

---

**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**  
**GENEVA**

---

# **TRADE AND DEVELOPMENT REPORT, 2007**

## *Chapter V*

### **REGIONAL FINANCIAL AND MONETARY COOPERATION**



**UNITED NATIONS**  
New York and Geneva, 2007



---

## **REGIONAL FINANCIAL AND MONETARY COOPERATION**

---

### **A. Introduction**

---

Financial and monetary cooperation has been a longstanding and repeatedly recurring issue in international economic integration. Long before modern pressures from a globalized market emerged, exchange of trade and services between countries with different monetary units has been accompanied by attempts to simplify the final settling of bills and to smooth the financial implications of real resource transfers. The leading idea behind international financial cooperation has been the conviction of early global traders that only a monetary system comparable in its efficiency to the monetary systems prevailing in the nation state would allow to exploit fully the benefits of a global division of labour. However, after the failure of early global monetary systems like the Gold Standard and the end of the most recent global monetary system, Bretton Woods, disintegration in monetary affairs has ruled the day.

With the opening of the capital accounts of developing countries on a broad scale in the 1990s the monetary challenge was back on the agenda of international cooperation in general. Obviously, the pressure to create new multilateral rules to

regulate volatile speculative financial flows grew dramatically with the dismal experiences of a number of countries in big financial crises in Asia, Latin America and the transition economies. The big powers, however, the countries who are big and self-contained enough to withstand even strong blows from the globalized capital market, were reluctant to engage in a truly global exercise to monitor and eventually control the global financial markets in the same way as national financial markets have been controlled since the beginning of market systems based on government issued paper money.

As a consequence, the choices for small and open developing economies to deal with huge and uncontrolled capital flows are strictly limited. As the means to steer and restrict such flows by administrative measures are constrained by trade openness and many other ties that cannot be fully cut, one option is to “tie its own hands” by attaching firmly the own national monetary system to the monetary system of one of the big powers and to adjust the real system accordingly. Dollarization, eurozation and other forms of fixing its own cur-

rency firmly to an anchor currency or allowing a foreign currency to penetrate national markets as “parallel currency” demonstrate better than anything else the helplessness of small countries in their struggle with the global capital markets.

A second option for small open economies is to join forces in regional groupings. If the regional trade ties are strong and the mobility of capital and labour is rather high regional financial and monetary cooperation and integration is a way to protect against the gyrations of international capital markets and to deepen and broaden the division of labour at the regional level. Renewed interest for regional monetary and financial cooperation is also related to the difficulties most developing countries face in their access to foreign financing under favourable conditions in terms of maturity, interest rates and currency denomination.

Regional monetary and financial cooperation also appears as a necessary complement to deepening regional trade integration. Cooperation in trade and finance have typically reinforced each other. For instance, regional payment and clearing agreements among trading partners help in developing intraregional trade, especially in times of foreign currency shortage; and trade integration makes it necessary to address exchange-rate misalignments or volatility, which can be as, if not more, harmful for trade within a region than tariff barriers. In the absence of global arrangements for bringing about greater exchange-rate stability and orderly correction of currency misalignments, monetary arrangements among developing countries, especially in advanced integration arrangements, hold the potential for achieving this, while at the same time promoting overall competitiveness; such monetary coordination may take the form of a regional exchange-rate mechanism, common-bloc floating or a monetary union.

At present, several emerging countries are responding to these problems through active interventions in the exchange markets and the accumulation of international reserves. These poli-

cies tend to avoid – or limit – exchange-rate misalignments and to provide a self-insurance to the vagaries of the international financial markets. However, a cooperative approach together with regional partners might provide better results than separate national actions. Several initiatives are actually under way, which address the problems not satisfactorily managed at the international level: swap agreements and pooling of reserves among Central Banks; exchange-rate coordination mechanisms; regional supervisory institutions; a more intensive use of regional payment agreements, which could include the use of domestic currencies in regional trade; and the expansion – or creation – of regional development banks and regional bond markets, as a way to boost the access to long-term financing. In fact, it seems that monetary and financial cooperation has gained a more prominent role in regional integration processes (Higgott, 2002).

This chapter examines three major areas in which regional monetary and financial cooperation may help in dealing with international financial system shortcomings. Section B will present part of the rich experience already accumulated

by developing countries in regional payment facilities and short-term financing. Even though these mechanisms were primarily related to trade facilitation, they may evolve towards more ambitious regional financial arrangements that may provide a complement – or, in some circumstances, a substitute – to multilateral sources of balance of payment financing. Section C presents the role of regional cooperation in the provision of development financing; in particular, it stresses the function of regional and subregional development banks. It also examines the initiative for creating regional bond markets, which could become a stable source of financing for companies, banks and public entities in the region, while at the same time offering regional investors, including pension funds, options for wealth accumulation. Section D describes the most advanced experiences in regional exchange-rate mechanisms (ERM) and monetary unions, aimed at preserving a regional market from exchange-rate volatility, which have taken place

---

**A cooperative approach with regional partners on monetary and financial matters might provide better results than separate national actions and help in dealing with shortcomings in the international financial system.**

---

in Europe and Africa. Section E explains the main lessons to be learned from the European experience for monetary cooperation and monetary

policy in developing countries. Finally, section F draws some conclusions for the global and regional monetary institutions.

---

## B. Regional cooperation for payment facilities and short-term financing

---

Payment and credit agreements among central banks are aimed at facilitating intraregional trade as well as providing liquidity financing to the member countries of a trade agreement. A clearing arrangement among a group of central banks is an instrument directly related to trade integration. It provides a mechanism to facilitate international transactions between countries, typically concerning trade in goods but sometimes extended to services (such as tourism) and financial flows. Through this facility, the participating central banks compensate the cross payments owed to each other for balance-of-payments transactions carried out during a given period and then settle the remaining debt in hard currency on a pre-established date. Thus countries participating in such payment arrangements need less international liquidity for carrying out their intraregional trade, benefiting from short-term credit until the date of settlement.

An early and successful payments agreement was launched in Europe in the aftermaths of the Second World War. A European Payments Union (EPU) was created in July 1950 as a multilateral clearing system for trans-national payments among the members of the Organisation for European

---

**Payment and credit agreements among central banks are aimed at facilitating intraregional trade as well as providing liquidity financing to the member countries of a trade agreement.**

---

Economic Cooperation (OECE).<sup>1</sup> At the end of each month, net balances among EPU countries were reported to the Bank for International Settlements, the EPU's financial agent, which cleared offsetting claims. Remaining balances were consolidated as assets or liabilities towards the EPU as a whole. As a result, the effective use of gold and dollars was only 25 per cent of what would have been required without this mechanism. At a moment of foreign currency scarcity the EPU permitted a strong expansion of intra-European trade, from \$10 billion in 1950 to \$23 billion in 1959 (Eichengreen and Braga de Macedo, 2001: 2–3). The EPU also provided for credit facilities extended to countries in balance-of-payments difficulties. It existed until 1958, when all member states introduced general foreign currency convertibility for current transactions within the Bretton Woods System.

Among the developing regions, Latin America has a long and overall successful experience in this field (Pasin, 2007). In the 1960s, Central American countries created a clearing house to act as a delayed net payment system; and in 1969, they founded the Central American Monetary Stabilization Fund (MSF) in order to finance balance-

of-payments imbalances. This was conceived as “a complement of the International Monetary Fund”. However, the operations of the MSF were suspended in the mid 1980s following the widespread payment difficulties of participating central banks.

The Latin American Free Trade Association (later transformed into the Latin American Integration Association, LAIA) established in 1965 a reciprocal credit and payment agreement among the central banks (RCPA). It functioned as a clearing house and a short-term credit mechanism for trade transactions. Subsequently, a credit facility for central banks facing liquidity problems (the Santo Domingo Agreements) was added to that mechanism.<sup>2</sup>

Within the RCPA, international payments resulting from trade transactions were cleared to facilitate payments among member countries. It also made these payments less expensive, since it eliminated triangulation with banking institutions outside the region. Additionally, the RCPA provided a short-term credit facility to cover central bank deficits, which were charged an interest rate of LIBOR plus 100 basis points. Moreover, as each central bank assumed responsibility for paying the creditor central bank even if the issuing commercial bank had failed to fulfil its obligations, exporters using the mechanism were covered from commercial risk. In the late 1980s, about 90 per cent of intraregional trade transactions were channelled through this mechanism. The payment agreement helped save up to 75 per cent of the hard currency that would otherwise have been needed. With abundant liquidity and capital liberalization during the 1990s, the mechanism lost its importance for trade financing. However, it is still in place and could be used more intensively as a clearing system for operations in national currencies.<sup>3</sup>

In 1978 the Andean countries (which are also members of LAIA) reinforced their own trade integration agreement with the establishment of a reserve fund (the Andean Reserve Fund, later transformed into the Latin American Reserve Fund, FLAR), where central banks pooled part of their reserves. Initially it only included countries from the Andean Group but during the crisis of the 1980s it was opened to other Latin American countries (so far, only Costa Rica has joined the

FLAR). Member countries have access to medium-term credits (3 years term) for balance-of-payment and debt rescheduling financing. They also have access to a liquidity facility of up to a one-year term, to contingency facilities (six months) and to treasury finance (from one to thirty days). The FLAR offers services such as the administration of reserves, repurchase operations and values custody, as well as accepting sight and fixed-term deposits. It also issued notes in the international capital markets in 2003 (\$150 million) and 2006 (\$250 million) at rather low spreads (FLAR has been given an A+ rating by Standard and Poor's). In 2006 it issued a 5-year term floating note indexed at LIBOR plus 20 basis points.

Similarly the Arab Monetary Fund (AMF), created in 1976 by 22 West Asian and African states, provides financing for balance-of-payments imbalances with conditions tailored to each beneficiary's situation, conditions that are much less strict than those of the IMF (Corm, 2006: 309). The Fund intends to be “a lender of last resort and a complementary rather than a principal source for financing those (balance-of-payments) deficits” (AMF, 2003: 13). Member countries can resort to different lending facilities: “automatic loans” and “ordinary loans” to finance balance-of-payment deficits; “extended loans” when the balance-of-payments problem is of a structural nature and requires a longer repayment term (up to seven years); “compensatory loans” to face unexpected shortfalls in exports receipts; and since 1997, the AMF offers a “structural adjustment facility”, which has been used especially for supporting reforms in the financial and banking systems as well as in the government finance sector. The maximum amount of financial support a member country may access is 475 per cent of its subscription to the Fund's capital in convertible currencies (AMF, 2003: 4–11; AMF, 2006: 7–9). The AMF's objectives also include developing Arab financial markets, establishing modes of monetary cooperation and paving the way towards a unified Arab currency. The outstanding loans of the Fund at the end of 2005 amounted to the equivalent of \$1.1 billion.

In Africa, the Common Market for Eastern and Southern Africa (COMESA) established a clearing house in 1984 that aimed at reducing the need for hard currency in intraregional trade; it

also housed a reinsurance company (allowing smaller insurance companies to spread their risks through a wider COMESA pool) and a regional bank: the COMESA Trade and Development Bank.

Some of these mechanisms of mutual credit, as mentioned above, had to be abandoned during the debt crisis of the 1980s since their financing capacities were insufficient to cover the huge financing needs that arose simultaneously for a large number of countries. When the situation in the international financial markets changed towards the end of the decade and most economies regained access to private credit, doubts about the usefulness of regional financial mechanisms increased. Indeed, during much of the 1990s the abundance of international financing reduced the need for mutual assistance among central banks or for regional payment mechanisms that had been designed for saving foreign currencies in an environment of scarce private capital inflows and widespread capital controls. Moreover, the expansion of international banks, which installed new branches in many emerging economies, created a network of private financial flows and payments that replaced the existing agreements among central banks to a large extent.

The idea of creating a regional mechanism for mutual support to cope with possible balance-of-payments problems regained strength after the late 1990s financial crises. In Asia, the 1997–1998 financial crises proved to be a watershed with regard to monetary cooperation in the region, as existing regional and multilateral institutions failed to handle the crisis with an immediate and adequate reaction to the economic turmoil. Therefore, ASEAN member countries initiated a process of cooperation on monetary and financial issues with their major partners in East Asia, China, Japan, and the Republic of Korea. This culminated in the formalization of the ASEAN+3 group in 1999. In May 2000, ASEAN+3 countries launched the Chiang Mai Initiative (CMI), which constitutes the most prominent bilateral swap arrangement to include developing countries (Park et al., 2006: 271).

---

The proposal for creating a regional mechanism for mutual support to cope with possible balance-of-payments problems aroused increasing interest following the financial crises of the late 1990s.

---

The CMI is geared both to crisis management and crisis prevention by providing participating countries with international financial liquidity through its two major pillars: the expanded ASEAN Swap Arrangement and the bilateral Swap network. The original ASEAN Swap Arrangement had already been introduced by the five founding ASEAN members back in 1977 and was intended to dampen temporary liquidity shortages (Wang and Andersen, 2002: 90). In May 2000, the ASEAN Swap Arrangement was expanded to all member countries and the available fund was increased from the initial amount of the equivalent of \$200 million to \$1 billion (Park, 2006: 245). Five years later, in April 2005, the ASEAN Swap Arrangement was raised once again from \$1 billion to \$2 billion. In case of liquidity problems, central banks of member countries are entitled to swap their own currencies against key international currencies, e.g. dollar, euro and yen, for a period of up to six months (with one possible prolongation of another six months) and to an amount of a maximum of twice their commitment under the expanded ASEAN Swap Arrangement (Rajan, 2006: 5; Wang and Andersen, 2002: 90).<sup>4</sup> For the respective currencies, LIBOR determines the interest required for swap transactions. Any request for financial support has to be put to the Agent Bank, which is appointed on rotation and responsible for coordination of financial support.

The second pillar of the CMI consists of a network of bilateral swap arrangements among eight ASEAN+3 member countries (table 5.1). As of mid 2006, six one-way and ten two-way bilateral swap arrangements had been concluded, with a total amount of the equivalent of \$75 billion, of which \$65 billion are provided by China, Japan and the Republic of Korea alone. Of the total amount agreed upon in the swap arrangements, 60 per cent are in local currency. However, participating countries have immediate access only up to a maximum of 20 per cent of the facility and only by consent of the swap-providing countries (Park, 2006: 251; Rajan, 2006: 5). For any further drawings above that threshold, IMF approval is

Table 5.1

## BILATERAL SWAP ARRANGEMENTS UNDER THE CHIANG MAI INITIATIVE

(Billions of dollars)

From: \ To:	China	Japan	Rep. of Korea	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total
China	..	3.0 <sup>a</sup>	4.0 <sup>b</sup>	2.0	1.5 <sup>c</sup>	1.0 <sup>d</sup>		2.0 <sup>c</sup>	13.5
Japan	3.0 <sup>a</sup>	..	13.0 <sup>e</sup>	6.0	1.0 <sup>f</sup>	6.0	3.0	3.0	35.0
Rep. of Korea	4.0 <sup>b</sup>	8.0 <sup>e</sup>	..	1.0	1.5	1.5		1.0	17.0
Indonesia			1.0	..					1.0
Malaysia			1.5		..				1.5
Philippines		0.5	1.5			..			2.0
Singapore		1.0					..		1.0
Thailand		3.0	1.0					..	4.0
<b>Total</b>	<b>7.0</b>	<b>15.5</b>	<b>22.0</b>	<b>9.0</b>	<b>4.0</b>	<b>8.5</b>	<b>3.0</b>	<b>6.0</b>	<b>75.0<sup>c</sup></b>

**Source:** UNCTAD secretariat calculations, based on Ministry of Finance, Japan (2006).

**a** Local currency swap between the Japanese yen and the Chinese yuan.

**b** Local currency swap between the Chinese yuan and the Korean won.

**c** The total of \$75.0 billion includes the bilateral swap arrangements (BSAs) between (i) China and Thailand and (ii) China and Malaysia, which are currently under negotiation for renewal, but does not include the BSA under the New Miyazawa Initiative and the ASEAN Swap Arrangement.

**d** Local currency swap between the Chinese yuan and the Philippine peso.

**e** Local currency swap between the Japanese yen and the Korean won.

**f** In addition to the BSAs under the Chiang Mai Initiative, there are other BSA under the New Miyazawa Initiative between Japan and Malaysia (\$2.5 billion) and the multilateral ASEAN Swap Arrangement (\$2 billion).

required. The maturity of the first drawing is 90 days and can be renewed seven times at maximum; member countries have to pay interest on the use of the swap facility in the range of LIBOR plus 150 basis points for both the first drawing and the first renewal, up to LIBOR plus 300 basis points for the last two renewals (Wang and Andersen, 2002: 91). At present, the CMI is evolving into a multilateral agreement in which part of the participants' reserves would be pooled. In their Kyoto Meeting of May 2007, the finance ministers of the 13 countries agreed to advance progressively towards "a self-managed reserve pooling arrangement governed by a single contractual agreement" for providing liquidity support. This "multilateralisation" of the CMI will also include a regional surveillance mechanism (Joint Ministerial Statement of the 10<sup>th</sup> ASEAN+3 Finance Ministers' Meeting, 5 May 2007<sup>5</sup>).

Several proposals for strengthened financial and monetary cooperation are also being discussed in Latin America. Some of them would replicate

the CMI arrangement of bilateral swap agreements, while others seek to establish a pool of reserves by several countries. The latter proposal might be achieved through the strengthening of the already existing Latin American Reserve Fund (FLAR) and enlargement of its membership.<sup>6</sup> It is worth noting that a fund like FLAR manages the reserves – which are protected by immunity – and also issues notes in the financial markets, so that its financing capacity is not strictly limited by the capital subscriptions of its members. Moreover, it benefits from good credit ratings, which are actually better than those of the sovereign debt of its member countries.<sup>7</sup>

In addition, the idea of using local currencies in intraregional trade activities has regained momentum. For instance, Argentina and Brazil have agreed to use national currencies for bilateral trade payments. Under this system – which at least initially will be optional – importers and exporters of both countries will pay to (or receive from) its central bank the amount due in domestic

currency at the daily exchange rate. Central banks will settle the outstanding balance at the end of each day. This mechanism will not only save hard currency in trade among the participant countries but it will also reduce the transaction costs for the firms, especially small and medium enterprises that must generally pay high fees for their international payments. It is likely to be extended to other South American countries through the LAIA payment system.

In the transition countries, small steps have been taken recently after the collapse of the Soviet Union led to monetary disintegration in the region. In the early 1990s, all CIS members introduced their own national currencies. Subsequently they embarked again on regional monetary cooperation to ensure that the *de jure* convertibility of these currencies could be translated into practice by a functioning market

---

Support for using local currencies in intraregional trade activities has gathered momentum.

---

for currencies. Furthermore, the International Association of Currency Exchanges of the CIS countries founded in 2000 and involving 20 stock exchanges in nine countries, aims at the creation of a common financial market through the harmonization of financial legislation, adoption of international standards, more extensive use of CIS currencies in regional trade as well as common exchange-rate policies. Since some member states have accumulated substantial amounts of foreign-exchange reserves in the past few years, it has also been suggested that further monetary cooperation might include the creation of a system of bilateral currency swaps to reduce vulnerability (Butorina, 2006: 106). However, installing such a system may be more difficult among CIS members than in Asia or Latin America, as long as there are no further advances in the creation of a common market.

---

## C. Regional cooperation for development financing

---

### 1. Regional development banks

---

Regional development banks play an important role in regional financial cooperation. Some of these banks, including the Inter-American Development Bank (IDB) created in 1959, the African Development Bank (AfDB) in 1964 and the Asian Development Bank (ADB) in 1966, are North-South initiatives. These banks allocate credit to countries in the region based on contributions from both regional members and developed-country partners. The engagement of the latter gives them significant weight in the decision-making proc-

ess. For example, developed countries hold almost 50 per cent of the capital and voting power of the IDB (the United States and Canada alone accounting for 34 per cent), and 59.5 per cent of the capital and 54.2 per cent of the votes of the ADB. In the case of the AfDB, extraregional member countries – including some from West Asia, other parts of Asia and Latin America – hold 39.9 per cent of the voting power. On the one hand, the participation of developed countries facilitates these banks' access to the international financial markets. On the other hand, developing countries have to accept that control over these institutions is in the hands of developed-country members to a large

degree, and these rich members exert their influence through the voting distribution and other mechanisms (Culpeper, 2006: 43–44).

In addition to the World Bank and the North-South regional development banks, several financial institutions have been created at the subregional level, with a membership composed almost exclusively of developing countries. Subregional development banks have been created in Africa, in Latin America and in the Caribbean, as well as in West Asia and the Arab world, where, since the 1970s, they have channelled surpluses resulting from surges in oil export earnings into development financing. These institutions tend to give higher priority to financing genuine regional integration projects than the international financial institutions (World Bank, 2007: 3) (table 5.2).

A large proportion of the financing from these banks supports infrastructure projects, including energy, transport and communications. The largest share of the credits for sub-Saharan Africa from the AfDB and Arab and Islamic institutions is for agriculture and rural development. Again, debt issued by the subregional development banks obtains a better risk rating than sovereign debt issued by the country members. According to some observers, the good performance of these subregional banks in terms of the exceptionally low levels of non-accruing loans and high ratings by risk agencies is due mainly to the ownership of these institutions by developing countries – which confers on them a preferred creditor status – and their ability to adapt and respond to the specific needs of smaller countries and borrowers (Ocampo, 2006; Sagasti and Prada, 2006).

In addition, subregional development banks are increasingly financing the production of regional public goods in the areas of transport, energy and communications as they become involved in regional infrastructure initiatives such as the Puebla-Panama Plan and the Initiative for the Integration of South American Regional Infrastructure. Indeed, “they can provide member countries with a coordination mechanism through

which to plan and finance the provision of regional trans-border infrastructure and other regional public goods requiring large initial investments” (UN/DESA, 2005: 129).

Recently, some regional development banks have sought to enlarge their capital and access to international markets by incorporating new members, but without the original founders losing their control over the institution. Mexico, China, Argentina, Colombia and Spain have subscribed equity shares in the Central American Economic Integration Bank (CABEI). In a similar way, the Andean Development Corporation (CAF) issued special shares that were subscribed mainly by other Latin American countries<sup>8</sup> and by private investors (mainly commercial banks) from the Andean Community (ANCOM). This enlargement of their capital allowed for an impressive expansion of credits: loans by CABEI rose from \$672 million in 2003 to \$3170 million in 2006; in the same period, credits approved by CAF increased from \$3300 million to \$5520 million, an increasing part of which is oriented toward Latin American members outside ANCOM. This trend may be deepening further, since some non-founding country members have announced their intention to expand their capital contributions to CAF significantly.

In addition, the Governments of Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and the Bolivarian Republic of Venezuela have recently decided the creation of a new subregional development bank, the Bank of the South, one of whose main goals will be the financing of infrastructure projects supporting regional integration.

An increasingly important feature of regional development banks is their local currency exposure and portfolio. The ADB is the first regional development bank that strengthens local and regional financial markets both in its function as a borrower and as a lender by using local currency denominated instruments. With the explicit aim of reducing currency mismatches in its developing member countries and supporting local capital market development, the ADB has introduced its

---

A large proportion of financing from regional banks supports infrastructure projects, including energy, transport and communications.

---

Table 5.2

**REGIONAL DEVELOPMENT BANKS OUTSTANDING LOANS:  
TOTAL AMOUNT, DISTRIBUTION AND DEBT RATINGS, 2005–2006**

Institution/region	Loans <sup>a</sup>	Destination by regions <sup>b</sup>		Distribution by main sectors <sup>b</sup>		Debt ratings <sup>c</sup>	
	(\$ million)	(Per cent)		(Per cent)		Long-term	Short-term
<b>Latin America and the Caribbean</b>							
Inter-American Development Bank incl. Fund for Special Operations (IDB)	53 047	South America	67.6	Energy	13.8	AAA	A1+
		Central America	24.9	Social investment	13.7		
		Caribbean	5.5	Transport and communic.	10.9		
		Regional operations	2.0				
Central American Bank for Economic Integration (CABEI)	3 179	Central America	100.0	Infrastructure	30.1	A-	A1
				Financial intermediation	30.0		
				Electricity	12.4		
Caribbean Development Bank (CDB)	1 126	Caribbean	98.3	Transport and communic.	26.4	AAA	A1+
		Regional operations	1.7	Finance and distribution	20.7		
				Multisector and other	18.1		
Andean Development Corporation (CAF)	7 347	Andean Community	89.1	Transport and communic.	37.4	A+	A1
		Other America and regional operations	10.9	Social and infrastructure	35.1		
				Electricity, gas and water	11.4		
<b>Africa</b>							
African Development Bank Group <sup>d</sup>	19 118	Sub-Saharan Africa	64.2	Agriculture and rural dev.	18.1	AAA	A1+
		North Africa	32.7	Transport	16.5		
		Regional operations	3.1	Multisector	15.2		
Ecovas Bank for Investment and Development (EBID Group)	54	West Africa	100.0	Infrastructure	65.6	..	..
				Agriculture and rural dev.	15.8		
				Energy	10.1		
Eastern and Southern African Trade and Development Bank (PTA Bank)	228	Eastern and Southern Africa	100.0	Manufacturing	25.9	..	..
				Infrastructure	22.1		
				Agribusiness	15.0		
<b>Asia</b>							
Asian Development Bank (ADB) and Asian Development Fund (ADF)	47 700	East and South-East Asia	57.0	Transport and communic.	23.1	AAA	A1+
		Central and South Asia	41.5	Energy	20.1		
		Oceania	1.4	Agriculture and natural resources	13.4		
		Regional operations	0.1				
<b>Arab and Islamic institutions</b>							
Arab Bank for Economic Development in Africa (ABEDA)	653	Sub-Saharan Africa	99.9	Infrastructure	52.2	..	..
		Regional operations	0.1	Agriculture and rural dev.	27.0		
				Energy	6.9		
Arab Fund for Economic and Social Development (AFESD)	6 313	West Asia	50.4	Energy and electricity	31.5	..	..
		North Africa	47.8	Transport and communic.	22.2		
		Sub-Saharan Africa	1.8	Agriculture and rural dev.	18.0		
Arab Monetary Fund (AMF)	1 086	North Africa	72.2	Balance-of-payments loans	74.2	..	..
		West Asia	19.7	Structural adjustments	19.8		
		Sub-Saharan Africa	8.1	Trade facilitation	6.0		
Islamic Development Bank Group (ISDB)	6 748	West Asia	36.3	Public utilities	26.0	AAA	A1+
		Other Asia	29.9	Social sector	22.7		
		North Africa	23.6	Transport and communic.	18.4		
		Sub-Saharan Africa	8.2				
		Rest of the World <sup>e</sup>	2.0				

**Source:** UNCTAD secretariat calculations, based on latest annual reports of concerned institutions; and Standard and Poor's (S&P), *Ratings in Products and Services*, at: [www2.standardandpoors.com](http://www2.standardandpoors.com) (accessed May 2007).

**a** Values correspond to the loan assets in the balance sheets as of end 2005, except IDB, ADB and ADF where data relate to 2006.

**b** The percentages concern either loan assets or cumulative approvals. Regional operations can consist of loans for regional organizations (economic cooperation and integration activities) or groups of countries. PTA's distribution by sector includes approvals (project financing) and loan assets (trade financing) in 2005.

**c** Ratings are from Standard and Poor's: AAA to BBB and A1 to A3 signify high quality credit and strong capacity to repay (long- and short-term respectively); BB to B (long-term) and B (short-term) indicate significantly speculative credit; CCC to C and C indicate vulnerability to non-payment; and D signifies default risk on both short- and long-term operations.

**d** African Development Bank, African Development Fund and Nigeria Trust Fund.

**e** Albania, Suriname, loans to Muslim communities in non-member countries, regional operations and special programmes.

local currency loan product. It has offered local currency loans since 2003, initially only to selected private borrowers but since 2005 to public sector entities as well. Furthermore, the ADB has issued local currency bonds of developing member countries and bonds in local financial markets of developing member countries. With the Indian rupee bond issuance in 2004, the ADB launched its first local currency bond on the domestic market of a borrowing member. This issuance was followed by similar transactions in Malaysia, China, the Philippines and Thailand.

Acknowledging the fact that making foreign currency-denominated loans to its clients from Latin America contributes to dollarization, the IDB has paved the way for local currency loans ever since September 2005. Already in 2004 the IDB, as the first institutional investor, had launched a global bond denominated in Mexican pesos that was available in the Mexican capital market. This was followed by bonds in Brazilian reals, Chilean pesos, Colombian pesos and Peruvian new soles. It was also issued in Hong Kong dollars, New Taiwan dollars and South African rand. Overall, 5 per cent of outstanding credit was denominated in developing-economy currencies in December 2006 (IDB, 2006a, IDB, 2006b). In a similar way, the Andean Development Corporation has issued bonds denominated in the currencies of member states.

The AfDB has provided its regional member countries with rand-denominated loans since 1997. After adopting a specific framework for lending in regional member country currencies, it is considering expanding its operations into regional capital markets, e.g. in Botswana, Ghana, Kenya, Mauritius, Nigeria, the United Republic of Tanzania, Uganda, Zambia and UEMOA. Accordingly, for the last 10 years it has issued rand-denominated bonds in the euro-rand market, albeit not in the South African market. At the end of 2005 the AfDB's first Botswana pula-denominated bond also qualified for the first true Eurobond in pula, which was followed by a Eurobond in Tanzanian shillings and Ghanaian cedi in 2006 (AfDB, 2007).

Subregional development banks in Africa, for instance the East African Development Bank, the East and Southern African Trade and Development Bank and the West African Development Bank, are important bond issuers in African capital markets, e.g., Kenya, the United Republic of Tanzania and UEMOA.

To the extent that such credit and payment mechanisms, along with mutual insurance through regional agreements, reduce the amount that each country must keep in liquid foreign assets for transaction and precautionary reasons, financial resources are freed for more productive uses. Some countries (mainly in Asia) are seeking to diversify their investment portfolios in order to increase their revenues and reduce the risks arising from asset concentration.

---

**Regional financial cooperation might offer investment alternatives that would not only increase the financial returns on foreign reserve holdings but also enhance regional development.**

---

Regional financial cooperation in the form of a regional investment fund based on hard currencies, or strengthening already existing regional financial institutions, might offer investment alternatives that would not only increase the financial returns on foreign reserve holdings but would also enhance regional development. As already mentioned, several South American countries have

already committed part of their international reserves to expanding their participation in subregional development banks and/or are considering the creation of a new regional bank – the Bank of the South, with the aim of promoting internal and regional integration.

Also in Latin America, the Bolivarian Republic of Venezuela, the country with the highest current-account surplus in the region, has diversified the use of its foreign exchange, in particular by providing financing to other Latin American countries. For example, it has acquired sovereign debt bonds issued by Argentina and Ecuador, and offers credit at very favourable conditions to countries importing its oil. It has also concluded an agreement with its associates in the Bolivarian Alternative for America (ALBA)<sup>9</sup> which, besides setting special financial conditions for their imports of the Bolivarian Republic of Venezuela's oil, has created a number of joint-venture enter-

prises in the field of energy and a regional fund for financing development projects.

## 2. Regional bond markets

The development of regional bond markets is high on the agenda of policymakers and monetary authorities in many developing countries.<sup>10</sup> The most sophisticated endeavour to deepen regional bond markets has been undertaken by the ASEAN+3 Finance Ministers, who launched the Asian Bond Markets Initiative (ABMI) in 2003. The ABMI is intended to develop more liquid primary and secondary bond markets and to recycle external surpluses into financing investment within Asia. To these ends, ABMI activities intend to address issues of market infrastructure in particular and of crowding-in a broader variety of issuers and investors into the national and regional bond markets. Six working groups have been established to work out studies and recommendations for improving bond markets, e.g., increased issuance of local currency bonds, improved capacity of local credit rating agencies or reduced foreign-exchange settlement risk to cross-border flows.

ASEAN+3's activities are complemented by the Executive Meeting of the East Asia-Pacific Central Banks group (EMEAP). EMEAP was established back in 1991 to deepen and strengthen cooperation between its members (EMEAP, 2003). During its initial phase, EMEAP was characterized by an informal consultation process; however, with increasing regional interdependence EMEAP began to formalize its structure by introducing three permanent working and study groups, e.g., the Working Group on Financial Markets, which prepared the ground for the formation of the Asian Bond Fund. It aims at deepening national and regional bond markets so as to reduce the dependence of Asian borrowers on short-term bank financing (EMEAP, 2006: 1).

Despite all these initiatives there has only been limited progress in the integration of regional financial markets. Between 1999 and 2005 the overwhelming majority of cross-border banking inflows to and outflows from ASEAN banks have

Table 5.3

### PORTFOLIO INVESTMENT ASSETS, ASEAN AND ASEAN+3, 2001–2005

(Stocks in per cent of GDP)

	2001	2002	2003	2004	2005
<b>ASEAN</b>					
Portfolio investment	21.2	21.9	24.4	27.4	26.7
Equity <sup>a</sup>	6.3	6.0	6.8	8.2	8.8
Intra-ASEAN	1.6	1.4	1.2	1.9	1.7
Extra-ASEAN	4.7	4.6	5.6	6.3	7.1
Debt	14.9	15.9	17.5	19.2	17.9
Intra-ASEAN	0.8	0.9	1.5	2.2	2.0
Extra-ASEAN	14.1	15.0	16.0	17.0	15.9
<b>ASEAN+3</b>					
Portfolio investment	22.4	24.2	27.3	29.0	29.2
Equity <sup>b</sup>	4.2	3.9	4.6	5.6	6.1
Intra-ASEAN+3	0.2	0.3	0.3	0.4	0.4
Extra-ASEAN+3	3.9	3.7	4.3	5.2	5.6
Debt	18.3	20.3	22.6	23.4	23.1
Intra-ASEAN+3	0.5	0.4	0.4	0.5	0.5
Extra-ASEAN+3	17.8	19.9	22.2	22.9	22.6

**Source:** UNCTAD secretariat calculations, based on IMF, *Coordinated Portfolio Investment Survey (CPIS) Data*, at: [www.imf.org/external/np/sta/pi/geo.htm](http://www.imf.org/external/np/sta/pi/geo.htm) (accessed May 2007); and *UNCTAD Handbook of Statistics* database.

- a** Data refer to Indonesia, Malaysia, the Philippines, Singapore and Thailand, which are the ASEAN countries included as creditors in the IMF database.  
**b** Data refer to the creditor countries for ASEAN plus Japan and the Republic of Korea only.

been directed to other regions, in particular to Europe and North America (Cowen et al., 2006: 10). Cross-border portfolio investment by the five founding members of ASEAN and China, Japan and the Republic of Korea (ASEAN+3) shows a similar pattern. Total portfolio investment of both ASEAN and ASEAN+3 countries increased strongly to 27 per cent of GDP and 29 per cent of GDP respectively (table 5.3).

However intraregional portfolio investment, which is investment in equity and debt securities held by ASEAN and ASEAN+3 countries, amounts to only 3.7 of GDP and 0.9 of GDP respectively in 2005. In both groups, regional debt securities take a somewhat larger share of all cross-border

portfolio investment, but this share is still low. Obviously regional capital markets are better integrated than regional bond markets, in particular between ASEAN member states, which is reflected in a higher proportion of intraregional equities to total equities than intraregional bonds to total bonds for both ASEAN and ASEAN+3. This is where the activities of ASEAN+3 Finance Minis-

ters and the EMEAP Asian Bond Fund Initiative come into play. One of the major accomplishments of the ABMI initiative is the issuance of local currency bonds by the Asian Development Bank during 2005–2006 on six Asian bond markets, all with a maturity between three and five years, with two additional 10-year bonds in China and in Thailand (ABMI, 2006: 12).

---

## D. Exchange-rate mechanisms and monetary unions

---

The last steps towards closer regional cooperation in the field of finance are the creation of regional exchange-rate mechanisms and monetary unions. On the global level, four regional monetary unions or strict exchange rate mechanisms exist. Three of them are to be found among developing countries: the Eastern Caribbean Currency Union (box 5.1), the Common Monetary Area in Southern Africa (CMA) and the Zone franc in Africa (CFA), which consists of two major groupings in francophone Africa. The Zone franc constitutes a monetary union between African countries and is the oldest existing North-South monetary arrangement. It is deeply embedded in the colonial past. The longest unaltered nominal exchange-rate peg with the French franc (now with the euro) links the Communauté Economique et Monétaire de l'Afrique Centrale (CEMAC), the Union Economique et Monétaire Ouest Africaine (UEMOA) and Comoros with France (see fig. 4.4).

Africa is home to another unusually long-standing and successful monetary coordination arrangement, namely, the Common Monetary Area (CMA). In contrast to the Zone franc member countries, CMA member states apply a nominal peg within the region and a common managed float

vis-à-vis all other currencies. All members of the CMA are also part of the oldest existing customs union in the world, the Southern African Customs Union (SACU), dating back to 1910. All SACU countries are also members of the Southern African Development Community (SADC), which has launched an ambitious programme for regional integration whose goal is a common market and monetary union. The Gulf Cooperation Council is also envisaging the creation of a monetary union by 2010 (see annexes to this chapter).

The largest regional monetary union is located in Europe, including only developed economies as member states. The European integration experience is a unique case in which regional cooperation has progressed during more than 50 years, with monetary union being reached after 30 years of a variety of exchange-rate mechanisms. The European Monetary Union and its predecessor, the European Monetary System, are often considered as models of cooperation and success. However, some hesitation is justified when considering the flaws of the process, the role of the regional anchor currency and the monetary regime applied by the European Central Bank and its predecessors.

## Box 5.1

**THE EAST CARIBBEAN CURRENCY UNION**

The East Caribbean Currency Union (ECCU) is a monetary union composed of eight small-island economies, six of which are independent states (Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia and Saint Vincent and the Grenadines), while the remaining two are British overseas territories (Anguilla and Montserrat). All these economies, together with the British Virgin Islands, constitute the Organization of Eastern Caribbean States (OECS). In June 2006, the OECS joined the CARICOM Single Market (CSM).

The predecessors of the ECCU were the British Caribbean Currency Board (BCCB, 1950) and the Eastern Caribbean Currency Authority (ECCA, 1965). The latter was created after the withdrawal of Trinidad and Tobago and British Guyana from the BCCB. The ECCA issued a currency that was initially pegged to the pound sterling. In July 1976, the peg was transferred to the US dollar at the parity of 2.70 East Caribbean dollars to 1 dollar. This parity has not changed since (ECCB, 2004).

In 1981, the OECS decided to replace the Eastern Caribbean Currency Authority with a regional central bank, the Eastern Caribbean Central Bank (ECCB), which issues the currency, conducts monetary policy and supervises the financial system; it has been in operation since 1983. It is headed by a Monetary Council comprised of one minister appointed by each of the eight member governments, and by a Board of Directors – the Governor and Deputy Governor along with one Director appointed by each participating country. The ECCB operation is close to that of a currency board, since it maintains a hard peg and has to back at least 60 per cent of its monetary base with international reserves; it preserves itself a room for manoeuvre however, as its mandate is not only to maintain monetary stability but also to promote development and regional integration. In December 2006, the ECCB had abundant liquidity, with international reserves representing 99.6 per cent of its demand liabilities (ECCB, 2007: 7).

The currency union seeks to provide a wider unified space for the development of a modern and efficient financial system. This not only includes harmonised banking legislation and joint regulation but also the creation of key regional financial institutions and markets: the Eastern Caribbean Home Mortgage Bank, the Eastern Caribbean Institute of Banking and Financial Services, the Eastern Caribbean Securities Exchange, the Eastern Caribbean Securities Market and the Regional Government Securities Market. With the unification of the eight former segmented bond markets, fiscal policy intended to reduce the cost of borrowing and to deepen regional financial markets by making primary bond markets more attractive for domestic and international investors. Turnover on the regional government securities market increased seven-fold between 2002 and 2006, and the share of foreign debt in total public debt could be reduced.

Strengthening the financial sector has a prominent place in the development strategy of the ECCU economies, especially as their agriculture sector is affected by the reduction of preferences delivered by the European Union to the exports of banana and sugar. This strategy aims to develop offshore finance further, an objective for which currency stability, low inflation and the solvency of financial intermediaries are essential as they preserve investor confidence. The strategy also intends to expand domestic credit through a network of development financial institutions for servicing small, medium and micro enterprises (ECCB, 2007: 3).

The currency peg has been the cornerstone of monetary policy and has provided the anchor for low inflation rates. Its maintenance requires rising exchange inflows from tourism and FDI (mostly related to tourism), in order to reduce or to finance a current account deficit that is close to 20 per cent of the region's GDP. At the same time, the currency peg could be threatened by persistent fiscal deficits and a public debt exceeding 100 per cent of GDP, which could trigger a movement to challenge the East Caribbean dollar. Fierce competition for attracting FDI has pushed governments to offer tax incentives, especially in the form of extended tax holidays, with a cost in terms of fiscal revenue that was estimated at between 10 and 16 per cent of GDP (IMF, 2007: 19). In a situation characterised by falling revenues from trade taxation, these generous concession regimes pose a policy dilemma with regard to conflicting goals concerning fiscal and external accounts. It would be desirable that, as part of policy coordination within OECS and CARICOM, a common incentive regime be adopted, thus "limiting the degree to which investors (can) induce governments to compete against each other" (IMF, 2007: 19; see also *TDR 2005*, chap. III).

## 1. Experiences in Africa

### (a) *The Common Monetary Area in Southern Africa*

The Common Monetary Area (CMA) is based on a tripartite arrangement between Lesotho, South Africa and Swaziland, at that time known as the Rand Monetary Area, which came into effect in 1974 (Namibia joined later in 1992) (Metzger, 2006). The agreement formalized existing de facto monetary integration, as the South African currency had been serving as legal tender in Lesotho and Swaziland since the 1920s. The CMA agreement provides for fixed exchange rates among its members and common bloc floating vis-à-vis other currencies as well as intraregional capital account liberalization, the distribution of seigniorage and some intraregional financial transfers. Both the Lesotho loti and the Namibian dollar are pegged at par to the South African rand. Although Swaziland legally withdrew from this commitment in 1986, it is still honouring it de facto. Botswana participated in the CMA negotiations in the 1970s but it opted out in favour of a managed floating of its currency, the pula. Since then, however, Botswana has pegged the pula to a basket whose composition is not displayed. However it is assumed that the basket, which is adjusted from time to time, includes the South African rand as a major part. Each of the four members has its own central bank, which issues its currency and is formally responsible for monetary policy within its respective country.<sup>11</sup> However, since the rand functions as the regional anchor currency, the South African Reserve Bank determines monetary policy for the CMA member countries via its interest rate policy.

Under the CMA arrangement, South Africa shares the seigniorage of the rand with Lesotho and Namibia. Although the South African rand still serves as legal tender in both these countries, none of the other currencies are legal tender in South Africa or are commonly used there. Swaziland does not participate in the seigniorage since it abolished the legal status of the rand in 1986.

Another important element of the arrangement is that the South African Reserve Bank acts as a lender of last resort for Lesotho and Namibia with a view to ensuring financial stability in the CMA. Moreover, member countries can draw on a pool of foreign-exchange reserves that is managed by the South African Reserve Bank. Lesotho, Namibia and Swaziland may hold additional foreign exchange for direct and immediate needs, of which up to 35 per cent may be held in currencies other than the South African rand. Their central banks and authorized dealers have free access to the foreign-exchange market in South Africa. Finally, while there are no restrictions on capital movements within the CMA, a common exchange control system vis-à-vis the rest of the world is administered by the South African Reserve Bank in cooperation with the central banks of the other members.

The only intraregional institution, apart from a technical committee, is the Common Monetary Area Commission. It is composed of one representative and advisers from each member state, and provides a formal consultation mechanism on monetary and financial policies. It meets prior to the Monetary Policy Committee of the South African Reserve Bank, which determines interest rates for South Africa and, via the peg, also for the other CMA countries. In 2005, central bank governors of the region analyzed the costs

and benefits of a common central bank for the CMA countries. However, no decision has yet been taken and when it will be taken depends on the performance of the common institutional structures recently created in SACU.

Due to the currency peg and to instruments akin to those of a monetary union, the financial sector within the CMA is highly integrated. However, financial relations are organized in a hub-and-spoke system, with South Africa at the centre. A capital flows survey conducted by the Central Bank of Lesotho (1996) revealed that one quarter of all customers of commercial banks in that country also had bank accounts in South Africa and that more than 40 per cent of households intended to open such accounts; another 20 per cent of domestic firms and households disclosed

---

Under the CMA arrangement, South Africa shares the seigniorage of the rand with Lesotho and Namibia.

---

that they were holding financial assets in South Africa. These figures are likely to have increased since the mid-1990s. The banking sector in particular, which accounts for a major part of the financial sector, is highly concentrated in terms of ownership. The South African banking sector is dominated by four South African commercial banks, with a combined market share of about 90 per cent. A similar concentration exists in Lesotho, Namibia and Swaziland; in these countries ownership of the major banks is also mainly South African.<sup>12</sup> Although the three countries might find it difficult to issue bonds or raise loans in domestic currency, they have free access to the South African credit and bond markets, where they are able to issue bonds and raise loans denominated in rand. Yet, overall, South Africa is a net debtor vis-à-vis the other member countries of the CMA (South African Reserve Bank, 2007). Net liabilities are due to deposits in the South African banking sector, as in the case of Lesotho and Swaziland, or due to holdings of South African debt securities by Namibian creditors.

CMA membership has resulted in a process of convergence of real growth and inflation rates. With regard to monetary convergence, the most important goal has been to reduce inflation to the South African level. The central banks of the three smaller member economies adjust their interest rates to defend the nominal exchange-rate peg and thereby “import” price stability. Although the deepening of the financial sector in Lesotho, Namibia and Swaziland is limited due to small market size, since 2000 the latter two middle-income countries either have the same or even slightly lower nominal short-term central bank interest rates than that prevailing in South Africa, while Lesotho’s nominal interest rate level has been converging with the South African benchmark since 2005.

Overall, real interest rates in the CMA countries have been rather high in relation to growth rates. This was due mainly to the fact that the anchor country, South Africa, had to fight with current-account deficits as well as relatively high wage growth and boom-bust cycles of deprecia-

tion and appreciation of its exchange rate. However, compared to other small African countries external volatility was relatively limited and the ability of CMA members to use the regional anchor currency for bond and loan contracts – rather than one of the major reserve currencies – brought other advantages.

Since the 1970s there has been a clear trend towards business-cycle convergence among CMA countries. Variations in real GDP growth rates have been reduced not only across CMA countries but also over time within each country.<sup>13</sup> Beyond intraregional trade flows remittances by migrant workers have played a role as transmission channel for real convergence. South Africa employs many migrants from CMA countries, especially in mining and agriculture. Higher growth in the South African mining industry increases the demand for migrant workers, their incomes and their remittances and vice versa.<sup>14</sup>

Given the geographical proximity and the dominance of the South African economy, regional integration between these four countries would have occurred even without formal regional cooperation agreements. However, the formal agreements have allowed Lesotho, Namibia and to a lesser extent Swaziland to share the benefits of this integration better. Without a formal agreement, these economies would most likely have experienced an uncontrolled process of “randization” similar to “dollarization” in Latin America or “euroization” in many of the economies of Central and Eastern Europe. Such processes expose countries to the risk of serious liquidity crises or misalignment of the real exchange rate.

Additionally, without the regulatory framework for monetary and financial relations created by the CMA agreements, the smaller countries would have been obliged to resort to restrictive monetary and fiscal policy time and again to defend their currencies and check capital flight to South Africa, a policy that has proved harmful for development in many other developing and transition countries (*TDR 2006*, chap. IV). Furthermore, intraregional competitive devaluations are ruled

---

CMA membership has resulted in a process of convergence of real growth and inflation rates.

---

out by the common bloc floating vis-à-vis the rest of the world. Thus negative balance sheet effects for the rand-denominated debt of Lesotho, Namibia and Swaziland are prevented. Consequently, the region displays an unusually high degree of monetary and exchange-rate stability, which has allowed Lesotho, Namibia and Swaziland to grow gradually out of a net debtor status to that of a net international creditor.

### (b) *The CFA franc zone*

The establishment of the CFA franc zone dates back to 1945. The creation of a common currency for the former French colonies, the CFA franc, was intended to protect these African countries from the effects of any depreciation of the French currency vis-à-vis the dollar under the Bretton Woods arrangements. The CFA franc was pegged to the French franc until 1999, and thereafter to the euro. In more than 60 years of the arrangement, the parity has changed only twice: in 1948, the CFA franc was re-valued by more than 17 per cent against the French franc and in 1994 it was devalued with the effect that the parity increased by exactly 100 per cent.

The economic deterioration that forced this dramatic devaluation led to the formation of two sub-groupings, each with its own common central bank: the Economic and Monetary Community of Central Africa (CEMAC) and the West African Economic and Monetary Union (UEMOA). As a result, two currencies were circulating in the CFA zone before the introduction of the euro: the franc of the Communauté Financière d'Afrique in West Africa and the franc of the Coopération Financière en Afrique Centrale in Central Africa. The two currencies are set at parity to each other but the use of each is restricted to their respective sub-region. The two sub-groupings were intended to deepen regional integration and strengthen harmonization between the policies of their member countries.<sup>15</sup> However, each of them belongs to different regional integration schemes: CEMAC forms the

major part of the Economic Community of Central African States (ECCAS) and all UEMOA states are members of the Economic Community of West African States (ECOWAS).

The CFA franc zone has adopted three main monetary instruments. First, France guarantees the convertibility of the CFA franc, which is issued by the central bank of each sub-group. In exchange, the central banks of CEMAC and UEMOA deposit at least 50 per cent<sup>16</sup> of their foreign-exchange reserves, converted to euro (formerly to French francs), in an account at the French Treasury. Second, the French Treasury compensates CFA zone members for any depreciation of the euro (formerly the French franc) against the special drawing rights (SDRs) and pays interest to the central banks of the countries of the CFA zone on their deposits. Third, in order to maintain financial stability, the Banque de France acts as a lender of last resort. In principle, the French Treasury gives all zone members unlimited overdraft facilities with progressively increasing interest rates. In exchange, CFA zone member countries are required to have foreign-exchange reserves at

their disposal equivalent to at least 20 per cent of their monetary base. Furthermore, credit from the two respective central banks of CEMAC and UEMOA to a member country must not exceed 20 per cent of that country's public revenues of the preceding year. Though crucial for the sustainability of the exchange rate, bilateral aid from France is not an instrument

agreed upon between CFA zone member countries and France but is at the unilateral discretion of France.

In terms of price stability the performance of CFA zone members has been far superior to that of most non-CFA zone countries in Africa. Annual consumer price inflation averaged 8 per cent during the period 1960–2004, and its variation within the CFA franc zone averaged 10 per cent, compared to non-CFA Africa where average annual inflation was 75 per cent and the inflation rate variation was more than 230 per cent (Yehoue, 2007; Nnanna, 2006). However, as France introduced a resolute “*franc fort*” policy in the early

---

In terms of price stability, the performance of CFA zone members has been superior to that of most non-CFA zone countries in Africa.

---

Table 5.4

REAL EFFECTIVE EXCHANGE RATE, FRANCE, CEMAC AND UEMOA, 1990–2006						
(Index numbers, 2000 = 100)						
	1990–1993 <sup>a</sup>	1994	1995–1999 <sup>a</sup>	2000	2001–2005 <sup>a</sup>	2006
France	111	112	111	100	105	108
CEMAC <sup>b</sup>						
Cameroon	154	97	109	100	108	113
Central African Republic	152	94	107	100	118	129
Equatorial Guinea	137	97	111	100	129	151
Gabon	173	103	111	100	102	105
UEMOA <sup>b</sup>						
Côte d'Ivoire	144	89	103	100	112	116
Togo	132	87	104	100	108	112

**Source:** UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database.

**a** Period average.

**b** Data were not available for other member countries of CEMAC and UEMOA.

1980s in an attempt to converge with the most stable economies in the European Union (EU), these low inflation rates (by developing-country standards) at the time were not low enough to prevent overvaluation vis-à-vis the French franc and the currencies of other Western European countries. However, the sharp devaluation in 1994 corrected the overvaluation, which had been accumulated in the years before (table 5.4).

In the aftermath of the devaluation in 1994, UEMOA countries reduced their average annual inflation rates even further to 2.6 per cent in the period 1996 to 2005 (IMF *International Financial Statistics* database). Although CFA franc zone countries slashed their inflation rates down to almost European levels only two years after the devaluation, this competitive advantage levelled out in 2000 and was replaced by incremental revaluation compared to France, with the notable exception of Gabon. Growth in the CFA zone has picked up recently mainly due to rising oil prices and the prices of other mineral and mining products exported from the region.

Financial integration within UEMOA has been limited mainly to cross-border transactions

in the growing government bond market, to which commercial banks channel much of their excess liquidity (Sy, 2006). The regional capital market is small and the regional inter-bank market rudimentary. Although French presence in the regional banking market is still strong, subsidiaries of French banks have been losing market shares to African banks having an explicitly regional approach. For example ECOBANK, which has branches in 13 countries of the region, has become the largest trans-national bank operating in the CFA franc zone. However as with GDP and trade volume, 50 per cent of regional banking assets in UEMOA are concentrated in Côte d'Ivoire and Senegal (Sy, 2006).

A process of regional surveillance over macroeconomic convergence was set in motion when UEMOA agreed upon a Convergence, Stability, Growth and Solidarity Pact in 1999. Both UEMOA and CEMAC adopted convergence criteria including an inflation target of 3 per cent, a balanced budget (excluding official development assistance (ODA)) and a maximum limit for total public debt set at 70 per cent of GDP (Banque de France, 2005; Comité de Convergence, 2007). Although there has been some success in convergence with re-

gard to the formal criteria, convergence in terms of GDP growth rates and reduction of regional social and economic disparities between UEMOA member countries has been limited and is almost non-existent within the CEMAC.

As in SACU, remittances are an important channel of convergence among UEMOA members. For example, over 40 per cent of workers' remittances to Burkina Faso originate in other UEMOA member countries, in particular Côte d'Ivoire (Banque de France, 2005), and around many workers in Côte d'Ivoire come from other UEMOA countries, in particular Burkina Faso and Mali (van den Boogaerde and Tsangarides, 2005). Whereas UEMOA is a net recipient of remittances, there is a net outflow of remittances from CEMAC countries to the rest of the world due to numerous skilled employees from industrialized and other developing countries working in their oil industries. Intra-regional remittances accounted for only 10 per cent of total gross remittances in CEMAC in 2005 (Banque de France, 2005).

Formal cooperation and regional institutions have had mixed results in terms of regional integration in the CFA franc zone. Various common regulatory frameworks to facilitate intra-regional trade and financial flows have been initiated, and economic actors seem to be taking advantage of the resulting opportunities. For example, since UEMOA established a customs union and liberalized intra-regional trade in 1999, the share of intra-regional trade in total trade has been increasing, although from a low level, and so far without a visible impact on industrialization and diversification.

To prevent a loss of competitiveness of their domestic industries on the European market, CFA zone members have to adjust their inflation rates to the euro zone level of 2 per cent, which may be quite tight for a low-income developing country undergoing rapid structural change. There are also other disadvantages to unilateral fixing. In the case of a euro appreciation, the loss of competitiveness on Asian markets or within the dollar area could even provoke region-wide deflation – which would be particularly dangerous for low-income countries seeking to develop their manufacturing capacities. Thus CFA zone countries have suffered time and again from the drawbacks of very rigid

nominal exchange rates vis-à-vis their European trading partners and the rest of the world without having derived many benefits from exchange-rate stability because of the relatively low level of intra-regional trade, especially in manufactures and services that are more exchange-rate sensitive than primary products.

Apart from their pro-cyclical character, stringent fiscal convergence criteria such as a balanced budget (without ODA) or even a budget surplus have not been conducive to the process of financial integration within the CFA franc zone either. This is because financial markets in both the sub-groups of the CFA zone consist mainly of public entities and commercial banks, with the former issuing domestic debt and the latter purchasing treasury bills and other public bonds. If the governments of the CFA zone countries were to abstain permanently from borrowing in their domestic or regional markets, the possibility of developing financial markets would be severely curtailed.

More generally, the choice of convergence criteria and quantitative targets is a delicate matter because the targets set in Europe are based on expectations formed under specific macroeconomic and market conditions. The Convergence, Stability, Growth and Solidarity Pact of UEMOA foresees that an initial convergence phase would be followed by a stabilization phase, which was originally scheduled for the period 2000 to 2002. However, the end of the convergence phase has already been postponed twice. Thus instead of enhancing credibility in regional institutions and in the process of regional integration, the Pact might even put in question the credibility of the whole project and of member countries' governments.

### (c) *African lessons*

Monetary and exchange-rate policy has been by far the most developed area of regional cooperation and integration in Africa. With the two currency unions of CEMAC and UEMOA, nominal exchange-rate stabilization within CMA and the prospective currency unions of SADC and West African Monetary Zone (WAMZ), Africa has

taken the lead in the developing world in terms of regional monetary integration. Nominal pegs seek to establish price stability at the level of the anchor currency and to import credibility in exchange-rate stabilization. This has already materialized for the members of CEMAC, CMA and UEMOA. The SADC and WAMZ countries are on their way to achieving price level convergence, although with mixed results due to different exchange-rate regimes. Thus the African experience with regional monetary cooperation shows that the adoption of a common exchange-rate regime may help reduce and contain the domestic inflation rate and its variation between individual countries and the regional grouping as a whole. As the converse does not hold – harmonization of inflation does not necessarily lead to stable nominal intraregional exchange rates – stabilization of the nominal exchange rate requires some form of managed fixing or managed floating at the regional level or even beyond.

---

**Monetary and exchange-rate policy has been the most developed area of regional cooperation and integration in Africa.**

---

The greatest handicap of exchange-rate based stabilization is the risk of an appreciation of the real exchange rate due to positive inflation differentials between the domestic and anchor currencies. Such real appreciation results in a shrinking of net exports and in a deterioration of the current-account balance. This can put the nominal anchor at risk, as was experienced by many developing countries in Asia and Latin America. However, intraregional overvaluation among CMA countries, as well as between CEMAC and UEMOA, has been moderate. But, although inflation rates in CFA zone countries have been strikingly low compared with other developing countries, overvaluation vis-à-vis the rest of the world has been devastating. The peg to the French franc, and subsequently to the euro, resulted in a major disincentive for CFA zone countries' exporters of both raw materials and processed goods. Thus a peg to a regional currency seems to be superior to a peg to an international key currency.

Stabilization of nominal intraregional exchange rates and common-bloc floating with the rest of the world as practised by CMA countries can imply vulnerability for extraregional trade if

the anchor currency is subject to speculation after the dismantling of capital controls, as was the case in South Africa (see chap. I). The exchange rate of the rand has been highly volatile, as were the exchange rates of the smaller CMA countries vis-à-vis the rest of the world. By contrast, a nominal peg to an international key currency is expected to reduce vulnerability for extraregional trade but the experience of the CFA zone countries has shown that in such an arrangement the exchange rate of the developing partner can be subject to volatility if the anchor currency swings as much as the euro did vis-à-vis the dollar. Thus the two different forms of pegs are almost equally disadvantageous with regard to any exchange-rate volatility caused by extraregional factors. Pegging to an international key currency, however, may involve much more ambitious targets for monetary and fiscal policy than pegging to a regional partner.

## **2. The case of the European Monetary Union**

### *(a) The end of disintegration after the war*

The European integration experience is a unique case, in which monetary cooperation has progressed during more than 50 years through all the steps from simple clearing arrangements to full monetary union. In this process, real integration went hand in hand with monetary cooperation. As a consequence, European determination to go step-by-step in the direction of a monetary union and a political union is seen as a model by many other regions facing similar challenges. However, it should not be forgotten that the conditions – both economic and political – to achieve such a result are simply not replicable and that European integration has now reached a critical juncture. The beginning of the integration process dates back to the end of the Second World War and in many respects European integration is a child of the Cold War (Holtfrerich, 2007). It was only after the confrontation between East and West emerged that

European politicians were willing to join forces and integrate the Western part of their wartime enemy, Germany.

Nevertheless, agreement among the Western European states that economic integration was necessary and would benefit all participants was rather easy to find. Belgium and Luxembourg had already formed a customs and monetary union in 1922 and agreed on a customs union with the Netherlands in 1947. Denmark, Sweden, Norway and Iceland considered forming a customs union in 1947, as did Greece and Turkey in the same year. The British government began negotiations with Sweden, Norway and Denmark in 1949 for a regional economic union. And France started negotiations in 1948 with Italy and the Benelux countries on an economic association for free trade and decontrol of foreign exchange. Only the Benelux customs union, however, reached the stage of implementation.

On the other hand, Western European countries were too heterogeneous for full political unification. The new principle, therefore, was a gradual approach: nation states should move in the direction of the final goal step-by-step and give up national sovereignty when and where it was acceptable to them. A limited transfer of sovereignty to a supranational institution would suffice for the time being to disentangle the problems of free access to Germany's coal resources and would integrate Germany into Western Europe on an equal footing, including with regard to European reconstruction. In 1957, the Treaty of Rome was signed instituting the European Economic Community (EEC). It aimed primarily at the free exchange of industrial goods and demanded an integrated foreign trade, transport and competition policy as well as a Common Agricultural Policy. Trade integration and a dismantling of trade barriers was the main target of the EEC dur-

ing the 1960s, as Europe was closely tied financially to the United States through the Bretton Woods monetary system.

When that system faded away in the early 1970s, financial stability stood high on the European agenda as a necessary complement to efficient trade relations. With closely integrated markets, members of the EEC had a strong interest in avoiding short-term exchange-rate instability between their currencies that would seriously compromise the functioning of markets; in particular, it would affect the organisation of the common agricultural market that relied entirely on a common price policy.<sup>17</sup> As a result, in April 1972 the European countries established a framework for limiting exchange-rate fluctuations among their currencies to  $\pm 2.25$  per cent ("the snake") within a band of  $\pm 4.5$  per cent to the dollar ("the tunnel"). With the floating of the dollar in 1973 the arrangement was reduced to a common float. Member countries were required to intervene with Community currencies to defend the internal margins of the "snake". At the outset, all EEC founding members participated in this arrangement. However, with increasing capital flows and oil price hikes in the 1970s, fluctuations of member currencies steeply increased and member countries found it more and more difficult to reconcile domestic macroeconomic policy requirements with exchange-rate discipline.<sup>18</sup>

In the late 1970s, with growing real integration and initiatives for greater political cooperation, Germany and France took the initiative to head for a much more comprehensive approach to European monetary integration. The newly-established European Monetary System (EMS) became effective in 1979 and, with some modifications, operated until the creation of the European Monetary Union in 1999. The EMS introduced fixed but adjustable exchange rates for the mem-

---

**The European integration experience is a unique case, in which monetary cooperation has progressed for more than 50 years.**

---



---

**In the late 1970s, with growing real integration and initiatives for greater political cooperation, Germany and France took the initiative by heading for a much more comprehensive approach to European monetary integration.**

---

ber countries of the European Union. A nascent form of common currency was created, the European Currency Unit (ECU): central banks participating in the EMS pooled together 20 per cent of their reserves in gold and dollars in the European Fund for Monetary Cooperation (EFMC); in exchange, the EFMC issued ECUs, which served for payments among the participating central banks.

### (b) *The European monetary system*

The core of the design of the EMS was the *parity grid*, a matrix of bilateral exchange rates vis-à-vis all the other ERM currencies. Until the 1992–1993 EMS crises, bilateral parities could move within a band of  $\pm 2.25$  per cent (for the Italian lira of  $\pm 6$  per cent), while after the crisis the band was widened to  $\pm 15$  per cent for all exchange rates. The symmetry of the bilateral parities implied that when currency A reached its *upper* intervention point (or depreciated) vis-à-vis currency B, currency B would simultaneously reach its *lower* intervention point (or appreciate) vis-à-vis currency A. Thus a currency pair drifting to its band limits implied that two central banks would be obliged to intervene.

Central banks could finance their interventions with very short-term financing. Within this mechanism each central bank opened an unlimited credit facility to all the others, but credits had to be repaid by the debtor central bank in assets other than its own currency, in principle six weeks after the end of the intervention month.<sup>19</sup> Thus, the central bank of the currency under threat of depreciation operated under a strict budget constraint and if the pressure continued was faced with the option of raising interest rates or devaluing. In contrast, interventions of the country with an appreciating currency actually increased its ECU balances and did not result in any pressure to change its policy stance. Hence the symmetry of the adjustment mechanism was only formal, since a speculative attack never changed the monetary policy stance of the strong-currency country but always forced substantial increases in short-term rates of the countries with weak currencies.

When the EMS came into operation its eight participants were rather heterogeneous in terms

of country size, per capita income, trade openness and macroeconomic fundamentals.<sup>20</sup> Thus the members did not meet the theoretical requirements for an “optimum currency area”. Convergence, in particular in monetary issues, was understood as a process that intraregional exchange-rate stability could help bring about. Given the credibility of Germany’s central bank and its extraordinary inflation performance, high-inflation EMS members used a stable nominal mark exchange rate as an external anchor to bring down domestic inflationary expectations at a time when, immediately after the second oil price explosion, inflation was a serious problem for most oil-importing countries.

During the first half of the 1980s, traditionally high-inflation countries had to depreciate time and again in order to restore their competitive position. However, the second half of the 1980s brought significant inflation convergence to the German level. The target of the European Council to create a “zone of monetary stability in Europe”, implying both relatively stable domestic price levels and stable exchange rates, seemed to have been achieved. While there had been 11 realignments up to 1987, no realignment occurred until the EMS crisis of 1992–1993. However the EMS, as every fixed exchange-rate system, was prone to the overvaluation of member states currencies and to speculative attacks.

The *nominal* exchange rate paths that the EMS members targeted vis-à-vis the mark were associated with very different real exchange-rate paths and competitive positions. While France, Denmark and the Benelux countries maintained a relatively stable real exchange rate vis-à-vis the mark, other member countries experienced massive real appreciations before 1992–1993 due to rising unit labour costs. The accumulated loss of competitiveness between 1987 and 1991 eventually amounted to 23 per cent for Italy and 28 per cent for the United Kingdom. This was reflected in a huge swing in their current accounts from surpluses to deficits.<sup>21</sup> This obviously unsustainable constellation triggered speculative attacks on the three big EMS currencies outside Germany.

When the tide of the global economy had turned in 1990, monetary policy in the United States quickly stepped in and lowered its interest rates. Germany’s economy, however, stimulated

by a unique boost of demand from the Eastern part of the country after its unification, did not show any sign of a slowdown. The German central bank eventually decided to stop the overheating of the economy by all means: it pushed policy interest rates in Germany to a high of 8 per cent in the summer of 1992, sending shock waves around the world and showing “utter disregard” of the policy impact on its European partners (Buiter, Corsetti and Pesenti, 1998: 41).

The big EMS crisis in 1992–1993 was solved by floating the British pound and by a sharp devaluation of the Italian lira. Italy temporarily resigned from the system and the United Kingdom completely retreated.<sup>22</sup> The French franc, despite being subject to fierce speculative attacks, did not devalue; it only widened its band in 1993 to  $\pm 15$  per cent.

In fact, France insisted that it had been playing within the rules of the game and deserved the kind of symmetric treatment that the letter of the European treaties had promised. Eventually France’s insistence proved to be justified. France, not unlike Austria and the Netherlands, had been able to preserve its competitive position after entering the EMS. The fact that France had been coming under pressure in the financial markets did not prove that its external situation was unsustainable. Notabene, its overall economic situation at the time was gloomy compared to Germany or Austria and depreciation would have been an easy way out of recession. However, the decision of the French government to insist on sticking to the “unwritten” rules of the game (using depreciation only in the case of an *external disequilibrium*) was confirmed in the end. In other words, the markets got it wrong in the French case whereas for the United Kingdom and Italy the attack was justified. The bold move of the French authorities to challenge the wisdom of the market proved to be right: The band was widened formally but the core rate of the French Franc never changed till it entered the EMU.

The 1992–1993 currency crisis in Europe highlighted the role that governments and central banks have to play by monitoring and steering the

system. Moderating capital flight out of the pound, the lira and the franc was justified in any case. However, thorough analysis of the fundamentals of the economies involved revealed that there was a need to adjust the pound and the lira to a certain extent but no need at all to adjust the franc. There was no reason to fear panic or a total collapse of the EMS.

The crisis phenomena and the waves of speculation occurring frequently in systems of fixed and semi-fixed exchange rates could give rise to the impression that an anchor approach to stabilize the external and the internal value of money is counterproductive in most cases. How-

ever, this is not always true. For instance, anchoring a small and very open country’s currency has in several cases proven to be a very effective method of stabilization of the domestic price level. The main economic policy target many anchoring countries had in mind was not the external value of money but its domestic value. Here is where the approach of “tying

your own hands” has proven to have its merits time and again.

This is definitely true for the small anchoring countries in Europe like Austria, the Netherlands and Belgium. In these countries inflation has been subdued for decades now in the same way as in their anchor country Germany and they have been able to adjust to shocks just as effectively. Moreover, the anchor approach has been successful in some larger countries like France and Italy as well. Although France fixed its exchange rate later than the smaller countries and the adjustment was not always as smooth, France managed to catch up fully with German inflation performance. Even a country like Italy, which was the subject of many speculative attacks and many backlashes in its adjustment process, finally converged in terms of growth rates of unit labour costs and flexibility in case of shocks. The growth rates of unit labour costs over time demonstrate the enormous convergence performance of the European countries (fig. 5.1)

Given the fact that recently the United Kingdom and the United States, i.e., countries with flexible exchange rates, have also been success-

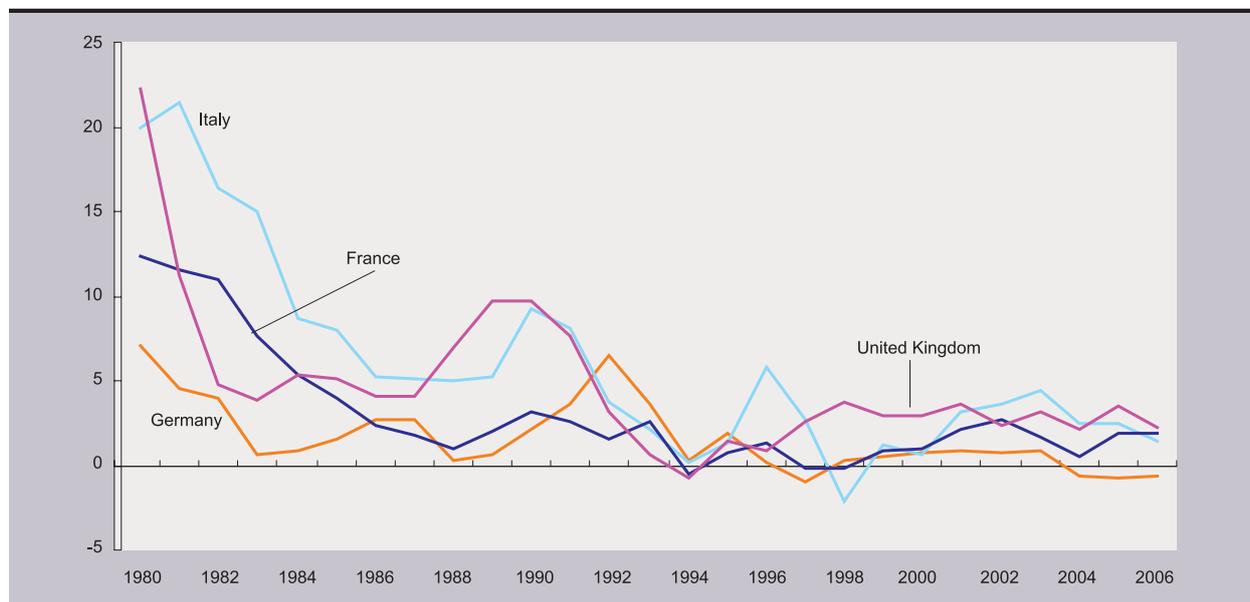
---

The 1992–1993 currency crisis in Europe highlighted the role that governments and central banks have to play in monitoring and steering the system.

---

Figure 5.1

**NOMINAL UNIT LABOUR COSTS, SELECTED EUROPEAN COUNTRIES, 1980–2006**  
(Annual percentage change)



**Source:** UNCTAD secretariat calculations, based on AMECO database.

**Note:** Data are for the total economy in national currency. 1980–1991 data for Germany refer to West Germany.

ful in terms of the speed and sustainability of their adjustment to shocks, the question arises as to whether this success has to be attributed mainly to the anchor approach or to other factors. Of course, Western industrialized countries have developed a variety of institutional arrangements concerning the labour and the goods markets to stabilize the internal value of money. Very different arrangements have proven successful in doing the job. However, for some countries' economies external pressure, e.g., pressure coming through the import and export channel, has been superior to domestic economic policy pressure alone. Italy is the most prominent example of a relatively large country where the domestic institutional framework has hardly ever been sufficient to stabilize monetary conditions.

The situation of candidates for membership in the European Economic and Monetary Union (EMU) changed dramatically one more time before 1997, the year in which the membership criteria, as decided by the European Council and laid down in the Treaty of Maastricht (1993), be-

came effective. Potential members had to adhere strictly to the so-called Maastricht criteria, limiting their control over macroeconomic policy submitting to expenditure cuts or tax increases in their public budgets. In addition, they had to fix their exchange rates absolutely, which meant in fact to follow the Bundesbank's monetary policy strictly during the two years prior to the official launching of the euro.

### (c) *The euro*

Despite some pain suffered by the member candidates in the run-up to monetary union, the euro was successfully launched – formally and technically – on 1 January 1999.<sup>23</sup> Member states obviously did not expect another dramatic change in Germany's economic conditions, but even before the formal start of the monetary union in 1999 Germany set off a deflationary race to the bottom. It de-coupled its cost level from the level of many other member countries by putting political

pressure on nominal and real wage growth. In fact, after 1996 the growth rates of unit labour cost fell consistently below the rates realized in Germany over many years before and below the pace consistent with the politically-agreed inflation target of close to 2 per cent. As nominal exchange rates were already fixed among the future members of the EMU, this meant a real depreciation for Germany.

From the narrow perspective of a German exporter, the strategy of wage disinflation has proved to be highly successful in boosting external competitiveness and net exports. Alas, the deflationary dynamics of German unit labour costs have pushed a number of EMU members into a very difficult position, experiencing a sharp and totally unexpected real appreciation. As a result,

Germany's current-account balance has improved from a deficit of \$27 billion in 1999 to a surplus of \$146 billion in 2006 – while its closest trading partners suffered corresponding movements into deficit. The irony is that, balancing domestic and external effects, Germany for a number of years has not really gained from its beggar-thy-neighbour policy. In large economies domestic demand is quantitatively more important than exports, and private consumption in Germany has stayed flat.<sup>24</sup> Meanwhile, the accumulated effects of improved competitiveness have dragged the economy out of stagnation. However, this policy of accumulating higher and higher surpluses and pushing other countries into a situation of permanently rising deficits is not sustainable and calls monetary coordination into question.

---

## E. Lessons for monetary cooperation

---

### 1. *There is no alternative to regional cooperation*

---

The European experience with different forms of monetary cooperation, which eventually led to full-fledged monetary union, offers some important lessons for developing countries. Firstly, to avoid adverse implications for trade and to ensure the smooth functioning of a common market, there is no viable alternative to some form of managed fixing or managed floating of the exchange rate. This implies that some form of cooperation in monetary affairs at the regional level or even beyond is unavoidable. Secondly, designing monetary cooperation in a format that includes full monetary union as the final target is clearly superior to monetary cooperation without such a target. Systems based on anchoring one country to another are hardly sustainable in the long term.

An implication of the first lesson is that most political and academic discussion of the subject misses the relevant points. The much-used approach of judging the chances of closer monetary cooperation against free floating is based on the so-called optimum currency area (OCA) approach (Wyplosz, 2006), an approach trying to find certain criteria in trade or in factor mobility between countries to define those countries for which monetary cooperation including a fixing of the exchange rate is rational. An implication of the OCA approach is to assume that for all countries not fulfilling these criteria should just choose floating of their exchange rate vis-à-vis all trading partners. However, the European experience at several stages of the process leading to monetary union reveals the general weakness of this approach. In Europe, free-floating exchange rates have never been regarded as a viable alternative to monetary cooperation because of the perceived

trade distortions of a solution based on the “rationality” of financial markets. The fact that governments knew all along the way that there is no easy alternative to monetary cooperation prepared the ground for increasingly closer monetary cooperation. In developing countries as well, the simplistic alternative of leaving it all to the market does not exist. Hence this is one of the rare cases of a valid TINA principle: There Is No Alternative to monetary cooperation!

Floating provides formal autonomy to monetary policy as the central bank is free to abstain from intervention in the foreign-exchange markets. However, in the same way as formal freedom does not imply material freedom, formal autonomy does not imply material autonomy. The latter would be warranted only if the market determined exchange rates by strictly following the purchasing power parity (PPP) rule, i.e., the changes in exchange rates between two countries would always exactly equal the inflation differentials between these countries. With short-term speculation in the financial markets, however, PPP, is only valid over extremely long periods.

The lively recent debate on carry trades (short term trades carrying money from low interest rate countries to high interest rate countries irrespective of their inflation rates) and much other evidence (chapter I of this *Report*; and *TDR 2004*) points to the fact that short-term flows are mainly driven by interest rate differentials, bringing about exactly the opposite of the effect expected by PPP over the short- and medium-run. Countries with relatively high inflation rates and consistently high interest rates are swamped by short term funds driving up their currencies in real terms, destroying absolute and comparative advantages and distorting the production structure between tradable and non-tradable goods. If this happens, formal monetary autonomy becomes an empty shell.

Once this is acknowledged, much simpler arguments can gain ground politically. In Europe, the argument that fixed exchange rates and a unified currency would be necessary to complete the common European market predominated in convincing politicians to take the next step towards

monetary union. In fact, however, there was another powerful argument in the political debate that never found its way into the academic mainstream. Germany had convinced its neighbouring countries that the internal stability of the value of money, which means stability of the domestic price

level, has been the most important tool in Germany for reaching other targets of economic policy, namely, more employment and higher growth rates of real income. This meant that the argument that the external stability of the price level in a common market would be as important as its internal stabil-

ity could hardly be rejected any more. Obviously, the political will to adhere to the same economic policy and a similar monetary model as well as the target to loosen the ties of the international capital markets and of the United States policy helped to build consensus.

As mentioned above, however, agreement on the overall policy approach in an anchor system is not tantamount to an optimal solution for all member states. The anchor country’s policy, even if it were perfect under the circumstances prevailing in the anchor country, is not automatically the perfect policy for the whole group tied to that country even if there is consensus about the inflation target. This had been one of the main problems of the Bretton Woods system in the first two decades after the Second World War. Monetary policy in the United States, as conducted by the Federal Reserve System, would only take into account the economic environment in the United States when formulating its decisions despite the dollar being the anchor currency of the global exchange-rate system. Germany, as the anchor of the European Monetary System, acted in exactly the same way. For the system as a whole such a policy approach is not automatically adequate.

In this situation, the rigorously necessary policy option for the long term points to monetary union. In a true multilateral monetary system all countries participate fully in the decision-making process and the economic conditions of the whole area determine the conduct of monetary policy. Nothing short of a monetary union can help to avoid systemic mismanagement of monetary policy

---

The external stability of the price level in a common market is as important as its internal stability.

---

in any region unified in the belief that the internal and the external value of money should be as constant as possible. In Europe, the drive to create the EMU was not only justified by the French government's determination to avoid economic and political domination by Germany indefinitely, as many have argued. From an economic point of view it was a fully justified step as well, given the fact that Germany as anchor could not be synchronized with European needs in an overall non-inflationary environment.

For very small, extremely open economies that are closely linked to an anchor country, the anchor approach can be adopted for a relatively long time if, by and large, the anchor country's economic policy follows reasonable principles and takes into account the interests of the smaller partners. But for any larger group or for countries of equal size and/or economic power, the anchor approach can only be a transitional stage on the way to monetary union. A consistent monetary policy is only possible for the group as a whole and can thus only be realized by a unified central bank. Nevertheless, the transitional phase may last very long. From the first steps to the very last it took Europe 30 years to achieve monetary union.

On the positive side, the formation of the different steps towards anchoring and monetary cooperation provides participating countries with an enormous degree of independence from the rest of the world, including the international financial markets and international financial organizations. If the anchor is economically strong and stable, the regional group will be able to solve its external problems as a group and no single country will have to apply to the international financial institutions or the financial markets. This is the main argument for small, open developing countries to fix their currencies even unilaterally. However, compared with the advantages of the different pre-monetary union stages, unilateral anchoring methods such as currency boards or

dollarization are less than second best. These systems lack the specific advantages of the pre-monetary union stages without being sufficiently isolated from the floating rate regimes surrounding them (*TDR 2001*; see also Akyüz, 2002).

In general, for the governments of very open economies that have high esteem for the stability of the internal and the external value of their money, monetary cooperation is a useful device. This can take the form of either South-South or North-South cooperation depending on the strength of the trade ties between cooperating countries. If a coalition of willing partners is able to stabilize price levels without instituting a particularly restrictive monetary policy, strong arguments can be presented in favour of a nominal convergence for all countries that are trading with one another. Volatile short-term capital flows, arbitrage and frequent over- and under-valuation can be avoided,

with all their severe consequences on the efficient allocation of resources and on the dynamics of adjustment.

Regional cooperation among Southern countries or between countries at similar levels of development is preferable if one of the targets of this cooperation is a "competitive" exchange rate vis-à-vis big trading partners in the developed world. The evidence supporting the importance of such an approach regarding

the creation of pro-growth macroeconomic and monetary conditions is widespread (Rodrik, 2005; *TDR 2006*, chap. IV). The real exchange rate with respect to high overall competitiveness is an important component of overall monetary conditions. As long as the major developed countries refuse to accept a new global monetary arrangement along the lines of the Bretton Woods system, developing countries, particularly those bound together by openness and close trade ties, should strive for monetary arrangements that will guarantee a high degree of overall export competitiveness and sufficient external monetary stability at the same time.

---

Regional cooperation among Southern countries or between countries at similar levels of development is preferable if one of the targets of this cooperation is a "competitive" exchange rate vis-à-vis big trading partners in the developed world.

---

## 2. Regional macroeconomic policy is key for growth

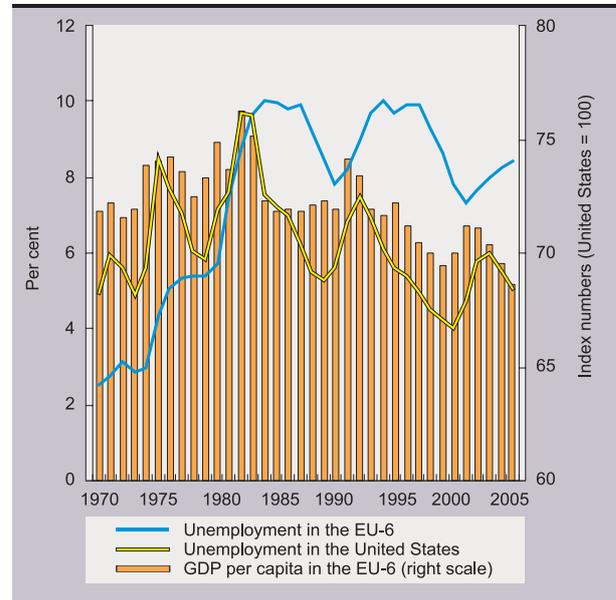
Given the success of European integration, the question remains as to why Europe did not succeed in its overall economic performance compared to the United States, especially since it de-coupled from the United States-led monetary arrangements of Bretton Woods. The economic performance of the six founding members of the EU has lagged behind that of the United States since the beginning of the 1970s. Surprisingly enough, the core countries of Europe were able to catch up impressively as long as they were members of a bigger global monetary arrangement led by the United States, the Bretton Woods system. After undocking from the big flagship they quickly lost ground in terms of GDP per capita and, even more important, in terms of unemployment (fig. 5.2)

Beyond data problems and a perceived preference for leisure in Europe, the search for reasons for this sudden drop has not yet provided convincing explanations. Based on the neoclassical conviction that long term growth cannot be influenced at all by short term economic policy, mainstream economic theory has mainly focused on so-called “fundamental structural changes” in Europe, like policy-induced inflexibility of the labour market or dramatic changes in the education system. The explanations of the lag in growth based on the preference for a voluntary increase in leisure in Europe explains only part of the observed divergence of per capita growth between core European countries and the United States (Blanchard and Wyplosz, 2004). The involuntary relative increase in leisure in the form of unemployment in Europe should not be ignored in such a comparison. There can be no doubt that since the middle of the 1970s the ability of Europe to contain the rise in unemployment by generating growth has been much less successful than in the United States.

This comes as a surprise to those observers who expected Europe, with its monetary anchor Germany, to make good use of the “monetary autonomy” that they gained after the demolition of the Bretton Woods system. Nevertheless, seen from another angle the main reasons for the failure to continue with a macroeconomic policy that

Figure 5.2

### UNEMPLOYMENT RATES AND GDP PER CAPITA: EU-6 AND THE UNITED STATES, 1970–2005



**Source:** UNCTAD secretariat calculations, based on OECD, *OLISNET* database.

**Note:** EU-6: Belgium, France, Germany, Italy, Luxembourg and the Netherlands.

was successful overall are easy to understand. Firstly, most of Europe experienced a strong real appreciation of their currency and the concomitant loss of competitiveness in relation to the dollar area after the end of Bretton Woods. Secondly and more importantly, the anchor country’s central bank, the German Bundesbank, in searching for a new and stricter monetary paradigm, began an affair with monetarism. Unfortunately, this affair resulted in a long-term policy stance that was much more restrictive than that of the Federal Reserve System before and after the end of Bretton Woods.

In the EU-6, the overall growth rate and short-term policy interest rate have fundamentally changed their relationship since the middle of the 1970s. Whereas Germany and the United States featured similar and very expansive monetary policy stances during the 1960s due to the dominance of the Federal Reserve System, the situation changed radically thereafter. The policy interest rate in Germany has been higher than in the United

States most of the time since the end of Bretton Woods and also higher than the domestic growth rate. This points to a permanent cap of economic policy on the growth rate and a resulting inability of the economy to escape the unemployment trap. In the United States, on the other hand, monetary policy turned out to be much more restrictive for a short period at the beginning of the 1980s but returned to the traditional expansionary stance soon thereafter.

The important lesson for developing countries is that national economic reform agendas cannot be successful without an adequate macroeconomic policy. The reform agendas of the 1980s and 1990s concentrated almost exclusively on making countries more responsive to market forces in order to improve resource allocation. Improvements in the incentive structure in all markets were combined with discretionary state intervention that was reduced to a minimum. The results of this strategy among developing countries were mixed. Evidence provided by a range of studies in this regard suggests that a more proactive government that supports capital accumulation and productivity enhancement is needed for a smooth integration into the international division of labour and as a basis for sustained improvements in the welfare and income of all groups of the population.

For successful development efforts at the national level, the formulation and effective implementation of a national development strategy is of key importance, along with taking the right approach towards macroeconomic policies. In many cases in the past, attempts to get microeconomic prices right were countered and nullified by macroeconomic policies that got the macro prices wrong. In other cases, structural character-

istics of national economies or asymmetries in global governance rules discouraged a successful implementation of reforms. Additionally, as has been pointed out in the second generation reforms debate, the successful implementation of any kind of policy such as proactive trade and industrial policies requires a complementary set of institutional and administrative capacities.

The most successful cases of economic catching-up, namely those in Asia, never followed the simplistic recommendations of the “sound macro-policies approach” as preached in many circles despite price stabilization being a key target of their economic policy. Indeed, the assignment of poli-

cies to reach this target was just the opposite of the orthodox approach. In the Asian model of stabilization, monetary policy stimulated investment and growth whereas heterodox tools were used to control inflation. Government income policy or direct government intervention into the goods and the labour markets were the preferred instruments for stabilizing the price level. In an environment of breakneck growth, with the clear danger of ending up with

an overheated economy, this approach has passed its acid test.

The theoretical basis for these kinds of pragmatic policies is the perception that higher fixed investment is not the result of higher planned savings of private households but rather the result of economic policy action. This approach requires a monetary policy that provides cheap financing to entrepreneurs and enterprises so that they can realize investment in new production techniques or new products. Such policy, in the orthodox view, is inflationary and is clearly avoided in the prevailing “sound” approaches to macroeconomic policy (*TDR 2006*, chap. I, annex 2; and chap. IV).

---

For successful development efforts, the formulation and effective implementation of a national development strategy is of key importance, along with taking the right approach towards macroeconomic policies.

---

---

## F. Conclusion

---

There is a growing recognition that global institutions by themselves are not able to promote developing-country interests. Thus, regional monetary and financial arrangements can offer the kind of sensitivity to and familiarity with local conditions – and not less important, the effective ownership – that are necessary for reconciling differing national needs and objectives with international opportunities and constraints. In particular, regional cooperation may provide decisive support for the management of exchange rates by the members of a regional bloc, without which further progress in trade integration would be very difficult. It may also expand the supply of long-term financing through the creation or reinforcement of regional financial institutions such as development banks and financial markets. Finally, it may reduce the vulnerability of the regional partners to the vagaries of the international financial markets by developing regional systems of payments and mutual financing, enforcing the use of national currencies and establishing regional mechanisms for policy coordination and macroeconomic surveillance.

At present, several developing countries have sought to reduce their financial vulnerability by accumulating large amounts of foreign reserves, thus creating a cushion of “self-defence” against external financial shocks. A regional approach – rather than one limited to the national level – may

be a more effective way of addressing these financial vulnerabilities. For instance, regional payment agreements that include clearing arrangements and the use of national currencies reduce the need for foreign “hard” currency and also diminish the cost of regional transactions. Furthermore, regional agreements on mutual credit and/or the pooling of part of the international reserves may also reduce the need for international reserves accumulation. To the extent that such credit and payment mechanisms, along with mutual insurance through regional agreements, reduce the amount that each country must keep in liquid foreign assets for transaction and precautionary reasons, financial resources are freed for more productive uses.

If an external financial shock affected simultaneously all members of a regional group of countries and did so with the same intensity, a regional financing agreement would be of little help. However, in general financial problems are localised initially and become a

regional or apparently “systemic” concern only after the problem spills over to other countries through a “contagion” process. If the initial difficulty is rapidly handled, not only would costs be minimised in the affected country, but also the contagion process might be avoided. Regional mechanisms are normally better equipped than multilateral institutions for rapid action since the member countries have a more effective ownership in its

---

**Regional efforts to strengthen financial cooperation do not preempt multilateral efforts aimed at improving the international financial system and promoting its greater coherence with the international trading system.**

---

governance and the disbursement of loans entails softer conditionality. In any case, given the size of the international capital markets there is no alternative to cooperation for small open economies.

In general, regional efforts to strengthen financial cooperation do not pre-empt multilateral efforts aimed at improving the international financial system and promoting its greater coherence with the international trading system. On the contrary, successful regional financial cooperation among developing countries may be one of the “building blocks” of an improved international monetary order. In fact, regional financing mechanisms may be either a substitute or a complement to international institutions. If the latter do not reform, regional agreements will be an alterna-

tive source of financial support even in the long run. But if international financial institutions change their orientation and governance structures in order to take into consideration better the needs and priorities of developing countries, then they could be the central office of a de-centralised monetary system in which regional funds would provide for the current financial needs of their constituents. The international institutions would thus function as a second-floor financing source, re-financing the regional institutions and acting as a lender of last resort in case of systemic crises. Eventually the organisation of regional monetary areas might become the cornerstone of a new international monetary system in which the hegemony of a key currency would be replaced by the principle of co-responsibility (Aglietta and Berrebi, 2007: 384). ■

---

## Notes

---

- 1 This organization was founded in 1948. It was responsible not only for allotting the Marshall Plan aid but also for making sure that the conditions tied to it by the American Administration would be met: the reduction of trade barriers within Europe and the creation of a European multilateral clearing system for transnational payments. By 1955 its members were Austria, the Benelux countries, Denmark, France, West Germany, Greece, Iceland, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.
- 2 The Santo Domingo Agreements (1969) provided short-term financing to central banks facing transitory problems for complying with the multilateral clearing. Each country committed an amount of financing related to its IMF quota, plus voluntary contributions (the main contributors were Argentina, Brazil, Mexico and the Bolivarian Republic of Venezuela). In 1981 two new facilities were added, one for balance-of-payments problems and one for natural catastrophes, with longer repayment terms. However, in 1984, a multilateral decision suspended the Santo Domingo Agreements due to the simultaneous liquidity problems faced by all central banks members.
- 3 At present, the monetary authority of the Bolivarian Republic of Venezuela has decided that all imports originating from other LAIA countries must use the RCPA mechanism. This is a way to reinforce its exchange control regime.
- 4 Six countries (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand) have each committed \$150 million; the remaining \$100 million is shared among Viet Nam (\$60 million), Myanmar (\$20 million), Cambodia (\$15 million) and the Lao People’s Democratic Republic (\$5 million) (Wang and Andersen 2002: 91).
- 5 Accessed at the website of the Ministry of Finance of Japan: [www.mof.go.jp/english/ifa/as3\\_070505.pdf](http://www.mof.go.jp/english/ifa/as3_070505.pdf)
- 6 At the meeting of the Ministers of Finance of Argentina, Bolivia, Brazil, Ecuador, Paraguay and the Bolivarian Republic of Venezuela in Quito in May

- 2007, the President of the host country called for the creation of a Fund of the South, which would pool part of the reserves of the participants. The Ministers agreed to postpone the discussion on the creation of that fund, and to strengthen the FLAR (*La Hora*, 3 May 2007, at: [www.lahora.com.ec](http://www.lahora.com.ec)).
- 7 Long-term debt issued by FLAR was rated A+ by Standard & Poor's in early 2007, which compares with the ratings of Bolivia (B-), Colombia (BB+), Costa Rica (BB), Ecuador (CCC), Peru (BB+) and the Bolivarian Republic of Venezuela (BB-).
  - 8 Non-founding country members of CAF are: Argentina, Brazil, Chile, Costa Rica, Dominican Republic, Jamaica, Mexico, Panama, Paraguay, Spain, Trinidad and Tobago and Uruguay.
  - 9 ALBA (Alternativa Bolivariana para la América) is a regional integration initiative comprised of Bolivia, Cuba, Nicaragua and the Bolivarian Republic of Venezuela.
  - 10 See Kahn (2005) for a discussion of the merits of a regional bond market in sub-Saharan Africa and Bobba, Della Corte and Powell (2007) for the large effect of the creation of the Euro on the size of the Euro bond market.
  - 11 Botswana and Swaziland began to issue their own currencies, the pula and the lilangi, in 1974 and Lesotho issued the loti in 1980, while the Namibian dollar came into existence only in 1993 following that country's independence in 1990.
  - 12 The South African Exchange Control Regulations even state that "Namibia, Lesotho and Swaziland should be treated as part of the domestic territory and not as foreign" (*Orders and Rules under the Exchange Control Regulations* (1998), Section Instructions, as published in Government Notice R1112 of 1 December 1961 and amended up to Government Notice R. 791. *Government Gazette* No. 18970, 5 June 1998). See also Okeahalam, 2002. As a result of these structures, the banking sector in all CMA countries complies with international banking standards and regulations such as Basel I.
  - 13 Grandes (2003) provides an econometric estimate for the synchronicity of business cycles in Southern Africa. Jenkins and Thomas (1997) show a long-term convergence in GDP per capita over a 30-year period. However, neither of these studies takes into account the influence of labour migration and remittance flows.
  - 14 Although not part of official CMA policy, immigration to South Africa from other CMA countries is widely accepted. However, labour migration has led increasingly to social friction between residents and migrants, to which the South African Government has reacted by tightening immigration laws. For more details and background information on migration issues, see the website of the Cape Town based South African Migration Project (SAMP) at: [www.queensu.ca/samp/](http://www.queensu.ca/samp/). Founded in 1996, SAMP is an international network of organizations that aims at raising awareness of the migration-development link within Southern African countries.
  - 15 See *Traité modifié de l'Union Economique et Monétaire Ouest Africaine* (2003); *Traité instituant la Communauté Economique et Monétaire de l'Afrique Centrale* (1994); and *Traité de l'Union Economique et Monétaire Ouest Africaine* (1994).
  - 16 Formerly the minimum share of foreign-exchange reserves to be deposited in the *compte d'operation* with the French Treasury had been 65 per cent. For the BCEAO and the BEAC, the share was reduced in September 2005 and January 2007 respectively, whereas the requirement remained at 65 per cent for the Comoros (Comité de Convergence, 2007).
  - 17 For many agricultural products intervention prices had to be set on an annual basis in a common currency. Thus fluctuating exchange rates would provide opportunities for arbitrage, which would impair or benefit local producers in an arbitrary way. To deal with the problem of adjustments of the official exchange rates, a complicated system of "green parities" and compensating payments had to be installed.
  - 18 The United Kingdom and Denmark joined the snake soon after its introduction but left it soon after that. Norway and Sweden became associated members. Italy stepped out in 1972 and France withdrew its membership twice, in 1974 and 1976. When Sweden opted out in 1977, participants in the snake only included Germany, the three Benelux states and Norway.
  - 19 After September 1997 (Bâle-Nyborg-Agreement) this period was extended to two months and a half.
  - 20 Their population varied from 360,000 inhabitants (Luxembourg) to more than 60 million inhabitants (Germany). The per capita income of the poorest country (Ireland) was only 58 per cent that of the wealthiest country (Netherlands). Inflation rates ranged from 15 per cent in Italy to 4 per cent in Germany, unemployment rates ranged from 8 per cent in Italy to 3 per cent in Germany and trade-to-GDP ratios from more than 50 per cent for the three Benelux countries to only 18 per cent for France. Even intraregional trade strongly varied, between 31.5 per cent of GDP in Belgium to 7.6 per cent of GDP in France (Bofinger and Flassbeck, 2000).
  - 21 Krugman's description of the European crisis as the "second generation model" of financial crisis is at least misleading. Krugman (1998) is weighing heavily the fiscal situation of the countries in crisis but doesn't take into account how quickly they all turned around after the depreciation of their currencies despite high budget deficits. There have not been several generations of models but only variations on one theme, namely loss of competitiveness and rising current-account deficits.

- 22 During 1992–1993 the Nordic countries (Finland, Norway, and Sweden) abandoned their peg to the ECU and accepted strong devaluations of their currencies.
- 23 In 1997, membership criteria for participation in the European Economic and Monetary Union (EMU) as decided by the European Council and laid down in the Treaty of Maastricht (1993) became effective. To these criteria belong fiscal targets, e.g., a budget deficit less than 3 per cent of GDP and public debt less than 60 per cent of GDP. Although elevated to an oft-repeated truism by developing countries as well, these so-called convergence criteria are based more on political considerations than on an economic foundation.
- 24 Ahearne and Pisani-Ferry (2006) find that domestic demand in Germany has barely grown since 1999. See Flassbeck and Spiecker (2000) for a more detailed exposition of this argument.

---

## References

---

- ABMI (2006). Progress report of the Asian Bond Market Initiative. AFDM+3, Pyang Chang, Korea, November. Available at: [http://asianbondsonline.adb.org/documents/Progress\\_Report\\_ABMI\\_Nov2006.pdf](http://asianbondsonline.adb.org/documents/Progress_Report_ABMI_Nov2006.pdf).
- AfDB (2007). Annual Report 2006. Tunis. African Development Bank Group, May.
- Aglietta M and Berrebi L (2007). *Désordres dans le Capitalisme Mondial*. Odile Jacob, Paris, March.
- Ahearne A and Pisani-Ferry J (2006). The Euro: Only for the Agile. Bruegel Policy Brief, Issue 2006/01. Available at: [www.bruegel.org](http://www.bruegel.org).
- Akyüz Y ed. (2002). *Reforming the Global Financial Architecture: Issues and Proposals*. UNCTAD, Third World Network and Zed Books.
- AMF (2003). *The Lending Activity*. United Arab Emirates. Arab Monetary Fund, June. Available at: [www.amf.org.ae](http://www.amf.org.ae).
- AMF (2006). *Annual Report 2005*. United Arab Emirates. Arab Monetary Fund, April. Available at: [www.amf.org.ae](http://www.amf.org.ae).
- Banco de Moçambique (2005). Integrated paper on recent economic developments in SADC. Maputo, October.
- Bank of Mauritius (2004). Integrated paper on recent economic developments in SADC. Port Louis, September.
- Bank of Namibia (2006). Integrated paper on recent economic developments in SADC. Windhoek, December.
- Banque de France (2005). Rapport annuel de la Zone franc 2005. At: [www.banque-france.fr/fr/eurosys/zonefr/page\\_2\\_2005.htm](http://www.banque-france.fr/fr/eurosys/zonefr/page_2_2005.htm).
- Blanchard O and Wyplosz C (2004). Deux thèses hétérodoxes sur l'économie européenne. En Temps Réel – CAHIER 14/15, June.
- Bobba M, Della Corte G and Powell A (2007). On the determinants of international currency choice: will the Euro dominate the world? Working Paper 611. Inter-American Development Bank.
- Bofinger P and Flassbeck H (2000). The European monetary system (1979–1988). Achievements, flaws and applicability to other regions of the world. Mimeo. Geneva, UNCTAD.
- Buiter WH, Corsetti G and Pesenti P (1998). *Financial Markets and European Monetary Coordination: The Lessons from the 1992–93 ERM Crisis*. Cambridge University Press.
- Butorina O (2006). Principles of monetary integration and their relevance for the CIS. In: Vinhas de Souza L, de Lombaerde P, eds. *The Periphery of the Euro: Monetary and Exchange Rate Policy in CIS Countries (Transition & Development)*. Aldershot and Burlington, VT, Ashgate Publishing Ltd.
- Central Bank of Lesotho (1996). Capital flows survey. Maseru.
- Comité de Convergence (2007). Rapport aux Ministres. Réunion des le Ministres d'Economie et des Fi-

- nances de la Zone Franc. Paris, Lomé, 4 and 5 April. Available at: [www.izf.net/IZF/Documentation/Rapports/ZFAvril2007/Rapport\\_Ministres\\_Comite\\_Convergence\\_5avril2007.pdf](http://www.izf.net/IZF/Documentation/Rapports/ZFAvril2007/Rapport_Ministres_Comite_Convergence_5avril2007.pdf).
- Committee of Central Bank Governors in SADC (2006). Annual Report 2005/2006. Reporting period 1 June 2005–31 July 2006. Available at: [www.reservebank.co.za/SADC/SADC.nsf/LADV/CE78D925487843A742257274002E464B/\\$File/CCBG+2006.pdf](http://www.reservebank.co.za/SADC/SADC.nsf/LADV/CE78D925487843A742257274002E464B/$File/CCBG+2006.pdf).
- Corm G (2006). The Arab Experience. In: Ocampo JA, ed. *Regional Financial Cooperation*. UN ECLAC-Brookings Institution Press, Chapter 10.
- Cowen D et al. (2006). Financial Integration in Asia: Recent Developments and Next Steps. Working Paper No. 196, International Monetary Fund, August.
- Culpeper R (2006). Reforming the Global Financial Architecture: The Potential of Regional Institutions. In: Ocampo JA, ed. *Regional Financial Cooperation*. UN ECLAC-Brookings Institution Press, Chapter 2.
- ECCB (2004). The Story of the EC Dollar and the Eastern Caribbean Central Bank – The Coming of Age of Small Island States. Eastern Caribbean Central Bank. Available at [www.eccb-centralbank.org/PublicAwareness/particles\\_5.asp](http://www.eccb-centralbank.org/PublicAwareness/particles_5.asp).
- ECCB (2007). Report and Statement of Accounts, Annual Report 2006/2007. St. Kitts, 31. Eastern Caribbean Central Bank, March. Available at: [www.eccb-centralbank.org/PDF/annual0607.pdf](http://www.eccb-centralbank.org/PDF/annual0607.pdf).
- Eichengreen B and Braga de Macedo J (2001). *The European Payments Union: History and Implications for the Evolution of the International Financial Architecture*. Paris, Organisation for Economic Co-operation and Development, March.
- EMEAP (2003). What is EMEAP? Its past, present and future. December. Available at: [www.emeap.org/](http://www.emeap.org/).
- EMEAP (2006). Working Group on Financial Markets. Review of the Asian Bond Fund 2 Initiative. At: [www.emeap.org/ABF/ABF2ReviewReport.pdf](http://www.emeap.org/ABF/ABF2ReviewReport.pdf).
- Flassbeck H and Spiecker F (2000). *Löhne und Arbeitslosigkeit im internationalen Vergleich*. Study for the Hans-Böckler-Stiftung und den Bundesvorstand des DGB. Available in German at: [www.flassbeck.de/pdf/2000/LoehneundArbeit.pdf](http://www.flassbeck.de/pdf/2000/LoehneundArbeit.pdf).
- Grandes M (2003). Macroeconomic convergence in Southern Africa: the Rand Zone Experience. Working Paper No. 231, OECD Development Centre. Paris, Organisation for Economic Co-operation and Development, December.
- Hanna D (2006). A new fiscal framework for GCC countries ahead of monetary union. International Economics Programme, IEP BP 06/02, Briefing Paper, May.
- Heard-Bey (2006). *Conflict Resolution and Regional Cooperation: the Role of the Gulf Cooperation Council 1970–2002*. Middle Eastern Studies, 42 (2): 199–222, March.
- Higgott R (2002). From trade-led to monetary-led regionalism. Why Asia in the 21st century will be different to Europe in the 20th century. UNU/CRIS *e-Working Papers*, W-2002/1.
- Holtfrerich (2007). *Post-1945 Western European Integration. The Foster Child of Vision, Crisis and Persistent Search for Compromise*. Mimeo.
- IDB (2006a). *Annual Report 2006: Latin America and the Caribbean in 2006*. Washington, DC, Inter-American Development Bank, January.
- IDB (2006b). Living with Debt: How to limit the risks of sovereign finance. Economic and social progress in Latin America. IPES 2007 Report. Inter-American Development Bank, August.
- IMF (2007). Eastern Caribbean Currency Union: 2006 Regional Discussion – Staff Report. Country Report No. 07/96. Washington, DC, International Monetary Fund, March.
- Jenkins C and Thomas L (1997). Is Southern Africa ready for regional monetary integration? LSE CREFSa Research Paper No. 10. London, Centre for Research into Economics and Finance in Southern Africa.
- Kahn B (2005). Original Sin and Bond Market Development in Sub-Saharan Africa. In: Teunissen JJ and Akkerman A, eds. *Africa in the World Economy: the National, Regional and International Challenges*. Fondad, The Hague.
- Krugman (1998). *What happened to Asia?* Presentation at a conference in Japan. Available at: <http://web.mit.edu/krugman/www/DISINTER.html>.
- Metzger M (2006). The Common Monetary Area in Southern Africa: a typical South-South coordination project? In: Fritz B and Metzger M, eds. *New Issues in Regional Monetary Coordination: Understanding North-South and South-South Arrangements*. Houndsmill, Palgrave Macmillan.
- Ministry of Finance, Japan (2006). Network of Bilateral Swap Arrangements (BSAs) under the Chiang Mai Initiative (CMI). As of 4 May 2006. Available at: [www.mof.go.jp/english/if/CMI\\_060504.pdf](http://www.mof.go.jp/english/if/CMI_060504.pdf).
- Nnanna OJ (2006). Economic and monetary integration in Africa. Paper presented at the G-24 meeting in Singapore, September. Available at: [www.g24.org/nnan0906.pdf](http://www.g24.org/nnan0906.pdf).
- Ocampo JA (2006). Regional Financial Cooperation: Experience and Challenges. In: Ocampo JA, ed. *Regional Financial Cooperation*, UN ECLAC-Brookings Institution Press, Chapter 1.
- Okeahalam CC (2002). Concentration in the banking sector of the Common Monetary Area of Southern Africa. Paper presented at the conference, Development Issues in the New Economy. University of Cape Town, Cape Town, 24–26 March.
- Park YC (2006). Regional financial integration in East Asia: Challenges and Prospects. In: Ocampo JA, ed. *Regional Financial Cooperation*. UN-ECLAC-Brookings Institution Press, Washington, DC.
- Park YC et al. (2006). Asian bond market development: rationale and strategies. In: Ocampo JA, ed. *Regional*

- Financial Cooperation. UN-ECLAC-Brookings Institution Press, Washington, DC.
- Pasin MC (2007). Financial integration in Latin America. Mimeo. Background paper prepared for UNCTAD's Trade and Development Report 2007.
- Rajan RS (2006). Monetary and financial cooperation in Asia: emerging trends and prospects. RSI-DP No. 207 (March). Research and Information System for Developing Countries, New Delhi, India.
- Rodrik D (2005). Rethinking Growth Strategies. In: Atkinson AB et al. *Wider Perspectives on Global Development*. Palgrave-Macmillan in association with UNU-WIDER, London.
- Rutledge E (2004). Establishing a successful GCC currency union. Preparations and future policy choices. Policy Paper, Gulf Research Center.
- SADC (2006a). Protocol on Finance and Investment. Maseru, Lesotho, 26 August.
- SADC (2006b). Sub-theme on trade, economic liberalization and development. SADC Secretariat. Paper prepared for the SADC consultative conference. Windhoek, 26–27 April.
- SADC Payment System Project (2006). Country-specific Progress Reports. Addendum report. Reporting period: April 2005–March 2006. Available at: [www.reservebank.co.za/SADC/SADC.nsf/LADV/EE4A070FF6B42213422572EA0044EA5D/\\$File/ADDENDUM.pdf](http://www.reservebank.co.za/SADC/SADC.nsf/LADV/EE4A070FF6B42213422572EA0044EA5D/$File/ADDENDUM.pdf).
- Sagasti F and Prada F (2006). Regional Development Banks: A Comparative Perspective. In: Ocampo JA, ed. *Regional Financial Cooperation*, UN ECLAC-Brookings Institution Press, Chapter 3.
- South African Reserve Bank (2007). *Quarterly Bulletin* No. 243. Pretoria, March.
- Sturm M and Siegfried N (2005). *Regional Monetary Integration in the Member States of the Gulf Cooperation Council*. European Central Bank, Occasional Paper Series, No. 31, June.
- Sy ANR (2006). Financial integration in the West African Economic and Monetary Union. Working Paper, No. 07/214. Washington, DC, International Monetary Fund, September.
- Traité de l'Union Economique et Monétaire Ouest Africaine (1994). Dakar, Senegal, 10 January. Available at: [www.banque-france.fr/fr/eurosys/telechar/zonefr/uemoa001.pdf](http://www.banque-france.fr/fr/eurosys/telechar/zonefr/uemoa001.pdf).
- Traité instituant la Communauté Economique et Monétaire de l'Afrique Centrale (1994). N'Djaména, 16 March. Available at: [www.beac.int/Textes/beac/trcemac.pdf](http://www.beac.int/Textes/beac/trcemac.pdf).
- Traité modifié de l'Union Economique et Monétaire Ouest Africaine (2003). Dakar, Senegal, 29 January. Available at: [www.uemoa.int/documents/TraitReviséUEMOA.pdf](http://www.uemoa.int/documents/TraitReviséUEMOA.pdf).
- UNCTAD (various issues). *Trade and Development Report*. United Nations publications, New York and Geneva.
- UN/DESA (2005). *World Economic and Social Survey 2005*, United Nations publication, sales no. E.05.II.C.1. United Nations Department of Economic and Social Affairs, New York.
- van den Boogaerde P and Tsangarides C (2005). Ten years after the CFA devaluation: progress toward regional integration in the WAEMU. Working Paper No. 05/145. Washington, DC, International Monetary Fund, July.
- Wang SD and Andersen L (2002). Regional financial cooperation in East Asia: The Chiang Mai Initiative and beyond. In: *Bulletin on Asia-Pacific Perspectives 2002/2003: Sustaining Growth amidst Uncertainties*, United Nations publication, New York.
- World Bank (2007). Independent Evaluation Group. *The Development Potential of Regional Programs: An Evaluation of World Bank Support of Multicountry Operations*. Washington, DC.
- Wyplosz C (2006). Deep Economic Integration: Is Europe a Blueprint? Paper presented to the *Asian Economic Policy Review* in Tokyo, April.
- Yehoue EB (2007). The CFA arrangements – more than just an aid substitute? Working Paper No. 07/19. Washington, DC, International Monetary Fund, January.

---

**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**  
**GENEVA**

---

# **TRADE AND DEVELOPMENT REPORT, 2007**

*Annex 1 to chapter V*

**THE SOUTHERN AFRICAN  
DEVELOPMENT COMMUNITY**



**UNITED NATIONS**  
New York and Geneva, 2007



**Annex 1 to chapter V**

## THE SOUTHERN AFRICAN DEVELOPMENT COMMUNITY

The Southern African Development Community (SADC) was founded in 1992 as the successor to the Southern African Development Coordination Conference (SADCC). It is comprised of 14 members: in addition to the five SACU countries, the other nine members are Angola, the Democratic Republic of the Congo, Madagascar, Malawi, Mauritius, Mozambique, the United Republic of Tanzania, Zambia and Zimbabwe. Regional integration is considered a means of alleviating poverty and redressing regional imbalances. With a trade protocol that came into effect in 2000 and a memorandum of understanding on macro-economic convergence, an ambitious programme for regional integration towards a customs union (2010), a common market (2015) and finally a monetary union (2018) have been initiated.

The Committee of Central Bank Governors of SADC, established in 1995, has initiated processes that should lead not only to greater macro-economic stability in the region and to the development of regional financial markets, but also to a more conducive environment for intra-regional trade flows. For example, considerable efforts have been made to harmonize national payments and clearing and settlement systems as well as to define a regional approach to cross-border payments (Committee of Central Bank Governors, 2006; SADC, 2006a; SADC Payment System Project, 2006). In August 2006, the Protocol on Finance and Investment was signed, which seeks to harmonize financial and investment policies. It aims at facilitating cross-border flows and prevent-

ing uncoordinated changes in investment policies by member countries in their efforts to attract FDI through fiscal and other incentives (SADC, 2006b). Effective implementation of the protocol would prevent a fiscal race to the bottom.

Furthermore, SADC is working towards full currency convertibility between member states to enable liberalization of capital and financial account transactions (SADC, 2006b: Annex 4, Articles 2–4). Regional coordination of the financial sector with regard to banking institutions, non-banking financial institutions, stock exchanges and development finance institutions is also envisaged. The 2006 Protocol establishes committees on tax, exchange control and payment settlement issues. However, it allows member countries considerable discretionary powers. For example, while the Protocol requires member states to accord equal treatment to intraregional and extraregional investors, it allows discrimination in the form of preferential treatment for certain investments and investors in order to achieve national development goals (SADC, 2006b, Annex 1, Articles 6 and 7). At this stage of regional integration, the strength of the Protocol is that it increases coherence in regional policies as it brings together finance- and investment-related issues that so far had only been discussed or developed separately.

Further regional integration in SADC is envisaged through setting a number of convergence criteria, including phased targets starting with a current-account deficit of 9 per cent of GDP and

Table 5.A1

**REAL EXCHANGE RATE VIS-À-VIS THE SOUTH AFRICAN RAND,  
SELECTED SADC COUNTRIES, 1990–2006**

Country	1990    1995    2000    2005    2006 (Index numbers, 1990 = 100)					Average annual change		
						1990– 2000	2000– 2006	1990– 2006
						(Per cent)		
Malawi	100	170	125	180	187	2.1	11.1	2.4
Mozambique	100	180	111	143	136	-1.6	4.0	-0.5
Madagascar	100	123	85	111	105	-2.5	8.5	-1.7
Zimbabwe	100	127	96	249	..	-0.1	30.5	-1.0
United Rep. of Tanzania	100	110	58	96	99	-6.4	12.5	-2.3
Mauritius	100	97	74	96	97	-3.0	6.6	-1.5
Swaziland	100	102	97	93	92	-0.7	-1.3	-0.9
Botswana	100	100	85	85	86	-1.4	0.6	-1.8
Namibia	100	99	88	85	84	-1.1	-1.1	-1.3
Lesotho	100	94	87	83	82	-1.2	-1.5	-1.1
Zambia	100	113	79	66	48	-3.8	-4.6	-4.5

**Source:** UNCTAD secretariat calculations, based on IMF, *International Financial Statistics*, April 2007; and IMF, *World Economic Outlook* database.

**Note:** The real exchange rate is derived from the nominal exchange rate adjusted for relative changes in consumer prices. Calculations are based on period averages. An increase (decrease) means a depreciation (appreciation) of the national currency to the rand. For Zimbabwe, annual average changes refer to 2000–2005 and 1990–2005.

a budget deficit of 5 per cent of GDP by 2008, and becoming increasingly tighter thereafter (Bank of Namibia, 2006: 25). A degree of flexibility is provided for countries that fall victim to external shocks from international commodity markets or bad harvests. In recent years the commodity price boom and debt relief for Malawi, Mozambique, the United Republic of Tanzania and Zambia under the Heavily Indebted Poor Countries (HIPC) debt Initiative have eased budgetary constraints and assisted efforts at converging budget deficits and public debt targets. These could also help overcome reluctance to lower customs duties, a reluctance partly motivated by fiscal considerations, thus facilitating intraregional trade liberalization.

Another convergence target is achieving a GDP growth rate of 7 per cent per annum by 2008, reflecting an ambition to reach the first Millennium Development Goal (MDG) of halving poverty in parallel with faster integration. Since the beginning of the new millennium, GDP growth has acceler-

ated in most SADC countries, but this positive development is largely the result of favourable external factors, especially the commodity price boom, rather than the result of closer regional cooperation, effective integration or changes in national development policies. Indeed, the SADC agreement does not specify areas of cooperation that are directly aimed at accelerating growth or employment creation.

Since the turn of the century, GDP growth rates of SADC members have been on the rise and converging. However, there has been no discernible degree of GDP per capita convergence. The share of SACU in total SADC GDP in 2005 was the same as it had been 15 years earlier. Apart from Angola and Zimbabwe, which have exhibited severe monetary instability and fiscal disorder, a process of monetary convergence can be observed among SADC members, again led by SACU countries (Bank of Namibia, 2006; Banco de Moçambique, 2005; Bank of Mauritius, 2004). Since 2000, both

inflation rates and nominal short-term central bank interest rates have been converging towards a lower level. This should facilitate intraregional trade flows since intraregional exchange-rate volatility is reduced and this will increase the reliability of prices. In addition, real appreciations of bilateral exchange rates of SADC countries vis-à-vis the rand can be reduced. These appreciations have frequently distorted intraregional trade flows. Since 1990, 7 out of 11 SADC countries for which longer time-series data were available have experienced real exchange-rate appreciations vis-à-vis the rand. This has been the case particularly for the four smaller members of SACU (table 5.A1).

Three of these have pegged their currency to the rand, while Botswana has pursued a regime of managed floating with an implicit exchange-rate target vis-à-vis the rand. Since 2000 the real exchange rates of the smaller members of SACU have changed only slightly, while Mauritius and the United Republic of Tanzania have considerably reduced their real overvaluation, thereby increasing their competitiveness. However, fluctuations in SADC real exchange rates have been extremely high due to monetary destabilization in some countries such as Malawi, Zambia and Zimbabwe, and due as well to wider swings in the exchange rate of the rand vis-à-vis the dollar and the euro. ■



---

**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**  
**GENEVA**

---

# **TRADE AND DEVELOPMENT REPORT, 2007**

*Annex 2 to chapter V*

**THE GULF COOPERATION COUNCIL**



**UNITED NATIONS**  
New York and Geneva, 2007



---

**Annex 2 to chapter V**

---

## THE GULF COOPERATION COUNCIL

The unstable political situation in West Asia at the end of the 1970s led six countries of the Gulf region, i.e. Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates to form the Gulf Cooperation Council (GCC) in 1981 (Heard-Bey, 2006: 199). Since its creation, the GCC has been following the standard economic integration steps: starting with a free trade area in 1983, it has established an effective customs union in 2003 and aims to implement a common market and a monetary union by the end of 2007 and 2010 respectively. Yemen, which had applied for GCC membership in 1996 and was accepted as an official candidate since 1999, joined GCC non-political bodies and agencies beginning in 2002 when Yemen and the GCC signed a protocol on their relations as an initial step towards membership. The main obstacle from the GCC countries' point of view is the different economic and political system of Yemen.

Membership in the monetary union does not strictly require the achievement of certain macro-economic criteria. However, GCC countries agreed that the convergence process has to be already started before the introduction of the common currency, the Gulf dinar (Rutledge, 2004). Therefore, in 2005 the GCC put into place a set of convergence criteria, similar to the Maastricht criteria of the European Union, which play the role of a barometer to gauge the readiness of member states for monetary union.<sup>1</sup>

At present, all of the members have their currency pegged to the dollar, officially from 2003 and in practice for more than twenty years. The

only exception being Kuwait, who prior to 2003 had pegged its currency to a basket of foreign currencies dominated by the dollar and against which it had let its currency fluctuate in a band of  $\pm 3.5$  per cent (Sturm and Siegfried, 2005: 35–36). Thus, excluding renegotiations, current bilateral exchange rates define the entrance rates to the monetary union and the replacement of national currencies by the Gulf dinar. The already-practiced peg to the dollar implies that the official transfer of monetary policy to a common central bank appears to be less costly for the GCC member countries than for other countries that lack a nominal peg. Moreover, this cost should be lower because of the heavy dependence on oil and external shocks that could affect the GCC economies in a similar way. However, the creation of a GCC central bank to which monetary policy will be transferred, as well as its institutional set-up, has not been announced as yet.

With the exception of Oman, GCC member countries have been closely following the monetary policy of the United States Federal Reserve to determine their interest rates since 1995. Together with the fixing of exchange rates in 2003, both the level and variability of inflation rates within the GCC has been decreasing in the new millennium. Fiscal revenues have been boosted since the oil price increase and in 2004 all GCC member states realized considerable budget surpluses. Accordingly, in case of a sharp decline in energy prices, the Gulf countries expect to face higher fiscal deficits and debt-to-GDP ratios as already experienced during the 1980s. Some sug-

gestions were made to take non-oil revenues as a parameter for fiscal balances (Hanna, 2006). However, national demand for the non-oil sector is largely based on oil income; thus, the economic performance of the non-oil sector depends on the oil price and non-oil revenues are expected to fluctuate as strongly as oil revenues (Rutledge, 2004).

For GCC member states the risk of overvaluation due to a nominal peg to an international key currency is relatively limited. First, with the exception of the years 1991 and 1995, GCC countries had negative inflation differentials compared to the United States between 1980 and 2003, even though these differentials were diminishing. In the beginning of the 1980s the inflation rate in United States decelerated faster than in the GCC, and from the middle of the 1980s the inflation rate in GCC had been gradually rising before it surged from 2004 onwards due to the oil price hike. Second, since they are rentier states and major energy exporters for which price elasticity of demand is low, moderate real exchange rate appreciation does not

constitute a major problem in the short run. However, if GCC member States aim at improving their manufacturing sector and strengthening their non-oil trade links with the United States and Asia, even moderate real appreciation might counteract their efforts in the long run. Third, both labour and unit labour costs in the private sector are highly flexible in the GCC member countries due to their dependence on expatriates, who form a buffer that minimises the price effects of shocks and therefore limits overvaluation. This assumes that the liberalization of intraregional labour mobility will be extended to expatriates (Rutledge, 2004). In contrast, GCC nationals are still mainly employed within the public sector. Fourth, if the weakening of the dollar against the euro is to continue, the EU market could become an important target for the GCC non-oil exports, permitting a further diversification of GCC economies despite moderate real appreciation versus the dollar. In fact, the EU is already the largest importing partner of GCC countries, although the trade balance with the EU has been negative for the last twenty years. ■

---

## Note

---

- 1 These criteria are: (i) a budget deficit under 3 per cent of GDP; (ii) public debt under 60 per cent of GDP; (iii) foreign-exchange reserves in excess of 4 months of imports; (iv) an interest rate not exceeding 2 per cent the average of the three coun-

tries with lowest inflation rates; and (v) an inflation rate not exceeding 2 per cent of the weighted average inflation of the total group. In 2006, Oman announced that it will join only at a later date (*Financial Times*, 12 December 2006).