the IMF might lead to better overall policies.

There are, however, also potential risks for stability stemming from a prominent role of RFAs. First of all, the lack of distance between lenders and borrower might create a situation where not enough pressure is brought to bear 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 could lead to even bigger problems later on. The ability to conditionality shop 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 and Mauro, 2007). (A counter example would be the Arab Monetary Fund, comprising net oil importers and exporters.<sup>21</sup>) Indeed,

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<sup>21</sup> For Latin America, Machinea and Titelman (2007) show that Chile and Colombia, both of which have a low reserve volatility, would not benefit from joining FLAR, since both would

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 CMIM into a fully-fledged Asian Monetary Fund that would supplant the role of the IMF in the region if they wish to do so, the situation appears different for other RFAs. An arrangement like FLAR does not obviate the need for global arrangements, given the limited resources of its member countries, even though the ranks obtained in specific criteria might be high. In this context, an issue that deserves some scrutiny is the role of large and small members within the same RFA. This could be important, because some RFAs are large enough in size (or could become large enough) to potentially replace the Fund in relation to smaller borrowers. For large members of RFAs, in contrast, the IMF is likely to remain the only institution that would be able to mobilise enough resources to support large economies.

## 4.2 RFAs and their interaction with the IMF

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 *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

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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.

conditionality – in cases where conditionality is due and the Fund’s conditionality is appropriate – with an insufficiently rigorous economic management and lax lending requirements leaves open the risk of crisis exacerbation and contagion.

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 division of labour in the provision of financing between global and regional organisations.<sup>22</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, 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.

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<sup>22</sup> See also Culpeper (2006).

There are various other ways by which the ties between RFAs and the Fund could be strengthened in order to create a healthy working relationship and synergies and avoid an unnecessary duplication of activities. These include collaboration in monitoring and surveillance and data collection. The Fund could also help RFAs in developing their capacities by providing training to RFA staff and fostering staff exchange. To intensify cooperation, the Fund could also invite RFAs to join member countries' Article IV consultations (provided the latter's agreement) and, in conjunction with the World Bank, the IMF could invite RFAs to take part and contribute to Financial Sector Assessment Programmes. Moreover, RFAs and the Fund could enter a dialogue on the future development of their lending toolkits and discuss how their respective facilities could be aligned.

## 5. Conclusions

In this article we examined the potential contribution of RFAs 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 main regional arrangements for emerging markets 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 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 in comparison to drawings from RFAs.<sup>23</sup> Why has more

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<sup>23</sup> See the recent contributions by Aizenman et al (2010) and Obstfeld et al. (2009).

recourse been made to these than RFAs in the recent crisis? What does this reveal about the financing needs of countries, and what does it imply for international monetary stability?

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