# Financial Regionalism

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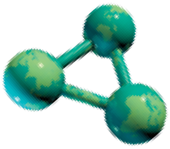
**Regional arrangements are reshaping the international financial architecture and helping global financial stability**



REGIONALISM has become an important feature of the global trading system. More than 500 notifications of bilateral and plurilateral free trade agreements were made between the end of World War II and early 2012, most of them in the past two decades.

Financial regionalism has also increasingly gained prominence, albeit only more recently. In June this year, for example, leaders of the Group of Twenty advanced and developing economies (G20) meeting in Los Cabos, Mexico, underscored "the importance of effective global and regional [financial] safety nets" and, along the same lines, the main policy committee of the IMF has regularly stated the importance for the IMF "to cooperate . . . with regional financial arrangements."

While there is a substantial stream of academic contributions on trade regionalism, our understanding of financial regionalism is quite limited, despite its potentially far-ranging implications in shaping the international financial architecture. This is true in Europe—where the recently proposed European Stability Mechanism is intended to be a currency union lending arrangement to provide direct assistance to sovereigns—and elsewhere.

In Latin America, the Andean countries successfully established the Latin American Reserve Fund (FLAR), which has been very active in providing balance of payments financing to its members for more than three decades. And, of course, in Asia, the Association of Southeast Asian Nations (ASEAN) + 3—that is, the 10 ASEAN countries plus China, Korea, and Japan—created the Chiang Mai Initiative in the aftermath of the 1997–98 Asian financial crisis. The Chiang Mai Initiative was multilateralized by consolidating a network of bilateral swap agreements into a single swap contract in

March 2010, and a regional surveillance unit, called the ASEAN + 3 Macroeconomic Research Office, has been operating in Singapore since 2011.

### Complementing broader integration

These regional financial arrangements are somewhat different and range from government financing and foreign exchange reserve pooling to currency swap arrangements. What is common to all these initiatives, despite their intrinsic diversity, is that they were all born of broader efforts to promote regional integration as well as macroeconomic and financial stability.

The most obvious case is Europe where, soon after World War II, the interdependence of that region's economies led to the establishment of the European Payments Union, a precursor of the more advanced regional framework that culminated with the introduction of the currency union in 1999.

Latin America boasts the oldest, although less well-known, tradition of regional integration efforts among the developing economies, which also date as far back as the 1950s. Aiming to create a regional common market for goods and services, policymakers in Latin America have succeeded in establishing clearing arrangements for intraregional payments, two development banks, and FLAR. The latter includes a small, cozy membership of seven small and medium-sized economies with strong cultural ties and a broad set of common interests. Indeed, FLAR provides a direct testimony to the potential of (sub)regional arrangements to provide greater ownership to those members who would otherwise struggle to be heard in the global, 188-member IMF.

**With systemic or region-wide shocks, regional arrangements and the IMF may have to join forces.**

It is exactly this idea of enhanced regional ownership that prompted the ASEAN + 3 countries to establish the Chiang Mai Initiative in May 2000. Disappointed by the response of the international community at the time of the Asian financial crisis, the 13 countries decided to reduce their dependence on the IMF.

Established soon after Japan's proposal to create an Asian monetary fund was opposed by the United States and the IMF, the Chiang Mai Initiative complements a broader range of integration efforts aimed at stepping up trade and financial linkages in east Asia. Such efforts comprise the Asian Bond Markets Initiative and the Asian Bond Fund programs to develop local currency–denominated bond markets, including the launch of the Credit Guarantee and Investment Facility, which is intended to promote the issuance of corporate bonds within the region.

A move toward an ASEAN + 3 or ASEAN + 6 (ASEAN + 3 enlarged to include Australia, India, and New Zealand) free trade agreement to forge a larger market for goods, services, and investment is another potentially significant move. Along similar lines, the establishment of an Asian Financial Stability Dialogue has been proposed, as well as an Asian currency basket index to gauge the individual movements of currencies in the region relative to a regional average.

### Managing regional spillovers

As the Chiang Mai Initiative illustrates, the membership of regional financial arrangements is heterogeneous in terms of the size of members. China (including Hong Kong SAR) and Japan account for 64 percent of ASEAN + 3 financial contributions, reflecting the large weights of their economies.

While their size makes such countries unlikely borrowers, their quota proportion highlights an important function of regional financial arrangements as a device to manage regional spillovers and the impact of problems from outside the region. Disruptions to intraregional trade and investment flows emanating from problems in smaller economies can be managed through a regional arrangement to preserve the overall stability of the region.

Not surprisingly, smaller members of FLAR have benefited considerably from the fund, but it has safeguarded the larger economies as well. Colombia, for instance, has indirectly gained from the repeated support provided by FLAR to Ecuador, because of their important trade relationship.

Indeed, such intraregional externalities can be managed more efficiently by a sovereign financial intermediary with regional scope. For instance, FLAR has a higher rating than any of its individual members, enabling the institution to borrow from financial markets at lower costs and to redirect such resources toward regional priorities.

However, reflecting a typical feature of regional financial arrangements, the Chiang Mai Initiative has only limited capacity to formulate and enforce policy conditionality associated with crisis lending and, thus, is designed to accompany an IMF program. This has been codified in the "IMF link," whereby any drawing above a certain threshold requires a concurrent IMF program. The threshold, initially set at 10 percent of the maximum borrowing limit, has now been increased to 30 percent and is targeted to rise to 40 percent by 2014. This loosening in the IMF link can mitigate one of the reasons why the Chiang Mai Initiative has never been activated: its binding IMF link and the reluctance of members to borrow from the IMF.

### Gaining perspective

Most likely, any further weakening of the IMF link will depend on the concurrent strengthening of the economic surveillance capabilities supported by the new unit, the ASEAN + 3 Macroeconomic Research Office (AMRO).

AMRO will have to prove that it can distance itself enough from its members to exercise the authoritativeness—not just the authority—to independently appraise the economic policies of its members. This challenge is symptomatic of regional financial arrangements in general and even of the IMF itself.

In the case of the European Stability Mechanism (ESM), this function is performed by the European Commission and European Central Bank, with the IMF also involved. FLAR does not carry out surveillance, nor does it have any peer-review forum in which members' economic policies are appraised. However, the ASEAN + 3 Economic Review and Policy Dialogue in Asia, which should, in fact, serve as a surveillance vehicle, has so far functioned more as a forum for exchanging information rather than as a peer-review or due diligence framework where policies are assessed and, if needed, amended.

Indeed, lack of distance between such regional bodies and their respective members typically prevents the former from designing policy conditionality in the event of crisis lending and, subsequently, from monitoring compliance with it.

Under the ESM framework, a link with the IMF is strongly encouraged although not necessarily required. FLAR, however, lends without policy conditionality. In so doing, its members have de facto accorded super-senior status to FLAR, as they have always honored their obligations to the reserve fund, even while defaulting to their commercial creditors or falling into arrears with the IMF.

A case in point is Peru in the 1980s, when the country borrowed from both the IMF and FLAR, but went off-track with the IMF-supported program. FLAR provided a financial backstop following a phase of turbulence with the international community. Upon taking office in 1985, the administration of President Alan Garcia announced that Peru would limit its external debt service payments to 10 percent of its foreign receipts. The country started to accumulate arrears with the IMF but kept current on its repayment obligations vis-à-vis FLAR. Finally, when the administration of President Alberto Fujimori took office in 1990, Peru cleared its arrears and normalized its relationship with the IMF, after which it secured a series of programs throughout the 1990s.

FLAR can thus provide liquidity support to its members, work to complement IMF support in normal times, as well as substitute for it in more difficult times. For the last to be feasible, however, the adverse shock should be limited to a small enough subregion and the demand for regional financial arrangement funds should occur in sequence and not simultaneously. That said, a lack of conditionality may postpone the policy adjustment needed to secure the support of the broader international community in the form of additional lending and/or debt restructuring.

## Spelling out who does what

Clarifying the respective roles and responsibilities of regional arrangements and the IMF may not be easy, let alone clarifying how experience from one regional financial arrangement may apply to another.

First, a shared understanding of an evolving degree of division of labor is needed. When a small-scale crisis occurs in one or two small countries, a regional financial arrangement tends to be better positioned to provide crisis lending, without involving the IMF. However, with systemic or region-wide shocks, regional arrangements and the IMF may have to join forces, given individual regions' interconnectedness with the global economy and their limited lending firepower.

In their infancy, regional financial arrangements may find it hard to formulate policy conditionality and monitor its implementation by themselves, in which case such roles may have to be assumed by the IMF, with the regional funds providing input for formulating conditionality. However, as the capacity of a regional fund—such as the Chiang Mai Initiative and AMRO in the case of Asia—improves significantly over time, it may lead crisis management, including liquidity provision and conditionality formulation and implementation, with more limited support from the IMF.

Second, there has to be a shared understanding of areas where competition between regional arrangements and the IMF may be healthy, even beneficial, and areas where competition might be detrimental.

Competition in information provision, forecasts, research, and the formulation, socialization, and dissemination of best practices is certainly beneficial. However, competition in setting conditionality is unhealthy, because it can undermine collective stabilization efforts. For instance, if different frameworks for private sector involvement were to be applied concurrently, there could be chaos in international capital markets.

So far cooperation has worked on an ad hoc basis, but this pragmatic approach, while maximizing flexibility, could escalate the risk of coordination failure in the midst of a crisis and of subsequent systemic spillovers into the global financial system. Europe is a prime example.

That said, it is difficult to devise a process similar to that in the international trading system, codified by Article XXIV of the World Trade Organization (WTO). This Article, in theory, empowers the WTO to assess the consistency of any bilateral or plurilateral arrangement with the multilateral trade system.

Yet, if one were to conceive of the IMF assuming an analogous role, then its governance structure would have to be reformed significantly to give it the needed legitimacy to discharge this potentially controversial function. The G20 could perhaps do it, having already introduced some basic principles in 2011, but it lacks universality since so many countries are left out of the process; that is, while the EU is a member, only one ASEAN country (Indonesia) belongs to the G20, and not a single member of Latin America's FLAR does.

We need to deepen our understanding of this new evolving regional dimension to the international financial architecture and of the ways in which it could contribute to financial stability, because financial regionalism, like trade regionalism, is almost surely here to stay. ■

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