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**REFORMING THE GLOBAL FINANCIAL ARCHITECTURE:
THE POTENTIAL OF REGIONAL INSTITUTIONS**

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Abstract

Regional financial organizations, including those without any industrial-country members, are likely to play a growing role in preventing or mitigating crises and in attracting long-term capital for development. Organizations comprising, or dominated by, emerging market countries will be the most successful because of their economic strength, readier access to markets, and bargaining power in the global economy. However, all regional financial organizations face greater challenges in mobilizing short-term than longer-term financing, although there is greater likelihood that those featuring emerging market countries will be able to undertake regional arrangements to prevent or mitigate short-term crises along the lines of the Chiang Mai Initiative. Similarly, the experience of the CAF (Andean Development Bank) suggests that regional organizations can also be very adept at mobilizing long-term development financing, provided the membership includes prominent emerging markets; additionally, portfolio composition and astute management are key factors.

Regional financial organizations comprising or dominated by the poorest or lower-income countries face much greater challenges, whether for short-term or longer-term financing purposes, unless they include donor or industrial countries in their membership. Considerably more thought and discussion is needed to develop regional mechanisms to address their particular short-term needs, whether for natural or man-made calamities, or for capital-account, commodity or aid shocks. For such groupings, partnerships with donor countries seem inescapable for the foreseeable future. However, it is important that the terms of the partnership are right for the developing countries. An excessively restrictive policy framework, ostensibly to appease donors, may unduly constrain growth and development potential.

REFORMING THE GLOBAL FINANCIAL ARCHITECTURE: THE POTENTIAL OF REGIONAL INSTITUTIONS

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1. Introduction

The international financial crises of the 1990s and early years of the 21st century initiated the beginnings of reform to the global financial system. These focused principally on remedying the financial fragility of emerging market economies, the principal victims of financial instability. In contrast, there have been no real reforms aimed at preventing or constraining financial instability at its core, for example by fundamentally restructuring the Bretton Woods institutions, or by rewriting the rules of the game for global financial markets. In the meantime the urge to reform has lost political impetus among the G-7, the key players on the reform agenda, with the recovery from the global financial turmoil of 1997-98, which had significantly abated by 1999.

The ensuing financial crises in Turkey and Argentina remained fairly contained to those countries. The absence of contagion seemed to signal that the international financial system, at least for the time being, had become more resilient, vindicating those who advocated a minimalist reform agenda limited to the vulnerable financial periphery, rather than the centre of the global system. This was little comfort to Turkey or Argentina, or for other developing countries that, for whatever reason, might encounter crippling financial shocks in the future.

Meanwhile, financing for the poorest countries continues to be grossly inadequate, whether for short-term exigencies or long-term development. Exhortations by a number of world leaders to double ODA at the International Conference on Financing for Development held at Monterrey in March 2002 resulted only in pledges by donors to increase aid by 25 percent over a number of years. While consensus has emerged around the Millennium Development Goals to halve poverty (along with the achievement of associated economic, social and environmental objectives) by the year 2015, there seems little prospect that the global financial system will mobilize the requisite resources to reach these targets, which are particularly ambitious in sub-Saharan Africa.

If restructuring the global financial architecture has been ruled out for the foreseeable future, it is important to seek alternatives. Some experts, including the Emerging Markets Eminent Persons' Group (2001) recommend building or reinforcing regional institutions mandated with preventing or mitigating crises for countries in their regions. To this objective could be added the achievement of longer-term development objectives. That is the focus of this paper. Drawing on the relevant precedents both in the developed and developing world, as well as the shortcomings of the current system for developing countries, the paper addresses the following questions.

¹ I am grateful for comments on an earlier draft by Gerry Helleiner and Rodney Schmidt.

- What organizational and institutional characteristics contribute to regional financial organizations playing an effective role?
- What are the key financial constraints faced by different groups of developing countries, with respect to short term financing and longer-term financing?
- To what extent can regional organizations play a key role in financial crisis prevention and management?
- How can regional financial organizations help bridge the large resource gap required for longer-term growth and development?

The next section of the paper provides some historical context, particularly for developing countries' experience with regional financial cooperation. The third section examines the rationale for regional financial cooperation, relating it to the rationale of broader or deeper regional economic cooperation and to reforming the global financial architecture. The fourth section undertakes a brief survey of regional organizations in two continents—Latin America and the Caribbean, and Africa—to draw some lessons about the extent to which such organizations can help to meet the financial needs of developing countries. The final section concludes by examining the potentials and pitfalls of regional financial cooperation in the broader agenda of reforming the global financial architecture.

2. Background

Regional financial cooperation among developing countries is not new. However, until very recently such cooperation was primarily aimed at longer-term economic objectives of growth, development, and integration, and was best exemplified by a number of regional and sub-regional development banks². It is worth noting that in at least one instance, the aspiration to such long-term regional development cooperation predates both Bretton Woods and Europe's postwar initiatives on regional economic cooperation. The earliest attempt to create an Inter-American Bank took place at the Inter-American Conference in Washington, D.C. in 1890, when Latin American countries attempted, but failed, to convince the United States of their project for regional cooperation. Fifty years later a convention to establish an Inter-American Bank was actually signed by the United States but abandoned during World War II. The latter proposal, four years prior to the Bretton Woods conference, was developed in part by U.S. officials such as Harry Dexter White, and helped shape the subsequent creation of the World Bank (Culpeper 1997:27).

The Inter-American Development Bank was ultimately born in 1959. Along with the Asian Development Bank (whose operations began in 1966) and the much later European Bank for Reconstruction and Development (which came into being in 1991), the creation of these regional development banks (RDBs) owed much to the Cold War. The first two came into being largely because the United States saw in them an economic bulwark against the spread of communism in Latin America and Asia, while the EBRD quickly materialized after the fall of the Berlin Wall, to assist Soviet bloc countries of Europe and Central Asia in their transition to capitalist democracies. In contrast, the African

² There are a number of sub-regional banks such as the Caribbean Development Bank and the Central American Bank for Economic Integration, discussed further below. Here the discussion is restricted to the continental regional banks.

Development Bank (created at almost the same time as its Asian counterpart) illustrated a fundamentally different history and political dynamic, discussed further below.

Here, two aspects of the RDBs as vehicles for regional cooperation are emphasized. First, notwithstanding their strong identification with, and ownership by, their developing country members, until recently membership of non-borrowing countries has remained critical to their capacities as financial intermediaries. Second, in practice regional cooperation has meant cooperating to promote the overall flow of resources to individual regional member countries, rather than to foster greater economic integration in the region.

Regional ownership vs. Non-regional control. The fundamental purpose of the RDBs, much like the World Bank, was to foster long-term economic and social development via investment in infrastructure, the productive sectors, and the social sectors as well. The United States and other leading industrial nations accepted some overlap in the mandates of the RDBs and the World Bank, reflecting an acknowledgement that the overall supply of long-term development finance was inadequate. But it also reflected their acceptance that new, regional institutions could give their developing country members what the World Bank would likely never give because of the permanent voting majority OECD members enjoy at the Bank: a greater sense of developing-country ownership and control. This consideration, although never explicit, was a key factor in the Western powers' political struggle against communism.

Greater ownership of RDBs by regional developing-country members has not, however, led to radically different policies, operational programs or conditionality from those of the World Bank (Kapur and Webb 1994). Notwithstanding the voting majority held collectively by the Latin American borrowing members of the IDB, *effective* control over major policy issues has been exercised by its largest minority shareholder, the United States. And at the Asian Development Bank, developing country members never did have a formal voting majority³. In any event, effective control by industrial country members in the RDBs springs not from their voting position but from the fact that their cooperation is vital to ensure resource mobilization through successive capital increases and replenishments, without which the RDBs would enjoy no growth in their lending program (Culpeper 2002).

The history of the African Development Bank (AfDB) illustrates how critical industrial country membership can be to a regional bank's ability to mobilize resources. Unlike the other RDBs, the AfDB was not a by-product of Cold War power politics. On the contrary, it was the manifestation of African countries, newly independent from colonialism, seeking to be free of alignment with the Cold War superpowers. Without explicit sponsorship by the industrial countries, the Bank reflected African countries' aspirations to blaze a specifically African path to development. For almost two decades, maintaining the "African character" of the Bank required that eligibility for membership be restricted to African countries only. By 1980, it became apparent that the Bank's

³ A voting majority was held by *regional* member countries, which included Japan, Australia and New Zealand (Kappagoda 1996).

ability to mobilize resources was highly limited by this formula. Non-concessional lending by MDBs is heavily dependent on their access to key capital markets in the North, which in turn is secured by the capital subscriptions of highly creditworthy members—in other words, by the membership of industrial countries⁴. And concessional lending has always been wholly dependent on funds provided by donor countries.

The AfDB was in fact able to establish a concessional lending affiliate, the African Development Fund (AfDF), in 1973, without any formal donor country membership in the Bank *per se*. Moreover, an attempt was made to preserve the Bank's "African character" in the Fund as well by insisting on voting parity between donors and African members. However, the magnitude of the concessional resources raised by the AfDF paled in comparison with the concessional affiliates of the Inter-American and Asian Development Banks, in which it was clear from the outset that donor members were clearly in control. After much debate the African Bank's membership was ultimately "opened" in 1982 to non-regional, i.e. developed country, members in Europe and North America. However, the principle of maintaining an African voting majority in the Bank (and parity in the Fund) persisted, although in the case of the Bank the African majority has subsequently drifted down through successive capital replenishment negotiations, at the insistence of the non-regional members (English and Mule, 1996).

Regional integration. The RDBs were all created with support for regional integration in mind as an objective, which has been reaffirmed over the decade of the 1990s. Despite this fact they have tended to operationalize this part of their mandate only to a negligible extent if the proportion of their lending portfolio allocated to regional integration projects is taken as the key indicator. For example, at the IDB, loans for regional integration constitute only 2 percent of authorizations which amount to \$8 billion annually, while regional technical cooperation amount to only \$12 million annually⁵. However, this indicator may not fully capture the RDBs' efforts to facilitate greater regional integration and cooperation. The IDB was extremely active in the 1990s, along with the OAS and UNECLAC, in the Hemispheric Summit Process, providing technical and financial support for the FTAA negotiations. For its part, the AsDB has become involved in regional economic and financial surveillance, to complement surveillance at national and global levels. And the AfDB, analogously to its counterpart in the Americas, is centrally involved with the OAU and UNECA in pan-African cooperation initiatives such as the New Partnership for African Development (NEPAD) and the creation of the African Union (Devlin and Castro 2002:27).

To conclude, the RDBs should be viewed as highly successful regional cooperation initiatives in mobilizing financial resources for their members' national development efforts. However, this judgment must be qualified by the fact that, until recently, industrial country membership has been vital to augmenting their lending capacity, and

⁴ By the 1990s this had changed—the Andean Development Bank (CAF) illustrated that a regional bank whose membership was exclusive to developing country borrowers could mobilize its resources solely on the strength of its borrowing members. The experience of CAF is elaborated below.

⁵ The AsDB, however, has allocated a more considerable part of its lending portfolio to multi-country regional projects such as the Greater Mekong Subregion Initiative.

the fact that, again until recently, they have not been particularly successful in enhancing cooperation among members, either by means of economic integration initiatives or coordinating development strategies. In the latter case, change has been facilitated by a new approach to regionalism.

Put bluntly, the “old regionalism,” of the 1950s and 1960s (the RDBs being exemplars) was characterized by groups of countries looking inward, motivated by a desire to substitute for the lack of multilateral liberalization and/or to facilitate holding aloof from what liberalization there was (e.g. the proposal for a Latin American Free Trade Area). The “new regionalism,” in contrast, is outward-looking, motivated by a desire to facilitate entrance into a more globally liberalized multilateral trading and investment system. Such regionalism is characterized by greater liberalization on the part of smaller than larger countries and by the quest for “deep integration,” whereby participating countries go well beyond border measures to harmonize or adjust various economic policies (the EU, Canada-US FTA and NAFTA are examples) (Ethier 1998)⁶.

After the Asian financial crisis of 1997-98, however, the promise of the new outward-looking regionalism became a little tarnished. Capital account liberalization—particularly when adopted prematurely, as it was in many countries, as part of a wider package of economic liberalization measures—left many vulnerable to massive financial shocks. The benefits of greater access to goods and long-term capital markets were dramatically offset, at least in the short run, by massive, crisis-induced capital flight and the domestic instability it precipitated. Furthermore, remedial measures implemented by the International Financial Institutions (and supported by the G-7 countries), came under considerable criticism for being procyclical (Ocampo 2002), and making a bad situation significantly worse (e.g. Stiglitz 2002).

Asian countries themselves were particularly critical both of the diagnosis and prescriptions applied by the G-7 and the IFIs to the region. Accordingly, soon after the outbreak of the Asian financial crisis in 1997 there were proposals from Japan for a regional monetary fund that received a positive response from a number of East Asian countries. At the time, the idea was opposed by the United States, European countries and the International Monetary Fund (Park and Wang 2001). However, the idea resurfaced in May 2000 at the Asian Development Bank meetings held in Chiang Mai, Thailand. This gave birth to the “Chiang Mai Initiative” among the “ASEAN+3” countries (the three countries in addition to ASEAN comprising China, Japan and Korea). While this initiative began essentially as a network of bilateral swap arrangements⁷, with informal surveillance arrangements, further discussion among the participants may lead to a multilateralization of the arrangements and the creation of a regional monetary fund.

⁶ As Bhagwati (1998) pointed out, however, a regional trade agreement on the lines of NAFTA was *not* an aspect of the East Asian Miracle or necessary to its emphasis of outward orientation through export promotion.

⁷ As at October 6, 2003, these amounted collectively to US\$32.5 billion.

3. The Rationale of Regional Financial Cooperation

Political motives. Regional financial cooperation can be motivated by larger political objectives as well as by narrower economic goals. Such political motives range from the need to facilitate conflict resolution or avoidance or mitigation between neighbouring states, to aspirations toward greater political integration or even union. The European Union, the pre-eminent example of politically-motivated regional cooperation, has travelled from one end of this spectrum, in the search for a durable peace at the end of World War II, toward the other end today, with monetary union and closely coordinated economic and social policies. Ever-increasing financial cooperation, in the EU project, is just a part of a much larger agenda of economic and political harmonization and integration, and after half a century it is still a work in progress. The deeper motives of political integration may be present in other parts of the world to the same degree as in Europe, but if they are, they are generally at a much earlier stage in the process. However, proposals for a Free Trade Agreement of the Americas, an African Union, and cooperative arrangements such as ASEAN and SAARC in Asia, are all suggestive of regional projects in which political motivations are indeed present. Conceivably, over time (and bearing in mind the EU's evolution over five decades) the political objectives associated with such initiatives could become more ambitious.

Moreover, political and economic motives are often intertwined and difficult to separate. Purely economic motives are no doubt undermined by historical enmity, mistrust or political grievances among neighbouring countries, simply because the transactions costs involved in negotiation and cooperation are likely to be higher in such circumstances. Put positively, economic motives are likely to be reinforced where political relationships between regional members are already strong and the desire for even closer relationships is growing.

Economic motives. That being said, there are several economic reasons for greater regional financial cooperation. There would seem to be two broad rationales: *co-operative* or *self-help* motives; and the need to remedy *incomplete international institutions*.

The co-operative rationale is straightforward. When countries of a region co-operate financially, they help to fill gaps caused by incomplete markets; increase external financing for various purposes; meet external development financing resource gaps generally; and exploit economies of scale. There are a number of examples of how they can do this:

- By pooling their risks, they can gain access on better terms to capital markets or donors than if they attempted to approach markets and donors separately. Regional or sub-regional development banks, in effect, play this role through financial intermediation.
- By forming trade payments settlement systems, they can reduce transactions costs of regional trade.

- By pooling foreign exchange reserves, they can reduce their individual reserve holdings and associated quasi-fiscal costs.
- By harmonizing policies and institutions in the financial sector and creating regional institutions, and instituting regional monitoring and surveillance to provide early warnings of countries likely to experience financial trouble, they can deepen regional capital markets, attract more foreign direct investment or attract it on better terms, and reduce the threat of regional contagion.

The “incomplete institutions” rationale deserves somewhat more explanation. As mentioned, global institutions such as the World Bank and the International Monetary Fund tend to be most responsive to the demands of their major shareholders—the G-7 countries—and also to the needs of the largest developing countries, which have significant voice and voting power in the institutions, constitute an important part of their lending portfolio (and hence their balance-sheets) and greater systemic importance with respect to global financial crises. The global institutions do not serve the world’s smaller and poorer countries particularly well, and this group of countries have a marginal role in the global institutions’ governance (Ocampo in Teunissen 2002). Regional arrangements therefore help to complete the global financial architecture in the following ways:

- By providing an institutional space, complementary to the global institutions, in which the voice and voting power of smaller and poorer countries is greater, along with a greater sense of regional ownership.
- By a more efficacious approach to conditionality. Global institutions are more inclined to impose conditionality; regional organizations in contrast are more able to rely on peer pressure to adopt policy reforms.
- At the same time, by providing some competition to the global institutions, generating more attention to the problems of the smaller and poorer countries.
- By focusing on providing international public goods that are regional rather than global in nature, and consistent with the principle of subsidiarity, by basing the arrangement in the region concerned with regional members as key players.
- By providing a source of countercyclical financing, to offset the procyclicality of private financing and official financing from the global institutions.

There is clearly a rationale for greater regional financial cooperation in general terms. But as a practical matter, different developing countries and regions face vastly differing needs, opportunities, and constraints. Therefore it is useful to distinguish among various groups of developing countries, in order to discern the potential benefits from regional financial cooperation for different groups and regions.

Per capita income provides one basis for differentiating among groups of developing countries. Another basis is the degree of access to international capital markets. It seems useful to distinguish two groups at opposite ends of the income spectrum—the poorest, and the emerging market countries. The former could be identified with the least-developed countries (as defined by the U.N.)—countries that are extremely poor and are

heavily dependent on foreign assistance on grant or concessional terms. Hereinafter, this group is referred to as the Least Developed Countries (LDCs). The second group consists of emerging market and transition countries in Asia, Eastern Europe and Latin America. This group consists predominantly of middle-income countries, but would also include India (a low-income country with growing access to capital markets) as well as China. This group is referred to below as Emerging Market Economies (EMEs). In between these two is a group of smaller, low- and middle-income countries (SMCs) which are neither among the poorest, nor can they be described as emerging market countries, since they have limited access to international capital markets.

These groups differ in their financing needs—whether for short-term financing or medium- to long-term financing. Short-term financing is required to meet emergencies and respond to crises; medium- to long-term financing is required for investment, capacity-building, and other constituents of sustainable development. Income levels also determine creditworthiness. Combined with the classification of developing countries by income group, this yields a “financing needs matrix” (see Figure 1).

Figure 1

	LDCs	SMCs	EMEs
Short-term needs	<ul style="list-style-type: none"> • Compensatory BOP financing caused by commodity, financial and aid shocks • Relief for natural disasters, post-conflict assistance and humanitarian emergencies (e.g. famine) 	<ul style="list-style-type: none"> • Compensatory BOP financing due to commodity and aid shocks • Relief for natural disasters and post-conflict assistance • Trade finance 	<ul style="list-style-type: none"> • Liquidity financing to prevent/mitigate financial panics, contagion. • Debt restructuring • Trade finance
Medium- and long-term needs	<ul style="list-style-type: none"> • Financing for infrastructure, social and productive sector investment • Debt restructuring • Budgetary and sector support • Capacity-building • Financing for countercyclical macroeconomic policy 	<ul style="list-style-type: none"> • Financing for infrastructure, social and productive sector investment • Debt restructuring • Capacity-building • Financing for countercyclical macroeconomic policy 	<ul style="list-style-type: none"> • Financing for infrastructure and productive sector investment • Financing for countercyclical macroeconomic policy
Credit-worthiness	<ul style="list-style-type: none"> • Grants and concessional lending 	<ul style="list-style-type: none"> • Semi-concessional lending 	<ul style="list-style-type: none"> • Market-based official lending

	• FDI	• Some forms of private financing	• All forms of private financing
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Least developed countries' short-term financing needs reflect their aid and commodity dependence and their greater vulnerability to natural disasters. Many of these needs are largely unmet, particularly in failed states. This group is generally not creditworthy for commercial financing on market terms. That is why they tend to be heavily dependent on the grant or concessional ODA from bilateral and multilateral aid agencies. Traditionally, such agencies have rendered project assistance and technical cooperation to support infrastructure, social and productive-sector investment. Recently some agencies have begun a transition to program-based assistance in the form of sector or budget support.

However, there is considerable evidence that ODA and other official flows are pro-cyclical, or serve to reinforce rather than dampen external shocks; therefore LDCs have unmet needs for countercyclical support (UNCTAD 2000, Part II, Ch.5). Debt restructuring is a medium- to long-term need, because the underlying problem is that of debt sustainability (i.e. reducing debt overhangs to levels compatible with growth and development) rather than short-term liquidity financing. Finally, while on a global basis most private foreign direct investment flows to middle-income countries, it is also true that the FDI that has flowed to a number of least developed countries is very significant as a proportion of GDP and in terms of domestic impacts. The likelihood is that such FDI will constitute a growing proportion of net resource inflows for such countries in the future. The fact is, however, that few LDCs have the monitoring or management capability even to maintain up-to-date, detailed data on the size and nature of such inflows (Martin and Rose-Innes 2004 forthcoming).

In contrast, emerging market countries' short-term needs arise more from their integration into, and shocks emanating from, international capital markets. (Some countries still suffer from commodity price shocks, but given a far lower level of dependence on commodity exports and greater degree of export diversification, the effects are far less devastating than those felt by the poorest countries.) Since the Asian financial crisis, much of the debate about short-term crisis prevention and mitigation, along with the argument that more could be done through regional cooperation, has been focused on this group. Debt restructuring is generally a short-term liquidity issue rather than a longer-term sustainability issue for this group. Finally there is also an unmet need for trade finance to put this group of countries at less of a disadvantage with their industrial country competitors.

With regard to longer-term needs, emerging market countries have much in common with the poorest countries but face more choices in meeting them. There is greater scope for domestic resource mobilization through financial intermediation, taxation, duty collection, and public-sector borrowing, and for a significant portion of investment, particularly for the productive sectors, to take place through private markets. However, particularly in those countries where domestic savings rates are low, investment needs must be met through accessing international capital markets. In particularly short supply

(as with least developed countries) is medium-term countercyclical financing, since available financing (official as well as private) tends to be procyclical.

In between these two groups are the smaller low- and middle-income countries, which tend to share many of the same financing needs as the poorest countries and some of the capabilities of emerging market countries. Thus they are able to absorb some semi-concessional financing and more forms of private foreign investment than LDCs. Some countries in this group are eligible for HIPC (e.g. Bolivia, Nicaragua and Honduras) and require medium-term debt restructuring.

Finally, casual observation suggests that the least developed countries face the greatest unmet needs, and that short-term needs tend to be unmet more than longer-term needs. In terms of Figure 1, this implies that the greatest unmet needs are in the top left-hand corner. Moving down and to the right in the table, rising per capita income and greater access to capital markets gives middle-income and emerging markets more choices either through official financing or through the markets.

4. Regional Financial Cooperation: Lessons from Current Experience

If the above is accepted as a useful conceptual framework, what lessons can be drawn from the experience of regional financial organizations, going beyond the Regional Development Banks mentioned above? What role do they play in meeting the needs of the three groups of countries? This question is addressed here via a brief survey of regional institutions in two continents—Africa and Latin America and the Caribbean.

Africa. Thirty-four, or almost three-quarters, of the world's 48 least-developed countries are in sub-Saharan Africa, which can be thought of as a least-developed region or a group of such regions. The African Development Bank Group (particularly its concessional affiliate, the African Development Fund), is the principal regional institution providing medium- to long-term development finance. However, the mandate of the African Development Bank Group covers the whole continent, including the countries of North Africa and the Republic of South Africa. There are a number of sub-regional organizations, including:

- The Economic Community of West African States (ECOWAS), comprising 16 members in West Africa⁸, was created in 1975 to promote intra-regional trade. The ECOWAS treaty also calls for joint infrastructural development, harmonized approaches to industrialization, and the improvement of regional competitiveness, objectives of its affiliated financial organizations, the ECOWAS Bank for Investment and Development, the ECOWAS Regional Investment Bank, and the ECOWAS Fund for Cooperation, Compensation and Development. The Fund has agreements with the African Development Bank and the Islamic Development Bank to co-finance projects. There is also a private regional investment bank, Ecobank Transnational

⁸ Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea Bissau, Liberia, Mali, Mauritania, Togo, Niger, Nigeria, Senegal, Sierra Leone.

Inc., based in Togo. Achievements in all these areas have been modest, although there has been some progress in infrastructure (Rwegasira 1996). In December 2000, five countries (The Gambia, Ghana, Guinea, Nigeria and Sierra Leone) agreed to create a West African Monetary Zone with a common currency and central bank and to merge this zone with the Western African Economic and Monetary Union by the year 2005. To that end, a West African Monetary Institute was established to work toward the harmonization of bank and non-bank financial regulation and of monetary policy, and to establish and monitor macroeconomic convergence criteria to facilitate the transition to a monetary union.

- The CFA Franc Zone is the most long-standing example of regional financial cooperation among a group of LDCs, dating back to 1948. The CFA Franc is a common currency fixed via a “hard peg” to the Euro (before 1999, to the French Franc), which effectively externalizes authority for short-term financing to the French Treasury. Moreover, the hard peg reduces the zone’s capacity to absorb external shocks, which is further complicated by the substantially different needs and capacities of its 14 members in its two zones in West and Central Africa⁹. Therefore because of the nature of its external peg and other features, the regional common currency *per se* cannot be said to have resolved the zone’s needs for short-term financing to meet commodity price fluctuations or natural disasters such as drought and desertification or financing for longer-term development. Indeed, it could even be argued that, rather than leveraging additional resources for regional members, the rigidities of the CFAF zone (including the recent adoption of a Convergence, Stability, Growth, and Solidarity Pact modelled on that of the Eurozone) hamper its flexibility. However, its proponents argue that the requirements of an externally-backed common currency have resulted in monetary and fiscal discipline, which in turn have served to strengthen the region’s growth performance. Additionally, members have agreed to a single banking supervisory authority (a “Banking Commission”) in each of the two subregions, as well as setting up common accounting and prudential standards throughout the zone, which may contribute to making the region more attractive to foreign investment, reducing the problems of information asymmetry, and with it the threat of financial contagion (Strauss-Kahn 2003). Members of UEMOA adopted a customs union and common external tariff in 2000. Progress toward regional integration in CEMAC has been slower (IMF Survey 2002).
- The Southern African Development Community (SADC), an association of 14 states of central and southern Africa¹⁰. Prior to 1992, When South Africa joined what was

⁹ The two zones are the West African Economic and Monetary Union, UEMOA, comprising Benin, Burkina Faso, Guinea Bissau, Côte d’Ivoire, Mali, Niger, Senegal and Togo; and the Central African Economic and Monetary Community, CEMAC, comprising Cameroon, Central African Republic, Congo, Chad, Equatorial Guinea, and Gabon. Most observers would agree that the CFAF zone is so large and heterogeneous that it does not constitute an optimal currency area in Mundell’s sense. De Macedo et al (2001) argue that regional cooperation is actually easier between countries with partly flexible, “intermediate” exchange rate regimes rather than “corner regimes” of hard pegs or complete flexibility.

¹⁰ Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia, Zimbabwe.

previously the Southern African Development Coordination Conference (SADCC), its main objective was to promote regional integration through investment and sector coordination driven primarily by donor funding. This group now provides a forum and a framework within which to coordinate policies and facilitate greater regional integration (on political issues such as security and defence, and the strengthening of democracy and human rights, as well as on the regional economy). SADC is phasing in a free trade area in 2008.

- The Common Market for Eastern and Southern Africa (COMESA, formerly the Preferential Trading Area or PTA) comprises 17 members¹¹ including many members of SADC. Its fundamental objective is to promote intra-regional trade through trade liberalization. It established a free trade area among nine members in 2000 and is working toward a customs union in 2004. (A subgroup, the East African Community, comprising Kenya, Tanzania and Uganda, is planning to implement a free trade area and common external tariff in 2004.) As part of this larger objective, COMESA has established three financial facilities, the Trade and Investment Bank (PTA Bank), created to establish a trade financing window, somewhat unique in sub-Saharan Africa; the COMESA Clearing House to facilitate the settlement of trade payments among members; and PTA Reinsurance Company (ZEP-RE), established to develop the insurance and reinsurance industry in the region. Strengthening of macroeconomic coordination is also an objective of the COMESA treaty, but little has been done in this regard (Rwegasira 1996; IMF 2002).

Certain features stand out from this brief survey of African regional organizations. First, apart from the CFA Franc zone, regional trade is the principal objective rather than financial cooperation. To a lesser extent regional integration through investment has been a motivation. In the case of the CFAF zone, regional trade and integration, including financial and macroeconomic harmonization, have been by-products facilitated by the common currency. Second, achievements have generally been modest, reflecting the stark challenges facing all member countries and the difficulties of coordinating policies in such circumstances. The level of intra-regional trade is somewhat higher in the CFAF zone than in other regional blocs, but is still far from dominating the direction of overall trade, which is still strongly oriented toward Europe. This outcome is not surprising given the low degree of complementarity in the region's trade and production structure. Third, notwithstanding some innovative attempts at financial cooperation (such as the PTA Bank in COMESA to facilitate trade financing), it is clear that such initiatives have not gone far in sub-Saharan Africa toward meeting the region's unmet needs for short- and longer-term finance. Finally, criticisms of the CFAF zone suggest that regional economic cooperation may be a two-edged sword. While it may be intended to increase the interest and confidence of outside investors, an unintended consequence of overly stringent standards of harmonization may be to hamper growth. Such criticisms are important given various proposals for new common currencies (see below).

¹¹ Angola, Burundi, Comoros, D.R. Congo, Eritrea, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Rwanda, Sudan, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.

Perhaps it is the limited success of such regional efforts that led African leaders during 2002 to launch the New Partnership for African Development, an initiative which explicitly invited donors to support African-led efforts, whether for infrastructure investment, regional security, or the transition to democracy¹². However, at the same time African leaders also agreed to a timetable for the creation of an African Union (AU) to replace the Organization for African Unity. The AU will ultimately have power over economic, political, social and judicial issues within the continent. It will ultimately develop a common currency, a continental parliament and a court of justice, and is modelled on the European Union rather than on NAFTA or FTAA. These developments, which have occasioned both optimism and skepticism, reaffirm the importance of political factors underlying regional cooperation.

Latin America and the Caribbean. The Latin America and Caribbean region includes groups of both EME and SMC subregions (the only LDC in the hemisphere being Haiti). Two examples of regional financial cooperation among SMCs and one among a heterogeneous group of EMEs and SMCs serve to illustrate some potentials and pitfalls.

- The Central American Bank for Economic Integration (CABEI), established in 1960, is a sub-regional bank based in Honduras, serving that country and four others—Guatemala, El Salvador, Nicaragua and Costa Rica, which in the framework of this paper all constitute SMCs. There are also four non-borrowing “regional” members, comprising Argentina, Colombia, Mexico, and Taiwan, all of which are EMEs. Its mission is to promote the progress and the integration of the Isthmus by fostering equitable, environmentally friendly economic growth. To that end, it supports public and private programs and projects that generate productive employment and contribute to improving productivity and competitiveness, as well as raising the human development indices of the region. Over the four decades of its existence, CABEI has proved itself to be a useful regional non-concessional financial intermediary for both public-sector investment, and increasingly over the past decade, private-sector investment, including small- and medium-sized enterprises. However, it encountered financial problems because of the Heavily-Indebted Poor Countries (HIPC) debt-relief initiative in the late 1990s, because two of its borrowing members (Nicaragua and Honduras) are eligible for relief. Without adequate compensation (for example through donor Trust Funds established under HIPC), the prescribed debt relief could have impaired one-half of CABEI’s net worth.
- The Caribbean Development Bank (CDB) was established in 1970, to promote economic growth and integration among the countries of the Commonwealth Caribbean, particularly the less-developed members. It currently has 25 members including three non-borrowing regional members (Colombia, Mexico and Venezuela) and five non-regionals (Canada, China, Germany, Italy and the U.K.). Like CABEI it has acted as a financial intermediary to mobilize non-concessional financing. Unlike CABEI, it also has a concessional window supported by a small group of bilateral donors. A review of the CDB undertaken in 1995 concluded that the CDB is a highly

¹² Mistry (1996), explicating the failure of structural reforms in Africa, argued for a more regional approach to investment coordination and cooperation, trade integration and institutional development.

effective lender to smaller countries (many of which are island micro-states), based on its portfolio of successful project loans, and sound management practices. Its success, relative to CABEL, rests in part on its ability to access concessional funds for its lenders, which cannot sustain high levels of debt. An innovative agreement between the CDB and the World Bank in 1990 resulted in the CDB “retailing” World Bank concessional funds to the microstates of the eastern Caribbean (Hardy 1995).

- The Andean Development Bank (or CAF, Corporación Andina de Fomento) began its operations in 1970 in Caracas. Its principal shareholders are members of the Andean community: Bolivia, Colombia, Ecuador, Peru and Venezuela. It also has seven “extraregional” shareholders (Brazil, Chile, Jamaica, Mexico, Panama, Paraguay, and Trinidad and Tobago, as well as 22 private banks from the Andean region (a somewhat unique characteristic of subregional development banks). Thus CAF’s membership comprises both EMEs (Brazil, Chile, Colombia, Mexico and Venezuela), as well as SMCs, all exclusively from the LAC region. Its mission is to promote the sustainable development and regional integration in both the public and private sectors of Latin America and the Caribbean. CAF’s approvals to its five Andean members (US\$18.7 billion, 1990-99) considerably exceed those of the IDB (\$14.4 billion) and the World Bank (\$10.2 billion), and while its bond rating is lower than those of the IDB and World Bank (S&P: AAA), it is higher than any other Latin American issuer (e.g. Chile’s S&P rating is “A-” while CAF’s is “A”)¹³. Its lending portfolio is concentrated in its Andean members, and 72 percent consists of infrastructure projects. CAF’s performance is all the more remarkable because one of its Andean borrowers, Bolivia, is a debt-distressed HIPC country, while another, Ecuador, has experienced severe financial distress in the last three years; and like CABEL (but in contrast to the CDB) it does not have a concessional lending window. In addition to its activity as a financial intermediary, CAF also plays an important role in the development and integration of the region’s financial markets, by strengthening regulatory and supervisory systems, harmonizing prudential criteria for the region’s banking systems, and helping to create an agreement on the framework for a regional securities market.

The experience of CAF proves that it is possible for a subregional financial institution to operate very successfully, without any industrial country shareholders, and without recourse to concessional funding. Indeed it has done so on a scale comparable to those of the world’s principal IFIs, despite the serious economic problems afflicting some of its key borrowing members—problems that have caused serious difficulties for CABEL. Factors explaining CAF’s comparative success likely include judicious management and the sectoral composition of the borrowing portfolio, with its heavy emphasis on public sector infrastructure. All three organizations include regional integration among their principal objectives, but like their IFI peers this does not seem to translate into a significant portion of their lending portfolios. Finally, while all three meet some their

¹³ Financially its return on assets (1.9%) and equity (7.0%) outperforms the IDB (1.0% and 5.0% respectively) and World Bank (0.7% and 5.6%). Carlos Quintela (2000), “Corporación Andina de Fomento: Thirty Years Financing Sustainable Development.” Presentation, Rio de Janeiro (September 25).

respective regions' needs for long-term capital, none of them are particularly well-placed to meet needs for short-term assistance, for example, in the face of natural disasters.

Other regional organizations worth mentioning briefly include¹⁴:

- the Reciprocal Payments and Credits Agreement of the Latin American Integration Association (ALADI), an arrangement dating back to the 1960 Montevideo Treaty, to settle trade-related payments among Latin American countries. After rapidly growing in the 1980s to the point of processing 90 percent of intra-regional import payments, the proportion processed by ALADI dwindled to 10 percent by 1999, partly because of the development of financial technology, de facto dollarization, and more flexible exchange rates reduced the advantages of ALADI's settlement system (Chang 2000).
- the Latin American Reserve Fund (FLAR), a reserve-pooling arrangement initiated by the Andean countries in 1978 (Costa Rica has subsequently joined); FLAR's current subscribed capital is US\$2.1 billion; its fundamental objective is to support the balance of payments of member countries by granting or guaranteeing loans. The ability to play this role effectively may be circumscribed both by FLAR's relatively limited resources¹⁵ and by its (thus far) limited membership (the five Andean countries plus Costa Rica). In the event of regional contagion spreading from a particular member's financial crisis, there would be simultaneous demands for balance of payments support that FLAR could not meet (Chang 2000).

Compared to Africa (and perhaps Asia as well, which we do not survey here), the Latin America and the Caribbean (LAC) region seems well-served by subregional organizations, despite the setbacks suffered by CABI on account of the HIPC initiative. In large part this is due to the greater economic strength of countries in LAC, which include several EMEs. The CAF has broken new ground among regional financial institutions by virtue of both the overall volume of its operations and its success on a number of indicators. And the FLAR predates the Chiang Mai Initiative (CMI) as a regional monetary fund, even if its resources are still modest. FLAR and CMI initiatives could well learn from each other—for example, FLAR could supplement its resources with bilateral swap agreements (ECLAC 2002), and the CMI could learn from FLAR's experience with reserve pooling. Finally, the “retailing” arrangement between the World Bank and the CDB could be replicated in a number of other subregional banks as a way of efficiently channelling resources to the world's smaller and poorer countries.

5. Conclusion: Regional Organizations in the Global Financial Architecture

Notwithstanding the important and innovative financial contributions of regional organizations such as CAF, the fact remains that a number key financial needs of their

¹⁴ The list could also include FONPLATA, a subregional bank

¹⁵ FLAR's capital of \$2.1 billion is clearly meagre compared to the bilateral swap arrangements under the Chiang Mai initiative of \$32.5 billion.

developing country members likely remain unmet. This is particularly the case for *all* the financing requirements of the poorest countries and some smaller and lower-income countries, and for the *shorter-term* financing requirements for poorer and emerging countries alike. These are discussed in turn, with a mind to the role of regional organizations in filling the gap.

Longer-term resource needs of the poorest countries. Despite the best efforts of the international community (most recently at the 2002 International Financing for Development Conference in Monterrey), it seems there is little likelihood of dramatic increases in ODA. Rather than the doubling of ODA required to help meet the Millennium Development Goals (which would have garnered an additional \$50 billion), pledges made at that time and subsequently amounted only to \$16 billion in additional ODA by 2006¹⁶. Given that backdrop, what can regional organizations or initiatives do to fill the gap?

There are two possible answers. The first looks *outwards*, principally to donors for resources, by facilitating aid flows through collective regional efforts. The obvious example here is NEPAD, an initiative of African leaders aimed at catalyzing aid and other resource flows to Africa. Through collective commitments to undertake economic and governance reforms, monitored through an African peer-review system, the objective is to increase the confidence of donors and private foreign investors that the economic and political climate is conducive to development, and therefore that aid will be more effective and private investment more productive and profitable.

An offshoot of the NEPAD initiative involves the UN Economic Commission for Africa and in the OECD Development Assistance Committee's own peer-review system, through ECA's participation in the reviews scheduled regularly for each donor member of DAC. Indeed, there is a paucity of mechanisms in the aid architecture to ensure that donors meet their pledges and stated commitments, in contrast to the host of mechanisms to ensure that developing country recipients meet theirs¹⁷. While a few recipient countries are developing mechanisms to monitor the commitments and behaviour of their entire family of donors, perhaps regional organizations (for example, the East African Community) could collectively arrange for independent monitoring and review of donors. The aim would be to identify and build on best practice as well as to remedy unacceptable practices of those donors.

The second answer to meeting the needs of the poorest countries looks *inwards*, to the possibility of mobilizing more resources domestically. Regional organizations can help deepen financial markets; develop the financial sector through capacity-building of banking and non-banking institutions and human skills; and help create or improve the regulatory and supervisory infrastructure. Regional cooperation may be particularly

¹⁶ Report to the Secretary-General of the High-Level Panel on Financing for Development (United Nations A/55/1000, 26 June 2001); UN General Assembly, "Implementation of and follow-up to commitments and agreements made at the International Conference on Financing for Development," (United Nations A/58/216, 5 August 2003) paragraphs 115-121.

¹⁷ Independent Monitoring Group (Tanzania) (2002).

useful to set up stock markets on a regional rather than national basis, since for poorer countries, local equity markets tend to be very thin. There could be cost advantages (by economizing on administrative and supervisory overheads) and benefits for local and foreign portfolio investors in the form of greater choice and market liquidity.

Additionally, regional public bond markets combined with integrated financial payments systems might effectively reduce the risk of contagion of financial crises, by facilitating a coordinated monetary policy response, and reducing the possibility of temporary failure of trade finance. Some regional institutions are already engaged in such an agenda, as evidenced by the financial reforms of the UEMOA (Western) subregion of the CFA Franc zone and the ECOWAS proposal for a second monetary zone. While the objective of mobilizing more resources from the savings of the poorest countries is ambitious—and some may even regard it as naïve or utopian—the fact remains that the “East Asian miracle” involved, to a large extent, poor countries with high savings rates (considerably in excess of those common in sub-Saharan Africa) *and* a reasonably efficient financial sector¹⁸.

However, an important caveat must be added. Regional rules and institutions should be designed, first and foremost, with regional needs in mind. To the extent that such rules and institutions reduce the scope for action on fiscal, monetary, financial sector, or exchange-rate policies, as seems to be the case at least for some countries in the CFA Franc zone, and elsewhere in sub-Saharan Africa, they could hinder rather than help domestic investment and growth. (Gottschalk 2003).

In conclusion, meeting the needs of the poorest countries for resources—whether long-term or short (discussed further below)—is the most demanding of all development challenges. It would be unrealistic to expect that regional cooperation, by itself, would help to bridge the enormous gap between availability and needs. Nonetheless, there may be certain ways in which regional cooperation can help as a catalyst for greater or more effective aid and private flows, or deepen local financial markets and increase the scope for domestic resource mobilization.

Bridging the gap for short-term financing. Most of the attention in the aftermath of the Asian financial crisis has dwelt on short-term measures to prevent or manage crises. While the 1998 proposal for an Asian Monetary Fund met with opposition from the IMF and some G-7 members, the 2000 Chiang Mai Initiative (CMI) has been widely endorsed, despite lingering misgivings.

In the meantime, as a result of the 1997-98 crisis, countries in the region have accumulated a large stock of foreign exchange reserves, estimated to be in excess of \$800 billion among the ASEAN countries plus China, Japan and Korea (Park 2001). Pooling these resources gives the region a considerable “war-chest” with which to fight speculative attacks against countries of the region. In that light, CMI bilateral swap and other arrangements amounting to \$32 billion in late 2003 scarcely tap this pool of

¹⁸ It is also true that countries such as Korea and Taiwan also benefited from large resource transfers from bilateral donors, particularly the United States.

reserves, although the CMI is viewed as a mechanism that will grow incrementally over time.

The promise of the CMI as a regional mechanism for coping with financial instability (like the success of CAF in Latin America in attracting longer-term financing) illustrate an obvious fact about emerging market economies: their per capita higher incomes and their aggregate market size endows them with significant resources, and access to capital. Given continued growth among such countries, it seems likely that such regional mechanisms, without industrial country membership in some cases, will play an increasing role in meeting their short-term financing needs.

The much more difficult challenge is meeting the short-term financing needs of the poorer countries (including the LDCs, and smaller and lower middle-income countries) to meet exigencies such as natural disasters, declining and volatile commodity prices, and post-conflict reconstruction.

For most of these needs international mechanisms and the involvement of donors seem imperative. In the specific case of commodity-dependent countries, past approaches to stabilize prices and protect against shocks, including international commodity agreements, have experienced, at best, mixed success. There may be scope for subregional initiatives, however, in the areas of research and development, and quality control and assurance, to enhance supply capabilities particularly to meet the increasingly stringent standards by consumers and buyers, and to facilitate the production and export of higher value-added products. Such activities could be financed through the Common Fund for Commodities (CFC) (UNCTAD 2002:231).

There may be scope for South-South Co-operation as well in this area (Helleiner 1999). For example, developing countries with national stabilization funds for particular commodities (for example, Chile's Copper Stabilization Fund) could provide assistance (again funded through the CFC) to regions that are heavily commodity-dependent in creating similar Funds on a regional basis, pooling revenues from the key commodities exported by member countries. Diversifying such funds to include revenues from more than one commodity would also serve as a stabilizing force, assuming that different commodities are subject to somewhat different supply and demand cycles.

Finally, let us revert to the questions posed at the outset of this paper with some tentative answers:-

- What organizational and institutional characteristics contribute to regional financial organizations playing an effective role?

It seems clear that regional groups comprising, or dominated by, emerging market countries are more effective because of their economic strength and readier access to markets. Put otherwise, they have some bargaining power in the global economy. Regional organizations comprising the poorest or lower-income countries face much

greater difficulties, unless they include donor or industrial countries in their membership, and that obviously raises other problems.

- What are the key financial constraints faced by different groups of developing countries, with respect to short term financing and longer-term financing?

The poorest and smaller countries face challenges across the entire spectrum—whether for short-term or longer-term purposes. All countries, including emerging market countries face greater challenges in mobilizing short-term than longer-term financing, although in the case of the latter there seems greater likelihood that EMEs will be able to organize regionally along the lines of the Chiang Mai Initiative.

- To what extent can regional organizations play a key role in financial crisis prevention and management?

It is too soon to tell whether the Chiang Mai Initiative is up to the task of preventing or mitigating crises in East Asia. However, it could be argued that as the CMI grows in scope, and the longer the region is spared further financial crises, the more effective is CMI in making the region speculation-proof. As for poorer and smaller lower-income countries, considerably more thought and discussion is needed to develop regional mechanisms to address their acute needs, whether for natural or man-made calamities, or for capital-account, commodity or aid shocks.

- How can regional financial organizations help bridge the large resource gap required for longer-term growth and development?

For the poorest and smaller countries, partnerships with donor countries seem inescapable for the foreseeable future. However, it seems important that the terms of the partnership are right for the developing countries. An excessively restrictive policy framework, ostensibly to appease donors, may constrain growth and development potential. For the emerging market countries, the experience of the CAF suggests that regional organizations can be very adept at mobilizing long-term development financing, provided the membership is appropriate (with prominent EME membership); portfolio composition and astute management are likely also key factors.

Clearly, more research is needed on the potentials of regional financial organizations in order to reach a comprehensive assessment of their effectiveness, or prescriptions to improve their performance, including a better division of labour with the global organizations. However, it seems clear that they can contribute significantly to the global financial architecture in meeting the particular needs of developing countries from very different parts of the world, facing considerably different opportunities and challenges.

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