

Regional Arrangements and the IMF

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Comments welcome

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Introduction

Regionalism is a defining feature of contemporary global politics and economics. One prominent political scientist (Katzenstein 2005) argues that regionalism is *the* single most important feature distinguishing world politics after the Cold War. Founded by nation states as instruments of international cooperation, the multilateral institutions are being challenged by regional arrangements across several issue areas.

In his overview paper for this conference, Truman argues that the member states of the IMF will have to confront a couple of tough questions: “[H]ow should the IMF seek to structure its relationship with independent organizations with essentially the same mandates to maintain economic and financial stability except in a regional context? Can the global monetary system function effectively with more than one set of understandings, conventions and rules, for example about the trade-off between financing and adjustment or about the ultimate goal of capital account liberalization?”

This paper addresses the adaptation of the IMF to the emergence of regional monetary and financial arrangements under three headings: membership, surveillance, and principles for regional financial facilities. The paper proposes a set of principles on regional financial arrangements for adoption by the Fund—its central recommendation. These principles would help the Fund and its members differentiate constructive from unconstructive regional financial schemes. As such, they would help (a) direct regional energy to constructive projects, (b) head off unnecessary debates over dubious proposals, and (c) promote complementarity between the regional financial facilities and the Fund’s own lending arrangements.

The author proposed such a set of principles—which can be loosely compared with Article XXIV of the GATT—in an earlier study (Henning 2002). Since then, the evolution of East Asian financial cooperation and the accumulation of reserves in that region have strengthened the case for such a set of principles. This paper develops the proposal further and addresses some of the objections that might arise.

Regional Monetary and Financial Arrangements

The global monetary landscape no longer corresponds to the simple one-county-one-currency picture of national monetary sovereignty. Cohen (2003) counts four full-fledged monetary unions, involving 37 countries, thirteen fully dollarized countries, five near-dollarized countries, and ten bimonetary countries. More than one-quarter of the world’s paper currency is located outside the country of issue, while in three dozen countries with one-third of the world’s population foreign-currency notes comprise more than twenty percent of the money stock. (Krueger and Ha 1996) Foreign currency represented more than thirty percent of the local money stock in eighteen nations in the mid-1990s. (Balino, Bennett, and Borestein 1999; see also IMF 2004) Cohen concludes: “Cross-border circulation of currencies, which had long been common prior to the emergence of the modern state system, has dramatically reemerged, resulting in a new geography of

money.” As new member states join Europe’s monetary union and other regions are inspired by the European example, the process of “deterritorialization” of money can be expected to continue.

Regional and plurilateral financial facilities are by no means new to global finance. The G-10 swaps were introduced in the 1960s, European financial facilities were introduced in the 1970s, and the North American Financial Arrangement was introduced in 1994 (Henning 2002). The Exchange Stabilization Fund of the United States has entered into nearly 120 agreements since its introduction in 1934 (Henning 1999). Nonetheless, new financial facilities in East Asia and dramatic reserve accumulation in that region, combined with the progressive decline in the scaled size of IMF resources, present the Fund with a new institutional environment in crisis finance, to which it should respond.

Membership

Created by national governments in the heyday of national monetary sovereignty, the IMF has reserved membership exclusively for “countries.” The Articles of Agreement (Art. II, sec. 1 and 2) established the original membership as those “countries” represented at the Bretton Woods conference and opened membership to additional “countries.” Joseph Gold (1988) argued that the Articles “make no provision for a joint membership of States” and that “participation in a monetary union has not prevented the partners from becoming members of the Fund as separate members.” This interpretation continues to prevail (see also Gianviti 1997 and 2004).

But when the essential attributes of monetary sovereignty are no longer exercised by states, reserving membership exclusively for “countries” is quaintly anachronistic. Such is the case with monetary unions, in which member states fully devolve authority to the union over monetary and exchange rate policy and enter a solemn obligation to adhere to a common position. In discussing Europe’s monetary union, Smits’ (1997, 442-44) makes this case in its clearest form:

The attribution of powers in the monetary and exchange rate fields to the Community takes away the substance for membership in the IMF. Responsibility for monetary matters, an essential characteristic of Statehood and a condition for the compliance with the obligations resulting from membership of the IMF, no longer lies with the Member States. Put differently, the necessary condition for the Member States to remain individual members of the IMF has ceased to be present.

Under these circumstances, the euro area has arguably assumed the characteristics of a “country” for the purposes of the Articles of Agreement (see also Louis 1997).

Member states are of course predictably hostile toward being displaced within the Fund by their regional monetary arrangements. The fact that not all the members of the European Union are members of the euro area and that authority over fiscal policy and

financial regulation has not been transferred to the monetary union, moreover, complicates the European case. The Fund has adapted to EMU while maintaining memberships for each of the member states of the monetary union (Maystadt 1997, Polak 1997, Thygesen 1997, and Goos 1997). However, these arrangements are complex and costly in terms of the ability of the euro area to represent itself cohesively and reduce its collective quota to a proportionate share. (Henning 1997 and Posen 2005, among others.)

More generally, the argument that states within monetary unions can exercise their membership privileges and discharge their obligations within the Fund without substantial monetary sovereignty is a rearguard defense of the *status quo ante*. The argument would protect the institutional prerogatives of member states while, at a minimum, complicating and, more realistically, compromising the effectiveness of decisionmaking within the Fund and achievement of the Fund's main objectives. The devolution of monetary sovereignty to currency unions thus deserves greater accommodation in the rules of membership than the IMF has yet conceded. Under its powers of "auto-interpretation" (conferred by Article XXIX), the Executive Board and Board of Governors (by eighty-five percent majority) could open membership to monetary unions and should take this step now.

Another useful change in IMF governance, which could be implemented without creating regional memberships, would be to reconfigure and consolidate the constituencies of the Executive Board around regional groupings. The Fund can and should improve upon the messy system by which EB constituencies have been cobbled together in the past (Woods and Lombardi 2005). This is particularly important in the case of Europe (see, among others, Truman's contribution to this conference, Henning 1997, Cœuré and Pisani-Ferry 2003, Bini-Smaghi 2004, and Posen 2005) and other complete monetary unions but applies as well to regions in which monetary and financial integration is less advanced but in which cross-border effects are nonetheless prevalent.

Surveillance

The IMF has been grappling for some time with the design of its surveillance of member states. Reconsideration has given significant attention to the role of regional arrangements in the process. In their study of surveillance, Crow, Arriazu, and Thygesen (1999, esp. 61-62) recommended that (1) surveillance of the euro area be centered on the ECB and EU bodies, with reviews of individual countries carried out through EU institutions and (2) the Executive Board give greater prominence to "spillover issues" (cross-border economic effects within the regional neighborhood) in country consultations. (See also staff response in IMF 1999, 96 and 100-102.)

Since then, missions to Europe have consulted with the ECB and European Commission and incorporated their discussions into Article IV reports, although the Fund has not surrendered bilateral surveillance to EU institutions. In addition to surveying the euro area, the Fund has also instituted surveillance of the two African monetary unions and the Eastern Caribbean Currency Union and conducted several studies on the Gulf

Cooperation Council and a recent study on Central America, without again apparently scaling back bilateral surveillance of the members of these arrangements.

It would nonetheless be fair to say that regional surveillance can be improved and that spillovers can be addressed more directly in bilateral consultations both within staff reports and Executive Board discussions.¹ Spillover issues can be as important for regions without formal monetary arrangements as for regions with currency unions—consider China and Japan’s impact within East Asia as a whole and contagion effects among Southeast Asian countries. One constructive proposal would be to group bilateral consultations by region, whether or not the region has formal arrangements. However, if regional reviews and spillovers are to be given greater emphasis without scaling back traditional bilateral surveillance, greater resources will have to be devoted to surveillance as a whole.²

Principles for Regional Facilities

Since the IMF was created, member states have carved numerous regional and plurilateral financial facilities out of the multilateral system. The history of the Fund’s relations with these arrangements—ranging from the European Payments Union to the G-10 swaps and NAFA—shows that there are no standards or criteria for evaluating regional arrangements that are agreed to or codified multilaterally. Although officials have welcomed new East Asian arrangements that are complementary with the IMF (Fischer 2001), the attributes that differentiate complementary from conflicting arrangements are not specified. Whereas the hierarchy of bilateral, regional and multilateral arrangements in the trade area is established by Article XXIV of the GATT and Article 5 of the GATS, at least in principle, the hierarchy has not been clearly established in international finance.³

In earlier decades, ambiguity with respect to the relationship between regional financial facilities and the IMF did not seriously threaten the integrity of the Fund or the basic efficiency of rescue packages. Countries that lent through regional or bilateral channels also tended to be the largest shareholders of the Fund and were thus in a position to effectively coordinate, though sometimes through delicate negotiation, lending activity at the two levels.

Several relatively recent developments create greater potential for costly conflicts, however. First, reserve accumulation has dramatically reduced the overall size of the Fund relative to reserve holdings. Some of those reserve holdings have been placed at the disposal of regional arrangements such as the Chiang Mai Initiative. But the uncommitted reserve holdings could in principle also be mobilized in a crisis for emergency finance

¹ I am indebted to Christian Thimann, Thierry Bracke, Paul Masson and Pier Carlo Padoan for their views and ideas on surveillance. Strengthening regional surveillance is endorsed by the IMFC (2005) and addressed in the Strategic Review (de Rato 2005).

² With an increase in competition among key currencies, such as the dollar and euro, Cohen (1994, especially pp. 218-221) proposes that the Fund adopt a role as mediator of governments seeking to promote their monies. Truman (2005) proposes a reserve diversification standard that would restrain disruptive adjustments of official currency portfolios. Both proposals could be incorporated into surveillance.

even in the absence of a pre-existing agreement. Second, there is a growing discrepancy between some key members' reserve holdings and their quotas and voting rights within the Fund. The discrepancy creates incentives to circumvent the Fund by lending directly or regionally, thereby controlling the terms of lending and garnering political credit for the assistance.

Moreover, the international community has reviewed the consistency of regional financial facilities with countries' multilateral commitments in a completely ad hoc fashion or failed to review them at all. There is no process or procedure through which such arrangements are evaluated formally. Some have been discussed by the IMF's Executive Board, whereas others have not. If the East Asian case serves as a guide, furthermore, the number of regional financial arrangements is likely to rise.

The member states of the IMF should agree to a set of criteria that differentiate acceptable regional financial arrangements from unacceptable ones and a set of principles to govern the relationship between regional facilities and the Fund.

With respect to criteria, regional financial and monetary arrangements should be deemed consistent with multilateral arrangements when they:

- create *no substantial conflict* with members' obligations under the Articles of Agreement;⁴
- are at least as *transparent* as the financial and monetary rules and operations of the IMF;
- adopt and pursue *sound rules of emergency finance*, to be understood as lending into liquidity shortfalls (as distinguished from insolvency) at premium interest rates and with assurance of repayment; and
- lend on *sound conditionality*, understood to mean policy adjustments that eliminate the financing gap in the medium term, or link lending to IMF conditionality directly.

With respect to principles relating regional facilities to the Fund, member states should agree to:

- to *report and disclose* the details of their regional cooperative arrangements to the IMF.

³ See, e.g., Dam 1963; Jackson 1969, 1986, and 1997; Lawrence 1996; Frankel 1997.

⁴ The most important of these relate to the maintenance of convertibility on current account transactions (Article VIII, Section 2), avoidance of discriminatory currency practices (Article VIII, Section 3), exchange arrangements and surveillance of economic policies (Article IV), quotas and subscriptions (Article III), operations and transactions (Article V), and participation in the Special Drawing Rights (SDR) department (Articles XV through XXV). Regional exchange controls and discriminatory capital controls, for example, must be specifically disallowed.

- to submit their arrangements to the purview and *assessment of the Executive Board*. In the case of inconsistencies between arrangements and these criteria or principles, the Executive Board should specify them in a publicly issued report and ask the members concerned to bring their arrangement into conformity. Existing arrangements should be assessed periodically and accession of new members should also be reviewed.

- that regional financial facilities shall *not undercut IMF conditionality*. When IMF financing is involved, the negotiation of lending programs and the disbursement of funds should be either linked to IMF programs or coordinated with the IMF.

- that regional policies with respect to financial regulation and *private-sector involvement* must be consistent with stabilization efforts on the part of the IMF.

Policy conditionality is a critical question in the relationship between the IMF and regional financial arrangements. When grappling with crises, the IMF and regional facilities must not compete by relaxing the policy adjustments required of borrowers. Despite its acknowledged mistakes, the IMF holds a comparative advantage over other regional and multilateral organizations in the specification conditionality. It holds this position by virtue of its analytic resources, the experience and expertise of its staff, and its global perspective, which confers a unique ability to draw lessons across countries and regions. Thus, at this time, regional financial arrangements are wise to “import” or “borrow” the IMF’s conditionality.

However, the present supremacy of the IMF should not be interpreted as a monopoly that has been conferred for all time.⁵ If a regional arrangement develops analytically sound, high-quality conditionality, it ought to be able to substitute it for IMF conditionality.⁶ The critical considerations are the quality of the program, not the institutional origin, and the operational coordination of the work of the region with that of the IMF. In contrast to competition in crisis lending, moreover, intellectual competition in the analysis and setting of policy conditionality among international organizations would be useful. The international community would benefit from having a more complete “market,” so to speak, in surveillance and conditionality.

Recognizing a predominant concern in the resolution of recent and current financial crises, regional groups must avoid guidance and policies with respect to the private sector that could undercut the IMF’s (and their own) efforts for stabilize countries. For example, regional arrangements must not encourage banks to reduce their exposures to countries that have borrowed from the IMF. Regional arrangements must

⁵ Note, for example, that the Organization for Economic Cooperation and Development’s Working Party #3 was probably more influential than the IMF with respect to surveillance of industrial countries through at least the mid-1980s and continues to cooperate on surveillance with the Fund.

⁶ Substantial analysis and debate surrounds the policy conditions that are appropriate for program lending, but that discussion is well beyond the scope of this paper.

not undercut arrangements that might be agreed upon within the IMF in the future regarding private-sector involvement and a sovereign-debt restructuring mechanism.

These new, explicit rules would continue the permissiveness of the status quo with respect to regional and plurilateral financial arrangements. But they would establish some new obligations with respect to conditionality, private-sector involvement, disclosure and review that reflect the lessons of experience with regional arrangements over the last several decades and some contemporary concerns.

These criteria and principles could be introduced in either a soft or hard version. The soft version could take the form of a code of conduct among members of the Fund. The hard version would carry potential sanctions for violations and would thus probably have to be incorporated into the Articles of Agreement. The threshold of approval for a code of conduct would be easier to meet than for amendments to the Articles.

A hard version of these principles could grant the Executive Board the authority to disallow regional arrangements that it finds to be inconsistent with the principles. In the absence of a vote of disapproval, which could be taken on the initiative of an executive director, regional arrangements would be accepted. A decision to disapprove should be made by a super-majority of the votes of the executive directors and could be enforced by the ability to declare offending members ineligible to draw IMF resources.

Any prospective mechanism of (dis)approval of a regional arrangement should be balanced fairly, however, which suggests several caveats. First, any vote in the Executive Board would have to be on the consistency of the regional arrangement with members' obligations in the IMF as defined by the Articles of Agreement and principles of regionalism. Members would have to defend their votes on the basis of the criteria and defend their interpretation of those criteria. They could not legitimately vote to disapprove because they simply did not favor the arrangements.

Second, the threshold of disapproval would have to be set appropriately. A simple majority would be too low, giving a relatively small group of countries virtual veto power. An eighty-five percent majority would be too high, because the region whose arrangement is under consideration might well be able to block disapproval even without outside support. A threshold of about two-thirds would require a relatively small block of advanced countries and most prospective regional groupings to secure outside support and would thus seem to be more equitable.

The purpose of these principles is not to give effective jurisdiction to the IMF over all balance of payments lending. Nor do these principles seek principally to protect the IMF as an institution, although well-functioning international institutions deserve support. Conflicts with the bureaucratic interests of the IMF—which should be distinguished from conflicts over the terms on which funds are lent to resolve a crisis—are acceptable when larger goals are at stake. If a subgroup of member states wishes to create an “IMF-plus” regional arrangement and is willing to commit the resources to

make it effective—as Europe has done and East Asia is in the process of doing—then protecting the bureaucratic interest of the Fund is not a legitimate objection.

However, coordination and jurisdictional problems arise when regional finance is mixed with multilateral finance. These principles are designed to prevent the misuse of IMF funds and facilitate coordination between multilateral and regional arrangements in situations of mixed finance. Because governments have an interest as shareholders in the health of the IMF and an interest in fostering timely economic adjustment on the part of neighbors, these principles are intended primarily to safeguard the collective interests of the member countries of the Fund.

Objections and Response

Several objections might be raised to the proposal to adopt a set of principles regarding regional financial facilities. Why, after so many decades since the establishment of the Fund, does the system need such a set of principles now? Why would we expect a set of principles on regionalism to work better in the finance than the trade field? Why would East Asian countries in particular want to submit their regional arrangements to multilateral review? The previous section addressed the case for such a set of principles at this time. My responses to the second and third objections follow.

These principles avoid several pitfalls that have become apparent with the multilateral trade regime's treatment of regional trade arrangements. First, they provide no loophole for "interim agreements," through which many dubious trade agreements have slipped. Second, they require the disclosure and transparency that is necessary to conduct a rigorous review, which was insufficient in the case of the GATT. Third, reviews can be conducted not just at the time of the creation of a regional financial arrangement, but also when new members accede to existing arrangements and as such arrangements evolve over time. By applying these lessons from the experience with GATT Article XXIV, we can expect the principles of financial regionalism to operate more satisfactorily than have the principles of trade regionalism.

Would establishing such a set of principles now be unfair to East Asian countries as they develop the Chiang Mai Initiative? What interest does ASEAN+3 have in accepting them? Three points provide the answer to this objection.

First, the Chiang Mai Initiative would largely pass the test posed by these principles. Eighty percent of borrowings under the CMI bilateral swap agreements must be tied to an IMF program. The twenty percent that can be disbursed without such a program is restricted to a term of six months or less. The non-linked portion is thus shorter term than the US credits to Mexico under the NAFTA in early 1995, for example. If a borrower drew on the twenty percent but subsequently realized that it would need medium-term money, it would have to submit to IMF conditionality. To fully comply with these principles, however, ASEAN+3 would have to be more transparent to the public, report more details of their swap agreements to the Fund, and agree to an Executive Board review.

Second, by contrast, these principles would have blocked the 1997 proposal to create an Asian Monetary Fund. Under that proposal, the AMF could have undercut IMF conditionality and weakened the impetus for economic adjustment in the region. By clarifying which arrangements would be complementary and in conflict, these principles, had they been part of an IMF code of conduct or the formal legal structure in 1997, would have almost certainly dissuaded Japanese officials from this proposal, saving the members of the system a fruitless and embittering debate.

Third, the adoption of these principles would be advantageous to East Asia in several ways. By defining more clearly the types of facilities that are in and out of bounds, these principles simplify bargaining within the region over the directions in which the CMI could evolve. They dampen temptation to experiment with unorthodox arrangements that could lead to mistakes that set back, or kill, the regional integration process. By providing transparency, East Asian members address suspicions among the rest of the membership about their intentions and lay the basis for cooperation with the Fund. Finally, the adoption of these principles would provide legal cover and legitimacy for sound regional regimes. In the absence of a clear set of principles, the US and European interpretation regarding which arrangements are acceptable can vary over changes in administration. These principles would protect legitimate arrangements from changes in sentiment by other, powerful states.

Conclusions

This paper has examined the role of the Fund in light of the increasing number of regional monetary and financial arrangements, with particular attention to membership, surveillance and principles governing regional financial facilities. It argues that the Fund should open membership to monetary unions that meet a high standard of cohesiveness and delegation of monetary sovereignty. It also argues that the regional dimension of surveillance should be enhanced in several ways. The paper's principal recommendation is that the members of the Fund adopt (a) a set of criteria that differentiate constructive from unconstructive regional financial facilities, (b) procedures for disclosure and review by the Executive Board, and (c) principles for coordinating lending by regional facilities with lending by the Fund.

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