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Systemic, Governance, and Regional Issues in the Reform of the International Financial Architecture

The three papers in this issue originally prepared for the Tokyo Club Foundation's November 2008 conference on *The Global Monetary and Financial System and its Governance* provide a comprehensive look at the status of the international financial architecture and the central issues in the renewed debate over its future.

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REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE AFTER TEN YEARS:

The View from Emerging Markets

Barry Eichengreen

1. Introduction[1]

The Asian crisis of 1997-98 was a shock to the countries at its epicenter and more generally to the international economic and financial system. One result was a debate on how to adapt policy in emerging economies and to strengthen international financial markets. Contributors to the literature on what came to be called "reforming the international financial architecture" quickly sorted themselves into two camps.[2] The first offered proposals for radically reshaping the international system. The second emphasized policy adaptations in the emerging markets themselves and advocated more limited changes in the structure and governance of international financial markets.[3]

The tenth anniversary of this debate is an opportunity to take stock and to reflect on the progress that has and has not occurred in emerging markets. Of course, the credit crisis of 2008 places both that progress and the earlier literature in a new light. As the tide has gone out it has become clear which emerging markets are bathing naked. More than that, the current crisis raises questions about the entire reform strategy. The presumption in the earlier literature, reflecting the fact that the 1997-98 crisis-hit emerging markets but not the United States or Europe, was that emerging markets should emulate financial arrangements in the advanced countries. They should build securities markets more like those in the advanced countries. They should regulate their banks in the manner of the

[1] Prepared for the meeting of the Tokyo Club, Tokyo, Japan, 11-12 November 2008.

[2] Adopting the terminology used by then-Treasury Secretary Robert Rubin in a speech at the Brookings Institution almost exactly ten years ago (Rubin 1998).

[3] The first camp tended to be dominated by academics, the second by officials. That my own contribution fell along the latter lines may be a reflection of temperament or the fact that my work on this subject began while I was on leave from academia at the IMF. It originated as a series of memos written starting in February 1998 (when Rubin's speech was delivered) for Michel Camdessus and senior staff on what reform of the international financial architecture should entail and, in particular, the role of the Fund. I revised these "non-papers," as they came to be called ("staff papers" must undergo an internal review at the Fund before being circulated), into a book upon returning to academia the following autumn. My most vivid memory of the process was when Camdessus, excited by the opportunities that reform of the architecture created for the Fund, offered to convene a small lunch in his private dining room to discuss the non-papers. Lunch turned out to involve not just food but three dozen members of senior management, microphones, and tape recorders. The dominant reaction of those present was that a new focus on standards and codes, more forceful advocacy of exchange rate flexibility, and new contractual provisions for bailing in the private sector were unrealistic and undesirable departures from past practice – that it was either infeasible or undesirable for the Fund to branch into these new areas. Whether or not they were right is one of the topics I take up below.

advanced countries. It is safe to say that the 2008 crisis has cast considerable doubt on this approach. It is a reminder that prevailing practice in the high-income countries is not, in itself, an adequate standard for emerging markets. It revealed the inadequacy of transparency in the high-income countries. It laid bare the inadequacy of supervision and regulation, failures in the coordination of macroeconomic and regulatory policies, the pervasiveness of regulatory arbitrage, and incentive problems associated with compensation practices in the financial-services industry. The current crisis points up the question of whether the financial architecture characteristic of the high-income countries provides an adequate template for the future.

Another product of the crisis is a second round of calls for a new international financial architecture. These have come from Gordon Brown, been echoed by Nicolas Sarkozy, and been embraced by George W. Bush. No doubt, additional leaders will add their voices to the chorus. Extensive discussions there will surely be. But, both to avoid reinventing the wheel and to prevent predictable mistakes, it may be helpful to understand better the dynamics and limitations of the previous round of architecture discussions.

2. Changes in the International Financial Architecture Anticipated in 1999

What were the priorities a decade ago? Mainstream reformers focused on strengthening supervision, regulation, financial transparency, and corporate governance through the adoption of international standards and codes. Morris Goldstein had already proposed an international standard for banking supervision and regulation (Goldstein 1997). Subsequent contributions generalized this to a range of other policies and practices related to financial stability. The idea was that standards and codes would encapsulate best practice. They would offer concrete targets to which countries could aspire. Compliance would constitute a visible indicator of what had been achieved. Standards would provide a focus for market assessments of national practice and apply peer pressure insofar as laggards experienced higher borrowing costs. They would provide a focus for the surveillance activities of the International Monetary Fund and perhaps also restrain its temptation to hold developing countries to ever more demanding requirements.

Some dismissed standards as weak soup; they argued that they were likely to be so general as to have little practical effect. Others complained that standards with bite would be rigid and prescriptive; they would end up foisting on emerging markets one-size-fits-all institutional advice.[4] Emerging markets would be instructed to dismantle bank- and family-led systems of corporate control in favor of an Anglo-Saxon system emphasizing hostile takeovers and proxy fights even when the functional prerequisites for the effectiveness of the alternative were not in place. The IMF and other official bodies charged with overseeing the new standards lacked expertise in auditing and accounting practice, bank regulation, and insolvency procedures. More generally, there was skepticism that governments would feel significant pressure to upgrade prevailing practice.

These objections were not groundless. The process of negotiating the new standards was long, complex, and bureaucratic, and the results were less than optimal. To see this, one need only recall that it took nearly ten years to update the existing Basel standard for capital adequacy for internationally active banks, which the recent crisis has shown to be deeply flawed. The IMF found it difficult to marshal the resources needed to assess practices in issue areas relatively far removed from the macroeconomic. It was reluctant to issue blunt statements where compliance is inadequate. Governments refused to allow it to undertake such reviews when they anticipated that the outcome would be unfavorable.[5]

That said, there has been progress in the promulgation of standards and codes. There are the aforementioned FSAPs organized jointly by the IMF and World Bank, introduced in May 1999: reviews of the condition of national financial systems are undertaken with input from experts seconded from national agencies and private-sector bodies as a way of addressing the problem of limited internal resources. By-products of these assessments are Reports on the Observance of Standards and Codes (ROSCs). Reports covering 12

[4] Notice the incompatibility of the two critiques.

[5] Thus, the IMF reportedly asked the United States to undergo a Financial Sector Assessment Program (FSAP) prior to the outbreak of the subprime crisis, which the U.S. government rebuffed. The United States finally agreed to an FSAP at the end of 2007 (Thomas and Munchetty 2008).

areas, including auditing and accounting, bank supervision, transparency, corporate governance, and insolvency and creditor rights, are produced approximately every two years. In 1996 the IMF had already targeted transparency and data dissemination by establishing the General Data Dissemination Standard and the Special Data Dissemination Standard (SDDS) for countries active on international capital markets. The SDDS lists 18 categories of data covering four sectors of the economy and sets down standards for coverage, timeliness, accuracy, and public access. Participation is voluntary but highlighted by the Fund's SDDS Bulletin Board, which links to relevant national sources. There is the Basel Committee's Core Principles for Effective Banking Supervision which date from 1997. The OECD, in conjunction with the Financial Stability Forum, established principles for corporate governance in 1999.[6] Official bodies have also highlighted the standards promulgated by private groups such as the International Federation of Accountants, International Accounting Standards Board and International Organization of Securities Commissions.

The question is how much difference is made by these standards and codes. Sundararajan, Marston, and Basu (2001) report an effect of compliance with the Basel Core Principles on financial stability outcomes. Christofides, Mulder, and Tiffin (2003) find that accounting standards, investor rights, and SDDS subscription matter for spreads and credit ratings. Cady (2004) estimates that SDDS subscription reduces spreads on new sovereign foreign currency bond issues by some 75 basis points. Glennerster and Shin (2007) offer a similarly upbeat assessment, arguing that subscribing to the SDSS and releasing information through publication of an Article IV review and a ROSC reduces credit spreads significantly.[7] Schneider's (2005) estimates are a bit smaller, but her results are broadly consistent with those of Glennerster and Shin.

Other evidence is less reassuring. There is the flawed Basel II standard for capital adequacy, two of whose pillars are banks' internal models of value-at-risk and commercial credit ratings for banks lacking internal models, both of which have been shown to be wholly insufficient for measuring risk.[8] There is the OECD's standard for corporate governance, which has been shown by the crisis to be an inadequate basis for limiting principal-agent problems and risk-taking in the financial sector in particular. There is the evidence of Tong (2007) and others that public information made available through the SDDS discourages investment in private information.[9] Common features of these problem areas include excessive confidence in market discipline, acceptance of the premise that practice in the advanced countries is an adequate standard for other countries, and the belief that markets always process and assimilate information efficiently.

A second focus of the reform agenda was the nexus between banks, capital flows and exchange rates. In the Asian crisis countries, banks were the weak links in the financial chain. They suffered from lax internal controls, concentrated exposures, and inadequate capital buffers. Banking crises in Asia, like banking crises elsewhere, had devastating macroeconomic effects.

While there were some distinctive features of the Asian case, there were also commonalities with other regions. The capital account of the balance of payments having been at least partially opened, banks were able to fund themselves by borrowing abroad, generally at short tenors in foreign currency.[10] Where loans were denominated in the domestic currency, the result was a currency mismatch which could have disruptive consequences when the exchange rate moved. Even where loans were denominated in foreign currency, their tenor was longer than that of the banks' foreign liabilities, resulting in a maturity mismatch that could be equally disruptive if capital flows turned around.[11] These problems were often extreme in the Asian crisis countries, but they were not limited to the region.

The prevalence of these funding practices was attributed to the perception that banks were too big and well-connected politically to fail, which encouraged risky borrowing but also a willingness to

[6] Since updated in 2004.

[7] Indicative presumably of strengthened investor confidence.

[8] I discuss both Basel II and the rating agencies at much greater length in Section 4 below.

[9] Furman and Stiglitz (1998) similarly argue that transparency standards that reduce the dispersion of beliefs across individuals may perversely amplify market volatility.

[10] The role of this famous double mismatch in the Asian crisis was highlighted early on by Goldstein (1998) and discussed further in Goldstein and Turner (2004).

[11] We now see, as a result of the credit crisis in the advanced economies, that this maturity-mismatch problem and excessive reliance on short-term (often foreign) funding is not limited to financial institutions in emerging markets.

lend on the part of foreign counterparties. Their dominance reflected long-standing use of the banking system as an instrument of industrial policy. In other words, public-sector bailouts were the quid quo pro for the banks having been utilized for directed lending. In cases such as Thailand and South Korea, opening to short-term flows prior to opening to long-term flows aggravated the problem. In others, a failure to embrace greater exchange rate flexibility encouraged banks and firms to leave their currency exposures unhedged. The devastating macroeconomic consequences were similarly ascribed to a model of state-led late development that privileged banking and left bond markets underdeveloped (Greenspan 1999).

Post-crisis reform efforts focused on this nexus. These attempted to put banks on a firmer commercial basis and limit the perception of too big to fail. In some countries – South Korea for example – the crisis was followed by an unprecedented wave of bank exits and takeovers. By early 2000, the number of Korean commercial banks had fallen to 7 from 26 before the crisis. This was an extraordinary development in a country that had never in its history experienced the closure of a major financial institution.

More broadly, however, progress on this front was mixed. Although loan classification and supervisory standards were raised, practice lagged principle. Moody's (2007) describes the case of Indonesia, where owing to lax corporate governance, banks continue to lag their regional peers in the implementation of international standards, although the standards themselves are not obviously inferior to those of neighboring countries. Fitch's indicator of the health of national banking systems as of April 2008 – that is, before the spread of the credit crisis and global slowdown to emerging markets – gave ratings of "weak" or very weak (D or E on an A-E scale) to almost 70 percent of emerging-market banking systems. Half of all emerging-market systems are in the D category and 20 percent were rated E. Only 11 received a B ("strong") rating – Bahrain, Chile, Czech Republic, Estonia, Korea, Kuwait, Mexico, Qatar, Saudi Arabia, South Africa and UAE – while only seven qualified for a C ("adequate") rating – Brazil, Latvia, Malaysia, Oman, Slovakia, Slovenia and Thailand. There is a preponderance of weak (D or E rated) systems in every emerging region other than the Gulf Cooperation Council.

Even more fundamentally, there was an inadequate understanding of what constituted a safe and sound banking system. Say what you will about the rating agencies, their evaluations tend to accurately reflect the prevailing consensus in official circles. Thus, the April 2008 Moody's report in question gave a rating of "strong" to South Korea's banking system, which required a massive government bailout six months later. Even more damningly, the rating agencies did not flag serious vulnerabilities in the U.S. banking system in the first half of 2007. A common feature here was failure to grasp the risks of excessive reliance on leverage and wholesale funding.[12] It was the naïve belief that privatization was enough to convince bankers that they would not be bailed out in the future like they had been in the past, where in fact private banks can be too big and connected to fail. Here, it is fair to say, we are going back to the drawing board.

Another feature of the post-Asian-crisis architecture was a more measured approach to capital account liberalization. The IMF acknowledged the need as early as the spring of 1998.[13] A series of subsequent staff studies and policy statements reiterated the desirability of capital account convertibility as a long-run goal but emphasized the existence of preconditions for ensuring that the benefits outweighed the costs.[14] They warned that capital flows could be volatile and that countries should avoid large current account deficits that heightened their dependence on foreign funding. This was advice that emerging markets in Asia and, to a somewhat lesser extent, Latin America took to heart: they shifted from current account deficit to surplus and accumulated foreign reserves as protection against sudden stops.

The efficacy of this advice is evident in the current crisis. Countries running current account surpluses, while far from immune, have avoided 1997-98-style crises, while others running current account deficits have experienced grave difficulties as funding for

[12] There were other problems as well, of course, such as inadequate internal controls and regulatory arbitrage (shifting high-risk exposures to conduits and structured investment vehicles). But that is a subject for another paper.

[13] Eichengreen and Mussa et al. (1998) emphasized the need for a more measured approach. This synthesis was presented to the Executive Board in the spring of 1998, and its findings were reflected in the associated board discussion and conclusions of the chair (IMF 1998).

[14] See inter alia Prasad, Rumbaugh, and Wang (2005), Kose, Prasad, Rogoff, and Wei (2006) and Prasad and Rajan (2008).

those deficits has dried up. Countries with ample reserves can avoid sharply contractionary adjustments. They can intervene to stabilize their banking systems insofar as foreign reserves exceed the decline in foreign finance.15

The problem is that not all countries were equally diligent at limiting capital inflows and preventing current account deficits from widening. In Central and Eastern Europe in particular, countries that allowed very large external deficits to develop are now paying the price. In part this was a problem of false confidence. The Baltics and other Eastern European countries had not experienced an Asia-like crisis. They were under the misapprehension that their capital inflows were stable, either because branches of foreign banks dominated the local market, intermediating those flows, or because their special status as EU members would reassure. In the event, they were disappointed.

The other problem was a dearth of instruments with which to manage flows. Interest rate responses tend to be at best ineffectual, at worst perverse.[16] Sterilization is costly – even for China now that domestic interest rates exceed their U.S. equivalents. Holding period taxes and other sand in the wheels can disturb investor confidence if applied with anything but the greatest delicacy.[17] The only instrument guaranteed to be effective is fiscal policy. By raising public saving, governments can influence the saving/investment balance. But doing so is difficult, especially in democratic societies where decisions regarding taxation and public spending are dominated by other priorities.

Another focus of the post-Asian-crisis agenda was limiting currency and maturity mismatches.[18] This was to be achieved through strengthening supervision and regulation of the banking system and by adopting more flexible exchange rates to encourage hedging by firms and households.[19] Once again, progress is best described as mixed. In Eastern Europe, regulators prevented banks from incurring currency mismatches but did not prevent them from passing them on to households and firms. In countries like Hungary, the majority of home mortgages and even car loans are denominated in Swiss francs and euros. The idea that households would be cautious about incurring foreign currency liabilities because the exchange rate was floating within a band turned out to be naïve. The same can be said of the idea that the fact of a floating won would prevent Korean banks from incurring large foreign currency exposures.

In this instance, the problem is not a lack of instruments but a reluctance to apply them. In some cases, the need is for more vigorous regulation of the banking and financial system–no more pretending that when banks pass their mismatches on to the nonbank sector the problem has gone away. In others, it means getting serious about exchange rate flexibility so that firms and households appreciate the risks of foreign-currency obligations. Here, too many governments have talked the talk but not walked the walk. The IMF's classification of de facto exchange rate regimes (Bubula and Otker-Robe 2002, as updated by the authors) confirms that there has been some movement in the direction of more flexible exchange rate regimes and away from crisis-prone intermediate arrangements: the share of emerging markets with intermediate regimes was down to 41 percent in 2006, from 77 percent in 1996. But 41 percent is far from a negligible fraction. Moreover, this movement away from intermediate regimes has halted in recent years. Flexible exchange rates are no panacea, but recent experience from Estonia to Hungary suggests that regimes of limited flexibility can contribute dangerously to the build-up of vulnerabilities.

A final agenda item in the earlier round of architecture discussions was enhancing the capacity of the International Monetary Fund and allied institutions to anticipate and manage crises. As part of the effort to better anticipate risks, surveillance of national and international financial systems was strengthened. At the national level there were the aforementioned Financial Sector Assessment Programs. At the

[15] As they did in the case of Korea. The contrast is striking between Korea's response to the last crisis, when it was forced to raise interest rates in a desperate effort to re-attract flight capital, and this one, when it has been able to avoid interest rate increases and instead work to re-liquefy its banking system.

[16] Raising interest rates to damp down the inflationary effects only tends to attract more capital inflows. Lowering rates discourages inflows but stimulates domestic demand, similarly resulting in problems of inflation and real overvaluation.

[17] Recall how their imposition in Thailand in late 2006 led to a stock market crash.

[18] See inter alia Goldstein and Turner (2004).

[19] Empirical studies (e.g., Duttagupta, Fernandez, and Karacadag 2004) suggest that the shift toward more flexible exchange rates has contributed to the development of deeper and more liquid hedging markets and encouraged banks and firms to better hedge their foreign currency exposures.

international level there was the creation in the Fund of a Capital Markets Department and biannual presentation to the board of a *Global Financial Stability Report*. In 2006, there was a Multilateral Consultations Initiative to bring together a handful of systemically significant members in order to better anticipate and head off cross-border risks. There was also investment in constructing forecasting models and early warning indicators of potential crises.

These too are works in progress. The Fund's capital markets function has been hamstrung by the difficulty of competing for talent with high-flying private institutions.[20] Despite some low-key successes, such as warning of risks to the U.S. subprime market in the spring of 2006, energy has been dissipated on daily reports to management on events occurring overnight in financial markets.

The idea that the IMF should strengthen its early-warning systems is back on the table; it features prominently in Gordon Brown's proposal for reforming the global financial architecture.[21] Unfortunately, the experience of the last ten years does not give one much confidence in the success of this enterprise. The structure of financial markets is changing continuously; this raises questions about whether forecasting models based on historical data can provide reliable early warnings of impending crises.[22] To be sure, there have been cases where crises could be foretold, Argentina in 2001 being an obvious example.[23] In this instance, the problem for the Fund was not anticipating the crisis but flagging the need for corrective policies in a way that did not precipitate the very disruptions that it was seeking to avert. It was compelling a member, even one that depended on Washington, D.C. for financial assistance, to take corrective action.[24] It was finding a way of curtailing its assistance without provoking an economic and financial meltdown.[25]

The intervening decade also saw proposals for the IMF to act more like an international lender of last resort (Fischer 1999).[26] This idea drew inspiration from the creditor-panic interpretation of the Asian crisis (Radelet and Sachs 1998), according to which liquidity disbursed quickly in large amounts could have prevented the region's fundamentally sound economies from succumbing to liquidity crisis. But empowering the Fund to disburse large amounts of money subject to only light conditionality was never viable; this would have put too much discretion in the hands of semi-anonymous technocrats who would have been the sole adjudicators of what were crises of solvency and crises of liquidity. The Meltzer Commission (International Financial Institution Advisory Commission 2000) proposed limiting the ability of the IMF to disburse front-loaded assistance to prequalified countries, where soundness of the banking system was the principal criterion determining prequalification.

The problem with this proposal, which is obvious in retrospect and did not go unappreciated at the time,

[20] A positive consequence of the credit crisis in the United States and Europe, insofar as it puts a damper on the expansion of the financial-services industry, may be to relax this constraint.

[21] See Reuters (2008).

[22] There is also the problem of Type 2 error – of warning of (and therefore) precipitating crises that would not otherwise occur. I am on record as questioning whether the Fund can succeed at developing an effective early-warning system (Eichengreen 2002).

[23] Four years of economic stagnation, soaring unemployment, real overvaluation, a heavy debt load and complete lack of monetary flexibility being incontrovertible leading indicators in this particular case.

[24] This problem was even more acute in the case of the Multilateral Consultations Initiative, participants in which were unlikely to borrow from the Fund. Thus the first such consultation, in which the Fund brought together the United States, Japan, China, the euro area, and Saudi Arabia to discuss risks to financial stability posed by global imbalances, did not suffer from shortcomings of diagnosis but did nothing to compel the participants to take corrective action.

[25] The decision of the IMF, with U.S. Treasury backing, to lend additional resources to Argentina as late as August 2001 is indicative of the dilemma. The Argentine episode, like the Mexican and Asian crises before it, also raised concerns that international rescues were a source of moral hazard – that multilateral "bailouts" did as much to encourage risky behavior as to address its consequences. It pointed to the need for a more orderly way of resolving crises, if only so that the IMF might, on occasion, be able to stand back and let events take their course. Suggestions here included an international bankruptcy regime, an IMF-directed sovereign debt restructuring mechanism, and the addition of collective-action clauses to sovereign debt contracts. The idea of an international bankruptcy regime went back at least to Raffer (1990) and Sachs (1995). Rogoff and Zettelmeyer (2002) summarize the intellectual history. Krueger (2001) is associated with the proposal for a Sovereign Debt Restructuring Mechanism. Proposals for promoting the adoption of collective action clauses include Macmillan (1995) and Eichengreen and Portes (1996) and were promoted by the U.S. Treasury during John Taylor's stint there. It is not surprising that schemes for a full-blown international bankruptcy court came to naught; neither creditors nor debtors were willing to trade an imperfect but workable system for the uncertainty of radical reform. Even a Sovereign Debt Restructuring Mechanism–under which only select decisions regarding debt resolution would have been made by an independent panel, under IMF aegis–proved a bridge too far. The response ultimately agreed was the more widespread use of collective action clauses by emerging markets, starting with Mexico in 2003. How much difference these contractual provisions will make is yet to be seen, the new arrangements not having been tested yet by a major emerging market crisis.

[26] An earlier call to this effect was Sachs (1995).

was that banking-sector soundness was not the only, or even, for that matter, the most, important determinant of economic and financial stability; the view that it was had been heavily informed by the Asian crisis and by the priors of the members of the Meltzer Commission. There was also the danger that applying might send an adverse signal about the state of a country's finances (since it would be signaling its potential need for funds), and that disqualifying a previously prequalified country (as necessary when its policies deteriorated) could precipitate the very crisis of confidence that the facility was designed to prevent.[27]

The idea that the Fund should be transformed into a true international lender of last resort that provides unlimited liquidity without conditions is back on the agenda as a result of the current crisis (Sachs 2008). On October 29, 2008, the Fund announced the creation of a new front-loaded, quick-disbursing, essentially unconditioned lending facility (the Short-Term Liquidity Facility, or SLF) for countries with strong policies experiencing liquidity problems as a result of the credit crisis. This jettisoned the problematic focus on banking-sector stability of the Meltzer Report, replacing it with general language to the effect that qualifying countries would have to display "a good track record of sound policies." It abandoned the unworkable idea of prequalification. And it avoided the adverse signaling problem in that every country, almost regardless of its policies, has suffered from the crisis and would benefit from access to dollar liquidity.

To be sure, this was still far from a true lender-of-last-resort facility in that disbursements were limited to five times the recipient country's quota and that the facility was limited in size.[28] There is also the danger that countries denied access to the facility because of large current account deficits or for other reasons will suffer capital flight as a result of that fact. This has led some, e.g., Dervis (2008), to suggest that access to the facility should be expanded – that additional countries should be provided with large amounts of front-loaded liquidity. Such proposals, however, come with an acknowledgment that liquidity support will have to come with conditions attached. If so, we are likely, ultimately, to be back in a world where every country's eligibility for IMF assistance will have to be judged on its individual merits, with either light, heavy, or no conditions attached.

A final issue commanding attention in the earlier round of architecture discussions was IMF governance. Asian countries came away from their crisis believing that the Fund was inadequately responsive to their needs and excessively influenced by the United States. The threat that they might opt for a regional alternative was motivation for governance reform.[29] A governance structure that enhanced the perceived legitimacy of the IMF was seen as important for the credibility of its policy advice. And a more efficient governance structure was seen as necessary for streamlining its decision making.

The subsequent process focused on adjusting quotas and voting shares. Proposals for new quota formulas were tabled, starting with those of the Cooper Committee in 2000, but there was no agreement on a formula. This is not surprising given that the quota formula has multiple functions and there is no consensus on the weight that should be attached to each. Quotas determine countries' financial contributions to the Fund. They determine how much they can borrow. Along with the fixed number of basic votes bestowed on every member, they determine how many votes each member is entitled to cast when strategic decisions and amendments to the Articles of Agreement are considered. They thus shape the voice that different countries have in the deliberations of the institution.

At the Bank-Fund meetings in Singapore in 2006, it was decided to push ahead with ad hoc quota increases for four under-represented emerging markets, China, South Korea, Turkey and Mexico, and to impose a two-year deadline on deliberations

[27] A watered-down facility along these lines, the Contingent Credit Line (CCL), was established in 1999, but no country applied, and the facility was allowed to lapse in 2003. During the tenure of Rodrigo de Rato as managing director, the Fund then sought to establish a successor facility, the Reserve Augmentation Line (RAL). Unlike some other elements of de Rato's "Medium Term Strategy" for reforming the Fund, this one died a quick death.

[28] The IMF itself provided no details on the size of the facility, although the *Wall Street Journal* (October 29, 2008) referred to up to $100 billion of three-month loans. At the time of writing, total free IMF resources are roughly $200 billion, while five-times quota for emerging markets as a group approaches $700 billion. So it would be reassuring to address the Fund's financial-resource constraint.

[29] The Japanese government had proposed an Asian Monetary Fund during the earlier crisis, but this was torpedoed by the active opposition of the United States and the reluctance of China to participate.

leading to a more comprehensive revision.[30] This camel's-nose-under-the-tend approach did not please countries that were not so favored, such as India and Brazil. Nor did this stopgap lend legitimacy to the quota-revision process. The more comprehensive agreement was announced in early 2008, in time for the spring Bank-Fund meetings, and approved by members holding the requisite 85 percent of votes in the Fund. This agreement increased the number of basic votes, modestly enhancing the voice of small countries. It provided additional budget and resources to the two Executive Directors representing large numbers of African countries and therefore with especially heavy workloads. It specified a new quota formula whose arguments included a weighted average of GDP at market prices and GDP at purchasing power parity (where the latter favored poorer countries) as well as measures of the level and variability of a country's international transactions.

But the new quota formula is no more analytically defensible than its predecessors.[31] In addition, the changes in quota shares resulting from application of the formula are too small to change anything consequential. The voting shares of Germany and Italy decline from pre-Singapore levels by a miniscule 0.16 and 0.08 percent of total votes, respectively. China's increase is 0.88 percent. India and Brazil receive increases of 0.42 and 0.30 percent. Mexico receives an increase of 0.27 percent. It is hard to see how such marginal changes will substantially affect decision-making, more so insofar as most operational decisions are reached in the Executive Board on the basis of consensus, not votes.

Thus, emerging markets continue to feel that they lack adequate voice and representation in the IMF. The result is that the Fund lacks legitimacy. This is evident in the reluctance of emerging markets to seek the assistance of the institution. Pakistan went first to its neighbor China for assistance. Hungary resorted initially to the European Central Bank (despite not being a member of the euro area) rather than appealing to the Fund.

3. Changes in the International Financial Architecture not Anticipated in 1999

Ten years on is also an appropriate time to note changes in the international financial architecture that were not anticipated during the earlier debate. Examples already have been noted: these include the tendency for capital to flow "uphill" from developing to developed economies, the accumulation of reserves, and the emergence of sovereign wealth funds.[32]

These unanticipated developments are all aspects of the same phenomenon. The shift from current account deficit to surplus in the developing world reflects a decision on the part of governments and central banks, in the wake of disruptive crises, to run their economies under less pressure of demand.[33] The result was a decline in investment relative to saving in emerging East Asia in particular (Rajan 2006, Asian Development Bank 2007). Sustaining those surpluses meant limiting currency appreciation, in turn implying intervention and reserve accumulation. To the extent that reserves also constituted a firewall protecting the economy from financial volatility, this was part and parcel of reducing the risk of financial instability. With the Federal Reserve doing all in its power to propel the U.S. economy out of its 2000-01 recession and the United States more generally adopting an attitude of benign neglect toward its current account, the result was uphill flows of capital and global imbalances on a scale not witnessed previously.[34]

[30] The United States agreed not to seek or accept an increase in its quota as part of that subsequent revision. One reason for the failure to adopt the quota-reform proposals of the Cooper Committee had been that almost any formula placing a significant weight on U.S. GDP at market exchange rates would have represented an increase in U.S. representation and a reduction in that of developing countries.

[31] It is hard to mount a coherent defense of the use of GDP at purchasing power parity. The IMF exists to lend to and represent the interests of countries according to their weight in the international system. What matters from this point of view is the market value of their transactions, which points to the use of market exchange rates; purchasing power parity adjustments are designed to facilitate international comparisons of living standards, not the market value of transactions. The use of purchasing power parity weights thus smacks of political expediency. And the fact that further ad hoc adjustments were applied, overriding mechanical implementation of the quota formula, before submitting the agreement to a vote does not enhance the legitimacy of the process. These changes were designed to prevent the voting shares of the high income countries as a group from rising further and those of low income countries from falling.

[32] Careful observers of emerging markets will have noted exceptions to the statement about crises, such as the banking crisis in the Dominican Republic in 2003, currency crashes in Indonesia and Thailand in 2005 and 2006, and a number of debt restructurings. But these were exceptions to the rule, and none had systemic significance or matched Asia in 1998 for its intensity.

[33] And thereby to reduce the risk of financial instability.

[34] Chronic U.S. deficits were, in fact, nothing new, but their scale has been unprecedented in recent years. And, previously, with

Nor was the emergence of sovereign wealth funds unrelated.[35] With their accumulation of foreign assets, it was inevitable that emerging markets would seek to diversify their holdings, not just across countries and currencies but to include equity as well as debt. Deciding on equity stakes was not an appropriate task for central bank portfolio managers; it was logically delegated to self-standing sovereign wealth funds and outsourced to private investment advisors.

The emergence of these funds has attracted attention and concern, making them the subject of codes of conduct and standards for transparency to reassure the countries targeted by their investment that strictly commercial, as opposed to political, criteria would prevail.[36] But it is not clear that we should be concerned that sovereign funds will in fact be used to advance political agendas rather than simply to diversify the government's foreign investment portfolio. What is clear is that this problem would not have arisen but for the dedication of emerging markets to the maintenance of current account surpluses and undervalued exchange rates and the complicity of the United States, which was dedicated to the converse. It is more than a bit disingenuous for the United States, having depended on emerging markets to finance its current account deficits, to now object to its lenders' desire to hold assets other than depreciating U.S. debt securities.

developing countries importing capital, finance for the U.S. deficit had come primarily from other advanced economies.

[35] The rapid growth and rising prominence of these funds was certainly not something that was widely anticipated in the late 1990s. In contrast, there was already widespread awareness of the emergence of the other so-called "new power brokers" (to quote the McKinsey 2007 survey of the same name), namely hedge funds and other highly leveraged institutional investors. One strand of the architecture debate emphasized the need to regulate hedge funds and limit the threat they posed to financial stability (de Brouwer 2001). My own view (Eichengreen, Mathieson, et al. 1998) was the footloose and chameleon-like character of hedge funds made them exceptionally difficult to regulate; I am not surprised that the last ten years has seen little progress in this direction. Moreover, it has always been my view that there is nothing fundamentally different between hedge funds and other highly leveraged investors, including investment banks and broker-dealers. It is tempting to see the subprime crisis, which has seen both hedge funds and investment banks (like Bear Stearns) fail as a result of having engaged in many of the same practices, as validation of this point.

[36] The IMF has become the main vehicle for negotiation of a code of conduct for sovereign funds – not without pushback from the governments operating those funds. See Weisman (2008). In February 2008, the European Commission indicated that it would craft its own code for sovereign wealth funds active in Europe. In May, the U.S. Treasury bilaterally negotiated an agreement on a list of basic principles for sovereign wealth fund conduct with Singapore and Abu Dhabi.

How many of these changes in the international financial architecture should be regarded as permanent, and how many are likely to be passing phases? The debate over Bretton Woods II is precisely a debate over whether this particular constellation is likely to endure or whether it might come to an early and abrupt end.[37] The most compelling argument for the Bretton Woods II proposition that the current constellation of exchange rates and imbalance could endure indefinitely was that the U.S. had a comparative advantage in producing financial assets while emerging markets had a comparative advantage in producing manufactures (Caballero, Gourinchas and Farhi 2006). Emerging markets lacked the technology to reliably develop and issue securitized claims in the volume demanded by their investors; they solved this problem by running current account surpluses and importing securities from the United States.

This rationale looks more than a little suspect in the wake of the credit crisis in the United States; it is now described as "they sell us toxic toys and we sell them toxic securities." The crisis has cast doubt on the ability of the U.S. to supply *high quality* financial assets to the rest of the world. As its economy lurches into recession and foreign purchases of its financial securities decline, global imbalances show clear signs of unwinding. And if the U.S. deficit shrinks, so too will the surpluses of other countries, as a matter of definition. By implication, their accumulation of foreign reserves will now slow. Indeed, the heyday of sovereign wealth funds may already be over, as countries from South Korea to the United Arab Emirates draw on their reserves to stabilize their exchange rates and recapitalize their banking systems.

4. Systemic Issues

Among the constructive effects of the subprime crisis has been to legitimize long-standing concerns about the role of the rating agencies and the efficacy of the Basel approach to gauging capital adequacy for financial institutions. Though criticism of the rating agencies and the Basel Accord is not new, such questions have been taken with a new seriousness

[37] Bretton Woods II is the name given to the thesis of Dooley, Folkerts-Landau and Garber (2003) that the constellation of global imbalances was an equilibrium phenomenon that was indefinitely sustainable. It is not to be confused with calls for a new Bretton Woods from the likes of Gordon Brown (see above). Of course, there is an irony in the fact that both camps employ the same terminology.

since the effects hit home – that is, since they hit the United States and Europe. The rating agencies are targets for criticism in every crisis if only because their job is to be bearers of bad news and because their pronouncements inevitably make a bad situation worse.

But the criticisms levied against them in Asia in 1998 now resonate more strongly in Europe and the United States. Ratings are lagging, rather than leading, indicators. The rating agencies persist in issuing upgrades even after a market or economy shows clear signs of problems. They then issue downgrades only after conditions have deteriorated. This positive-feedback behavior amplified volatility in Asia in 1997-98, and it similarly amplified volatility during the subprime crisis. We see this again in the failure of the rating agencies to recognize the vulnerability of countries with large current account deficits; refer back to table 1 above.

In part, this problem reflects inability of the agencies' models to forecast out of sample. They are estimated on short time-series. Just as the agencies rated emerging-market debt in the 1990s on the basis of only a few years of data on the operation of sovereign bond markets, they rated subprime-mortgage-backed securities using only the short time-series generated by an enormous housing boom.[38] Their best forecasters are continually hired away by the banks, which pay higher salaries. Then there is the conflict of interest between the agencies' advising and rating roles. Asked by an issuer of collateralized debt obligations how to structure an instrument so as to obtain an AAA rating, it can be impossible for the agencies to rate the resulting issue any other way.[39]

One way of addressing this conflict would be to bar agencies issuing ratings from also advising issuers. But it is not clear how to do this without at the same time creating other problems.[40] The major rating agencies currently earn fees from advising issuers on how to structure their securities but not from issuing ratings, which are public information. One small U.S. rating agency, Egan-Jones, has shunned advising and earns income by providing its ratings only to paying clients. The problem with more widespread adoption of this model is that public information would become private. Companies would have to charge for their ratings. The information provided by the latter would then be less freely available. It is not clear that they could be used by regulators, whose operations require a certain degree of transparency. Another approach would be to levy a tax on every security issuer and/or trader and use the revenues to compensate those issuing the ratings, which could then remain public. But it is not obvious how such a scheme could be administered. What private rating companies would qualify for redistribution? What public or semi-public entity would decide on their shares? Would non-U.S. issuers and investors be subject to the tax? Would it have to be levied and administered on a global basis? Just posing these questions casts doubt on the viability of such schemes.[41]

Alternatively, it has been suggested that agencies providing advice on how to structure an issue could be required to keep skin in the game. That is, they could be required to hold a certain amount of the same security in their own portfolio to ameliorate potential conflicts of interest between the financial- and investment-advisor functions, but where the application of such regulation to a commercial bank or even investment bank would be straightforward, how to apply it to rating agencies would be less so.[42] It would require a fundamental transformation of the function of those agencies from modestly capitalized

[38] In addition there is the problem that the model is estimated on a different structure from the one that currently prevails in the market. In the case of housing-related securities, the agencies adopted a methodology long used to model and rate corporate bonds, which are subject to a very different set of risks. Emerging market corporations that were subject to the so-called sovereign ceiling (where their ratings could not exceed those obtained by the sovereign) complained about similar practices.

[39] There do not appear to be such widespread complaints by investors that the rating agencies, which also consult with governments, which pay to have their bonds rated, about conflicts of interest in the sovereign-rating context. "Why not?" is an interesting question.

[40] New York State Attorney General Andrew Cuomo has pressed the rating agencies to agree to a fee structure in which they charge for services all through the issuance process to prevent issuers from shopping for ratings. Securities and Exchange Commission head Christopher Cox, for his part, has proposed a ban on allowing the same employee from both advising the issuer and rating his security. But whether assigning these two functions to the occupants of neighboring cubicles would really make much of a difference is unclear.

[41] Again, shades of the Tobin tax.

[42] Even for commercial and investment banks, the efficacy of this reform, advocated in Europe, can be questioned. In fact, many investment banks held large amounts of the securities they originated on their own balance sheets, whether for warehousing or proprietary trading purposes. They ended up suffering serious credit losses as a result, but this did not deter them from originating highly risky securities.

advisors to generously capitalized financial institutions.

Another approach would be to encourage competition. If investors and issuers had more rating agencies to turn to, those that repeatedly got it wrong would lose market share and ultimately franchise. Promoting competition is first and foremost a problem in the United States, where Moody's, Standard & Poor's and Fitch dominate the market. This reflects the need for a rating agency to secure Nationally Recognized Statistical Rating Organization (NRSRO) status in order to be a viable competitor. NRSRO status allows fiduciaries who pick a bond that goes bad to defend themselves against legal or regulatory sanction: they can say "an NRSRO recognized by the SEC told us these securities were good." Agencies without this status have an extra handicap when competing for business.[43]

The Credit Agency Reform Act of 2006 is intended to increase competition by making it easier to obtain preferred status from SEC staff. So far this has led to the granting of NRSRO status to exactly one additional rating agency, the above-mentioned Egan-Jones, in December 2007.[44] It may also be possible to address the problem by encouraging more rating agencies in other countries. There has been movement in this direction: following the 1997-98 crisis a number of Asian countries promoted the establishment of local rating agencies. There is now an Association of Credit Rating Agencies in Asia with 25 members at last report.

The question is why these entities have not taken more market share from the Big Three. It could be that economies of scale and scope dominate the advantages of local knowledge. But, if so, it is not clear that more competition is a feasible solution to the inefficiency of the rating process.

These observations are more troubling insofar as credit ratings are used to gauge the riskiness of assets under the Basel II capital accord for banks that do not possess internal models through which value-at-risk can be estimated.[45] Insofar as ratings are an unreliable measure of the riskiness of an asset class, they provide unreliable guidance as to the size of the capital buffer needed to guard against price fluctuations. They also accentuate the pro-cyclicality of the financial system. Insofar as ratings rise (fall) in expansions (contractions), they reduce (increase) the capital that banks must hold against their existing assets, allowing for the further pro-cyclical expansion (contraction) of the balance sheet.

Similar criticisms can be registered about the use of internal models of value-at-risk as a basis for assessing the adequacy of capital buffers under Basel II. These models have repeatedly underestimated the likelihood of extreme events. Like the rating agencies' models, the banks' models were developed in a period of unusually low volatility. Given encouragement from management to minimize costs, staff estimating and running these models feel pressure to underestimate risks to avoid inflating capital requirements. The operation of these models also accentuates the pro-cyclicality of credit. During expansions, highly leveraged issuers perform relatively well; their debts are therefore modeled as less risky, allowing banks to reduce their capital buffers and lend more; the inverse then occurs during contractions.

Besides the fact that capital requirements may be too low and pro-cyclical, there is the fundamental problem that they do not apply to the so-called shadow banking system. The idea that banks should be required to hold a minimum level of capital flowed from the observation that they were subject to runs (which liquid capital helped them to pay out) and that in extremis they should be the recipients of last-resort lending (where requiring them to hold capital was one way of preventing them from taking additional risk in response to the associated moral hazard). The problem now is that nonbanks are similarly exposed to the danger of a run, through the money market rather than from depositors, and they are similarly too important to be allowed to fail.

These problems are easier to point to than to solve. Abolishing capital requirements and instead requiring banks to issue subordinated debt places more faith in the power of market discipline than most of us would feel comfortable with in the wake of the recent crisis. Going back to Basel I, where different assets were

[43] Dizard (2008) observes that prior to the granting of NRSRO status in the 1970s there was a greater tendency for investors to shop around for the most accurate rating – since there was no anointed rating agency that guaranteed them protection from legal and regulatory action – and in this earlier world there was a greater incentive for rating agencies to derive their fee income from investor rather than issuers.

[44] After 11 years of trying by the company's principals.

[45] For more on these internal models see below.

placed into different risk buckets carrying different amounts of required capital, would throw away valuable information about value-at-risk conveyed by the correlation between asset classes which provided much of the impetus for moving to Basel II. Abandoning risk weighting entirely and basing capital requirements on unweighted assets, as some have suggested, would be equally bad.

My own suggestion would run as follows.[46] Start by clamping down on regulatory arbitrage. The fundamental reason for the rise of conduits and structured investment vehicles was to evade capital requirements. Like banks, these entities funded themselves short term, by issuing asset-backed commercial paper or securing a revolving credit line from the parent, while making illiquid investments. But because their operations were off the bank's balance sheet, capital did not have to be held against those investments. Often, however, those investments came with a guarantee that the parent or the issuing bank would take them back if the market in them collapsed. Even where this was not the case, the fact that these subsidiaries were related to the parent often meant that it was too embarrassing to allow them to fail. Unavoidably, then, these off-balance sheet operations came back onto to the banks' balance sheets at the worst possible time. For these reasons, the logic for requiring capital to be held against these operations is overwhelming. The experience of Spain, where regulators have already done so, demonstrates its feasibility.

Next, build in some redundancy. In the spirit of the U.S. Alternative Minimum Tax, it should be possible to compute a bank's minimum required capital in a couple of different ways and hold it to the higher value. One would be the Basel II value that requires a bank to consolidate its portfolio (effectively, to move its off-balance-sheet exposures back onto its balance sheet) and calibrate the associated capital requirement using its internal model or commercial credit ratings. Another would be a simplified Basel I value, that requires the bank simply to hold capital that equals some fixed fraction of its portfolio. The old Basel I procedure could be simplified by eliminating the old process of risk weighting.[47]

[46] Laid out in more detail in Eichengreen (2008).

[47] The Swiss National Bank has recently proposed something along these lines for banks under its regulatory jurisdiction.

Then raise the minimum capital ratio under this old "Basel I pillar" to more than 8 percent. There are compelling reasons to require banks to hold more capital. The risk of extreme events, against which capital is supposed to provide a cushion, is clearly greater than many regulators and bank risk officers had convinced themselves. More capital will mean more own funds at risk, which will encourage more prudent behavior. More capital will of course also mean higher intermediation costs. But the costs of intermediation have fallen significantly in recent years as a result of financial innovation (not least the types of securitization that are also at the root of the present crisis). Accepting slightly higher costs in return for significantly greater stability would not be an undesirable tradeoff.

Finally, index the capital ratio to the rate of change of bank balance sheets.[48] When balance sheets are expanding, the capital ratio – as opposed to the simple amount of capital that banks must hold – should increase. This would restrain the rate of growth of bank lending in good times and, conversely, limit the contraction needed to build capital in bad times. The tendency for the present system of capital requirements to accentuate pro-cyclical financial dynamics would thereby be attenuated.

5. Implications for Impending Debate

What inheritances will be handed down from the first (post-1997) round of architecture discussions to the new debate over how to reform the international financial architecture that will surely follow the 2008 credit crisis? The recent crisis underscores the need to enhance the transparency of financial instruments and markets. The opacity of collateralized debt obligations and the facility of banks in disguising their exposures by moving them off balance sheet were significant factors in the crisis. At the same time, that experience underscores doubts that transparency in and of itself will be enough to prevent excesses and ensure that market discipline is applied early – that is, before serious vulnerabilities are allowed to build up. The idea that well-informed investors, supported by adequate transparency standards, will be able to discipline large institutional investors and thereby prevent significant vulnerabilities from building up has shown to be naive. Insofar as the problem is not

[48] As argued by Goodhart and Persaud (2008).

simply the availability of information but the capacity of investors to process it (even sophisticated institutional investors in collateralized debt obligations and the like appear to have been unable fully to assimilate the available information about the risk characteristics of those instruments), transparency alone will not be enough.[49]

In addition, there is the need for strengthened prudential supervision and regulation – another inheritance from the earlier architecture debate that is likely to be an even higher priority in light of recent events. There will be discussion of regulations limiting investment in complex derivative securities to sophisticated investors (as recommended by the Corrigan Committee).[50] There will be reforms of Basel II to require internationally active banks to hold more capital, to key their capital to the riskiness of not just their investments but also their funding, and to make capital requirements less pro-cyclical, as described above. There will be reform of the rating-agency industry. All these are again issues that featured to some extent in the earlier architecture literature that will again be priorities in future discussions.

An issue that did not feature in the earlier architecture debate but which will surely be the subject of extensive discussion this time is the desirability of forcing transactions in credit default swaps and other derivative instruments into clearinghouses and an organized exchange.[51] Counterparty risk was not a prominent factor in the Asian crisis.[52] But it is central to why the failure of Lehman Brothers ramified into a systemic crisis in 2008. When one large financial firm was unable to execute its obligations, several of its counterparties quickly found themselves in the same position. In turn, the problems of each of these counterparties created a problem for several of their respective counterparties, and ultimately the whole house of cards tumbled down. This problem can be ameliorated by reorganizing the market in credit default swaps and similar instruments so that transactions are netted through a central clearinghouse or traded on an exchange with real-time gross settlement.

Such reforms will be resisted by broker-dealers who earn hefty commissions on over-the-counter transactions. There will also be resistance on the grounds that exchange-based trading will require the standardization of instruments. It will limit scope for tailoring contracts to individual circumstances. But the political leverage of large financial institutions has been diminished by the crisis. And greater standardization is an acceptable price to pay for financial stability.

There is also likely to be more discussion of the need for a global financial regulator or "World Financial Authority" along the lines suggested by Eatwell and Taylor (2000). Questions will be raised about the appropriateness of delegating the supervision and regulation of financial markets to individual countries, given the extent to which problems in one country can infect others. In cases like Switzerland, where short-term bank liabilities are two-and-a-half times GNP, questions will extend to the notion that the national authorities are the appropriate entity to deal with rescue and recapitalization operations. No doubt the IMF, the BIS, and the Financial Stability Forum will all scramble to lay claim to the mantle of World Financial Authority.

But if the first round of architecture discussions teaches us one thing, it is that countries remain reluctant to compromise their sovereignty. Specifically, they remain reluctant to delegate the regulation of national financial institutions and markets to any supranational authority. Notwithstanding the creation of the Asian Bond Fund and Asian Bond Market Initiative, there was no willingness to do so in Asia. EU member states have been reluctant to embrace the case for a single financial regulator for their single market. It would not be surprising if the current wave of enthusiasm for a World Financial Authority dies down as soon as the worst of the crisis has passed.

This is not to deny that there will be renewed efforts to strengthen, harmonize, and coordinate supervision and regulation through the Basel Committee of Bank Supervisors and the Financial Stability Forum. Europe being the only part of the world with experience in creating supranational institutions, it may rethink its reluctance to move in the direction of a single

[49] But then most contributors to the earlier architecture debate never suggested that transparency was a sufficient condition for financial stability.

[50] See Counterparty Risk Management Policy Group III (2008).

[51] An early and influential statement of the case is Cecchetti (2007).

[52] Although it did figure in the failure of Long-Term Capital Management that followed in 1998.

regulator for the euro area or the EU as a whole.[53] If one wishes to imagine more far-reaching scenarios, the least implausible is the creation of a new international body or empowerment of an existing one to issue directives for how national markets should be regulated, which would then be enacted into law by individual countries (much in the manner that the European Commission's directives are enacted by EU member states).[54] This could be made an obligation of countries joining the "World Financial Organization" in the same way that legislation providing freedom of access to foreign suppliers is an obligation of members of the World Trade Organization. Countries that did not adopt the relevant legislation would then see their banks denied access to foreign markets and financial instruments issued on their markets denied eligibility for the portfolios of foreign pension funds, insurance companies and the like.

Another focus of the next round of discussions, like their predecessors, will surely be IMF reform. This is implicit in the fact that many of those calling for a new international financial architecture are already referring to the need for a new Bretton Woods Agreement – the original Bretton Woods Conference being where the IMF was established and some like Gordon Brown already highlighting IMF reform as a priority. They have a point. The IMF's inability to say anything critical about its large members is a weakness in the architecture. The IMF was notable for its silence in September 2008 when the U.S. Treasury rolled out a flawed bank rescue plan that emphasized purchases of troubled assets at something resembling market prices rather than capital injections – this despite the fact that the Fund had extensive experience with the resolution of banking crises and had published definitive analyses of the issue (Laeven and Valencia 2008). The inadequate voice and representation of emerging markets, which renders them reluctant to approach the organization until it is too late, creates unnecessary vulnerabilities. The inability of the Fund to move quickly in response to unfolding events is a significant liability.

Meaningful reform requires changing the structure, composition and selection of the Management and Executive Board responsible for priorities and policies.

[53] We know from long experience, though, that institutional evolution in Europe does not occur quickly.

[54] Phillips (2008) suggested something along these lines.

The twenty-four member Executive Board is unwieldy; national central banks typically make decisions in a considerably smaller board.[55] Corporations rely for oversight on a board of directors with considerably fewer than twenty-four members and an even smaller executive committee. The current board is also unrepresentative. That there are as many as nine European Executive Directors (depending on whether or not Spain is in the chair of its mainly Latin American constituency) is an anachronistic inheritance from the middle of the twentieth century when Europe loomed larger in the world economy and decolonialization had not run its course.[56] Finally, the current board is poorly structured, with regional neighbors scattered between different constituencies, former imperial powers and their one-time colonies grouped together in constituencies, and other groupings whose composition simply defies logic.

The appropriate response would be to downsize the board to streamline decision making, to change its composition to better reflect the realities of the twenty-first century, and to rationalize the constituency system. Pivotal to these steps would be the willingness of the European Union to consolidate its representation (initially almost certainly two, one for the euro area and one for the remaining EU countries). This would allow the board to be reduced in size. It would permit more directors from developing countries. It would enable Europe to speak with one voice. The idea of consolidated European representation has been on the agenda for some time. It has been advocated by both officials (Bini-Smaghi 2004) and academics (Ahearn and Eichengreen 2007). It is now being pushed by the European Commission in the face of resistance from EU member states that anticipate losing their position at the board table.[57]

Meaningful governance reform also requires changing a leadership selection process that allows the Europeans to nominate the managing director and the U.S. to select his first deputy (and the U.S. to designate the president of the World Bank). This anachronism reflects the era long past when the Americans and Europeans could divvy up leadership of

[55] The ECB is an exception, but with the expansion of the euro area it too plans to move to a rotation system designed to limit board size.

[56] Included in this encompassing list is Switzerland, which is not an EU member (relevant for the discussion below).

[57] Not all European states; some such as the Dutch have come out cautiously for consolidated representation.

the international financial institutions.[58] It does nothing to reassure other regions. It diminishes the legitimacy of the institution. Other regions have increasingly objected to this convention and even nominated their own candidates, but with the Europeans and Americans supporting one another in the Bank and the Fund it is hard to overcome their blocking coalition. Because there is little scope for rival candidates to compete on their merits, there is little assurance that the most qualified will be selected. Reform of leadership selection has been on the agenda for some time (Kahler 2001), but there has been little progress. Each time the managing directorship opens up, there is a promise to open up the process a bit "the next time around." Here the failure of the United States to open up the selection of the World Bank president so as to pressure the Europeans to offer the same concession at the Fund was an opportunity missed.

There are in addition a number of even more far-reaching schemes for reforming IMF governance, such as making directors independent in the manner of a central bank board (DeGregorio, Eichengreen, Ito, and Wyplosz 1999) or turning over their central responsibilities to nonresident directors – that is, to finance ministry and central bank deputies who would travel to headquarters periodically (King 2006). There has been a tendency, not least in the United States, to dismiss these ideas as unrealistic. Now that there is a new appreciation of the need for the Fund to be able to tell hard truths about even its largest shareholders, perhaps these ideas will come back on the table.

Finally, it is important to emphasize that, calls for a "new Bretton Woods System" notwithstanding, the result of future discussions is not likely to be a new global system of fixed exchange rates. There have been some somewhat peculiar suggestions that the breakdown of the Bretton Woods System is the ultimate cause of the 2008 credit crisis, the implication being that the world should now go back to fixed rates.[59] In reality, the opposite implication follows from recent events. Had emerging markets maintained more flexible dollar exchange rates for the last five years, global imbalances, notably between the United States and the emerging world, would not have been allowed to balloon to the same extent. Less foreign finance for the U.S. deficit would have meant less accommodating U.S. financial conditions, moderating the credit boom in the United States.[60] The call for a new Bretton Woods Conference to strengthen the regulation of global financial markets is welcome. But the idea that this might translate into a new Bretton Woods System of pegged exchange rates is not.

[58] And when the Americans opted for the presidency of the World Bank on the assumption that it would be the more consequential of the two Bretton Woods twins.

[59] Thus, an article in the *Economist* (2008) argues that President Nixon's decision to close the gold window and allow the dollar to float ushered in a period of generalized floating that permitted the removal of controls on international capital flows, which in turn created current vulnerabilities. In fact, the reality is exactly the opposite: it was the progressive recovery of international capital mobility following the Great Depression and World War II that ultimately undermined the viability of the pegged-but-adjustable rates of Bretton Woods.

[60] Thus, Warnock and Warnock (2005) estimate that foreign inflows reduced the level of interest rates in the United States by as much as 100 basis points.

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ON WHAT TERMS IS THE IMF WORTH FUNDING?

Edwin M. Truman

Since the middle of this decade, the International Monetary Fund (IMF) has faced triple crises of legitimacy, relevance, and budgetary finance. IMF members endeavored to address these crises, until recently against the background of sharply diminished demand for IMF financial assistance as a consequence of a sustained period of global expansion despite, or because of, rising global imbalances. During the first twelve months of the global turbulence that started in August 2007, many observers noted disapprovingly that the Fund was on the sidelines. Some noted more critically that it was likely to remain there either by the intent of its members or by the design of the institution. Since September 2008, the Fund has been thrust back into the lending business amid some calls that it should also play a more central role in the supervision and regulation of the global financial system.

In this paper, I take stock of these developments and answer the question that will face the new U.S. Obama administration: On what terms is the IMF worth funding? My answer to this question is not as straightforward as it would have been six months ago.

In the spring of 2008, after several years of intense discussion and a number of other policy changes at the IMF, an internationally agreed package of measures was approved and submitted to members for their ratification or acceptance. For the United States, the package involves: (1) acceptance of an increase of about $7.5 billion (SDR4.97 billion at $1.50 per SDR) in the U.S. quota in the Fund; (2) approval of an amendment to the IMF Articles of Agreement and the U.S. Bretton Woods Agreements Act that will increase the basic votes of each member of the Fund, fix permanently the share of basic votes in total votes, and provide for an extra alternate executive director for any constituency group of countries in the Fund with at least 19 members; (3) approval of a second amendment to the IMF Articles that will expand the powers of the IMF to invest certain of its financial resources; and (4) authorization for the U.S. Secretary of the Treasury to vote to approve the sale of a portion (12.97 million ounces, or 12.5 percent) of the IMF's 103.4 million ounces of gold, which is worth about $80 billion (at a market price of $800 an ounce).[1]

Action by the U.S. Congress is needed for any of these measures to go into effect because they require approval by 85 percent of the weighted votes of the members of the IMF, and the current U.S. voting share in the Fund is 16.77 percent. The Bush administration submitted this package to the Congress on November 12, 2008 in a letter from Treasury General Counsel Robert Hoyt to House Speaker Nancy Pelosi and another identical letter to the President of the Senate Richard Cheney. The governments of the other

[1] The first two elements of the package are linked in that the first cannot go into effect without the second. As a practical matter, the last two elements are also linked in that the expanded investment powers for the IMF will not be of much use if the IMF does not have the authority to invest the proceeds from the gold sales. Furthermore, although the U.S. Congress could act separately on the four elements, or separately on the two pairs of elements, the four elements most likely would be voted upon as a package.

members of the Fund, including, importantly, European members of the Fund with more than 30 percent of the voting power, also must act on the first three elements of the package before they can become effective, but in most cases such actions are more routine than in the United States.[2]

Six months ago, I would have written that the package of measures requiring congressional action should be endorsed by the incoming administration and resubmitted to the Congress and that the Congress should vote its approval. Although the package and other changes at the Fund over the past several years fall short of what I would have liked, rejecting them would pose an existential question. Given the broad endorsement that the package had already received and would likely automatically receive from other countries, if the United States were to reject the package or fail to ratify it, this country would be turning its back on the Fund as the preferred locus of multilateral approaches to the solution of common problems. Without U.S. support, the IMF would not disappear, but its role as a major institution of global governance promoting economic growth and financial stability would be further reduced. One qualification to this earlier answer remains relevant: I assumed that negative U.S. congressional opinion on China's exchange rate policies would be mollified by further substantial appreciation of the renminbi (RMB) against the dollar, as well as other currencies, by the time any final votes were taken.

Writing in late November 2008, I would further qualify my answer. My principal recommendation to the incoming Obama administration is to explore with other countries reopening the package on an expedited basis. The new administration should seek to include in the expanded package: (1) a further change in the formula used to guide the allocation of quotas in the Fund in the direction of giving less weight to the traditional industrial countries, (2) a doubling of IMF quotas with the allocation of increases based on the revised quota formula and a parallel doubling of the amounts that the IMF can borrow from members under the general arrangements to borrow (GAB) and the new arrangements to borrow (NAB), (3) a consequent further adjustment of voting shares in the Fund of at least five percentage points away from the traditional industrial countries, and (4) an allocation of SDR 50 billion (about $75 billion).[3] I also recommend (5) that the Obama administration seek authorization for the Federal Reserve to swap unlimited amounts of U.S. dollars for SDR issued by the Fund for up to two years and an amendment of the IMF Articles of Agreement to allow the Fund to swap SDR for the national currencies of the United States and of other countries issuing currencies that are heavily used in international finance. These national currencies would be used to finance a short-term liquidity facility in the IMF to assist member countries in supporting the international financial operations of financial institutions chartered within their jurisdictions. The aim should be completion of congressional action on the entire package by the end of 2010.

This paper, first, reviews progress on IMF reform over the past several years. The second section examines the role of the IMF in the unfolding global financial crisis and how that should affect the answer to the question posed in the title to the paper. A final section returns to the title question.

My review of IMF reform loosely follows the recommendations in my strategy for IMF reform (Truman 2006b). That strategy was based on a conference held at the Peterson Institute for International Economics in September 2005 (Truman 2006c). At that time, there were other IMF reform proposals, including ones by a previous IMF managing director Michel Camdessus (2005) and by the then-current managing director Rodrigo de Rato (IMF 2005a). There have been others since, for example, by the current IMF managing director Dominique Strauss-Kahn (2008) and others calling for broader reforms of the international architecture such as World Bank president Robert Zoellick (2008) and UK Prime Minister Gordon Brown in the *Washington Post* of October 17, 2008. However, my agenda provides a framework to discuss progress on reform issues during the past three years.

Before proceeding to the review of recent IMF reform accomplishments, it is useful to remind ourselves what we mean when we refer to the IMF. The Fund, first and foremost, consists of its member countries as represented on the 24-member executive board or in

[2] The two amendments of the Articles of Agreement also require approval by three-fifths of the members of the IMF before they can go in to effect.

[3] Only item 2 requires Congressional action. The U.S. quota in the IMF is currently SDR 37.1 billion (about $55.7 billion) and its GAB/NAB commitment is SDR 6,640 million (about $10 billion).

the "advisory" International Monetary and Financial Committee (IMFC). In particular, if the members cannot reach consensus on IMF reform or on the role the Fund should play in the international economy and financial system, the Fund as a functioning institution will be severely hampered. Even without consensus, the Fund is not completely stuck because the management of the institution, in the person of the managing director, can propose, prod, embarrass, and otherwise try to lead the members of the organization to endorse proposals that promote the IMF's objectives in the world economy and financial system. In doing so, the managing director can be substantially helped, or hindered, by the imagination and technical quality of the work of the IMF staff.

The State of Play on IMF Reform

In 2005, I identified six components of an IMF reform agenda: (1) substantial progress on IMF governance; (2) greater attention to the policies of a broader group of systemically important countries, in particular their exchange rate policies; (3) reestablishing the central role of the Fund in external financial crises, (4) refocused engagement with low-income members; (5) attention to the capital account and the financial sector; and (6) the need for additional IMF financial resources.[4] This list did not include the issue of financing the administrative budget of the IMF, in contrast with its lending operations. However, Mohamed El-Erian (2006) addressed the issue at the conference, and I will cover the topic under the sixth heading below.

IMF Governance

The principal focus of the recent IMF governance debate, and in fact the debate for at least 15 years, has been on the formulas that traditionally have been used as the basis for IMF quotas and, in principle, for periodic increases and adjustments in quotas. IMF quotas determine the amount of a country's own currency a member must lend to the Fund to finance its lending operations, are the basis for the amount a member may borrow from the Fund, and the principal component of absolute and relative voting power in the Fund. The distribution of voting power in favor of the traditional industrial countries derives from the history of the Fund and the application of the basic formulas as it evolved until the late 1970s when it was frozen (Truman 2006a and Cooper and Truman 2007).[5] On these twin issues, there have been some changes, but it is debatable whether these changes represent significant progress.[6]

With respect to the formula, the IMF executive board approved a new quota formula that replaced a combination of formulas (IMF 2008b). The single new formula is simpler to understand and at least some of the variables included are appropriate. The formula is a weighted linear combination of four variables: a member's share of global gross domestic product (GDP) with a weight of 50 percent, openness (trade in goods and services) with a weight of 30 percent, variability of current receipts and net capital flows with a weight of 15 percent, and international reserves with a weight of 5 percent. A "compression factor" reduces the relative shares of a handful of the countries with the largest shares and boosts the shares of all other countries.

GDP appears as the weighted sum of two measures: GDP at market exchange rates (60 percent) and GDP at purchasing power parity (PPP) rates (40 percent). Thus, the new formula has five variables. Moreover, the GDP variables are the only ones that are free from criticism although even here the weights that have been assigned to the two measures are controversial. As detailed by Ralph Bryant (2008a and 2008b) and by Richard Cooper and Edwin Truman (2007), the openness variable is not the conventional measure of trade as a percent of GDP, but rather it is each country's share of total trade in goods and services, reinforcing the influence of each country's economic size.[7] The variability measure also is not scaled by a measure of a country's economic size, so it also tends to "reward" large countries over small countries. Finally, in today's world where the size of a country's reserve holdings is often a sign that it has been impeding the international adjustment process, it is questionable whether that variable should be included in the formula at all.

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[4] I argued that the first three items in my six-part agenda were relatively more pressing.

[5] See also Ralph C. Bryant (2008a and 2008b).

[6] For example, I advocated (Truman 2006a) a reduction in the combined voting share of the 26 traditional industrial countries by 10 percentage points from more than 60 percent to about 50 percent. The proposed change produces a quarter of this amount.

[7] The measure has the added weakness that it fails to exclude intra-Euro area trade.

After two and a half years of extensive, but not particularly imaginative, work by the executive board and the IMF staff, the resulting new quota formula was decidedly disappointing. The formula points in the wrong direction. At the time of its adoption, the new formula implied that the share of the 26 traditional industrial countries should increase by 2.2 percentage points vis-à-vis those of the other 159 members of the Fund.[8]

With respect to adjusting IMF quota and voting shares, the good news and the bad news is that the executive board ignored the formula in recommending quota adjustments. The result was that the advanced countries' combined quota share in the Fund is proposed to be reduced by 1.4 percentage points compared with where it was in 2005.[9] Under the agreed proposal, the combined voting share of the advanced countries would be reduced 2.6 percentage points, but almost half of that is due to the one-time tripling of basic votes.[10] Although a political and fairness case can be made for increasing the number of each member's basic votes (which has not been adjusted from the founding of the IMF in 1944), under the agreed proposals, the overall result for countries that are small in economic size is modest. The voting share of the 138 poorest members of the Fund would increase by a combined 0.52 percentage points, while their quota share would decline by 1.47 percentage points.

Some argue that the reforms should have done something about the U.S. veto in the Fund, which is not an across-the-board veto but only allows the United States to block a short list of institutional changes that require an 85 percent majority vote. This could have been done by lowering the U.S. voting share below 15 percent.[11] Alternatively, the 85-percent majorities could have been reduced to 80 percent. My view has been, and remains, that until the Europeans agree to a substantial reduction of their combined voting share in the IMF from more than the 30 percent currently for the European Union to something close to the U.S. share, reducing the U.S. voting share below 15 percent is a nonstarter. As a result of the proposed changes the EU voting share would decline only marginally from 32.5 percent to 30.9 percent. The Fund would remain a European-dominated institution.

Why were the Europeans able to work their way to prevent a meaningful shift in IMF power and influence in the Fund away from them, in particular given the overall lack of coherence in their national positions? One answer is that the two European managing directors (Rodrigo de Rato and Dominique Strauss-Kahn) who oversaw the process did not push hard for change because they needed European support on other issues. In particular, the staff was not encouraged to put on the table quota formulas that would point to significant change. A second answer is that the United States, which did push hard and was open to substantial change, was not ready to go to the mat with the Europeans and raise the issue to the highest (presidential) political level. A third answer is that the other members of the Fund, which hold about 40 percent of the voting power and, thus, in principle were able to block any set of proposals, lacked the cohesion to do so and enough of them were bought off by the contents of the final package. My answer is all of the above plus a lack of consensus in the membership about what was needed to enhance the IMF's legitimacy and why. The crisis of legitimacy was a rallying cry without well-directed content.

Some argued in the spring of 2008 that these proposed changes in the formula, in basic votes, and in actual quotas are just a first step, and the process will continue. Since it took 30 years to bring about these changes, one could be excused if one were skeptical whether the members of the Fund will return to these issues to make substantial further adjustments in the near future, absent a cataclysmic event that transforms the debate. The issue is whether the 2008 global financial crisis and associated world recession provides that catalyst.

[8] The new formula implies a set of pro forma quota shares for these countries that is 1.8 percentage points less than the old formulas, but the old formulas had been ignored. The actual combined quota share of this group was 4 percentage points below what was implied by the old formulas.

[9] The quotas of four members (China, Korea, Mexico, and Turkey) were adjusted in 2006 in the first round of the quota-reform effort, resulting in a slight reduction in the voting shares of the traditional industrial countries. The United States and a few other countries magnanimously gave up part of the increases in their quotas to which they were "entitled" under the application of the new quota formula, but this just underscores the weakness of the formula and the scope for blocking future progress.

[10] A member's voting power in the IMF consists of a certain number of basic votes (to be raised from 250 to 750) plus one vote for each SDR 100,000 of its quota.

[11] The U.S. voting share is to be lowered by 0.3 percentage points to 16.732 percent, compared to where it was in 2005.

A second high-profile governance topic for the IMF has been the process by which it chooses its senior management—the managing director and three deputy managing directors. By convention, the managing director is a European and the president of the World Bank is a citizen of the United States. There have been various efforts to break this convention; see Miles Kahler (2001 and 2006) for descriptions of those efforts. In 2007, in the middle of the IMF reform effort initiated by managing director Rodrigo de Rato in 2005, he resigned and was replaced by Dominique Strauss-Kahn. His appointment came shortly after Robert Zoellick replaced Paul Wolfowitz as president of the World Bank. In both of these transitions, the convention held though in the case of Fund, as has been the case in several previous elections, the election was contested. That has never happened in the World Bank.

On October 12, the Development Committee of the World Bank and IMF declared: “There is considerable agreement on the importance of a selection process for the President of the Bank that is merit-based and transparent, with nominations open to all Board members and transparent consideration of all candidates.” This agreed approach, which is non-binding, would only align the Bank’s actual practices with those of the Fund during its last three elections of managing directors. Nevertheless, the U.S.-European consensus may well be renounced or destroyed before the next elections scheduled for 2012 at the latest.

The third governance topic is representation on the 24-member executive board, which is dominated by 7–10 Europeans, depending on how you count Europeans and the day of the meeting.[12] Many critics and observers inside and outside Europe have endorsed a total or partial consolidation of European representation in the Fund (Ahearne et al. 2006).[13] The U.S. government in early 2008 (McCormick 2008) proposed, as a facilitating step, an amendment to the IMF Articles so that all executive directors would be elected and the progressive reduction in the size of the board to 20 members from the current 24.[14] Nevertheless, the Europeans blocked any serious discussion of this issue. The only change that has been proposed is to amend the Articles of Agreement to provide for an additional alternate executive director in constituencies with more than 19 member countries.

This list does not exhaust the agenda for IMF governance reform. The Independent Evaluation Office (IEO) of the International Monetary Fund (2008) issued a critical evaluation of the effectiveness and efficiency of the governance structures of the IMF including the executive board, management, and IMFC. In partial response, in September 2008, managing director Strauss-Kahn appointed a committee of eminent persons under the chairmanship of South African minister of finance Trevor Manuel “to assess the adequacy of the Fund’s current framework for decision making and advise any modifications that might enable the institution to fulfill its global mandate.”

One proposal favored by former managing director Michel Camdessus (2005) is the creation of a Council with formal decision-making power to replace what was once called the Interim Committee and is now called the International Monetary and Finance Committee.[15] The Development Committee, under this type of approach, might well become a body relating solely to the World Bank rather than its current status as a joint committee of the governors of the two institutions. The 2008 IEO evaluation of IMF governance endorsed the Council proposal as a device to force ministers to pay more attention to their responsibilities vis-à-vis the IMF. Such a device falls in the category of leading a horse to water without being able to force him to drink. Finance ministers in general are chosen to manage their own economies, are preoccupied by such domestic issues, and do not have the time, space, inclination, or experience to think in great detail about issues of the global collective good.

A final topic under the heading of IMF governance is how much of that governance should be exercised by outside bodies such as the G-7, the newly invigorated

[12] Does Europe include Switzerland or just the European Union? In some constituencies the alternate executive director comes from Europe while the executive director does not, for example, he may come from Mexico or Venezuela in the case where the alternate is from Spain.

[13] I have proposed a multi-step consolidation of European representation (2006a).

[14] The Articles require that the five members with the largest quotas select rather than elect their executive directors. In fact, there are now a total of eight single-country constituencies (China, Russia, and Saudi Arabia in addition to the G-5 of France, Germany, Japan, the United Kingdom, and the United States).

[15] The amendment of the Articles of Agreement that went into force in 1979 provided for the establishment of a Council.

G-20, a slightly smaller group like the F-16 (Bergsten 2006), a new G-14 (Zoellick 2008), or one or more Gs but always with a secretariat supplied by the IMF (Strauss-Kahn 2008).[16] That there will be some type of steering committee for the IMF and global economic and financial topics more broadly is demanded by efficiency, as even Strauss-Kahn has admitted. That it should be broader than the G-7 is increasingly obvious. Exactly what form it should take is a more difficult question. As Bergsten (2006) argues the size and effectiveness of any new steering committee is linked to the future of the European Union and its representation in international forums.[17] My expectation is that the meeting of the G-20 leaders in Washington on November 15, 2008, preceded by the meeting of the G-20 finance ministers and governors in Sao Paulo, Brazil on November 8–9, will be remembered more for marking the beginning of the end of the G-7 at both levels than for any resulting financial reforms. Crisis brings progress!

Policies of Systemically Important Countries

It follows from the observation that the G-7 is no longer an appropriate steering committee for the international economy and financial system that the list of systemically important countries should be lengthened.[18] For some time, many observers have argued that the IMF should be more assertive in its role as a global umpire. Much of the focus of such criticism has been to encourage the Fund (meaning members but also its management) to pay more attention to member countries' exchange rate policies (Goldstein 2006 and Williamson 2006).

What does it mean to call for the IMF to be a "better global umpire"? Different countries and observers will offer different interpretations. At one level, a better global umpire would do a better job enforcing agreed rules, in particular when those rules are cast in the IMF Articles of Agreement as obligations of members of the Fund, which is the case for exchange rate obligations: to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members" (Article IV, section 1 (iii)). These are strong obligations, but the management and staff of the Fund in recent years (through at least mid-2007) had failed to enforce them. (See IEO-IMF 2007 and Mussa 2008.) The responsibility for that failure lies in part with the Fund's member countries. Consensus on the interpretation of those obligations had dissipated, if it ever existed. Moreover, some countries had their own agendas. The members of the European Union wanted to build a fixed exchange rate regime (and later a common currency) and kept the IMF at arm's length when the exchange rate mechanism (ERM) came under stress in 1992 as well as in 2008 when pressures were building on the currencies of EU members that are not yet in the Euro Area. The issuers of the G-3 currencies (US dollar, euro, and yen) have blocked discussions in the IMF executive board of the global exchange rate arrangements for more than a decade.

In areas of the IMF's responsibility other than exchange rate policies and their economic effects, the obligations on IMF members are generally less well defined.[19] An example is the obligation to cooperate in the pursuit of common economic and financial objectives via participation in the surveillance activities of the Fund—bilateral, regional, and multilateral. To be successful in these areas, the members of the Fund must, first, share a consensus on the role of the Fund, second, recognize a common interest in preserving and protecting that consensus, third, be willing to allow Fund staff and management to call them to task about their associated obligations and commitments, and fourth, tolerate those processes even when doing so is politically inconvenient. For its part, the management and staff must play its assigned role consistently over time and across member countries. For the umpire, not only are the rules important, but their consistent application is as well.

Over the past several years, IMF members (via the executive board) and management (via the staff) have endeavored to update the IMF's surveillance role, in particular, with respect to the systemically important countries: expanding the list of such countries, revamping the 1977 decision on surveillance over the foreign exchange policies of members, addressing the

[16] Bergsten's "F" was intended to distinguish meetings at the level of finance ministers from meetings at the leader level which would be designated with a "G."

[17] See Colin Bradford (2008) for a review of some of these representational issues at the leader level.

[18] I argued this position in my strategy for IMF reform (2006c).

[19] One exception is the obligation to provide certain information to the Fund. Not all members are scrupulous in this area either.

problem of global imbalances, and establishing a set of surveillance priorities.

With respect to expanding the list of systemically important countries, the IMF management expanded the country coverage of its staff-level Consultative Group on Exchange Rates (CGER) to include a number of emerging market members, and the staff published a report on their methodology for doing this work (Lee, et al. 2008).[20] The IMF staff also started to incorporate into Article IV documents its judgments about whether a member's exchange rate was undervalued or overvalued, but many members deleted or scaled back this material before the reports were released to the public. In general, my nonscientific impression is that there has been somewhat of an increase in the critical content about countries' economic and financial policies in Article IV documents with limited impact in particular in the case of exchange rate policies.

On revamping the 1977 decision on exchange rate surveillance, the executive board reached agreement on a revised decision in June 2007(IMF 2007b).[21] It introduced two new concepts, "external stability" and "fundamental misalignment," into the review of members' exchange rate policies.

The decision has been severely criticized for not breaking any new ground and confusing, rather than clarifying, the nature of the exchange rate obligations of members under the Articles of Agreement. The decision sidesteps issues of multilateral surveillance and policy consistency and essentially gives a pass to any country whose exchange rate is floating, such as Japan, but nevertheless may be frustrating the functioning of the balance of payments adjustment process. Stanley Fischer (2007) has been critical of the decision for placing too much emphasis on external stability and too little on other policies, such as fiscal policies, that may affect internal balance and external adjustment.

More importantly, more than a year later the new decision has produced no tangible results on exchange rate policies. It is widely understood that the IMF staff have identified for the executive board situations that, under the new decision, merit consideration of the implications of a country's exchange rate policy for its own external stability or may involve fundamental exchange rate misalignment, but the board has declined to accept the staff's judgment. In addition, the conclusion by the executive board of several countries' Article IV consultations has been delayed, including in the important and sensitive case of China.

In response to some of these conceptual and procedural concerns, the executive board in August 2008 agreed to a clarification that involves inter alia the option of a board decision to authorize an ad hoc consultation with a member in cases where a member may not be observing the principles for guidance of its exchange rate policies that have been adopted by the Fund or where its exchange rate may be fundamentally misaligned (IMF 2008a).[22] We do not know yet whether this process will ever be used or yield meaningful results.

With respect to global imbalances, in the spring of 2006, the management of the Fund initiated a "multilateral consultation" involving China, the Euro Area, Japan, Saudi Arabia, and the United States. The Fund, in effect, dealt itself into the policy coordination business essentially for the first time since the collapse of the Bretton Woods system of fixed exchange rates.[23]

However, as far as one could tell, the management of the Fund exerted no pressure on the participants to make new, specific policy commitments. The participants' resulting statements of policy intention in April 2007 were not new and not news. In some respects, they were less explicit than those contained in the G-20 Accord for Sustained Growth issued in

[20] The IMF did not take the advice of John Williamson (2006) to establish a set of reference exchange rates for major currencies to guide the IMF in conducting its surveillance of exchange rate and other economic policies of members. William Cline and Williamson (2008) endeavored to plug this hole by publishing a set of fundamental equilibrium exchange rates for major countries and currencies consistent with internal macroeconomic balance and external imbalances.

[21] This action implemented one of Goldstein's (2006) triad of recommendations in the area of exchange rates.

[22] This action partially implements one of Goldstein's (2006) suggestions that the IMF management should be more active in the use of ad hoc and special consultations, but the twist is that the suggested procedure involves the executive board, which may be a good thing if it produces any concrete results, rather than just involving the management and staff. The Fund has not acted on the third element of the Goldstein triad: issuing a semi-annual report on members' exchange rate policies based on a reference exchange rate framework.

[23] The IMF management did not accept my 2006 recommendation to hold a collective consultation with major Asian countries on exchange rate issues. My view at the time was, and still is, that such a broad approach might produce more results in terms of relaxing exchange rate policies than focusing on China's policies alone.

Melbourne, Australia in November 2006, which followed the release by the IMFC in September 2006 of a policy strategy for all countries.

The proposed measures envisaged a process of "immaculate adjustment," in other words adjustment without significant exchange rate changes. The only mention of exchange rates was by Saudi Arabia, which said that it would not alter its peg to the U.S. dollar, and by China, which again said that its "exchange rate flexibility will gradually increase." For the United States, Japan, and the Euro Area, there was no mention of exchange rate adjustment. This is not *Hamlet* without the Prince, it is *Hamlet* set in Never-Never-Land.

In hyping up the limited achievements of the multilateral consultation process, the IMF management's earlier warnings about the risks of external adjustment were turned upside down. In place of concern that there will be too little in the way of preemptive policy actions, the first deputy managing director John Lipsky (2007) declared, "excessively precipitous policy actions undertaken with the sole aim of immediate and substantial reductions in imbalances could be unnecessarily disruptive to global growth and could even undermine financial market stability." It is rare to hear a responsible official charged with promoting policy adjustment worrying about a decline in the U.S. budget deficit that is too large, an appreciation of the Chinese RMB that overshoots, or economic reforms in the Euro Area or Japan that are too rapid. At the time, the IMF staff (2007c) claimed the results "would in combination constitute a significant further step toward sustaining solid economic growth and resolving imbalances." In other words, nothing new needed to be done to reduce the imbalances, which would take care of themselves.

Let's look at the recent record of adjustment in global imbalances. In 2006, at the start of the multilateral consultation, the U.S. current account deficit was 6.0 percent of GDP. In October 2008, the IMF (2008g) projected that the U.S. deficit would reach 3.3 percent of GDP in 2009—a decline of 2.7 percentage points—and 2.8 percent in 2013. China's current account surplus in 2006 was 9.4 percent of GDP, rose to 11.3 percent in 2007, and in October 2008 was projected to decline to only 9.2 percent in 2009—a net decline of 0.2 percentage points—and to rise back to 9.9 percent in 2013. The subsequent collapse in energy prices and plunge of the global economy into recession may alter these estimates and forecasts, but the failure of China to adjust while the United States has adjusted is palpable.

Where is the major imbalance in the global economy today? It would appear to be in China. What has happened to China's real effective exchange rate since it moved to a more flexible exchange rate regime in July 2005? From June 2005 through February 2008, the RMB had appreciated 15.6 percent on the broad index calculated by the Bank for International Settlements. Through November 2008, it had appreciated a further 10.3 percent, largely because of the U.S. dollar's 12.3 percent real effective appreciation over this period. (The RMB only rose 4.2 percent against the dollar from the end of February through the end of November.) It should be noted that William Cline and John Williamson (2008) estimated that the RMB would have to appreciate in real effective terms almost 20 percent from February 2008 as part of a balanced global set of exchange rate adjustments in which the Chinese current account surplus would be cut in half.[24] These facts, along with the additional consideration that the Chinese authorities have been able to persuade the IMF management and their executive board colleagues to delay the completion of China's 2007 Article IV consultation for more than a year, point to the conclusion that IMF members, management, and staff have been ineffective in discharging their responsibilities with respect to the global adjustment process and exchange rate policies.

Finally, with respect to IMF surveillance more generally, as a part of the IMF executive board's triennial surveillance review, it approved a statement of surveillance priorities under the prodding of certain of its members, the United Kingdom in particular (IMF 2008c and 2008e). It remains to be seen what this initiative will produce in substance; the laundry list of

[24] Cline and Williamson also called for substantial real effective appreciations from their February 2008 levels for the Singapore dollar of 24.7 percent (it appreciated 1.4 percent through November), Taiwan dollar of 9.0 percent (actual 0.6), Hong Kong dollar of 8.2 percent (actual 5.7 percent), and Japanese yen of 5.7 percent (actual 20.4 percent). In the case of the Korean won, their analysis called for a real effective depreciation of 3.5 percent from the February 2008 level, and it had depreciated by 29.4 percent through November. The comparable figure for India was a depreciation of 3.6 percent against an actual depreciation of 6.8 percent. These divergent movements in Asian exchange rates relative to the Cline-Williamson norms do not bode well for the global adjustment process going forward.

priorities is rather long. The four detailed economic priorities (resolve financial market distress, strengthen the global financial system, adjust to sharp changes in commodity prices, and promote the orderly adjustment of global imbalances) and four detailed operational priorities (risk assessments, financial sector surveillance and real-financial linkages, multilateral perspective, and analysis of exchange rates and external stability risks) appear to rule out very little.

Today, we hear three interpretations of the IMF's stewardship of the global economy and exchange rates over the past several years: (1) The Fund has unfairly and inappropriately focused on the position of China and a few other countries. (2) The Fund has been distracted from focusing on its primary mission of the promotion of global growth and, in particular, financial stability by the United States, which has been using the IMF to pursue a bilateral agenda to force the Chinese authorities to appreciate their currency. (3) The Fund has been totally ineffective. How should one evaluate these three interpretations?

The first interpretation contains a small grain of truth. The IMF has focused insufficiently on the exchange rates and policies, including policies other than exchange rate policies, of a broader group of countries, starting with Japan and including the Euro Area and the United States. In its 2008 Article IV report on the United States released in July 2008, the Fund staff declared that the U.S. dollar was somewhere between slightly undervalued and 30 percent overvalued. A year earlier, the Fund staff also reported that the dollar was overvalued by 10–25 percent, and U.S. authorities disputed the reliability of the models producing those estimates. The U.S. authorities' protest, in particular under the circumstances, undermined their broader case for more effective surveillance of exchange rates by the IMF. However, unlike the Japanese authorities, the U.S. authorities did not insist that the estimates of the dollar's overvaluation be deleted from the published version of the report. The 2008 Article IV report on Japan released in July 2008 merely reported that the yen was undervalued and that the Japanese authorities also disputed the relevance of the staff's models.

The second interpretation, distraction from focusing on global financial stability, has been heard from those who from the beginning did not like the idea of the IMF criticizing their own exchange rate policies, in particular within the European Union but also in Asia, and therefore favored deflecting the Fund from focusing on the exchange rate policies of other countries. It is interesting that some of the same people who urged the United States to seek multilateral solutions to problems subsequently also complained when the U.S. authorities did so. However, there is no substance to the basic accusation. With approximately 3,000 employees until the recent staff cuts, the Fund has had ample staff resources to focus on both exchange rate policies and financial policies.

The third interpretation, ineffectiveness, sadly, is the most compelling. Managing director Strauss-Kahn was dealt a weak hand in the flawed revision of the 1977 decision on exchange rate surveillance and the failure of the IMF staff and management in previous years to discharge their obligations under the IMF Articles, which in turn led members of the Fund not to comply with their own obligations under the Articles.[25] In effect, the management of the Fund downplayed substantially its umpire or regulatory role with respect to the exchange rate policies of members. It had failed Mervyn King's (2006) test of "ruthless truth telling."

One consequence is that the incoming Obama administration faces an uphill battle in pushing any IMF legislation through the U.S. Congress unless the IMF (members, management, and staff) is dramatically more effective in persuading the Chinese authorities that it is in their interests as well as those of the system to allow a substantial further real appreciation of the RMB against most currencies as well as against the dollar. However, it is also evident from the adjustments in real effective exchange rates within Asia since February 2008 that the task of persuading the Chinese authorities has become dramatically more difficult.[26]

Nevertheless, absent significant movement before the end of April 2009, when the new team at the U.S. Treasury is scheduled to release its first semiannual report to the U.S. Congress on International Economic and Exchange Rate Policies, and, based on the position of candidate-for-president Obama, the Treasury's report is almost certain to conclude that the Chinese authorities have been "manipulating" the value of

[25] See IEO-IMF (2007) for the particulars of the failings.

[26] See footnote 24.

their currency to obtain or maintain a competitive advantage.[27] Under the legislation mandating the report, such a finding would trigger bilateral discussions between the United States and China, which of course have already been underway since late 2003 and most recently in the U.S.-China Strategic Economic Dialogue.

More seriously, the finding of "manipulation" by the U.S. Treasury will set up a fundamental conflict between the views of the IMF executive board and management and those of its largest member. This would be a no-win situation for China, the United States, and in particular the IMF. Interested bystanders can only hope for constructive action sooner rather than later: bilaterally, multilaterally, and through the efforts of other members of the IMF. It might start with an IMF-sponsored special consultation on exchange rate relations within Asia.

The Central Role of the Fund in External Financial Crises

"The IMF remains bedeviled by philosophical disputes about the scale and scope of its lending and crisis-related activities. These disputes distract the institution from its role as a global lender of final resort." I wrote these words in late 2005 (Truman 2006b, 532). However, until recently this statement had no operational significance because many countries were paying down their financial obligations to the Fund. IMF credit outstanding under the general resources account (GRA), which is financed out of IMF quota subscriptions, peaked on an end-of-year basis at $98.9 billion in 2003. By the end of 2005, it was down to $43.2 billion. As of September 30, 2008, it was $11.5 billion, but only two of the 23 countries with credit outstanding from the Fund had active programs with the institution (Gabon and Georgia).[28] Until very recently, the IMF had been out of the new lending business for several years.

The global financial crisis and unfolding global recession have changed all that. It is unfortunate that during the interim, members of the Fund were not able to reaffirm the IMF's central role in international financial crises, including in work-out situations and in establishing an insurance type of facility for countries with strong policies and a temporary need for external liquidity assistance.[29]

Given that IMF management backed off from its extreme, hands-off posture in the Argentine restructuring when they handled the Uruguay and Dominican Republic cases, there is some hope that if the coming global recession and associated emerging-market external financial crises produce a need, the IMF management will discharge its traditional role in mobilizing collective action among the creditors as well as actively advising the debtors about the economic and financial implications of the arrangements they are being offered.

With respect to new financing vehicles, such as an insurance facility, members of the Fund have wrestled for the past decade with questions of the desirability and usefulness of a semi-automatic credit facility that would be available to countries with strong policies. In 1999, the contingent credit line (CCL) was created as a component of the supplemental reserve facility (SRF) that had been established two years earlier. The CCL provided for a specified amount of financing to be automatically available to countries that had previously been approved to receive it if conditions changed. Despite some interim tinkering with the CCL, no member signed up, and the mechanism was not renewed in November 2003. Nevertheless, discussions about a new liquidity instrument continued (IMF 2008c and 2008e). On October 11, the IMFC (2008) called for decisions on an "accelerated basis in those areas where there is strong consensus—such as the establishment of a new liquidity instrument—and on the full range of [lending and access] issues by the time of the 2009 annual meetings."

With respect to the insurance or liquidity facility, the traditional tension has been between those members who oppose any semi-automatic IMF lending (and in some cases any lending at all) without strong policy conditions associated with the lending, and those that see such an insurance arrangement as a desirable addition to the IMF's arsenal of lending instruments in the 21st century. By mid-October, we had reached a point at which it appeared that a number of countries were being sideswiped by the global financial

[27] If the Chinese authorities actually bring about a depreciation of the RMB against the dollar from its level at the end of November, a course on which they may have embarked in early December, the case will be all the stronger.

[28] Three other countries had active programs but had not drawn upon them: Honduras, Iraq, and Peru.

[29] These were my recommendations three years ago (Truman 2006c).

turbulence and no facility of this type was in place. We also witnessed the actual and potential emergence and use of bilateral or regional lenders or arrangements as substitutes for such a facility in the Fund.

In my view such a trend toward bilateralism and regionalism weakens the international financial system unless such arrangements are firmly anchored in the IMF via a parallel-approval or take-out process. In most cases, the borrowers see the arrangements as a substitute for IMF assistance that comes with conditions on economic and financial policies. At the political level, bilateral lenders under-appreciate the financial risks involved and the political challenges associated with imposing even minimal economic and financial conditions on bilateral or regional lending.

Thus, the inability of the members of the Fund to agree on a semi-automatic disbursing facility during a period of calm meant that it was not there when the storm broke. Fortunately, the management and staff of the Fund were in a position to move quickly to force a consensus when the financial turbulence spilled over and became a full-blown global financial crisis in the second half of October as the world economy plunged into almost certain recession.

On October 27, the IMF executive board approved a new short-term lending facility (SLF) for a period of two years. Countries with very sound economic and financial policies and underlying fundamentals plus sustainable external and internal debt positions on the basis of their most recent Article IV consultations can draw up to five times their IMF quotas for three months with up to two three-month rollovers. The executive board notionally set aside an initial $100 billion out of its estimated total forward lending capacity of about $200 billion as of the end of September.

On the same date, the Federal Open Market Committee (FOMC) of the Federal Reserve System approved $30 billion reciprocal swap arrangements with each of four emerging-market countries: Brazil, Korea, Mexico, and Singapore. It remains to be seen whether any country draws on the SLF and how that facility interacts with the Federal Reserve swap arrangements. (I will return to this topic in the next section of this paper.)

Given that countries can in effect prequalify for the SLF on the basis of their previous Article IV consultations, the issue in drawing on the facility is the associated stigma and the risk that doing so will trigger a further run on the country. Some are also concerned that the SLF will divide the membership of the Fund between those that qualify to draw and those that do not. Such distinctions are inevitable, and it should be noted that as of the end of November five countries had signed up for regular IMF programs.[30] Moreover, there should be the presumption that if any country cannot repay the IMF's SLF on the agreed terms, it will need to apply for a regular IMF program. Under current conditions of collapsing commodity prices and global demand, it also would be reasonable to refurbish the IMF's compensatory financing facility to provide quick-disbursing financing on a smaller scale than the SLF to those countries facing export shortfalls as suggested by Morris Goldstein (2008b).

Refocused Engagement with Low-Income Members

The IMF's involvement with its low-income members has received extensive criticism, in particular from the NGO community, which often criticizes the Fund for focusing too much on macroeconomic stability and too little on economic growth and the reduction of poverty. Over the years, there also has been extensive criticism of the lack of collaboration (or presence of excessive competition) between the World Bank and the IMF with respect to these countries.[31]

For obvious political reasons, the Fund in recent years could not afford to pull out entirely from engagement with low-income countries; the authorities in these countries want the financial assistance the IMF might provide and, preferably, endorsement of their policies without strings. However, the Fund has pulled back from full-force engagement with its low-income members. Along with the Bank, it established a review group under the chairmanship of former Brazilian finance minister Pedro Malan to review Bank-Fund collaboration. The resulting report (IMF 2007d) is a sensible document that points in the direction of more

[30] By the end of November, the IMF executive board had approved new traditional stand-by arrangements under existing expedited procedures providing financing of about $42 billion to Hungary, Iceland, Pakistan, the Seychelles, and Ukraine.

[31] In 2006, I wrote, "the Fund should be more selective and focused in its engagement with its low income members, ready to assist them in areas of its comparative advantage, reluctant to add to their debts, and respectful of the skills and opportunities offered by institutions centrally involved with development issues" (Truman 2006b, 534).

cooperation and less competition across 19th Street in Washington, D.C.

To an outside observer, the Fund and the Bank appear to have been diligent in implementing the recommendations of the Malan Report.[32]

Following the implementation of, first, the Heavily Indebted Poor Countries (HIPC) initiatives and, later, the Multilateral Debt Relief (MDR) initiative, the debts of many low-income countries to official agencies, including debts to the IMF and the World Bank, have been substantially reduced. Some NGOs and parliamentarians continue to press for more debt relief, but at this point debt relief primarily is an issue for a few countries that have not yet qualified for existing programs. A more important issue is restraining the accumulation of new debt, for example, to purchase arms or that is otherwise thrust upon countries by bilateral lenders on commercial terms.

A total of 35 member countries have been assisted in their debt-relief programs through the IMF, 33 countries under the HIPC initiatives and an additional 2 countries among the 25 assisted under the MDR initiative. In recent years, again facilitated by benign conditions in the global economy as well as better policies, IMF credit outstanding to members under the Poverty Reduction and Growth Facility (PRGF) and related arrangements, which are financed primarily by loans to the IMF outside of its quota resources, had been reduced by 40 percent from an end-year peak of $10.5 billion in 2003 to $6.1 billion at the end of September 2008. Only 23 members had active PRGF programs, less than a third of the eligible total. A few countries have converted to, or established, “programs” under the Fund’s new Policy Support Instrument (PSI) created in October 2005, which involves IMF endorsement and oversight of a member’s policies, but no funding. To date six countries have taken advantage of the PSI: Nigeria, Uganda, Cape Verde, Tanzania, Mozambique, and Senegal in order of the date of their participation. No country has participated in the past year. Nigeria’s participation provided cover for a Paris Club debt-relief program.

The test of whether the IMF can continue its more balanced approach to its involvement in low-income countries will come with the pending slowdown in the global economy. Will the Fund, again, be drawn, or forced by the policies of high-income members, into stepping up its engagement to the point of unbalanced intrusion? I hope not.

Some observers favor the “transfer” of the PRGF and associated lending entirely to the World Bank. I doubt that is necessary as long as the IMF does not pass its tin cup to replenish significantly the PRGF’s financing capacity. It would be preferable to allow the IMF’s subsidized development-related lending to wither away except with respect to genuine short-term balance of payments needs. Otherwise, the IMF’s involvement in the policies of low-income countries should be limited to advice on macroeconomic and financial policies conveyed during Article IV consultations and used to condition IDA and other lending by the World Bank Group.

The Capital Account and Financial Sector

“Capital account and financial-sector issues are central to the IMF’s role in the twenty-first century. Technology, demography, and policy have converged to stimulate and release unprecedented global flows of capital” (Truman 2006b, 536). It was obvious three years ago that the IMF needed to make another attempt to reorganize its work on financial-sector and financial-stability issues. The global financial turbulence that emerged in August 2007 and escalated with virulence a year later confirms that judgment.

Following the report of the McDonough Group (IMF 2005b), the Monetary and Capital Markets Department was established and its semi-annual Global Financial Stability Report has been gradually transformed into more of a forward-looking document along with quarterly updates. For example, this group produced early estimates of the size of potential losses by financial institutions from the global financial meltdown, estimates that were regarded as exaggerated at the time but that since have been confirmed as on the low side.

Nevertheless, criticism of the IMF’s work in this area continues with some justification. See, for example, IEO-IMF 2006 for a set of judgments roughly coincident with those of the McDonough Group, and the more recent conclusion of the International Monetary and Financial Committee (IMFC-IMF 2008): “Work should also be undertaken toward a revamped

[32] For managing director Strauss-Kahn’s view on the Fund’s activities in low-income countries, see IMF 2008e.

Financial Sector Assessment Program that is better integrated with the Fund's surveillance mandate." (I return to this topic in the next section.)

A related issue is whether the IMF Articles of Agreement should be amended to clarify the IMF's role with respect to the capital accounts of members. Three years ago, I concluded (Truman 2006b, 563) that it is not essential to do so. However, in light of recent developments including calls for a more active role for the Fund on financial-market issues, it would be appropriate to revisit this contentious topic. The point should not be to compel all member countries immediately or even expeditiously to open their capital accounts. That should be set only as an ultimate goal. Meanwhile, the IMF would be provided with an updated mandate to assess and guide progress toward this objective in light of each country's economic and financial development. As argued by William Cline (2008), the risk is that the considerable benefits of financial globalization will be undervalued and the world will fall back on widespread capital controls in overreaction to the international financial crisis. An associated risk is an increase in financial protectionism under the guise of prudential regulation.

Finally, to complete this short review of the Fund's recent record on financial issues, I note with approval and satisfaction the institution's impressive contribution in facilitating the work of the International Working Group (IWG) of Sovereign Wealth Funds (SWFs) in expeditiously reaching agreement on a set of Generally Accepted Principles and Practices (GAPP) for SWFs (IWG 2008) that will help to defuse the issue of the role of these government investment vehicles and make the world safer for them. It is important that the IWG push forward on implementing the GAPP, using the IMF as its secretariat, to help to contain financial protectionism. Members of the OECD should also do more to strengthen and open-up their foreign investment regimes.

Additional IMF Financial Resources

In 2006, as IMF members were actively repaying credit received from the IMF partly as a result of benign global economic and financial conditions as well as of improved policies, I noted, "Wise observers caution that those benign conditions are coming to an end, and the demand for external financial support from the IMF is likely to rise" (2006b, 537). My implicit prediction of an immediate need to augment IMF financial resources was somewhat off the mark. At the time, I endorsed the proposal of Desmond Lachman (2006) that the IMF executive board should put in place a mechanism so it can borrow from the private market as a temporary supplement to its quota resources.

I also advocated that at the conclusion of the 13th review of IMF quotas in January 2008, members should approve a general increase in IMF quotas as part of an overall package to rebalance IMF quotas; see also Cooper and Truman 2007. Unfortunately, not only was the effort to rebalance IMF quotas woefully deficient, the IMF executive board (meaning the members of the Fund, we do not know the recommendation of the management and staff) concluded the 13th review and declined to recommend a general increase in IMF quotas. The result is that the Fund faces renewed demands to lend to members. Moreover, such lending will be scaled on the basis of the size of each member's quota that was approved a decade ago when the world economy was substantially less than half the size that it is today. Consequently, in the context of the current emergency the Fund, as of early October 2008, was set to revisit the contentious issue of access limits (IMF 2008c and 2008e) rather than proceed to use limits based on new quotas that were agreed in January this year.

It is true that the IMF's current financial resources for lending are substantial, an estimated one-year forward commitment capacity of about $200 billion as of the end of August 2008. It is also true that total IMF quotas will have been increased by 11.5 percent since 2005 if the second round of ad hoc quota adjustments (of about 9 percent) is approved by members, starting with the United States whose approval is necessary if the major portion of the increase is to go into effect.[33] However, very few of the 54 countries that would receive increases in their quotas are likely to need to borrow from the Fund over the next several years.[34]

How serious is the impending financial crisis for emerging-market countries? In October 2008, the

[33] In 2006, a first round of ad hoc adjustments in the quotas of China, Korea, Mexico, and Turkey boosted total IMF quotas by about 2 percent.

[34] An interesting fact reported in IMF 2008c (table 1) is that only 35 of 185 members of the Fund have never used IMF credit, and a few of the countries that have not used IMF credit, such as Germany, used the Fund for other types of financial transactions.

Institute of International Finance (IIF 2008) estimated that its sample of 30 emerging-market (and formerly transition) economies would continue to run a collective current account surplus in 2008 and 2009 as they have over the past several years, but the estimated collective surplus is more than accounted for by China and Russia.[35] The surplus for this group of countries was $435 billion in 2007 and was estimated at $378 billion this year and $338 billion next year. However, non-direct investment inflows were $596 billion in 2007 up more than 50 percent from 2006, and they were projected to fall at about 15 percent this year and another 15 percent next year, for a total decline of $280 billion with an estimated drop of $266 billion in net flow from foreign commercial banks.

These estimates, now almost certainly out of date, illustrate the error of focusing on net flows (the current account surplus and associated capital account deficit) rather than on gross flows (gross capital outflows—official and private—that slightly exceed large gross capital inflows). In 2007, all regions, with the exception of Central and Eastern Europe, had combined current account surpluses, but many countries in those regions with current account surpluses were receiving large gross capital inflows that have now dried up or reversed. The use of large accumulated holdings of foreign exchange reserves is only a partial and second-best (because of high opportunity costs) option in these situations. Thus, we can understand why many emerging-market economies reluctantly have been turning back to the IMF for financial assistance, but they are doing so when IMF financial resources are under strain.

The major concern is not that the IMF will run out of financial resources to lend. The GAB and NAB are largely available. The IMF can easily borrow $50 billion in the market without amending its Articles of Agreement. The Japanese authorities have offered to lend the Fund $100 billion, and IMF management can pass the hat around more broadly. However, this is a sloppy way to do business. The G-7 countries' policies to starve the Fund of financial resources to limit Fund lending, or in the misguided view that the days for large-scale IMF lending were over, have proved to have been destructive to the health of the institution and the international monetary and financial system. (I return to this issue in the next section.)

To the extent that the IMF gets back into the lending business, the budgetary crisis that it has faced in recent years should ease.[36] However, as was argued persuasively in the Crockett Report (IMF 2007a), since the lending activities account for less than 25 percent of the administrative budget of the IMF, it is inappropriate to finance all of the Fund's activities from earnings on those activities. This is the rationale behind the proposal to sell 12.5 percent of the IMF's gold, invest the proceeds (in effect as an endowment), and use the income on those investments to finance the non-lending activities of the IMF. As noted in the introduction, this sensible step cannot be taken unless the U.S. Congress authorizes the Secretary of the Treasury to vote for the gold sale.

The IMF and the Global Financial Crisis

It is ironic that a year or so ago, it was fashionable to argue that the IMF was irrelevant as a lender and in its surveillance activities, that benign conditions would prevail forever in the global economy and international financial system, and that all systemically important countries had effectively self-insured against future external financial crises. The conclusion was that the IMF's administrative budget was strapped and the institution had nothing useful to do in either its lending or non-lending activities. Starting in mid-September this year, the criticism shifted to "Where has the Fund been?" The chorus of critics said: the IMF is not discharging its duty to protect the international financial system. Some added: we must remake the international financial architecture with a central role for the IMF.[37]

As noted earlier, a sub-theme of the recent criticism is that the IMF has been distracted from focusing on the emerging crisis by the U.S. insistence that the Fund focus on members' exchange rate policies. An alternative newly fashionable view is that by not focusing sufficiently on global imbalances, the IMF

[35] The IMF (2008g) projects a current account surplus of $785 billion for all emerging and developing economies, but China, Russia, and the Middle East group account for $1,023 billion. In 2009, the corresponding figures are $612 billion and $875 billion, but they are based on the assumption of an oil price of $100.50 a barrel.

[36] Meanwhile, under pressure primarily from the major creditor countries, managing director Strauss-Kahn has implemented a program to cut the staff by about 10 percent from 3,000. This has involved the loss of senior people, but almost certainly is healthy in the medium term because it allows the institution to reorient itself.

[37] A number of these people were prime ministers and presidents of countries that had over the previous two years blocked meaningful IMF reform.

contributed to the crisis. A third view is that the United States contributed to the global financial crisis by refusing to allow a review of the weaknesses in its financial system under the Fund's financial sector assessment program (FSAP).[38]

How the IMF handles the current global financial crisis, including any additional roles its members assign to the Fund, no doubt will affect the future of the Fund and support for the institution, including by the United States.

Prognostication has been clouded by the fact that what started out as an episode of financial turbulence with adverse effects primarily on the financial systems and economies of industrial countries has become a global economic and financial meltdown that affects all countries and most likely will be worse than the 1981–82 period of global recession. In the associated global debt crisis, the banking systems of all major countries were also threatened with collapse. One consequence of the current crisis was the meeting on November 15 in Washington, DC of the G-20 at the leaders' level. Although the meeting was more about Gordon Brown's efforts win the upcoming UK election and Nicholas Sarkozy's effort to cement a position as Europe's chief actor, the summit and the promise of another one before the end of April 2009 have altered the trajectory of, and efforts to manage, the crisis.

Diagnosis of the Crisis

From the individual and collective pronouncements over the past few months, and from discussions with colleagues around the world, it is clear to me that there is no shared diagnosis of the origins of this crisis. I am, therefore, concerned about acting prematurely on the basis of incomplete information and a lack of shared understanding. My own point of diagnostic departure is as follows:

Macroeconomic policies in the United States and the rest of the world, to a substantial degree, were jointly responsible for the crisis we are now experiencing. In the United States fiscal policy contributed to a decline in the U.S. savings rate and monetary policy was too easy, too long. In Japan the mix of monetary and fiscal policies distorted the global economy and financial system. After Japanese growth was restored, fiscal policy was tightened and monetary policy was put in the deep freeze at approximately zero interest rates. Thus, Bank of Japan policy also was also too easy, for too long, contributing to global financial imbalances via the carry trade. Finally, many other countries also had very easy monetary policies in recent years, including many other Asian countries, energy and commodity exporters, and in effective terms some countries within the Euro Area. The accumulation of foreign exchange reserves to an impressive extent in many countries also distorted the international adjustment process taking the pressure off of the macroeconomic policies of the United States and other countries.

The result was not just a housing boom in the United States and also housing booms in many other countries, some to a greater extent than in the United States.[39] In addition to housing booms, there was a global credit boom fueling increases in prices of equities and other manifestations of financial excess.[40]

Financial sector supervision and regulation, or the lack thereof, also played a role. However, without the benign economic and financial conditions and the associated belief that "this time it is different," the crisis would have taken a different form. National policymakers and officials in international institutions did not serve themselves or the system well by acting as cheerleaders for the remarkable run of economic growth with few signs of a dramatic rise in inflation until early 2008.

Benign conditions lead to lax lending standards, just as the night follows the day. In principle, financial sector supervision could have helped to curb the excesses associated with relaxed lending standards, but it did

[38] Because I was personally involved, I know that in 2000 the U.S. government agreed to have an FSAP review. That decision was reversed by the Bush administration. This was a political mistake. The United States should not have held itself aloof from the FSAP program. As of the end of September 2008, 126 members of the IMF had participated or were completing their participation in the program, including 15 of the 19 countries that are regular members of the G-20. The exceptions were Argentina, China, and Indonesia, as well as the United States. Recently, the United States finally agreed to participate, and China also has signed up. It is highly doubtful that an FSAP for the United States conducted, for example, in 2003, when it most likely would have been scheduled, would have produced a diagnosis of either the problem of excessive leverage in the U.S. financial system or flawed housing lending standards. However, the United States might have received some benefit, and the international financial system as well.

[39] See, for example, IMF 2008g for a broader treatment of recent housing booms.

[40] The Bank of England (2008) and Issing, et al. (2008) offer similar interpretations of the macroeconomic contributions to the global crisis.

not do so in the United States nor in many other countries around the world. This is not to say that there was no competition in laxity among supervisors.[41]

In some cases, including importantly the United States in this regard, but again elsewhere, regulation and supervision were incomplete. The rise of what is now known as the shadow financial system had been going on for decades in many countries: money market mutual funds, special purpose investment vehicles, hedge funds, private equity firms, etc. In many cases, these entities were highly leveraged and used short-term funding to finance longer-term investments. We saw a gradual shift over several decades in financial intermediation from banks to other financial institutions that were less well capitalized and subject to less close supervision. The global financial system became overleveraged, particularly in the United States, but also to varying degrees in other countries. When the funding dried up, the structure collapsed, and the deleveraging began.

Part of the overall picture was new forms of financial engineering, but such innovations have been a feature of domestic and international finance for decades. In many cases, the associated innovations were poorly understood resulting in a failure of risk recognition, which is a necessary precondition for good risk management. It is noteworthy that these new forms were a global phenomenon. They contributed to the market dynamics once the crisis got underway, but they were not "the cause" of the crisis.

Finally, some argue that the problems faced by the global financial system today reflect the fact that about 50 large financial institutions are global and lacked adequate supervision. In this view, these institutions were the cause of the crisis because no single national financial supervisor or regulator could possibly understand the full scope of their operations. True, some global financial institutions have failed, or the authorities have decided to rescue them. However, the cause of their failures was not that they had multiple national supervisors. Moreover, I would argue that the technical aspects of the failures themselves have had remarkably little impact on the evolution of the crisis compared with the fact that they failed. Size has been a problem and complexity has led to some decisions to rescue particular institutions in whole or in part, but their global scope has not been a major contributing factor.

I have set out above my own summary diagnosis of this crisis not to assert that I have all the answers but to illustrate the range of issues on which there is little or no consensus among observers on what went wrong and which country or countries or institution or institutions should be fingered for the blame.

My views on what is required in the period immediately ahead are motivated by four observations that have little to do with the diagnosis of the causes of the crisis, which can and should wait. (1) The global economy and financial system are in the midst of a massive deleveraging process. (2) The increased globalization of the world economy and, more important, of the world financial system in recent decades means that countries can run but not hide from this and future crises. (3) The incidence and virulence of future crises may be reduced by decisions taken in the wake of this crisis, but those crises will not be prevented. (4) What is important now is to cushion the impacts of the global recession and to restore stability to financial markets.

These observations point to the need for a strengthened IMF as a central institution of global governance as well as financings. This process should start as soon as possible, because the Fund must be part of the solution to the immediate problems. These observations also point to the desirability of setting aside reform of national and international financial systems until the impact of those obviously needed reforms is no longer procyclical—exacerbating the deleveraging process and deepening the global recession.

The Role of the IMF—Immediate Recommendations for the Obama Administration

In the lead up to the 2008 annual meetings, the IMF was thrust into a central coordinating role. It also is clear now that the IMF will have a financing role in connection with the global recession and with the financial crisis. I urge the Obama administration, working with its partners, to focus in the short run on shoring up the financial role of the IMF and laying a better foundation for this aspect of the Fund's work in the future. Reform of the financial system can wait.

[41] The U.S. Treasury's (2008) Blueprint for a Modernized Financial Regulatory Structure released on March 31 started out as an initiative to bolster the competitiveness of U.S. capital markets—to further deregulate them.

First, to meet the immediate financing needs of the IMF, to help restore confidence that the Fund can discharge its responsibilities as lender of final resort, and in the process to help address the institution's crisis of legitimacy, the Obama administration should propose, preferably before the next G-20 leaders meeting, a doubling of IMF quotas and of the Fund's emergency borrowing arrangements—the GAB and NAB. My proposals would respond to the commitment of the G-20 summit on November 15 for immediate action to "review the adequacy of the resources of the IMF, the World Bank Group, and other multilateral development banks and stand ready to increase them where necessary." Augmentation of the lending resources of the Fund is clearly necessary. This would produce an additional $250 billion in the IMF's capacity to lend. This was approximately the Fund's total lending capacity as the global recession hit. Note that the Federal Reserve System has already lent other central banks more than twice this amount under its reciprocal swap arrangements.

The Obama administration should not merely propose the doubling of IMF quotas, but also should advocate correcting the error that was made in the existing package of IMF reform measures. They should address the IMF legitimacy issue by advocating a meaningful redistribution of quota and voting shares in the Fund. This will require revisiting the flawed new quota formula that was adopted in the spring of 2008 so that it points toward reducing over time the combined share of the traditional industrial countries. Using the revised new quota formula to distribute quota increases for all members sufficient to double total IMF quotas should produce at least a further shift of five percentage points in voting power away from the those countries.[42]

Second, the Obama administration should endorse a special one-time allocation of SDR 50 billion, about $75 billion.[43] This would increase the existing stock (SDR 21 billion) by about 2.5 times.[44] Even though the distribution of SDR would be skewed toward the industrial countries, some of those countries might need the international liquidity. Moreover, at a time of concern about global deflation and loss of confidence, this step would provide an economic boost in some countries.[45] Finally, it would help to blunt any tendency of countries to seek to build even larger stocks of international reserves as even larger self-insurance mechanisms. To the extent that this tendency takes hold, it would further distort the international adjustment process and potentially the global trading system. Every country cannot devalue its way to a current account surplus at the same time, and if too many try to do so, the resulting trade wars would be highly disruptive. If countries want to pursue strategies of building huge holdings of international reserves in order to cushion the international adjustment, at least they should do so without distorting the system as a whole and SDR allocations offer a means of doing so.

Third, the Obama administration should propose an amendment to the IMF Articles of Agreement that would allow the Fund to swap SDR for national currencies of certain (to be determined) members whose currencies are central to the functioning of global financial markets. The currencies would be used to fund the short-term lending facility that has recently been created by the Fund. This would centralize the responsibility and risk of extending the type of liquidity support that the Federal Reserve has been providing to other central banks over the past 12 months—more than $500 billion of such credit—and that other central banks such as the Swiss National Bank (SNB) and the European Central Bank (ECB) have been doing on a much smaller scale as well. This authority would help to support the central role of the IMF in the international financial system and

[42] The U.S. voting share should be reduced but not below 15 percent. It will be necessary to change the proposed amendment on basic votes to preserve the intended share of basic votes in total voting power as agreed in the spring.

[43] The allocation of SDR should be immediate to have the intended confidence effect. Therefore, it would have to be distributed on the basis of current quota shares.

[44] The Obama administration should also make a commitment to seek the ratification of the fourth amendment of the IMF Articles of Agreement. The amendment would provide for a special one-time allocation of SDR 21.9 billion. The IMF governors approved the amendment in September 1997. The initial motivation was to provide allocations of SDR to members that had joined the Fund since the first allocations in 1970–72 or the second allocations in 1979–81, in particular to Russia but also to other countries. The United States was a strong supporter of the initiative. After the collapse of Russia's IMF program in 1998, the U.S. administration lost interest and never submitted the amendment to the Congress. The IMFC, most recently on October 10, has repeatedly called for acceptance of the amendment. It is an embarrassment that the United States has not done so, and it would be consistent with the thrust of my other recommendations on IMF liquidity and legitimacy if the U.S. authorities promised to remove their roadblock.

[45] One of the standard arguments against SDR allocations is that they would be inflationary because the developing countries that received the allocations in effect would spend them in the industrial countries.

discourage countries from setting up bilateral or regional arrangements in order to bypass IMF policy conditionality.

When this expanded IMF package is submitted to the U.S. Congress, the new administration would have to ask the Congress to authorize the Federal Reserve to engage on the other side of such swap arrangements.[46] I would recommend approving Federal Reserve authority to swap unlimited amounts with the Fund for periods of up to two years.

Although one can question the immediate need for this type of approach given that, in principle, the Federal Reserve swap arrangements and the new SLF are operating in tandem, incorporating this provision in the package sent to the Congress has two advantages. First, it builds a bigger package and obviates the need to go back for an authorization at a later date. Second, it clarifies the central, multilateral role of the Fund for the future. The extensive use of Federal Reserve swap arrangements, and similar operations by the SNB and ECB, has tended to encourage the development of regional, lower-conditionality substitutes for the IMF, which is not healthy for the longer run.

The Role of the IMF—International Financial Supervision and Regulation

I have argued above that work on the reform of the international system of financial supervision and regulation should be set slowed down because the current focus on this area is having a negative pro-cyclical effect and because diagnosis remains incomplete and constructive change will take time. Nevertheless, a process of reform is underway.

In his remarks in advance of the annual meetings on October 10, 2008, managing director Strauss-Kahn signaled that he is prepared to seize the moment in the name of the Fund. He was implicitly critical of the work of the Financial Stability Forum (FSF).[47] The Fund is a member of the FSF, but it does not have a dominant role. [48] The FSF, as formally constituted, reports to the G-7 finance ministers and central bank governors.

In September 2007, the FSF was called upon by the G-7 to prepare a comprehensive set of recommendations for addressing the weaknesses that have produced the crisis that was then breaking and for strengthening the financial system going forward. After several interim reports, a final report with 67 recommendations was submitted to the G-7 in April 2008 with associated timelines for action in five areas: strengthened potential oversight of capital, liquidity, and risk management; enhanced transparency and valuation; changes in the role and uses of credit ratings; strengthened official responsiveness to risks; and arrangement for dealing with stress in the financial system.[49] In his report to the G-7 and IMFC in October 2008 (FSF 2008), FSF chairman Mario Draghi added four additional topics: monitoring and addressing the international interaction and consistency of emergency arrangements and responses; working to mitigate procyclicality in the financial system; reassessing the scope of financial regulation to cover institutions, instruments, and markets that are unregulated (or lightly regulated); and integrating with macroeconomic oversight and prudential supervision (so-called macro-prudential supervision).

The IMF and FSF should make peace. This statement means that the IMF management, the G–7, and the major central banks and supervisory authorities should make peace. There is plenty of work for everyone. On November 13, 2008, managing director

[46] The United States government cannot lend to the IMF without Congressional authorization.

[47] The G-7 finance ministers and central bank governors established the FSF in 1999 to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. Its members include representatives of the G-7 countries, a number of other financial centers, the IMF, World Bank, OECD, and BIS, international standard-setting bodies such as the Basel Committee on Banking Supervision and Regulation, and two BIS committees that are dominated by G-10 central banks.

[48] Stanley Fischer, Governor of the Bank of Israel, and former first deputy managing director of the IMF was more pointed in his remarks on the Per Jacobsson Foundation panel on October 12, "The Financial Stability Forum was set up after the Asian Crisis in a way that ensured the IMF would not be closely involved in this area [global financial stability]. . . . That was simply a mistake. The FSF is doing excellent work, but it is not a global institution as is the Fund" (IMF 2008f).

[49] Other individuals and bodies have released competing or complementary reports, including Morris Goldstein (2008a). See Annex B to FSF (2008) for a list of documents and reports by official or semi-official bodies. Goldstein's ten recommendations cover some of the same ground as the FSF recommendations although some of his suggested reforms are deeper and more specific or cover different areas. For example, Goldstein calls for action on the macroeconomic dimension in the form of coordination between monetary and supervisory authorities during the build-up of asset-price bubbles; establishment of a clearing house for OTC derivatives; new standards for compensation; rationalizing the U.S. financial regulatory structure; and reforms in U.S. housing finance.

Stauss-Kahn and FSF chairman Mario Draghi wrote a joint letter to the G-20 ministers and governors before the G–20 summit meeting in Washington laying out the respective roles of the two organizations and promising to enhance their collaboration:

1. Surveillance of the global financial system is the responsibility of the IMF.

2. Elaboration of international financial sector supervisory and regulatory policies and standards, and coordination across the various standard-setting bodies, is the principal task of the FSF. The IMF participates in this work and provides inputs as a member of the FSF.

3. Implementation of policies in the financial sector is the responsibility of national authorities, who are accountable to national legislatures and governments. The IMF assesses authorities' implementation of such policies through FSAPs, ROSCs, and Article IVs.

4. The IMF and the FSF will cooperate in conducting early warning exercises. The IMF assesses the macro-financial risks and systemic vulnerabilities. The FSF assesses financial system vulnerabilities, drawing on the analyses of its member bodies, including the IMF. Where appropriate, the IMF and FSF may provide joint risk assessments and mitigation reports.

This outline of intended IMF–FSF collaboration raises many questions. Moreover, it is widely understood that the IMF management and staff would like to have a larger role than the letter implies. It is unrealistic that the FSF should come under the total purview of the IMF. The FSF is primarily a coordinating body. Its members include sovereign governments as well as independent central banks, and they participate voluntarily in the FSF's activities.

On the other hand, the link between the G–7 and the FSF should be severed because the G-7 lacks legitimacy. Henceforth, the FSF should report to the G-20 finance ministers and central bank governors. This could be arranged at the same time that membership of national authorities in the FSF is expanded, as has been agreed in principle. Placing the FSF nominally under the G–20 would help to limit the size of that expansion because the FSF itself would be responsible, to the extent that it does make its own agenda, to a broader group of countries. Some of the G–20 members might be satisfied with this indirect involvement in the activities of the FSF. At the same time, the recent informal practice of having the FSF report to the IMFC should be formalized.

What should be on the FSF's agenda other than those items that have already been placed there and how should that agenda relate to the work of the Fund? I would highlight five truly cross-border issues thrown up by the financial crisis that, in my view, have not received sufficient attention but that merit work by both the FSF and the IMF.

First is the issue of banks that are too large for the authorities of their home countries to support or rescue. The FSF and G–20 leaders' agenda calling for colleges of supervisors for all the systemically important financial institutions does not fully address this issue. Some banks, for example in Iceland, have proved to be too big for their countries, but those banks were not systemically important. This is not an easy or new issue. It first surfaced in the Herstatt and Franklin National banks crises in 1974 which led to (1) the formation of the Basel Committee on Banking Supervision, which nominally reports to the G-10 central bank governors, and successive understandings concerning the supervision of banks that operate in multiple jurisdictions and (2) the crafting in the Euro-Currency Standing Committee (now the Committee on the Global Financial System) of a loose understanding about lender of last resort responsibilities for such institutions. These issues must be addressed, but reaching agreement on the appropriate treatment will take time, patience, analysis, and understanding.

Second is the issue of the resolution of failures of large cross-border financial institutions. This is an issue in the United States where there is no procedure for resolving failed non-bank financial institutions. However, going forward, it is an issue for the global system in particular if the aim is to have more controlled failures and fewer rescues. The legal wrangles surrounding the recent Lehman bankruptcy echo those surrounding the failure of the Bank of Credit and Commerce International in 1991. However, in the meantime little has been done to resolve conflicts between how these failures are handled in different jurisdictions although there has been some progress with respect to the purely market related aspects, e.g., closing out financial contracts. Again, this is a contentious subject and will not be easy to resolve, but it should be on the agenda going forward.

Third is the issue of the provision of liquidity to internationally active financial institutions, in particular, those that are large relative to the size of their countries. One potential mechanism is the one I proposed above under immediate recommendations. Central banks issuing major international currencies should provide short-term financing to the IMF to help finance a permanent short-term lending facility.

The Fund traditionally advances credit to governments, and the governments use the foreign exchange borrowed from the IMF primarily to replenish their reserves. Secondarily, governments use the foreign exchange to meet their own foreign currency obligations, including debt obligations, and, to a limited degree, to support their currencies in the foreign exchange market. In the financial crisis of 2008-09, governments and their central banks, in industrial as well as developing countries, have used foreign exchange, reserve holdings as well as new borrowings, to help their domestic financial institutions to repay international creditors, in particular their interbank borrowings. In the future, with the ongoing globalization of finance, these needs are likely to continue if not increase. In general they should be met not through bilateral or regional arrangements among central banks but multilaterally through the IMF. This would be one use for a permanent short-term liquidity facility in the IMF. The design of such a permanent facility raises a number of questions about both country eligibility as well as about the facility's financing. However, such a facility would help to address the first issue of banks that are large relative to the size of their countries. It would be up to the borrowing country to make the difficult determination whether an individual financial institution faced a liquidity crisis rather than solvency crisis.

Fourth is the issue of coordination of financial system crisis response. In recent months, responses have been almost exclusively at the national level without reference to international norms and standards. A number of them, such as raising limits on deposit insurance and guaranteeing the debt of financial institutions, have had disruptive cross-border effects, serving to propagate the crisis rather than to contain it. What is needed in this area is to draw up new codes and standards for all countries. At the same time, the dozen existing international codes and standards should be revisited by the relevant standard-setting bodies that report to the FSF. Subsequently, this new structure of codes, standards, norms, etc. should be incorporated into the IMF surveillance activities.

Finally, IMF surveillance is probably the most complex issue growing out of this global financial crisis. It is clear, at least to me, that the crisis had its origins in macroeconomic policies, in micro-prudential policies, and in what are called macro-prudential policies—prudential policies that have macro-economic implications and vice versa. The challenge for policymakers at the national and international level is that there is no agreed conceptual framework to guide international cooperation in these three related areas even if one assumes that all the relevant players would participate openly in the resulting structures. Moreover, the latter assumption is probably not wholly justified. The macroeconomic authorities, for example central banks are not accustomed or particularly open to having their policies critiqued by international organizations such as the IMF or by regulatory groups such as the FSF. Similarly, the supervisory authorities are not accustomed or particularly open to having their own macroeconomic authorities, to say nothing of the IMF, critique the procyclicality of their actions or inactions. Again, there are no easy answers with respect to process. However, equally if not more important, there is no common understanding on a conceptual framework to use. The IMF as a global institution must play a major role in helping to implement whatever consensus emerges on these procedural and substantive issues if there is to be any chance that the world economy and financial system is to reduce the incidence and virulence of such crises in the future.

On What Terms Is the IMF Worth Funding?

Returning to the question that motivated this paper, on what terms is the IMF worth funding? In particular, how should the Obama administration and U.S. Congress proceed with respect to the IMF legislative package that was submitted to the Congress on November 12, 2008?

My conclusion is that the package can and should be substantially improved. In addition to, or as a substitute for, the elements in the package agreed in the spring of 2008, the new administration should seek international and subsequent domestic approval (1) for doubling of IMF quotas on the basis of a revised new quota formula along with a doubling of associated GAB and NAB commitments and (2) for the

Federal Reserve to swap dollars for SDR with the IMF. The United States should also propose and support an allocation of SDR 50 billion, which does not require congressional authorization. These steps would help the Fund to perform its role as lender of final resort and provide confidence to the global economy and financial system.

The new administration should also work to strengthen the role of the Fund in the global economic and financial system not only in its lending role but also in its surveillance role. Neither the IMF nor the FSF should be transformed into a global financial regulator. However, the FSF should be strengthened by having it report formally to the G-20, and the FSF and IMF should work cooperatively on a number of multilateral financial issues that I have detailed. The surveillance of macroeconomic, micro-prudential, and macro-prudential policies should be improved. Here, both the Fund and the FSF have roles to play not only in conducting the surveillance, but principally in trying to construct a better overall framework of analysis.

Over the next few months, if the Obama administration is unable to generate international support for an enhanced package along the lines I have proposed, it should revert to supporting the package that was agreed in the spring of 2008. The aim should be to pass the package of IMF legislation by the end of 2010 at the latest. Further delay would seriously undermine the IMF as a central multilateral institution.

Gaining Congressional support for either type of package will not be easy. How difficult it is will depend in large part on whether the United States and China with the help of the IMF can work out their differences over China's exchange rate policies as well as how effectively the IMF performs in the global recession.

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THE FUTURE OF THE IMF AND OF REGIONAL COOPERATION IN EAST ASIA

Yung Chul Park and Charles Wyplosz

1. Introduction[1]

The U.S. Subprime crisis that broke out in August 2007 has since developed into a full-scale global financial crisis. Despite a series of measures taken by the United States and European countries, investors are in a state of panic and financial markets display an extreme degree of volatility all over the world.

Having experienced a major financial crisis in 1997-98, most East Asian countries are expected to be better prepared for managing fallout from the current crisis. Perhaps partly for this reason, East Asia has so far suffered less compared to other regions. But with the crisis deepening, the region will not be immune to what appears to be the most serious recession since the 1929 depression. Already some of the East Asian economies are sliding into recession and afflicted by severe financial market instability. However, since the crisis has originated in the United States and economic fundamentals of most East Asian economies are relatively stronger than those of other emerging economies in different regions, there is a widespread view that the economic deterioration in East Asia could be arrested and hence its effects could be milder. This outcome would depend on whether the member states of ASEAN+3 could cooperate more closely to coordinate expansionary macroeconomic policy and provide mutual liquidity support by activating the bilateral swap arrangements (BSAs) under the Chiang Mai Initiative (CMI), a system of currency swaps among members that was established as the region's response to the 1997-98 Asian crisis as a means of warding off or better managing future crises.[2]

The system of bilateral currency swaps has undergone many structural changes since its inception. Current efforts aim at developing a self-managed reserve pooling arrangement (SRPA), which will replace the existing swap system sometime in 2009. This, however, requires that the members agree on operational details including surveillance. To the disappointment of many in the region, leaders of ASEAN+3 have so far been unable to agree on the structure, operational details, and management of the SRPA. Because of this disagreement, the completion of the SRPA is likely to take longer than expected.

The unfolding crisis has exposed many structural defects of the existing international financial system, which, understandably, have elicited a chorus of voices calling for creating a new international financial architecture. Although the structural defects have yet to be clearly identified, it is almost certain that the reform of the International Monetary Fund (IMF) will occupy the center stage of the debate on a new international financial architecture.

The purpose of this paper is to analyze the role of a regional financial arrangement such as the BSAs or the SRPA in East Asia in the context of the expected global financial reform; can a regional arrangement be a building block for a new international financial architecture by complementing the lending and

[1] This paper draws heavily on section 3 of Park and Wyplosz (2008).

[2] ASEAN+3 includes the ten current members of the Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam) plus Japan, China, and the Republic of Korea.

surveillance operations of a new IMF that may emerge after the completion of the reform? For this purpose, section 2 discusses the role of the IMF in the management of the 1997-98 Asian crisis. It argues that the IMF failed to manage in a way that could have minimized the cost of restoring stability and that its mismanagement is in part responsible for its loss of credibility in East Asia. Sections 3 and 4 are devoted to an examination of policy and regional cooperative measures—including the regional movement that led to the creation of the Chiang Mai Initiative—taken by East Asia's crisis-hit countries in their efforts to prevent future crises. Section 5 discusses prospects for future regional financial cooperation within the framework of the SRPA and whether reserve pooling at the regional level can be an important component of a new international financial architecture. Concluding remarks are in a final section.

2. IMF and Management of the 1997-98 East Asia's Capital Account Crisis

A number of recent studies (Park 2007, Park and Wyplosz 2008, and Takagi 2008) show that the IMF was responsible for several misjudgments in managing the 1997-98 Asian crisis. One was the failure to identify structural vulnerabilities of the crisis-affected countries that had made them susceptible to a financial crisis—those weaknesses of both the financial and corporate sectors and macroeconomic policies that prevented speedy adjustment to external shocks. Instead of warning about their vulnerability, the IMF was giving misleading information on the prospects of the economies that were about to be swept over by a crisis. For instance, the Staff Report of the 1997 Article IV consultation with Indonesia, which was released in June of the same year, stated that contagion of the Thai crisis, as far as the country was concerned, was limited and that Indonesia's economic fundamentals were sound and prospects for maintaining development momentum were promising (Takagi 2008). The 1997 Article IV consultation for Korea, which took place a month before the country was engulfed in a crisis, was very sanguine about Korea's future economic prospects as it concluded that the country was well prepared to deal with further external pressure.[3]

In retrospect, it is clear that the IMF did not fully comprehend the nature and depth of the crisis, which originated in the capital, rather than the current, account. This failure led to imposition of policy adjustments inappropriate to a capital account crisis, such as fiscal tightening and high interest rate policy. A review of management of the 1997-98 Asian crisis by the Independent Evaluation Office of the IMF (2003) makes clear that it was a capital account crisis and as such required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deterioration. In the run-up to the crisis, a large increase in capital inflows into some East Asian countries set off an asset market boom and a precipitous increase in the current account deficit, thereby making these countries susceptible to speculative attacks. The perception of vulnerability of these countries triggered a sharp and large capital outflow, which was further aggravated by the panic and herding of foreign investors. Once the dollar peg had become indefensible, the value of the currencies plummeted. Many banks and corporations with balance sheet mismatches could not service their foreign currency-denominated debts and eventually became insolvent. A sharp contraction in the level of output then followed.

In addition to fiscal and monetary tightening, the crisis resolution strategy of the IMF required the crisis-hit countries to undertake a wide range of institutional reforms in the corporate, financial, and public sectors with the aim of strengthening the structural foundation of the economy and thereby restoring the confidence of international lenders. Even before the crisis, cynics would often express doubt by saying that nothing short of a major shock could force East Asian economies to accept reforms that were badly needed and overdue. It was not surprising, therefore, that the IMF rescue programs for the crisis countries mandated structural reforms along the lines of the Washington Consensus without careful scrutiny of their appropriateness and of reform capacity. Implementing deep reforms in the midst of a crisis is a questionable objective. As a result, many of these reforms were ignored, put on the backburner, or, at best, resulted in cosmetic changes. The view that structural problems were the root cause of the crisis has not been borne out by subsequent events.

[3] See Takagi (2008). To be fair, the IMF expressed its concerns about the gaping current account deficit of Thailand and recommended tightening of fiscal policy, financial sector reform, and a more flexible exchange rate system before the onset of the crisis. It should be noted, however, that its failure to assess contagiousness of the crisis may have exacerbated the difficulties of resolving the financial meltdown.

It has also became known that, when a crisis in a country originates in the capital account, policy coordination, or at least policy dialogue and review among neighboring countries, is essential in preventing contagion. In the absence of a constant exchange of information and policy dialogue among close economic partners, individual countries often find it difficult to assess the causes of large changes in capital flows and exchange rates and hence they fail to coordinate their policies. At the time of the 1997 crisis, the IMF did not have the institutional capacity to monitor developments in regional financial markets, which is crucial for policy coordination at the regional level. It still does not have such capacity.

The IMF can monitor capital flows within and between regions and also the behavior of market participants, but it is difficult to imagine that it could establish close working relationships with individual member countries and coordinate their policies. Furthermore, as an institution entrusted with monitoring economic developments in the member countries, the IMF may have to maintain an arm's length relationship with them. Moreover, to the extent that it cannot serve as a lender of last resort, the IMF cannot serve notice to the international financial markets that it is ready to supply whatever amount of liquidity it takes to thwart an impending speculative attack.

To manage a capital account crisis, instead of tightening monetary and fiscal policy as the IMF required, an effective strategy would have focused on squelching speculation by supplying a large amount of short-term financing to replenish foreign exchange reserves. But there were neither regional nor global lenders of last resort. With limited financial resources, the IMF could not resolve the East Asian crisis by itself; in the end, it had to enlist the financial support of the G-7 and other countries.

At the time of the Asian crisis, the ASEAN+3 countries jointly held about US$700 billion in foreign reserves. The total amount of financing required to restore financial stability in Indonesia, Korea, and Thailand by the IMF, other international financial institutions, and a number of donor countries amounted to US$111.7 billion. If the countries belonging to ASEAN+3 had established a cooperative mechanism in which they could have pooled their reserves and immediately supplied liquidity to stave off speculative attacks, they could have nipped the Thai crisis in the bud and minimized contagion by making available a small fraction of their total reserves. In view of the large loss of output and employment that followed, such a cooperative arrangement was indeed desirable.

Regional support is also logical when contagion is geographically concentrated. In addition to providing financial assistance in tandem with international support, a regional financial cooperation mechanism may conduct policy reviews and initiate a dialogue process. Policy dialogue, including monitoring and surveillance, is the bedrock on which coherent policy formation under regional financial arrangements rests. Monitoring and surveillance processes are needed to provide prompt and relevant information and to assess the situation of countries in trouble and potential contagious effects.

Another misjudgment stemmed from the IMF's decision to bring into effect a large number of structural reforms, some of which were not relevant to the crisis management, to restore foreign investors' confidence. Indeed, the programs the Fund laid out for the three East Asian crisis countries were overwhelming in terms of their number, scope, and detail of structural policy conditions. As recounted by Goldstein (2003) "the number of structural policy conditions included in these programs with the three Asian crisis economies is very large: many more than you can count using all your fingers and toes." At the peak, Indonesia faced 140 conditions, South Korea 94, and Thailand 73.

Particularly striking is the case of Indonesia. The Fund program included a surprising number of nontraditional areas of conditionality. "There were, inter alia, a measure dealing with reforestation programs; the phasing-out of local content programs for motor vehicles; discontinuation of support for a particular aircraft project and of special privileges granted to the National Car; abolition of the compulsory 2 percent after-tax contribution to charity foundations; appointment of high-level advisors for monetary policy; development of rules for the Jakarta Clearing House; the end of restrictive marketing arrangements for cement, paper, and plywood; the elimination of the Clove Marketing Board; the termination of requirements on credit scheme to assist small businesses, and the raising of stumpage fees" (Goldstein 2003). Goldstein speculates that these reform measures were included "for anti-corruption reasons, to facilitate monitoring of commitments, and (for some commitments) to reflect

the structural policy agendas of either other IFIs (the World Bank and the Asian Development Bank) or certain creditor countries" (p. 401).[4]

To make matters worse, there has been a widespread perception that the imposition was dictated by the IMF's major shareholders (Blustein 2001) and that the IMF took the crisis and its position as a lender as an opportunity to push through many of the reforms that the crisis-hit countries had refused to implement earlier. Such an attempt, which may have been justifiable, was viewed as opportunistic, earned the resentment of the general public, and more importantly, may have overburdened the reform capacity of the crisis-affected country to increase the cost of crisis resolution and to delay recovery.

Should, then, the IMF be criticized and bear responsibility for the mismanagement of the crisis? The answer is no. The IMF should not be criticized for its failure to develop a comprehensive framework ex post facto. After all, the IMF did not have the luxury of spending many months designing a coherent program; it could not give due consideration to possible conflicts between different reform objectives, as the crisis was deepening every day–threatening the total collapse of the various reform measures that were presumed to help restore market confidence, reduce the likelihood of a recurrence, and improve the long-term economic performance of these countries. From the outset, the IMF reform programs for the crisis countries did not have a well-defined road map to guide the formulation and implementation of stabilization policies, financial and corporate restructuring, or institutional reforms, except for the general policy prescription of the Washington Consensus (Lane et al. 1999). At the same time, it should be noted that the economic profession could not agree on how to deal with a capital account crisis in emerging economies, even when it saw one.

What confounded the East Asian policymakers and public in general was that "the IMF has remained defensive and refused to engage in frank and constructive dialogue with stakeholders in Asia instead of explaining the errors it committed with openness and humility" (Takagi 2008). This failure deprived the IMF of the opportunity to regain its credibility in East Asia. As the situation today shows, a financial crisis can breakout in any economy whether it is developed or underdeveloped, because bubbles, excesses, and calamities are inherent to Western-style finance, which East Asia has accepted as its model. The United States' 2002 enactment of the Sarbanes-Oxley Act to reform public company accounting and investor protection demonstrates that governance problems related to auditing disclosure and non-transparency of internal control were not unique to East Asian corporations. In retrospect, it is clear that the IMF did not have a viable framework for corporate reform.

Nevertheless, the IMF continues to argue that financial- and corporate-sector frailties were at the root of the crisis and that the crisis-hit countries have made a great deal of progress in improving the efficiency and safety of their financial systems (Burton 2007). Insofar as the IMF is not prepared to review its past mistakes, it is uncertain whether the IMF and its East Asian members (excluding Japan) are better prepared today to deal with the ongoing global financial crisis that is likely to throw the global economy into a severe recession. This uncertainty has created an environment in which East Asia's emerging economies do not seek, and often ignore, the IMF's policy advice and even its economic analyses.

3. East Asia's Responses to the 1997 Crisis

3.1 Reserve Accumulation

The 1997 Asian financial crisis marked a watershed in the region's recent economic history. It signaled the end of the East Asian economic miracle and opened up a long and painful period of economic reform and restructuring. As part of their efforts to build resilience to external shocks, most of the East Asian countries including the crisis-hit ones have voluntarily or under external pressure increased the flexibility of their foreign exchange rate system and the pace and scope of domestic financial and corporate reform. In order to draw a secure line of defense against speculative attacks, they have also amassed large amounts of reserves. In theory, floating rates and capital account liberalization are supposed to minimize holdings of reserves. In contrast to theory, however, the East Asian countries have increased their accumulation of reserves since the 1997 crisis. Part of the reason, of course, is that they have not let their currencies float freely and have resisted a significant appreciation vis-à-vis the depreciating U.S. dollar. Another part of

[4] In the case of South Korea, the creditor country was the United States. Blustein (2001: 143) quotes a remark made by an IMF official, who says 'the U.S. saw this (crisis) as an opportunity…to crack open all these things that for years have bothered them.'

the reason is the widely held belief that large reserve stocks provide insurance against currency crises. Except for Malaysia, all other crisis countries have deregulated their capital account transactions to a considerable degree since 1998. This liberalization has increased, not reduced, Asian demand for reserves. The emerging market countries have not witnessed any marked improvement in their access to international capital markets. Crucially, they perceive that capital flows remain unstable and unpredictable.

There is also the argument that East Asia is using the financial services of the United States to channel its savings, and will continue to do so for many years (Dooley et al. 2003), much as Europe did in the 1950s and 1960s, as then argued by Kindleberger (1965). These various reasons explain the heated controversy over whether reserve accumulation has been excessive in some countries. On the other hand, the widely held belief that large amounts of reserves provide a solid guarantee against speculative attacks may one day be revealed to be mistaken. Before the onset of capital account liberalization in the 1990s, as far as the adequacy of reserves was concerned, developing economies were generally preoccupied with the management of their current accounts. A popular rule of thumb was to hold an amount of reserves equivalent to three to four months of imports. With considerably increased capital mobility, this rule has become inadequate. For instance, since the last crisis, Korea has accumulated a large volume of foreign reserves (US$ 260 billion as of the end of 2007) equivalent to 25.5 percent of its GDP (table 1). At the same time, its capital account transactions have increased tenfold in gross terms.

This has led to another rule of thumb, sometimes referred to as the Greenspan-Guidotti-Fischer (GGF) rule, which prescribes holding reserves equal to a country's short-term foreign currency liabilities. The intuition is simple: in an emergency, the rule would enable a central bank to buy back all the liabilities that investors could liquidate. This intuition can be deceptive, even though there is no doubt that very large reserves stocks discourage speculative activity. On the other side, determined markets can virtually overwhelm any stock. Speculators chiefly operate by taking short positions in a currency that they perceive as weak. If expectations are unsure, they will not act when facing a central bank that holds sufficient reserves to sustain a speculative attack, because the outcome could be costly for them. If, however, the market sentiment builds up and expectations are firm, speculators can hold short positions of any size. In effect, a speculative attack is a run on the reserves of the central bank: the larger the reserves, the bigger the run.[5] The main advantage of very large stocks of reserves is that they are likely to raise the level of conviction required for markets to dare trigger a speculative attack. Yet, once an attack is under way, this protection is lost.

Table 1. Foreign Exchange Reserves as a Percent of GDP

	2000	2008
China	13.8	39.8
Hong Kong	63.6	70.4
Indonesia	17.1	11.5
Korea	18.7	27.0
Malaysia	29.2	58.2
Philippines	17.1	18.9
Singapore	79.9	91.8
Taiwan	33.2	68.7
Thailand	26.0	37.9

Note: GDP for 2008 (IMF Estimates).
Source: *International Financial Statistics*, IMF.

3.2 Regional Economic Cooperation and Integration

The 1997 financial turmoil has also served as a catalyst for a movement for building a region-wide defense system against future crises as well as for financial market and monetary integration in East Asia. This movement has culminated in the institutionalization of the two regional initiatives: the Chiang Mai Initiative (CMI) and Asian Bond Market Development Initiative (ABMI).

In 1997, the leaders of ASEAN invited China, Japan, and the Republic of Korea to join an effort to build a regional mechanism for economic cooperation in East Asia. This invitation resulted in creating the grouping known as ASEAN+3. The Joint Statement on East Asian Cooperation released by the ASEAN+3 summit in November 1999 covered a wide range of possible areas for regional cooperation. One area was in creating regional financial arrangements to supplement the existing international liquidity support facilities at the IMF.

Following up on the summit, the finance ministers of ASEAN+3 agreed at their meeting in Chiang Mai,

[5] The argument is formalized in Jeanne and Wyplosz (2003).

Thailand, in May 2000 to set up a system of bilateral currency swap arrangements (BSAs) among the original eight members of ASEAN+3. In addition to the annual ASEAN+3 summit, the eight countries participating in the CMI have also institutionalized regular meetings of finance ministers (ASEAN+3 Finance Ministers' Meeting, AFMM+3) and deputy ministers (ASEAN+3 Finance and Central Bank Deputies' Meeting, AFDM+3) for policy dialogue and coordination and concerted efforts at financial reform in the region.[6] The CMI rests on three pillars: liquidity assistance, monitoring and surveillance, and exchange rate and other policy cooperation. It is anticipated that cooperation will evolve over time, much as has been the case in Europe. The initial mutual credit arrangement in the form of bilateral swaps is being restructured into foreign reserve pooling without any commitment to exchange rate coordination.

4. Evolution of the CMI

4.1 The Currency Swap Arrangements

The CMI consists of two regional financial arrangements: a network of bilateral swaps and repurchase agreements among the original eight members of ASEAN+3 and an expanded ASEAN swap arrangement (ASA) created by the original five ASEAN countries in 1977. In May 2000, the ASA was expanded to include the five new ASEAN members and the total amount of the facility was raised from the initial amount of US$ 200 million to US$ 1 billion.[7]

Structure

The bilateral swap arrangements (BSAs) provide for liquidity assistance in the form of swaps of U.S. dollars for the domestic currencies of the participating countries.[8] In the initial agreement, for each BSA, the contracting parties determine the maximum amount of swap. A member country can automatically draw up to 10 percent (now 20 percent) of the contracted amount before being placed under IMF surveillance including a macroeconomic and structural adjustment program. The BSA network is thus complementary to the IMF lending facilities. Participating countries are able to draw from their respective BSAs for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR (London interbank offered rate) plus a premium of 150 basis points for the first drawing and the first renewal. Thereafter, the premium rises by an additional 50 basis points for every two renewals, but it is not to exceed 300 basis points.

The BSAs include one-way and two-way swaps. China's and Japan's initial contracts with the five Southeast Asian countries were one-way BSAs from which only the ASEAN five can draw. The first round of CMI contractual agreements was completed in May 2004 with sixteen BSAs totaling US$36.5 billion. Japan contracted seven agreements, and China and Korea each six. Korea, which is the largest beneficiary of the CMI, could draw a maximum of $13 billion from the system, including the resources made available under the Miyazawa Initiative. The amount of liquidity available from the CMI, however, was seen as insufficient to support members suffering from short run balance of payment problems and hence to prevent contagion of future crises in the region. This realization led in 2005 to doubling the total size of the CMI. Since then, further contributions have been made to increase the total amount to US$84 billion by April 2008.

Surveillance

Most participating countries agree that, in principle, the BSA network needs to be supported by an independent monitoring and surveillance system. At this stage, however, they do not seem to be prepared to establish such a system, although collective efforts are being made in this regard.[9] In the initial agreement, surveillance is not required because up to 10 percent of each BSA swap can be disbursed without the consent of the swap-providing countries and any additional drawing is subject to IMF surveillance. Hence, there is no provision for the resolution of defaults on repayments. This deficiency effectively puts the onus of surveillance on the lending countries and the IMF. With the increase in the size of the BSAs and the of the automatic drawing limit, however, a consensus emerged that in the future the CMI would

[6] The eight members include the five original members of ASEAN (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) plus China, Japan, and Korea.

[7] The five new members of ASEAN do not participate in the Chiang Mai Initiative.

[8] China chose swaps between local currencies with Japan, Korea, and Indonesia. With Indonesia, it has also a dollar-local currency swap.

[9] For instance, the ASEAN surveillance process is based on consensus and informality, in keeping with the tradition of non-interference (Manzano 2001).

need its own surveillance mechanism to make it a credible liquidity support system with procedures for activation, execution, and default-resolution.

In fact, a number of participating countries have proposed to sever the CMI's linkage with the IMF conditionality and to replace it with an independent regional monitoring and surveillance system that could also serve as an institutional framework for policy dialogue and coordination among the members. At the 2005 annual AFMM+3, ASEAN+3 finance ministers reaffirmed the necessity of enhancing the ASEAN+3's economic surveillance capacity and integrating it into the CMI, but they were not able to make any decision on the structure, role, and location of the proposed surveillance institution. The joint statement of the AFMM+3 at the 2006 Asian Development Bank (ADB) annual meeting once again reiterated the members' commitment to improving the regional surveillance capacity, but, beyond this, all they did was establish a group of experts and a technical working group of finance ministry officials to study further the feasibility of constructing a regional monitoring and surveillance system.

As currently structured, the CMI is a small regional source of financial assistance and bilateral swaps are not guaranteed to be activated in times of crisis. These deficiencies do not mean that the CMI is irrelevant. To the contrary, in addition to providing liquidity, it has been evolving into a regional forum for policy dialogue and even coordination for regional financial stability, a forum that has been wanting in East Asia for a long time. Most CMI members are not likely to draw from the BSAs in the foreseeable future as they have managed to reduce some structural weaknesses of their financial systems through reform and more importantly they have amassed large amounts of foreign exchange reserves. At the end of 2007, the seven CMI members excluding Japan held more than $2.5 trillion in reserves.

Now that they feel more secure and are hence less in need of regional liquidity assistance, the ASEAN+3 members have turned their attention more to policy dialogue and coordination, which has led to institutionalization of a peer review mechanism known as "Economic Review and Policy Dialogue" (ERPD). ERPD assesses regularly the overall economic outlook of the region and serves as a forum for policy dialogues among members. ASEAN+3 members have also established an early-warning system for crisis management and formal and informal communication channels within the framework of the CMI on significant market changes such as a large appreciation or depreciation of any regional currency caused by speculative capital inflows or outflows.

Regional cooperation may open other formal and informal channels of liquidity support, in addition to the BSAs among the ASEAN+3 countries. For example, in 2005when Indonesia and the Philippines showed signs of financial strain that was deemed contagious ASEAN+3 policymakers considered short-term public sector loans a first line of defense before activating the BSAs. In 2007, when Vietnam was suffering from a gaping current account deficit, both China and Japan reportedly offered short-term U.S. dollar loans, although Vietnam does not participate in the BSAs. In the end, in all three cases, these loans were not needed.

4.2 Enlargement and Multilateralism of the CMI

Since its inception, the eight participating members of ASEAN+3 have gone through several rounds of discussion on enlarging the size and improving operational procedures of the CMI, including the limit on automatic drawing and the linkage with the IMF. As pointed out in the previous section, the total size of the BSAs has been raised to $84 billion. Several members of the CMI had previously proposed raising the limit available without the IMF conditionality from 10 percent to 20 or 30 percent. In 2005, the limit was lifted to 20 percent.

In redesigning the CMI, the member countries have been mostly preoccupied with the joint activation or multi-lateralization of the BSAs. Multi-lateralization has been of particular concern because there is no guarantee under the existing system that the BSAs will be activated promptly, in time to support a member in need of short-term liquidity. Some of the swap-providing countries could exercise their right to opt-out. Any country wishing to obtain short-term liquidity must negotiate activation with all swap-providing countries individually. If many members refused to provide swaps or if different swap-providers demanded different terms and conditions, then the CMI could cease to be an efficient liquidity support system. Swap activation with multiple parties may take time and, hence, may deprive the swap-requesting country of the ability to

mount an effective and prompt defense against a speculative attack.

Despite these defects, the CMI members realize that neither multi-lateralization nor increasing the drawing limit will be possible unless an effective surveillance system is established. This has been a controversial issue. The working group assigned to make recommendations on surveillance has not been able to produce a system acceptable to all members: the member countries are divided on its role and structure. The bilateral swap arrangements, when activated collectively and supported by a surveillance system, can function as a de facto regional monetary fund and in the long run could lay the foundation for monetary cooperation and integration that follows in the footsteps of European monetary integration. At this stage of development, at least some members of the ASEAN+3 do not appear to be prepared to restructure the CMI into an Asian Monetary Fund, an idea that was proposed by Japan in 1997 and quickly abandoned.

5. Future Prospects for Regional Financial Cooperation in East Asia

5.1 Creation of Self-Managed Reserve Pooling Arrangement (SRPA)

In recognition of the structural deficiencies of the BSAs, in 2005 ASEAN+3 began a review of the system to develop a more effective multilateral framework of regional liquidity support. The proposal for multi-lateralization approved at the ninth meeting of finance ministers in 2006 has culminated in the conversion of BSA bilateral contracts into a single contract informally known as a common fund or a self-managed reserve pooling arrangement (SRPA). At their tenth meeting held in Kyoto, Japan, the ASEAN+3 finance ministers "agreed in principle that a self-managed reserve pooling arrangement governed by a single contractual agreement is an appropriate form of multi-lateralization" of the existing swap system (ASEAN+3, 2007). They also agreed to carry out further in-depth studies on the key elements of the multi-lateralization including surveillance, reserve eligibility, size of commitment, borrowing quota, and activation of a new system. For these studies, a task force was established in November 2006.

The SRPA, which is meant to replace the BSAs, essentially replicates the model of reserve pooling of the European Monetary Cooperation Fund (EMCF). From the Asian perspective, the innovation of the SRPA is that it is meant to be a legally binding and enforceable contract, which would give effective protection to participating members. Even when finance ministries or the central banks manage the system, unlike the BSAs, the new reserve pooling system would require a single contractual agreement to be governed by a third country's law so as to make it a multilateral arrangement.

Constructing an efficient system of surveillance would be crucial to garnering public credibility for the SRPA. For the ASEAN+3 countries to contribute sizable amounts to the fund, they need reassurances that moral hazard will be contained. Unless an effective system of surveillance is established, there is the danger that the SRPA may not function as an efficient liquidity support system.

At the eleventh meeting of finance ministers in Madrid in May 2008, some of the features of the SRPA, such as the size, the respective shares of the members, the modality of decision making, and the terms and conditions of borrowing were agreed upon (ASEAN+3 2008). On other issues, such as borrowing accessibility, the activation mechanism, custody, and surveillance, the ministers could not reach consensus and decided to wait for recommendations from a task force. The size of the pooled reserves was agreed to be at least $80 billion (20 percent provided by ASEAN countries and 80 percent by the other three members). The shares of individual countries will be determined through negotiations among the members belonging to the two respective groups.

The ASEAN members agreed in principle that the maximum amount of borrowing in U.S. dollars against collateral in local currency could be equal to a multiple of the member's contribution to the pool. However, the exact figures remain undecided, except that multiples are likely to be higher for the ASEAN members than for Japan, China, and Korea. On the pooling structure of reserves, four options have been proposed: 1) pooling of investment assets; 2) cash contributions to the SRPA in return for a claim on the arrangement; 3) pooling of promissory notes to be issued to the ADB or ASEAN secretariat, which acts as an administrator; and 4) pooling in a single global custodian.

As for the conditions and covenants of borrowing from the pool, ASEAN+3 has decided to adopt those of the

BSAs. They will also retain the 20-percent IMF rule. On the mechanism for management decision-making, the members appear divided between majority and unanimity rule. They are likely to adopt a consensus-based rule on important matters such as lending, but other routine management issues could be decided by majority rule. The members have not been able to reach consensus on two critical issues: the pooling structure and surveillance. On the pooling structure, they are debating the feasibility and relative merits of two options: pooling of promissory notes and pooling in a single global custodian.

As previously emphasized, surveillance has been a major concern ever since the establishment of the CMI. It has become critical with the introduction of a reserve pooling arrangement. Despite a series of protracted discussions, the members have not been able to agree on a modality of surveillance. At present ASEAN+3 relies on informal surveillance conducted through ERPD when finance ministers and their deputies meet (once a year for the ministers and twice a year for their deputies). The ERPD will serve as the normal mechanism for monitoring and for exchange of information, but when a request for borrowing is made by a member, it will be decided by other members either by majority or unanimity rule. There will be more ERPD meetings and more standardized information and data will be shared among the members. Obviously, this type of peer review and informal exchange on policy coordination will not be sufficient. Up until now, the member countries have not shown much interest in setting up an independent surveillance mechanism. This ambivalence means that ASEAN+3 will have to rely on the IMF and other IFIs for surveillance, but they could not agree on the extent to which they are going to depend on them.

Since China and Japan, the two largest contributors to the arrangement, are not likely to borrow from the reserve pool, there is a clear line of demarcation between potential lenders and borrowers. China and Japan are potential lenders and four ASEAN members (Indonesia, Malaysia, the Philippines, and Thailand) are potential borrowers, while South Korea and Singapore could be either lenders or borrowers. Therefore, cooperation between the two major contributors, China and Japan, which has been wanting in recent years, will be crucial to a successful launching of the SRPA.

Would the $80 billion reserve pool be enough to make it a credible liquidity support system? Would it not be dismissed outright by the market because it is so small compared with the amount of foreign exchange reserves held by the ASEAN+3 members? More generally, when markets can take huge positions, is the pool likely to deter speculative attacks? Answers will not be known until the SRPA is put through a market test in the future. However, as noted earlier, the ASEAN+3 members are going to increase their contributions as they have done with the BSAs. The SRPA has symbolic significance for regional solidarity and cooperation for mutual assistance among the ASEAN+3 members, and if the members could make use of other formal and informal channels of assistance, they may not need a large regional liquidity support system.

The BSAs have been ignored because of their small size and complicated activation procedure, and the new system could well meet the same fate. As long as the reserves remain under respective members' custody and management instead of being centrally managed by an independent third party, the activation mechanism becomes crucial. The mechanism under discussion does not appear to be a major improvement on that of the BSAs. This raises concern that liquidity will be no more readily available with the SRPA than with the BSAs. Furthermore, for the new facility to be helpful, the maximum amount a member can draw needs to be well above the level of the BSAs. It may be necessary to include an opt-out clause, but this clause should only be available under exceptional circumstances. If the IMF link were to be maintained, precise and transparent agreements between the IMF and ASEAN+3 would need to be spelled out.

The new system signals a desire to deepen financial and monetary integration through an advanced institutional structure. Few details are known about how long it will take to construct an operational framework. The shortcomings of the BSAs have long been well known, but what is not known is their effectiveness, because the system has never been activated. ASEAN+3 are introducing a new system without having had the opportunity of learning the advantages and drawbacks of the existing bilateral swap system. In the end, it seems that the SRPA is designed not so much as a regional liquidity assistance mechanism as it is a regional forum for policy cooperation. As discussed in the following section, the ongoing crisis is likely to provide a market test of

whether the SRPA, together with BSAs, can operate as a regional liquidity support system.

5.2 The Reform of the Global Financial Architecture: Viability and the Role of Regional Financial Cooperation Arrangements

A consensus is emerging that the U.S. sub-prime crisis, which broke out in August 2007 and has since exploded into global financial turmoil, has exposed many structural deficiencies of the global financial system related to large and volatile cross-country capital flows, in particular in both domestic and global financial regulation and supervision of financial actors and in the role of the IMF (ASEM 2008). Although these deficiencies and their causes have yet to be spelled out, there is broad agreement that unless rectified, they could continue to play havoc with the global financial system and provoke retreat from economic globalization.

A series of financial crises that erupted in Asia in 1997 and spread to Russia, Turkey, and Argentina in subsequent years brought to the fore the need to construct a new international financial architecture. Many international committees including the G-22 were established to examine issues related to strengthening the global financial system.[10] Few of the reform proposals were seriously considered for implementation, however, largely because of the difficulty in compromising among the different countries' interests at the global level, and most major global finance players lost interest in the proposed restructuring with the return of financial stability. Since then, the reform efforts have fizzled out. The IMF released its latest fact sheet on the reform of the international financial architecture in July 2000 (IMF 2000). Two years later, the Managing Director of the IMF delivered a speech on the urgency of international financial reform (IMF 2002). That was the last time a new international financial architecture was mentioned.

Would the new initiatives meet the same fate as the earlier ones or would they break with precedent to spearhead global reform efforts? Although it is too early to judge, this time the scope and intensity of the demand for reform could be much greater than before. This is because the U.S. sub-prime crisis has thrown all countries, developed and developing, into financial turmoil, inflicting collateral damage of likely unprecedented magnitude and because there is a widespread awareness that a crisis resolution requires "strengthening coordination and cooperation of the international community by taking effective and available economic and financial measures in a comprehensive way" (ASEM 2008).

ASEM (Asia-Europe Meeting) and G-7 member states acknowledge the urgency of reform and could take action. Although ASEM leaders have fallen short of offering solutions to the crisis, they "pledged to undertake effective and comprehensive reform of the international monetary and financial systems . . . in consultation with all stakeholders and the relevant international financial institutions including the International Monetary Fund to help stabilize the international financial situation" (ASEM 2008).

The leaders of the Group of Twenty (G-20), meeting in Washington on November 15, 2008, declared their determination to enhance policy cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems. Their work will be guided by "a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction" (G-20 2008).

From the perspective of ASEAN+3, there are five issues raised by the G-20 related to reform of the international financial system around which East Asia's leaders may consider galvanizing regional support for a common stance. The G-20 leaders agreed to:

i) to provide liquidity to help unfreeze credit markets (on which ASEAN+3 leaders need to articulate the role the BSAs and SRPA could play);
ii) to reform IFIs by modernizing their governance and membership so that emerging economies and developing countries have greater voice and representation;
iii) to review the mandates, governance, and resource requirements of the IFIs;
iv) to reinforce international cooperation in financial regulations by making national laws and regulations more consistent and encouraging regulators to enhance their coordination and cooperation across all segments of financial markets; and
v) to establish processes whereby national supervisors who oversee globally active financial institutions meet together and share information

[10] On various proposals see IMF (2000).

and expand the Financial Stability Forum to include a broader membership of emerging economies;

Focusing on the G-20 agenda item concerning the reform of IFIs, this section asks (i) whether a new international financial architecture has room for regional financial arrangements (RFAs) such as ASEAN+3 created to provide liquidity support in East Asia–i.e., the BSAs under the Chiang Mai Initiative which will be restructured as a Self-managed Reserve Pooling Arrangement (SRPA), and (ii) if so, whether the SRPA could be a building block of the new international system.

As before–in view of the fact that the global financial crisis in progress has underscored the common knowledge that the IMF is not structured to manage a capital account or short-run liquidity crisis, whether local or regional, let alone global–restructuring the IMF is expected to be a major item on the agenda for the reform of the international financial architecture.[11] Traditionally, the IMF has had very little to do with the lending operations of G-7 countries. Despite its efforts to broaden its role in multilateral surveillance and policy consultation, the IMF has not been effective in getting major players, including the G-7 economies, to coordinate their policies to bring the ongoing global financial turmoil under control. At the same time, the IMF may not have sufficient resources to help ease U.S. dollar liquidity shortages faced by a growing number of emerging economies.[12]

These limitations of the IMF as a regional and global crisis manager raised the question whether RFAs could be viable components of a new international financial system. There are several arguments that they could complement the role of the IMF to enhance efficiency and stability of a new international financial architecture. One argument invokes the European experience with financial and monetary integration. If the EMU has contributed to deeper economic integration of Europe and has also developed into a critical component of the international financial system, many in East Asia believe they could replicate a similar experience. In establishing the CMI its architects shared a vision of laying the foundation for financial and monetary integration as a long-run objective by following in the footsteps of the EU. They may or may not succeed, but in view of the European achievement, their endeavor to promote regional economic integration deserves support of the global community.

The second and perhaps the most frequently raised argument for creating regional financial arrangements is that, as discussed in section 2, they may be better adapted to managing a regional capital account or liquidity crisis than the IMF is. Indeed, it appears that the IMF has learned that resolution of a capital account crisis requires emergency lending. According to a recent IMF announcement, “the Short-Term Liquidity Facility (SLF) is designed to help emerging market countries with a track record of sound policies address the fallout from the crisis. The new facility, approved by the IMF's Executive Board on October 29, comes with no conditions attached once a loan has been approved and offers large upfront financing to help countries restore confidence and combat financial contagion” (IMF 2008).[13] While the SLF would mean a departure from the traditional role of the IMF, at this stage it is too early to make any judgment about its effectiveness as little is known about its operational details, including policy conditionality, as some policy conditions will have to be attached (IMF 2008). Most of all, it has not been tested because so far no country with a liquidity problem has approached the IMF to borrow from the SLF

A third argument refers to a host of institutional weaknesses of the IMF that narrow its role as an institution entrusted with global lending and surveillance. One such weakness is the limited ability of the Fund to raise sufficient financial resources to make it a lender of first, if not last, resort. Reportedly, the IMF has more than $200 billion of loanable funds and can draw on additional resources through two standing borrowing arrangements with groups of its members. But this amount may fall short of what it needs to rescue emerging and developing economies

[11] Eichengreen (2008) suggests that the U.S. and EU will be unresponsive to an IMF-directed Multilateral Consultation bringing together the U.S., European Union, and others to discuss the credit crisis. “European finance ministers meet as the Ecofin Council, and if they need to reach Mr. Paulson, they know his number. They do not need a Multilateral Consultation to bring them together.”

[12] Eichengreen (2008) is skeptical whether the IMF could have a role in aiding emerging economies caught up in the crisis. As he sees it, “Eastern Europe crisis countries may be bailed out by the EU and the ECB, while their East Asian counterparts may receive swaps and credits through the Chiang Mai Initiative. Once again the Fund may end up being sidelined unless it demonstrates that it has a better idea, in this case about how to link emergency lending with policy adjustment.”

[13] See appendix.

suffering from the fallout of the U.S. sub-prime crisis. As of this writing, the Fund is already negotiating provision of emergency financing with Iceland, Hungary, Pakistan, and Ukraine and expects that other emerging economies are likely to approach it for liquidity. If global availability of liquidity tightens further, the IMF may experience a shortage of funds to bail out a growing number of liquidity-seeking countries across Eastern Europe, Latin America, Africa, and parts of Asia.

Regional lenders could join forces with the IMF to provide additional funds for emergency lending. For example, depending on how it is organized, the SRPA could command a large amount of loanable funds. If the CMI members were able to contribute five percent of their combined reserves ($4 trillion) and establish surveillance appropriate for the operations of the SRPA, the pooled reserve would be large enough to supply as much liquidity to CMI members as the IMF facilities could. As far as the potential amount of funding is concerned, the SRPA could therefore easily qualify as a major regional lender, although whether the CMI members are willing to create such a large fund is uncertain at this stage.

The limited availability of loanable funds at the IMF does not provide rationale for establishing regional lenders such as the SRPA, however. This is because one could make a counter argument that IMF members, including regional organizations such as ASEAN+3, could contribute more financial resources to the IMF instead of creating RFAs. The IMF could then benefit from scale economies and dispel any concerns of potential moral hazard that may beset the RFAs. The problem with this view is that the insufficiency of lendable resources is not the only limitation of the IMF.

As noted earlier, the IMF has been trying to diversify its functions to serve as a forum for multilateral surveillance and consultation. But adding this relatively new global role to surveillance of and crisis-lending to emerging and developing economies may impinge further on its human and financial resources. For example, one department cannot effectively monitor and analyze economic developments in a region as vast as the Asia and Pacific, which includes ASEAN+3, India, Australia, and New Zealand–46 percent of the global population. Emerging and developing economies in different regions do not have many structural characteristics in common. They have different economic and social backgrounds, are susceptible different external shocks, and also display different cyclical patterns.

Given these dissimilarities, the IMF may overburden itself with covering a broad spectrum of emerging and developing economies. In development financing, a large number of regionally specialized development banks complement the role of the World Bank. As it is organized, the IMF is not a global lender of last resort. Nor is it capable of coordinating macroeconomic policies of its members. Logic fails to support the argument that there should be only one global monetary fund. One possible mode of cooperation between the IMF and the RFAs is for the IMF to consolidate its financial and human resources to strengthen its activities for multilateral consultation together with global and cross-country surveillance, while RFAs such as the SRPA specialize in monitoring and analyzing country- and region-wide economic developments. In the case of the SRPA, the IMF could provide technical assistance to ASEAN+3 for expanding the ERPD’s scope and improving the quality of its research and surveillance. In this framework of cooperation, the IMF’s participation in various ASEAN+3 fora, including the AFMM, could enhance efficiency and complementary relations between the two institutions.

A third institutional weakness of the IMF is related to its key role as a provider of policy advice and economic analyses. As many emerging economies are moving up the ladder of development, they have been able to improve and diversify their research and surveillance capacity. The IMF has also become one of many private and public providers of market information, economic analyses, and even policy advice. As a result, the role of the IMF as a confidential adviser has declined in importance, much more so in East Asia since the 1997-98 Asian crisis. Furthermore, as Takagi (2008) points out, an IMF mission that comes with a preset agenda offers little to East Asian policymakers. Because of these developments, many emerging economies are likely to find it in their interest to take advantage of all these sources of information plus their own surveillance. And an RFA with a lending function may facilitate compilation and assessment of information on regional as well as global economic developments from diversified sources.

Although there is rationale for creating RFAs, it has yet to be shown that regional arrangements can be credible regional lenders and hence viable building blocks for a new international financial architecture. The, SRPA, for example, will not become operational until the members agree on its structural details and whether any BSA member in need of liquidity would consider activating the swap arrangements has never been tested.

Several members of ASEAN+3 such as Korea may need to make arrangements to secure additional U.S. dollar liquidity, but given the stringent withdrawal process, few members of the CMI will be inclined to approach the BSAs for liquidity. The decision to borrow from the BSAs could mean an admission that the member in question is in a serious financial difficulty, which could erode confidence of foreign investors, thereby risking further capital outflows. The amount of liquidity available to each member through the BSAs is relatively small. Korea, which is the largest beneficiary of the BSAs, can draw up to $17 billion on its currency swaps with both China and Japan. To complicate the disbursement process further, the members will have to weigh in the possibility of opting-out or borrowing conditions attached by its contractual partners before activating the swap agreements. In addition, if the member requesting the swap activation needs more than 20 percent of its swap limit, it will have to accept the IMF policy conditions.

In addition to the SLF, the U.S. Federal Reserve has also recently authorized the establishment of temporary liquidity swap facilities with the central banks of four large and systemically important emerging economies suffering from liquidity shortages. These new facilities will support the provision of U.S. dollar liquidity in amounts up to $30 billion each by the Banco Central do Brasil, the Banco de Mexico, the Bank of Korea, and the Monetary Authority of Singapore. If the IMF could offer large loan packages with streamlined policy conditions attached, the CMI members will have few incentives to borrow from the BSAs. Unless, therefore, the participants in the CMI are prepared to increase swap amounts substantially to meet financing needs of its members and impose conditionality less demanding than that of the IMF, the CMI will become oblivious to the international financial community, irrevocably setting back ASEAN+3's aspiration for regional financial cooperation and integration.

Yet, leaders of the ASEAN+3 appear to be in no hurry to revamp the BSAs or to expedite the construction of the SRPA. In fact, unlike their counterparts at the EU, they have been most conspicuous by being inactive, watching the global financial crisis from the sidelines as if they could ride out the financial turbulence. Most of East Asia's emerging economies have a strong aversion to turning to the IMF for possible loan packages in case they need dollar liquidity. Given the widespread distrust of the Fund, seeking IMF financial assistance, in particular for those crisis-affected countries, would be politically disastrous: they will not entertain the idea of returning to the IMF until all other possible sources of liquidity are exhausted.

As the global financial crisis takes hold, all members of ASEAN+3 are sliding into recession and enduring financial market instability, although their plight differs in degree from country to country. All economies have seen sharp deceleration of their export earnings while domestic demand has remained sluggish. Stock prices have nosedived all over the region. Sovereign spreads have widened (table 2), and the quality of their U.S. dollar-denominated liabilities measured by the CDS premium has deteriorated (table 3). In this atmosphere of crisis, banks and other financial institutions have been pulling back from their lending operations by recalling loans instead of extending new ones as future economic prospects look dim and their losses are piling up. This pro-cyclicality in lending will accelerate the economic downturn.

Few of East Asia's emerging economies will be able to pull through the crisis without considerable loss of output and employment. Some countries such as South Korea have suffered a large increase in capital outflows as foreign investors are shifting to high quality assets such as U.S. treasuries and liquidating their investments to deleverage and cover their losses back home. The flight to quality together with the pessimistic economic outlook has generated an expectation of depreciation of their currencies, inducing further capital outflows. At present, the only recourse to short-term U.S. dollar liquidity is borrowing from the overnight interbank market. A vicious circle seems to be setting in. Although designed to support dollar liquidity to its members, the BSAs do not offer any relief and the completion of SRPA remains uncertain.

Table 2. Emerging Market Sovereign Bond Spread (basis points)

Trade Date	China	South Korea	Malaysia	Philippines	Indonesia
Dec-06	51	64	66	128	138
Jan-07	50	66	71	136	128
Feb-07	50	64	69	155	136
Mar-07	53	62	73	142	131
Apr-07	50	60	69	132	125
May-07	49	57	69	114	101
Jun-07	54	63	75	139	122
Jul-07	74	95	100	203	166
Aug-07	80	85	100	214	211
Sep-07	88	74	108	144	155
Oct-07	87	73	99	140	148
Nov-07	114	102	111	202	224
Dec-07	119	98	115	164	204
Jan-08	128	173	138	267	327
Feb-08	150	194	174	312	342
Mar-08	154	206	154	279	326
Apr-08	154	178	136	223	285
Jun-08	143	174	202	338	363
Sep-08	198	260	255	392	516
Oct-08	220	335	285	588	921

Source: Korea Center of International Finance.

Table 3. CDS Premiums for Selected ASEAN+3 Members (basis points)

CDS 5yr Premium	Korea (A2)	Japan (Aaa)	China (A1)	Malaysia (A3-)
07-Dec	45	8	29	42
08-Mar	96	26	82	99
08-Jun	104	15	75	112
08-Sep	180	19	88	168
08-Oct	301	32	116	175
	Taiwan (B1)	**Vietnam (Ba3)**	**Philippines (B1)**	**Indonesia (B1)**
07-Dec	55	126	153	153
08-Mar	110	214	239	245
08-Jun	135	321	262	282
08-Sep	170	359	285	360
08-Oct	212	468	414	753

Note : Ratings by Moodys.
Source : Bloomberg.

Understandably, East Asian countries are reluctant to seek IMF rescue financing again. Unless the international community joins forces to create a new international financial architecture that could ensure global financial stability by preventing future crises or responding in a concerted manner when they do occur, there is the danger that most emerging economies would conclude that their foreign exchange reserves are not enough to cushion external shocks. Indeed, if this happens, East Asia's emerging economies may be tempted to return to the export-led growth strategy, which would delay global recovery and worse yet sow the seeds for another crisis to be sparked by ever-growing global imbalances and a fall in the U.S. dollar.

This danger can be preempted if the members of ASEAN+3, the United States, and the EU collaborate to elevate the status of the SRPA to a credible regional lender. On its part, ASEAN+3 should consider enlarging the reserve pool in order to have it be taken seriously by the market. The UK and Japan have proposed that the reserve-rich countries including China and Saudi Arabia contribute $200 billion to the IMF to bolster its lending operations. Given the large amount of reserves held by the CMI member countries, the size of the BSAs or the SRPA easily could be doubled. Policy conditions to be attached to SRPA loans should be no more stringent than those for the IMF's SLF. Most of all, the disbursement process will have to be relatively straightforward and expeditious. On their parts, the United States and the EU could consider including the SRPA in the reform agenda for constructing a new international financial architecture.

Despite the talk of "capitalism at bay," the region is bound to integrate more extensively and deeply with the global trading and financial system unless the multilateral trading system collapses. The proposed reform of the international financial architecture will not break up the IMF: instead, it is likely to create a new IMF (ASEM 2008). East Asia needs to establish its presence in and closer and broader cooperative arrangements with the new IMF. If the SRPA could help East Asians present a united front at the new IMF, ASEAN+3 would benefit from a stronger Fund insofar as it relies on the IMF surveillance for the management of the BSAs and SRPA.

6. Concluding Remarks

The ongoing global economic crisis has highlighted many deficiencies of the existing international financial system that threaten global financial meltdown. In a globalized financial system, a crisis originating in one country or region can spill over into other countries with impunity and lightning speed. As with the case of the U.S. sub-prime crisis, a crisis in a large economy can be more devastating as it leaves few countries unscathed, whether they are developed or developing. The lesson of the current global financial turmoil is that such a crisis cannot be resolved without policy coordination and mutual support among the affected countries.

There is an emerging consensus that unless rectified, the structural deficiencies will delay the recovery of the global economy and make it susceptible to future crises. This consensus has led to global calls for a fundamental restructuring of global financial system that culminated in the "Declaration of the G-20 Summit on Financial Markets and the World Economy" on November 15, 2008. Even before that Summit, leaders of the EU affirmed their determination and unity by organizing coordinated policy responses to the crisis, providing support to member states experiencing financial difficulties, and reforming the international financial system. In contrast, East Asian political leaders have been most conspicuous by their inactivity—watching the financial meltdown from the sidelines.

East Asian countries can prevent further deterioration of their own economies and in so doing of the global economy as well, if they can coordinate their policies to boost internal demand. So far, leaders of ASEAN+3 have not been able to organize what they can and should do collectively to help resolve the crisis. This is unfortunate. The rest of the world believes that the member states of ASEAN+3 could play a critical role in mitigating the severity of the impending global recession by coordinating their policies with those of other advanced economies. East Asia should not let them down. Now is the time for ASEAN+3 to rise to the expectations of the rest of the world.

In this regard, ASEAN+3 member states must be prepared to do three things. First, they should be at the forefront of promoting regional free trade. Recognizing the risk that the global financial crisis could provoke protectionist measures in both developed and developing countries, which would only deepen the global economic crisis, at their meeting in Lima in November 2008, the APEC leaders affirmed their strong support for the G-20 Washington Declaration and agreed to "refrain within the next 12 months from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures in all areas, including those that stimulate exports."

Equally important was their decision to seek "an ambitious and balanced conclusion to the Doha Development Agenda negotiations and to reach agreement on modalities before the end of 2008 on the basis of progress made to date and to direct their trade ministers to meet in Geneva in December to achieve that objective." The leaders of ASEAN+3 should not only reiterate their support for the Washington and Lima declarations, but also go one step further in promoting freer trade in East Asia by declaring their plan for creating an ASEAN+3 FTA. In this regard, meeting in Fukuoka, Japan on December 13, 2008, the heads of state of China, Japan, and Korea declared that the three countries would support an earlier conclusion of the Doha round and begin discussions on formation of a free trade area among themselves.

Second, the members need to agree to a region-wide stimulation of demand to sustain robust growth and to absorb more imports from the United States and Europe. Recent macroeconomic forecasts suggest that despite the slowdown in global trade, the group as a whole is likely to run a substantial current account surplus. ASEAN+3 leaders should consider commissioning a study to identify a set of effective policy measures that could help withstand the impact of the global financial crisis. If they are serious about participating in global policy coordination, they should also consider announcing their plan to meet a target level of the surplus as a proportion of regional GDP as part of their efforts to augment global aggregate demand.

Third, they would be well advised to utilize all formal and informal channels of mutual assistance in providing U.S. dollar loans to those members experiencing short-run balance of payments difficulties, provided they are not structural, so that they can pursue expansionary monetary and fiscal policy without the fear of a liquidity crisis. The eight members participating in the CMI are currently sitting on a total of $4 trillion in foreign exchange reserves. The lack of U.S. dollar liquidity is therefore one thing they could easily overcome if they enlarged the bilateral swaps or the SRPA and streamlined the disbursement process. This note proposes tripling the total amount of liquidity available from the BSAs and making the policy conditions attached to withdrawals the same as those of the IMF's SLF.

Finally, it would be in their interest to participate actively in reforming the global financial system. In this regard, it is important for the four members of ASEAN+3 participating in the G-20 meetings to work with other members to present a united front at the G-20 process. The regional financial cooperative

arrangements in East Asia, such as the BSAs and SRPA, even though they may not be effective to provide protection against crises, may be transformed into one building block of a new international financial architecture. For that to happen, it would need to be supported by the international financial community and by the IMF's recognizing legitimacy of the BSAs and the SRPA as a regional crisis manager and lender that is a component of a new international financial architecture.

If ASEAN+3 constructed an efficient SRPA, the new arrangement could fill in as a regional liquidity supplier to complement the global role of a new IMF. Although the CMI was launched almost eight years ago, the creation of a credible liquidity support system has been a slow process in East Asia. As many members of ASEAN+3 have accumulated large amounts of reserves as self-insurance against future crises, complacency has set in to delay the reinforcement of the BSAs and completion of the SRPA negotiation. A lesson from the management of the current crisis is that large amounts of reserves do not necessarily keep speculators at bay.

At present, the reform of financial regulations and supervision at the global level has become the focus of a new international financial architecture. Although many proposals have been put forward, they are not likely to garner global support. ASEAN+3 considers developing its own program on global financial regulatory reform.

There is a real danger that after financial stability is restored, unless the reform assures their access to international financial markets, in order to prevent future crises most East Asian countries will go back to the export-led strategy and accumulate even more reserves than before by running current account surpluses. Otherwise, there will be retrenchment from financial globalization and from multilateral trade and investment liberalization in East Asia.

Appendix: Short-term Liquidity Facility of the IMF

• Purpose.
Provide large, upfront, quick-disbursing, short-term financing to help countries with strong policies and a good track record address temporary liquidity problems in capital markets.

• Eligibility.
Countries with a good track record of sound policies, access to capital markets and sustainable debt burdens may qualify (the IMF's standard debt sustainability analysis should indicate a high probability that both public and private debt will remain sustainable). Policies should have been assessed very positively by the IMF's most recent country assessment.

• Conditions.
Financing is made available without the standard phasing and loan conditions of more traditional IMF arrangements. However, borrowers are expected to certify that they are committed to maintaining strong macroeconomic policies.

• Size of loan.
Disbursement of IMF resources can be up to 500 percent of quota, with a three month maturity. Eligible countries are allowed to draw up to three times during a 12-month period

Source: IMF 2008

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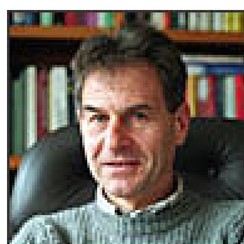

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