What Can the WTO Teach the IMF? Dealing with Global Financial Crises Amid the Rise of Financial Regionalism

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Despite rising back to prominence during the global economic turmoil, the International Monetary Fund remains under severe pressure over its lack of legitimacy and effectiveness. It is surrounded by increasingly vibrant and potentially competing systems of regional financial arrangements. But while it is feared that regional arrangements can undermine the global financial order, they can also help buttress the multilateral institutions that are struggling to manage an increasingly complex global economy. The purpose of this article is to draw on trade, exploring the decades-long efforts to ensure compatibilities between regional trade agreements and the multilateral trading system, to offer lessons to financial policymakers.

Keywords: financial regionalism, International Monetary Fund, World Trade Organisation, preferential trading arrangements

As the great crisis of 2008–09 battered economies around the world, the International Monetary Fund (IMF), fading into obscurity in the thriving world economy only a few years before, sprang back into business. Some of the first rescues went to Ukraine, Iceland, Pakistan, Belarus, Georgia and Latvia, followed by Serbia, Romania, Poland and a number of Latin American nations. Policy thinking on the Fund's future shifted rapidly as well. The G20 pledged to triple the Fund's lending capacity to USD 750 billion, and minted it as the manager of the G20's rebalancing initiative. Paradoxically perhaps, the crisis rescued the venerable global rescuer.

While the crisis raised the Fund's profile, it also brought regional and bilateral financial arrangements to centre stage. In response to the debacle, Asian nations bolstered their regional financial schemes, eurozone members built a historic financial rescue facility, and Latin American nations began discussions on a regional

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crisis response mechanism. Also numerous temporary bilateral schemes emerged, as leading central banks issued swap lines to alleviate liquidity shortfalls around the world.

Where the bolstered IMF and financial regionalism met was in Europe. As the eurozone crisis began to flare in 2010, European authorities and the IMF forged a common plan for rescuing the continent's ailing economies. Nevertheless, the crisis has deepened and today threatens the global economy, posing stark challenges both to the Fund and European governments. Events have also raised broader questions about the effectiveness of regional financial arrangements in managing crises, and the relationship between multilateral and regional responses. The issues at stake are critical. After all, failure to effectively tackle contagious financial crises can be detrimental to all nations around the world, as evinced by the global repercussions of the eurozone crisis. The effectiveness of regional arrangements in containing and managing financial crises is unclear. Also unclear are the exact relationship, the responsibilities and the division of labour between the IMF and regional facilities, even though delineating these relationships is critical for preventing and managing financial crises.

Some efforts have been made. For example, the November 2010 G20 Summit host, Korea, called for a "global safety net" as a means to introduce greater coherence and coordination among global responses, regional financial arrangements and bilateral schemes. However, these proposals have yet to translate into effective policies.

This is where trade policymakers can offer valuable lessons to financial policymakers. The growing attention to the effects of regional financial arrangements is reminiscent of the discussions that have surrounded preferential trade agreements (PTAs) over the past two decades. It was long feared that PTAs would balkanize the global trading system, cause discrimination against outsiders, and result in trade diversion, thus making everyone worse off and undermining the multilateral trading system supported by the World Trade Organisation (WTO). In response, trade policymakers and scholars made efforts to ensure that PTAs were compatible with the aspiration of most favoured nation (MFN) treatment and global free trade. These efforts are instructive, and provide several lessons for financial policymakers. Indeed, just as it is in each WTO member's interest to ensure that the PTAs formed by other nations are not discriminatory, so it is in every IMF member's interest to harmonize global and regional instruments to ensure that global financial instability is effectively managed. This is of course easier said than done: just as WTO members are jealous of their PTAs, so IMF members guard their regional financial arrangements.

Granted, finance and trade are distinct domains – for example, it is unlikely that there will ever be 300 distinct financial arrangements. Trade agreements are also about regulating economic exchange among nations, while financial arrangements are about ensuring regional financial stability. Many trade agreements are not strictly 'regional' in that they are now formed among nations from different continents, while financial arrangements are by and large formed among neighbouring nations. Financial regionalism is also not discriminatory in the way PTAs are feared to be; rather, any regional financial scheme should, at least in theory, also provide positive externalities to non-members, first and foremost economic stability.

Multilateral institutions are also very different in trade and finance. The WTO Secretariat has a small budget and a staff of some 500, mostly lawyers charged with aiding in negotiations and preparing national Trade Policy Reviews. The IMF has USD 750 billion in lending power and a staff of 2000, mostly PhD economists. As the core of the global financial system, its recommendations are widely publicised and influential. The WTO, on the other hand, is facing perhaps its most severe crisis to date as the multilateral Doha Trade Round is all but dead.

At the same time, the parallels between trade and finance are striking. In both arenas, a set of bi- and plurilateral arrangements has emerged to parallel the multilateral system, and in both trade and finance these arrangements are highly consequential to the effectiveness and relevance of the multilateral system, as well as to global economics and politics. The purpose of this article is to connect the two arenas – draw lessons for financial policymakers from the decades-long efforts to ensure compatibilities between PTAs and the multilateral trading system. Such a lessons-learned exercise is timely: in trade, the regionalism horse is out of the barn, and the WTO is lagging far behind. Financial regionalism is still nascent: the horse is only at the gate. By grabbing the reins now, policymakers can systematise and institutionalise the relationships between the different levels of financial integration to ensure well coordinated and effective responses to financial crises.

The following sections discuss the implications of the wave of PTAs on the WTO system and the efforts to ensure compatibilities between PTAs and the 1948 General Agreement on Tariffs and Trade (GATT) and WTO Agreements. The subsequent sections elaborate on regional financial arrangements and their implications for the IMF, drawing on the efforts to deal with PTAs to develop policy proposals for an effective relationship between financial regionalism and the IMF. The last section concludes.

Multilateral vs. regional: a false choice?

Regional trade agreements have been forged for centuries. Ancient Greeks traded extensively around the Mediterranean basin and entered into several trade agreements in the region. For instance, in order to ensure an adequate supply of grain for its citizens, Athens forged agreements with other states to provide passage and favourable treatment to inbound traders. The Roman Republic of the 5th-1st centuries BC, whose economy was based on trade, entered into several commercial agreements with, among others, Carthage.

The first modern-day regional trade agreements were launched in the late1950s.[1] But it is since the 1990s that PTAs have spread like wildfire around the world. The wave started with the formation of sub-regional pacts like the Southern Common Market (MERCOSUR) established in 1991 between Argentina, Brazil, Paraguay and Uruguay; the consolidation of the European Union, including the launch of the Single Market in 1993, and the deepening of the Association of South-East Asian Nations (ASEAN) throughout the 1990s and, perhaps most notably, the 1994 formation of the North American Free Trade Agreement (NAFTA) among the United States, Canada and Mexico.

Bloc formation was followed by prolific bilateralism. The EU entered into numerous FTAs with Eastern European candidate countries, while the United States negotiated FTAs with Chile and Central America, and Latin American countries signed agreements with each other. The PTA wave subsequently engulfed Asia. The latest PTAs are transcontinental, with such partners as United States and Morocco, Mexico and Japan, and Chile and the European Union having recently formed bilateral agreements.

Overall some 200 regional trade agreements have been notified to the WTO; the total number of agreements hovers around 300.[2] In addition, there are numerous agreements that cover only trade in services. Virtually all countries are member to at least one PTA, and most countries belong to two or more agreements at once. Reluctant to form preferential agreements up until the 1990s, the United States has become one of the most prolific integrators, signing 14 agreements in little over a decade with partners in the Americas, Asia and the Middle East. Other particularly keen integrators include Mexico, Chile, Peru, Singapore, Canada and the European Union.

Not only have integration schemes mushroomed, their content has become more complex and encompassing. Most agreements go beyond market access in goods to address trade in services and so-called behind-the-border issues, such as investment, intellectual property rights, competition policy and government procurement. US agreements and FTAs modelled on them in the Americas are often particularly precise and encompassing; intra-Asian agreements tend to cover less ground and be less specific. Some sub-regional pacts have taken collaboration even further to issues ranging from macroeconomic cooperation to labour mobility and coordination of members' positions in multilateral trade negotiations.

[1] PTAs here include free trade agreements (FTAs), customs unions and common markets.
[2] WTO, *World Trade Report 2011.*

Remarkably, GATT and WTO members have been forming PTAs even while concluding seven multilateral trade rounds, establishing the WTO in 1994 and, since 2001, negotiating the Doha Round agreement. There are countless theories for why practically all of the 154 WTO members have pursued regional integration alongside the multilateral liberalisation processes. Some focus on interest group pressure by exporter, importer and investor lobbies, others on political leadership, and still others on strategic considerations in world economy and politics as well as the dynamics in the multilateral trading system.[3]

Whatever their drivers, PTAs have essentially proliferated alongside the GATT/WTO system, although uncoordinated by it. Two parallel systems, global and regional, are now in place. Covering nearly one-half of global trade flows, PTAs and their various rules are a prominent part of the world trading system and the global economy.

The key policy question, and one that is instructive for policy thinking on financial regionalism, is whether PTAs help or hamper the aspiration of global free trade, the optimal outcome. This is a hugely important question. Incompatibilities between PTAs and the multilateral trading system could seriously distort global trade flows, production patterns and economic growth, and violate international trade law. It is a question that has troubled economists and legal experts for decades. And it is a question that is at the very heart of the ongoing Doha Trade Round, whereby WTO members elevated PTAs to a 'systemic issue', or one that affects the entire world trading system and must be addressed as such. The answer, however, is far from clear.

Do PTAs comply with multilateral trade rules?

Based on the principle of non-discrimination and MFN treatment, the GATT system has from the very start allowed member countries to grant each other preferential treatment in free trade areas or customs unions, as long as certain conditions are met. These conditions are defined mainly in GATT Article XXIV, but also in the General Agreement on Trade in Services (GATS), other WTO Agreements, and the so-called Enabling Clause, which exempts developing countries from the MFN obligation for PTAs they form with each other.

GATT Article XXIV stipulates that members must notify their PTAs to what is now the WTO, and that the PTAs must liberalise "substantially all trade" among the members "in a reasonable length of time" and not introduce new "restrictive

[3] The literature is huge and only some representative studies are highlighted here. For more exhaustive literature reviews, see, among others, Baldwin, *Multilateralising Regionalism*; Bhagwati, *Termites in the Trading System*; and WTO, *World Trade Report*.

rules on commerce''.[4] The article also demands open regionalism – that PTA members not raise barriers to third parties.

Have countries complied with Article XXIV? The answer is not clear-cut. It is negative in the sense that numerous PTAs have never been notified to the WTO. In addition, PTAs among some developing countries are exempt from the article, which leaves numerous PTAs outside its reach. Moreover, the WTO members' interpretations of the sparsely worded article vary widely. For example, ''substantially all trade'' has at least four interpretations – a quantitative approach geared to a statistical benchmark, such as a percentage of trade between the parties, most commonly suggested as 90, 85 or 80 percent; and a qualitative approach stipulating that no sector (or at least no major sector) should be kept from liberalisation, with definitions of ''sector'' also varying widely.

There is no agreement as to what constitutes ''other restrictive regulations of commerce''. PTAs carry several rules that can qualify the extent of market access that tariff liberalisation provides, such as tariff rate quotas, special safeguards, non-tariff measures, and rules of origin. Such disciplines are often put in place for political reasons: governments may be more willing to engage in deep tariff liberalisation when other defensive instruments are available. Problematically, the distortionary impact of such potentially protectionist provisions can be significant and may accentuate over time, as they tend to remain in place even after preferential tariffs have been phased out.

Are PTAs good or bad for the world trading system?

The prohibition for PTAs to raise barriers against third parties is hugely important, but WTO members' compliance with it is disputed. Indeed, economists have long engaged in a contentious debate on whether PTAs are 'building blocs' or 'stumbling blocs' to multilateral trade liberalisation. The building bloc camp argues that PTAs fuel the liberalising logic of the multilateral system, help advance global trade talks, and serve as laboratories for new trade rules that could eventually be multilateralised. The stumbling bloc camp maintains that PTAs are discriminatory instruments that lead to trade diversion and deviate governments' attention from multilateral trade talks.

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[4] For the purposes of Article XXVI, a customs union is understood as "the substitution of a single customs territory for two or more customs territories, so that (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and (ii) . . . substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union". A free-trade area is ''a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories''.

Empirical work provides support for both sides; however, the bulk of studies have glazed over the complexity of PTAs, operationalizing them as a dummy variable.[5] Indeed, asking whether PTAs comply with multilateral rules and whether they are good for global trade is simplistic: the question should be which PTAs do so, and, in particular, which PTA disciplines do so and why. The answer, in turn, depends on how exactly the multilateral disciplines governing PTAs are interpreted – which is ultimately a political question. Indeed, the design of Article XXIV was not immune to politics. It was sponsored in the 1940s by the United States, a staunch advocate of multilateralism and non-discrimination, as a means to address customs unions, but it was extended to allow for the formation of FTAs to accommodate the imminent US–Canada FTA that was under secret negotiation but failed to materialise in the end.[6]

Positively, however, research indicates that most PTAs do meet the common interpretations of GATT Article XXIV. Particularly, PTAs whose members uphold the principle of open regionalism tend to be trade-creating rather than trade-diverting. Synergies among the various PTA provisions can accentuate such positive effects. For example, simultaneous liberalisation of tariffs, services and investment can spur trade well beyond what a simple tariff lowering would. Often going much beyond the multilateral commitments in such areas as services, investment, customs procedures and competition policy, PTAs also often entail deep, mutually beneficial integration among nations. At their best, PTAs can help

[5] Frankel *et al.*, ("Trading Blocs and the Americas") analyze the EU, MERCOSUR, the Association of South-East Asian Nations (ASEAN), and East Asia, concluding that regionalism has over the past decades been trade-creating. Soloaga and Winters (*How has Regionalism Affected Trade?*) find that, except for Latin America, PTAs of the 1990s did not boost intra-bloc trade significantly, but also that there was trade diversion only in the cases of the European Union and the European Free Trade Association. However, Adams *et al.* (*Trade and Investment Effects*) estimate that 12 out of 16 trade agreements, including the EU, ASEAN and NAFTA, have diverted more trade than they have created among members. World Bank (*Global Economic Prospects 2005*) finds that PTAs whose members have high external barriers, especially PTAs in Africa, are trade diverting, while PTAs where members have reduced external barriers are trade-creating. DeRosa (*Trade Effects of Preferential Arrangements*) shows that some of the world's major PTAs, such as EU, NAFTA, ASEAN, MERCOSUR and EFTA, are trade-creating – even though there is trade diversion in agriculture, an unsurprising finding in light of the pervasive barriers in the sector around the world. Studies that examine tariff concessions at the product-level provide necessary nuance, but yield mixed results. Limão ("Preferential Trade Agreements as Stumbling Blocks") finds that the United States and the EU have limited their multilateral tariff liberalisation in goods traded with the PTA partners, risking trade diversion. Limão and Olarreaga (*Trade Preferences to Small Developing Countries*) make a similar finding in the case of import subsidies provided to PTA partners by the United States, EU and Japan. However, Estevadeordal *et al.* ("Does Regionalism Help or Hinder Multilateralism?") find that PTAs in the Western Hemisphere region have helped further the PTA members' multilateral liberalisation process.
Rules other than tariffs can also have implications for the building bloc/stumbling bloc debate. For example, Suominen (*Rules of Origin in Global Commerce*) finds that restrictive rules of origin dampen PTAs' trade-creating potential. More positively, customs procedures and trade facilitation clauses in PTAs, if propelling modernisation in the member states' customs procedures, will inherently facilitate trade not only among PTA partners, but also with all other trading partners. PTAs have also often helped advance trade in services with outsiders; however, this effect varies widely across PTAs and their members (Roy *et al.*, *Services Liberalisation*).

[6] Chase, "Multilateralism Compromised".

propel global liberalisation. They can be building blocks for multilateral liberalisation, 'WTO+' laboratories for new global trade law, and training grounds for countries to negotiate and implement multilateral trade rules. They can also help aggregate governments' preferences at regional levels, reducing collective action problems at the multilateral level.

At the same time, some PTA partners offer only limited tariff liberalisation in certain sensitive sectors, and/or lower tariffs only very gradually, and many a PTA contains provisions that could be classified as "other restrictive regulations of commerce" under Article XXIV, such as tariff rate quotas, special safeguards, and demanding rules of origin. These rules can also violate the principle of open regionalism. Moreover, countries that are party to several agreements with their key trading partners can be disincentivized from investing resources in multilateral negotiations. And the now multiple overlapping trade agreements can create undue transaction costs for companies and customs that would be averted in the best scenario world of one single, deep multilateral agreement.

(Vain) efforts to tame PTAs

PTAs have become the centre of gravity in the global trading system and the main means for countries to pursue deep liberalisation and extensive trade-related commitments. The proliferation of PTAs and the vexing questions about their discriminatory effects have created a sense of urgency among the WTO members on ways to address PTAs in a more rigorous fashion: after all, while each member is party to numerous agreements, each is now also outsider to an ever growing number of PTAs. However, efforts to somehow deal with PTAs have been complicated by clashes among the WTO members.

As early as 1983, the GATT Director-General created an independent group of seven eminent persons to study and report on the problems facing the international trading system. The so-called Leutwiler Report issued in March 1985 concluded that multilateral "rules permitting customs unions and free-trade areas have been distorted and abused" and that "(t)he exceptions and ambiguities which have thus been permitted have seriously weakened the trade rules, and make it very difficult to resolve disputes to which Article XXIV is relevant".

During the subsequent, 1986–94 Uruguay Round, a group of countries that included Australia, India, Japan, New Zealand and Korea – nations that at the time had not set out to form numerous PTAs but did worry about the discriminatory impact of emerging agreements – called for a toughening of the language of Article XXIV.[7] India proposed reviewing the requirement that duties and other restrictive regulations be eliminated on "substantially all trade" between the PTA

[7] WTO, *World Trade Report 2011.*

partners.[8] Japan called for improving the consultations before and after preferential agreements were reached, and for improved procedures for examination of such agreements, proposing the establishment of special procedures separate from the GATT dispute settlement system aimed at discussing compensation for damages to outsiders to PTAs. The members that opposed Japan's proposal suggested that PTAs be analysed under the newly-created Trade Policy Review Mechanism, which assesses WTO members' compliance with their multilateral trade commitments.

The grievances did result in the Understanding on Interpretation of Article XXIV, which helped clarify "reasonable length of time" as 10 years into a PTA's lifespan, and fine-tuned paragraph 5 to call for multilateral assessments of "the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union". The Understanding also established procedures for compensation to non-members of a customs union if the common external tariff applied by the customs union is above the level of the tariff previously applied by any of the members. It also stated that concerns related to Article XXIV should be submitted to dispute settlement.[9] Despite initial opposition by the European Community, India and Yugoslavia, the Understanding was adopted and became part of the Uruguay Round agreements.[10] A further important outcome of the Uruguay Round was the inclusion in GATS of a provision on the regulation of regional and bilateral agreements on trade in services.

Further efforts were made to address PTAs in the wake of the Uruguay Round. In 1996, the WTO General Council established the Committee on Regional Trade Agreements (CRTA) as a means to examine individual PTAs and to consider their systemic, cross-cutting implications for the multilateral trading system. The members that were eager to engage in the debate included Australia, Hong Kong, India, Japan, Korea, New Zealand and Pakistan, while the EU and the United States, both increasingly engaged in negotiating PTAs, were reluctant. The Committee remained dormant, not issuing any examinations from 1996 to 2001.[11]

The Doha Round launched in 2001 brought a new focus on PTAs. The Fourth Ministerial Meeting resulted in an agreement to launch negotiations geared to

[8] Croome, *Reshaping the World Trading System*.
[9] *Ibid*.
[10] WTO, *World Trade Report 2011*.
[11] *Ibid*. One of the reasons was that WTO members were reluctant to provide information or agree to conclusions that could later be used or interpreted by the WTO's dispute settlement panel. Process was also stifled by the disagreements over Article XXIV terminology, and lack of specific multilateral language on such provisions as preferential rules of origin. Views on whether the CRTA or the dispute settlement body should deal with PTAs remain divided. Some hold that examination of the consistency of PTAs ought to be reserved solely for the CRTA. One notion is that GATT and WTO rules applying to PTAs are of less relevance today in light of the facts that trade diversion is reduced as a result of multilateral tariff reductions, that there is empirical evidence of PTAs' positive welfare effects, and that PTAs are different from WTO agreements in that they cover more trade-related disciplines (Mavroidis, "WTO and PTAs"). As such, the Transparency Mechanism should become the *de jure* new forum to discuss PTAs within the multilateral trading system.

clarifying and improving the existing multilateral disciplines and procedures that apply to PTAs. Further progress was made in December 2006, when the members issued a "Transparency Mechanism for Regional Trade Agreements" that requires the members to provide an "early announcement" of their involvement in PTA negotiations and promptly notify a newly concluded PTA. It also put forth a schedule for the PTA's examination by the WTO Secretariat.[12] Parties to a new PTA are required to submit certain data to the WTO, such as on the PTA's tariff concessions and rules of origin, and the members' MFN duties and import statistics. The CRTA is subsequently supposed to prepare a detailed survey of the contents of the PTAs. The CRTA is also tasked with carrying out legal analyses of WTO provisions pertinent to PTAs, drawing comparisons across PTAs, and examining the economic aspects of PTAs.

Notably, the Transparency Mechanism is not tied to the fortunes of the Doha Round. This reflects the WTO members' growing concerns about PTAs. However, the scope of the studies mandated by the mechanism is limited by political considerations: they are to remain "factual" and refrain from value judgments. The WTO's 2011 annual research report, which focuses on PTAs, is similarly rather circumspect about naming countries or agreements that may breach the spirit of MFN treatment. The WTO is also pressed for resources to examine PTAs in deep detail. Most of the best analyses on PTAs have been made by outside experts and institutions, often in collaboration with WTO researchers.[13]

Despite the various attempts to tackle PTAs, WTO members have practically never debated or agreed on whether any one PTA breaches multilateral trade rules, let alone revised Article XXIV. This is hardly surprising: given that all WTO members belong to at least one PTA, they are reluctant to challenge the PTAs of other members as discriminatory, let alone take another member to the dispute settlement body which has dealt with PTAs on only a handful of occasions.[14]

PTAs as a backdoor to global trade?

Importantly, the limitations of the multilateral processes do not mean that PTAs are inherently bad for the global trading system. As discussed above, regional agreements can be complementary to the multilateral trading system and many of them have been shown to be; much depends on their design and the members' policies *vis-à-vis* third parties. It could also be argued that multilateral regulation of PTAs is less consequential than in the past: the odds of trade diversion are less a result of unilateral and multilateral tariff cuts around the world, and most empirical

[12] WTO, *World Trade Report 2011*.
[13] See, for instance, Estevadeordal and Suominen, *The Sovereign Remedy*; Low and Baldwin, *Multilateralizing Regionalism*; and Kawai and Wignaraja, *The Asian Noodle Bowl*.
[14] The main one is *Turkey–Textiles*, the WTO Appellate Body held that the burden of establishing that an PTA meets the requirements of Article XXVI falls on the respondent WTO member if it invokes the PTA to justify a discriminatory measure.

studies show that PTAs are welfare enhancing. In addition, since they cover a host of disciplines not addressed at the multilateral level, it could even be argued that PTAs are too different from the WTO to be seen as a parallel, let alone competing or conflicting system.

Moreover, the PTA universe is transforming. Some groups of countries are making concrete efforts to converge their respective bilateral and plurilateral PTAs into broader integration blocs – in a gastronomic analogy, turn the ‘spaghetti bowl’ into a ‘plate of lasagna’. Such convergence processes are independent of the WTO, but complementary to the aim of building larger economies of scale and reducing the transactions costs by and large inherent in the spaghetti bowl. One of the most prominent examples is the expansion of the Trans-Pacific Partnership in the Asia-Pacific, which currently encompasses eleven nations and over two dozen PTAs. Once formed, the agreement would essentially consolidate these agreements into one agreement. As long as they are based on open regionalism and do not introduce stringent rules of origin, such regional arrangements can reduce the complexities in the world trading system and possibly even represent a ‘backdoor’ to further global trade liberalisation.

PTAs can help catalyze broader-based agreements – be ‘multilateralised’. For example, certain sector agreements in PTAs could be expanded at the multilateral level in a similar fashion to the Information Technology Agreement (ITA), which in 1996 brought tariffs on IT goods down to zero among the original 14 WTO members (the then 15-member EU counted as one member). Only WTO members that were genuinely committed to signing the ITA took part in the negotiations; however, other parties joined and the agreement now claims 46 of the WTO’s largest members, such as the United States, the EU, Japan and China. ITA-type plurilateral deals are now advocated as a potential future negotiation modality in the WTO. PTAs can play a powerful role in this process.

The IMF’s critical role in a world of financial regionalism

The proliferation of trade agreements over the past three decades can provide useful lessons for the world of finance, where regionalism has raised its head forcefully only quite recently, yet where it is similarly consequential to international economics, politics and the role of the core ‘system-manager’ institution, the IMF.[15]

Much like PTAs in trade, regional financial facilities can be useful. They can provide the first line of defence in regional crises, and their surveillance can supplement the Fund’s analyses and alleviate its propensity for group-think. In theory, regional funds would also help the Fund weather crises beyond its means, reduce

[15] This and the subsequent sections draw on Suominen, *Peerless and Periled*.

competing claims on its resources, and turn down some of the political heat for rescues incurred by one administration after the another in Washington.

Much as in trade, however, regional financial arrangements are not sufficient in themselves to prevent crises. A regionalised system for managing global financial crises would risk conflicts and gaps between regional responses and complicate efforts to identify crises. Moreover, even the larger regional arrangements are untested and inadequate for staving off a major regional crisis: a second line of defence is still needed. Nevertheless, there are impulses in the various regions to 'go it alone' and thus avoid the Fund's tough policy prescriptions and loan conditionalities. The dynamics in Asia and Europe, the world regions with the most substantial financial arrangements, are particularly illustrative of this.

Runaway Asia?

Scarred by the IMF's policy conditionalities during the 1997–98 regional financial crisis, East Asian nations have been building national reserves and established the Chiang Mai Initiative (CMI) as a means to wean themselves off the Fund's influence. Chiang Mai was construed as a system of bilateral emergency swaps, but during the 2008–09 crisis, East Asians expanded the scheme to USD 120 billion and multilateralised it into a regional pool. In 2011, CMI was expanded to USD 240 billion.

Chiang Mai has a link to the IMF: borrowers can draw up to 20 percent of their bilateral or multilateral swaps, but need to agree on an IMF program, including the Fund's policy prescriptions, to access the remaining 80 percent. Calls have been intensifying in Asia, however, to sever the link, and there are growing ambitions to create a full-fledged Asian Monetary Fund.

At the same time, Asia is not ready to disengage from the Fund for three reasons. First, it is much more integrated with the US and European financial markets than intra-regionally.[16] The global exposure renders the region vulnerable to volatility elsewhere, calling for multilateral engagement.

Second, CMI is still small and untested. It was not the region's liquidity window during the great crisis. Hit rather hard, Korea and Singapore turned directly to Japan and China, and Korea performed its largest, USD 30 million swap arrangement not with Asia, but with the US Federal Reserve. The reluctance to use the Chiang Mai is to a good extent due to its link to the IMF: Asian nations worry that they would ultimately have to be subject to the IMF's conditionalities if they were to draw on the CMI.

Third, intra-regional politics complicate financial regionalism. Even if Tokyo and Beijing were able to collaborate in Chiang Mai, political divisions not unlike

[16] See, for example Eichengreen and Yung, "Financial Liberalization".

those at the IMF could erupt between them, on the one hand, and the smaller regional nations, on the other. China has intricate economic ties with the ASEAN nations and there is a large Chinese diaspora in the region. Chinese leadership is also resolved to expand the reach of the renminbi (RMB) in the region, something it has already done through various bilateral swap arrangements. While the ASEAN nations find these advances appealing in light of their trade ties with China and Beijing's promises of infrastructure loans, they are very uneasy about China's hegemonic intentions. Like Japan, ASEAN prefers the broader ASEAN + 6 to counter China's efforts to build an exclusive East Asian bloc it would dominate.

Europe without exits

Rather similar dynamics are at play in Europe. The Southern European debt crisis built momentum for a watershed European regional fund. In the spring of 2010, the German finance minister floated the idea of a European Monetary Fund (EMF), but Europe eventually opted for cooperation with the IMF: rescuing Greece in the spring of 2010, the 17 eurozone nations and the IMF provided €110 billion. Seeking to restore market confidence in the beleaguered Southern European economies and, by extension, the euro, the eurozone also created a €440 billion European Financial Stability Fund (EFSF) that can be activated through a memorandum of understanding between the affected country and the European Commission, with expert consultations with the European Central Bank (ECB) and the IMF.

The IMF is, in short, integrated into EFSF decision-making. Granted, the setting is very different from Asia: as the main IMF shareholders, Europeans have an inherent stake in ensuring a seamless relationship between regional arrangements and the IMF. The French have expressed concerns that the Fund's involvement gives the United States a say in European affairs, but German Chancellor Angela Merkel prevailed in insisting on a partnership with the IMF, paving the way for the joint rescues. Economic and fiscal adjustment programs and debt sustainability analyses that will form part and parcel of any lending are to be carried out jointly by the European Commission and the IMF, in liaison with the ECB. Private sector creditors will be treated as they are under IMF rules; in case of insolvency, they will have to negotiate a restructuring plan in line with IMF practices.

This arrangement is in many ways useful for the Fund's non-European members, such as the United States. It ensures that Europeans will keep signing from the IMF's hymnbook, which the United States has a role in authoring. It also keeps the Fund involved in designing and enforcing loan conditionalities for the recipient nations to get their economic houses in order.

However, the condominium with Europe is hardly a panacea for the IMF. European responses, worked through at various summits among the 17 heads of state, have been agonizingly slow, revealing the perils in fast-moving crises for the

Fund to partner with a procrastinating and politically circumscribed regional grouping. Moreover, the EFSF/ESM system has several flaws that the Fund will now have to live with.[17]

For starters, the EFSF's €440 billion lending capacity is too limited. Estimates among banks and investors of resources adequate to assure markets range from €700 billion to €2 trillion. Moreover, Europe's reflexes in activating funding promise to be glacial. The decisions for the terms of loans, loan approvals, bond purchases, and conditionalities require unanimity among eurozone finance ministers (unlike the simple majority needed for IMF lending), opening the spectre for immense delays and politicisation, as any creditor nation can threaten the supposed recipient government with a veto unless the latter curries favour with the former.

Worse, the EFSF design may only magnify the eurozone's troubles for three reasons. First, just like US mortgage giants Fannie Mae and Freddie Mac, the facility repackages low-grade assets into a product that is then being sold as a triple-A rated security, risking a pile-up of suspect assets in the banking systems.[18] Second, the fact that plausible debtors – the Southern European nations – are also creditors in the EFSF means that the rescue burden will be ever more concentrated in Germany and France, along with the Benelux and Finland.

Third, the incentive systems are flawed. If the European Commission, which is required to assess the sustainability of the beneficiary nation's public debt prior to loan disbursement, were to declare the recipient insolvent, the ESM would be allowed to lend only on the condition that the private sector would also be involved. Yet the very fact that a country resorts to the ESM means that investors have deemed it insolvent and are unlikely to get involved. As such, the sustainability assessment is moot: the Commission would hardly risk declaring any recipient insolvent. Emblematically, the joint EU, ECB and IMF mission to Greece very promptly declared there were no problems with Greece's sustainability.

The IMF is in a bind in Europe. On the one hand, some of the leading members, such as the United States, have expressed repeated concerns about bailouts to European nations when the odds of success are uncertain. The crisis is instructive of the perils for the Fund to get entrapped in a crisis whose resolution lies primarily with the regional authorities. On the other hand, the Fund cannot just march out of Europe. First, the crisis is grave and has serious global spillover effects, as exports from Asia and the United States to Europe plunge, so do the profits of US multinationals in Europe. Second, Europeans have repeatedly been unable to marshal an adequate regional response and impose tough conditionalities on each other: the

[17] P. Manasse, ''The Trouble with the European Stability Mechanism'', *VoxEu.org*, 5 April 2011, http://www.voxeu.org/article/trouble-european-stability-mechanism, and D. Gros, ''Pact for the Euro: Tough Talk, Soft Conditions?'' *VoxEu.org*, 14 March 2011, http://www.voxeu.org/article/pact-euro-tough-talk-soft-conditions.

[18] D. Rocah and M. Lehuta, ''A Fannie Mae for Europe'', *Wall Street Journal*, 19 July 2011.

Fund in many ways is the last hope. And third, the Fund will remain involved as long as Europeans want it to: as its largest shareholder group, Europeans have a major say in Fund involvement, a situation quite unlike that of the emerging market crises of the 1980s.

Responding to crises, regionally and multilaterally

Whether the trend toward financial regionalism is driven by politics – backlash against the IMF – or by the expansion of intra-regional trade linkages, it will likely play a growing global role in the 21st century. The growth of national reserves and the rise of different pools of sovereign capital and bilateral financial agreements will likely tempt bilateralism alongside regionalism.[19]

However, regional funds are still rather untested and politicised, and their undoubtedly strong technical expertise is hostage to the members' reluctance to criticize and impose tough conditions on each other. What is more, regional schemes not predicated on rigorous conditions for good macroeconomic governance similar to those demanded by the IMF could perpetuate bad policies in the borrower nations while increasing moral hazard. Worse, an inadequate regional response would only erode market confidence, making the task for the second line of defenders harder, not unlike what has happened in Europe.

The IMF has unrivalled technical expertise, global experience and institutional memory. It brings to the table financial resources, blunt and sound policy advice, and tough-love policy conditions. At the same time, the Fund cannot be and does not have to be a monopoly: division of labour between the Fund and regional arrangements is desirable as long as it leads to prompt crisis management and policy prescriptions aimed at financial stability – and the Fund has sufficient leverage to affect outcomes and a clear exit option, a situation quite the opposite of that in the eurozone. Indeed, the eurozone crisis has driven home the importance of a clear delineation of the Fund's role, powers and exit strategy in managing regional crises with a regional counterpart. How should the relationship between the Fund and regional schemes best be delineated?

What the WTO can teach the IMF

Just as WTO members are jealous of their preferential trade agreements, IMF members guard their regional financial arrangements. But just as it is in each WTO member's interest to ensure that the PTAs forged by other nations are not discriminatory, so it is in every IMF member's interest to align global and regional instruments to ensure global financial instability is effectively managed.

[19] For a similar argument, see Henning, *US Interests*.

This takes political agreements, and such agreements are urgent: crises afford little time to define exactly what the relationship between regional and multilateral facilities is. Formal, *ex ante* specification is needed. Drawing on the experience of trade policymakers in the past decades, a number of measures can be envisaged for financial policymakers:

Craft a global code. The G20 should take a lead in fashioning a clear set of principles to define the relationship among the IMF, regional financial facilities and bilateral arrangements, akin to, but more specific than, the principles laid out in GATT Article XXIV. The principles – perhaps termed a 'Global Code on Financial Regionalism' – should address both money and policy, or the sequencing of the allocation of the funds from the different instances, as well as potential cost-sharing among them, and cooperation between the Fund and regional authorities in designing country programs and enforcing policy conditionalities.

Such principles should not be excessively detailed so as to account for the diversity among current and new regional funds. At the same time, they should also leave much less room for interpretation than the GATT's sparse phrasing gives WTO members. Forging such a code would of course be difficult, especially as emerging markets would be loath to have the Fund dictate the terms for regional arrangements. However, it is also the case that nations in any region should have an interest in the stability and developments in other regions, emerging and advanced. Precisely such concerns about developments in the rest of the world were what sparked a mass demand among governments for empirical analyses of PTAs.

Monitor. Much like what has been attempted by the WTO, the IMF should start performing regular, informal multilateral, comparative reviews of the various regional financial schemes that map out the dimensions of the regional funds, examining their compliance with the global code, and assessing their economic prowess and significance, such as their capacities to push back regional crises. The scope, methodology and timing of such studies and the Fund instance in charge of them, and of the pooling of knowledge generated in the organisation that is pertinent to the issues of financial regionalism, should be defined *ex ante* with the membership.

Engage experts. The Fund should complement its monitoring role by partnering with independent outside analysts in staging periodic conferences on issues surrounding financial regionalism, much like the WTO has done. Engaging outside academic experts would not only alleviate the Fund's own workload, but raise the level of debate and open spaces for thinking unconstrained by the politics and sensitivities in the Fund.

Share best practices. The Fund should also bring authorities of the regional funds together to share best practices and lessons learned in such areas as economic surveillance, technical assistance, financial operations, and the relationship of the funds with the private sector. Besides cross-fertilizing each other, regional schemes can serve as useful laboratories and incubators of new practices. The best of these new models could be multilateralised in the IMF. Conversely, the Fund's programs and facilities can offer a blueprint for the regional authorities on ways to structure their pools and operations.

Tie fates together. Key actors can and need to play a role. For example, working with Japan and Korea, its postwar linchpins in the Asian economic and security theatres, the United States should work to retain the 20 percent link between the CMI and IMF. The G20 should recommend that the IMF study and make recommendations on a range of further, less formal mechanisms to foster synergies between the Fund and regional financial mechanisms, and enhance a sense of ownership of Fund policies among regional economies. For example, members of a regional fund could be given committee status to set the agenda or pre-approve IMF packages for their region, and they could gain voting shares in IMF decisions concerning their region in proportion to their contributions to the regional fund.[20] Regional authorities could also accompany the Fund in Article IV missions, and partner with the Fund in early warning exercises and bank stress tests.

Specialise. The IMF and regional financial authorities should develop formal channels of communication on surveillance and economic analysis. Duplication of efforts should not be completely averted, as some overlap helps ensure a diversity of opinions. There could however be some topical division of labour, with the Fund handling the fiscal issues and analysis, and regional experts focusing on specific issues pertinent to them. For example, in Asia, regional efforts could focus on asset bubbles, exchange rates and liquidity concerns.

Stick to high standards. The Fund should not loosen its conditionalities and standards just because there are potential alternative lenders. The Fund cannot become an automatic loan dispenser: that would inspire moral hazard and undercut the power of conditionality. Substantially looser strings would also be objectionable to the Fund's main shareholders, including the United States, where Congress has a right to, and is bound to insist on bailouts having a price, and wants to see guarantees that the beneficiary government is able to repay its loans. At a minimum, further flexibility in lending practices places a premium on sturdy surveillance, particularly of financial sectors. Also needed is adherence to clear parameters for placing Fund members in the baskets of distinct conditionalities.

Conclusion

Both the WTO and the IMF are at a defining moment. Both face questions about their legitimacy and effectiveness, and both are surrounded by increasingly vibrant

[20] Lipscy, "Japan's Shifting Role".

and potentially competing systems of regional arrangements. But while it is feared that regional arrangements can undermine the multilateral trade and financial orders, they can also help buttress the multilateral institutions that are struggling to manage an increasingly complex global economy. Regional facilities are not enough in either trade or finance; multilateralism is also critical, and global system-manager institutions are still needed.

In trade, multilateralism is critical for ensuring non-discrimination. In finance, the past few years have made it very clear that no single government or even a multi-region effort suffices for delivering the world from economic instability. Havoc in New York or London can devastate distant economies, just as turmoil starting in Thailand ravaged emerging markets on the opposite side of the world. With crises disregarding borders, regional responses are but imperfect substitutes for the IMF. The Fund has technical expertise, institutional memory and worldwide experience that are unrivalled, and its globalised insurance pool is much more cost effective for the members and better for the world economy than reserve hoarding. Yet regional financial arrangements are here to stay. Financial policymakers would be well advised to draw on the experience of trade policymakers for ways to ensure the most effective relationship between the IMF and regional schemes – and do so now, before having to do so amid a new financial crisis.

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