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Reforming the IMF for the 21st Century

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Regional Arrangements and the International Monetary Fund

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Regionalism is a defining feature of contemporary global politics and economics. One prominent political scientist (Katzenstein 2005) argues that regionalism has been the single most important feature distinguishing world politics since the end of the Cold War. Founded by nation-states as instruments of international cooperation, each of the multilateral institutions is being challenged by regional arrangements within its issue domain.

Edwin M. Truman highlighted specific challenges posed by regionalism for the International Monetary Fund in his overview of IMF reform (chapter 2). Can the global monetary system function effectively with more than one set of conventions and rules, such as with respect to the trade-off between financing and adjustment or with respect to capital account liberalization? How should the IMF's relationship with regional organizations that have overlapping substantive mandates be structured?

In this chapter, I argue that the IMF should adapt to the emergence of regional monetary and financial arrangements in three ways: membership, surveillance, and principles for regional financial facilities. The chapter—as its central recommendation—proposes a set of principles on regional fi-

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financial arrangements for adoption by the Fund. These principles would help the Fund and its members differentiate constructive from unconstructive regional financial schemes. As such, they would help (1) direct regional energy to constructive projects, (2) head off unnecessary debates over dubious proposals, and (3) promote complementarity between the regional financial facilities and the Fund's own lending arrangements.

I proposed such a set of principles—which can be loosely compared with Article XXIV of the General Agreement on Tariffs and Trade (GATT)—in an earlier study (Henning 2002). Since then, the evolution of East Asian financial cooperation and the accumulation of reserves in that region have strengthened the case for these principles. This chapter develops the proposal further and addresses some of the objections that might arise.

Regional Monetary and Financial Arrangements

The global monetary landscape no longer corresponds to the simple one country—one currency picture of national monetary sovereignty. Benjamin J. Cohen (2004) counts 4 full-fledged monetary unions involving 36 countries,¹ 13 fully dollarized countries, 5 near-dollarized countries, 7 bimonetary countries, plus 7 countries with currency boards. More than one-quarter of the world's paper currency is located outside the country of issue, and in three dozen countries with one-third of the world's population foreign currency notes make up more than 20 percent of the money stock (Krueger and Ha 1996). Foreign currency represented more than 30 percent of the local money stock in 18 nations in the mid-1990s (Baliño, Bennett, and Borensztein 1999; IMF 2004). Cohen (2003) concludes: "Cross-border circulation of currencies, which had long been common prior to the emergence of the modern state system, has dramatically reemerged, resulting in a new geography of money." Driven largely by the globalization of markets, the process of "deterritorialization" of money can be expected to continue.

Regional and plurilateral financial facilities are by no means new to global finance. The Group of 10 (G-10) swap network was introduced in the early 1960s, European financial facilities were introduced in the 1970s, and the North American Framework Agreement (NAFA) was introduced in 1994 as the financial arm of the North American Free Trade Agreement (NAFTA) (Henning 2002). The Exchange Stabilization Fund (ESF) of the United States has entered into nearly 120 agreements since its introduction in 1934 (Henning 1999). Nonetheless, new financial facilities in East Asia and dramatic reserve accumulation in that region combined with the

1. The monetary unions comprise the Eastern Caribbean Currency Union, the Economic and Monetary Union (Europe), the CFA Franc Zone (Africa), and the Common Monetary Area (South Africa).

progressive decline in the relative size of IMF resources present the Fund with a new institutional environment in crisis finance. If members of the IMF wish the Fund to remain at the center of monetary and financial developments in East Asia and elsewhere, members must adapt the institution to this new environment.

Membership

Created by national governments in the heyday of national monetary sovereignty, the IMF has reserved membership exclusively for “countries.” The Articles of Agreement (Article II, sections 1 and 2) established the original membership as those countries represented at the Bretton Woods conference and opened membership to additional countries. Joseph Gold (1974 and 1988) argued that the articles “make no provision for a joint membership of States” and that “participation in a monetary union has not prevented the partners from becoming members of the Fund as separate members.” This interpretation continues to prevail (Gianviti 1997, 2004).

Other legal scholars have advanced the case for membership for regional entities when the essential attributes of monetary sovereignty are no longer exercised by states. Such is the case with monetary unions, in which member states fully devolve authority to the union over monetary and exchange rate policy and enter a solemn obligation to adhere to a common position. In discussing Europe’s monetary union, René Smits (1997, 442–44) makes this case in its clearest form:

The attribution of powers in the monetary and exchange rate fields to the Community takes away the substance for membership in the IMF. Responsibility for monetary matters, an essential characteristic of Statehood and a condition for the compliance with the obligations resulting from membership of the IMF, no longer lies with the Member States. Put differently, the necessary condition for the Member States to remain individual members of the IMF has ceased to be present.

Under these circumstances, Smits concludes, the euro area has arguably assumed the characteristics of a “country” for the purposes of the Articles of Agreement.²

The scope of the IMF’s mandate and surveillance transcends the monetary realm, however, extending to financial and broader economic policies. The fact that European member states have not transferred authority over fiscal policy and financial regulation to the monetary union complicates the European case, as does the fact that not all the members of the European Union are members of the euro area. Finally, as a political matter, member states are predictably hostile toward being displaced within the Fund by their regional monetary arrangements. By admitting the Eu-

2. For additional comments, see also Martha (1993) and Louis (1997).

ropean Central Bank (ECB) as an observer, therefore, the Fund responded to the creation of the Economic and Monetary Union (EMU) while it maintained memberships for each of the individual member states of the euro area (Maystadt 1997, Polak 1997, Thygesen 1997, Goos 1997).

However, the Fund's adaptation to monetary union in Europe is incomplete. The arrangements by which the position of the euro area is expressed through its member states are exceedingly complex. The representation of the non-European countries within several of the constituencies of the European executive directors and the desire of those executive directors to differentiate their message within the Executive Board constrains the ability of the euro area to represent itself cohesively. Separate representation of euro area member states perpetuates a barrier to reducing the collective European quota to a more appropriate share of total quotas, a redistribution that is arguably essential for the effective governance and long-term relevance of the Fund (Henning 1997, Boyer and Truman 2005, among others).

The devolution of monetary sovereignty to currency unions thus deserves greater accommodation in the rules of membership than the IMF has yet conceded: The Fund should provide for the membership of monetary unions. The case for regional membership ultimately rests on the requirements of efficient decision making and achievement of the Fund's goals. Rather than being simply a legal issue, the question is fundamentally political. Unified European membership in particular hinges first and foremost on the willingness of the member states of the euro area to surrender individual membership.

Regional membership would not enhance the effectiveness of the institution if it introduced a double veto into decision making, however. If, after ceding membership to the union, European member states were to establish their common position by unanimity, an individual member could block Fund decisions requiring an 85 percent majority through the combination of its veto within the union and the union's veto within the Fund. Avoiding a double veto is thus an important caveat to the creation of memberships for regions.

If the European members were to agree nonetheless on unified membership and majority decision making—which is by no means clear—the full membership of the Fund should move quickly to establish the possibility of membership for monetary unions. This could be done through one of two routes. First, under its powers of “auto-interpretation” (conferred by Article XXIX), the Executive Board and Board of Governors could reinterpret the existing articles on membership. Second, the Board of Governors could pass and member states could ratify an amendment to the articles providing explicitly for regional membership.

Another useful change in IMF governance, which could be implemented without creating regional memberships, would be to reconfigure and consolidate the constituencies of the Executive Board around regional group-

ings. The Fund can and should improve upon the messy system by which Executive Board constituencies have been cobbled together in the past (Woods and Lombardi 2005). This is particularly important in the case of Europe (Truman 2005, Henning 1997, Coeuré and Pisani-Ferry 2003, and Bini Smaghi 2004 and chapter 10 of this volume) and other complete monetary unions, but it applies as well to regions in which monetary and financial integration is less advanced but in which cross-border effects are nonetheless prevalent.

Surveillance

The IMF has been grappling for some time with the design of its surveillance of member states.³ Reconsideration has given significant attention to the role of regional arrangements in the process. In their study of surveillance, John Crow, Ricardo Arriazu, and Niels Thygesen (1999, 61–62) recommended that (1) surveillance of the euro area be centered on the ECB and EU bodies, with reviews of individual countries carried out through EU institutions, and (2) the Executive Board give greater prominence to spillover issues (cross-border economic effects within the regional neighborhood) in country consultations.⁴

Since then, missions to Europe have consulted with the ECB and European Commission and incorporated their discussions into Article IV reports although the Fund has not surrendered bilateral surveillance to EU institutions. In addition to surveying the euro area, the Fund has also instituted surveillance of the two African monetary unions and the Eastern Caribbean Currency Union and conducted several studies on the Gulf Cooperation Council and a recent study on Central America, again without apparently scaling back bilateral surveillance of the members of these arrangements.

Improving regional surveillance commands a fairly broad consensus within the IMF (IMFC 2005, IMF 2005). Spillover effects within regions can be addressed in bilateral consultations within both staff reports and Executive Board discussions more effectively than in the past.⁵ Spillover issues can be as important for regions without formal monetary arrangements as for regions with currency unions: Consider China's and Japan's impact within East Asia as a whole and contagion effects among Southeast Asian countries. One constructive proposal would be to group bilateral consultations by region, whether or not the region has formal arrangements.

3. Broader treatments of surveillance include Pauly (1997), Boughton (2001), and Duignan and Bjorksten (2005).

4. See also the staff response in IMF (1999, 96 and 100–102).

5. I am indebted to Christian Thimann, Thierry Bracke, Paul Masson, and Pier Carlo Padoan for their views and ideas on surveillance.

However, if regional reviews and spillovers are to be given greater emphasis without scaling back traditional bilateral surveillance, greater resources will have to be devoted to surveillance as a whole.⁶

Principles for Regional Facilities

Since the IMF was created, member states have carved numerous regional and plurilateral financial facilities out of the multilateral system. The history of the Fund's relations with these arrangements—ranging from the European Payments Union to the G-10 swaps and NAFA—shows that there are no standards or criteria for evaluating regional arrangements that are agreed or codified multilaterally. Although officials have welcomed new East Asian arrangements that are complementary with the IMF,⁷ the attributes that differentiate complementary from conflicting arrangements are not specified. Whereas the hierarchy of bilateral, regional, and multilateral arrangements in the trade area is established, at least in principle, by Article XXIV of the GATT and Article 5 of the General Agreement on Trade in Services (GATS), the hierarchy has not been clearly established in international finance (Dam 1963; Jackson 1969, 1997; Jackson and Davey 1986; Lawrence 1996; Frankel 1997).

In earlier decades, ambiguity with respect to the relationship between regional financial facilities and the IMF did not seriously threaten the integrity of the Fund or the basic efficiency of rescue packages. Countries that lent through regional or bilateral channels also tended to be the largest shareholders of the Fund and were thus in a position to effectively coordinate, though sometimes through delicate negotiation, lending activity at the two levels. US law restricts the use of the ESF to situations that are “consistent with the obligations of the Government in the International Monetary Fund,” for example, and the US Treasury normally receives a letter from the managing director certifying disbursements as consistent (Henning 1999, 58–59).

Several relatively recent developments create greater potential for costly conflicts, however. First, reserve accumulation has dramatically reduced the overall size of the Fund relative to reserve holdings. Some of those reserve holdings have been placed at the disposal of regional arrangements

6. The prospect of increased competition among key currencies such as the dollar and euro has led Cohen (2004, 218–21) to propose that the Fund adopt a role as mediator of governments seeking to promote their monies. Truman (2005) proposes a reserve diversification standard that would restrain disruptive adjustments of official currency portfolios. Both proposals could be incorporated into surveillance.

7. Stanley Fischer, “Asia and the IMF,” remarks at the Institute of Policy Studies, Singapore, June 1, 2001. Available at www.imf.org.

such as the Chiang Mai Initiative (CMI). But the uncommitted reserve holdings could in principle also be mobilized in a crisis for emergency finance even in the absence of a standing agreement. Second, there is a growing discrepancy between some key members' reserve holdings and their quotas and voting rights within the Fund. The discrepancy creates incentives to circumvent the Fund by lending directly or regionally, thereby controlling the terms of lending and garnering political credit for the assistance.

Moreover, the international community has reviewed the consistency of regional financial facilities with countries' multilateral commitments in a completely ad hoc fashion or has failed to review them at all. There is no process or procedure through which such arrangements are evaluated formally. Some have been discussed by the IMF's Executive Board, but others, such as the CMI, have not. Furthermore, if the East Asian case serves as a guide, the number of regional financial arrangements is likely to rise.

The member states of the IMF should agree to a set of criteria that differentiate acceptable regional financial arrangements from unacceptable ones and a set of principles to govern the relationship between regional facilities and the Fund.

With respect to criteria, regional financial and monetary arrangements should be deemed consistent with multilateral arrangements when they

- create no substantial conflict with members' obligations under the Articles of Agreement;⁸
- are at least as transparent as the financial and monetary rules and operations of the IMF;
- adopt and pursue sound rules of emergency finance, to be understood as lending into liquidity shortfalls (as distinguished from insolvency) at premium interest rates and with assurance of repayment; and
- lend on sound conditionality, understood to mean policy adjustments that eliminate the financing gap in the medium term, or link lending to IMF conditionality directly.

With respect to principles relating regional facilities to the Fund, member states should agree on the following four points:

8. The most important of these relate to the maintenance of convertibility on current account transactions (Article VIII, section 2), avoidance of discriminatory currency practices (Article VIII, section 3), exchange arrangements and surveillance of economic policies (Article IV), quotas and subscriptions (Article III), operations and transactions (Article V), and participation in the special drawing rights (SDR) department (Articles XV through XXV). Regional exchange controls and discriminatory capital controls, for example, must be specifically disallowed.

- Member states shall report and disclose the details of their regional cooperative arrangements to the IMF.
- Members shall submit their arrangements to the purview and assessment of the Executive Board. In the case of inconsistencies between arrangements and these criteria or principles, the Executive Board should specify them in a publicly issued report and ask the members concerned to bring their arrangement into conformity. Existing arrangements should be assessed periodically and accession of new members should also be reviewed.
- Regional financial facilities shall not undercut IMF conditionality. When IMF financing is involved, the negotiation of lending programs and the disbursement of funds should be either linked to IMF programs or coordinated with the IMF.
- Regional policies with respect to financial regulation and private-sector involvement must be consistent with stabilization efforts on the part of the IMF.

Policy conditionality is a critical question in the relationship between the IMF and regional financial arrangements. When grappling with crises, the IMF and regional facilities must not compete by relaxing the policy adjustments required of borrowers. Despite its acknowledged mistakes, the IMF holds a comparative advantage over other regional and multilateral organizations in the specification of conditionality. It holds this position by virtue of its analytic resources, the experience and expertise of its staff, and its global perspective that confers a unique ability to draw lessons across countries and regions. Thus, at this time, regional financial arrangements are wise to import or borrow the IMF's conditionality.

The present supremacy of the IMF should not be interpreted as a monopoly that has been conferred for all time, however.⁹ If a regional arrangement develops analytically sound, high-quality conditionality, it ought to be able to substitute it for IMF conditionality.¹⁰ The critical considerations are the quality of the program, not the institutional origin, and the operational coordination of the work of the region with that of the IMF. In contrast with competition in crisis lending, moreover, intellectual competition in the analysis and setting of policy conditionality among international organizations would be useful. The international community

9. Note, for example, that the Organization for Economic Cooperation and Development's Working Party No. 3 was probably more influential than the IMF with respect to surveillance of industrial countries through at least the mid-1980s, and it continues to cooperate on surveillance with the Fund.

10. Substantial analysis and debate surrounds the policy conditions that are appropriate for program lending, but that discussion is well beyond the scope of this paper.

would benefit from having a more complete market, so to speak, in surveillance and conditionality.

Recognizing a predominant concern in the resolution of recent and current financial crises, regional groups must avoid guidance and policies with respect to the private sector that could undercut the IMF's (and their own) efforts to stabilize countries. For example, regional arrangements must not encourage banks to reduce their exposures to countries that have borrowed from the IMF. Regional arrangements must not undercut arrangements that might be agreed within the IMF in the future regarding private-sector involvement and a sovereign debt restructuring mechanism.

These new, explicit rules would continue the permissiveness of the status quo with respect to regional and plurilateral financial arrangements. They would, however, establish some new obligations with respect to conditionality, private-sector involvement, disclosure, and review that reflect the lessons of experience with regional arrangements during the past several decades and some contemporary concerns.

These criteria and principles could be introduced in either a soft or hard version. The soft version could take the form of a code of conduct among members of the Fund. The hard version would carry potential sanctions for violations and would thus probably have to be incorporated into the Articles of Agreement. The threshold of approval for a code of conduct would be easier to meet than for amendments to the Articles.

A hard version of these principles could grant the Executive Board the authority to disallow regional arrangements that it finds to be inconsistent with the principles. In the absence of a vote of disapproval, which could be taken on the initiative of an executive director, regional arrangements would be accepted. A decision to disapprove should be made by a supermajority of the weighted votes of the executive directors and could be enforced by the ability to declare offending members ineligible to draw IMF resources.

Any prospective mechanism of disapproval of a regional arrangement should be balanced fairly, however, which suggests several caveats. First, any vote in the Executive Board would have to be based on the consistency of the regional arrangement with members' obligations in the IMF as defined by the Articles of Agreement and principles of regionalism. Members would have to defend their votes on the basis of the criteria and defend their interpretation of those criteria. They could not legitimately vote to disapprove because they simply did not favor the arrangements.

Second, the threshold of disapproval would have to be set appropriately. A simple majority would be too low, giving a relatively small group of countries virtual veto power. An 85 percent majority would be too high because the region whose arrangement is under consideration might well be able to block disapproval even without outside support. A threshold of 70 percent would require a relatively small block of advanced countries

and most prospective regional groupings to secure outside support and would thus seem to be more equitable.

The purpose of these principles is not to give effective jurisdiction to the IMF over all balance of payments lending. Nor do these principles seek principally to protect the IMF as an institution, although well-functioning international institutions deserve support. Conflicts with the bureaucratic interests of the IMF—which should be distinguished from conflicts over the terms on which funds are lent to resolve a crisis—are acceptable when larger goals are at stake. If a subgroup of member states wishes to create an “IMF-plus” regional arrangement and is willing to commit the resources to make it effective—as Europe has done and East Asia could be in the process of doing—then protecting the bureaucratic interest of the Fund is not a legitimate objection.

Coordination and jurisdictional problems arise, however, when regional finance is mixed with multilateral finance. These principles are designed to prevent the misuse of IMF funds and facilitate coordination between multilateral and regional arrangements in situations of mixed finance. Because governments have an interest as shareholders in the health of the IMF and an interest in fostering timely economic adjustment on the part of neighbors, these principles are intended primarily to safeguard the collective interests of the member countries of the Fund.

Objections and Responses

Several objections might be raised to the proposal to adopt a set of principles regarding regional financial facilities. Why, after so many decades since the establishment of the Fund, does the system need such a set of principles now? Why would we expect a set of principles on regionalism to work better in the finance field than in the trade field? Why would East Asian countries in particular want to accept multilateral review of their regional arrangements? The previous section addressed the case for such a set of principles at this time. My responses to the second and third objections follow.

These principles avoid several pitfalls that have become apparent with the multilateral trade regime’s treatment of regional trade arrangements. First, they provide no loophole for “interim agreements,” through which many dubious trade agreements have slipped. Second, they require the disclosure and transparency that is necessary to conduct a rigorous review, which was insufficient in the case of the GATT. Third, reviews can be conducted not just at the time of the creation of a regional financial arrangement, but also when new members accede to existing arrangements and as such arrangements evolve over time. By applying these lessons from the experience with GATT Article XXIV, we can expect the

principles of financial regionalism to operate more satisfactorily than have the principles of trade regionalism.

Would establishing such a set of principles now be unfair to East Asian countries as they develop the CMI? What interest does ASEAN + 3 have in accepting them? Three points provide the answer to this objection.

First, the CMI would largely pass the test posed by these principles. Under the CMI bilateral swap agreements, 80 percent of borrowings must be tied to an IMF program.¹¹ The 20 percent that can be disbursed without such a program is restricted to a term of six months or less. If a borrower drew on the 20 percent but subsequently realized that it would need medium-term money, it would have to submit to IMF conditionality. To fully comply with these principles, however, ASEAN + 3 would have to be more transparent to the public, report more details of its swap agreements to the Fund, and agree to an Executive Board review.

Second, by contrast, these principles would have blocked the 1997 proposal to create an Asian monetary fund (AMF). Under that proposal, an AMF could have undercut IMF conditionality and weakened the impetus for economic adjustment in the region. By clarifying which arrangements would be complementary and in conflict, these principles, had they been part of an IMF code of conduct or the formal legal structure in 1997, would have almost certainly dissuaded Japanese officials from this proposal, saving the members of the system a fruitless and embittering debate.

The financial arrangements of other regions would also come under review at the Executive Board. The NAFA and the US Treasury's use of the ESF would pass muster. Because of high oil prices, however, oil-exporting countries outside East Asia are also accumulating reserves. Some of these governments will be tempted to deploy their reserves more creatively than did OPEC members in the 1970s and early 1980s. For example, President Hugo Chavez of Venezuela has used reserves to fund regional neighbors and has proposed creating a Latin American monetary fund (Bertozzi and Mondino 2005). Arrangements such as these could well fail the test posed by these principles.

Third, the adoption of these principles would be advantageous to East Asia in several ways. By defining more clearly the types of facilities that are in and out of bounds, these principles simplify bargaining within the region over the directions in which the CMI could evolve. They dampen temptation to experiment with unorthodox arrangements that could lead to mistakes that set back or kill the regional integration process. By providing transparency, East Asian members address suspicions among the

11. In their 2005 review of the CMI, the finance ministers of ASEAN + 3 agreed to raise the nonlinked portion from 10 to 20 percent and double the total amounts that could be borrowed under the bilateral swap agreements. They then began to renegotiate the individual swap agreements to incorporate these new terms.

rest of the membership about their intentions and lay the basis for cooperation with the Fund. Finally, the adoption of these principles would provide legal cover and legitimacy for sound regional regimes. In the absence of a clear set of principles, the US and European interpretations regarding which arrangements are acceptable can vary as governments change. These principles would protect legitimate arrangements from changes in sentiment by other, powerful states.

Conclusions

This chapter has examined the role of the Fund in light of the increasing number of regional monetary and financial arrangements, with particular attention to membership, surveillance, and principles governing regional financial facilities. It argues that the Fund should open membership to monetary unions that meet a high standard of cohesiveness, delegation of monetary sovereignty, and majority decision making. It also argues that the regional dimension of surveillance should be enhanced in several ways. The paper's principal recommendation is that the members of the Fund adopt (1) a set of criteria that differentiates constructive from unconstructive regional financial facilities, (2) procedures for disclosure of these facilities and review by the Executive Board, and (3) principles for coordinating lending by regional facilities with lending by the Fund. The accumulation of prodigious reserves by East Asian countries and, prospectively, oil-exporting countries underscores the need for multilateral rules for regional finance.

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