NOVEMBER 2010

Global Economy and Development at BROOKINGS

FINANCIAL REGIONALISM: A REVIEW OF THE ISSUES

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Acknowledgments:

The author acknowledges helpful comments from Masahiro Kawai, Mario Lamberte and other participants to the High-Level International Workshop on Financial Regionalism: Lessons and Next Steps, cohosted in Washington by the Asian Development Bank Institute (ADBI) and the Brookings Institution, on October 13 and 14, 2010. He gratefully acknowledges the ADBI's support for this project and the excellent research assistance provided by Ana Maria Salamanca.

The views expressed in this paper are personal and do not involve the ADBI or the Brookings Institution.

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INTRODUCTION

In an unprecedented effort to counteract the spread of the financial crisis in Europe, its finance ministers have announced the establishment of the European Stabilization Mechanism, which can mobilize up to $1 trillion. Earlier, in 2009 in Asia, the finance ministers of the Association of Southeast Asian Nations Plus Three announced the multilateralization of the Chiang Mai Initiative and, in April 2010, the establishment of a surveillance unit, in effect laying the foundation for an Asian Monetary Fund.

Despite these important developments, however, thus far relatively little attention has been paid to the purpose, the potential, and the actual accomplishments of regional and/or subregional financial arrangements. Additionally, it is unclear whether these arrangements should complement, or serve as alternatives to, a global monetary institution like the International Monetary Fund.

The discussion of financial regionalism has often been confined to Asia, because this region's massive accumulation of reserve assets may lead to the establishment of a regional institution on the scale of the IMF that could both compete with the Fund and offer an alternative to its regulatory role. Perhaps in acknowledgment of this, and as a sign of a shifting attitude, an IMF communiqué released on October 9, 2010, pointed out that it is important for the Fund "to cooperate . . . with regional financial arrangements."[1]

Against this backdrop, the present paper aims to provide basic elements to inform current discussions. However, though the paper focuses on the latest developments in Europe and Asia, and their implications for an "optimal" regional architecture, an exhaustive treatment of financial regionalism is beyond its scope.[2]

The paper is organized as follows. The second section reviews the developments in the European crisis, the related policy response, and its implications for the European financial architecture; the third and fourth sections focus on the increasing use of bilateral swap lines in the recent financial crisis, the Chiang Mai Initiative's multilateralization, and the potential for further economic integration in Asia; the fifth section looks into the issues of consistency between regional and global financial architectures; and finally, the sixth section points to the relevance of the increasing wave of financial regionalism for the United States, despite the fact that it is not playing an active part in the trend.

[1] The full text of the communiqué is available at http://www.imf.org/external/np/sec/pr/2010/pr10379.htm.
[2] The paper does not cover all the regional financial arrangements in place, such as those in Latin America. For a comparative analysis, see McKay, Volz, and Wölfinger (2010).

FINANCIAL REGIONALISM AND MONETARY UNION IN EUROPE: LESSONS FROM THE CURRENT CRISIS AND NEXT STEPS

CHRONOLOGY OF A CRISIS

The recent financial turmoil in Europe was initially triggered by the Greek crisis. Between 2001 and 2008, Greece's reported budget deficits averaged 5 percent a year, compared with a euro zone average of 2 percent, while its current account deficits averaged 9 percent a year, compared with a euro zone average of 1 percent.[3] Budget deficit and debt levels in Greece have consistently been higher than the European Union's' Stability and Growth Pact ceilings. In October 2009, however, when the newly elected Socialist government revised the estimate for the 2009 budget deficit from 6.7 percent of gross domestic product (GDP) up to a whopping 12.7 percent of GDP (Oxford Economics 2010), the economic community could not help but take note. Credit-rating agencies began downgrading Greek bonds, while investors faced concerns about the country's high debt and allegations that the Greek government had altered official statistics so as to enable spending beyond the country's means.

At the onset of the crisis, some EU officials reportedly insisted that the euro zone should manage the Greek crisis without any intervention from the IMF, but by late March 2010, countries had pledged to provide financial assistance to Greece jointly with the IMF, if necessary and so requested by the Greek government. What prompted the turnaround with regard to the IMF's involvement was apparently the lack of trust of some European countries in EU surveillance, coupled with the increasing appeal of the IMF's "technology," which would allow for fast approval of significant additional resources and rapid deployment of staff with the needed analytical capabilities. A joint program offered a greater perception of credibility in monitoring economic performance. Thus, on April 23, 2010, EU officials recognized Greece's formal request to activate the financial support mechanism with the IMF (EC 2010).

In early May 2010, a loan agreement between the euro area countries, the IMF, and the Greek government was announced in the amount of €110 billion, of which €80 billion would be financed by the euro area countries and €30 billion by the IMF (IMF 2010e). On May 3, 2010, the European Central Bank (ECB) decided to suspend the application of the threshold of the debt instruments issued or guaranteed by the Greek government "until further notice" (ECB 2010).

THE ROLE OF THE EUROPEAN FINANCIAL STABILITY FACILITY

As the Greek crisis reached its peak, the EU, concerned about contagion risks within euro zone countries, came forward in May 2010 with a broad package of measures worth €500 billion to preserve financial stability in the region. In addition, the IMF expressed its willingness to support such financing arrangements with an additional €250 billion, bringing the total amount of the "safety net" to €750 billion (Ecofin 2010).[4]

More specifically, the package of measures included the adoption of the European Financial Stabilization Mechanism (EFSM), worth €60 billion, to preserve financial stability in Europe, in accordance with Article

[3] According to Nelson, Belkin, and Mix (2010): "The debt crisis has both domestic and international causes. Domestically, analysts point to high government spending, weak revenue collection, and structural rigidities in Greece's economy. Internationally, observers argue that Greece's access to capital at low interest rates after adopting the euro and weak enforcement of EU rules concerning debt and deficit ceilings facilitated Greece's ability to accumulate high levels of external debt."

[4] Given its own legal framework, the IMF cannot formally commit resources in advance; it can only do so on a country-by-country basis and upon request from a country's authorities.

122 of the EU Treaty.[5] The European Commission is the entity that administers the EFSM, which is not unlike that used in the past to assist the non–euro area countries Latvia, Hungary, and Romania (Sibert 2010).

The European Council also established a special-purpose vehicle, the European Financial Stability Facility (EFSF), which was incorporated on June 7, 2010, in Luxembourg, with the objective to provide temporary financial assistance to euro area partners. The EFSF's board of directors is composed of high-level representatives from the sixteen euro area countries, with the European Commission and the ECB participating as observers. The ESFS became fully operational on August 4, 2010, and is designed to operate for only three years.[6]

The EFSF is authorized to issue bonds and/or other debt instruments on the market, with the support of the German Debt Management Office. Issues are to be backed by guarantees from euro area countries, for a total amount not to exceed €440 billion. Individual country guarantees are determined on a prorated basis, in accordance with each country's share of the ECB's paid-up capital (see table 1 for the specific guarantee commitments of each country). The EFSF will have the same standing as any other sovereign claim on the country (pari passu), and its bonds are expected to be eligible for use as collateral with the ECB. In September 2010, EFSF bonds were assigned the top credit rating (AAA) by rating agencies.

Broadly speaking, the EFSF would intervene as follows. Upon a request from a euro area country for financial assistance, it would take three to four weeks to draw up a support program, including sending experts from the EU Commission, the IMF, and the ECB to the country in difficulty. Any financial assistance to the country would be linked to strict policy conditions set out in a memorandum of understanding between the country and the Commission, in consultation with the ECB and the IMF. The finance ministers of the sixteen euro area countries would need to agree unanimously by vote on the size of the loan, its price and length, and the number of installments over which it is to be disbursed. If the borrowing country failed to meet the conditions imposed by the Commission, by the ECB, or even by the IMF, the loan disbursements and the entire program would be suspended.

NEXT STEPS

There remains the question of whether the EFSF could one day evolve into a more structured European Monetary Fund (EMF), along the lines proposed by Daniel Gros and Thomas Mayer, for instance (see box 1). Although the establishment of the EFSF can already be seen as an embryonic EMF, an EFSF-like regional financial arrangement would finally give real strength to EU surveillance. In fact, recent studies of the IMF have found that its statutory surveillance draws its authority from lending programs above all.[7] The effectiveness of IMF surveillance comes precisely from the fact that the IMF leverages its bargaining power in both borrowing countries and potential borrowing countries. Because countries that do not comply with the IMF risk jeopardizing additional sources of multilateral and

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[5] Article 122 of the EU Treaty establishes that "1. Without prejudice to any other procedures provided for in the Treaties, the Council, on a proposal from the Commission, may decide, in a spirit of solidarity between Member States, upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy. 2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken."

[6] According to Gerlach (2010, 5), "the temporary nature of the EFSF reduces its effectiveness since it signals that we will soon return to the pre-crisis situation where the SGP [the Stability and Growth Pact], although renegotiated, is again the only institutional arrangement designed to limit the risk of fiscal crisis. Rather than hoping that ambiguity about whether financial support will be available if needed will lead governments to adopt sounder fiscal policies, it seems much better to adopt a permanent framework that specifies under what conditions any help would be made available."

[7] See Lombardi and Woods (2008).

bilateral financing, bilateral surveillance is particularly effective.

With a focused mandate to support euro area countries in financial distress in exchange for tight policy conditions, an EFSF-like mechanism can relieve pressure from euro area monetary authorities, thus allowing the ECB to fully focus on its price-stability objective while being shielded from pressures to cooperate with European governments in solving sovereign-debt problems. Along similar lines, an EFSF-like mechanism can provide a valuable alternative to IMF support in those instances where the country in question does not face an immediate problem in its balance of payments, thus relieving the IMF of pressures to intervene when circumstances do not exactly correspond to those envisaged in its mandate.

Admittedly, the institutional framework established at the outset for the European single currency did not explicitly include a safety pillar such as an EFSF-type mechanism. But that mainly reflected the assumption, not fulfilled ex post, that subsequent to the introduction of the European single currency, the overall stability of the euro zone would be underpinned by a sustained convergence toward a unique policy process that would go well beyond monetary policy. In contrast, the issue now is what backstops can be deployed to restrict policy divergence and to contain policy variables within an acceptable band of limits.

Although the introduction of a safety pillar for the euro further complicates the institutional architecture of the single currency, the case could still arise in which the euro area would come to the support of a member country, despite its noncompliance with the policy measures agreed upon in the context of an EFSF-type program, so as to avoid a systemic crisis in the euro zone. Thus, the possibility of relying on resources provided by fellow countries could create an incentive for moral hazard that an EFSF-like mechanism might not be able to fully control—with the end result of (further) weakening fiscal discipline in potentially noncompliant countries. Moreover, because the IMF already provides assistance with its resources to countries in need, it can be argued that European countries should work toward strengthening the IMF's financial capability rather than diverting their attention to setting up yet another regional institution like the EMF.[8]

TABLE 1. List of Guarantor Euro-Area Members with Their Respective Guarantee Commitments

Country	Guarantee Commitments (millions of euros)
Germany	119,390.07
France	89,657.45
Italy	78,784.72
Spain	52,352.51
The Netherlands	25,143.58
Belgium	15,292.18
Greece	12,387.70
Austria	12,241.43
Portugal	11,035.38

Country	Guarantee Commitments (millions of euros)
Finland	7,905.20
Ireland	7,002.40
Slovak Republic	4,371.54
Slovenia	2,072.92
Luxembourg	1,101.39
Cyprus	863.09
Malta	398.44
Total commitments	440,000.00

Source: Annex 1 of the EFSF Framework Agreement, June 7, 2010 (EFSF 2010).

[8] For a critical view of the EMF, see Tanzi (2010).

BOX 1. Proposal for a European Monetary Fund

Daniel Gros and Thomas Mayer (2010b) have articulated a concrete proposal for establishing a European Monetary Fund (EMF), which would provide a framework for assisting member countries in financial difficulty.

THE MECHANICS OF THE PROPOSAL

According to Gros and Mayer, the creation of the EMF would provide the following advantages: (1) The funding mechanism would encourage member governments to maintain control of their finances; and (2) the EMF would be capable of organizing an orderly default as a measure of last resort. For the authors, "the key policy aim must be to restore market discipline by making failure possible." These features would lower the moral hazard problem generated by the assumption that the governments of countries under financial distress "can count on a bailout because the EU could not contemplate the bankruptcy of one of its members." To reduce the moral hazard that potentially results from the creation of the fund, they have proposed a financing mechanism for the EMF and a conditionality framework attached to its support.

First, for the initial financing of the EMF, the fund should be given the authority to borrow from markets with the backing of its member countries. Borrowing by the EMF could be used to develop a common euro bond. In addition, contributions to the EMF would depend on the potential risk each member country represents, with countries breaching the Maastricht Treaty criteria making higher contributions. The contribution rates would be calculated on the following basis:

- 1 percent of their "excess debt," which is defined as the difference between the actual level of public debt and the Maastricht limit of 60 percent of GDP;
- 1 percent of the governments' excess deficits or the amount of the deficit for a given year that exceeds the Maastricht limit of 3 percent of GDP.

This mechanism would give the countries an incentive to keep their finances in order, while discouraging excessive debt and deficits.

Second, any member country could call on the EMF for up to the same amount that the member country has deposited in the past (including interest), provided its fiscal-adjustment program has been approved by the euro area finance ministers. Any call on EMF resources for more than this amount would be possible only if the country agrees to a tailor-made adjustment program supervised by the European Commission and the Eurogroup. In this context, if a country did not fulfill its commitments, an enforcement mechanism would be available in the form of sanctions imposing considerable economic and political costs (i.e., new funding and structural funding cut-offs).

One of the key aspects of the EMF would be to manage an orderly default for a country that failed to comply with the adjustment program. To protect against systemic effects of a default, the EMF could offer all holders of the debt issued by the defaulting country an exchange against new bonds issued by the EMF. The fund would require creditors to take a uniform "haircut" on their existing debt in order to protect taxpayers. Having acquired bondholders' claims against the defaulting country, the EMF would allow the country to receive additional funds only for specific purposes that the EMF approved. The EMF would also provide a framework for sovereign bankruptcy comparable to the Chapter 11 procedure for bankrupt companies in America (Gros and Mayer 2010a).

EMF COMPLEMENTARITIES

The ECB is barred from giving credit to governments and, thus, is not a substitute for an EMF. According to Gros and Mayer (2010b), "without a fiscal agent like the EMF in times of crises, the ECB becomes the fiscal agent of euro area governments by default. This role, if maintained, will destroy the institution in the intermediate future." Conversely, the EMF would be complementary to the IMF, which has no mechanism for allowing orderly defaults.

The euro area member countries have much closer economic and political relations with each other than the average IMF member country has with the rest of the IMF membership. In this respect, Mayer states that "the principle of subsidiarity suggests that problems specific to these countries are better dealt with at the regional than at the global level" (Mayer 2009).

EMF GOVERNANCE FRAMEWORK

The EMF would be established under the concept of "enhanced cooperation" set in the EU Treaty and could be a concrete expression of the principle of solidarity. This principle implies that EU member countries could expect to receive support in cases of extraordinary financial difficulties; that is to say, countries that might be a burden for the euro area should contribute to "building up the resources needed for a potential support effort" (Gros and Mayer 2010b). Similar to the IMF's own staff, the EMF would have professional staff removed from direct political influence and a Board with representatives from euro area countries (Gros and Mayer 2010a).

BILATERAL AND PLURILATERAL SWAP LINES AND THE CHIANG MAI INITIATIVE: LATEST DEVELOPMENTS AND PERSPECTIVES

THE MULTILATERALIZATION OF THE CHIANG MAI INITIATIVE

In May 2000, the Chiang Mai Initiative (CMI) was established by the finance ministers of the Association of Southeast Asian Nations Plus Three countries (ASEAN+3, with the "three" being the People's Republic of China, Japan, and the Republic of Korea) in Chiang Mai, Thailand, at a meeting on the sidelines of the Annual Meeting of the Asian Development Bank (ADB). Following the 1997–98 Asian financial crisis, the CMI represented a formal acknowledgment of the need to create a regional financing arrangement to supplement the existing international facilities. It achieved the latter by means of an expanded ASEAN Swap Arrangement that would include ASEAN countries, and a network of bilateral swap agreements and repurchase agreement facilities among the ASEAN+3 countries (ASEAN Secretariat 2000). Under the terms of the agreement, any drawing of an amount greater than 20 percent of a member's quota would also require a concurrent IMF program (Oh 2010).

The CMI evolved into the CMI's multilateralization (CMIM) over the course of ASEAN+3 finance ministers' meetings held in 2008 and 2009, as the respective member countries agreed to transform bilateral swap agreements into a self-managed reserve pooling arrangement governed by a single contract (ASEAN Secretariat 2008, 2009). The Joint Ministerial Statement released at the 2009 Bali meeting outlined the terms of an agreement aimed at (1) addressing short-term liquidity difficulties in the region; and (2) supplementing the existing international financial arrangements. Of the CMIM's total $120 billion, the maximum amount that each country can borrow is based on its respective contribution, multiplied by a borrowing multiplier that favors smaller economies. Table 2 shows the contribution, the borrowing multiplier, and the voting power for each country, as stipulated in Bali and then amended at the Tashkent meeting in May 2010.[9]

In the Bali agreement, the ASEAN+3 also introduced a decisionmaking mechanism, whereby decisions on fundamental issues would be made by consensus and decisions on lending matters would be made by a majority. CMIM members also agreed to establish an independent regional surveillance unit in Singapore by early 2011, namely, the ASEAN+3 Macroeconomic Surveillance Office (AMRO).[10] AMRO is meant to provide CMIM with its own collective resources to assess and identify the appropriate combination of financing and adjustment, to step up its prospective operational capabilities, and to pave the way for a possible implementation of the CMIM independent of the IMF.

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[9] For a more extensive treatment on the CMI, see Kawai (2007, 2009).
[10] Joint Media Statement of the 14th ASEAN Finance Ministers' Meeting held in April 2010.

Table 2. CMIM Contributions, Purchasing Multipliers, and Voting-Power Distribution

<table>
<tr><th rowspan="2">Country</th><th colspan="4">Financial Contribution</th><th>Purchasing Multiple</th><th>Basic Votes</th><th>Votes Based on Contribution</th><th colspan="2">Total Voting Power</th></tr>
<tr><th colspan="2">Billion U.S. dollars</th><th colspan="2">(percent)</th><th></th><th>(no. of votes)</th><th>(no. of votes)</th><th>(no. of votes)</th><th>(percent)</th></tr>
<tr><td rowspan="2">PRC</td><td rowspan="2">38.40</td><td>PRC (excluding Hong Kong) 34.2</td><td rowspan="2">32.0</td><td>28.50</td><td>0.5</td><td>1.60</td><td>34.20</td><td>35.8</td><td>25.43</td></tr>
<tr><td>Hong Kong 4.2</td><td>3.50</td><td>2.5</td><td>0</td><td>4.20</td><td>4.2</td><td>2.98</td></tr>
<tr><td>Japan</td><td colspan="2">38.40</td><td colspan="2">32.00</td><td>0.5</td><td>1.60</td><td>38.40</td><td>40.00</td><td>28.41</td></tr>
<tr><td>Korea</td><td colspan="2">19.20</td><td colspan="2">16.00</td><td>1</td><td>1.60</td><td>19.20</td><td>20.80</td><td>14.77</td></tr>
<tr><td>Plus 3</td><td colspan="2">96.00</td><td colspan="2">80.00</td><td></td><td>4.80</td><td>96.00</td><td>100.80</td><td>71.59</td></tr>
<tr><td>Indonesia</td><td colspan="2">4.552</td><td colspan="2">3.793</td><td>2.5</td><td>1.60</td><td>4.552</td><td>6.152</td><td>4.369</td></tr>
<tr><td>Thailand</td><td colspan="2">4.552</td><td colspan="2">3.793</td><td>2.5</td><td>1.60</td><td>4.552</td><td>6.152</td><td>4.369</td></tr>
<tr><td>Malaysia</td><td colspan="2">4.552</td><td colspan="2">3.793</td><td>2.5</td><td>1.60</td><td>4.552</td><td>6.152</td><td>4.369</td></tr>
<tr><td>Singapore</td><td colspan="2">4.552</td><td colspan="2">3.793</td><td>2.5</td><td>1.60</td><td>4.552</td><td>6.152</td><td>4.369</td></tr>
<tr><td>Philippines</td><td colspan="2">4.552</td><td colspan="2">3.793</td><td>2.5</td><td>1.60</td><td>4.552</td><td>6.152</td><td>4.369</td></tr>
<tr><td>Viet Nam</td><td colspan="2">1.00</td><td colspan="2">0.833</td><td>5</td><td>1.60</td><td>1.00</td><td>2.60</td><td>1.847</td></tr>
<tr><td>Cambodia</td><td colspan="2">0.12</td><td colspan="2">0.100</td><td>5</td><td>1.60</td><td>0.12</td><td>1.72</td><td>1.222</td></tr>
<tr><td>Myanmar</td><td colspan="2">0.06</td><td colspan="2">0.050</td><td>5</td><td>1.60</td><td>0.06</td><td>1.66</td><td>1.179</td></tr>
<tr><td>Brunei</td><td colspan="2">0.03</td><td colspan="2">0.025</td><td>5</td><td>1.60</td><td>0.03</td><td>1.63</td><td>1.158</td></tr>
<tr><td>Laos</td><td colspan="2">0.03</td><td colspan="2">0.025</td><td>5</td><td>1.60</td><td>0.03</td><td>1.63</td><td>1.158</td></tr>
<tr><td>ASEAN</td><td colspan="2">24.00</td><td colspan="2">20.00</td><td></td><td>16.00</td><td>24.00</td><td>40.00</td><td>28.41</td></tr>
<tr><td>Total</td><td colspan="2">120.00</td><td colspan="2">100.00</td><td></td><td>20.80</td><td>120.00</td><td>140.80</td><td>100.0</td></tr>
</table>

Note: ASEAN = Association of Southeast Asian Nations.
Source: Attachment to the Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers' Meeting, May 2, 2010, Tashkent, Uzbekistan.

BILATERAL AND PLURILATERAL SWAP LINES

Against the backdrop of the recent international financial crisis, which brought the financial systems of some advanced economies to the brink of meltdown, there has been an unprecedented rise in swap agreements among the central banks of larger economies. At the height of the crisis, while negotiating the strengthening of the CMIM, Singapore and Korea sought and obtained the support of the U.S. Federal Reserve through bilateral currency arrangements. Under these arrangements, each country received $30 billion directly from Federal Reserve—the issuer of the dollar, the main international reserve currency—to support their respective financial systems at a time when global capital markets had dried up.[11]

Since 2007, the U.S. Federal Reserve has in fact extended fourteen swap lines equivalent to a total of $755 billion, with the People's Bank of China and the ECB committing

[11] See the press release of the U.S. Federal Reserve of October 29, 2008. In Singapore, the monetary authorities did not draw on the facility, which expired on February 1, 2010 (Monetary Authority of Singapore, Press Release, January 28, 2010). In South Korea, the central bank distributed the swap dollars to Korean banks through competitive tender in the form of temporary dollar liquidity support over eighty-four or eighty-five days. The Bank of Korea used a total of $16.3 billion, which it began returning to the Federal Reserve as of March 19, 2009, and had fully repaid on December 18, 2009 (see http://eng.bok.or.kr/eng/engMain.action).

to six and four swap lines, respectively, for amounts equal to RMB 650 billion and €31.5 billion.[12] Recent research has investigated the determinants of this unprecedented supply of swaps, which are mainly related to (1) the degree of exposure of the swap provider's financial system to the recipient's economy; (2) the relative importance of the swap recipient's markets as export destinations; and (3) sound economic management in the recipient countries.[13]

NEXT STEPS

The discussions pertaining to the CMIM are now likely to focus on (1) a possible expansion of its regional membership to include India and, potentially, Australia and New Zealand; (2) an increase in its overall size to better reflect the potential financing gap that a member might face due to a sudden withdrawal of international capital flows; (3) the establishment of both the operational capability and the reputational credibility of its surveillance arm, AMRO; and (4) the delinking of its lending programs from IMF conditionality or any other Fund-related "seal of approval." Tangible progress along these lines will lay the groundwork for the CMIM to successfully evolve from its current stage as an embryonic Asian Monetary Fund to a full-fledged regional institution for enhancing and regulating monetary cooperation in Asia.[14]

With particular regard to the recent crisis, although the recipients of bilateral swap lines extended well beyond CMIM member countries, CMIM countries such as Korea and Singapore did not resort to Chiang Mai credit lines and, likewise, China lent outside the CMIM framework. Four (concurrent) explanations might account for this: (1) The maximum size of CMIM drawings for Korea and Singapore ($19.2 and $11.4 billion, respectively) is well below what they were able to mobilize from the U.S. Federal Reserve; (2) the swap lines were activated before the newly centralized decisionmaking mechanism of CMIM entered into effect; (3) because activation of CMIM requires an IMF program beyond any drawing above the 20 percent threshold, recipient countries did not want to apply for IMF assistance; (4) to counteract market expectations about a sudden reversal in capital flows, a direct swap line with the issuer of the international reserve currency would provide the most credible backstop. Thus, although definite progress has been made, the reliability of the CMIM is still, technically, untested.[15]

[12] Aizenman, Jinjarak, and Park (2010).
[13] Aizenman and Pasricha (2010).
[14] For an extensive treatment of monetary cooperation in Asia, see Volz (2010).
[15] For a prospectus on the CMIM, see Kawai (2010).

THE ECONOMIC AND FINANCIAL INTEGRATION IN ASIA: BEYOND THE CHIANG MAI INITIATIVE

According to a recent ADB study, "Asia's output today roughly equals that of Europe or North America, and may well be 50 percent larger than theirs will be by 2020, in terms of purchasing power parity" (ADB 2008, 2). The Asian region, which is home to more than half the world's population, consistently registers the world's highest economic growth rates. Acknowledging regional sensibilities, the recent ADB study notes that the "region's opinion leaders welcome this interdependence and place a high priority on regional cooperation and integration" (ADB 2008, 2).

Formal institutions that can facilitate regionalism are pivotal for the continued economic activity and growth of Asia and for the realization of an Asian Economic Community (ADB 2010).[16] Strenghtening institutions for regionalism already in place—like the ASEAN+3—and establishing new ones—like the Asian Investment Bank and the Asian Infrastructure Fund (AIF)—will be instrumental in achieving these goals.

The ASEAN+3 is one of the subregional institutions that play a key role in Asian integration and regional economic growth, as witnessed by its financial cooperation efforts, namely, to strengthen the CMIM framework and to lay the groundwork for a future Asian Monetary Fund. The ASEAN+3 could benefit from an expansion of its coverage and membership, which would be instrumental in promoting intraregional trade and allowing investment flows between countries. Although "Asian integration" has in fact until now meant mainly "East Asian integration" (ADB 2008), including India in the ASEAN+3 would "significantly enhance welfare gains accruing to member countries" (Kumar and Alex 2010). This ASEAN+4 could pool a remarkable 96 percent of Asia's GDP in purchasing power parity terms and more than 80 percent of its exports and imports. And further expanding the ASEAN+4 to include Australia and New Zealand would generate even greater welfare gains and would boost economic activity in Asia significantly more than the ASEAN+3 process already has (Kumar and Alex 2010).

There is evidence for the key role that infrastructure plays in promoting and sustaining rapid economic growth (ADB and ADBI 2009). For the ADB and the ADB's Institute (ADBI), the establishment of an AIF will be important to help mobilize Asian and global funds, and to prepare and finance "bankable" regional infrastructure projects.[17] "The inadequacies of Asia's infrastructure networks are a bottleneck to growth, a threat to competitiveness, and an obstacle to poverty reduction" (ADB and ADBI 2009). In the next decade, developing Asia will require about $8 trillion in national infrastructure capacity and an additional $287 billion to invest in regional infrastructure projects. A globally competitive infrastructure in Asia and its individual

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[16] According to the ADB study (2010, 6), institutions for regionalism are "organizations mainly involved in regional economic integration and cooperation in Asia and the Pacific (whose mandate may also extend to noneconomic issues) in which the principals or contracting parties are national governments (although nongovernment organizations and other non-state actors may also participate in their work)." The study proposes that Asia should strengthen and consolidate its regional institutions to cement recent gains, broaden integration, and ensure that regional and global processes remain compatible and mutually reinforcing. The ADB has counted fifty-four institutions related to regionalism in Asia and the Pacific. The study finds that these institutions have served the region well, but the next steps in Asian integration will require stronger institutional support. Therefore, the study sets forth two general principles for reform and four specific recommendations. The principles are to (1) make the most of global institutions and conventions; and (2) enhance the governance of institutions that encourage regionalism by providing more information about their activities and more civil society input into their deliberations. The four recommendations for institutional reform are (1) to strengthen existing subregional institutions, (2) to develop institutions to exploit compelling functional opportunities, (3) to create an Asian Court to ensure that international legal obligations are implemented uniformly, and (4) to establish an encompassing panregional institution.

[17] See box 2 for a summary of the study by the ADB and ADBI (2009) on regional infrastructures and on the proposal for the AIF.

economies would expand manufacturing activity, which is relatively underdeveloped in the South Asian countries, and would also help improve productivity in the East Asian service-sector economies.[18] According to the ADB and ADBI (2009, 10), "the required investment in regional infrastructures for pan-Asian connectivity would produce large real income gains of around $13 trillion for developing Asia during 2010–2020 and beyond" (see box 2).

By strenghtening institutions that encourage regionalism, such as the ASEAN+3 and the current CMIM-AMRO framework for monetary cooperation, and by establishing new regional entities such as the AIB and the AIF, with a focused mandate, the stage could be set for a future Asian Economic Community.

Box 2. ADB and ADBI's Study of Infrastructures for a Seamless Asia

The study examines regional infrastructure development in Asia up to 2020 and the key issues and challenges associated with developing regional infrastructure through fostering regional cooperation in Asia. The study's long-term vision is the creation of a seamless Asia, that is, "an integrated region connected by world-class environment-friendly infrastructure networks that link national markets with distinct strengths, promote strong and sustainable economic growth, provide for people's basic needs, and thus help reduce poverty." The study's main findings and recommendations are summarized here.

SUPPORTING REGIONAL TRADE AND INVESTMENT

Where infrastructure connections are good, Asia's trade has expanded rapidly. In contrast, where infrastructure connections are poor (i.e., in South Asia and among Asian subregions), trade remains low. In addition, as Asian economies have liberalized their trade policies, infrastructure deficiencies have become an increasingly significant impediment to trade. Correcting these weaknesses in regional infrastructure would do more to lower the cost and increase the volume of trade in Asia than would eliminating any remaining tariff and nontariff barriers. There is a special need to develop efficient and cost-effective logistics networks that combine speed, flexibility, and timely information, thus providing better connections. Boosting countries' export competitiveness would attract and facilitate greater investment in productive capacity, increase employment opportunities for the poor, and broaden consumer choice for Asia's citizens. Harmonizing and strengthening soft (facilitating/institutional) infrastructure is an essential complement of enhanced hard (physical) infrastructure.

HARNESSING THE BENEFITS OF REGIONAL INFRASTRUCTURE

Regional infrastructure is particularly important to Asia's economic development. There is evidence of the key role of infrastructure in promoting and sustaining rapid economic growth. Several studies of developing Asian countries echo international findings that better infrastructure significantly reduces poverty. Connective infrastructure expands and links markets together, enabling firms to develop economies of scale, permitting greater specialization in production, and allowing a greater division of labor. Creating and

[18] Kumar and Alex (2010).

improving regional infrastructure networks can boost an economy's rate of innovation and technological advancement, increasing long-term growth. Case studies of Central Asia, the Greater Mekong Subregion, and South Asia show that the benefits of subregional infrastructure projects greatly exceed their costs.

DEVELOPING EFFECTIVE POLICIES AND INSTITUTIONS

Effective policies and institutions are important in order to prevent limited, sporadic, and ineffective cooperation on regional infrastructure. The study showed that Asia can learn from the experience of its own subregional programs as well as from other regions. The EU's experience, for example, showed that creating a framework for regional infrastructure cooperation often requires the active role of a third party to forge the convergence of interests. In Asia, this role could be filled by multilateral institutions such as the ADB. Conversely, Latin America's experience showed that a forum for dialogue and cooperation can help build awareness of the benefits of regional integration and infrastructure, filter out unproductive projects, improve coordination among various national and subnational agencies, and increase stakeholders'participation.

The study points out the importance of the establishment of a Pan-Asia Infrastructure Forum (PAIF) to help coordinate and integrate existing subregional infrastructure initiatives. PIAF would also bring together all the key stakeholders in the region, and develop harmonized standards based on international best practices. Within the PAIF, sectoral subforums could also be established (i.e., for transportation and energy) as well as subforums for soft aspects of infrastructure matters, (i.e., for regulatory and legal issues).

FINANCING REGIONAL INFRASTRUCTURE

Developing and financing regional projects is a slow and complicated process. Regional projects are usually a low priority for domestic policymakers. Concessional financing from external sources is sometimes necessary to make a project more economically and financially viable. Attracting private-sector investment in regional projects is particularly difficult due to the additional risks and uncertainties involved. Given the turmoil in global financial markets, it is unrealistic to assume that many cross-border projects in Asia will involve public-private partnerships. The region's vast domestic savings, including those accumulated in sovereign wealth funds, would be the main source of financing for Asia's massive infrastructure investment requirements. Asian governments must bolster their collective work to mobilize a large pool of regional savings for regional infrastructure investments. Strengthening national and regional bond markets—notably through vehicles such as the Asian Bond Markets Initiative and Asian Bond Funds—is one of the first steps in creating a viable source of infrastructure financing.

An Asian Infrastructure Fund (AIF) should be established to help mobilize Asian and global funds, and to prepare and finance "bankable" regional infrastructure projects. The AIF's capital could come from a variety of sources, including governments, sovereign wealth funds, multilateral development banks, and bilateral agencies. It should have a legal identity in order to help finance projects through its own resources as well as by issuing bonds or through cofinancing with other entities, including private investors. The AIF would help finance projects identified, agreed upon, and prioritized by the PAIF. The AIF could also provide grants and concessional financing in order to make regional projects financially

viable and bankable. It might also need to provide guarantees against major risks, such as operational, financial, country, and political risks.

THE WAY FORWARD

Investing in infrastructure should be a priority for the region's policymakers. It will help to boost growth and spread its benefits more widely, enhance the region's competitiveness, reduce poverty, and promote greater environmental sustainability. But it will be possible only with political leadership commitment and partnership at the highest level.

Source: ADB and ADBI (2009).

FINANCIAL REGIONALISM AND THE IMF: COMPLEMENTARITIES, CONSTRAINTS, AND TRADE-OFFS

The coexistence between regional financial arrangements, of varying structural degrees, and the IMF has been a feature of the IMF since it was first established (see box 3 for an early prototype of a regional financial arrangement). However, with the recent proliferation of regional arrangements and their increasing size and nature, at times in competition with the IMF, the consistency of such arrangements with the global financial architecture needs to be more closely scrutinized and assessed.

In the area of international trade, for instance, the provisions in Article XXIV of the General Agreement on Tariffs and Trade do, in fact, allow for such a review. Henning (2006) proposes that the IMF's Executive Board could possibly be the body in charge of reviewing the consistency of financial arrangements, although this implicitly assumes that the IMF's governance boasts the legitimacy necessary among its membership to carry out such a function.

Before determining the "who" and the "how" in the hierarchy of regional, plurilateral, and multilateral financial arrangements, however, one first needs to examine the comparative advantage, if any, of surveillance and lending activities at the regional level. With regard to surveillance, a regional framework can enhance knowledge and ownership among its members on account of a generally smaller, more homogeneous membership.[19] The regional perspective might also allow for a more effective engagement of country officials, making regional surveillance the closest thing to pure peer pressure, which would enhance learning and foster mutual trust.[20] Conversely, the close proximity of different countries' officials might backfire by turning peer pressure into peer solidarity—unlike with IMF surveillance, in which a near-universal membership diminishes the incentive among country representatives to "collude" in their assessment.[21]

As far as lending is concerned, the advantages of regional financial arrangements are the possibility of activating resources based on the need to preserve stability in a region or subregion and the fact that control over such a decision remains squarely in the hands of regional member countries. In contrast, in the case of the IMF, any lending decision must be approved by the majority of its global membership, which may have a different appreciation of the trade-offs and priorities. In the event that an entire region were to be truly at risk, however, one would need to ask if a regional arrangement would really be the most relevant instrument or if the homogeneity of the group and the regional shock would not instead require some form of multilateral coinsurance.

In any case, the coexistence between regional and global facilities should not be based on a competitive relationship, because this would only water down lending standards and the link between adjustment and financing. In Europe, for example, the IMF and European institutions have been working closely together. Greece is a particular case in point, where program design was a joint undertaking. Although this level of cooperation could prove more challenging in other circumstances, it does not change the fact that consistency must be ensured. In principle, a solution might even be for the IMF to lend to regional financial arrangements or institutions, though this would require significant changes to the IMF's legal framework.

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[19] See Henning (2010).
[20] For a comparative analysis of IMF and regional surveillance, see Lombardi and Woods (2008).
[21] An external evaluation did, however, find instances of such collusion in IMF surveillance. See IMF (1999).

Recently, the IMF has been working on modalities to provide short-term liquidity simultaneously to multiple countries whose economies could threaten the stability of the international financial system when hit by a systemic shock (see box 4). Although discussions are still ongoing among the membership, the effectiveness of this Global Stabilization Mechanism, if it were to be established, would greatly benefit from synergies with financial arrangements in those regions where they would be offered.

Box 3. The European Payments Union: An Early Case of Regional Financial Arrangements

The European Payments Union (EPU) was created in 1950 by the member countries of the Organization for European Economic Cooperation (OEEC). The EPU was a multilateral clearing system designed to eliminate trade barriers and to promote monetary integration among European countries (see Martinez Oliva 2003). (The Marshall Plan led to the creation of the OEEC to foster European recovery after World War II. The United States contributed $350 million from the Marshall Plan to the EPU; Eichengreen and Braga de Macedo 2001.)

The EPU rules were based on "multilateral surveillance and commitment, which are the main building blocks of cooperation" (Martinez Oliva 2003). In essence, this meant that each country's net balances were to be reported monthly to the Bank for International Settlements, the EPU's financial agent. Remaining balances were then consolidated, giving each member country a claim on the EPU as a whole rather than on individual countries.

Upon its establishment, each country received a quota equal to 15 percent of its total trade with the overall EPU area. The liabilities to the EPU were financed by credit, as long as they did not exceed 20 percent of a country's quota. If liabilities exceeded 20 percent, settlement had to be partly in gold. Settlements were based on a progressive rule "involving decreasing credits and increasing gold payments as the deficit grew" (Martinez Oliva 2003). In this way, "trade was multilateralized and its volume was stimulated by the availability of EPU credit lines" (Eichengreen and Braga de Macedo 2001).

The EPU was guided by a Managing Board composed of financial experts who reported directly to the Council of the OEEC. The Board could make policy recommendations and provide special credits and quota extensions to countries that, facing exceptional circumstances, exhausted their quota. The provision of exceptional assistance was conditional on the country's early adoption of adjustment policies (Eichengreen 2007). Thus, "financial assistance came with conditionality minimizing the scope for exploitation of creditors by debtors" (Eichengreen and Braga de Macedo 2001).

The EPU's members were bound by a Code of Liberalization, which was a formal program for dismantling trade barriers based on balance of payment considerations. According to Eichengreen (2001), "participants were required to reduce trade barriers by a given percentage of their pre-existing level, initially one half and then escalating to 60 and 75 percent." Oatley (2001) argues that by "1954 80 percent of intra-European trade had been freed from quantitative restrictions, and governments had begun to consider meaningful tariff reductions as well."

At the end of 1958, when it became feasible to restore the convertibility of currencies for current account transactions, the EPU was dissolved.

Box 4. The IMF and Global Financial Safety Nets

In March 2010, the IMF staff proposed a facility called the Multi-Country Swap Line (MSL) (see IMF (2010a). The MSL was a mechanism enabling the Fund to unilaterally offer liquidity lines to multiple countries simultaneously in systemic crises to prevent contagion. The offer would be made only to countries assessed to be systemic, in that their stability would help preserve confidence on the core of the global financial system. It would complement the role played by central banks and other institutions in that it was to help limit contagion stemming from a systemic shock. (According to IMF 2010a, when the recent financial crisis struck, it exposed gaps in the Fund's lending tool kit. Some countries, in order to meet their financial needs, sought other alternatives, such as swap lines from the U.S. Federal Reserve and precautionary loans from multilateral developments banks—i.e., the World Bank's Deferred Drawn-Down Option and the Asian Development Bank's Countercyclical Support Facility.)

After an initial discussion of the above-mentioned staff paper, many IMF Executive Board members had reservations about establishing an identified set of qualifying countries and expressed concern regarding the operational complexity of the MSL and its uncertain resource requirements. A follow-up IMF paper, "The Future Financing Role: Reform Proposals," proposed a Global Stabilization Mechanism (GSM) to be activated only in the case of systemic events (see IMF 2010b).

THE GSM AS A MECHANISM TO RESPOND TO SYSTEMIC EVENTS

Should a systemic event occur, the GSM would be set in motion and would proactively channel financial assistance to help countries cope with large-scale liquidity shortages. ("Systemic crises are virulent events where localized problems trigger panic responses by investors and set off chain reactions across asset markets and countries irrespective of their fundamentals"; IMF 2010b.)

The mechanism would be a Board-centered process, so as to assure members and the markets of the full support of the international community in responding to a systemic crisis. Activation would be determined by a Board decision that a "systemic event" had in fact occurred. Some of the potential elements of the GSM are described below.

1. Unilateral offer to approve financial assistance

   Circumstances under which the IMF would intervene
   The Board would be able to make a unilateral offer to approve Flexible Credit Lines (FCLs) for multiple qualifying countries that are systemic and that also meet the high qualification bar for FCLs. If a member country wished to accept the offer, it would notify the Fund to this effect, triggering a separate Board decision to confirm that the qualification criteria continue to be met and approve the arrangement on a lapse-of-time basis.

   Amount and terms or conditionality
   The offer would be for uniform access (in terms of percent of IMF quota), to avoid sending unintended signals regarding the relative strength of individual country policies and fundamentals. The offer would be available for only a limited period of time, to be specified in the Board decision activating the GSM. Generally, this would mean from 3 to 6 months, at the Board's discretion, with a presumption that the time frame would not be extended.

2. Short-Term Liquidity Line

2.1. Activation of SLL on Demand for Qualifiers Hit by Shock

Circumstances under which the IMF would intervene

The Fund could also establish a new Short-Term Liquidity Line (SLL) to be activated in case of systemic events with the facility being dormant during normal circumstances. The SLL would be limited to countries with fundamentals and policies sufficiently sound to qualify for the Precautionary Credit Line (PCL). The specific balance-of-payments (BoP) problem addressed by the SLL should be a temporary, short-term liquidity need resulting from the systemic shock in question. Establishment of the SLL would require a Board decision by an 85 percent majority of the total voting power. Once established, activation of the SLL in the context of the GSM would require a Board decision by a simple majority of votes cast.

Amount and terms or conditionality

The SLL (unlike the PCL) would not be subject to ex post conditionality. In this way, qualifying members would be encouraged to arrange liquidity support more quickly in a systemic event. An SLL arrangement would be approved for a period of six months, and could be renewed once by the Board at the request of the member country, provided the country continues to meet the qualification criteria and to experience the special BoP need addressed by the SLL. Access under SLL arrangements would normally be approved for amounts up to 500 percent of quota, though the Board could raise the cap, based on the size of the shock and provided sufficient resources are available to cover potential SLL commitments without undermining the confidence in the Fund's liquidity position. Reflecting its ex ante conditionality structure, the entire amount of access approved under the SLL arrangement would be made available upfront and would remain available throughout the arrangement period. Drawings on the SLL would have a repurchase period of 1¼ to 2 years.

2.2 Activation of Modified PCL on Demand for Qualifiers Hit by Shock

Circumstances under which the IMF would intervene

As an alternative to creating the SLL, the IMF staff proposed that the decision on the PCL could include a separate lending window that would be activated under the GSM and could be used to address non-precautionary/liquidity needs of PCL qualifiers. It could be used for both potential and actual BoP needs, to allow for an immediate drawing, subject to approval, if needed.

Amount and terms or conditionality

The new credit tranche window would not be subject to ex post conditionality. Its duration would be 6 months, renewable once, reflecting the short-term nature of the liquidity shock. Access would be in the amount of 500 percent of quota, but the Board could consider revising this level under the GSM, if so warranted by circumstances and resource availability.

FINANCIAL REGIONALISM AND THE UNITED STATES

The fact that the United States is not directly involved in the current drive toward financial regionalism, either in Asia or in Europe, does not mean that the country remains unaffected by it. The United States is the most important stakeholder in the international monetary system, due to the reserve currency status of the dollar, the size of its financial markets, and its preeminent position in the governance of the IMF, the multilateral institution mandated to oversee the international monetary system.

As was noted above, at the height of the recent international financial crisis, in Asia important members of the CMIM turned directly to the U.S. Federal Reserve, opting for bilateral lines of credit with the issuer of the international reserve currency rather than activating the support available under the regional arrangement. Had they opted for the latter, it is likely that the size of their withdrawals would have required a concurrent IMF program.

In Europe, as was also noted above, the IMF intervened in the Greek crisis through a joint EU-IMF program. The approval of this joint program, which gave Greece exceptional access to IMF financing, would have not been feasible without U.S. consent. More recently, the establishment of the European Financial Stability Facility and European Financial Stabilization Mechanism have openly foreshadowed the IMF's direct involvement in the event of another European sovereign crisis—which will give the United States yet another opportunity to affect the IMF's response.

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