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ISSUE BRIEF

Shaping the Asia-Pacific Economic Order

Looking Forward Twenty Years after the Asian Financial Crisis

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This year marks the twentieth anniversary of the Asian financial crisis—an event that profoundly shaped the economic policy views of Asian leaders. The crisis generated a concerted regional effort to protect against future crises and to undertake policy reforms geared toward long-term financial resilience and economic growth. When faced with the 2007–09 global financial crisis, the Asian region survived without major dislocations.

Over the past decade, the entire region has seen strong economic growth. It has built up financial buffers, including the accumulation of massive reserves by central managers, rebalanced away from external demand toward new domestic drivers of growth, instituted macro-prudential measures to address financial vulnerabilities, and promoted greater regional integration and opening of financial markets and national borders. During this period, there was a diffusion of power from the West to the East, and the center of economic gravity shifted to the Asian region, with two-thirds of global growth originating in Asia.

Despite these achievements, the rules-based order in Asia now faces complex challenges from within and without. Globalization has become more region-centric, with proliferating regional and bilateral trade accords. Global cross-border capital flows have dropped by 65 percent, with much of the decline resulting from a plunge in cross-border lending.[1] Global trade growth, which grew at nearly twice the rate of the world economy through much of the post-World War II period, has been flat, mirroring global gross domestic product growth, only 1.2 percent in 2016, and projected to be 2.4 percent through 2018.[2] Global supply chains, though alive and well, have become shorter and more localized. Many economists view this as structural, not cyclical.[3] The Chinese economy, which has been the single largest driver of regional

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1 Susan Lund, Eckart Windhagen, James Manyika, Philipp Härle, Jonathan Woetzel, and Diana Goldshtein, *The New Dynamics of Financial Globalization*, McKinsey Global Institute, August 2017, http://www.mckinsey.com/industries/financial-services/our-insights/the-new-dynamics-of-financial-globalization.

2 World Trade Organization, "Trade recovery expected in 2017 and 2018, amid policy uncertainty," April 12, 2017, https://www.wto.org/english/news_e/pres17_e/pr791_e.htm.

3 Shawn Donnan, "Global Trade: Structural Shifts," *Financial Times,* March 2, 2016, https://www.ft.com/content/0e0e6960-da17-11e5-98fd-06d75973fe09.

economic growth, is slowing and is encumbered by large and rising debt, along with the long-term burdens of an aging population and environmental damage. Geopolitical and security concerns, particularly in Northeast Asia, carry economic implications.

During the twenty-year period since the Asian financial crisis, new official arrangements have been put in place globally to address the risk of financial crisis and instability. The International Monetary Fund (IMF) has seen its role affirmed and its capacity enhanced. The Group of Twenty (G20) process has added legitimacy to global economic governance and has demonstrated effectiveness in global crisis management and with new measures aimed at fostering resilience. The IMF's global role notwithstanding, the trauma of financial shocks and lingering concerns about the terms of IMF conditionality have spurred Asian efforts to create their own financial safety nets to address balance-of-payments and short-term liquidity problems. At present, these efforts to create regional shock-absorbing mechanisms are by design linked to the IMF. However, resentful of their IMF dependence and anxious to cordon off their respective financial systems from the next global financial crisis, Asian economic managers continue to hedge with regional financial arrangements (RFAs). These arrangements are largely untested, and questions exist about the adequacy of coordination between IMF and regional arrangements. The risk of fragmentation of the global monetary order, while not imminent, remains a latent possibility, one that is perhaps only one more financial crisis away.

This brief will examine the safety-net mechanisms that have been developed in the Asian region. It will assess their adequacy in responding to financial crisis, and importantly, whether the Asian region is likely to move toward fragmentation or toward improved coordination. Historically, the United States and the mainstream Asian leadership have strongly supported linkage and coordination. How do the United States and the region best manage the risk of fragmentation of the global monetary order and the possibility of delinking Asian monetary arrangements from global mechanisms?

Asian Regional Economic Outlook and Challenges Ahead

In the Asia-Pacific, the medium-term outlook for economic growth is reasonably positive. The IMF and the Asian Development Bank (ADB), as well as private economists, project regional growth around 5.5 percent for 2017-18 and beyond.[4] There has been greater emphasis on balanced and sustainable economic growth and on better governance and structural reforms. Interest rates have been stable, and financial markets have been less volatile. Regionally, there is significant reserve coverage, as well as available global liquidity. While not without financial risks, Asia is well-positioned to continue its role as an engine of global economic growth.

The foundations of continued sustainable growth seem to be in place. Yet, there are challenges ahead. Greater interconnectedness in the region generates greater risks of the transmission of financial vulnerabilities and spillover effects from inside and outside the region. The danger of geopolitical instability persists, such as a crisis or military conflict in northeast Asia on the Korean Peninsula and tensions in areas of maritime dispute in the East and South China Seas.

Questions about the long-term growth trajectory remain:

- Can sustainable growth be maintained within middle-income countries?
- What are the regional implications of a slowing growth trajectory in China and its high and rising debt?
- What will be the effect of aging populations in China and Japan?
- Can slowing productivity growth and rising inequality be reversed?
- Can the legacy challenges of environmental degradation be adequately addressed?
- What is the capacity to cope with the transition to normalization of monetary policy in major countries?
- Can the risk of protectionism to regional trade, data and financial flows, and economic integration be contained?

4 *Asian Development Outlook 2017: Transcending the Middle-Income Challenge,* Asian Development Bank, accessed November 30, 2017, https://www.adb.org/sites/default/files/publication/237761/ado-2017.pdf; Pablo Lopez Murphy and Koshy Mathai, *Regional Economic Outlook: Asia Pacific, October 2017: Making the Most of the Upswing*, International Monetary Fund, October 13, 2017, https://www.imf.org/en/Publications/REO/APAC/Issues/2017/10/09/areo1013.

Although the economic outlook is reasonably positive for the region as a whole, these challenges raise many questions for Asian government agendas, including the adequacy of existing regional mechanisms to address financial vulnerabilities and potential economic crises, and whether more should be done to mitigate risks and to strengthen these regional mechanisms for addressing unexpected liquidity shortages and financial market disruptions.

Asian Regionalism Evolves: Strengthening Regional Institutions and Mechanisms

Many of the fears, speculation, and assumptions about the impact of the 2007–09 global financial crisis—the largest financial disruption since the 1930s—on the future of the regional and global monetary order appear in retrospect overstated, if not unwarranted. The Bretton Woods institutions, particularly the IMF, through the coordinated effort of their major shareholders, have demonstrated impressive adaptability and resilience in the face of these challenges.[5]

Ironically, apart from the United States, where support for and contributions to the Bretton Woods institutions have waned, there is little evidence of any substantive decline in support for these institutions among the majority of their member states. The leading shareholders and leadership of the IMF have continued to demonstrate institutional adaptability in response to crises and rapidly changing realities (e.g., the end of US dollar-gold convertibility in 1971, the oil price shocks of the 1970s, and the 2007–09 financial crisis). Through the trials and errors in the IMF's efforts to restore financial stability in response to the 1997-98 Asian financial crisis, and the European sovereign debt crisis in the aftermath of the 2007–09 global financial crisis, the IMF has taken a leading role in addressing systemic threats to financial stability. The IMF's learning curve on the policy side, the additional resources provided by member states, combined with structural reforms giving China and emerging economies like India and Brazil a larger voice, have helped reinforce its legitimacy. The G20 process, including the Financial Stability Board (FSB) that was established in response to the 2007–09 global financial crisis, has also proved to be critical to managing global crises and sustaining the support of the world community, including the major Asian countries; Asia has benefited from the G20 and FSB processes.

While global mechanisms have demonstrated strength in response to the global financial crisis, regional financial facilities are also being developed, particularly in Europe in response to the European debt crisis—such as the European Stability Mechanism (ESM). Asia, too, has seen the creation of regional financial mechanisms aimed at crisis management.

Asia has witnessed quiet, but steady, progress in building new regional mechanisms of significant magnitude. The most prominent of these are the Chiang Mai Initiative Multilateralization (CMIM), along with the Association of Southeast Asian Nations (ASEAN) "+3" (China, Republic of Korean [ROK], and Japan) Macroeconomic Research Office (AMRO), and the relatively new BRICS' (Brazil, Russia, India, China, South Africa) Contingency Reserve Arrangement (CRA). The origins and interconnections of these organizations are discussed below. All remain formally linked to the IMF, though with a modicum of autonomy.[6] Neither CMIM nor the CRA mechanism have ever been activated, but they are developing more specific and transparent decision-making processes and surveillance capacity.

In parallel, the IMF has been strengthened alongside the enhancement of new Asia initiatives in the aftermath of the global financial crisis. The IMF is not being weakened or supplanted by an Asian alternative, nor is there any momentum in that direction. On the contrary, recognizing the complementary role they can play, there has been a desire to link the global and regional components.

Moreover, the notion of the Chinese renminbi (RMB) displacing the US dollar as the world's principal reserve currency appears not only far beyond the horizon, but its internationalization has stalled, if not gone into reverse.[7] The US dollar remains unchallenged as the world's international reserve currency. As noted in an April 2017 ADB report examining lessons learned twenty years after the Asian financial crisis,

5 "IMF Reforms Clear Last Hurdle with US Adoption," *BBC News,* December 19, 2015, http://www.bbc.com/news/business-35141683.

6 C. Randall Henning, *Global and Regional Financial Governance: Designing Cooperation,* Council on Foreign Relations, September 2016, https://www.cfr.org/content/publications/attachments/Discussion_Paper_Henning_Financial%20Governance_OR.pdf.

7 Gabriel Wildau and Tom Mitchell, "China: Renminbi Stalls on Road to Being a Global Currency," *Financial Times*, December 11, 2016, https://www.ft.com/content/e480fd92-bc6a-11e6-8b45-b8b81dd5d080.

"The continued prominence of the US dollar as the currency underpinning the global banking system is an important constant."[8]

The Asian region holds more than $5.5 trillion (China's share: $3.1 trillion) in foreign exchange reserves, roughly half of the global total, and thus, the latent wherewithal to transform itself into an Asian Monetary Fund.[9] The debate is ongoing, with some participants seeking to push CMIM toward increasing independence from the IMF. To date, political divisions among participating countries, continued high regard for the IMF among many Asian participants, and the absence of any compelling crisis have prevented any such moves.

The 1997-98 Asian financial crisis and ill-considered, IMF-imposed conditions led Japan to propose an Asian Monetary Fund in the 1990s, but faced with US opposition, the idea dissipated. However, in May 2000, the finance ministers of the ten ASEAN+3 nations took a more modest step, creating the Chiang Mai Initiative (CMI), a bilateral currency swap network. It was accompanied by the Economic Review and Policy Dialogue (ERPD), a process to enhance transparency and mutual financial surveillance. The United States begrudgingly accepted this effort, with the admonition that any such endeavors should be linked to the IMF.[10]

Since its beginning as a network of bilateral currency swap arrangements for short-term liquidity problems, the CMI incrementally evolved, though its final trajectory remains uncertain. In 2010, ASEAN+3 finance ministers and central banks reached an agreement to integrate these bilateral swaps into a collective arrangement. They then increased the total resources to $120 billion and dubbed it CMI-Multilateralization (CMIM). The ASEAN+3 finance ministers decided to double this to $240 billion in 2012, which went into force in 2014, along with a new precautionary crisis prevention facility for rapid disbursement in the event of immediate liquidity problems. CMIM's precautionary credit line would allow members to draw unlinked IMF funds every six months for up to two years. The five largest ASEAN countries could access up to $22.76 billion in combined linked and unlinked funds. Longer-term funds, and any amount over 30 percent of a country's quota, would require CMIM facility approval, in close consultation and cooperation with the IMF.[11]

"Asia has witnessed quiet, but steady, progress in building new regional mechanisms of significant magnitude."

CMIM is roughly divided into major creditors (China, Japan, ROK), which have committed 80 percent of the $240 billion, and the most prospective borrowers, the ASEAN 10, who have committed the remaining 20 percent. CMIM also has a complex decision-making structure that precludes any one member from dominating. Related to the proportion of foreign currency reserves their central banks have committed (it is important to note: there is no paid-in capital), China, Japan, and the ASEAN 10 each have equal voting shares of 28.41 percent, while the ROK has a smaller share of 14.77 percent. A two-thirds supermajority is required to approve a decision.[12] It is also worth noting that beyond CMIM, its member states have an additional $160 billion in bilateral currency swaps among them.[13]

Under the current arrangement, CMIM members may draw up to only 30 percent of their credit line without an approved IMF program. The question of CMIM's link to the IMF has been a topic of debate since its inception and has not abated. CMIM member states

8 ADB, *20 Years After the Asian Financial Crisis: Lessons, Challenges, and the Way Forward*, Confeerence Highlights, April 13-14, 2017, https://www.adb.org/sites/default/files/publication/363326/20-years-asian-financial-crisis.pdf.

9 "Reserves of Foreign Exchange and Gold by Country," Global Firepower, accessed November 20, 2017, https://www.globalfirepower.com/reserves-of-foreign-exchange-and-gold.asp.

10 Masahiro Kawai, "From the Chiang Mai Initiative to an Asian Monetary Fund," ADBI Working Paper Series no. 527, May 2015, https://www.adb.org/sites/default/files/publication/160056/adbi-wp527.pdf.

11 C. Randall Henning, *Global and Regional Financial Governance: Designing Cooperation,* Council on Foreign Relations, September 2016, https://www.cfr.org/content/publications/attachments/Discussion_Paper_Henning_Financial%20Governance_OR.pdf, 5-6; See also Masahiro Kawai for a detailed history of CMIM evolution and details on the Precautionary Line: Masahiro Kawai, "From the Chiang Mai Initiative to an Asian Monetary Fund."

12 C. Randall Henning, "The Chiang Mai Initiative," in *East Asian Financial Cooperation: Policy Analyses in International Economics* no. 68, (Peterson Institute for International Economics, October 2002), 11-31, https://piie.com/publications/chapters_preview/345/3iie3381.pdf.

13 Chalongphob Sussangkarn, "Does the Chiang Mai Initiative Multilateralisation Make a Difference?" *East Asia Forum*, May 31, 2017, http://www.eastasiaforum.org/2017/05/31/does-the-chiang-mai-initiative-multilateralisation-make-a-difference/.

Politician leaders of the G20 at the 2017 summit in Hamburg, Germany. *Photo credit*: Kremlin/Wikimedia.

have debated raising the credit portion delinked from the IMF to 40 percent for more than five years, but they remain divided.

The IMF's rich track record, capacity, and battle-tested financial crisis-response experience makes it the unrivaled leader and credible standard on financial surveillance. In 2011, in an effort to close that gap, and prompted by the ERPD, the ASEAN+3 ministers agreed to establish the ASEAN+3 Macroeconomic Research Office (AMRO), based in Singapore, to create their own surveillance institution to monitor member economies and advise CMIM decision-making.

Capacity building with AMRO is still in its infancy, though significant progress has been made. AMRO has rotating directors and six advisors—three from the "+3" nations and three from the ASEAN 10. It has grown considerably from its initial staff of twelve, and in 2016, it officially became a separate, formal international organization. In 2017, AMRO publicly released its Regional Economic Outlook for the first time. But the extent to which AMRO should disclose its macroeconomic country assessments and policy recommendations is still a matter of some internal debate.[14] While AMRO has clearly continued to be upgraded, CMIM remains "in its very early stage," according to Hoe Ee Khor, AMRO's Chief Economist.[15] Whether AMRO will attain the ability to be forthright and with candor publicize its members' macroeconomic and financial strengths and weaknesses—and recommend sometimes painful policy solutions—is an open question. Some argue that well into the future, AMRO will be too small and lack the quality and size of the IMF to compete with it and would be well-advised to recognize a division of labor with the IMF.[16]

Regardless, internal debate on the scope and role of CMIM continues. Whether CMIM is equipped to respond

14 Masahiro Kawai, "From the Chiang Mai Initiative to an Asian Monetary Fund."

15 Hoe Ee Khor, "Chiang Mai Initiative Multilateralization (CMIM): Progress and Challenges," ASEAN+3 Macroeconomic Research Office, March 2017, http://www.imf.org/~/media/Files/News/Seminars/2017/The-future-of-international-monetary-system-for-asia/31dr-khorkim.ashx.

16 Masahiro Kawai, "From the Chiang Mai Initiative to an Asian Monetary Fund."

to another financial contagion is a key question. It has been pointed out that the IMF packages for the ROK ($58.2 billion) and Indonesia ($42.3 billion) were of a magnitude beyond that which the CMIM could reach. Thus, some have advocated options like the doubling, or more, of CMIM's capacity to $500 billion and/or transforming CMIM from pooled reserves to a fund with members providing capital.[17] But such aspirations represent an isolated view, as they would likely transform into an IMF competitor organization—the Asian Monetary Fund—rather ambitious for an entirely unproven institution.

Indeed, *perhaps the single most important point about CMIM is that it has never been used*. How it would work remains in the realm of the hypothetical. It is worth noting that when the ROK had major liquidity problems during the 2007–09 global financial crisis, it did not go to either CMIM or the IMF, but instead executed a $30 billion currency swap with the US Treasury. As one prominent academic observer summed up: "Until it disburses, questions will linger over whether the member states of the region have the political cohesion and technical mechanisms required to operationalize such assistance."[18]

The interplay of political rivalries and internal tensions between the major prospective creditors and prospective borrowers will shape CMIM's trajectory. Competing visions of world order may be a factor: Japan's Prime Minister Shinzō Abe is ardently committed to sustaining the current rules-based order; and China, which to date remains invested in the IMF, also has sought to provide public goods to fashion new, more Sino-centric institutions like the Asian Infrastructure Investment Bank (AIIB), its Belt and Road Initiative, and the BRICS New Development Bank and Contingent Reserve Arrangement (CRA).

BRICS Contingent Reserve Arrangement

Though more modest in scale, the BRICS CRA was launched at the same time as the New Development Bank in 2014, and came into force in July 2015. Both were animated in response to the 2007–09 global financial crisis, and both were seen as China-backed efforts to forge institutions of "South-South" cooperation between emerging economies and separate from the Western-dominated Bretton Woods institutions. Like CMIM, the CRA is designed as a "self-managed" precautionary safety net to ease members' balance-of-payments pressures.[19]

The CRA has total committed resources of $100 billion, with individual commitments from: China ($41 billion); Brazil, Russia, and India ($18 billion each); and South Africa ($5 billion). As with the CMIM, it is committed, pooled capital of each nation's central bank, not a fund.[20] Similar to the CMIM, member states can draw up to 30 percent of their quota without having a parallel IMF accord; the other 70 percent is linked to the IMF. Each nation has a director, with a "one-man, one-vote" decision process. Unlike the CMIM, the CRA has no surveillance capacity and essentially relies on the IMF. Members must be in compliance with IMF surveillance and disclosure obligations (Article IV). Given its modest size, the CRA could only be a supplement to the IMF, not an alternative. In any case, unlike the CMIM, there has been little further development of the CRA decision-making processes.

Another important parallel with the CMIM is that the CRA has never been utilized. To understand the fervor that spurred the creation of the CRA, one must not underestimate the enormous economic disruption and sense of systematic unraveling at the peak of the 2007–09 financial crisis. In 2008, many feared a level of financial failure more severe than anything since the 1930s. As the recovery unfolded and a sense of stability took hold, the psychology of a "new normal," however fragile, emerged. The emphasis on emerging-economy alternatives to the IMF gradually dissipated.

Regarding concerns about the impact of the AIIB on established multilateral development banks like the World Bank/International Finance Corporation and the ADB, new regional financial safety-net mechanisms, for the moment at least, appear to be complementary additions to the existing rules-based order.

17 Ibid.

18 C. Randall Henning, *Global and Regional Financial Governance: Designing Cooperation*, Council on Foreign Relations, September 2016, https://www.cfr.org/content/publications/attachments/Discussion_Paper_Henning_Financial%20Governance_OR.pdf.

19 Ministry of External Relations of Brazil, "Treaty for the Establishment of a BRICS Contingent Reserve Arrangement," BRICS Information Centre, July 15, 2014, http://www.brics.utoronto.ca/docs/140715-treaty.html.

20 Ibid.

China's Stake in the Bretton Woods System

In July 2017, IMF Managing Director Christine Lagarde said in a Washington speech, perhaps exaggerated for effect, that ". . . if we have this conversation in 10 years' time . . . we might not be sitting in Washington, DC. We'll do it in our Beijing head office."[21] Her hyperbolic remark did indeed raise many eyebrows, and was a telling allusion to the Asia-Pacific, emerging as a key driver of global economy. The Articles of Agreement require its headquarters to be located in the member state with the largest quota.[22] Whether China becomes the world's largest economy in a decade and obtains the largest quota is dubious.

But Lagarde was projecting a vision of IMF adaptability that few, not least China, would have anticipated in 2008 amidst the US subprime mortgage-triggered financial crisis. Indeed, there was a mood of triumphalism among many in China at the time, who saw the crisis as the demise of the reign of the USD and the US model of capitalism, the so-called "Washington Consensus."[23]

The financial crisis spurred doubts about the future of the Bretton Woods institutions—and the role of the US dollar. In an extraordinary move in 2009, Zhou Xiaochuan, then the governor of China's Central Bank, published an essay in English and Mandarin on the bank's website arguing, "The desirable goal of reforming the international monetary system, there, is to create an international reserve currency that is disconnected from individual nations. . . ." Zhou proposed that the IMF's basket of currencies, the Special Drawing Rights (SDR), replace the US dollar as the world's reserve currency.[24]

Governor Zhou's proposal reflected long-simmering discontent from China and other emerging economies at the dominance of the United States and other Group of Seven (G7) states over the global economic system, which was forged seventy years ago amid very different economic circumstances. The IMF's challenges and imperfections are often cited—from its expanded notion of surveillance well beyond that of exchange rates to difficult coordination problems in addressing sovereign debt crises.[25]

> ". . . China appears more entrenched in the IMF than ever, even as it has taken the lead in fostering new parallel institutions . . ."

Yet today, China appears more entrenched in the IMF than ever, even as it has taken the lead in fostering new parallel institutions from the AIIB, CMIM, and CRA, along with utilizing its state-owned banks, to taking an outsized role as a creditor nation with offshore loans dwarfing those of the World Bank.[26] The seeming paradox is indicative of a grudging, quiet acknowledgment that IMF reforms have given China and the RMB a new status and a greater role addressing the impulse of a rising great power seeking to alter the existing order to better serve its interests.

Indeed, China's relationship to the Bretton Woods institutions has been a part of China's economic success. Since joining in 1980, China has received more than $40 billion in loans, and perhaps more important, has received technical and policy advice. Beijing has been receptive to certain significant elements of World Bank economic policy guidance.[27] In fact, Beijing's economic agenda—to transform itself from an investment-driven export model to a services and knowledge economy—has been heavily influenced by its substantive interactions with the Bretton Woods institutions.[28]

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21 Technically, Lagarde misspoke, as the IMF Articles of Agreement says Headquarters are to be in the nation with the largest quota. It is also unlikely that in a decade such a change would occur, Reuters Staff, "IMF Could Be Based in Beijing in a Decade: Lagarde," Reuters, July 24, 2017, https://www.reuters.com/article/us-imf-china-lagarde/imf-could-be-based-in-beijing-in-a-decade-lagarde-idUSKBN1A922L?il=0.

22 IMF, Articles of Agreement, https://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf.

23 John Williamson, "Did the Washington Consensus Fail?" Institute for International Economics, November 6, 2002, https://piie.com/commentary/speeches-papers/did-washington-consensus-fail.

24 Zhou Xiaochuan, "Zhou Xiaochuan: Reform the International Monetary System," *BIS Review* no. 41 (2009), http://www.bis.org/review/r090402c.pdf.

25 Barry Eichengreen and Ngaire Woods, "The IMF's Unmet Challenges," *Journal of Economic Perspectives 30,* no. 1 (Winter 2015), 29-52, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.30.1.29.

26 Peng Qinqin and Denise Jia, "China State Banks Provide Over $400 Bln of Credits to Belt and Road Projects," *Caixin Global,* May 11, 2017, http://www.caixinglobal.com/2017-05-12/101089361.html.

27 Françoise Nicolas, *China and the Global Economic Order: A Discreet Yet Undeniable Contestation,* trans. David Buchanan, (China Perspectives 2, 2016), 7-14, https://chinaperspectives.revues.org/6960.

28 The World Bank and China's State Development and Reform

It should not be a surprise that even the showcase of Beijing's efforts to create parallel institutions, the AIIB is roughly modeled on many, though not all, of the norms, standards, and organizational structures of the World Bank and the ADB.

The IMF reforms agreed to at the 2010 G20 meeting—though it took five years for the US Congress to finally approve them—and subsequent inclusion of the RMB in the SDR, taken together, marked an important shift in the global financial architecture. Key features of the 2010 reforms were: China and other emerging economies increased their voting shares, with China's nearly doubling from 3.9 to 6.4 percent (making it the third largest IMF shareholder); the IMF Executive Board would all be elected (rather than appointed, mainly by G7 nations); and the IMF's quota would be doubled to roughly $755 billion. Moreover, there has been an increase in Chinese nationals within the IMF senior staff, including a deputy managing director.[29]

Explaining the RMB decision, IMF Executive Director Christine Lagarde said:

> "The Renminbi's inclusion reflects the progress made in reforming China's monetary, foreign exchange, and financial systems, and acknowledges the advances made in liberalizing and improving the infrastructure of its financial markets. The continuation and deepening of these efforts, with appropriate safeguards, will bring about a more robust international monetary and financial system, which in turn will support the growth and stability of China and the global economy."[30]

The key operative point is that the decision assumed "the continuation and deepening" of China's monetary and financial reforms. The IMF decision was, to some extent, a political and anticipatory one, based on a liberal interpretation of IMF criteria (currency must be "freely usable"). "The inclusion of the RMB in the SDR basket," an IMF official proclaimed, "consolidates the RMB's internationalization process."[31] This is a revealing overstatement, as it is an IMF assumption, extrapolating from trends at the time. The RMB is gradually becoming internationalized (estimated at 1.07 percent of global currency reserves). However, the RMB's path to internationalization has not been linear, and Beijing has backtracked. Progress has been limited because of political unwillingness to deepen domestic financial market development and reform.

Faced with difficult choices pitting economic stability against RMB liberalization, Beijing has retreated from the latter since the November 2015 IMF decision and has placed more controls on capital flows. The portion of Chinese foreign trade in RMB shrank from 26 to 16 percent by the end of 2016, and RMB deposits in Hong Kong, its largest offshore center, were down by nearly 50 percent from 2014 by early 2017.[32] Its use in global bond markets is down 45 percent since its 2015 peak.[33] Concerned about capital outflows and currency pressures, Beijing has already drawn down more than $1 trillion of its foreign currency reserves.

Despite Chinese President Xi Jinping's frequent promises of more reform and economic opening, China remains a long way from transforming its investment-driven, state-centric economy into one based more on consumption, services, and innovation. The tension between the pledge of "market-based allocation of resources," and the commitment to "support state capital" is becoming stronger. Chinese corporate, shadow bank, and property debt bubbles have not been squarely addressed. By all evidence, China's economic dynamic is likely to change very slowly. Indeed, at the Nineteenth Party Congress in October 2017, outgoing Central Bank Governor Zhou Xiaochuan

Commission of the State Council, *China 2030: Building a Modern, Harmonious, and Creative Society*, The World Bank, March 23, 2013, http://www.worldbank.org/en/news/feature/2012/02/27/china-2030-executive-summary.

29 International Monetary Fund, "Senior Officials of the IMF," September 8, 2017, https://www.imf.org/external/np/sec/memdir/officers.htm.

30 IMF Communications Department, "IMF Launches New SDR Basket Including Chinese Renminbi, Determines New Currency Amounts," International Monetary Fund, September 30, 2016, http://www.imf.org/en/News/Articles/2016/09/30/AM16-PR16440-IMF-Launches-New-SDR-Basket-Including-Chinese-Renminbi.

31 IMF News, "IMF Adds Chinese Renminbi to Special Drawing Rights Basket," International Monetary Fund, September 30, 2016, http://www.imf.org/en/News/Articles/2016/09/29/AM16-NA093016IMF-Adds-Chinese-Renminbi-to-Special-Drawing-Rights-Basket.

32 Gabriel Wildau and Tom Mitchell, "China: Renminbi Stalls on Road to Being a Global Currency," *Financial Times,* December 11, 2016, https://www.ft.com/content/e480fd92-bc6a-11e6-8b45-b8b81dd5d080; Jennifer Hughes, "Renminbi Internationalization Remains Elusive," *Financial Times*, January 30, 2017, https://www.ft.com/content/1bac9e56-d706-11e6-944b-e7eb37a6aa8e?mhq5j=e5.

33 Benn Steil and Emma Smith, "The Retreat of the Renminbi," *Project Syndicate*, June 22, 2017, https://www.project-syndicate.org/commentary/decline-of-the-renminbi-by-benn-steil-and-emma-smith-2017-06.

International Monetary Fund Managing Director Christine Lagarde meets with China's Prime Minister Li Kequiang in Beijing, China in March 2016. *Photo credit*: IMF/Flickr.

warned of a "Minsky moment" (where overconfidence leads to collapsing economies), and wrote on the Central Bank's website that China was accumulating "hidden, complex, sudden, contagious" risks.[34]

In any case, the IMF structural reforms—the inclusion of the RMB in the SDR basket combined with the 2010 set of reforms—marked a significant adjustment in the Bretton Woods system. China is more deeply invested in the institution, suggesting that it seeks a larger voice in the system, commensurate with its global economic weight, not necessarily an alternative to it—at least for now.

That said, Zhou's public comments about US dollar dominance reflects a mindset that could lead China in another direction. Certainly, given the financial assertiveness China has demonstrated with the creation of the AIIB, aggressive lending by its state banks, and its ambitious trillion-dollar Belt and Road Initiative, Beijing could, over time, move in a direction more independent of the IMF, perhaps even to an alternative order.

Balancing Regional Interests and Global Linkage: US and Japanese Perspectives

When Japan proposed the establishment of an Asian monetary fund after the financial crisis in 1997, Tokyo's reasoning was that global institutions were inadequate and that Asia needed its own institutions that were more sensitive to regional considerations. Subsequently, Asian countries pursued other approaches set forth earlier in this brief, including building hard currency reserves, domestic structural reforms, bilateral swap arrangements among central bank managers, and RFAs. The question of the relationship between regional initiatives—as well as individual country initiatives—and global institutions and policies of resilience in response to financial crises, has always been central. Most RFAs, including in Asia, have chosen to link disbursement of

34 "Close to Retiring, China's Central-Bank Chief Warns of Financial Risk," *Economist*, November 9, 2017, https://www.economist.com/news/china/21731180-zhou-xiaochuan-trying-burnish-his-legacy-close-retiring-chinas-central-bank-chief-warns.

the majority of resources to the existence of an IMF program. Bilateral swap arrangements, however, have not been tied to IMF participation.

Although RFAs have become part of the global financial safety net, many are untested, including in Asia, still have undefined decision-making processes, and are subject to political uncertainties affecting coordination. Even where there is resolution on whether to link the RFA to IMF participation, there remain questions as to how the linkage is made operational and how conflicts over policy conditionality are to be resolved.

"... China remains a long way from transforming its investment-driven, state-centric economy into one based more on consumption, services, and innovation..."

Historically, all major countries in the Asia-Pacific region have favored some degree of linkage between the CMIM and the IMF. The United States, not being a member of Asian regional arrangements, historically has viewed the IMF as the primary channel through which policy influence can be exercised. Thus, the United States has supported only modest deployment of resources in the absence of linkage with the IMF.

Certainly, the recent European debt crisis has been a defining experience, underscoring the need for more effective regional-global coordination. The contentiousness of the ESM and the IMF approaches to the Greek sovereign debt crisis reached a boiling point in 2012, as the IMF pressed for conditionality (large debt write-downs) that the European Central Bank (ECB) strongly opposed.[35] Similarly, ECB-IMF disparities over how to manage severe sovereign debt problems in Italy and Portugal and other European Union (EU) nations earlier in this decade point to differing imperatives of the IMF and the calculus of the European Monetary Union and the ECB. Obviously, Europe has a very different dynamic than the one in Asia. But the fundamental issue of regional imperatives versus the IMF's global financial role is a salient theme facing RFAs writ large.[36]

Nonetheless, the United States has recognized that RFAs, in times of financial crisis, can put into play significant liquidity, as well as provide policy insights based on local expertise and buy-in from local political stakeholders.

The United States also has favored an upfront understanding of the principles and modalities of coordination between the IMF and RFAs so as to reduce the risk of misjudgment through hasty action in a crisis. Speed in a crisis may be important, and thus, prior understandings among RFA participants presumably reduce the risk of mistakes in policy judgment.

To this end, the United States and Japan have supported a robust linkage of RFAs to the IMF as necessary to bring coherence to the global safety network. If US support for the IMF weakens, the coherence and effectiveness of crisis response also may be endangered. IMF involvement additionally provides a basis for cross-regional learning with respect to financial crises.

As RFAs have proliferated and the risks of fragmentation have grown, the G20 in November 2011 adopted a broad set of non-binding "Principles for Cooperation Between the IMF and Regional Financing Arrangements." These principles endorsed enhanced cooperation between the IMF and RFAs, while recognizing that these institutions have comparative advantages and would benefit from the expertise of the other. The principles seek to offer an overarching collaborative framework of common norms while respecting regional differences.

The Way Forward: Combining Global Framework and Regional Perspectives

There should be a way forward on a collaborative regional basis to strengthen the Asia-Pacific safety net consistent with global principles. As a fundamental objective, the Asia-Pacific region should agree that approaches to addressing systemic financial crisis should take place within a multilateral and global framework, which at the same time is sensitive to regional perspectives. The development of regional safety nets per se should not be considered a threat

35 Rebecca M. Nelson, Paul Belkin, and James K. Jackson, *The Greek Debt Crisis: Overview and Implications for the United States*, Congressional Research Service, April 24, 2017, https://fas.org/sgp/crs/row/R44155.pdf.

36 Ibid.; "This time in the euro debt crisis, the IMF will come bearing gifts for the Greeks," *Guardian,* May 22, 2016, https://www.theguardian.com/business/2016/may/22/greece-euro-debt-crisis-imf-bearing-gifts.

to US interests, but fragmentation of the system would indeed run counter to US interests.

The G20 has offered a set of principles and guidelines for cooperation between the IMF and RFAs that remain to be fully adopted in practice. Based on the difficulties and disputes evidenced in IMF-EU management of the Greek and other European debt crises, guidelines for IMF regional safety-net cooperation are an issue best addressed before the next crisis unfolds. The IMF and G20 processes offer an avenue for the United States and like-minded countries to work toward more specific norms and operational guidelines related to the relationship between the IMF and RFAs.

Areas where more specific guidance would be advisable include: alignment with respect to lending and policy conditionality; greater transparency and sharing of information and even joint missions; and improved clarity on resolution of differences with respect to debt sustainability.

The ASEAN+3 finance ministers and the Central Bank governors' process have played important roles in enhancing regional financial cooperation, promoting regional economic resilience, and strengthening the regional financial safety net. The United States, though not a direct participant in this process, should nonetheless show support for it and urge its members to operate within a coherent multilateral regional and global framework. ASEAN+3 also has encouraged specific financial market development and reform initiatives, such as developing deeper local currency bond markets to manage heightened volatility in global financial markets. The United States should view such initiatives as consistent with its interests and should seek to reinforce such financial market development initiatives in other international fora such as the G20 and regional gatherings like the Asia-Pacific Economic Cooperation (APEC) summits.

With respect to AMRO, its primary goal should be independent surveillance capacity, regardless of the preferences of individual members. In pursuit of this objective, AMRO should take transparency of its analysis as a working objective and strive in regard to its data and analysis for a level of transparency at least equal to that provided by the IMF. The recent AMRO Regional Economic Outlook 2017 is a step in the right direction and should be repeated and enlarged. AMRO should continue to enhance its organizational capacity through high personnel standards and staff exchanges with the IMF.

Global and regional financing arrangements have sought to utilize so-called "precautionary financing facilities," which are designed to protect countries with sound policies that may be subject to financial contagion in a crisis, by committing to make liquidity available if needed. Credibility with the markets derives from awareness that funds will be disbursed immediately when required. CMIM created a precautionary facility in 2009, but AMRO does not yet appear to have the technical capacity to review countries for qualification. CMIM could accept IMF qualification of a country as sufficient for CMIM purposes.

The leading countries in the Asia-Pacific should support G20 efforts in encouraging financial reform in key Asian markets as a primary means of achieving greater economic resilience and capacity to manage periods of global financial instability.

Finally, to sustain a coherent global framework for the operation of RFAs and the relationship between the IMF and RFAs, concerted leadership on behalf of an effective IMF by the major powers of the Asian region, including the United States, Japan, China, India, South Korea, and Australia, will be required.

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