

SYMPOSIUM ON INTERNATIONAL INSTITUTIONAL BYPASS

MONETARY UNIONS, REGIONAL FINANCIAL ARRANGEMENTS, AND CENTRAL BANK SWAP LINES: BYPASSES TO THE INTERNATIONAL MONETARY FUND?

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Background: History Matters

Countries hold international reserves (mainly in the form of gold, foreign exchange, and the composite currency called Special Drawing Rights (SDRs) issued by the International Monetary Fund (IMF)) as a precaution against large and unexpected temporary deteriorations in their balance of payments position. In the absence of the reserve cushion, the options facing a country in external imbalance are unappealing:

- (1) It would have to borrow funds on the international capital markets, which are expensive and involve high transaction costs; and/or
- (2) It would have to pursue expenditure-reduction policies, or expenditure-switching policies that involve changing the exchange rate or introducing capital and/or import controls, all of which impose adjustment costs on the economy.

But reserves come with the opportunity cost of foregone alternative uses. These resources could have been invested in higher yielding but less liquid financial instruments, or to finance domestic development thus contributing to economic growth and citizens' quality of life.

The situation calls for international cooperation, and all the parties at the Bretton Woods Conference understood this. A pool of international reserves that was readily accessible under mutually agreed upon rules by its members would be a "global public good," providing considerable efficiency over having all countries solely hold their own stock of international reserves. Since balance of payments shocks are typically asynchronous across countries and over time, the principles of pooling and insurance would assure a net gain from the arrangement.

The Conference, held in 1944, spawned much of today's international economic architecture: an IMF to oversee balance of payments matters; an International Bank for Reconstruction and Development (IBRD, later called the World Bank) to finance postwar activities in Europe and broader development in poorer countries; and the General Agreement on Tariffs and Trade, not quite a full-fledged institution until the creation of the World Trade Organization in 1995.

This was a compromise result. Acquiescing to the United Kingdom's desire to maintain some colonial trade patterns and not create an unfettered global trading regime, the United States agreed not to push for a full-fledged treaty-based International Trade Organization. It used this concession to obtain from its principal negotiating partner what

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it valued the most: an IMF that oversaw a system of exchange rates fixed to the official price of gold with the U.S. Dollar at the core, and a global pool of international reserves that members contributed in a preallocated proportion. Moreover, the IMF had no capacity to either oversee domestic financial sectors or create its own liquidity.

Both the United States and the United Kingdom, principal players at [Bretton Woods](#), ignored proposals by countries like India to build development considerations into the functioning of the IMF, seeing instead a strong dichotomy between international finance and macroeconomics on the one hand, and poverty alleviation in developing countries on the other. For full measure, they also agreed that the voting structure at the IMF and IBRD would be weighted by an index of economic strength rather than one vote per country.¹

This brief history helps explain why the IMF is often perceived as being unrepresentative of the interests of large parts of the world, thus leading to calls for its reform and even abolition, and the creation of alternative monetary arrangements—international institutional bypasses.

Regional and Bilateral Financial Cooperation

The IMF is the node (in all cases shared with national authorities or another international organization) of the global architecture around balance of payments, macroeconomic policy, exchange rates, debt management, and financial sector management. It serves its 189 members by monitoring and pronouncing on national economic and financial policies, offering policy advice, and lending to member states facing actual or potential balance of payments problems.

In addition to national institutions and processes, there are a number of regional and supranational initiatives that perform some or all of the same functions as the IMF. These cooperative arrangements might be classified into three groups:

1. A monetary union is the most complete form of regional monetary cooperation, with a common central bank issuing a common currency for member states, overseeing their financial sectors and managing pooled international reserves.
2. A less intense form of cooperation, sometimes called a regional financial arrangement (RFA), involves individual countries with their own central banks and currencies explicitly pooling a portion of their international reserves or agreeing to make a portion of their reserves available to meet exceptional needs on the part of other members.
3. A third form of cooperation may be found in swap lines, bilateral agreements between central banks to temporarily lend hard currency to each other in the event of need.

While all are bypasses as defined in the framing essay, each of these arrangements has distinct characteristics. Collectively, they pose normative questions about global governance, as discussed below.

Monetary Unions

The West African Economic and Monetary Union (WAEMU) dates to 1948, but its modern history started in 1962 when six countries were banded together by the colonial authorities under a common central bank and thus a reserve pool and common currency pegged to the French Franc. Balance of payments deficits within the membership were initially settled from the pool, but the [French Treasury](#) guaranteed the peg by offering additional (and

¹ For recent accounts of the Conference, see BENN STEIL, [THE BATTLE OF BRETTON WOODS: JOHN MAYNARD KEYNES, HARRY DEXTER WHITE, AND THE MAKING OF A NEW WORLD ORDER](#) (2013); ERIC HELLEINER, [FORGOTTEN FOUNDATIONS OF BRETTON WOODS: INTERNATIONAL DEVELOPMENT AND THE MAKING OF THE POSTWAR ORDER](#) (2014).

in principle unlimited) liquidity to the pool. A series of changes starting in 1974 has strengthened the role of the common central bank, strengthened financial sector oversight, changed the value of the peg (first to the French Franc and later to the Euro), changed the nature of the seemingly unlimited French guarantee to something more limited and conditional, strengthened other aspects of integration such as trade and labor mobility, and added to the membership. Today, the [WAEMU](#) comprises eight countries: Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.²

The [Central African Economic and Monetary Community](#) (CEMAC) is an arrangement with a similar history and shared characteristics to the WAEMU, comprising Cameroon, Chad, the Central African Republic, Equatorial Guinea, Gabon and the Republic of Congo.³

The [Organization of Eastern Caribbean States](#) (OECS) dates to 1965.⁴ Unlike its African counterparts, the peg (first to Pound Sterling and since 1976 to the U.S. Dollar) was not [guaranteed](#) by either the United Kingdom or the United States.⁵ The eight members of the OECS are: Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and Anguilla and Montserrat.

The WAEMU, CEMAC, and OECS meet the core criteria of an international institutional bypass: they offer countries an alternative pathway to deal with balance of payment problems. They also do not affect the function of the IMF or directly try to reform it. The resources in their reserve pool are a fraction of the resources that would be available to the member countries through their IMF lending quotas. But through the policy windows of the common central banks and the availability of early and unconditional liquidity from the reserve pool, an alternate path to the functions of the IMF is in place. However, unlike regional financial arrangements (see next section), their primary driver is wider regional integration, not dissatisfaction with how the IMF operates.

Regional Financial Arrangements

There are four major RFAs currently in operation: the BRICS Contingent Reserve Arrangement (CRA), Chiang Mai Initiative (CMI), European Stability Mechanism (ESM), and Fondo Latinoamericano de Reservas (FLAR). With the exception of FLAR, they are of recent vintage. [Table 1](#) outlines the key features of these initiatives. All four RFAs share the objective of providing members a quick and clean “first line of defence” against unexpected or expected abnormal requirements for international reserves.

The FLAR is the only RFA that accepts deposits from members, and also provides asset management services. The FLAR is also the most unconditional in its support. By contrast, while initial access to reserves at the CMI and CRA is open, they require users to have a concurrent IMF program in place to access larger levels of reserves. The ESM has no formal stated borrowing limits or policy conditions to access its resources. Those that exist in practice are opaque and ad hoc, as resolution of the Greek crisis and other cases have [demonstrated](#).⁶ The ESM goes

² For more detail, see Rohinton Medhora, *The West African Monetary Union: Institutional Arrangements and the Link with France*, 13 CANADIAN J. DEV. STUD. 151 (1992); Jean-Claude Tchatchouang, *The CFA Franc Zone: A Biography*, in 2 THE OXFORD HANDBOOK OF AFRICA AND ECONOMICS (Célestin Monga & Justin Yifu Lin eds., 2016).

³ Bernard J. Laurens & Antonio Pancorbo, *Central African Economic and Monetary Union: Financial System Stability Assessment*, INTERNATIONAL MONETARY FUND (2015).

⁴ *The Story of the EC Dollar and The Eastern Caribbean Central Bank The Coming of Age Of Small Island States*, EASTERN CARIBBEAN CENTRAL BANK (2016).

⁵ Frits van Beek et al., *The Eastern Caribbean Currency Union: Institutions, Performance, and Policy Issues*, INTERNATIONAL MONETARY FUND (2000).

⁶ Christoph M. Schmidt, *The Threat of Greek Debt Relief*, PROJECT SYNDICATE (2015).

Table 1: Key Characteristics of Regional Financial Arrangements (relative to the IMF)

	Estd.	Membership	Lending Capacity (\$b)	Lending Capacity (% of members' GDP, 2014)
Chiang Mai Initiative	2010	13 members: ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam), China including Hong Kong, Japan, South Korea	240	1.25
BRICS Contingent Reserve Arrangement	2014	5 members: Brazil, China, India, Russia, South Africa	100	0.59
European Stability Mechanism	2012	19 members: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain	920	5.03
Fondo Latinoamericano de Reservas	1978	7 members: Bolivia, Colombia, Costa Rica, Ecuador, Peru, Uruguay, Venezuela	2.3	0.22
International Monetary Fund	1945	189 members	350	0.47

beyond being a pure reserve pool, because it leverages members' contributions to raise additional funds in the short-term bond and long-term debt markets.

To varying degrees, all four RFAs were created because of dissatisfaction with the role the IMF plays in official global finance. This is the case with the FLAR (and its predecessor the Andean Reserve Fund) and CMI, which emerged from unhappiness with the IMF's handling of various Latin American debt crises and of the 1997 Asian financial crisis. It is also the case with the CRA, through which the world's largest emerging economies, frustrated by the slow pace of reforms to the IMF voting structure, have created a shield against having to resort to the IMF and private international capital markets in times of need.

While replacing the IMF is unrealistic and (except for occasional rhetoric) not a serious driver of the RFAs, providing an alternative to it *is* a driver. Moreover, through competition of ideas and resources, RFAs tried to make the IMF "modify, change, or reform" itself. And the [IMF's views](#)⁷ and [approach](#)⁸ have changed. Examples include the softening of its stance against capital controls, a reduced role for austerity in resolving economic crises, recognition of the debilitating effects of economic inequality for growth and development, and acknowledging the importance of gender considerations in designing economic policy.

From a relational point of view, the case of the ESM has a different dynamic. It is not suspicion of the IMF as much as legacy that explains intent—Western Europe, a principal architect and funder of the Bretton Woods institutions, cannot also be seen as the IMF's client. At over \$900b for its nineteen members, the lending capacity of the ESM also far exceeds that of the IMF (\$350b, for its 189 members). In practice, as events around the Greek debt negotiations demonstrate, the IMF is a member with the European Commission and the European Central Bank, albeit a junior one, of the troika managing negotiations with the Greek government. Yet, the ESM can still be defined as a bypass.

⁷ See *IMF Survey: Evolution Not Revolution: Rethinking Policy at the IMF*, INTERNATIONAL MONETARY FUND (2016).

⁸ See Jonathan D. Ostry et al., *Neoliberalism: Oversold?*, INTERNATIONAL MONETARY FUND (2016).

Central Bank Swap Lines

Swap lines are not a recent phenomenon, but they assumed a greater role and slightly modified functions recently. An ad hoc system of swap lines existed among the G10 central banks⁹ until the post-1973 flexible exchange rate era. Since the global financial crisis of 2008, they have also served the more technical purpose of addressing currency-specific liquidity shortages and have proliferated in size and number.

The U.S. Federal Reserve (Fed) remains the leader in the magnitude (dollar value) of swap lines, but China has recently emerged to manage the largest number of such arrangements. Although all swap lines have the overall objective of enhancing the availability of liquidity to partners, they also serve four other key functions: (1) providing traditional balance of payments support; (2) providing specific currencies to help meet the transactional needs or balance the portfolio and risk profile of a partner; (3) settling a trade; and (4) deepening an offshore financial market.

Typically in swap arrangements, the degree of coordination with the IMF is low, while surveillance, information exchange, and policy coordination are informal. Table 2 outlines the swap arrangements into which the Fed and People's Bank of China (PBOC) have entered. In the case of the Fed, the principal drivers of the selection of partner central banks appears to be the degree of exposure of the U.S. financial system (hence the inclusion of Brazil, Mexico, and South Korea), systemic importance of the country, and soundness of macroeconomic management in the country. In China's case, the main drivers appear to be exposure, and the related considerations of geopolitical goals and internationalization of the RMB.

Swap lines are explicitly quick and temporary transactional arrangements. The unlimited nature of some of the Fed's swap lines has yet to be tested, so the degree to which this mechanism competes with or presses for changes in the IMF is unclear. In their support via specific currency needs, and for trade settlement and offshore financial market development, swaps provide services that the IMF does not provide (and is unlikely to provide for statutory reasons).

Conclusion: Making the Bypass Silkier

Though varied in their history, intent, and relationship to the IMF, all the arrangements outlined above have a set of features in common. They operate at the regional or bilateral level (making them "vertical" bypasses), and provide rapid, stigma-free, relatively unconditional financial support to members facing temporary balance of payments difficulties on a sliding scale of complementarity with the work of the IMF itself. Using the bypass concept sharpens the global governance discussion, as it signals an inherent tension between international and regional cooperative arrangements. Unlike the international trade arena, there is currently no formal hierarchy between the various forms of global, regional, and bilateral financial cooperation arrangements.

While the concept of institutional bypass provides a strong descriptive tool, more work needs to be done on the normative and prescriptive aspects of this phenomenon. In economic policy, for instance, consistency is essential. The IMF and its bypasses might not operate in harmony, thus leading to counterproductive processes. If a bilateral or regional arrangement offers access to international reserves with no policy conditionality while the IMF deems that some is necessary, or where such an arrangement offers access with different policy conditionality than what the IMF might demand, there is conflict. This is essentially what we saw in the operation of the troika during the Greek debt saga.

⁹ The G10 currently has eleven members: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

Table 2: The Fed's and People Bank of China's Swap Arrangements

The Fed with:	Value (\$b, with each country separately)	The PBOC with:	Value in RMB b, with each country separately (and in \$ at app. RMB 6.6 = \$1)
<i>Canada, Euro Area, Japan, U.K.</i>	No Limit	Hong Kong SAR	400 (60)
<i>Australia, Brazil*, Mexico*, Singapore*, South Korea*, Sweden</i>	30	<i>South Korea</i>	360 (54)
Denmark, New Zealand, Norway	15	<i>Euro Area</i>	350 (53)
		<i>Singapore</i>	300 (45)
		<i>Australia, Canada, UK</i>	200 (30)
		<i>Brazil</i>	190 (29)
		Malaysia	180 (27)
		Russia, Switzerland	150 (23)
		Indonesia	100 (15)
		Argentina, Thailand	70 (11)
		Qatar, UAE	35 (5)
		South Africa	30 (5)
		New Zealand	25 (4)
		Various – Mongolia, Ukraine, Hungary, Pakistan, Sri Lanka, Turkey, Belarus, Kazakhstan, Iceland, Albania, Armenia, Surinam, Uzbekistan	Ranging from 15 to 1

*indicates a non-traditional partner for the Fed.

Italics indicate a swap arrangement with Fed and PBOC

This is a live issue in global governance. Some have called for a [greater complementarity](#) between the operation of regional arrangements and the IMF,¹⁰ suggesting that acceptance by the IMF's Flexible Credit Line (the IMF's quick disbursing, pre-qualifying lending facility) should be a precondition for a country's participation in a regional arrangement. An ideal has not yet been developed, but it would have two key attributes: a formal hierarchy among the bypasses and the IMF, and therefore, the appearance of a seamless global liquidity safety net.

This issue illustrates that while bypasses may be offering alternatives and may be pressing for reform and innovation, they may be also sources of conflict and counterproductive processes. Thus, while the concept of institutional bypass allows us to more accurately describe and analyze these complex interactions, more work needs to be done in assessing their desirability and their optimal design for each intended function.

¹⁰ See Barry Eichengreen, *The International Financial Architecture and the Role of Regional Funds* (2010); Randall C. Henning, *The Global Liquidity Safety Net: Precautionary Facilities and Central Bank Swaps*, in GLOBAL FINANCIAL GOVERNANCE CONFRONTS RISING POWERS: EMERGING PERSPECTIVES ON THE NEW G20 (Randall C. Henning & Andrew Walter eds., 2016).