

# Remaking the architecture: the emerging powers, self-insuring and regional insulation

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In the wake of the global financial crisis, the sheen may be wearing off the G20 leaders process. Advisers have begun to warn that the opportunity afforded by the global crisis to transform relations between the traditional powers and the emerging powers, push through needed reforms of the international financial institutions and implement the G20's plan to rebalance the world economy is being squandered. Frustration inside 'the 20' has been mounting over the slow pace of progress on global macroeconomic adjustments, prompting warnings of future crises and continuing low growth.

A sign of trouble was the letter sent by the leaders of the US, Britain, France, Canada and South Korea to 'the 20', which emphasized the 'need to design co-operative strategies and work together to ensure that our fiscal, monetary, foreign exchange, trade and structural policies are collectively consistent with strong, sustainable and balanced growth'.<sup>1</sup> Some analysts suggest, however, that the slow pace of progress has been due mainly to the G7 countries not demonstrating the necessary resolve in opening up the global summitry process or in relinquishing control over the major multilateral organizations.<sup>2</sup> The result, according to one close observer, is that the emerging powers have remained aloof from the global reform process, reluctant to support the financing needs of the global multilaterals and unwilling to go along with the IMF's efforts to tackle global imbalances; and that developing countries are turning towards national and regional financing options, to the detriment of global multilateral problem-solving.<sup>3</sup> They warn that an ambiguous new order may be emerging in which

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<sup>1</sup> Chris Giles and Alan Beattie, 'China reprimanded by G20 leaders', *Financial Times*, 30 March 2010, <http://www.ft.com/cms/s/0/a1e38f96-3c23-11df-b40c-00144feabdco,s01=1.html>, accessed 22 March 2010.

<sup>2</sup> See e.g. Sanjay Suri, 'G20: moving up BRIC by BRIC', *IPS News*, 4 Sept. 2009, <http://ipsnews.net/news.asp?idnews=48339>, accessed 22 March 2010; Ngaire Woods, 'Global governance after the financial crisis: a new multilateralism or the last gasp of the Great Powers?', *Global Policy* 1: 1, 2010, pp. 51–63.

<sup>3</sup> Woods, 'Global governance after the financial crisis'.

the global multilateral institutions will have a more limited role to play alongside emerging national and regional solutions.<sup>4</sup> Such predictions are reasonable. The failure of the existing governance system to prevent the recent global crisis has reignited memories of how new regional financial initiatives emerged after previous financial crises.<sup>5</sup> American monetary leadership has been called into question.<sup>6</sup> And a sizeable group of developing and emerging economies has built up large currency reserves over the past decade—a strategy that seems to have paid off during the recent global crisis from a national perspective.<sup>7</sup>

The pattern of interaction between the emerging and traditional powers on reforming the system of global governance, and the evolving economic statecraft of China and Brazil suggest that we are heading towards an international financial order that is more fragmented, where power is more diffused, and non-global arrangements play a more prominent role. This article offers two main findings.

First, the reserve accumulation of emerging countries is motivated by a complex set of systemic and country-specific factors, and the predominant approach that has been taken to dealing with the reserves and imbalances, which has focused on applying pressure for exchange rate adjustments, has not offered a credible multilateral alternative to self-protection. It has not come close to addressing the range of concerns that lie behind the self-insuring policies of developing countries or China's complicated mix of motivations for keeping large-scale reserves. In addition, the reaction of the emerging countries to the G7's continuing focus on macro-imbalances and exchange rates, the reticence about further expanding the use of special drawing rights (SDRs) as a global reserve asset option, and the IMF's limited governance reforms lead one to suggest that strong reliance on national reserve accumulation for financial crisis management is likely to continue.

Second, the significance of regional alternatives in the emerging architecture should not be overstated at this stage. It should be noted that the emerging countries of East Asia and South America turned quickly to unilateral national self-help and bilateral tools, rather than regional arrangements, to stabilize their economies in the face of the global crisis. Whereas national and bilateral solutions

<sup>4</sup> Woods, 'Global governance after the financial crisis'. For a similar prediction from the angle of international monetary relations, see the chapters by Benjamin Cohen ('Towards a leaderless world') and David Calleo ('Twenty-first century geopolitics and the erosion of the dollar order') in Eric Helleiner and Jonathan Kirshner, eds, *The future of the dollar* (Ithaca, NY: Cornell University Press, 2009), pp. 142–64, 164–90.

<sup>5</sup> See e.g. statements from the IMF and Asian Development Bank, as well as prominent think-tank analysis: John Lipsky, 'Asia, the financial crisis, and global economic governance', speech of the deputy managing director of the IMF to the Federal Reserve Bank of San Francisco Conference, 29 Oct. 2009, <http://www.imf.org/external/np/speeches/2009/102009.htm>, accessed 12 April 2010; Asian Development Bank, 'Global financial crisis and proposed ADB response', Jan. 2009, <http://www.adb.org/Documents/Others/in17-09.pdf>, accessed 12 April 2010; C. Fred Bergsten, 'A blueprint for global leadership in the twenty-first century', Peterson Institute for International Economics, 4 Nov. 2009, <http://www.iie.com/publications/papers/paper.cfm?ResearchID=1323>, accessed 12 April 2010; Peter Drysdale, 'East Asia and the global financial crisis', *East Asian Forum*, 25 Dec. 2008, <http://www.eastasiaforum.org/2008/12/25/east-asia-strategic-interests-in-fixing-the-global-financial-crisis/>, accessed 12 April 2010.

<sup>6</sup> Benjamin J. Cohen, 'The future of reserve currencies', *Finance and Development* 46: 3, Sept. 2009, p. 28.

<sup>7</sup> Ronald U. Mendoza, 'International reserve holding in the developing world: self-insurance in a crisis prone era', *Emerging Markets Review* 5: 1, 2004, pp. 61–82; Gregory Chin, 'China and the BRICs: state insulation and continuing rise', in John Kirton, Chiara Oldani and Paolo Savano, eds, *Global financial crises: national economic responses and geopolitical implications* (Aldershot: Ashgate, forthcoming 2010).

are already being prominently applied in managing the effects of the recent global financial crisis, it remains to be seen whether regional solutions will have a significant role in future crises. During the recent crisis, the most substantial advances in regional arrangements involved regional development banks taking on the role of providing temporary, crisis prevention financing to developing countries to enact countercyclical policies.

In the concluding section of this article I will synthesize the main findings and outline some global policy implications.

### **National reserves, imbalances and geo-economics**

All the states involved in the G20 process acknowledge that dealing with the large macro-imbalances in the world economy is important to longer-term global stability. At the meeting of the International Monetary and Financial Committee (IMFC) of the board of governors of the IMF in Istanbul in October 2009, the Fund was asked to 'assist the G20 mutual assessment by developing a forward-looking analysis of whether policies are collectively consistent with more sustainable and balanced trajectories for the global economy, and to prevent the reaccumulation of unsustainable global imbalances'.<sup>8</sup> The IMF was further asked to study and report on '*whether* there is a need for enhancing financing instruments and *whether* this can offer *credible* alternatives to self-insurance'.<sup>9</sup> The word '*whether*' hints at the scale of difficulty in brokering a new consensus on what is to be done about the reserve holdings, and about the imbalances between the trade surplus and deficit countries. The word '*credible*' alludes to the challenge of creating *institutionalized* incentives for countries to choose collective insurance over national reserves. For the G7, the hope is that the IMF can help address global imbalances by putting pressure on the emerging countries to reduce their currency reserves, through providing a multilateral alternative to national reserves, increasing its surveillance of exchange rate manipulation and enforcement of multilateral rules, and providing technical assistance to improve the financial regulatory regimes of the emerging countries.<sup>10</sup>

The reality is that national solutions will continue to have a prominent role in managing balance of payments and financial crises. Scholars of International Relations have long explained that nation-states are reluctant to cede a portion of their sovereignty to supranational institutions. Central banks have acted for many decades as lenders of last resort. The ability to access national solutions for financial crisis management will continue to be a 'core interest' of any state. The issue, for multilateralists, is to what degree the national solutions prevail over collective options, and whether it is possible to encourage states to shift a portion of their

<sup>8</sup> Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, 4 Oct. 2009, <http://www.imf.org/external/np/cm/2009/100409.htm>, accessed 5 April 2010.

<sup>9</sup> Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, 4 Oct. 2009 (emphasis added).

<sup>10</sup> Woods, 'Global governance after the financial crisis', p. 56.

self-protection to collective insurance. The data show, however, that in the wake of the recent global crisis the reserve holdings of the major emerging economies have increased. By the second quarter of 2010, China's reserves had climbed to US\$2.4 trillion, and Brazil's to US\$240 billion. Other emerging countries have followed suit by shoring up their reserves. Despite the high cost of maintaining large reserve holdings that generate capital losses, central banks throughout the developing world have continued to amass foreign currency reserves. The trend is set to continue, for reasons that will be outlined below.

### *Motivations for reserve accumulation*

The effort to convince emerging or developing countries to reduce their reserves in exchange for collective insurance would have to start with understanding why they accumulate such reserves. Research to date has focused on whether the major reserve holders are mainly trying to protect themselves against financial/currency crises or are stockpiling foreign exchange to manipulate exchange rates in order to achieve competitive advantages in trade and investment. The analysis that has tested the opposing hypotheses has concluded that 'self-insuring' motives generally outweigh 'neo-mercantilism' (although a few countries, among them China, Japan and Korea, are seen as holding suspiciously large reserves).<sup>11</sup>

Leaving aside for now the question of China, it is tenable to suggest that a number of the large reserve-holding developing countries, including Brazil, are motivated mainly by 'self-insurance' motives. The decision to self-insure is partially rooted in uncertainty about 'reserve adequacy' in an increasingly unpredictable global economy. The old standard of maintaining reserves to cover three months' imports no longer seems relevant in a world of capital mobility and frequent and costly financial crises.<sup>12</sup> The replacement formula, the Greenspan–Guidotti rule (that reserves should cover the stock of short-term debt), appears to have its own shortcomings, namely in the arbitrary and elusive definition of 'short-term'.<sup>13</sup> Developing states have come to understand that protection against balance of payments and financial crises requires more than just avoiding the supposedly 'bad policies' that make financial crises more likely. Experience has shown that financial crises can be avoided if a country has ample international liquidity and readily available lines of credit that allow it to correct external imbalances without having to rely on outside support.<sup>14</sup> To quote Brazilian President Luiz Inácio Lula

<sup>11</sup> Yung Chul Park and Charles Wyplosz, 'Emerging economies in East Asia: are they safe from future financial crises?', *IDS Bulletin* 38: 4, July 2007, pp. 7–28; Oliver Jeanne and Romain Ranciere, 'The optimal level of international reserves for emerging market countries: formulas and applications', IMF working paper WP/06/229, 2006; Joshua Aizenman and Jaewoo Lee, 'International reserves: precautionary vs. mercantilist views, theory and evidence', IMF working paper WP/05/198, Oct. 2005.

<sup>12</sup> Mendoza, 'International reserve holding', pp. 65, 66.

<sup>13</sup> Charles Wyplosz, 'The foreign exchange reserves build up: business as usual?', paper prepared for the workshop on 'Debt, finance and emerging issues in financial integration', United Nations Department of Economic and Social Affairs and Commonwealth Secretariat, London, 6–7 March 2007, <http://www.un.org/esa/ffd/events/2007debtworkshop/Wyplosz.pdf>, accessed 5 April 2010.

<sup>14</sup> Ariel Buira, 'Allocating special drawing rights to increase international financial stability', in Inge Kaul, Katell Le Gouvello and Mirjam Schnupf, eds, *Global public goods financing: new tools for new challenges* (New York:

da Silva: 'We know how to deal with the crisis, because we have taken preventive measures ... We did the homework at home when it was necessary and now we have reserves for this and other crises.'<sup>15</sup>

Distrust of the IMF and the World Bank among many developing countries has intensified the drive to self-insure. The impression has been that the Fund's prescriptions have been unhelpful, excessively intrusive and overly influenced by the goals of American policy-makers.<sup>16</sup> Officials of developing countries have noted that the Fund and the Bank have too often placed the onus of adjustment on developing countries without demanding much change from themselves or international financiers.<sup>17</sup> A related reason for large-scale reserve holdings among developing countries is development financing. The pro-cyclical 'bias' of the Bretton Woods institutions and foreign aid flows, as well as the volatile and pro-cyclical nature of private flows of international capital, have caused developing states to funnel a portion of their reserves to their own national development banks, to ensure that they have ready and sustained access to international liquidity to support their national development objectives.<sup>18</sup> The national development banks of the emerging powers have also started to provide development financing both to neighbouring states inside their home regions and to developing countries in other regions. Brazil's Banco Nacional de Desenvolvimento Econômico e Social (National Bank of Economic and Social Development, or BNDES) has provided a growing amount of financing to states in South America, the Caribbean and Africa (more details are provided below). The China Development Bank has provided large amounts of concessional financing to states throughout the entire developing world over the past five years.<sup>19</sup>

Scholars have examined whether it would be possible to persuade some of the large reserve-holding states to reduce the overall size of their national reserves and to accept an IMF alternative to national reserves if the international financial architecture could be sufficiently reformed to ensure that emerging and developing countries had access to ready, stable and more flexible supplies of capital from both official and private sources for the purposes of crisis management

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United Nations Development Programme, Office of Development Studies, 2002), pp. 75–6; Martin Feldstein, 'Self-protection for emerging market economies', NBER working paper 6907, Jan. 1999.

<sup>15</sup> 'Lula says Brazil not at risk despite global financial crisis', *Xinhua*, 6 Oct. 2008, [http://news.xinhuanet.com/english/2008-10/06/content\\_10154264.htm](http://news.xinhuanet.com/english/2008-10/06/content_10154264.htm), accessed 21 March 2010.

<sup>16</sup> Richard Higgott, 'The Asian financial crisis: a study in the politics of resentment', *New Political Economy* 3: 3, Nov. 1998, pp. 333–56; Paul Bowles, 'Asia's post-crisis regionalism: bringing the state back in, keeping the (United) States out', *Review of International Political Economy* 9: 2, May 2002, pp. 244–70; Joseph Stiglitz, *Globalization and its discontents* (New York: Norton, 2002).

<sup>17</sup> Developing countries were urged to adopt financial codes and standards to enhance transparency and access for market actors, but few corresponding obligations for disclosure by private financial institutions were called for, even on highly leveraged products such as hedge funds. See Stephany Griffith-Jones, 'International financial stability and market efficiency as a global public good', in Inge Kaul, Pedro Conceicao, Katell le Goulven and Ronald Mendoza, eds, *Providing global public goods: managing globalization* (New York: Oxford University Press, 2003), p. 439.

<sup>18</sup> Jose Antonio Ocampo, 'The instability and inequities of the global reserve system', *International Journal of Political Economy* 36: 4, Winter 2007–2008, pp. 71–86.

<sup>19</sup> Gregory Chin and Eric Helleiner, 'China as a creditor: rising financial power?', *Journal of International Affairs* 61: 2, Fall 2008, pp. 87–102.

and prevention.<sup>20</sup> However, easing access to financing and architectural fixes would only be part of the solution. The gridlock in the G20 process shows that, beyond these adjustments, and the provision of more money for the IMF or World Bank, a reduction in self-insuring would come about only if belief and confidence in the global financial institutions were strengthened: in particular, the perception that the institutions were actually capable of managing global finance in ways that could ensure that future financial crises would be minimized and contained.<sup>21</sup> The current efforts of central banks to create more effective national regulations and supervision of the financial service industry, and of the G20 members working internationally through the Financial Stability Board (FSB) to coordinate efforts across the national systems, are attempting to create such belief and confidence.

Most importantly, rebuilding confidence in the system inevitably requires fully tackling the issue of developing country representation in the major institutions, as well as the status and role of the emerging powers in decision-making. It is no secret that developing countries have felt that industrial countries and the interests of private market actors have been better reflected in international financial decision-making, particularly in the IMF, the World Bank and the Bank of International Settlements;<sup>22</sup> or that the emerging countries believe that the governance structure of the global multilateral institutions no longer reflects the changed balance of power. The issues of representation and the governance of these institutions need to be addressed in parallel with that of redefining their functions and operations.<sup>23</sup> Currently, the reform processes in these dimensions are not synchronized. Effective resolution of these issues is an unavoidable precondition for any serious effort to encourage the large reserve holders in the developing world to exchange a portion of their national reserves for a global multilateral alternative.

### *The China question*

China's reserve accumulation is more complicated than a simple case of self-insuring. Creating multilateral alternatives sufficiently credible to persuade China to seriously consider exchanging a portion of its reserves requires a more comprehensive geostrategic approach to the issue than has been undertaken to date. Such an approach would have to address four layers of motivations that lie behind the Chinese government's large currency reserves. Prominent Chinese economists have

<sup>20</sup> Ocampo, 'The instability and inequities of the global reserve system'; Griffith-Jones, 'International financial stability'.

<sup>21</sup> The experience of previous attempts to manage international financial crisis, and the previous effort of creating a 'new international financial architecture' just a decade ago, suggest that it is unrealistic to assume that regulators could prevent international financial crises from ever breaking out again in the future. For example, if part of the cause of the recent global crisis was the 'skill' of professionals in the financial industry in evading regulation, experience has shown that it is difficult for the regulators to stay one step ahead of the evaders. Regulators tend only to find out about regulatory evasion when a crisis breaks out, at which point they are functioning in a reactive mode. I thank Alistair Newton for this point.

<sup>22</sup> Ariel Buira, 'The governance of the International Monetary Fund', in Kaul et al., *Providing global public goods*, pp. 225–44.

<sup>23</sup> See Anthony Payne's article in this special issue.

acknowledged that the Chinese government has intervened heavily in currency markets, in order to 'sterilize' or offset its foreign exchange operations from large capital inflows and so maintain the semi-pegged or pegged exchange rate between the dollar and the renminbi (RMB).<sup>24</sup> Those who argue that China and other East Asian export-oriented economies are motivated by 'neo-mercantilism' and engaging in 'currency manipulation' see the accumulation of reserves as the other side of the coin of aggressive export-led development strategies, facilitated by systematic undervaluation of exchange rates. Others have also asserted that the reserves have been accumulated to encourage foreign investment.<sup>25</sup> The Chinese government has consistently repudiated that assessment, maintaining that they have intervened in currency markets only to maintain a stable exchange rate, and that minimizing currency volatility is key to maintaining stable growth, trade and development.<sup>26</sup> Some Chinese researchers also suggest that currency stability helps to maintain investor confidence.<sup>27</sup> However, the need to sterilize incoming capital flows in order to manage the exchange rate is only one consideration behind the accumulation of reserves—and it is a relatively recent consideration, given that China's reserves were modest during the 1980s and 1990s, growing dramatically (multiplying more than tenfold) only after 2003.

China's reserve accumulation has been motivated in part by self-insuring considerations similar to those of other developing countries.<sup>28</sup> However, 'reserve adequacy' is gauged in China according to a broader set of calculations than the usual criteria of a country's economic size (measured by GDP and trade), the possible effects of rising inflation on the value of its foreign exchange reserves, and how increases in world aggregate GDP affect the country's calculation of reserves to GDP. The management of China's currency reserves is one component in its national economic security and national defence calculations, and the calculation of currency reserve adequacy is one component within a broader regime of national reserves that also includes reserves of grain, energy and material supplies.<sup>29</sup>

<sup>24</sup> Yu Yongding, 'Ten years after the Asian financial crisis: the fragility and strength of China's financial system', *IDS Bulletin* 38: 4, July 2007, p. 32.

<sup>25</sup> Michael Dooley, David Folkerts-Landau and Peter Garber, 'Savings gluts and interest rates: the missing link to Europe', NBER working paper 11520, Aug. 2005; Jeffrey Frankel, 'On the renminbi: the choice between adjustment under a fixed exchange rate and adjustment under a flexible rate', NBER working paper 11274, Apr. 2005.

<sup>26</sup> The differences in this exchange rate debate ultimately come down to fundamentally differing views of the relative costs and benefits of differing exchange rate regimes, i.e. flexible, fixed and managed floating. China sees a managed floating exchange rate as providing the optimal balance of stability and responsiveness to market conditions in times of world economic stability, and reinstated a fixed exchange rate during the global crisis. Beijing does not support the paradigm of flexible exchange rates coupled with one nation's currency acting as the major global currency. However, it has become more willing of late to consider gradually expanding the band within which the renminbi can float—in other words, gradually allowing for greater flexibility in the exchange rate.

<sup>27</sup> Li Yang, 'China's foreign exchange reserve is enough', *Shanghai Securities News* (Chinese), 17 March 2006.

<sup>28</sup> China would be classified as an extreme case of self-insuring in that it has never accepted any IMF loans, and has consciously avoided doing so because of IMF conditionality.

<sup>29</sup> Author's discussions with Chinese think-tank and academic specialists. See also Fan Li, 'Macro-adjustment mechanism of national reserves in-kind' (Chinese), CASS policy paper (Chinese Academy of Social Sciences, Institute of Finance and Trade Economics), Dec. 2004.

Strategic planning in this 'grand reserve system' encompasses both crisis prevention and self-insuring considerations. Ensuring a stable supply of national reserves is seen as the underlying imperative for guaranteeing China's emergency preparedness. Chinese scholars note that the current national reserves system continues to exhibit the legacies of command-and-control planning, when national reserves were stockpiled 'in kind' and distributed according to administrative fiat. The challenge recently has been to devise reform measures to ensure that the reserve system can be adjusted adequately to meet the needs of China's 'socialist market economy'. Most importantly for the purposes of this article, Chinese strategists have been rethinking the interconnections between national reserves, market conditions and governmental administration. They are rethinking the appropriate role of government intervention in ensuring reserve supplies, in relation to market considerations. This adjustment includes allowing a greater role for demand/supply dynamics in determining 'appropriate' reserve holdings ('reserve adequacy'), but also devising measures for anticipating and managing market volatility. Chinese analysts are working on devising a 'macro-adjust mechanism' whereby China's national reserves can be managed more efficiently, in response to China's evolving conditions and changing world conditions, without endangering in any way the stability of the national reserves.<sup>30</sup> Keeping large currency reserves is one means of achieving this. At the same time, Chinese strategists are rethinking the conceptualization of 'reserve adequacy' and looking for ways to transfer an ever larger portion of the currency reserves into real assets, including through long-term commodity and energy supply agreements.

It should be noted that although the Chinese authorities believe that the 'grand reserve system' needs to be reformed, they remain steadfast in believing that a substantial level of national reserves is still needed to ensure national defence, economic security and social stability are protected. Nor are China's efforts to maintain national reserves, in a broader sense, unique: the US, Japan, India, EU countries and Russia also keep national reserves of a range of strategic items, including oil and gas. What this suggests is that any serious discussion about changing the reserve holdings of Great Powers would need to address the unique geo-economic considerations of those powers. Some of these considerations are about relative strengths; others are about relative vulnerabilities.

Chinese leaders have referred to such vulnerabilities during strategic crisis management discussions. They highlight the large (geological) country considerations that lie behind the grand reserve system, pointing out that China experiences major natural calamities every year, often including both flooding and drought in the same year, and recurrent earthquakes, and that a secure supply of national reserves must therefore be maintained to protect the country's economic security. They go on to emphasize that because of the country's large size in terms of both population and geography, those reserves must be large, and insist that ensuring that such national security needs are met is the Chinese

<sup>30</sup> See Fan, 'Macro-adjustment mechanism of national reserves in-kind'.

government's sovereign responsibility, and neither can nor should be delegated to any other country or institution.<sup>31</sup> In other words, in the view of the Chinese leadership, China's situation demands more emergency preparedness as a routine part of statecraft, and larger stockpiles of reserves, than most other countries. Holding large reserves of US dollars enables China to purchase international supplies when and as needed.

Geostrategic considerations also come into play in China's reserve accumulation in another sense. China shares the national developmentalist considerations that have motivated Brazil and other emerging economies to build up currency reserves. However, the PRC is not just another major developing country. Considerations stemming from the Cold War era continue to shape how the 'great democracies' relate to China, as well as Beijing's handling of its currency reserves. For Chinese leaders, lingering geopolitical concerns are reignited during each period of increased Sino-US tension. Yang Yingjie, a leading economics professor at the Central Party School, explains: 'Huge US dollar reserves can *deter* international speculators as well as foreign politicians who like to make threats about economic sanctions.'<sup>32</sup> It was just over a decade ago that the Chinese leadership had to provide support to Hong Kong to deter speculative attacks on the Hong Kong dollar. Sizeable national reserves also provided insulation while the Chinese government undertook successive rounds of banking reform after the financial crisis of 1997. Since 2005, large reserves have also provided reassurance to investors and trading partners as China has gradually internationalized the use of its currency. The reserves, in combination with capital controls, have thus been part of a *deterrence strategy* against potential attacks by private speculators or foreign officials on the Chinese (and Hong Kong) currency, and a means of protecting China's foreign trade and investment interests.

Any serious effort to encourage the major emerging economies, above all China, to reduce their reliance on national solutions in exchange for an IMF alternative will require action going far beyond the issue of the IMF's representational legitimacy crisis, giving the IMF more financial resources, or exerting pressure for exchange rate adjustments. It would have to address deeper geopolitical and geo-economic considerations, as well as the self-insuring and developmental concerns that motivate the large reserve holders. Assuming that China, Brazil, other emerging countries or the traditional powers would agree to such a discussion, it would involve negotiations and bargaining that explicitly address the links between the various sets of considerations and motivations behind reserve accumulation. To date, such a comprehensive strategic dialogue has yet to occur, and therefore the suggestion is that national solutions for dealing with financial crises—specifically large-scale reserve accumulation—will persist and potentially expand in the wake of the global crisis.

<sup>31</sup> Author's discussions with senior Chinese party and government officials, Beijing, 2004.

<sup>32</sup> 'Blessing or burden: \$1 trillion US dollar reserves spark debate in China', *People's Daily* (online), 15 Nov. 2006, [http://english.peopledaily.com.cn/200611/15/eng20061115\\_321713.html](http://english.peopledaily.com.cn/200611/15/eng20061115_321713.html), accessed 5 April 2010 (emphasis added).

Another factor that reinforces the persistence of national solutions is the response that China and Brazil (and Russia) have received to their calls for reform of the international monetary system. What is interesting is that these calls for more fundamental systemic reforms, as one way of dealing with imbalances and reserve accumulation, implicitly address geo-economic considerations. At various times during 2009, the 'BRICs' (Brazil, Russia, India and China) called on the international community to consider diversifying beyond the dollar as the de facto global currency and to take gradual steps towards developing SDRs into a supplemental global currency option. The BRICs (though India to a lesser extent) have made their suggestions through the G20/G8 process and the IMF, and discussed the idea at their own summit in Russia in June 2009. The most detailed explanation of the BRIC thinking on SDRs came in a speech by China's central bank governor, which asked what 'kind of international reserve currency we need to secure global financial stability and facilitate world economic growth', and answered that the world needs an international currency option 'that is disconnected to individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies'.<sup>33</sup> The governor's speech alluded to the seigniorage privileges of the United States in the current monetary order, and the implications for imbalances and the reserve accumulation of other states, especially in the developing world. The main message from China, Brazil and Russia was that it is in the world's interest to reform the international monetary system by strengthening and expanding the role of the IMF's SDRs as a global multilateral reserve asset option.<sup>34</sup>

The traditional powers, particularly senior British government authorities, also discussed the idea of expanding the use of SDRs with IMF officials in the lead-up to the London summit of April 2009. At the London meeting the G20 agreed to increase the amount of SDRs to the value of US\$250 billion, first through a special allocation, as a crisis management measure to deal with the global crisis, and second by increasing the general allocation of SDRs. The special allocation was implemented on 9 September 2009.<sup>35</sup> It increased members' cumulative SDR allocations by SDR21.5 billion, using a common benchmark ratio as described in the Fourth Amendment of the Articles of Agreement of the IMF, which became effective on 10 August 2009. The third general allocation of SDRs was approved on 7 August 2009 for an amount of SDR161.2 billion, and took place on 28 August 2009. However, the traditional powers (France excepted) have been reluctant to discuss more fundamental reform of the international monetary system, or further increasing the use of SDRs. To date, the G7 have continued to focus on exchange

<sup>33</sup> The Chinese and English versions of the speech can be accessed at the official website of the People's Bank of China: <http://www.pbc.gov.cn/detail.asp?col=4200&ID=279>, accessed 3 April 2010 and <http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178>, accessed 3 April 2010.

<sup>34</sup> Gregory Chin and Wang Yong, 'Debating the international currency system: what's in a speech?', *China Security* 6: 1, 2010. The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies, and SDRs can be exchanged for freely usable currencies.

<sup>35</sup> See IMF, 'Special Drawing Rights (SDRs): factsheet', International Monetary Fund, 31 Jan. 2010, <http://www.imf.org/external/np/exr/facts/sdr.htm>, accessed 5 April 2010.

rate adjustment. This pattern of engagement has reinforced the *political* gridlock in dealing with imbalances, when a change in strategy may be needed.

## **Regional solutions?**

Knowing the inefficiencies in maintaining large national currency reserves, developing states have considered regional options for insulating themselves against financial crises, such as collective pooling of reserves at the regional level. But has there actually been substantial progress in building regional alternatives to global institutions for dealing with financial crises, or regional complements to self-insuring? And to what extent could any such moves potentially 'threaten' the position of the IMF in the international architecture?

## *Emergency financing*

The Chiang Mai Initiative (CMI) in East Asia is often referred to as a key new example of regional emergency financing. There has been progress in regional institution-building in the East Asian financial realm since the onset of the crisis. In late February 2009, during the height of the global fallout, ASEAN+3 finance ministers (ASEAN plus China, Japan and Korea) unveiled their 'Action Plan to Restore Economic and Financial Stability of the Asian Region'. The plan stated that the CMI reserve pool would be expanded from US\$90 billion to US\$120 billion, and outlined the differing contributions of the respective member countries. Finance ministers also announced that an independent regional monitoring body would be established to carry out multilateral surveillance of the use of loans from the reserve pool. The monitoring body would help implement the decision to reduce the proportion of funds still subject to IMF review and approval from 90 per cent to 80 per cent, and study options for further reductions. In May 2009 the partners reached formal agreement to 'multilateralize' CMI.

The transformation of the CMI into a self-managed reserve pooling arrangement is dependent on further steps to adopt a collective decision-making procedure to activate the pooled funds; to allow currency swap-providing countries to provide prompt liquidity support to any parties in the CMI if there is an emergency; and to enact the legal modality of the institution (i.e. a legally binding single contractual agreement). The decision to graduate to 'CMI Multilateralized' (CMIM) was supported by Chinese leaders in various speeches. In his speech in September 2009 to the UN General Assembly, Chinese President Hu Jintao said that, since the outbreak of the global financial crisis, China had 'actively contributed to the building of an East Asian foreign currency reserve pool', and would 'continue with its efforts to promote regional monetary and financial cooperation, maintain financial and economic stability, and push forward financial cooperation and trade within the region'.<sup>36</sup> However, the actual willingness of the most

<sup>36</sup> The content of Hu Jintao's speech is cited in 'China to further assist developing countries', *China Daily*, 24 Sept. 2009, [http://www.chinadaily.com.cn/china/2009-09/24/content\\_8730895.htm](http://www.chinadaily.com.cn/china/2009-09/24/content_8730895.htm), accessed 2 April 2010.

powerful states in the region to abide by the multilateral commitments of CMIM is still to be seen. Moreover, the real capacity of East Asia's regional arrangements to actually manage financial crises, payments problems or currency attacks is still untested.<sup>37</sup> Key thresholds in multilateralizing the CMI still lie ahead, including reaching collective agreement on the 'conditionality' formula for CMIM loans and enacting the mutual surveillance commitments. Governments in the region would probably acknowledge that implementing mutual surveillance between regional neighbours involves delicate interstate and geopolitical considerations, and that sometimes it is easier to delegate such a politically sensitive duty to an international body, such as the IMF, that is far away. What all this suggests is that, while the ASEAN+3 have homed in on addressing the constraints on multilateral cooperation under the original CMI, the actual will to fully follow through, and the capacity of this regional arrangement to provide emergency financing, remain uncertain. At most, CMIM is at the 'rudimentary' stage of becoming an 'Asian Monetary Fund',<sup>38</sup> and for the present its primary significance lies in its providing the perception of a regionalized 'safety net' to maintain the confidence of international creditors.

During the recent global financial crisis, Latin America suffered much less severe effects than during previous crises in the 1990s. Most of the crisis-related lending in Latin America was for crisis prevention rather than emergency liquidity for crisis management related to payments or currency instability.<sup>39</sup> To what extent has there been progress in building regional options for short-term emergency financing in Latin America? The proponents of regional financial integration suggest that the Fondo Latinoamericano de Reservas (FLAR, or Latin American Reserve Fund<sup>40</sup>) performed well in providing short-term financing for crisis management during various episodes of crisis in the 1980s and the second half of the 1990s.<sup>41</sup> However,

<sup>37</sup> Hyoung-kyu Chey, 'The changing political dynamics of East Asian financial cooperation: the Chiang Mai Initiative', *Asian Survey* 49: 3, May–June 2009, p. 452. Some analysts emphasize that the designation of CMIM as a 'complementary liquidity funding mechanism within the framework of the IMF', and the fact that the remaining 80% of CMIM funds require IMF review and sign-off for release, illustrate the serious limits of this supposed 'regional' initiative. See Saori Katada, 'Politics that constrains: the logic of fragmented regionalism', EAI Fellows Program working paper 21, Oct. 2009, p. 9.

<sup>38</sup> For a similar assessment, see Zhang Ming, 'China's new international financial strategy amid the global financial crisis', *China and World Economy* 17: 5, 2009, p. 29.

<sup>39</sup> The IDB did provide debt relief lending to Haiti in 2009.

<sup>40</sup> What is now FLAR was originally created in 1978, as the Andean Reserve Fund, to serve the countries of the Andean Community. The fund has acted largely as a credit cooperative that uses different credit facilities to lend to members' central banks (in proportion to their capital contributions). FLAR has three main objectives: to provide balance of payments financial support for its member countries; to improve the terms for its members' reserves investments; and to encourage macroeconomic coordination between its members in their monetary and financial policies. See Jose Luis Machinea and Daniel Titelman, 'Less volatile growth? The role of regional financial institutions', *CEPAL Review* (UN Economic Commission for Latin America and the Caribbean [ECLAC]), April 2007, p. 16; Daniel Titelman, 'La cooperación financiera en el ámbito subregional: las experiencias de América Latina y el Caribe', in Jose Antonio Ocampo, ed., *Cooperación financiera regional* [Regional financial cooperation], *Libros de la Cepal* 91 (Santiago: ECLAC Publications, 2006).

<sup>41</sup> Machinea and Titelman, 'Less volatile growth?', p. 16. Proponents of Latin American financial regionalism further note that, over the past decade, loans from FLAR's regional reserve pool have been much larger than loans from the IMF, as many countries in the region have avoided IMF loans. According to one estimate, between 1978 and 2003 FLAR provided loans amounting to nearly 60% of the total amount of loans provided by the Fund (US\$4.9 billion from FLAR and US\$8.1 billion from the IMF), the great majority consisting of credits for balance of payments support and liquidity. See Titelman, 'La cooperación financiera en el ámbito subregional'.

FLAR's limitation is that it covers only a few countries of the region, specifically Bolivia, Colombia, Costa Rica, Ecuador, Peru and Venezuela. The largest economy in South America, Brazil, is not a member, and has kept at a distance. Brazilian reticence has also constrained the proposal for a 'Latin American IMF', the Bank of the South (BOS). The strong rhetoric of the Venezuelan government has drawn attention to this initiative; however, by the time of its official launch in late September 2009, the mandate of the bank had been narrowed to that of a 'project-finance bank' for the region. Its role has been confined to longer-term lending for 'development projects' in agriculture, energy, health care, infrastructure and trade promotion within the region; lender-of-last-resort emergency finance is not included. With this decision, the BOS joined an existing group of regional financial institutions that provide long-term development financing in the region, namely Corporación Andina de Fomento (CAF, or the Andean Development Bank), the Inter-American Development Bank (IDB) and the Argentine-led FONPLATA—as well as a number of relatively large national commercial banks such as Itau Unibanco and Banco do Brasil, whose lending has also been on the rise inside the region.

Brazil is key to any regional initiative in South America. Brasília, lukewarm about both FLAR and BOS, has directed its attention instead to resurrecting the Convenio de Pagos y Créditos Recíprocos (CCR, or Agreement on Reciprocal Payments and Credits). The CCR fell into neglect during the 1980s and 1990s.<sup>42</sup> However, steep falls in intra-regional trade during the global crisis prompted Brazil and Argentina to push for an increase in the total amount of trade that is guaranteed between central banks under the CCR agreement. In April 2009 the CCR's guaranteed coverage was accordingly enlarged from US\$120 million to US\$1.5 billion.<sup>43</sup>

One of the most significant multilateral developments in the region since the outbreak of the global financial crisis has been the return of the IMF. Prior to this, the majority of South American economies, benefiting from high commodity prices and growing currency reserves, had reduced their exposure to the IMF. By 2007 only two countries in the region (Peru and Honduras) had arranged new standby agreements with the Fund, and both were set to expire in early 2009. According to one estimate, Latin America's share of the total IMF loan portfolio fell from 80 per cent (of US\$81 billion) in 2005 to 1 per cent (around US\$700 million), at the start of the global crisis.<sup>44</sup> However, since the onset of the global crisis, a number of Latin American countries have reconsidered their relationship with the Fund, so that, having been pushed to the margins in recent years, the IMF

<sup>42</sup> The CCR has functioned since 1966, when it was created under the Asociación Latinoamericana de Integración (ALADI, or Latin American Integration Association). Of the 13 members of the association, 12 are subscribers to the agreement: Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela (Cuba is the exception). The CCR played a significant role in helping states in the region deal with payments crises and short-term liquidity crises after its creation and during the 1970s. See Jose Rocha, 'Brasil e Argentina vão elevar linha de crédito do CCR para US\$ 1,5 billion', *Valor Econômico*, 24 Apr. 2009.

<sup>43</sup> Jose Rocha, 'Brasil vai propor acesso de Cuba a mecanismo comercial da Aladi', *Valor Econômico*, 16 Apr. 2009.

<sup>44</sup> See Vince McElhinny, 'Global crisis is good news for IFIs in Latin America', Bank Information Centre, 9 Jan. 2009, <http://www.bicusa.org/EN/Article.11015.aspx>, accessed 2 April 2010.

has returned to the region. It has made new loans to Colombia and Mexico. The Argentinian government has agreed to reopen its door to IMF expert counselling and to have the IMF restart the 'annual revisioning' of the country's economy, though it has yet to decide whether to accept a new IMF loan. These new IMF loans are being made under a new flexible credit line, established at the behest of the G20 during the crisis, which reflects the rising influence of the major emerging countries and demonstrates how their interventions on IMF reforms have resulted in changes in the Fund's lending practices.

Brazil has left its imprint on financial cooperation in the region in another sense. As the crisis worsened, Brazil (and Argentina) reached not for regional but for bilateral tools to complement its domestic crisis management measures. The domestic package included a large fiscal stimulus estimated at 8.5 per cent of GDP;<sup>45</sup> tax cuts and direct government spending to help mitigate the effects of the global downturn; continued fiscal support for social programmes, expanded unemployment insurance, and low-income housing and other support.<sup>46</sup> It also involved injecting billions of dollars into the banking system, lowering reserve requirements, and reducing the key short-term interest rate many times (from 13.75 per cent to 8.75 per cent) to increase liquidity in the domestic economy;<sup>47</sup> authorizing state banks to purchase private banks; approving stricter accounting rules for derivatives; extending credit directly to firms through the BNDES and the central bank; exempting foreign investment firms from the financial transactions tax; and granting Unibanco, one of Brazil's largest banks, permission to procure a US\$60 million credit extension from the World Bank's International Finance Corporation to support trade financing.

In October 2008, during the early stages of the crisis, as an international protection measure Brasilia signed a bilateral 'payments system on local currency' agreement with its biggest trading partner in the region, Argentina. To shore up its major export markets and foreign exchange inflows, as well as its import capacity, the Brazilian government also signed a US\$30 billion 'temporary reciprocal currency arrangement' (swap line) with the US Federal Reserve in late October 2008,<sup>48</sup> and then negotiated another bilateral currency swap agreement with China, for an undisclosed amount and duration, during 2009. Argentina also announced a three-year currency swap agreement worth RMB70 billion (US\$10 billion) with China in late March 2009, which one Argentinian central bank official said 'should boost confidence. Even if none of this money is ever used, its mere existence should serve to boost confidence in the currency.'<sup>49</sup>

<sup>45</sup> Business Monitor International (United Kingdom), *Latin American monitor: Brazil*, Sept. 2009; Andre Soliani and Iuri Dantas, 'Brazil freezes 37.2 billion reais of 2009 budget', *Bloomberg*, 27 Jan. 2009, [http://www.bloomberg.com/apps/news?pid=20601086&ref=latin\\_America&sid=aBEtHVYj519](http://www.bloomberg.com/apps/news?pid=20601086&ref=latin_America&sid=aBEtHVYj519), accessed 18 April 2010.

<sup>46</sup> To accommodate its increased fiscal commitments, the Brazilian government reduced its primary fiscal surplus target from 3.8% to 2.5% of GDP, with a cost of worsening deficit and debt positions in the short term.

<sup>47</sup> UN ECLAC, *Economic survey of Latin America and the Caribbean, 2008–2009* (Santiago, Chile, July 2009).

<sup>48</sup> Press release of the board of governors of the Federal Reserve System, 29 Oct. 2008, <http://www.federalreserve.gov/newsevents/press/monetary/20081029b.htm>, accessed 25 March 2010. Other countries that signed bilateral currency swaps with the US during the global crisis included Mexico, Singapore and South Korea.

<sup>49</sup> Argentina could use the swap to pay for Chinese imports in renminbi, and China would accept pesos for Argentine imports. An Argentinian central bank official said the deal's main goal was to restore confidence in the

In East Asia, as states nervously watched the US subprime mortgage crisis deepen, they quickly arranged a new set of bilateral currency swap agreements, rather than reaching for the currency swaps that already existed under the CMI. South Korea arranged a one-year US\$30 billion currency swap with the US in October 2008, and followed up with a three-year currency swap of RMB180 billion (US\$26.3 billion) with China and a two-year US\$20 billion swap with Japan. Singapore signed a US\$30 billion currency swap with the US in October 2008, and followed up by arranging a swap with Japan.<sup>50</sup> From December 2008 onwards, China signed three-year currency swap agreements with seven trading partners, including Hong Kong (RMB200 billion, or US\$29 billion), Indonesia (RMB100 billion, or US\$14.6 billion), Malaysia (RMB40–80 billion) and Belarus (RMB20 billion, or US\$2.9 billion), along with Argentina, Brazil and South Korea. The Chinese swap agreements enable the partner countries to pay for Chinese exports in renminbi rather than dollars, while Chinese firms can pay for the goods from their trading partners in their respective currencies.

While the bilateral swap agreements were not insignificant to China in responding to the crisis, they were more important to China's trading partners. For China, the currency swaps were more about crisis prevention than emergency stabilization measures. China was not *directly* affected by the global financial crisis: the effects it felt were indirect, seen mainly in declining trade levels and foreign investment, falls in production, rising unemployment in export-related sectors and instability in real estate markets. The most important self-protection or self-help mechanism for Beijing was the US\$586 billion domestic stimulus package that it announced on 8 November 2008.<sup>51</sup> Controls on capital flows and significant reforms in China's banking sector undertaken since 1997 meant that this sector was largely insulated from the crisis. The relatively conservative investment strategies of the State Administration of Foreign Exchange (which administers the national currency reserves), the China Investment Corporation (a US\$200 billion sovereign wealth fund created in 2007) and state banks had kept their exposure to the troubled sub-prime US mortgage market low relative to their total investments.

In brief, the enduring reliance on national and bilateral measures rather than regional arrangements for emergency financing for dealing with payments and currency stabilization is duly noted.

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Argentinian government's ability to manage the value of the peso. See Taos Turner, 'China, Argentina agree to currency swap', *Wall Street Journal*, 31 March 2009, <http://online.wsj.com/article/SB123845815223971685.html>, accessed 25 March 2010.

<sup>50</sup> Japan also arranged swaps with India in 2007 and in 2005 negotiated a swap with Vietnam valued at US\$1 billion.

<sup>51</sup> *Xinhua News Agency*, 12 Nov. 2008. The domestic stimulus package focuses on infrastructure projects, affordable housing, rural infrastructure, water, electricity, transport, the environment, technological innovation and rebuilding areas hit by natural disasters, especially the areas affected the May 2008 earthquake. In addition to the stimulus spending, in October 2008 China's central bank also cut interest rates and the reserve requirement ratio of banks in order to help increase liquidity in the economy. Most significantly, this announcement was coordinated with similar announcements by the US Federal Reserve, the UK Treasury and central banks of other major economies lowering their benchmark interest rates.

### *Crisis prevention*

There has, however, been a noticeable advance in one type of regional solution for crisis-related financing since the global crisis: namely, the new lines of rapid financing that were established to support developing and low-income countries in enacting countercyclical policy. Scholars have noted that prior to the global crisis the Asian Development Bank (ADB) was already lending more than the World Bank inside the region, and the IDB and FLAR were providing more crisis-related financing in South America than the IMF.<sup>52</sup> The new temporary, rapid, countercyclical funding facilities that were created at the regional level represent an expansion of the role of regional development banks beyond longer-term development assistance and 'poverty reduction' programmes in Asia, Africa and Latin America.

At the London summit in April 2009, the G20 leaders instructed the IMF to greatly increase its emergency lending capacity in order to support the emerging economies and developing countries in preventing financial contagion, and agreed to triple the resources of the IMF to US\$750 billion. At the same time, the Fund was instructed to undertake a major overhaul of how it lends money by offering larger amounts and tailoring loans to countries' varying strengths and circumstances. This included introducing new, more flexible and more rapid funding facilities to meet the needs of developing countries. In London the G20 also set a target of more than doubling concessional lending to the world's poorest countries. Strong lobbying from the emerging states in the G20 led to agreement to support the recommendation of G20 Working Group 4 that multilateral development banks provide support to countercyclical efforts to offset capital flight and maintain demand by providing financing for fiscal expansion, support to social safety nets, trade financing, bank recapitalization and infrastructure investment in emerging markets and low-income countries.<sup>53</sup>

Most importantly for the focus of this article, the G20 leaders agreed in London to support an Indonesian proposal to devolve to the ADB the management of a portion of the new commitments to the IMF, to finance the adoption of flexible, fast-disbursing and front-loaded instruments that could provide rapid assistance to well-governed developing countries in Asia that were facing financing gaps because of the global crisis. With the G20's backing, the ADB rapidly introduced a new countercyclical instrument—the 'Counter-cyclical Support Facility'—to provide budget support of up to US\$3 billion to crisis-affected developing countries in Asia.<sup>54</sup> Beijing gave strong support to the proposal to enhance the ADB's role in such financing. At the Boao Forum for Asia in April 2009, China's central bank governor stated that the IMF had failed in its crisis prevention responsibilities and that 'regional institutions such as the Asian Development Bank could also alleviate

<sup>52</sup> Woods, 'Global governance after the financial crisis'.

<sup>53</sup> G20 Working Group 4, 'Final report: the World Bank and other multilateral development banks', March 2009, pp. 1–12.

<sup>54</sup> Asian Development Bank, 'Enhancing ADB's response to the global economic crisis: establishing the countercyclical support facility', ADB policy paper, May 2009, pp. 1–15.

the impact of financial crisis through increasing spending and boosting regional activities'.<sup>55</sup>

Regional development banks in other parts of the developing world quickly followed the ADB's example, and were also given a portion of the new funds committed to the IMF to establish new regional-level lending facilities to promote rapid countercyclical financing support within their regions.<sup>56</sup> The African Development Bank (AfDB) established a US\$1.5 billion 'emergency liquidity facility' to offer access to finance to a range of beneficiaries including middle-income countries and their central banks, public and private financial institutions, non-sovereign-guaranteed projects in danger of delay or failure of financing or refinancing because of the global crisis, and non-bank clients (which were already receiving assistance from other international financial institutions whose due diligence is similar to that of AfDB). The IDB established a US\$6 billion 'liquidity program for growth sustainability' to support its member governments' countercyclical efforts, which included providing financing to those domestic companies that were facing temporary difficulties in accessing foreign and interbank credit lines as a result of the financial crisis.<sup>57</sup> The IDB reported that it set record levels of loan approvals and disbursements in 2009 in providing such support to countercyclical policies.<sup>58</sup>

The changes described above appear to indicate a shift towards increased reliance on regional options for crisis-related lending. As IDB President Luis Alberto Moreno proclaimed: 'The political and economic maturity our region has displayed, as well as the response capacity of our governments and multilateral institutions such as the IDB, are proof that Latin America and the Caribbean can shape their own destiny.'<sup>59</sup> However, closer examination of the flows of development financing within the region leads one to be cautious, and to reserve judgement about the importance of regional multilateral lenders in Latin America. The reality is that a significant amount of development financing inside the region involves national banks. Large financial flows in the region are also managed by national governments. In a comparison of assets, the BNDES eclipses all other national lending institutions. In 2007 its assets totalled US\$14.07 billion. This placed it just slightly behind the IDB, whose assets amounted to US\$20.35 billion in 2007. The assets of Venezuela's BANDES are next at US\$4.56 billion, followed by those of CAF at US\$4.12 billion and FONPLATA at US\$415 million (2006). Figures for other supranational banks in the region in 2007 were: the Central American Bank for Economic Integration (BCIE) US\$1.63 billion; the Foreign

<sup>55</sup> 'China's central bank governor says IMF needs improvement', Xinhua.net (online), 18 April 2009, [http://news.xinhuanet.com/english/2009-04/18/content\\_11210468.htm](http://news.xinhuanet.com/english/2009-04/18/content_11210468.htm), accessed 7 April 2010

<sup>56</sup> I thank an Indonesian participant-observer at the G20 summits in Washington and London for sharing this information.

<sup>57</sup> Asian Development Bank, 'Enhancing ADB's response to the global economic crisis', p. 10.

<sup>58</sup> The IDB approved 165 new operations totalling US\$15.9 billion in 2009, up from US\$11.2 billion in 2008. Disbursements rose to nearly US\$12 billion, from US\$7.6 billion in 2008. See 'IDB, countering crisis, sets record for loans to Latin America', *Inter-American Development Bank News*, 29 Dec. 2009, <http://www.iadb.org/news/detail.cfm?language=EN&artid=6186&cid=6186>, accessed 5 April 2010.

<sup>59</sup> 'IDB, countering crisis'.

Trade Bank of Latin America (BLADEX) US\$612 million; and the Caribbean Development Bank (CDB) US\$506 million. The assets of all these financial institutions (minus the IDB) amounted to just over US\$27 billion, of which the BNDES constituted over 50 per cent.

Since the start of the global crisis, the BNDES has lent over \$15 billion to countries in the region. The bank has attached particular importance to supporting the regional integration of South American countries. Its president, Luciano Coutinho, has emphasized that the countries of the region need to intensify their integration efforts in order to mitigate the effects of the global crisis on their economies, and that the preservation of Latin America's growth is crucial to the balance of the world economy.<sup>60</sup> In August 2009, the BNDES opened its first branch office in South America in Montevideo (Uruguay): this will enable Brazilian companies to get closer to local companies and local government to help boost business and, according to the BNDES, will help reduce disparities within the Mercosur trade bloc.<sup>61</sup> BNDES senior executives note that 'the Bank will make greater efforts to expand commercial interchange among Latin American countries, and also support infrastructure projects with direct regional impacts'.<sup>62</sup> The commercial reality is that the BNDES plays a crucial role in export financing for Brazilian goods and services and for direct investment abroad by Brazilian companies. Between 1997 and 2009 the bank disbursed US\$4.8 billion in credit for goods and services exports in South America.

While the rising tide of international financing within the region, both crisis-related and longer-term developmental, does signal diversification in the number of financial providers on terrain traditionally dominated by the World Bank, the Bank has not merely stood still, watching the advance of regional alternatives. Since the outbreak of the global crisis, and as a result of the international credit squeeze, the Bank has been able to re-enter South America. It has done so with the support of national governments in the region, including that of Brazil, to arrange new financing packages. The World Bank recently arranged US\$4 billion in new loans to Brazil, including a three-way loan for Brazil in partnership with the IDB and the BNDES. A number of Central American countries have also recently signed new loans with the Bank, including Costa Rica, El Salvador, Mexico and Colombia. According to Marcelo Giugale, director of the World Bank's programmes for economic policy and poverty reduction in Latin America and the Caribbean, the Bank had plans to provide US\$13 billion in new loans to the region in 2009.<sup>63</sup>

There is a lot of room for providing more stable, flexible and readily available development financing to the developing world, especially for supporting countercyclical policy, beyond crisis scenarios. This is not a zero-sum game: the

<sup>60</sup> 'Coutinho highlights the importance of regional integration in a meeting held in Argentina', BNDES website, 31 Oct. 2008, [http://inter.bndes.gov.br/english/news/not196\\_08.asp](http://inter.bndes.gov.br/english/news/not196_08.asp), accessed 22 March 2010.

<sup>61</sup> 'BNDES reinforces internationalization by setting up office in Montevideo', BNDES website, 27 Aug. 2009, [http://inter.bndes.gov.br/english/news/not103\\_09.asp](http://inter.bndes.gov.br/english/news/not103_09.asp), accessed 22 March 2010.

<sup>62</sup> 'BNDES reinforces internationalization'.

<sup>63</sup> McElhinny, 'Global crisis is good news for IFIs in Latin America', accessed 2 April 2010.

various key financial institutions, regional and global, could all see increases in their lending. In particular, more financing from a range of development banks to support countercyclical fiscal and macroeconomic policy (rather than simply temporary crisis lending) would help developing countries to overcome the significant constraints they have faced in undertaking countercyclical policies as a sustainable growth strategy.<sup>64</sup> One potential benefit from such increased multilateral lending could actually be a reduction in the incentive for developing countries to self-insure.

## Conclusion

The analysis presented above highlights three points. First, the accumulation of reserves by emerging countries is motivated by a complex set of interconnected global, systemic and country-specific factors, and the predominant approach to dealing with the reserves so far, which has focused on applying pressure for exchange rate adjustments to fix imbalances, is not likely to achieve the desired results. The motivations for reserve accumulation include self-insurance, and beyond that encompass a range of national developmental and geo-economic considerations. These factors, combined with the limited interest that the traditional powers have shown in the proposal to expand the global currency function of the SDR and the limited reforms of the global multilateral institutions, suggest that we are likely to see continued heavy reliance on national reserve accumulation for the purposes of protecting countries' balance of payments, currency stability and ability to manage financial crises.

Second, although the significance of regional institutions in the emerging architecture is expanding, their potential role should not be overstated for the immediate future. The most significant advances in regional solutions that have come in the wake of the global crisis have been in crisis prevention financing—especially in providing countercyclical financing support to developing and low-income countries to ward off the effects of the global crisis—rather than in emergency lender-of-last-resort financing for balance of payments crises or currency stabilization. Such gains in financial regionalism as have been made affect the realm of the World Bank more than that of the IMF itself. It should further be noted that when the global financial crisis began to destabilize the emerging countries of East Asia and South America, they turned quickly not to regional arrangements but to unilateral and bilateral tools. Whereas national and bilateral solutions already play a major role in international financial crisis management, it remains to be seen how much of a role regional solutions will play in the future.

In East Asia since the global crisis, regionalized cooperation on short-term emergency liquidity support has moved beyond 'symbolic benefits' or a 'hedging

<sup>64</sup> Jose Antonio Ocampo, 'A broad view of macroeconomic stability', in Narcis Serra and Joseph Stiglitz, eds, *The Washington Consensus reconsidered: towards a new global governance* (New York: Oxford University Press, 2009), pp. 63–94.

tactic'.<sup>65</sup> However, there is still a long way to go before we can declare that the regional arrangements that aim to provide emergency lender-of-last-resort financing pose a 'threat' to the IMF. We have seen that since the onset of the global crisis the IMF and the World Bank have re-entered some regions, after having seen their presence decline over the previous decade. At the same time, developing countries are turning increasingly to the ADB and an assortment of regional development banks in Latin America and Africa for crisis management support as well as longer-term development financing. The regional development banks have also taken on an important role in helping to insulate the economies of their regions against possible contagion effects of international financial crises from elsewhere. These findings suggest that we are in the middle of a period of transition to a more diverse and multitiered global financial and monetary system.

Third, a reformed IMF could play a role in helping to reduce self-insuring activity, and may continue to have a significant role to play as a lender of last resort for the foreseeable future. However, this will require the legitimacy of, and confidence in, the Fund to be built up among developing and emerging countries. This is likely to happen if the global consensus on financial crisis management policies and development lending practices in general continues to evolve in the direction of policy that actually meets the needs of developing countries; if the major multilateral organizations undergo fundamental governance reforms to give adequate voice to developing countries and better reflect the changing balance of international power; and if a new consensus can be reached between the traditional and emerging powers on how to address the imbalances.

There is one regional wild card that could change the balance in the global architecture: Europe. It is not so much southern regionalism as the recent talk of a 'European Monetary Fund' that is complicating the emerging trends.<sup>66</sup> Europe has the capacity to establish such a regionalized emergency funding mechanism. EU members are working on the basis of an established monetary union and an existing regional central bank. European monetary union was arguably strengthened in the course of dealing with the global crisis. In response to the worsening financial predicament of Greece, and with an eye to other southern European countries, the college of 27 commissioners is now talking about a potential European fund and plans for 'reinforced economic policy coordination and country surveillance'.<sup>67</sup> EU spokespeople state that there is clear will within the euro-zone member states and the European Central Bank to learn lessons from what happened and to take measures. In addition to being useful for crisis management, a new European Monetary Fund or EMF could also be a useful tool for diplomatic face-saving. It could allow EU members to agree to reduce their level of representation within the IMF while simultaneously demonstrating that they have the political will and

<sup>65</sup> Jennifer Amyx, 'Regional financial cooperation in East Asia since the Asian financial crisis', in Andrew MacIntyre, T. J. Pempel and John Ravenhill, eds, *Crisis as catalyst: Asia's dynamic political economy* (Ithaca, NY: Cornell University Press, 2008), p. 122; William W. Grimes, *Currency and contest in East Asia: the great power politics of financial regionalism* (Ithaca, NY: Cornell University Press, 2008).

<sup>66</sup> Andrew Willis, 'European Monetary Fund to launch by June', *Businessweek*, 9 March 2010, [http://www.businessweek.com/globalbiz/content/mar2010/gb2010039\\_054891.htm](http://www.businessweek.com/globalbiz/content/mar2010/gb2010039_054891.htm), accessed 5 April 2010.

<sup>67</sup> Willis, 'European Monetary Fund to launch by June'.

economic capacity to establish their own regional monetary fund.<sup>68</sup> Such a move by Europe could have a catalytic effect in motivating other regions to take similar measures.

### *Global policy implications*

To date, the G7 (minus France) have not offered publicly to discuss fundamental reforms of the international monetary system within the G20 process. Nor has it offered to discuss further steps to expand the use of SDRs as a bargaining chip to create more space for negotiations on exchange rates and imbalances. A key factor that will influence any shift in negotiating strategy will be how the Obama administration's economic team read the international financial and economic predicament that the US is facing. For example, to what extent is the overriding concern of the US Treasury still to defend America's long boom against foreign incursions? This was the top priority for the US from the 1994 Mexican currency crisis through the crises that followed in Thailand and the Asian region and eventually the crises in Brazil and Russia. Clarity is needed on whether, or to what degree, the Geithner–Summers–Volker team has since adjusted America's macroeconomic and geo-economic strategy. With global recession receding, and the US economy apparently having made the turn to recovery, there will be a great temptation to focus mainly on containing the effects of the global crisis rather than thinking about more fundamental changes.

However, achieving any degree of substantial progress on collective insurance, that is, on reducing national reserve accumulation and systemic imbalances, is likely to require a new accommodation to be forged between surplus and deficit countries. Putting pressure on exchange rates will not be enough, and will be met with growing resentment, even if there are minor adjustments along the way. All governments in the G20 can agree that excessive international financial and trade macro-imbalances are a problem that a global steering committee should address.<sup>69</sup> But a new consensus must be brokered on how. Tackling excessive reserve holding is part of the solution, but only a part. It is symptomatic of deeper systemic incoherence.

The ability of the IMF to play some role in such negotiations will depend on the degree to which its organizational reforms enhance its legitimacy, and on its capacity and willingness to broker tradeoffs to help resolve the dispute. One step could be to redirect the discussion into quantifying *acceptable* reserve levels: that is, to determine the upper limits of reserve holdings for individual countries on the basis of a range of criteria, including their particular developmental, crisis management and emergency preparation needs, measures for anticipating risks in the global economy and the commensurate national impacts. Experience has shown that the formula of covering 'three months of imports' is no longer

<sup>68</sup> I thank Avinash Persaud for highlighting this point.

<sup>69</sup> On the distinction between the G20 as a global crisis committee and as a global steering committee, see Andrew Cooper's article in this special issue.

adequate. Nor is the new formula that focuses on covering 'short-term debt' politically acceptable to many emerging countries. The goal could instead be to reach a new consensus on reserve levels that are adequate, reasonable and politically acceptable among the IMF membership. The price for achieving this would probably be agreement by the US and its close allies to support the discussion of concrete steps for further increasing the use of SDRs.

The above points lead one to question the utility, in addressing the reserve holdings of Great Powers, of the G20 process as opposed to a 'new Yalta' or new G5 format, and also the coexistence of smaller and larger 'G-type' meetings, with all the coordination that is needed between them. Assuming that the Great Powers would agree to such a small group meeting, the advantage of a Yalta-type dialogue would be that the smaller group of geo-economic powers could focus on negotiating a 'grand bargain'. This type of negotiation would require significant confidence-building measures, and cross-verification of data and information. The challenge in hosting a Yalta summit in current circumstances is that the current Great Powers (including the US, China, Russia, Japan and the EU) would not have the 'benefit' of clarity on the hierarchy of international power which usually results from a great war. Nor would they be able to draw on the added momentum for grand strategic vision that runs high during periods of war, fuelled by wartime propaganda.<sup>70</sup>

While comprehensive negotiations on national currency reserves and imbalances may sound far-fetched to some, particularly in dealing with China, it is useful to note that there is a precedent for similar negotiations with China in the recent past. The WTO negotiations over the level of domestic agricultural subsidies that would be compatible with China's accession into the global trading regime were based on reaching a new consensus on the Chinese government's national food security policy, particularly the level of national self-sufficiency in grain that China could maintain. In response to the new accommodation that was struck, the Chinese authorities adjusted the country's national grain reserves system.<sup>71</sup> The WTO negotiations concerned quantifiable subsidy limits. Although ensuring strict compliance on multilateral agreements is always a challenge, these negotiations did lead to a new accommodation and international accountability measures. In brief, this article has suggested that the formulation of credible options for reducing China's reserves or Brazilian self-insuring in exchange for an increased measure of collective insurance will require the reserve accumulation issue to be considered in relation to the larger question of systemic reform.

Finally, the discussion above has also shown that although we may be heading towards a world of less centralized global governance, it is not a world in which international governance is absent. Even if we are heading towards a global scenario in which the IMF or the World Bank does less than before, and regional

<sup>70</sup> See Eric Helleiner's article in this special issue.

<sup>71</sup> Li Ping, 'Foreign capital and food security in China, part 1', *China Economic Observer* (Chinese), 9 Sept. 2008; author's discussions with officials of the Canadian Grain Commission and China's State Administration of Grain, Beijing, 2001, 2002.

### *Remaking the architecture*

arrangements do more, there can still be multilateral and international coordination, though it would involve a more diverse group of institutional players and international arrangements. Some analysts may see hopeful possibilities in a less centralized global system. However, it should be remembered that a more diffused global order could also degenerate into a more fractured, fragmented and divisive international order. In the transition to a multipolar order, it would be important to ensure that a sufficient level of interstate and transnational coordination could still be provided for within a more diffused structure of global governance, in order to avoid any escalation of tension into interstate conflict, and to facilitate stable and sustainable growth.