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Regional Financial Cooperation: Experiences and Challenges

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The period following the 1997 Asian crisis generated an extensive discussion on the international financial architecture. The debate made clear that there is an undersupply of services by international financial institutions that has become more glaring as a result of the growing economic linkages created by the current globalization process. The associated "global public goods" that are being undersupplied include adequate mechanisms for preventing and managing financial crises, as well as for guaranteeing global macroeconomic and financial stability. The debate also underscored the fact that private international capital markets provide finance to developing countries in a highly procyclical way, effectively reducing the room for maneuver of developing countries to undertake countercyclical macroeconomic policies. Finally, the debate emphasized that international capital markets squeeze out many developing countries, particularly the poorest among them, from private global capital markets.

The possible role of regional institutions in providing these services was underestimated in the debate on how to improve global financial arrangements.

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It was, indeed, absent in major northern reports[1] and from the views of international financial reform coming from the Bretton Woods institutions (for example, in the reports on international reform presented by the International Monetary Fund [IMF] to the Interim Committee and its successor, the International Monetary and Financial Committee). It was also given at best a passing reference in major academic analyses of reforms of the international financial architecture.[2] There was even open opposition to regional arrangements, particularly to the 1997 Japanese proposal to create an Asian Monetary Fund, although this idea was revived in 2000 in the form of the Chiang Mai Initiative among the Association of Southeast Asian Nations (ASEAN) countries, plus China, Japan, and the Republic of Korea.

There were obviously exceptions to this rule. Among the many reports, that of the United Nations stands out for its defense of the potential role of regional financial arrangements in an improved international financial architecture.[3] Strong defenses of regional financial arrangements were also made by Percy Mistry, José Antonio Ocampo, and the Emerging Markets Eminent Persons Group convened by the Ford Foundation.[4] Regional and subregional development banks have been given greater attention.[5] As already pointed out, after the crisis Asia took the most important steps forward,[6] while the Economic Commission for Latin America and the Caribbean (ECLAC) provided a strong defense of the role of regional financial arrangements in Latin America and the Caribbean.[7]

The lack of adequate attention to regional financial arrangements was surprising in at least three ways. First, it is evident to all observers that the new wave of globalization is also one of "open regionalism." Second, postwar Western Europe is widely recognized as a successful example of regional financial cooperation, which in the financial area encompasses a history that extends from the creation of the European Payments Union and the European Investment Bank (EIB) in the 1950s to a series of arrangements for macroeconomic coordination and cooperation that eventually led to the current monetary union among most members of the European Union. Third, regional development banks have been recognized as an important part of the world institutional land-

1. See, for example, Council on Foreign Relations (1999) and Meltzer and others (2000).
2. Eichengreen (1999); Kenen (2001).
3. United Nations (1999).
4. See Mistry (1999); Ocampo (1999, 2002, 2003); and Ford Foundation (2001).
5. See Bezanson and Sagasti (2000); Culpeper (1997); Birdsall (2001); and Sagasti, Bezanson, and Prada (2005).
6. See Park and Wang (2000).
7. See United Nations, ECLAC (2002a) and Agosin (2001)

scape since the 1960s. In the developing world, there are also several experiences with "developing-country-owned" multilateral development banks,[8] regional payments agreements, at least one successful reserve fund, and a few monetary unions. These experiences coincide in several ways with those of regional and subregional trade agreements, with undoubtedly a mixed history in both cases.[9]

Reflecting the lack of adequate attention to this issue, there is no book or report that makes a comparative evaluation of experience with regional financial arrangements. This book aims to fill this important gap. The different forms of financial cooperation are clustered into two groups: (1) development financing, the area where there is more extensive experience, including novel ideas, such as the Asian initiatives to strengthen regional bond markets, and (2) mechanisms for macroeconomic and related financial cooperation (liquidity financing during balance-of-payments crises), which include mechanisms of policy dialogue and peer review, and more elaborate systems of macroeconomic surveillance and policy consultation or coordination; reserve funds and swap arrangements among central banks; and, in the most developed form, monetary unions. Two additional forms of cooperation that belong to the second cluster are regional payments agreements and cooperation in the area of prudential regulation and supervision of domestic financial systems. This study makes only passing reference to them. It should be emphasized that, although our central aim is to explore the potential service that regional financial cooperation can make to developing countries, the experience with such cooperation in Western Europe is used as a benchmark.

This chapter provides an overview of a set of relevant experiences with both forms of regional cooperation and links the comparative evaluation of these experiences with the broader debate on international financial reform. In this regard, it looks not only at the advantages of regional financial cooperation in comparison with global arrangements, but also at its revealed shortfalls and, equally important, at the possible complementarities between regional and global institutions. The chapter is organized into six sections, the first of which is this introduction. The next two sections provide the case for regional financial arrangements and analyze some of the challenges they face. The fourth and fifth sections look at major experiences with regional cooperation in the areas of development financing and macroeconomic cooperation respectively. The last draws some conclusions.

8. This chapter uses the term "developing-country-owned" to denote multilateral development banks that do not have any capital from industrialized countries (although they may have capital from relatively rich oil-producing countries).

9. See the analysis of the different experiences of regional cooperation in the series of books published by the Forum on Debt and Development (FONDAD) in the 1990s. See, in particular, Mistry (1996) and Teunissen (1998).

The Case for Regional Financial Institutions

Several arguments can be made for a more active use of regional financial arrangements to strengthen the international financial architecture. This chapter groups them into four major arguments.[10] The first relates to the fact that, as already pointed out, the current globalization process is also one of open regionalism. Intraregional trade and investment flows have deepened as a result of both policy and market-driven processes of regional integration.[11] This process is, of course, uneven, being clearly stronger in Western Europe, East Asia, and North America and much weaker in other parts of the world, particularly South Asia. However, even in regions that have lagged behind, a web of regional initiatives has played an important role in reshaping the world economic system since the early 1990s. In addition, since the 1980s the contagion effects of financial crises have also had important regional dimensions. As a result of all these processes, macroeconomic linkages among countries and the externalities generated by national macroeconomic policies on neighbors have increased.

A stronger case can thus be made than in the past for policies and institutions that build regional defenses against financial crises and explicitly internalize the effects of domestic macroeconomic and financial policies on regional partners. In this regard, regional reserve funds and swap arrangements can serve as a first line of defense against crises. In turn, macroeconomic dialogue or stronger forms of regional surveillance and policy consultation could internalize, at least partially, the externalities that national macroeconomic policies have on regional partners. Furthermore, the effectiveness of national macroeconomic policies may be enhanced (or reduced) by the credibility generated by the willingness (or refusal) of regional partners to support a specific country.[12] A complementary argument is that, in a world where the room for maneuver of national macroeconomic policies has become more limited, the regional arena has become crucial for exercising what remains of macroeconomic policy autonomy. On the contrary, macroeconomic policies that take into account only domestic considerations (as has been traditional in IMF programs) may be said to contribute to

10. See complementary arguments in Culpeper's contribution to this volume. He differentiates between cooperative motives and the need to remedy the incomplete set of international institutions.

11. The first refers to the web of regional, subregional, and bilateral trade agreements that have generated the "spaghetti bowl" of current trade agreements. The second is used in the analysis of East Asia to refer to a process that was largely driven by investment and trade in intermediate goods for the production of manufactures for the world market—following the "flying geese" pattern that has been reshaped in recent decades by the irruption of China into global markets.

12. Mistry (1999).

the contraction of regional trade and to encourage competitive devaluations that effectively compound contagion.

Growing regional linkages also mean that there is a role for regional development banks or other mechanisms to support investments in regional infrastructure and other "regional public goods." Indeed, the limited financing for "regional public goods" in current development cooperation has led Birdsall to claim that the underfunding of regionalism is one of the major problems of current international arrangements.[13] Classical risk-pooling arguments also enhance the potential role of regional and subregional development banks. An advantage of all these mechanisms is that information asymmetries may be smaller at the regional level, and that the mix of peer pressure and the strong sense of ownership of regional institutions may reduce the risks that these development banks face, and have positive effects on investment and the financial development of members of a regional club.

Similar arguments can be made for cooperation in developing the financial infrastructure to support domestic financial development and to expand regional capital markets. Regional mechanisms can also play a role in supporting national systems for the prudential regulation and supervision of domestic financial systems, including the adaptation of international standards to regional conditions, or even in setting special regional norms (for example, in the developing world, on maturity and currency mismatches in the portfolios of financial institutions). In all of these areas, regional cooperation can help to reduce learning costs and help countries share the experience of institutional development.

According to the second argument, the heterogeneity of the international community implies that world and regional institutions can play complementary roles, following the principle of subsidiarity that has been central to European integration. The need to fill the gaps in the world's current highly incomplete international financial architecture makes this role even more important, as Roy Culpeper argues in this volume.[14] Furthermore, some of the services provided by international institutions may be subject to diseconomies of scale, and it is unclear whether others have large enough economies of scale to justify single international institutions in specific areas. In particular, regional and subregional institutions may be better placed to capture and respond to specific regional needs and demands. The diverse portfolios of existing multilateral development banks are tailored to the specific needs of countries in the regions

13. See Birdsall (2006).
14. See also Sakakibara (2003).

where they operate, and they are also capable of operating successfully on very different scales.

In the same vein, macroeconomic surveillance and consultation at the world level are necessary to guarantee policy coherence among major countries, but they are inefficient for managing the externalities generated by macroeconomic policies on neighbors in the developing world (or even within Western Europe). Thus, while the IMF should play a central role in macroeconomic policy coordination at the global level,[15] there is plenty of room for regional and subregional processes of a similar nature. Also, although regional and international contagion implies that the role of the IMF should be to manage the largest balance-of-payments crises, regional funds could actually provide full support to small and medium-sized countries during crises.[16] Indeed, the rising concentration of balance-of-payments support on a few countries indicates that there may be biases in the response of global financial institutions according to the size of countries.[17] Thus, an argument can be made for a division of labor in the provision of financing between world and regional organizations, with the latter assuming a greater role in the support of smaller countries.

The third is an argument for competition, particularly in the supply of services to small and medium-sized countries. Owing to their small size, the power of these countries to negotiate with large organizations is very limited, and their most important defense is therefore competition in the provision of financial services. For these countries, access to a broader menu of alternatives with which to finance development or to manage a crisis may be relatively more important than the "global public goods" that the largest international organizations provide (such as global macroeconomic stability). Furthermore, since they can assume they have little or no influence on the provision of those "global public goods," they are prone to take the attitude of "free riders" toward them. This implies that, aside from the case for complementarity between global and regional financial institutions, competition between the two sets of organizations in the provision of development bank services, liquidity financing, or technical support is the best arrangement for small and medium-sized countries.

The final argument in favor of regional arrangements is of a political economy order, and may be called the "federalist" argument. In this regard the essential issue is that regional and subregional institutions enjoy a greater sense of ownership because member states feel that they have a stronger voice in these organizations.

15. See United Nations (2005).
16. See, for example, the estimates of Agosin (2001) for Latin America.
17. See Griffith-Jones, Ocampo, and Cailloux (1999); and Ocampo (2002).

This creates a special relationship between them and member countries, which in the case of financial institutions may generate a strong "preferred-creditor status." The preferred-creditor status may, in turn, reduce the risks that regional and subregional development banks and reserve funds face, further encouraging the virtues of risk pooling.

One element of this argument is that, no matter what arrangements are adopted at the world level, the voice of small and medium-sized countries in global institutions is unlikely to be strong. The inadequate representation of developing countries in existing financial arrangements, an issue that was underscored at the International Conference on Financing for Development, held in Monterrey, Mexico, in 2002,[18] and the even greater informal concentration of power in international financial institutions, contributes to this view. This means that, within the global order, the smaller countries will be able to make their voice heard (or heard much more clearly) only if it takes the form of a regional voice. In fact, a paradox of the global system is that global rules are most important for small countries, even though it is precisely they that have the least influence over the formulation and defense of such rules. This problem can only be solved if the smaller countries organize themselves and if regional institutions are truly made part of a broader international order.

The foregoing discussion implies that, although there is a strong case for greater international macroeconomic and financial cooperation, it is unclear whether the increasing supply of services from the associated institutions should come from a few world organizations. Rather, in some cases the organizational structure should be one of networks of institutions providing the required services on a complementary basis, and in others it should function as a system of competitive organizations. The provision of services required for financial crisis prevention and resolution should probably be closer to the first model, whereas in the realm of development finance, competition should be the basic rule (and in fact should include competition with private agents as well). But purity in the model's structure is probably not the more desirable characteristic: it may be better for parts of the networks to compete against one another (for example, regional reserve funds or swap arrangements versus the IMF in the provision of liquidity financing) and for rival organizations to cooperate in other cases.

This implies that the International Monetary Fund of the future should be better viewed as the apex of a network of regional and subregional reserve funds and swap arrangements.[19] Indeed, such a structure would be more akin to that

18. United Nations (2002).
19. See United Nations (1999); and Ocampo (1999, 2002, 2003).

of the European Central Bank or the United States Federal Reserve system than to its current centralized structure. To encourage the development of regional reserve funds, incentives could be created giving them automatic access to IMF financing or a share in the allocation of special drawing rights (SDRs) proportional to their paid-in resources, or both—in other words, contributions to common reserve funds could be treated as equivalent to IMF quotas. As already noted, regional reserve funds or swap arrangements could provide not only most of the exceptional financing for smaller countries within a region, but also part of the financing for larger countries, and they could also serve to deter (at least partly) would-be speculators from attacking the currencies of individual countries within a region.

This model should be extended to the provision of macroeconomic surveillance and consultation, as well as to the surveillance of national systems of prudential regulation and supervision, and to developing the infrastructure for domestic and regional capital markets. This would complement, rather than replace, regular IMF surveillance and IMF/World Bank support to financial development. In the area of development financing, subregional development banks can play a significant role as a mechanism for pooling the risks of groups of developing countries, also allowing them to make more aggressive use of opportunities provided by private capital markets.

An institutional framework such as this would have two positive features. First, it would bring more stability to the world economy by providing essential services that can hardly be provided by a few international institutions, owing both to the heterogeneity of the international community and to the dynamic processes of open regionalism that are under way. Second, from the point of view of the equilibrium of world relations, it could be more balanced than a system based on a few world organizations. It could also increase the commitment of small countries to abide by rules that contribute to world and regional stability.

The Challenges Facing Regional Arrangements

Regional financial cooperation also faces significant challenges, which must not be underestimated. They relate to the viability and long-term sustainability of the arrangements that are created, and involve three major issues: the capacity of a given group of developing countries to supply the relevant financial services; the need to guarantee that strong regional institutions are developed; and an equitable distribution of the benefits of regional integration.

Culpeper's contribution to this volume poses the first of these issues as the need to match the demands from developing countries with their capacity to supply the associated financial services. In this regard, he argues that the presence of industrial or emerging-market economies within a region is crucial for successful financial cooperation, as they provide a rapidly growing pool of savings and greater creditworthiness. In this sense, regional cooperation may be unable, by itself, to meet the resource needs of the poorest countries, whether they are of a short- or long-term nature. This is particularly true when such funds must be provided with a larger, or even a full, grant component to avoid building an unsustainable debt dynamic, as has been underscored in recent years. However, not all the potential services of regional financial institutions require additional funding (some forms of macroeconomic cooperation do not), and some may actually reduce the need for external funds (reserve pooling) or allow countries to reduce the costs of accessing private capital markets (risk pooling).

In any case, for large-scale funding, partnerships with donor countries seem to be inescapable for low-income countries for the foreseeable future. The term of the partnership must be adequate, however, and could include channeling cooperation through regional institutions in ways that do not undermine developing countries' "ownership" of the regional arrangement. Indeed, this was the experience of Western Europe during the years of postwar reconstruction characterized by a "dollar shortage."[20] The channeling of Marshall Plan aid through the European Payments Union is a successful example of external financial support channeled through a regional institution.

For middle-income or "emerging" countries, the demand for regional financial cooperation will depend, in part, on how deep regional trade and financial integration are. The constraints on supplying effective services may also be important, but will differ in nature from those faced by low-income countries. The main problem lies in providing short-term liquidity financing to cope with capital account shocks, particularly if external funds are supplied in a procyclical manner to all countries in a region and there are significant factors of "regional contagion." However, cooperation from neighbors during crises may actually be highly effective, as evidenced by the successful support of France by Germany during the European currency crisis of 1992, or China's support for Hong Kong SAR during the Asian crisis.[21] Although of a more limited nature, the successful experience of the Latin American Reserve Fund (which, despite its name, continues to be essentially an Andean arrangement, with Costa Rica as the additional member) in supporting member countries during the Latin American debt crisis of the 1980s, and during the Asian crisis of the late 1990s, shows that, despite

20. Triffin (1957).
21. Mistry (1999).

contagion, all members of a region can benefit from the supply of liquidity financing by regional institutions (see Daniel Titelman's contribution to this volume). As the experience of the Latin American Reserve Fund indicates, the demand for funds by different countries does not coincide exactly in time. This facilitates the functioning of reserve funds and helps them to mitigate contagion. On the contrary, lack of support or, worse still, an explicit attempt by other countries in a region to differentiate themselves from a regional partner undergoing crisis, may reduce the effectiveness of any adjustment policies that this country undertakes and end up increasing contagion.

Although "ownership" provides a strong case for regional arrangements, it also has its downside. The essential problem is that regional and subregional institutions may be weak in the face of pressures from some of their individual members, particularly the more powerful among them. Therefore, the virtues of ownership can only be realized when matched by strong institution building, which is ultimately what will determine the effectiveness of regional cooperation arrangements. Political considerations play the dominant role in the process of institution building—and indeed, regional integration is always a political process and its weakness a sign of a lack of political will to build strong regional institutions.[22]

The history of European cooperation provides a clue about the long-term nature and complexities of this process. According to Charles Wyplosz (in this volume), since regional integration involves continuous erosion of national sovereignty—or, put in a more positive way, a transfer of sovereignty from the nation-state to regional institutions—it requires building confidence in regional institutions, which takes place only gradually. Each step in this process implies an uneasy compromise between integrationist and nationalist forces, and the latter may lead to reversals in the road to integration, implying that it is not a linear process.[23] Although it is essential to have clear vision and objectives, a master plan is neither necessary nor useful. To quote Wyplosz: "Integration has always been characterized by a process of muddling through, taking two steps forward and one step back, with deep and lingering divergences as to what the end objective should be. But each integration step has made the next one more likely. Success in one area emboldened political leaders to contemplate another even bolder project in another area. More crucially perhaps, each important step has been matched by some additional institutional buildup, which has provided

22. Teunissen (1998).

23. The associated complexities have recently manifested themselves, among other areas, in the Stability and Growth Pact. In this case, however, as recent debates have underscored, the inappropriateness of the Maastricht rules are a key part of the problem.

the backbone for further moves. It is difficult to overestimate the importance of the early creation of institutions to support the integration process, no matter how imperfect those institutions are."

Powerful countries may prefer weak regional institutions, to allow them to exercise more influence over them. The struggle for regional influence among major regional powers may also become an obstacle to strong institution building. This seems to have underlain some of the problems facing the design of strong regional macroeconomic arrangements in East Asia in recent years, and is evident in other processes, such as the Southern Common Market (Mercosur). The way a power struggle among major players is settled, and whether it results in strong or weak regional institutions, will be critical for smaller members of a regional or subregional club, which clearly benefit from strong regional institutions in their relations with large regional players.

Historical and cultural affinity may help institution building, as Culpeper argues in his chapter, but the story is mixed in this regard. European integration took place despite diversity, whereas Latin American integration has advanced slowly regardless of affinity. Political motivations are obviously behind the integration efforts in these two regions, and clearly have been stronger in Western Europe, as well as in building up the network of Arab and Islamic financial institutions and in the history of regional development banks. The breakdown of the regional arrangements inherited from the colonial past is quite a common historical phenomenon, as evidenced by both Spanish America in the nineteenth century and the end of colonialism in Africa and Asia in the second half of the twentieth century. It can perhaps be argued that national institution-building almost always comes at the cost of regional integration, and in many cases involves confrontation with neighbors. Some arrangements that have survived decolonization have sometimes had a troubled history, even when supported by an industrial country, as macroeconomic cooperation among the francophone countries in West Africa indicates.

The distribution of the benefits of integration is one of the crucial issues in the design of institutions appropriate for a given integration process. Owing to agglomeration economies, the benefits from trade integration may accrue disproportionately to larger and higher-income countries. So there is no presumption that trade integration will facilitate convergence in real incomes within regions.[24]

Most integration processes include provisions to facilitate an equitable distribution of their benefits. In trade integration, they commonly include preferential rules of varying types: slower liberalization, the possibility of maintaining

24. Mistry (1996).

higher levels of protection or subsidies, and exceptions to some rules. This practice has been extended to World Trade Organization (WTO) agreements and, to a lesser extent, to bilateral trade agreements. In more elaborate integration processes, they also include special development financing facilities and, in a few instances, fiscal transfers to the weaker countries or regions. Western Europe again represents the best model in both areas. In the past, some integration processes in Africa and Latin America also included industry-sharing agreements, under which weaker partners were allocated certain industries, but these arrangements usually failed and were abandoned. Freer labor mobility may also be seen as an adjustment mechanism that allows weaker countries or regions to adapt to the effects of integration. However, although it is generally seen as an essential element of full integration, it is unlikely to be considered a rule for the equitable sharing of its benefits.

In sum, the development of a dense institutional network of regional and subregional institutions in development finance and macroeconomic cooperation faces three major challenges: matching demand with supply capacities; a clear long-term commitment to institution building; and an equitable distribution of the benefits of integration. These issues are interrelated: supply capacities are not exogenously given, as they are largely created through a gradual process of institution building; and strong institutions are unlikely to be accepted by weaker partners unless they perceive that there is an equitable distribution of the benefits of integration.

Development Financing

Regional development financing arrangements have followed three basic models. The oldest and best-developed model is multilateral development banks and related multilateral financial institutions. These institutions are present in all regions, although with different coverage, structures, and priorities. A second model, which is mainly used by the European Union, is fiscal transfers with explicit redistributive regional objectives. A third and more novel model is the development of regional bond markets; the most important initiatives in this regard have come from East Asia.

The regional development banks (discussed by Francisco Sagasti and Fernando Prada in this volume) are the oldest of the first group of institutions: the Inter-American Development Bank (IDB); the Asian Development Bank (AsDB); the African Development Bank (AfDB); and the European Investment Bank (EIB). Strong political motivations led to their creation in the 1950s and 1960s. The first two institutions may be viewed as the result of cold war politics, while the third is the daughter of decolonization. EIB was born, in turn, out of two basic objectives of European integration: to support lagging regions and thus an equitable integration process; and to finance the investment in the infrastructure of integration—"regional public goods" in current terminology (see in this regard the chapter by Stephany Griffith-Jones, Alfred Steinherr, and Ana Teresa Fuzzo de Lima in this volume). To these we should add the European Bank for Reconstruction and Development (EBRD), which was established in 1991 and is the daughter of post–cold war politics.

With the exception of the EIB, which is made up entirely of industrial-country members, all of which can borrow from the institution, the regional banks include a division between developing country borrowers and nonborrowing industrial-country members. Borrowing members are a majority in AfDB and slightly over half of the capital of IDB, but are a minority in AsDB and particularly in EBRD. This structure was adopted only late (in 1982) by the African Development Bank, which was initially a strictly African institution, but was forced to converge with the structure of other regional development banks because of its financial difficulties.

This capital structure allows developing countries to benefit from the excellent credit rating of the industrial-country members. It is amplified by the practice of maintaining a large ratio of subscribed to paid-in capital, which may be seen as a huge guarantee fund for the credit operations of these institutions. This may be understood as a cross-subsidy from countries with good to weaker credit ratings. It may also be seen, however, as a correction of a market failure: the overestimation of risk in private capital markets, particularly during periods of bust in private financing. The better lending conditions, as well as the willingness of these institutions to finance countries under difficult circumstances—that is, during crises—tend to reinforce their preferred-creditor status. This becomes a "self-fulfilling prophecy" in terms of portfolio quality, and in this sense can also be considered a correction of market failures: low risk margins are justified by the fact that loan losses are minimal, but this reinforces the willingness of debtors to keep a good credit history with these institutions. The requirement that first-class guarantees be maintained (from governments or private banks) further reinforces credit quality, whereas the lack of retail services reduces the staff required and thus intermediation costs.[25]

The most elaborate system of multilateral financial institutions that are strictly "developing-country-owned" is that of the Arab and Islamic world. As Georges Corm describes in this volume, the origin of these institutions lies in

25. For a further analysis of these issues, see the two chapters by Sagasti and Prada and Griffith-Jones, Steinherr, and Fuzzo de Lima in this volume. See also Birdsall (2001).

the regional solidarity generated by the Arab-Israeli war of 1967 and, in economic terms, in the sudden increase in resources of Arab oil-exporting countries in the 1970s. Most of these institutions started to operate in the 1970s, although one of them, the Arab Fund for Economic and Social Development (AFESD), had been created in 1968. With the partial exception of the Islamic Development Bank, which includes some major non-oil-exporting countries as shareholders, these institutions essentially operate as mechanisms for transferring resources from the oil-rich countries of the region to poorer regional members, as well as to other developing countries, particularly in the Islamic world and Africa. Thus they complement the specific national cooperation extended by the oil-rich countries. This feature also implies that lending by these institutions is highly dependent on the oil price. This reduces the countercyclical role that financing by multilateral development banks should play.[26] The sharp upturn in oil prices since 2000 has led, however, to a small increase in funding, relative to the oil boom of the 1970s; thus financing by these institutions remains today significantly below the levels reached in the second half of the 1970s and early 1980s. They have also made suboptimal use of the opportunities to tap global or national capital markets.

The largest of these multilateral institutions in terms of cumulative commitments is the Islamic Development Bank, which also has the largest membership and the largest interregional coverage of its lending operations. It is followed by the Arab Fund for Economic and Social Development, which provides soft lending operations for Arab League countries, largely for infrastructure projects. In turn, the Arab Monetary Fund focuses its activities on financing inter-Arab trade. Although smaller in size, the Arab Fund for the Development of Africa channels funds to the African continent. Other institutions provide equity capital and insurance coverage for inter-Arab investment. The main beneficiaries of this network of institutions are the middle- and low-income Arab countries, which have received on average about three-fifths of the financing that has been available from the institutions since 1970. Indeed, some of these countries, particularly in the Middle East, have received more funds from these institutions than from countries in the Development Assistance Committee of the Organization for Economic Cooperation and Development (DAC/OECD).

Integration efforts in sub-Saharan Africa have also led to the design of some development banks and other financial institutions. These institutions were set up by the Economic Community of West African States (ECOWAS) and the failed (but now revived) East African Community—although its financial

26. See Ocampo (2002); and United Nations (2005, chap. 5).

branch, the East African Development Bank, survived that process. To these must be added the trade financing facilities set up more recently by the Common Market for Eastern and Southern Africa (COMESA). However, as Culpeper argues in this volume, their performance has been modest at best. Nonetheless, their existence creates the possibility of using them more actively in the future as instruments of regional development.[27]

Latin America and the Caribbean undoubtedly provide the best example of a well-developed network of subregional financial institutions, which include three major banks: the Andean Development Corporation (CAF, Corporación Andina de Fomento), the Central American Bank for Economic Integration (CABEI), and the Caribbean Development Bank (CDB) (see the chapter by Titelman in this volume).[28] These institutions were created in the 1960s to support the subregional integration processes and thus service the small and medium-sized countries of the region, which are the main participants in those integration processes. The Central American and Caribbean banks have the same structure as the regional development banks, and thus include both borrowing and nonborrowing countries; nevertheless, some of the nonborrowing countries are the larger Latin American countries in the vicinity of Central America, which are also part of the Caribbean basin.

The Andean Development Corporation is unique in being exclusively owned by developing countries (Spain joined in recent years, but is also a potential borrower). It is the most dynamic of all these institutions, and in recent years its loans to the Andean countries have actually surpassed joint lending to these countries by the IDB and the World Bank. Its membership has also gradually increased to near that of a regional development bank. This dynamic institution is, indeed, the best example of risk pooling in the developing world: it holds investment-grade status, regardless of the fact that none of the Andean countries does. The meager loan losses experienced by the Andean Development Corporation, despite the troubled macroeconomic history of most of its members, also demonstrate the strong preferred-creditor status of this institution with its members. The Caribbean Development Bank is a smaller but also very dynamic institution in the subregion. The history of the Central American Bank for Economic Integration is more mixed. It experienced a severe crisis in the 1980s as a

27. See a full inventory of these institutions in United Nations, Economic Commission for Africa (ECA) (2004, chap. 6). Some of these institutions have cofinancing arrangements with the African and the Islamic development banks.

28. A fourth small institution, FONPLATA (Fondo Financiero para el Desarrollo de la Cuenca del Plata), finances projects for the development of the Plata River basin.

result of the arrears of one of its members, Nicaragua, but recovered in the latter part of that decade and has expanded again since the 1990s.

There are crucial regional differences in the roles played by different types of multilateral development banks in the various regions (see table 1-1). As discussed, the expansion of regional development banks has focused primarily on the middle-income countries, where their combined net flows surpass those of the World Bank. In the Middle East and North Africa, the Arab and Islamic institutions are also an important financing source. In Latin America and the Caribbean, IDB lending surpasses the World Bank's by a large margin, and the subregional banks also play an important role where they operate. Indeed, as table 1-1 indicates, the subregional banks make the largest contribution, relative to gross domestic product (GDP), in the small and medium-sized countries of Latin America and the Caribbean, followed by the Middle East and North Africa. Sub-Saharan Africa and South Asia are highly dependent on the World Bank/IDA (International Development Association). East Asia falls somewhere in between, with the World Bank lending slightly more than the AsDB and, as in South Asia, with a relative absence of developing-country-owned financial institutions. The EIB is the dominant institution in Europe, even when we leave aside the old members of the European Union (EU-15 in the table). In the transition economies, however, both the World Bank and the EBRD play an important role.

The greater weight of poorer borrowing members in different regions, and the support provided through different financial institutions by nonborrowing industrial countries, is also reflected in the relative share of concessional lending and grants. Thus concessional lending is particularly important for AfDB (44 percent of total lending), the World Bank/IDA (40 percent), and the AsDB (27 percent); the IDB also has a concessional fund for special operations that amounts to 7 percent of total lending.[29]

Given the fact that only limited concessional lending can be provided by institutions entirely owned by developing countries, poor countries are likely to continue to be dependent on official development assistance (ODA) provided by industrial countries and to a certain extent intermediated by multilateral development banks. This coincides with the arguments put forward by Culpeper and the above analysis of the constraints on regional cooperation in the poorest countries. The strong presence of developing country–owned financial institutions in the Arab and Islamic countries and in several subregions of sub-Saharan Africa, as well as in Latin America and the Caribbean, reflects a mix of cultural affinity

29. World Bank and IMF (2005, box 6.1).

Table 1-1. *Multilateral Development Banks: Outstanding Loans, 2004*[a]

Millions of current U.S. dollars

				Asia			Europe		Latin America and the Caribbean	
Institution	*Outstanding loans*	*Africa*	*Middle East and North Africa*	*East Asia and Pacific*	*South Asia*	*Central Asia*	*EU-15*	*Rest of Europe*	*Argentina, Brazil, Mexico*	*Rest of Latin America and the Caribbean*
World Bank group										
International Bank for Reconstruction and Development (IBRD)[b]	104,401	4,484	8,655	25,981	10,354	4,183		15,117	24,523	11,103
International Development Association (IDA)[b]	120,907	48,120	3,561	15,643	43,804	2,654		2,521		4,604
Regional development banks										
European Investment Bank[c]	656,578						597,486	45,960		
Inter-American Development Bank (IDB)[d]	49,800								28,138	21,661
Fund for Special Operations[d]	7,000								1,131	5,869
African Development Bank Group (AfDB + AfDF + NTF)[e]	8,511	6,724	1,787							
Asian Development Bank (AsDB)	24,159			15,112	9,047					
Asian Development Fund (AsDF)	27,216			17,025	10,192					
European Bank for Reconstruction and Development (EBRD)[f]	18,434					3,781	7,961	6,693		

(continued)

Table 1-1. *(continued)*

Millions of current U.S. dollars

				Asia			Europe		Latin America and the Caribbean	
Institution	*Outstanding loans*	*Africa*	*Middle East and North Africa*	*East Asia and Pacific*	*South Asia*	*Central Asia*	*EU-15*	*Rest of Europe*	*Argentina, Brazil, Mexico*	*Rest of Latin America and the Caribbean*
Subregional development banks										
Nordic Investment Bank (NIB)[g]	14,125	424[h]		847[i]			11,300	989	565[j]	
Nordic Development Fund (NDF)[k]	528	240[h]		181[i]					108[j]	
Central American Bank for Economic Integration (CABEI)[l]	2,789									2,789
Caribbean Development Bank (CDB)[m]	2,484									2,484
Andean Development Corporation (ADC)	7,216								433	6,783
FONPLATA[n]	378								94	284
North American Development Bank (NADB)[o]	43								22	
East African Development Bank (EADB)[p]	111	111								
West African Development Bank (BOAD)	545	545								
Islamic Development Bank Group (IsDB + ICD)[q]	17,929	1,793	8,845	1,076	4,124	239		1,853		

Arab Bank for Economic Development in Africa (ABEDA)	606	606								
Arab Fund for Economic and Social Development (AFESD)	11,982		11,982							
Arab Monetary Fund	1,297		1,297							
Total	1,077,050	63,047	36,138	75,865	77,519	10,857	616,747	73,133	54,341	56,251
Total without World Bank group	851,742	10,442	23,922	34,241	23,362	4,020	616,747	55,495	30,491	39,871
GDP[r]		511,818	622,396	3,016,618	878,785	645,548	12,167,879	1,154,722	1,432,854	564,519

Sources: Data compiled from the official web pages of each institution. Where available, data were obtained from the annual reports of each institution for 2004.

a. Regions: Japan is not included in the figures for East Asia. Gulf Cooperation Council members (Saudi Arabia, Bahrain, Kuwait, Oman, Qatar, United Arab Emirates) are not included in total GDP for the Middle East and North Africa.

b. Country distribution by cumulative IBRD and IDA lending. Data from 2005.

c. Also reports credits to ACP (1 percent) and Asia and Latin America (1 percent) without any further disaggregation (not included in the table). Country distribution by 2004 loan approvals. Data from 2005.

d. Country distribution by approved loans (1961–2006).

e. Country distribution by debt outstanding.

f. Country distribution by total project value of EBRD investments.

g. Some relatively small credits go to the Russian Federation (Central Asia), without further disaggregation. Country distribution by 2004 loan portfolios. Data from 2005.

h. Includes North Africa.

i. Total for all regions of Asia.

j. Total for Latin America and the Caribbean.

k. Country distribution by project portfolios.

l. Reported as gross loan portfolio.

m. Reported as net total financing.

n. As reported. Not specific whether figures represent cumulative lending, outstanding lending, or lending for a specific year.

o. Country distribution for Mexico (50 percent) and United States (50 percent, not included in the table) by loan portfolios.

p. Data from 2003.

q. Country distribution by IsDB net approved operations sheet. Data from 1425H (2004–05).

r. GDP data from World Bank, *World Development Indicators* (online) database.

and political motivation, while their absence in South and East Asia reflects the lack of these factors.[30]

The difference in the portfolios of the various multilateral development banks reflects not only their specific strategies, but also their adaptation to the diversity of demands and financial needs of the developing world and the transition economies. Thus while the IDB has focused increasingly on social spending, subregional banks in Latin America and the Caribbean give greater weight to infrastructure and production sector lending.[31] Both the AfDB and the AsDB give more emphasis to infrastructure than the IDB does. The heavy focus on infrastructure lending is also typical of Arab institutions. Financing intraregional trade is also a mandate of some institutions, particularly the Arab Monetary Fund. Although many institutions have private sector lending facilities, which have tended to grow over time, this is the focus of EBRD activities (see the contributions of Corm, Sagasti and Prada, and Titelman in this volume). According to Sagasti and Prada, this diversity in the portfolios of these institutions is "in line with the general idea behind the creation of regional and subregional institutions: they play specific and localized roles, which are not always covered adequately by global or even by regional institutions."

The combination of collective-action problems in regional processes, in the absence of supranational institutions, indicates how important the regional and subregional development banks can be in supporting regional strategies. They can provide a coordination mechanism for member countries to plan and finance the provision of regional infrastructure. This is an incipient activity in most of the developing world but one that has been receiving increasing attention from some regional and subregional banks.[32] These institutions also have the ability to provide a regional public good essential for development: the transmission and utilization of region-specific knowledge. That ability puts them in a position to help countries in their respective regions to design specific policies

30. Nonetheless, South Asia set up a modest development fund in 1991. See United Nations Economic and Social Commission for Asia and the Pacific (United Nations, ESCAP) (2004, chap. 6), which provides a full inventory of regional cooperation mechanisms in South and East Asia. United Nations, ESCAP (2005) also proposed the creation of an Asian Investment Bank.

31. As Sagasti and Prada argue in this volume, the trend in lending by regional development banks has involved reduced support for the productive sector through state-owned financial institutions, but has been partially offset by operations with private banks and the development of domestic capital markets, which are classified as "financial infrastructure."

32. This is the case with the Initiative for the Integration of Regional Infrastructure in South America (Iniciativa para la Integración de la Infraestructura Regional Suramericana, IIRSA) and the Plan Puebla-Panama (involving Mexico and Central America).

appropriate to the countries' economic needs and political constraints.[33] Nonetheless, there is still very little financing of "regional public goods" in most of the institutions serving developing countries (1 percent or less for the AfDB, AsDB, and IDB), as well as in ODA in general.[34] This is in sharp contrast with the experience of the European Investment Bank, which has had regional infrastructure as one of its major mandates since its creation.

Indeed, as was pointed out at the beginning of this section, the EIB, the largest multilateral development bank in the world, is probably the best example of an institution designed to help compensate for regional disparities and to support the development of regional infrastructure. In recent decades, it has also been increasingly used for major extraregional initiatives of the European Union, such as projects in the African, Caribbean, and Pacific (ACP) countries and the Mediterranean region, as well as the liberalization processes of the former socialist countries of Central and Eastern Europe. Another reason for creating this institution in the 1950s was to correct market failures, since currencies were not fully convertible and international private capital markets had not fully recovered from the collapse of the 1930s, but it has continued to grow in recent decades, despite full capital account convertibility and booming global financial markets.

The chapter by Stephany Griffith-Jones, Alfred Steinherr and Ana Teresa Fuzzo de Lima in this volume provides some clues about the strengths of this institution in a region with significant financial development. Some of the reasons are: (1) the implicit subsidy and better access to finance by poorer countries in the region, which fulfills one of its historical mandates; (2) its signaling role to private lenders, which helps to correct another type of market failure (information asymmetries) and may be particularly important for infrastructure investment, one of its major lending activities; (3) the capacity to internalize the risks of offering long-term lending at fixed rates (which, nonetheless, as the authors argue, can be more costly to a borrower than floating interest rate loans of similar maturity); and (4) its capacity to be very competitive in its pricing, which makes it a desirable source of borrowing even by large private banks in the case of "global loans" for financing small and medium-sized enterprises. On the contrary, correcting market failures associated with large risks in innovative sectors has not been one of the main activities of the EIB. In the recent past, this has led to the creation of the European Investment Fund—of which it is the largest shareholder—to provide guarantees, take equity participation, and support venture

33. See Birdsall and Rojas-Suarez (2004).
34. See Birdsall (2006).

capital funds. However, on the whole, this institution continues to be risk averse, which is indeed a salient feature of multilateral development banks.

The creation of EIB as an instrument of European integration was matched from the beginning by fiscal transfers to poorer regions and specific sectors (particularly agriculture). This implied an explicit acknowledgment that integration would not achieve the aim of helping different parts of an integrating region to converge in their development levels, in the absence of an explicit policy to achieve this purpose—a policy that came to be labeled "cohesion policy." The focus on lagging regions rather than countries has also provided a source of support from major countries to this policy, because even rich countries may have lagging regions. These fiscal redistributive mechanisms (structural and cohesion funds) were further reinforced at every major step in the history of European integration. So they were extended as a result of the northern expansion of the European Community in the 1970s, particularly when the relatively poorer Southern European countries were incorporated in the 1980s. The 1990s saw, in turn, the design of more generous pre-accession funding for Central European countries. Although regional and even global trade integration processes have generally recognized the asymmetries of its member states, fiscal transfers have rarely been tried outside Europe; in fact, they were only used, rather unsuccessfully, in the early postcolonial experience of the East African Community.

The historical dearth of regional financial cooperation in South and East Asia has been amply compensated for in recent years by a series of initiatives in the area of development financing, as well as in monetary cooperation. The major reason was the traumatic experience of the 1997 East Asian financial crisis. These initiatives also reflect a sense of frustration with the slow speed and even, in many areas, the international financial system's complete lack of reform to enable it to face the problems that became evident during the Asian crisis, as well as a critical view of the policies implemented by the global financial institutions for managing the crisis.[35]

Although there have been proposals to create an Asian Investment Bank along the lines of the EIB,[36] the major initiatives under implementation relate to support for the development of national and regional bond markets. The basic rationale for these initiatives is the sense that over-reliance on short-term foreign currency loans was a major factor in the East Asian crisis. Since the crisis, another important factor has been the large current account surpluses and international reserves accumulated by economies in the region. International

35. Park and Wang (2000); Sakakibara (2003).
36. See United Nations, ESCAP (2005).

reserves, as well as private funds, are to a large extent invested in the deeper bond markets of the industrialized countries, some of which are recycled back into the region by foreign financial intermediaries. According to this view, the development of deeper national and regional bond markets would help to short-circuit this intermediation through world financial centers outside Asia. Therefore, the development of bond markets will be both a development and a crisis-prevention instrument, helping in the latter case to reduce the maturity and currency mismatches in the portfolios of private agents that were at the heart of the East Asian crisis.

The various initiatives, reviewed by Yung Chul Park, Jae Ha Park, Julia Leung, and Kanit Sangsubhan in their contribution to this volume, have taken place in different regional forums and are of two different types.[37] The first are of an institutional nature and aim to develop appropriate infrastructure for the functioning of either national or regional bond markets, particularly for bonds denominated in the local currencies of the economies of the region. This includes the Asia Pacific Economic Cooperation (APEC) initiative for developing securitization and credit-guarantee markets by means of policy dialogue and the provision of expert advice and panel visits to the economies concerned. In a similar vein, the ASEAN+3 (China, Japan, and the Republic of Korea) initiative focuses on facilitating market access by several public and private sector agents, and on improving the institutional infrastructure, including regional clearing and settlement mechanisms, credit-guarantee and hedging facilities, the development of national and regional credit rating agencies, and the dissemination of information on Asian bond markets. In a complementary manner, the various working groups convened under this initiative will aim to improve the harmonization of financial standards, regulatory systems, and tax treatment of financial assets throughout the region.

The second type of initiative, launched by the eleven members of the Executives' Meeting of East Asia–Pacific Central Banks (EMEAP), has focused on developing specific funds, the Asian Bond Funds (ABFs).[38] ABF 1, announced in June 2003, was composed of U.S. dollar-denominated bonds issued by sovereign and quasi-sovereign issuers of the eight emerging economies of EMEAP. Although this first action represented a milestone in central bank cooperation, it was limited in size (to U.S.$1 billion), and more particularly, it did not support the development of local-currency-denominated bonds. So a second fund (ABF 2)

37. See also United Nations, ESCAP (2004, 2005).

38. The eleven members of EMEAP are Australia, China, Hong Kong SAR, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand.

was launched in December 2004, with an initial amount of U.S.$2 billion, to invest in local-currency-denominated bonds of the EMEAP emerging economies, and to help create a convenient and cost-effective instrument fund and a new asset class for regional and institutional investors. As argued by Yung Chul Park and his coauthors, this new initiative has helped to introduce a new asset class (exchange-traded bond funds) and a new family of bond indexes; it has helped to remove some of the barriers to cross-border capital flows; and it has contributed to the adoption of new standards and to greater market transparency. All these effects, which largely relate to developing the associated regional financial infrastructure, indicate that this initiative is complementary to the above-mentioned approach that focuses directly on developing the regional financial infrastructure.

Macroeconomic Cooperation

Contrary to the rich historical experience in the area of development financing, particularly with multilateral development banks, there is a dearth of experiences in the area of macroeconomic cooperation in the developing world. However, several initiatives have been launched in this area in recent years. They sometimes match regional trade initiatives that have resulted from the dynamic process of "open regionalism" currently under way, and attempt to replicate in some ways the experience of European monetary integration. Some of the existing arrangements, as well as new initiatives, show the potentialities of this form of cooperation in the developing world, but also their limitations. As the attempts to replicate European trade integration in the past have had mixed success in the developing world, the more recent attempts to replicate European macroeconomic cooperation follow a similar mixed pattern. Furthermore, regional trade integration is more limited in the developing world than in Europe—although it has been growing rapidly in some regions, particularly in East Asia. There are, however, two additional rationales for macroeconomic cooperation in the developing world, particularly in emerging economies: to build stronger walls of defense against financial crises; and to avoid distorting competition among export-oriented economies.[39]

The links between trade and macroeconomic cooperation are, of course, at the heart of the formation of the European Union. As Wyplosz argues in this volume, this feature has been accompanied by two other major characteristics. The first is the emphasis on building strong institutions, albeit in a gradual and pragmatic way. The second is the clear subordination of macroeconomic coop-

39. See Sakakibara (2003).

eration to the objective of trade integration. The major objective of macroeconomic cooperation has thus been exchange rate stability, which has been seen as the only way to create a level playing field for intraregional trade. In particular, *real* exchange rate stability has been the implicit target of such cooperation.

Since the breakdown of the Bretton Woods parities, this has implied the negotiation of regional arrangements (the snake, followed by the European Monetary System) to stabilize exchange rate parities, which finally led to European Monetary Union (EMU). Until the launch of EMU, these arrangements not only left room for limited flexibility (variable over time), but also involved a large number of nominal exchange rate adjustments, which used purchasing power parity criteria to determine the level of adjustment for achieving a desirable real target. These readjustments were fully symmetrical, thus involving both strong and weaker currencies at different moments. The choice of bilateral parities was collective, and was in fact based on consensus. Although the deutschmark gradually emerged as the anchor/central currency, this feature was not part of the system of cooperation to stabilize the exchange rates, and indeed was only consolidated de facto in the late 1980s. In turn, the defense of agreed parities implied the unprecedented commitment, if necessary, to defend the agreed parities with unlimited interventions by both countries whose bilateral rates were pushed to the declared margin of fluctuation. This rule implied that no explicit reserve pooling was necessary.

The commitment to exchange rate stability implied that capital mobility was entirely subordinated to that objective. This meant that capital controls were in place for decades, and were reestablished when necessary. Therefore, whereas current account convertibility came early (in 1958, coinciding with the launch of the Common Market), capital account liberalization came late, and was part of a gradual process that did not culminate in the collective removal of capital controls until 1990. This was soon followed by a major crisis in 1992. It thus became clear that exchange rate stability required a full-fledged movement toward monetary union. This was combined with the Stability and Growth Pact, which established explicit fiscal rules and convergence criteria. Although the principle that monetary integration must be accompanied by fiscal discipline is widely accepted, the rationale of the specific rules adopted in the Maastricht Treaty (which target the current fiscal deficit rather than a structural deficit or, better still, debt sustainability), as well as the mechanisms of enforcement (which are intrusive into national sovereignty, but for the same reason weak in practice), have become a subject of heated debate in recent years.

Wyplosz's summary of the sequence followed by the European Union and its implications for similar arrangements in the developing world today is sharp and simple: "Regional trade integration, exchange rate stability and institution-building came first, capital mobility and monetary union came later. A key question is whether this sequencing can be modified and whether the pace can be accelerated. The answer is that both are quite unlikely." This answer is, of course, critical, and refers both to the potential benefits of macroeconomic cooperation and to current debates on capital account liberalization.

Indeed, the classical case for optimum currency areas assumes not only a similarity among participating countries, but also a high level of economic integration among participating countries.[40] Accordingly, one of the major benefits of currency union is that it encourages intraregional trade by eliminating one of the "taxes" on trade: the uncertainties associated with exchange rate volatility. An additional argument is that it acts as an external disciplining agent on individual members and, to the extent that one of the members is a strong economy, it allows others to "borrow credibility."

Capital account liberalization continues to be a topic of heated debate. Its costs in terms of macroeconomic volatility are by now widely recognized.[41] On this basis, many analysts claim that capital account liberalization is undesirable for the developing world, and that some form of capital account controls or regulations should be the rule rather than the exception.[42] In terms of the debate on regional cooperation, this means that capital account liberalization should be, at best, the end rather than the beginning of a process of macroeconomic cooperation. This was, in fact, the route followed by the European Union—a long route indeed, taking more than three decades to complete the transition. It is also the sequence between trade and capital account liberalization recommended by McKinnon.[43] However, given the pervasiveness of global capital markets and related financial innovations, and the fact that several countries have already liberalized their capital accounts, new questions arise about the appropriateness of classical sequencing issues and even about the rationale for currency unions. In particular, and following the defense of polar exchange rate regimes, it has been argued that a developing country with full capital account liberalization that is not willing to adopt a fully flexible exchange rate may find

40. See Mundell (1961); and McKinnon (1963). The classical criteria proposed by Mundell and McKinnon include a large share of intraregional trade and synchronized business cycles, which assume a substantial degree of economic integration. They also indicate that a common currency area is more attractive for smaller countries and when factor markets are more flexible.

41. See, for example, Prasad and others (2003).

42. See, for example, Stiglitz and others (2006).

43. McKinnon (1979).

it more desirable to dollarize or euroize than to form a currency union with other developing countries.

Although the developing world's experience with monetary unions has been neither abundant nor successful, European monetary integration has sparked some initiatives for forming monetary unions in the developing world. The initiative taken by the members of the Gulf Cooperation Council stands out in this regard.[44] The members of the Caribbean Community are also formally committed to a monetary union but have not made much progress in that direction. As with other developing countries where independence was not gained until after World War II, the formation of a monetary union among these countries would in a sense be a return to the monetary arrangements of the past, where these countries shared a common currency (in the Caribbean, until the early 1960s), although they are now managed by the countries themselves and perhaps do not have the strict currency-board characteristics of the colonial arrangements.

Even more than monetary unions, the European experience has encouraged looser forms of macroeconomic dialogue or more elaborate consultations in the developing countries, including the adoption of Maastricht-type criteria in the context of several integration processes.[45] However, unless the adoption of these criteria leads to regular surveillance, as well as to consultation processes that help to internalize the effects of macroeconomic policies on regional partners, their credibility and rationale may be totally lost. In the developing world it is also necessary to strike a balance between targets and a certain degree of policy flexibility, which is essential for economies subject to large shocks. However, the right balance is difficult to achieve.

As discussed, the 1997 crisis led, in East Asia, to the adoption of the Chiang Mai Initiative, aimed at building a strong pillar of regional balance-of-payments support as a crisis-prevention device. Preexisting arrangements in this area were the Latin American Reserve Fund and the ASEAN Swap Arrangement.

One way to view these different initiatives is that they break up macroeconomic cooperation into its basic components: macroeconomic policy dialogue and eventual policy surveillance and consultation; liquidity support during crises; and exchange rate coordination. Furthermore, given the frequency of shocks faced by developing countries, they generally eliminate (or, at least, significantly postpone in time) the desirability of the third component—which, as we

44. International Monetary Fund (1973).

45. See, for example, United Nations, ECA (2004, chap. 6) in relation to sub-Saharan Africa, and United Nations, ECLAC (2002b, chap. 5) in relation to Latin America and the Caribbean.

have seen, was the major objective of European macroeconomic cooperation. It should be added that clearinghouses for intraregional trade are a weaker form of macroeconomic cooperation, which is closely tied to trade integration. They also bring specific benefits during crises: by reducing the need for foreign exchange to settle intraregional transactions they may help to mitigate the effects of crises on intraregional trade and the multiplier effects on macroeconomic activity. There are several experiences of this type in the developing world, some of which have been functioning for several decades; a few have faced difficulties owing to the accumulation of arrears by some members during balance-of-payments crises.[46] However, we shall not examine their experience here.

The history of common currency areas in sub-Saharan Africa shows how difficult these arrangements can be in the developing world, even when they have the strong backing of an industrial country.[47] The monetary arrangements among the former British colonies collapsed soon after independence, but a franc zone survived in Western Africa with strong French backing. It is organized into two currency unions: the West African Economic and Monetary Union (WAEMU), and the Central African Economic and Monetary Union.[48] The larger Economic Community of West African States, comprising the first group of countries plus some others, set an agenda that adopted a monetary cooperation program, aimed at a single currency, but its achievements have been limited to improving intraregional payments.[49] In 2000, five of its members agreed to create a West African Monetary Zone, and to merge this zone with the West African Economic and Monetary Union.[50] However, the convergence process has been slow and the deadline for merging this zone with the existing monetary union (December 2005) was postponed until December 2009. In recent decades, initiatives in East and South Africa have focused on

46. In Central America, for example, Nicaraguan arrears led, in the early 1980s, to the accumulation of large debts with other countries in the subregion, as well as to the suspension of lending by the Central American Monetary Stabilization Fund of the Central American Bank for Economic Integration.

47. See the chapters by Ernest Aryeetey and Roy Culpeper in this volume, as well as Honohan and Lane (2000).

48. The first includes Benin, Burkina-Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Togo, and Senegal. The second encompasses Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon. Guinea dropped out of the franc zone upon independence, and Mali dropped out for a while. Guinea-Bissau and Equatorial Guinea are new members that joined the corresponding arrangement in 1997 and 1985, respectively.

49. The other members are Cape Verde, Gambia, Ghana, Guinea, Liberia, Mauritania, Niger, Nigeria, and Sierra Leone.

50. The members are Gambia, Ghana, Guinea, Nigeria, and Sierra Leone.

trade integration and shied away from establishing major initiatives in the area of macroeconomic cooperation. To these we should add the Rand Monetary Area, which dates back to 1910 and was established formally as a monetary area in 1974 and a common monetary area in 1986.[51]

The former franc (now euro) zone captured for its member states some of the classical benefits of a monetary union. In particular, price stability has been greater for these countries than for neighbors in their region. However, the monetary union worked as a weak external mechanism of restraint. Although the central banks were freed by statute from fiscal pressure, they were forced to support commercial banks that had lent to fiscal authorities. This factor, together with other domestic and external factors, led to a banking crisis in the 1980s. Many of the institutions involved were joint ventures between national governments and major French-based banks. The recapitalization of these banks led to the eventual collapse of the system, which was formally recognized in the 50 percent devaluation of the CFA franc in January 1994.[52] The devaluation was matched by other reforms to strengthen the monetary union and deepen financial cooperation. Although the devaluation facilitated the recovery of economic growth in the following years, the political crisis of the largest member of WAEMU, Côte d'Ivoire, generated fresh macroeconomic problems in the early 2000s; the crisis was compounded by a broader lack of compliance with the agreed fiscal targets by members of the monetary union.[53]

This story showed the limits not only of monetary union as a mechanism of restraint, but also of the benefits of rules-based macroeconomic policy.[54] Also, as Culpeper claims in this volume, the hard peg of the CFA franc to the French franc, and now to the euro, reduces the zone's capacity to absorb external shocks and effectively externalizes authority for short-term financing to the French Treasury. The fluctuations of the exchange rate of, first, the French franc and, in recent years, the euro, have also been transmitted to these countries and, in fact, the strength of the French franc was a factor behind the conditions that led to the 1994 devaluation.

51. The Rand Monetary Area encompasses South Africa, Lesotho, and Swaziland. Botswana withdrew in 1974 before the monetary area was formed. There is also the very ambitious (and probably unrealistic) project of forming a single continental currency area by 2025, which is enshrined in the African Monetary Cooperation Program.

52. The CFA franc is the common currency of fourteen African countries that are members of the franc zone.

53. See Boogaerde and Tsangarides (2005).

54. See Honohan and Lane (2000).

In light of this experience and other problems facing sub-Saharan Africa, Ernest Aryeetey and Honohan and Lane suggest that the focus of cooperation among these countries should probably shift to the development of financial markets, aimed at overcoming the thinness and illiquidity of African capital markets, including possibly the regionalization of banking and capital-market development.[55] Other arrangements, such as liquidity financing to avoid regional contagion, seem less important in sub-Saharan Africa, given the absence of significant contagion in the region during past crises, but may become more important in the future.

In Latin America and the Caribbean, the Eastern Caribbean Currency Union (ECCU) may be considered one of the few success stories of its kind in the developing world.[56] It involves very small economies with a well-developed domestic banking system and an important offshore financial sector. Its history goes back to the British Caribbean Currency Board and operates as a quasi-currency board with large effective reserve cover. Its peg to the British pound was shifted to the U.S. dollar in 1976. However, it has faced some challenges associated with the rapid growth of public sector debts during the slowdown of the early 2000s, poor compliance with the agreed fiscal rules, and some weakness in its banking, regulatory, and supervisory framework.[57]

As previously mentioned, in 1990 members of the broader Caribbean Community made a commitment to create a monetary union as part of the development of a single market and economy. However, no concrete steps have been taken in that direction (and, it should be added, the commitment to build a single market and economy has also been postponed on several occasions).[58] In fact, divergence among the exchange rate regimes and deviation from the agreed convergence criteria continue to characterize this subregion.

Latin America has shied away from similar efforts but, in the 1990s, adopted mechanisms for macroeconomic policy dialogue in the context of its three major integration processes: Mercosur, the Andean Community, and the Central American Common Market.[59] Maastricht-type criteria for economic conver-

55. See the chapter by Aryeetey in this volume, and Honohan and Lane (2000).

56. This currency union includes Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, as well as two dependent territories of the United Kingdom (Anguilla and Montserrat).

57. IMF (2004).

58. It can be argued that, given the very different commodity shocks that these countries face, the Caribbean Community (Caricom) may not even be an optimal currency area. Worrel (2003) advocates a currency union, but based on arguments that justify fixed exchange rates rather than a common currency.

59. United Nations, ECLAC (2002b, chap. 5).

gence have been agreed for these processes. In their contribution to this volume, José Luis Machinea and Guillermo Rozenwurcel analyze the rationale for these efforts. Although intraregional trade is still limited and integration of domestic financial markets is virtually nil, macroeconomic linkages associated with global financial shocks have been significant during the past quarter-century. They have been reflected in macroeconomic adjustments that have had major spill-overs onto neighbors, either through the contractionary effects of adjustment policies or through exchange rate variations. This creates a strong case for policy dialogue and eventual coordination of macroeconomic policies. A major incentive for such coordination is, however, absent: the ability to "borrow credibility" from neighbors. Rather, the attempt of neighbors to differentiate themselves from countries facing a crisis, as was typical of Mercosur in the late 1990s and early 2000s, contributed to the further loss of credibility by the authorities.

Based on the European and Latin American experience, Machinea and Rozenwurcel argue that the exchange of information and periodic technical meetings involved in integration processes help to build knowledge and mutual trust.[60] Nonetheless, the transition to more explicit coordination mechanisms, which would help to internalize the effects of macroeconomic policies on neighbors, is a difficult task in the Latin American context. These authors argue, furthermore, that in developing countries the agreed macroeconomic convergence criteria should include, in addition to fiscal objectives (the fiscal deficit, preferably set as the structural stance, and the public sector debt ratio), external sector targets, particularly for the current account deficit and the short-term external debt. Striking a balance between compliance with explicit targets and the degree of policy flexibility that is required in economies subject to large shocks is, however, an important challenge. Some degree of exchange rate stabilization would be desirable, particularly smoothing short-term swings, which may require active use of capital account regulations, particularly on short-term capital flows. In this area, according to these authors, at least two further objectives should be agreed: the harmonization of the exchange rate *regimes,* and the principle that countries should consult with one another concerning possible courses of action to follow in crisis situations.

The existence of regional reserve funds can serve as an important incentive for macroeconomic coordination. In this regard, the experience of the Latin American Reserve Fund, analyzed by Daniel Titelman in this volume, demonstrates the possibilities of using this type of mechanism, which has been widely underutilized in the developing world. It shows that even a modest fund can

60. See also Ghymers (2005).

make essential contributions to the balance-of-payments financing of developing countries. Since 1978 this fund has provided such financing to member states, equivalent to 60 percent of that of the IMF, benefiting in particular its smallest members, Bolivia and Ecuador. Its financing was clearly countercyclical, and its preferred-creditor status has been reflected in its healthy portfolio, even in the face of two major crises in the region, when some member countries accumulated arrears in their public sector obligations. It also shows that the fear that "soft conditionality" would result in major losses by an institution providing emergency liquidity financing is exaggerated. Such funds can help manage trade shocks and even, to a limited extent, abrupt reversals of capital flows. Indeed, Agosin has estimated that, during recent decades, even a relatively modest fund, equivalent to 15 percent of Latin America's international reserves, could have provided financing to cope with capital outflows equivalent to the entire short-term debts of all the countries except Mexico.[61]

The most ambitious project of this kind is the Chiang Mai Initiative, agreed in 2000 by the ASEAN countries plus China, Japan, and the Republic of Korea. The agreed mechanism is the negotiation of bilateral swap arrangements among the central banks of the member countries. To do this, it built on the modest ASEAN Swap Arrangement, which had been created in 1977. Aside from liquidity financing, the mechanism has provided an instrument of policy dialogue, and an appropriate surveillance mechanism is currently being designed. Strong regional monitoring and surveillance is deemed essential by net contributors to liquidity financing to guarantee that its lending is protected; this condition is deemed particularly important by Japan.

As Yung Chul Park argues in his contribution to this volume, this arrangement builds on two essential lessons from the Asian crisis: that in the face of capital account crises, policy coordination, or at least a regional policy dialogue, is essential in preventing contagion, and that the countries need ample access to liquidity to thwart the speculative attacks that characterize contemporary capital account crises. The capacity of regional partners to provide such financing is reflected in the fact that the funds provided by the IMF to Indonesia, the Republic of Korea, and Thailand during the crisis (U.S.$111.7 billion) were only a fraction of the international reserves held by the members of the Chiang Mai Initiative at the time (about U.S.$700 billion), and a very small fraction of the reserves accumulated by these countries since the Asian crisis (U.S.$2.5 trillion at the end of 2005). As noted above, this initiative is also a sign of East Asia's frustration with the speed of reform of the international financial system.

61. Agosin (2001).

The mechanism entitles countries to a disbursement of up to 20 percent of the maximum amount of drawings from the bilateral swaps without an IMF program. This limit, agreed to in May 2005, was an increase over the 10 percent originally set. When this limit is reached, the country would thus be placed under an IMF program. This implies that regional liquidity financing is complementary to that of the IMF in a more explicit way than in the case of the Latin American Reserve Fund. These bilateral arrangements, which added up to U.S.$71.5 billion in February 2006, could eventually be multilateralized. Indeed, a step in that direction was also agreed in May 2005, when it was decided that the swap activation would be based on a collective decisionmaking process, the details of which must be agreed. The mechanism has not yet been utilized, and indeed, the buoyant conditions of the member countries in recent years, including the accumulation of record levels of "self-defense" in the form of large international reserves, may have slowed the pace of action. According to Park, the major stumbling blocks in the process seem to be the weak institutional arrangements that have been established and the unsettled leadership among the two major economic powers in the region.

The recent decision to multilateralize the swap arrangement could lead to some form of reserve pooling, which could be used to back a common reserve currency. If a strong surveillance mechanism is put in place, using this mechanism of liquidity, financing could be detached from an IMF program. Also, the policy dialogue could eventually evolve into a more formal system of policy coordination, including the establishment of mechanisms to stabilize the bilateral exchange rates of the member countries, even though the members of the initiative have not yet expressed their desire to do so. If these steps are taken, and the membership of the initiative is expanded to include other countries that have requested membership (including India), the system could eventually evolve into a full-fledged Asian monetary system.[62] It must be added that this is more likely if the issue of the Asian countries' voice and participation in the IMF is not solved in an acceptable manner.

As the previous discussion indicates, designing an adequate monitoring and surveillance process is key to ambitious efforts in macroeconomic cooperation. In this area, four mechanisms have been agreed in Asia since the 1997 crisis. One of these was abandoned (the Manila Framework Group, adopted in the context of APEC), and another is still in its infancy (the South Asian process). The ASEAN Surveillance Process, adopted in 1998, is the most advanced. It has put in place a peer review mechanism for national policies, based on a Surveillance

62. Rana (2005).

Report prepared by the ASEAN Secretariat, and the ASEAN Economic Outlook, prepared by the Asian Development Bank. However, neither this mechanism nor the less structured ASEAN+3 Economic Review and Policy Dialogue (which is now integrated into the Chiang Mai Initiative) qualifies as an effective surveillance process. This has been attributed to the overemphasis on consensus and noninterference in the peer review, at the expense of frank and in-depth policy discussions. So, although there is now an adequate supply of forums for policy dialogue (those mentioned above, plus the dialogues among central banks), a full-fledged monitoring and surveillance process is still not in place.[63]

Conclusions

This chapter argues that the international financial architecture would be strengthened if it were to rely not on a few specialized world organizations, but rather on a *network* of institutions that provide the services expected from such an architecture (liquidity and development financing, macroeconomic surveillance and consultation, peer review of prudential regulation). An institutional framework such as this would have two positive features. First, it might help to bring more stability to the world economy by providing essential services that can hardly be provided by a few international institutions, particularly in the face of a dynamic process of open regionalism. Second, from the point of view of the equilibrium of world relations, it would be more balanced than a system based on a few world organizations.

The chapter sets out four arguments in favor of a strong role for regional and subregional cooperation in the international financial system: the growing linkages generated by the open regionalism characterizing the current globalization process; the complementary role that world and regional institutions play in a heterogeneous international community, and in a world that still lacks a fully developed international financial architecture; the case for competition in the supply of services to small and medium-sized countries; and the strong sense of ownership that regional institutions have, and their capacity to serve as channels for better articulating the voice of smaller countries. At the same time, it is argued that such arrangements face three major challenges: developing the capacity to match the demand for financial support with their supply capacities, which restricts the capacity of the poorer developing countries to create viable regional financial institutions; making a strong long-term commitment to institution building, a basic lesson of European cooperation in this area; and putting

63. See, for example, Kuroda and Kawai (2004).

together arrangements that would guarantee an equitable distribution of the benefits of integration. These issues are interrelated, since supply capacities and equitable integration are not exogenously given because they are largely created through a gradual process of institution building.

The experiences of regional financial cooperation are clustered in two groups: development financing; and mechanisms for macroeconomic cooperation and related financial arrangements (liquidity financing during balance-of-payments crises).

The best-developed form of cooperation is that of multilateral development banks. The network of regional and subregional institutions of this type has shown the advantages of diversity, particularly in their capacity to adapt to the demands of specific regions. However, they have advanced only marginally outside Europe, to support the provision of "regional public goods." Whereas the most developed network is that of the regional development banks, the most elaborate set of "developing-country-owned" financial institutions is that of the Arab and Islamic world, with the network of subregional development banks in the Latin American and Caribbean region coming next. At least one institution, the Andean Development Corporation, shows that it is possible for a set of non-investment-grade developing countries to build an investment-grade institution. Most institutions of this type have a very strong financial structure, which is associated, at least partially, with their preferred-creditor status. Only a few have faced difficulties throughout their history (the African Development Bank and the Central American Bank for Economic Integration). The history of the African Development Bank shows, however, how hard it is to create dynamic development financing institutions for the poorest countries without backing from industrial nations—and, even with such backing, demonstrates the difficulties faced by these institutions in building strong loan portfolios in structurally weak development contexts. The Arab institutions have a different sort of problem: excessive dependence of available finance on oil prices, which reduces their capacity to operate as a countercyclical device.

Two other mechanisms of development financing have been available in a few regional processes. Fiscal transfers to the poorer members of a regional group are used exclusively by the European Union, having been tried unsuccessfully in only one integration process in the developing world. In recent years, East Asia has launched a third model of cooperation in the area of development finance, which focuses on bond markets. This novel form of cooperation aims to deepen local and regional financial development through joint actions to design the appropriate financial infrastructure and by launching specific bond funds that become investment vehicles for central banks in the region.

Contrary to the rich historical experience in the area of development financing, there is a dearth of experiences in the area of macroeconomic cooperation in the developing world. This is, however, an area where several initiatives have been launched in recent years, in many cases aiming to replicate European arrangements. The links between trade and macroeconomic cooperation are, of course, at the heart of the formation of the European Union. Certainly trade links are weaker in the developing world—although they have been growing rapidly in some regions, particularly in East Asia. However, two additional rationales for macroeconomic cooperation are present in the developing world: building stronger walls of defense against global financial shocks, and avoiding distorting competition among export-oriented economies. Aside from the role of the links between intraregional trade and macroeconomic cooperation, European integration brings two additional lessons for the developing world: the emphasis on building strong institutions in a gradual and pragmatic way, and the subordination of capital mobility to other macroeconomic objectives of regional cooperation.

The experience with macroeconomic cooperation in the developing world generally breaks up such cooperation into its different components: policy dialogue, monitoring, and surveillance; liquidity support during crises; and exchange rate coordination. The third objective, which has, of course, been central to European cooperation, is generally left aside, except in the few experiences with monetary unions, which have not usually been very successful. The most common recent initiatives have thus taken the form of macroeconomic dialogue and consultations based on Maastricht-type convergence criteria; and, even in the best example of its kind—the ASEAN surveillance arrangement—they have not evolved into effective surveillance processes. However, unless the adoption of convergence criteria and dialogue among authorities evolve into regular consultations, and eventually into effective coordination processes, their credibility and rationale may be lost. Furthermore, for the developing world, the balance between targets and a certain degree of policy flexibility required in economies subject to shocks is a difficult one to strike.

In the area of liquidity financing, the experience of the Latin American Reserve Fund illustrates the possibilities of using such mechanisms, which have been widely underutilized in the developing world. It shows that even a modest fund can make essential contributions to balance-of-payments financing of developing countries. In turn, the 1997 crisis led in Asia to the adoption of the Chiang Mai Initiative, aimed at building a strong pillar of regional balance-of-payments support as a crisis-prevention device. The recent multilateralization of bilateral swap arrangements could eventually lead to some form of reserve pooling. The basic weakness of the Chiang Mai Initiative has been its slowness to take strong institutional shape.

All in all, these experiences indicate that regional cooperation can be very effective in reducing the inadequate supply of financial services that the current international financial architecture provides. Nonetheless, these institutions remain limited in scope and are not recognized as central to the international financial architecture. In this regard, we argue that the International Monetary Fund of the future should be viewed as the apex of a network of regional and subregional reserve funds and swap arrangements—that is, a structure more akin to that of the European Central Bank or the United States Federal Reserve system than to its current centralized structure. In turn, competition among global, regional, and subregional institutions is probably the best arrangement in this area. And above all, in an era when developing countries have made a call for greater South-South cooperation, financial cooperation should be placed at the top of the agenda.

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