Strengthening *regional financial* cooperation

Manuel R. Agosin

Regional Economic Adviser, Inter-American Development Bank (IDB), and Professor in the Department of Economics of the University of Chile
manuelag@iadb.org

The severe international financial crises which rocked the Latin American economies in the 1980s and 1990s suggest that the international financial system suffers from serious defects. This article looks at one of the reforms which has been mooted in recent years: strengthening regional financial cooperation. It concludes that a Latin American fund made up of a modest portion of the reserves of the countries of the region, possibly backed up with contingency credits from the international banking system, could be an effective line of defense against financial crises caused by capital flight and could help to prevent the spread of crises within the region. A fund of this nature could also have other functions, such as providing finance to cope with balance of payments problems associated with temporary slumps in the terms of trade. It would also promote harmonization of the macroeconomic policies of its members, which is an essential condition for achieving more stable bilateral exchange rates and effective regional integration. Such a regional fund would not be a substitute for the International Monetary Fund, but would be complementary to it.

I

Introduction

The recurrent international financial crises which have rocked the "emerging" economies have given rise to a vigorous debate on possible reforms in the international financial architecture. Many reform proposals have been put forward, and some of them include the creation of regional monetary bodies (see Ocampo, 1999, pp. 68-70; Mistry, 1999; FLAR, 2000). This article analyses the importance of the role that could be played by measures to strengthen the capability of regional bodies to tackle financial "contagion" and promote intra-regional trade and investment.

The Latin American countries have been particularly active in efforts to establish subregional financial institutions to come to the aid of countries with balance of payments problems. There are also regional and subregional mutual payments mechanisms in Latin America which are designed to reduce the need to resort to foreign exchange to finance payments among their members. Although these institutions have played an important role in the last two or three decades, they need to be strengthened in order to face up to the challenges of globalization and become the regional link currently absent from the international financial architecture.

Strengthening the regional financial institutions would have the following objectives:

i) helping member countries to cope with balance of payments crises due to reasons unconnected with the quality of their macroeconomic policies;
ii) promoting regional integration by furthering greater stability of the bilateral exchange rates between the countries of the region;
iii) protecting intra-regional trade and investments at times of global financial crisis;
iv) providing a forum to help in the coordination of macroeconomic policies, thus leading to less vulnerability to external crises and greater stability of bilateral exchange rates; and
v) promoting the exchange of information on matters vital for international financial stability, such as prudential regulation of the financial sector and capital flows.

After it is posited in the introduction to this article that the nature of financial crises within the context of globalized finance makes it advisable to have stronger regional institutions in this field, section II deals with the last-generation financial crises and their effects on recipient economies. Section III sets out the arguments in favour of the strengthening of regional financial mechanisms. Section IV deals with the role such mechanisms could play in promoting regional integration. Section V then describes two of the international financial cooperation institutions which already exist in the region: the Latin American Reserve Fund (FLAR) and the Mutual Payments and Credits Agreement (CPCR) of the Latin American Integration Association (ALADI), after which section VI presents some options for strengthening the regional financial institutions to face the challenges of financial globalization and Latin American integration. Section VII analyses the feasibility of a strengthened regional fund and the size it should have in order to be considered capable of coping with the challenges of globalization. Finally, section VIII presents some conclusions.

☐ The author wishes to express his thanks for the comments made on a previous version of this study by an anonymous referee and by Reinaldo Bajraj, Javier Camboni, Roberto Guarnieri, Felipe Jiménez, Edgard Moncayo, Humberto Mora, José Antonio Ocampo and Rogério Studart. The preparation of the study was greatly facilitated by the excellent research assistance of Ricardo Mayer and Víctor Zuñiga. This study was financed by an ECLAC project which received resources from the Latin American Reserve Fund (FLAR) and the Andean Development Corporation (CAF).

II

The latest generation of financial crises

The international financial crisis set off by the depreciation of the Thai baht in July 1997 had world repercussions and severely affected the developing countries which had managed to gain access to the international capital markets. In this context, the Latin American countries were not able to isolate their economies from the vicissitudes of international capital. As from 1998, the region's growth rate markedly deteriorated, and in 1999 they turned in their worst economic performance since the debt crisis.

In the paragraphs below we will define more precisely what the word "contagion" means in this context. Suffice it to say at this point that we consider contagion to mean a pure external shock which has nothing to do with the virtues or shortcomings of the domestic economic policy of the countries affected by it. Generally speaking, the term contagion has been used with reference to the financial field: a financial crisis acts as a signal, and this signal sets off forms of herd behaviour in the capital markets. Although this is one of the most important forms of contagion in a financially globalized world economy, it is by no means the only form, however. There are countries in Latin America which participate only marginally in the global financial markets but have nevertheless been severely affected by the indirect effects that events in those markets have on their terms of trade or export volumes. For these reasons, we use the term contagion in a broader sense which also naturally covers capital flight caused by international financial problems in other countries or by interest rate rises in the industrialized countries.

The contagion mechanisms suffered by the region during the most recent world financial crisis were of various types:

i) there was trade contagion through the impact on the terms of trade caused by the recession in the Asian economies (which were the hardest hit by the financial crisis): the prices of various raw materials exported by the Latin American countries to international markets went down sharply. Although it is true that the fall in the prices of export products was offset to some extent in some cases by lower prices of some imported products (especially oil and manufactures), there was nevertheless a deterioration in the terms of trade of most of the countries;[1]

ii) trade contagion also occurred through a contraction in the volumes of exports to Asia, with particularly severe effects on the countries for which the Asian economies are important markets, but it also took the form of a disproportionate contraction in intra-regional exports, which are concentrated on manufactures;

iii) financial contagion was serious for most of the countries of the region, and it had particularly adverse effects. As a result of the run on capital by all the emerging countries, the banks and companies of many countries of the region had difficulty in renewing their lines of credit. The spreads at which they could sell new corporate bonds increased dramatically. In some cases, even first-line companies in the region simply could not sell bonds at any price, while foreign portfolio investors liquidated their holdings;

iv) financial contagion also had a purely domestic aspect. The sudden increase in exchange risk caused domestic agents to shift their investments from national-currency securities to others denominated in dollars, thus aggravating the trend towards depreciation of the local currency. Companies with foreign-exchange liabilities, accumulated during the long period of easy availability of foreign capital, hastened to cover themselves, thus further aggravating the crisis caused by the flight of foreign capital and the non-renewal of loans by the international banking system;

v) all the countries (except those with fixed exchange rates) registered excessive degrees of exchange-rate depreciation in nominal and even in some cases real terms, although some of these have now been reversed.

Most of the countries of the region suffered both trade and financial contagion, which was why the crisis had such severe effects. The consequences of both types of

[1] This study was completed before the oil price rises in the second half of 2000.

contagion can be relieved through the provision of suitable finance. In the case of trade contagion, if it is expected that the deterioration in the terms of trade and/or the drop in export volumes are temporary and reversible, the best policy is to obtain compensatory finance to tide over the period of such problems. This is the reason for the existence of the IMF Compensatory Financing Facility.

Financial contagion is also of a temporary nature. As the Mexican and Asian crises of the 1990s showed, inflows and outflows of capital follow each other in a cyclical manner (a matter which will be dealt with below in greater detail). If balance of payments problems are due to financial contagion, there would be grounds for the provision of advance lines of credit to supplement the international reserves of the countries affected, thus saving their authorities from having to apply over-restrictive policies to reduce the external deficit.

In view of the globalization of finance, the growing participation of the countries of the region in the international capital markets and the behaviour of both domestic and international financial agents make it very likely that financial crises will be increasingly frequent and increasingly due to contagion from outside. The reforms proposed in the international financial architecture are designed to reduce the likelihood that such crises will occur and protect the developing countries from the worst effects of those that do take place.[2]

This means that the balance of payments crises now being suffered by many countries may have little to do with erroneous macroeconomic policies. The typical balance of payments crises to which we were accustomed in the region in the past were due to current account deficits which it became impossible to finance. The macroeconomic policies associated with these crises included heavy fiscal deficits (even in cyclic boom periods), which had to be monetarized in some way, and over-expansionary monetary policies or insistence on the maintenance of an overvalued exchange rate (perhaps because domestic inflation had been higher than international levels for a substantial length of time). Imprudent macroeconomic policies led to ultimately unsustainable current account deficits and to loss of reserves by the Central Bank. It is this kind of situations that the IMF is prepared to tackle by granting its conditional loans.

The region is not of course entirely free as yet of these "first generation crises" (whose formal expression as a model may be found in Krugman, 1979). What distinguishes the present crises from those crises is that they now occur in several countries in sequence, often without any evident causes attributable to the macroeconomic management of the countries concerned. This is what we call "financial contagion". As we shall see below, this sequential nature was very evident in the Asian financial crisis.

An empirically verifiable constant is that countries which become victims of this new generation of crises associated with globalization first of all receive a heavy inflow of capital. This is what happened in Mexico in the period before 1994, and it also happened in all the countries most severely rocked by the recent financial crisis: Thailand, Malaysia, Indonesia, the Philippines, South Korea, Russia, Brazil and Argentina. Thus, to some extent financial crises are gestated during periods of excessive capital inflows, especially of short-term capital (Rodrik and Velasco, 1999). The massive inflow of resources into certain countries is due to a combination of factors, including the favourable perceptions of foreign financial investors or simply expectations that the currency in question will appreciate.[3] Since interest rates are normally higher in emerging markets than in those of the developed countries, expectations of exchange-rate appreciation can spark off heavy capital inflows.

Those inflows are often by no means marginal for an individual recipient. In emerging economies, they may amount to over 10% of the gross domestic product (GDP). Furthermore, as the financial markets of those economies are very shallow, capital movements often form a very high proportion of the national finances. As may be seen from table 1, whereas in the developed countries international capital movements hardly ever exceed 5% of the (M2) money supply, in emerging economies they may amount to as much as 25%.

Consequently, waves of capital inflows can cause serious negative externalities in the developing countries, for they can generate current account deficits, lead to exchange rate appreciation, give rise to asset price bubbles, and increase the national financial system's

[2] There is extensive literature on this subject, and many reform proposals have been put forward. See for example Ocampo (1999), Eichengreen (1999), Agosin (1999) and Ahluwalia (2000).

[3] This is a rather *sui generis* international version of Keynes's "beauty queen contests" (Eatwell, 1997, p. 243). Thus, some agents are more sensitive to what other agents plan to do than to the intrinsic value of assets. When these agents predominate over the "fundamentalists", financial markets can become extremely volatile.

TABLE 1

Developed and emergent economies (14 countries): Net capital flows[a] as a percentage of M2[b]

Country	1990-1998	1990-1994	1995-1998
Japan	1.7	1.8	1.7
Canada	3.1	4.2	1.7
United States	3.1	2.1	4.2
Switzerland	5.7	5.3	6.0
South Korea	5.7	4.7	7.0
Brazil	7.2	3.3	10.4
Indonesia	9.1	8.9	8.4
Malaysia	11.2	13.2	6.3
Venezuela	14.5	18.5	11.4
Chile	18.6	18.9	19.2
Colombia	18.5	11.8	26.0
Mexico	18.9	23.8	12.9
Ecuador	19.6	16.4	19.3
Argentina	22.0	25.5	18.2

Source: IMF (2000).

[a] Net inflows or outflows (outflows in the case of Switzerland and Japan, inflows in all the other countries).

[b] Currency outside banks, demand deposits, term deposits and savings deposits.

vulnerability to a run on short-term credits or failure to renew them. Moreover, they often raise the ratio of short-term debt to the international reserves. Likewise, the short-term nature of capital flows means that investors can easily leave the country in masses and creditors may refuse to renew their loans as soon as they sense some problem.

When there is a change in the fundamental economic variables, at some point the perceptions of vulnerability begin to grow and the inflow of capital shrinks and may even turn into a net outflow, with massive flight of resources. When a country has lost a certain volume of its reserves, foreign and domestic financial investors perceive the existence of exchange risk, and when fears of devaluation begin to gather force, everyone begins to liquidate their national currency holdings or try to cover their foreign-exchange liabilities, thus speeding up the loss of reserves and precipitating an acute crisis.

As the banks were major recipients of foreign credits during the boom period, outflows of capital are associated with the non-renewal of credits and cause serious banking crises. Because of this, the last-generation crises are usually "twin crises" affecting the balance of payments and the banking system simultaneously (Kaminsky and Reinhart, 1996; Kaminsky, Lizondo and Reinhart, 1998).

It should be stressed that in the present context both inflows and outflows of capital are subject to contagion. In the case of inflows, portfolio investors and bank creditors tend to underestimate the risks involved in investing or lending money to agents in the recipient economy. Inflows of capital into an emerging economy are usually accompanied by inflows into other countries with similar characteristics. In contrast, at times of abrupt outflows there is a tendency to overestimate the risks involved in staying in them (Ocampo, 1999, p. 21). The vast majority of the Latin American economies received enormous amounts of portfolio investments and international bank loans in the 1990s. Among these economies, some had already carried out profound economic reforms, while others were just embarking on that process (Calvo, Leiderman and Reinhart, 1993; Devlin, Ffrench-Davis and Griffith-Jones, 1995; Ocampo and Steiner, 1994). Consequently, although many countries had made great progress in their macroeconomic management, many were very vulnerable to contagion from financial stampedes like those that occurred after the Asian crisis, the Russian crisis (July 1998) and the two Brazilian crises (August-September 1998 and January 1999).

When there are capital inflows which are very large in comparison with the size of the financial markets of the recipient economies, macroeconomic management becomes a very complicated business in the latter. Although it is possible to counteract the expansionary effect of the inflows to some extent with restrictive fiscal and monetary policies, no Latin American country has been completely successful in this, even in the case of those like Chile and Colombia which made this an explicit objective of their economic policy. Experience shows that the wisest course for emerging economies is to adopt prudential regulations on capital flows.

Although there is evidence that some forms of financial contagion are simultaneous (simultaneous increases in the spreads that debtors in emerging economies must pay, for example), the experience of the last few years indicates that international financial crises tend to occur sequentially. After one economy begins to suffer from capital outflows, international investors and creditors begin to have doubts about the creditworthiness of debtors in other countries which might display similar symptoms. In some cases, the contagion is due to the effects of the initial crisis: the exchange-rate depreciation caused by the first crisis makes the exports of other economies with similar export profiles less competitive.

III

The role of regional funds in coping with financial crises

As already noted at the beginning of this article, the phenomena described here have given rise to the perception that the international financial architecture needs major modifications and have set off a very interesting international debate on the elements that should make up this new structure. One conclusion reached is that much greater importance should be attached to the regional monetary institutions as an extra line of defense against financial crises and contagion.

This objective of strengthening the regional financial institutions does not mean making them take the place of the IMF, which is a key institution in the international monetary system. No regional fund would have either the volume of resources of the IMF or the political capacity to mobilize large-scale financial rescue operations when necessary. Moreover, many international financial problems go beyond the regional ambit and require global solutions.

Regional funds could however be an important link between individual countries and a strengthened and reformed IMF, thus giving the system greater capacity to promote international financial stability. Furthermore, if international-level reforms were not carried out, this would be all the more reason for the Latin American countries to strengthen their lines of defense against financial crises by strengthening regional cooperation.

There are a variety of reasons for strengthening regional funds. All the Latin American countries are continually exposed to temporary external shocks due to fluctuations in their terms of trade, higher interest rates on international financial markets, or financial shocks like those described earlier. These shocks can be tackled in various different ways. One way is self-insurance, which consists of maintaining higher levels of international reserves than those currently prevailing or arranging contingency credit lines with the international banking system. This solution involves two problems: the opportunity cost of the reserves is high, and the contingency credits that each country could expect to receive from the international banking system are costly and quite modest in size. A second option would be to resort directly to the IMF. The Latin American countries will undoubtedly continue to do this when they run into severe financial difficulties, but the Fund usually imposes conditions which are not always the right ones for dealing with the problem, and its decisions are usually too slow to cope with problems that call for quick responses. Finally, the Latin American countries have very little influence on the IMF's decisions and criteria.

For all these reasons, making use of a regional body could be an attractive option. A regional monetary body could respond effectively to essentially regional problems. The desirability of having adequate reserves to deal with common problems is thus a powerful argument in favour of establishing what would in effect be an international credit union in the region. If at the same time financial crises have an element of regional contagion, the arguments in favour of forming regional funds to deal with them become all the stronger, especially if avoiding a balance of payments crisis in one country of the region would mean avoiding similar crises in other countries of the same region. In other words, a regional financial body would have substantial externalities.

Regional contagion was clearly visible in the most recent financial crisis, which had two phases, both of them with strong regional implications. The first phase was markedly Asian: it began in July 1997 in Thailand and in the second half of the year it gradually spread in turn to almost all the emergent markets of Asia: Indonesia, the Philippines, Malaysia, Hong Kong, Taiwan, Singapore and finally, in November of that year, South Korea. The crisis was no respecter of persons, affecting not only countries with high levels of short-term indebtedness in proportion to their reserves (Thailand, Indonesia, Malaysia and South Korea) but also countries with a very sound reserve situation, such as Hong Kong and Singapore, and not only countries with high current account deficits as a proportion of their GDP (Thailand and Malaysia) but also countries with only moderate deficits (South Korea and Indonesia) and even economies with significant surpluses (Singapore and Hong Kong).

In 1998, after the Russian crisis, the Brazilian real had to withstand a first speculative onslaught in August and September. This worsened the crisis in Latin America, which was already experiencing substantial but still manageable trade and financial difficulties. By the middle of 1998, with the mass exit of portfolio investors from the emergent economies and the negative revision of Latin American debtors by international creditors, the countries of the region had already begun to experience serious balance of payments problems which called for severe adjustment policies. It was the second –and this time successful– attack against the real in January 1999, however, which sparked off the most acute phase of the crisis in the other countries of the region.

If the financial crises were not of a sequential nature, a regional fund would be unlikely to have sufficient resources to deal with cases of capital flight from several countries simultaneously. As crises of this nature can indeed occur (the debt crisis in the 1980s was an outstanding example of this), regional funds cannot play the role of an institution like the IMF in solving such crises.

If crises gradually spread from one economy to another, a regional fund capable of stemming the capital flight from the first country in the region affected would significant reduce the danger for the other countries of the region, assuming of course that the initial crisis was not due to bad macroeconomic management. A regional body designed to control cases of contagion would not be suitable for dealing with the latter situation, which could only be dealt with by the international provision of liquidity on suitable conditions.

Regional funds are also justified on other grounds. The countries of a region will have a much greater say in the policy of a regional fund than in that of an organization like the IMF, and a regional fund would therefore meet the needs of its member countries much more completely. This can be very important when trying to coordinate monetary and economic policies in order to attain a more advanced stage in regional integration: a matter which will be addressed in the next section.

IV

The role of regional funds in furthering integration

The need to strengthen regional financial cooperation goes beyond the pursuit of a common line of defense against possible contagion. Regional integration is a major objective of the development policy of all the Latin American countries. In recent years there have been substantial advances in the trade-related aspects of integration, both within the framework of the multilateral integration agreements already operating in Latin America –MERCOSUR, the Andean Community, the Central American Common Market (CACM) and the Caribbean Community (CARICOM)– and between individual countries. Likewise, since the beginning of the 1990s a number of quite comprehensive bilateral trade agreements have been signed. Both the multilateral and the bilateral agreements have helped to increase intra-regional trade significantly, and indeed it has grown faster than inter-regional trade.

However, the lack of harmonization of macroeconomic policies and the sharp fluctuations which have taken place in bilateral exchange rates have militated against faster progress towards trade integration and mutual investments among the countries of the region. In the Andean Community, the strong growth of mutual trade registered in recent years came to an abrupt stop in 1998 because of the financial crisis.

So far, governments have acted on the implicit assumption that progress towards trade integration can be achieved by concentrating on tariff reduction and the removal of non-tariff barriers to trade, while leaving exchange and financial matters for a later stage. Perhaps now is the time to reverse these priorities. Experience has shown time and again that exchange rate volatility and financial crises seriously upset trade flows and end up in practice by dismantling the formal arrangements of the trade agreements. An international financial crisis can suddenly cause the exchange rate of a country vis-a-vis its regional partners to vary by a much larger percentage than its most-favoured-nation tariff. This shows that exchange-rate stability can be more

important than tariff reductions for promoting regional and subregional trade flows.

MERCOSUR itself –the most ambitious subregional integration process of recent time– has come under considerable pressures precisely because of the instability of the exchange rate prevailing between its two biggest members, caused by the impact on the economies in question of changes in direction of capital flows and the lack of macroeconomic and exchange rate coordination between countries.

There are various reasons why financial crises are so harmful to mutual trade. When a country begins to suffer from balance of payments problems, two phenomena occur in particular: its exchange rate is depreciated vis-a-vis the currencies of its neighbours, and there is a fall in aggregate demand. This latter effect can be further amplified by the adoption of restrictive policies aimed at tackling the balance of payments crisis. The trade-related effects of these phenomena hit neighbouring countries particularly hard, since they find it harder to sell their own products on the market of the country suffering the crisis, while at the same time they have to face stronger competition from the exports of that country.

Latin America's regional trade is strongly concentrated on manufactures, the demand for which is highly sensitive to fluctuations in the exchange rates and aggregate demand of other members. This is not so in the case of commodities, which are mainly exported to the industrialized countries.

Instability in the financial flows to Latin American countries gives rise to great volatility of bilateral exchange rates within the region and depresses economic activity in all the countries of the region. These two factors are highly prejudicial to the achievement of closer economic integration.

Generalized financial crises are particularly harmful to integration. When a country begins to suffer from contagion from other crises in the region, its

exchange stability is needed among the countries seeking to integrate. Without this, it is unlikely that much more progress can be made in the region towards greater integration. This does not mean that we should hasten to adopt a common currency. Integration processes take place gradually, and in Latin America they are still at an early stage. It is essential, however, to take the first steps towards financial integration, for which bilateral exchange rates must be much more stable than they have been so far.

We need only recall the experience of Europe. The whole of the first stage of European integration took place within the framework of the exchange rate stability provided by the system of fixed (but adjustable) exchange rates adopted at Bretton Woods. When that system broke down in 1971-1973, much of the work for establishing a customs union had already been done. Nevertheless, the members of the European Economic Community quickly succeeded in giving their bilateral exchange rates a degree of stability that would have been impossible if they had decided to use the system that began to prevail as from 1973 for convertible currencies: flexible exchange rates with a dirty float. The European countries, however, decided first that their currencies would float together within what they called the "snake", which limited the fluctuations in bilateral exchange rates. They the went on to adopt the European Monetary System (EMS), with an exchange rate mechanism which fixed a central exchange rate for each currency with respect to the European Currency Unit (ECU), with narrow ranges of permissible floats around that central parity. The final stage in this process was reached early in 1999, with the establishment of the Euro.

The stormy moments that the exchange rate mechanism had to weather during the financial crises of 1992-1993 did not prevent final progress towards the irrevocable fixing of exchange rates and the adoption of the Euro by 11 European countries. There

预览已结束，完整报告链接和二维码如下：
https://www.yunbaogao.cn/report/index/report?reportId=5_3156