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**No. 238**

**The Evolving Multi-layered Global Financial Safety Net:  
Role of Asia**

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## Abstract

This paper argues that in the aftermath of the global economic crisis, the relatively centralized international monetary architecture set up at the Bretton Woods conference is evolving towards a more decentralized multi-layered global financial safety net (GFSN) comprising (i) the G20 at the apex as an overarching institution (ii) multilateral financial safety nets (MFSNs) established under the auspices of the IMF (iii) bilateral financial safety nets (BFSNs) among central banks, (iv) regional financial safety nets (RFSNs) established in various regions of the world, and (v) national financial safety nets (NFSNs) or reserve accumulation by individual countries. The most significant factor explaining this evolution is the increased incidence of capital account crisis subsequent to the deepening of financial globalization. The paper argues that the evolving GFSN has increased the flexibility of the international monetary architecture and enhanced the voice (weight and influence) of emerging markets on global economic governance to some extent. However, more needs to be done. Also there is the need for institutional and other reforms to prevent and manage a systemic crisis in the future and to protect innocent bystanders. What is the role of Asia and what can Asia do?

*Keywords:* international economic institutions, global economic governance, international monetary architecture, global financial safety net, Bretton Woods, Group of Twenty.

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Integration which spearheaded the ADB's support for Asian economic integration. Prior to that, he held various senior positions at the ADB for many years. He has teaching and research experience at the NTU, NUS, and the Tribhuvan University (Nepal). He obtained his PhD from Vanderbilt University where he was a Fulbright Scholar and a Masters in Economics from Michigan State University and Tribhuvan University where he was a gold medalist. He has published widely in the areas of Asian economic development and integration, financial crises, and economic policy reforms in transition economies. These include 15 authored or edited books, over 25 chapters in books, and over 50 articles in international scholarly journals including *Review of Economics and Statistics*, *Journal of International Economics*, *Journal of Development Economics*, *Journal of Asian Economics*, *World Development*, *Developing Economies*, and *Singapore Economic Review*. Recently, he co-authored books on *Asia and the Global Economic Crisis: Challenges in a Financially Integrated World* (Palgrave Macmillan) and *South Asia: Rising to the Challenge of Globalization* (World Scientific Publishers). Most recently, he edited a book entitled *The Renaissance of Asia: Evolving Economic Relations between South Asia and East Asia* (World Scientific Publishers). He also co-edited books on *Pan-Asian Integration: Linking East and South Asia* (Palgrave Macmillan) and *National Strategies for Regional Integration: South and East Asian Case Studies* (Anthem Press, UK). He was the Guest Editor of the Singapore Economic Review Special Issue on *Asian Economic Integration* (Volume 55, Number 1, March 2010).

# **The Evolving Multi-layered Global Financial Safety Net<sup>1</sup>: Role of Asia**

## **I. Introduction**

The international monetary architecture set up at Bretton Woods in 1944, comprised the IMF whose task was to promote macroeconomic stability by providing short-term financial support to countries facing a temporary balance of payments problem. Subsequently, the G7/G8 was established in the mid-1970s to oversee the process of provision of public goods by various international economic institutions including by the IMF. In the aftermath of the global economic crisis of 2008-2009 this relatively centralized international monetary architecture is evolving towards a more decentralized multi-layered global financial safety net (GFSN) comprising (i) the G20 at the apex as an overarching institution (ii) multilateral financial safety nets (MFSNs) established under the auspices of the IMF (iii) bilateral financial safety nets (BFSNs) among central banks, (iv) regional financial safety nets (RFSNs) established in various regions of the world, and (v) national financial safety nets (NFSNs) or reserve accumulation by individual countries. The most significant factor explaining this evolution is the increased incidence of capital account crisis – associated with large inflows and sudden reversals of capital flows and the bursting of asset bubbles – subsequent to the deepening of financial globalization. As Kawai and Rana (2009) have argued preventing and managing such crises requires actions at multiple levels - at the global, regional, and national levels.

The multi-layered GFSN is still evolving and needs to be strengthened further to prevent a systemic crisis and protect innocent bystanders in the future. This topic was, therefore, introduced as a new agenda item at the Seoul G20 Summit of November 2010 where the Leaders agreed that “Strengthened GFSNs can help countries to cope with financial volatility, reducing economic disruptions from sudden swings in capital flows and the perceived need for excessive reserves accumulation”. They also agreed to explore “ways to improve collaboration between regional financing arrangements and the IMF, acknowledging the potential synergies from such collaboration” (The

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<sup>1</sup> The GFSN refers to a set of crisis prevention and resolution instruments encompassing self-insurance (reserves), bilateral arrangements (swap lines between central banks), regional arrangements, and multilateral arrangements with the IMF in the center (<http://www/imsreform.org/safety>)

G20 Seoul Summit Leaders Declaration 11-12 November 2010). At the Cannes Summit of November 2011, with their attention diverted towards the eurozone crisis, the leaders “agreed to continue the efforts”. The IMF was requested to expeditiously discuss and put in place new Precautionary and Liquidity Line and a single emergency facility to provide non-concessional financing for various types of emergency needs (The G20 Cannes Summit Leaders Declaration, 4 November 2011).

The objectives of this paper are four-fold, to (i) review trends in the international monetary architecture (ii) discuss factors responsible for the evolution of the multi-layered GFSN and Asia’s role (iii) discuss how Asia’s voice (weight and influence) could be strengthened further in the new architecture especially in the G20 and the IMF and (iv) highlight what other actions may be required to prevent a systemic crisis including contagion to innocent bystander countries in the future.

The paper is organized as follows: Section II, outlines the move from a centralized international monetary architecture of the Bretton Woods period towards a multi-layered GFSN. Section III discusses the reasons for the change. It argues that among the various components of the GFSN, RFSNs show the most promise and potential. But as noted by the G20, RFSNs should complement MFSNs and not try to supplant them. Section IV, argues that while Asia’s voice in the new multi-layered GFSN has increased to some extent, it is still not commensurate with Asia’s economic and political clout. The new architecture, therefore, still lacks legitimacy. It then suggests a number of ways through which Asia’s voice (weight and influence) could be further strengthened in the new architecture. In this context, India’s role, as one of the fastest growing countries in the world and a member of the G20, is highlighted. Section V, argues that despite recent efforts to strengthen it, the present GFSN is insufficient to prevent and manage a systemic crisis. In addition to the institutional actions proposed in Section IV, a number of policy actions to increase its “firepower” and flexibility are, therefore, highlighted.

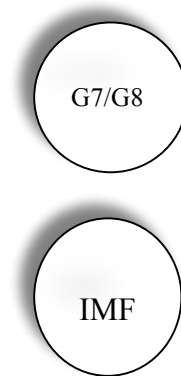
## **II. From Centralized to a Decentralized International Monetary Architecture**

The Bretton Woods conference held in July 1944 created the IMF, the World Bank, and the GATT, the predecessor of the WTO. Initially the IMF was to promote macroeconomic stability but now with the increasing incidence of financial crisis it also focuses on financial stability namely crisis prevention and crisis management.

The GATT was to ensure an open trading system globally, and the World Bank and the later the regional development banks were to provide development finance for poverty reduction. The G7 was created in the mid-1970s from the G5 to oversee the process of provision of international public goods by these international institutions. Russia joined the group in 1997 to form the G8.

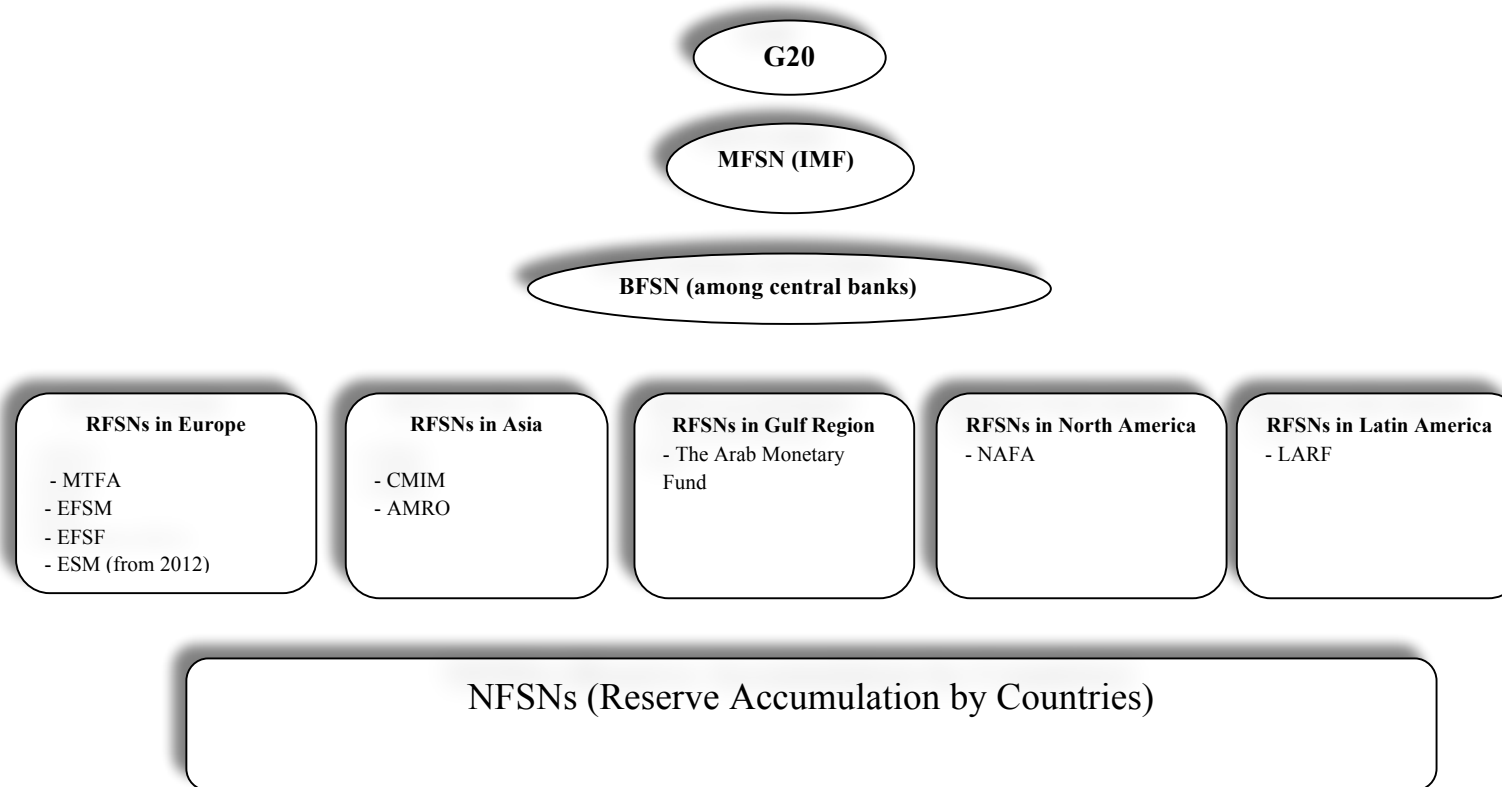
The international monetary architecture that prevailed in the 1970s and the 1980s is depicted in Figure 1. It comprised the IMF with the G8 as the oversight body. This architecture worked fairly well in promoting macroeconomic and financial stability aside from the Latin American debt crisis of the 1980s and the problems with the EMS in the early 1990s.

Figure 1: International Monetary Architecture of the 1970s and the 1980s



In the aftermath of the global economic crisis, however, the relatively centralized international monetary architecture of the 1970s and 1980s is moving towards a more decentralized multi-layered global financial safety net (GFSN) comprising (i) G20 as an apex body (ii) multilateral financial safety nets (MFSNs) established under the auspices of the IMF (iii) bilateral financial safety nets among central banks (BFSNs) (iv) regional financial safety nets (RFSNs) established in various regions of the world, and (v) national financial safety nets (NFSNs) or reserve accumulation by individual countries. The present monetary architecture is depicted in Figure 2

Figure 2: Multi-layered GFSN



The G20 is at the apex of the multi-layered GFSN. The G20 Summit was established after the GEC by upgrading the G20 finance and central bank officials’ forum started since 1999 but which was kept under the shadow of the G7. The leaders have self-appointed the forum as the “premier forum for international economic cooperation” including monetary cooperation. As already mentioned, since the Seoul Summit, the G20 has adopted the topic of strengthening the GFSN as one of its agenda items.

Following the London G20 Summit and the eurozone sovereign debt crisis, IMF resources have been substantially increased. Also in an attempt to prevent and more effectively manage a capital account crisis, the IMF has revamped its lending policies. These include the various contingent financing facilities or MFSNs that have been established. In 2009, the IMF introduced a new Flexible Credit Line (FCL) designed to meet the increased demand for crisis prevention and crisis mitigation lending from countries with robust policy frameworks and very strong track records in economic performance. A year later it also introduced the Precautionary Credit Line (PCL) for countries with sound fundamentals and policy track record that may not meet the FCL requirement (See Table 1 for further details). Proposals for a Global Stabilization Mechanism, where the IMF would finance a number of countries simultaneously,



have also been launched, although it has not received enough support from member countries.

Despite, these innovations, the IMF's capacity to prevent a crisis in the future is in doubt. The new IMF's FCL, which provide large-scale access to finance without conditionality to protect countries against contagion have been taken up by only three countries (Colombia, Mexico, and Poland). Similarly, the PCL has been taken up by only one country (Macedonia). A major problem is stigma – countries fear that applying for these facilities would be seen by capital markets as a sign of underlying weakness and as indicating that the countries were in difficulties. There is now talk of the IMF unilaterally prequalifying countries and of countries applying as a group so that no one country is singled out as a weak country.

In 2008, when countries faced a severe credit crunch because of the crisis in the US, the Fed extended \$30 billion in the form of bilateral swaps to Brazil, Mexico, Singapore, and Korea. Korea also obtained such funding from the Bank of Japan and the People's Bank of China. Although some countries wish to establish BFSNs by regularizing these bilateral dollar swap arrangements entered with various central banks in times of crisis, it may not be possible. For example, the swaps were criticized by the US Congress as giveaways to countries that could lead to moral hazard.

Table 1: IMF New Non Concessional Facilities

IMF New Non Concessional Facilities		
	Flexible Credit Line (FCL)	Precautionary Credit Line (PCL)
<b>Purpose</b>	To reduce the perceived stigma of borrowing from the IMF and to encourage countries to ask for assistance before they face a full-blown crisis.	To support countries with sound fundamentals and policy track records, but facing moderate vulnerabilities that may not yet meet the high FCL qualification standards. It combines a qualification process similar to FCL with focused ex-post conditionality aimed at addressing vulnerabilities identified during qualification.
<b>Eligibility</b>	Available to member countries that meet the qualification criteria.	Available only to countries that do not face an actual balance-of-payments need at the time of approval.
<b>Duration and repeated use</b>	Works as a renewable credit line, which at the country's discretion could initially be for either 1 or 2 years with a review of eligibility after the first year.	Works as a renewable credit line, with duration between 1 and 2 years. Countries that qualify under the PCL have large frontloaded access, with up to 500% of quota made available on approval of the arrangement and up to a total of 1,000% of quota after 12 months on satisfactory progress in reducing their vulnerabilities
<b>Conditionality</b>		Countries using the PCL should commit to a focused set of policies aimed at reducing the remaining vulnerabilities identified in the qualification process.
<b>Lending Terms</b>	The cost of borrowing under the FCL is the same as that under the traditional Stand-By Arrangements, which varies with the scale and duration of lending. The lending rate is tied to the IMF's market-related interest rate (basic rate of charge), which is linked to the special drawing rights (SDR) interest rate.	Subject to the same charges, surcharges, commitment fees, and repurchase period (3.5–5 years) as the FCL and Stand-By Arrangements
<b>Qualification Criteria</b>	To qualify for an FCL arrangement, a member country should have: (i) sustainable external position; (ii) capital account position dominated by private flows; (iii) track record of access to international capital markets at favorable terms; (iv) comfortable reserve position; (v) sound public finances; (vi) no bank solvency problems; (vii) effective financial sector supervision; and (ix) data integrity and transparency	The criteria to assess whether a country qualifies for the PCL are the five broad areas encompassed in the FCL qualification criteria: (i) external position and market access; (ii) fiscal policy; (iii) monetary policy; (iv) financial sector soundness and supervision; and (v) data adequacy. Countries suffering any of the following problems at approval cannot access the PCL: (i) sustained inability to access international capital markets; (ii) the need to undertake large macroeconomic or structural policy adjustment; (iii) a public debt position that is not sustainable in the medium term with a high probability; or (iv) widespread bank insolvencies

Source: www.imf.org

Efforts have also been made to establish or expand existing regional financial safety nets (RFSNs)<sup>2</sup>. Europe has the Medium-term Financial Assistance established in 1971 to support European Union members facing payments difficulties. In 1999, this program was narrowed to cover only the non-eurozone members. Subsequently, fears that the contagion from Greece could affect other countries in Europe led to the establishment of in May 2010 of the European Financial Stability Facility (EFSF) for eurozone members and the European Financial Stabilization Mechanism (EFSM) for the all EU members. Recently, European leaders agreed to a permanent replacement of the EFSF and EFSM by the European Stability Mechanism (ESM) to be established in 2012 (originally, 2013). The ESM will in effect be an European Monetary Fund (Henning 2010 a).

In 1994, the North American Framework Agreement (NAFA) was established as a parallel financing agreement to the North American Free Trade Agreement. Also the Arab Monetary Fund was established in 1976, and the Latin American Reserve Fund in 1978.

In Asia, about a dozen and half bilateral swaps had been established between central banks of the region under the Chiang Mai Initiative in the aftermath of the Asian financial crisis. In March 2010, these were combined and expanded to become the Chiang Mai Initiative Multilateralization (CMIM) or the \$120 billion “self-managed reserve pooling arrangement”. All ASEAN+3 members (plus Hong Kong) contribute to this fund and are eligible to borrow from it in case they face payments problem. Under this arrangement, foreign exchange is earmarked for crisis prevention but held in separate national accounts. Individual country contributions, borrowing multipliers, and voting power as agreed is in Table 2. Executive level issues (initial execution of drawing, renewal of drawing, events of drawing) are to be determined by 2/3 majority at the Executive Level Decision Making Body which comprises deputy level representatives of ASEAN+3 and Hong Kong. The CMIM retains the provision of the CMI that only 20% of the amounts can be withdrawn without an IMF program in place. The IMF link and the lack of an independent surveillance unit to conduct due diligence had inhibited the use of these arrangements during the recent crisis. In April

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<sup>2</sup> See McKay, Volz, and Wolfinger (2010) and Eichengreen (2010) for a comparative analysis of various RFSNs

2011, the ASEAN+3 Macroeconomic Research Office (AMRO), an independent surveillance unit for the CMIM, was established in Singapore. AMRO's mandate is to "monitor and analyze regional economies, which contributes to the early detection of risks, swift implementation of remedial actions, and effective decision-making of the CMIM" (ASEAN+3 Finance Ministers Joint Media Statement May 2, 2010)<sup>3</sup>. AMRO became fully operational in October 2011 with 10 staff. More are being recruited. AMRO is to produce quarterly reports and table them biannually for discussion by the ASEAN+3 finance and central bank deputies. In the event that the CMIM is activated, AMRO assumes the key role of providing an objective assessment of swap requesting countries and makes a recommendation to the CMIM parties. If the application is approved, AMRO then monitors the use and impact of swap funds. In a recent perception survey of ASEAN+3 opinion makers conducted by a team from NTU, two-thirds of the respondents felt that sometime in the future (during 2016-2020) the CMIM and AMRO should be combined to form the Asian Monetary Fund (Rana, Chia, and Jinjark 2012).

Data in Table 3 suggest that European RFSNs are the strongest in terms of financing capacity, speed of decision-making, impartiality, and the ability to work with the IMF. The Arab Monetary Fund and the Latin American Reserve Fund are older but have limited resources. Their surveillance capacity is fairly strong and they have no links with the IMF. The CMIM is in between with \$120 billion and link with the IMF. The surveillance capacity for the CMIM is also being built at the AMRO.

Many developing countries have built up foreign exchange reserves as first lines of defence. Pretty much every country that has been able to do so has accumulated ever-growing amount of reserves intended to serve as self-insurance and thus prevent the need to resort to the IMF. While there is evidence that countries with more reserves did better during crises, self insurance has its costs (Eichengreen 2010). Yield on reserve assets are low and accounting losses could be experienced if the country's currency appreciates vis a vis the dollar and euro. Further, reserve accumulation could aggravate the global imbalance problem.

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<sup>3</sup> AMRO's purposes are (i) conduct macroeconomic and financial surveillance of members (ii) provide members with policy recommendations to mitigate economic and financial crisis (iii) assist members if they are utilizing financial resources of CMIM (Economist, 10 December, Job Description)

### **III. Factors Responsible for the Multi-layered GFSN**

The first and foremost factor responsible for the move towards the multi-layered GFSN is financial globalization of the post-1990 period. While policymakers had been wary of uncontrolled financial flows during the Bretton Woods era and in fact permitted capital controls, in the 1980s and the 1990s under the Washington Consensus they embraced financial liberalization and deregulation, thereby ushering in an age of highly integrated financial markets and capital flows which have dwarfed the operation of the IMF. As early as

Table 2: CMIM Contributions,Purchasing and Voting-Power Distribution

	Financial Contribution			Purchasing Multiple	Basic Votes	Votes based on contribution	Total voting power		
	USD (billion)	(%)					(no. of vote)	(no. of vote)	(no. of vote)
China*	38.40	China (Excluding Hong Kong, China) 34.2	32.0	28.5	0.5	1.60	34.20	35.8	25.43
		Hong Kong, China 4.2		3.5	2.5	0	4.20	4.2	2.98
Japan	38.40		32.00		0.5	1.60	38.40	40.00	28.41
Korea	19.20		16.00		1	1.60	19.20	20.80	14.77
<b>PLUS 3</b>	96.00		80.00			4.80	96.00	100.80	71.59
Indonesia	4.552		3.793		2.5	1.60	4.552	6.152	4.369
Thailand	4.552		3.793		2.5	1.60	4.552	6.152	4.369
Malaysia	4.552		3.793		2.5	1.60	4.552	6.152	4.369
Singapore	4.552		3.793		2.5	1.60	4.552	6.152	4.369
Philippines	4.552		3.793		2.5	1.60	4.552	6.152	4.369
Vietnam	1.00		0.833		5	1.60	1.00	2.60	1.847
Cambodia	0.12		0.100		5	1.60	0.12	1.72	1.222
Myanmar	0.06		0.050		5	1.60	0.06	1.66	1.179
Brunei	0.03		0.025		5	1.60	0.03	1.63	1.158
Laos PDR	0.03		0.025		5	1.60	0.03	1.63	1.158
<b>ASEAN</b>	24.00		20.00			16.00	24.00	40.00	28.41
<b>TOTAL</b>	120.00		100.00			20.80	120.00	140.80	100.0

Source: Key points of CMI Multilateralization Agreement AMRO (<http://www.amro-asia.org/wp-content/uploads/2011/12/Key-Points-of-CMIM.pdf>)

Table 3: Details of RFSNs

	<b>Europe</b>	<b>CMIM</b>	<b>The Arab Monetary Fund</b>	<b>The Latin American Reserve Fund (FLAR)</b>
Brief Description	<p>1. Medium Term Financial Assistance (was MTF A) established in 1971 to provide financial support to all EU members facing payments difficulties: since 1999 covers only to non-euro zone members.</p> <p>2. European Financial Stability Mechanism (EFSM) was established in May 2010 with similar mandate as MTF A but covers all EU members</p> <p>3. European Financial Stabilization Facility (EFSF) was established in May 2010 and covers only euro zone countries. In 2012, EFS will evolve into the permanent European Stability Mechanism (ESM).</p>	<p>CMI of May 2012 became the CMIM (Chiang Mai Initiative Multilateralization) or a “self managed” reserve pool of \$120 billion in March 2010.</p>	<p>The Arab Monetary Fund started operations in 1977. It has 22 member countries and has provided 146 loans benefiting 14 countries.</p>	<p>It was established in 1978. Membership comprises 5 Andean countries, and Uruguay. Originally it focused on providing balance of payments support. Now it also helps in debt restructuring and harmonising macroeconomic policies of members.</p>

Sources: Data from McKay, Volz, Wolfinger 2010; Eichengreen 2010; Park 2011

Table 3 continued

	<b>Europe</b>	<b>CMIM</b>	<b>The Arab Monetary Fund</b>	<b>The Latin American Reserve Fund (FLAR)</b>
<b>Adequacy of Finance</b>	MTFA: Max capacity presently €50 billion EFSM: €60 billion EFSF: € 440 billion	\$ 120 billion	Its paid up capital is small, only \$3 billion.	It has roughly \$2 billion of paid-up capital. FLAR can borrow specified amounts.
<b>Surveillance Capacity</b>	Decisions are taken by the ECOFIN Council based on the recommendations of the Commission or request of a member: Strong Surveillance	ASEAN +3 Macroeconomic Research Office was established in May 2011 in Singapore as the independent surveillance unit. AMRO's purposes are to (i) monitor and analyze regional economies and (ii) contribute to (a) an early detection of risks, (b) policy advice for remedial actions, and (c) effective decisions\ making of the CMIM. AMRO is new and staff are being recruited.	It has a technical staff of 50 and conducts regular country reviews.	FLAR has an Economic Studies Department and is quite effective.
<b>Speed of Decision Making</b>	Relatively fast	Not sure, but may not be too slow.	Relatively fast	Relatively fast
<b>Impartiality in lending decisions</b>	Impartial	Impartial	Impartial	Impartial
<b>Ability to work with IMF</b>	Working closely with IMF in resolving the present euro zone crisis.	Strong ties with the IMF because only 20% can be used without an IMF programme in place.	No provision for working with the IMF	No provision for working with the IMF, but shares information with the IMF.



the 1960s, the British had been promoting financial globalization through their support of deregulated Euromarkets for London. But the momentum accelerated when Thatcher in 1979 and Reagan in 1980 took political office. IMF management even launched an initiative in 1995 to overturn the commitment to capital controls by amending their articles of agreement in order to gain liberalization mandate with respect to capital movement. It was only recently that this initiative was withdrawn.

With financial globalization not only has the incidence of financial crisis increased<sup>4</sup> but its nature has also changed. Crisis of the past were currency crisis or debt crisis due mainly to governments borrowing excessively in international capital markets to finance their current account deficits. Speculative attacks occurred as international reserves of the country fell below a critical level. These were the standard currency crisis or the “generation one” type crisis first discussed by Krugman (1979).

With financial globalization, a new type of crisis called capital account crisis or “generation three” crisis (Dornbusch 2001) – associated with large inflows and sudden reversals of capital flows and the bursting of asset bubbles and banking crisis – have started to hit emerging markets<sup>5</sup>. Such crisis tends to affect balance sheets of countries and impact on solvency positions. The costs of balance sheet recessions tend to be higher and recovery from the crisis also takes a longer time. They also tend to be systemic affecting most or all sectors of the economy with strong contagion to neighbouring countries (which may be innocent bystanders).

Based on the experience with the Asian financial crisis, Kawai and Rana (2009) had argued that efforts to prevent and manage a capital account crisis, required actions at the global, regional, and national levels. Last year, the G20 came up with a similar message in relation to the global economic crisis: “Current volatility of capital flows is reflecting the differing speed of recovery between advanced and emerging market economies. National, regional, and multilateral responses are required” (G20 Seoul Summit Leaders Statement). The IMF had until recently not appreciated the value of RFSNs. But now that view is changing and the IMF is working closely with various

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<sup>4</sup> Kawai and Rana (2009) noted that 10 such crisis had hit countries all over the world since the Asian financial crisis of 1997-1998. Chamon, Ghosh, and Kim (2010) have identified more episodes of such crisis.

<sup>5</sup> “Generation two” crisis are the self-fulfilling type of crisis that hit the European Monetary System in 1992/1993.

FSFNs (especially those in Europe in attempting to resolve the eurozone crisis. Last year the IMF organized a high-level seminar to create stronger links with RFSNs (Goretti, Lanua, Ramakrishnan 2010). There is, therefore, a consensus now that we need a multi-layered GSFN and global and regional policy coordination. Regional policy coordination could add value in two ways. First, policymakers tend to be more frank when discussing policies with neighbouring countries than at the global level. Second, regional policy agenda also tends to be more focused on the common issues affecting a set of countries rather than those at the global level.

Second, the governance system of the international monetary architecture in the 1970s and the 1980s reflected the dominance of the US and this system lacked legitimacy and needed to be changed in an environment where the economic and political power of emerging markets, particularly those in Asia (China and India) was rising rapidly. Emerging markets whose footprint in the global economy is increasing rapidly must also participate in global governance.

According to the long term projections made by Goldman Sachs, emerging markets will continue to grow rapidly over the next 40 years. In 2003, Goldman Sachs (2003) projected that the three largest economies in the world by 2050 would be China, US, and India. In 2007, Goldman Sachs (2007) revised this ranking to China, India, and US. More recently, the ADB (2009) has projected that the above ranking could be obtained even earlier, within the next 30 years. Despite their economic dynamism, China and India will be very much behind the US in terms of per capita incomes, poverty, and military might.

Third, the IMF is a club in the sense that it produces a benefit that is partially non-rivalrous (more than one user can consume) and at least partially excludable (users can be denied access to them). Kawai, Petri, and Sisli-Ciamarra (2009) have applied the theory of clubs to explain that the IMF, like other clubs, is an inflexible institution designed to maintain firm control in the hands of the founding members and not open to allowing new members in its governance system. The charter, quotas, and voting rights of the IMF were designed in the interest of like-minded original core members in 1944 and placed strict limits on change as membership expanded. That is why as explained in Section V, even though the G20 has pledged to allocate higher quota and voting power to emerging markets, governance reform of the IMF can only proceed at

a glacial pace . In comparison with 44 countries that participated at the Bretton Woods conference, the membership of the IMF now stands at 187.

Kawai, Petri, and Sisli-Ciamarra (2009) have examined the evolution of the shares of developing and emerging markets in IMF quotas, and in global trade and GDP (in terms of purchasing power), two rough indicators of their importance in the world economy. They have found that the trade shares of developing and emerging economies have risen more rapidly than their share in IMF quotas. This contrast is even clearer for their share of world GDP. Quotas which also determine voting power at the IMF are especially low for the rapidly growing emerging markets countries, such as Brazil, China, and India. Kelkar et al (2005) found that these three countries had 19% fewer votes than Belgium, Italy, and Netherlands collectively, although they had 21% more nominal GDP, 400% more purchasing power GDP, and 2,800% more population in the second group. On the other hand, Europe controls directly or indirectly 10 chairs out of 24 at the IMF Board even though it has common monetary policy and it has 30% of quota and voting rights.

Fourth, another reason why Asian countries have adopted national and regional self-help measures is to protect themselves from the policy mistakes made by the IMF in managing the Asian financial crisis. The IMF saw the Asian financial crisis as a standard current account crisis and recommended its standard prescription to manage it comprising tighter monetary and fiscal policies and currency crisis. These policies aggravated the impacts of the capital account crisis where an appropriate response would have been to pump liquidity into the system through expansionary monetary and fiscal policies – just the opposite of the policies that the IMF prescribed. The IMF also prescribed too many structural conditions which extended beyond its core competencies<sup>6</sup>.

The fifth 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 limited, and their most important defence is therefore competition in the provision of financial services to them ( Ocampo 2010)

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<sup>6</sup> An IMF IEO (2003) report accepts many but not all of these criticisms.

The final argument relates to the fact that regional and sub-regional institutions enjoy a greater sense of ownership because member states, particularly small ones, feel that they have a strong voice in these organizations. The “preferred creditor status” that results from this fact reduces the risks that regional reserve funds face, further encouraging the virtues of risk pooling (Ocampo 2010). Large regional countries may be willing to take a lead role in regional bodies before global bodies.

#### **IV. Asia’s Voice (Weight and Influence) in the Multi-layered GFSN**

Unlike in the old architecture where the non-G8 countries had no voice whatsoever in global economic governance, the multi-layered GFSN provides an opportunity for Asia to gain a significant role in global economic governance. This is historic. Asia is represented in the G20 by six countries – China, India, Indonesia, Korea, Japan, and Australia. The G20 has also pledged to give higher voting power to emerging markets (including those in Asia) at the IMF. At the Pittsburgh Summit, the leaders pledged to increase voting power of emerging markets at the IMF by 5 percentage points and increased this figure to 6 percentage points at their Seoul Summit. But as implied by the theory of clubs, IMF quota reform can only proceed at a very slow pace as it requires acceptance by three-fifths of the members with 85 per cent of weighted votes. Even those agreed in 2008 and announced in March 2010, have yet to come in effect.

In addition to pursuing their bilateral agenda with the G7/8 countries, how can Asian members of the G20 jointly synergize and leverage their growing economic and political clout into more effective participation in the G20. And what is the role of India, the second fastest growing country in Asia? (Rana 2010 and Rana 2011)

First, the G20’s approach of making the grouping more inclusive beyond the 19 members is to invite representatives of various regional groupings. Initially this process was ad hoc at the discretion of the host country. For example, UK invited ASEAN and New Partnership for Africa’s Development (NEPAD), Canada added African Union (AU), Korea brought in the Global Governance Group (3G), and France has brought in the Cooperation Council for the Arab States of the Gulf (GCC) for the November 2011 summit. Since the Seoul Summit, however, it has been decided to invite no more than five non-member invitees of which at least two are to be from Africa. Under this agreement, there is a possibility that ASEAN, which has

participated in all of the summits, could be left out. Since the likelihood of other regional groups in Asia being invited by the G20 is low, Asian countries should lobby to formalise the membership of the ASEAN in the G20 and actively participate in ASEAN-led efforts in Asia. For example, Sussangkarn (2010) has made the case for India, Australia, and New Zealand to be associate members or contributing partners in the CMIM. While not sitting in the governing bodies of the CMIM and borrowing from it, these countries could, at the first stage, contribute funds to the CMIM.

Second, Asian countries should organise meetings of the “expanded” ASEAN+3 (ASEAN+3 plus India, Australia, and New Zealand) just prior to the G20 Summits to coordinate policies and develop common views and opinion to support the participation of the ASEAN representative in the G20. After the Asian financial crisis, a number of fora for policy coordination have been established such as the Executives’ Meeting of East Asian and Pacific Central Bankers and the ASEAN Surveillance Process. Among these, the most comprehensive and the one with the strongest technical support is the ASEAN+3 Economic Review and Policy Dialogue (ERPD) which brings together finance ministers and deputies of 13 countries. A system to monitor financial sector vulnerabilities and early warning systems of banking and financial crises have also been established. Reflecting their growing economic weight and linkages with other countries in the region, India, Australia, and New Zealand should also be invited by the ASEAN+3 to join their policy coordination meetings. The deliberations of the “expanded” ASEAN+3 prior to the G20 Summits would provide a robust agenda for the ASEAN representative to table at the Summit. After the Summit the ASEAN representative should also brief the “expanded” ASEAN+3 grouping on the G20 outcomes.

Third, Asian countries should coordinate their views and positions with those of developing countries in other regions of the world by joining and supporting the Global Governance Group (or the 3G) convened by Singapore under the auspices of the UN (Menon 2010). This Group presently comprises about two and half dozen small and medium states from around the world (of which 6 are from Asia -- Brunei, Malaysia, New Zealand, Philippines, Singapore, and Vietnam) which have come together to develop a constructive dialogue on coordination and cooperation between G20 and non-G20 members. The 3G has put forward several important ideas in a UN document. The UN Secretary General should be an active participant in all aspects of

the G20 process. The G20 should also undertake consultations as widely as possible with the non-G20 members before the G20 Summits. The G20 should allow non-G20 states to participate in ministerial and other gatherings and other working groups involving senior officials/experts on specialised issues. And finally, the G20 should continue the practice of inviting established regional groupings to the Summits.

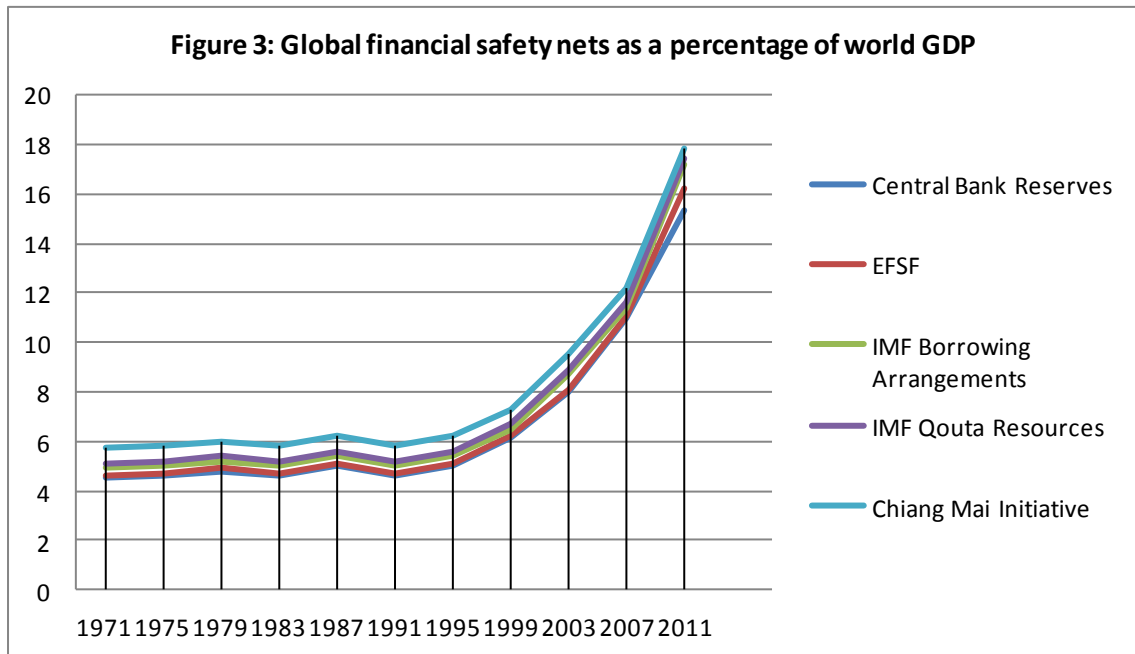
Fourth, even with the above actions, there will be countries left out of the G20. For them, a system of indirect participation should be considered. For example, South Africa has set up Committee of Ten (C10) finance ministers and central bank governors from around Africa to support its participation in G20 (see [www.treasury.gov.za](http://www.treasury.gov.za)). India could initiate a similar approach in South Asia, and Australia in the South Pacific.

Fifth, Asian countries should seek to form common grounds and coalitions with non-G7 members of the G20. Given the size of Asia, a common position among Asian members on major issues would carry considerable weight in G20 discussions. To strengthen the position of all non-G7 countries, Asian countries should reach out to the other non-G7 members and involve them in taking a unified position (Henning 2011b)

## **V. Next Systemic Crisis and the Multi-layered GFSN**

Even if all of the institutional reforms proposed above were adopted, would the new multi-layered GFSN be enough to prevent and manage the next systemic crisis? The answer is, no. Although much improved, existing mechanisms for dealing with crisis are deficient in two important respects (i) insufficient amount of fire-power to provide sufficient liquidity to offset private flows and convince markets and (ii) insufficient flexible ways to disburse funds.

As a recent IMF paper (2010) argues, the total amount multilateral fire-power available from the IMF and regional financial safety nets has done little more than keep pace with global GDP growth, standing at around 2-3 per cent and has fallen far behind the increase in global trade and financial flows (Figure 3). By far, the largest part of resources available to



Source: IMF, 'Strengthening the International Monetary System: Taking Stock and Looking Ahead', March 2011, <http://www.imf.org/external/np/pp/eng/2011/032311.pdf>

countries is their national reserves, which have grown in total over the last ten years from about 5 per cent to 15 per cent. However, these resources are spread unevenly and have tended to concentrate in countries that are less likely to face financing problems. As mentioned above they are also costly for countries and have contributed to the global imbalance problem.

What should be done to further strengthen the multi-layered GFSN? Recommendations made by Pickford (2011) deserve consideration:

On the financing side:

- (i) allow the IMF to borrow from the markets to augment its traditional sources of finance from its members
- (ii) ex-ante agreements between central banks for a network of swap arrangements, deciding in advance the amounts involved, the range of countries covered, and the conditions under which the arrangements would be activated

(iii) formalize links between the IMF and the RFSNs, especially the EFSF/ESM and Chiang Mai Initiative, setting out clear modalities for cooperation on programme design and co-financing arrangements<sup>7</sup>.

On flexibility of financing:

(i) use Article IVs to assess whether countries prequalify for FCLs and PCLs to reduce the stigma attached related to borrowing from the IMF

(ii) make clear ex ante the scale of resources that could be made available under these IMF program.

## **VI. Conclusions**

With financial globalization, the incidence of capital account crisis and the associated costs have increased. Preventing and managing such crisis requires actions at the global, regional, and national levels. The evolving multi-layered GFSN has increased the flexibility of the international monetary architecture created at Bretton Woods in 1944. It has also enhanced the voice of emerging markets in global economic governance to some extent. Further institutional and other reforms are, however, required to prevent and manage a systemic crisis in the future and to protect innocent bystanders.

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<sup>7</sup> Henning (2011b) provides several insights on how this may be done in relation to the IMF and CMIM.



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