



REGIONAL MONETARY  
COOPERATION AND  
GROWTH-ENHANCING POLICIES:  
**the new challenges**  
**for Latin America and the Caribbean**





UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**REGIONAL MONETARY COOPERATION  
AND GROWTH-ENHANCING POLICIES:  
THE NEW CHALLENGES FOR LATIN AMERICA  
AND THE CARIBBEAN**

Study prepared by the secretariat of the  
United Nations Conference on Trade and Development



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## PREFACE

Persistent global macroeconomic imbalances and financial fragility highlight the necessity of internationally coordinated policy responses and greater multilateral cooperation in the coming years. As this framework evolves, regional economic cooperation and integration arrangements are likely to play an increasingly prominent role in helping policy makers, at the national and international levels, cope with the vicissitudes of a globalized economy and to address key global development challenges.

In recent years, Latin American and Caribbean countries have shown a growing interest in policies and cooperation activities that aim to foster regional integration. Since 2008, the region has witnessed a surge of initiatives such as the Union of South American Nations (UNASUR), the *Banco del Sur*, and the *Fondo del Sur*, among others. With respect to enhancing regional monetary cooperation, particular importance has been given to the possible role of a common payments systems. Any such proposals for regional cooperation have to be based on sound macroeconomic analysis and a clear understanding of relevant conditions for rapid and sustainable growth, as well as an institutional framework to help close economic gaps among participating countries.

Latin America has, in fact, a long history of regional integration initiatives, with varying degrees of scope and intensity. However, a challenge common to all these initiatives has been to prevent the divergence of macroeconomic policies from undermining the strength and effectiveness of regional monetary cooperation. This challenge is faced even when external economic conditions are favourable but it is particularly true in conditions of global economic instability when increased regional cooperation appears even more urgent. In this respect, the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development of June 2009 noted “the value of regional and subregional cooperation efforts in meeting the challenges of the global economic crisis” and encouraged “enhanced regional and subregional cooperation, for example, through regional and subregional development banks, commercial and reserve currency arrangements, and other regional initiatives, as contributions to the multilateral response to the current crisis and to improved resilience to potential future crises.”

These critical issues fall squarely within the mandate of UNCTAD, whose tri-pillar approach combining research/analysis, consensus building and technical cooperation is particularly well suited to assisting policy makers in Member States. As part of its work-programme on global financial and monetary issues, UNCTAD has for many years advocated strengthened regional cooperation in these areas as one component of a successful integration of developing countries in the globalized world economy. It was thus encouraged to learn of the initiative of the Government of the Republic of Ecuador, in the context of its policy to drive forward reform of the existing international monetary and financial system and the creation of the *Presidential Commission for a New Regional Financial Architecture and Banco del Sur*. In September 2009, it was agreed that UNCTAD would deliver a series of technical support studies and activities to complement Ecuador’s own efforts to engage in the design of new regional financial arrangements appropriate to the challenges of the changing global economy.

The starting point of this UNCTAD study is the Ecuadorian proposal of the SUCRE, a virtual currency initially for use among the members of ALBA. This new payments system is intended to gradually but progressively replace the United States dollar as the invoicing currency of intra-regional trade. It is also seen as a tool not only for the strengthening of commercial ties, but also to move forward in the building of a new regional financial architecture.

The perspective of this UNCTAD study is that while the proposal points in the right direction of greater regional monetary and financial cooperation, it should be accompanied by more intense efforts of policy coordination, particularly with respect to exchange and interest rates, in order to achieve the expected outcomes in terms of trade, growth and employment. Because of this, emphasis is put on macroeconomic conditions and on the need to coordinate macroeconomic policies at the regional level.

An aim of this study is to foster further debate among technical experts and policy makers at the regional level, as well as to raise awareness and build consensus on the issue of regional monetary cooperation and its links to growth and development. In UNCTAD, we remain committed to extend technical assistance and additional support as requested by developing countries in this and other pivotal areas of multilateral and South-South economic cooperation.



Supachai Panitchpakdi  
Secretary-General of UNCTAD

## EXECUTIVE SUMMARY

Evidence suggests that a suitable development strategy for Latin America presupposes growth-oriented macroeconomic policies. In this regard, monetary policy is central to an integrated development policy framework to foster a virtuous circle of increased investment, rising productivity, job creation and expanding consumption. Investment creates both income for workers as well as profits for business. As wage growth feeds into consumption, company profits can be re-invested to sustain investment in the knowledge that the additional capacity will be matched by expanding markets, thereby enabling a virtuous circle of domestic demand-led growth. Growth-oriented monetary policy needs to be complemented by a competitive exchange rate that avoids a deficit on the current account.

Regional monetary cooperation can help maintain this circle by providing some degree of protection against external shocks. It can, in particular: help to shield the region against shocks of extra-regional origin if the cooperating countries respond in ways that properly internalize the impact of those policies on the region; and eliminate the threat of intra-regional shocks arising from competitive beggar-thy-neighbour strategies. In this way, regional monetary cooperation can make an important contribution toward establishing stable monetary conditions conducive to growth and development. However, it does not offer a substitute for growth-oriented macroeconomic policies. Moreover, successful regional monetary cooperation presupposes agreement on, and establishment of, a regional reference point for appropriate growth-oriented macroeconomic policies.

The SUCRE initiative, launched by the Bolivarian Republic of Venezuela, Bolivia, Cuba, Ecuador, Honduras and Nicaragua, aims at offering members an alternative system that offers the option to invoice intraregional trade transactions using a virtual unit of account, the SUCRE, and permitting the use of domestic currencies of the member countries for final clearing and settlement. The main objectives of the SUCRE initiative, namely to foster trade expansion, to balance trade among member countries and to decouple their currencies from the dollar, are important. But in the longer term, in order to reap the expected gains, it will be necessary to go beyond these targets by establishing a roadmap towards deeper integration; from trade-related initiatives to the overall goals of supporting competitive exchange rates and low real interest rates through full monetary cooperation in the region.

An important step to be taken at the beginning of the cooperation process would be to agree on the approach the region should take in terms of monetary and fiscal policies and the role of labour market institutions. Exchange rate shocks and persistent overvaluation of the currencies of developing countries are among the major hindrances to development and to reaping gains from international integration. High real interest rates are, more than anything else, associated with a combination of a lack of investment dynamics, weak productivity and weak employment performance.

Regional performance can be improved, first, if cooperation is able to buffer global monetary shocks better than national policies and, second, if it allows countries to conduct monetary policies conducive to growth without running the danger of an acceleration of inflation as soon as a recovery in real activity gathers pace. However, the ability to buffer shocks is the necessary condition for success. Even if a group of countries succeeded perfectly well in reducing the vulnerability of their currencies and smoothening the adjustment of the nominal exchange rate to the inflation differentials (which means stabilizing the real exchange rate over time), the right choice of the overall monetary regime, applied to the group as a whole, would remain essential for successful growth and job creation.





## Table of contents

	<i>Page</i>
<i>Preface</i> .....	iii
<i>Executive Summary</i> .....	v
<i>Acknowledgements</i> .....	viii
<i>Abbreviations</i> .....	ix
<b>Chapter I</b>	
<b>What Went Wrong? An Analysis of Growth and Macroeconomic Prices in Latin America</b> .....	1
A. Falling behind: Lack of dynamism in Latin America .....	1
1. What went wrong? .....	1
2. Getting the macroeconomic prices right .....	3
B. A closer look at macro prices in Latin America .....	5
1. Exchange rates: Growth-hindering trends among “peggers” and “floaters” .....	5
2. Macroeconomic policies and interest rate management in Latin America .....	10
C. Conclusions .....	14
Notes .....	15
<b>Chapter II</b>	
<b>Regional Monetary Cooperation for Growth-enhancing Policies</b> .....	17
A. The need for regional monetary cooperation .....	17
1. Limitations of the optimal currency area theory .....	18
2. Conditions for growth-enhancing effects of regional monetary cooperation .....	21
B. The need for a growth-oriented regional monetary regime .....	27
Notes .....	29
<b>Chapter III</b>	
<b>Regional Payment Systems and the SUCRE Initiative</b> .....	31
Introduction .....	31
A. General framework .....	31
B. A typology of regional payment systems .....	32
C. Lessons from past and present experiences .....	34
1. The European Payments Union .....	34
2. The Agreement on Reciprocal Payments and Credits (CPCR-LAIA) .....	37
3. The Asian Clearing Union .....	39
4. The system of payment in local currencies .....	40
D. The SUCRE initiative .....	42
1. An initial appraisal of the SUCRE initiative .....	42
2. An evaluation of the SUCRE as a virtual currency .....	43
E. Conclusions .....	46
Notes .....	48
<b>Chapter IV</b>	
<b>Policy Conclusions</b> .....	51
A. The relevance of money and currencies for economic development .....	51
B. Diminished importance of savings .....	52
C. New economic policies for growth and employment .....	53
D. No automatic gains from regional cooperation .....	56
E. Macro prices and the SUCRE initiative .....	56
F. The SUCRE initiative and the way towards a new common economic policy .....	57
<b>Annex 1: Why homogeneity of macroeconomic regimes can bolster regional cooperation:</b> Latin America and South-East Asia compared .....	59
<b>Annex 2: Sequencing of trade and monetary cooperation:</b> Experiences in Europe, South-East Asia and Latin America compared .....	63
<b>Annex 3: Monetary anchors in regional monetary cooperation and integration:</b> Experiences in Europe and South-East Asia .....	65
<b>References</b> .....	69

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## **Abbreviations**

ACU	Asian Clearing Union
ADB	Asian Development Bank
ALBA	Bolivarian Alliance for the Peoples of Our America (Alianza Bolivariana para los Pueblos de Nuestra América)
AMU	Asian Monetary Unit
ASEAN	Association of Southeast Asian Nations
CAF	Andean Development Corporation
CCC	Central Unit of Compensation (Camara Central de Compensacion, SUCRE initiative)
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralization
CPCR-LAIA	Agreement on Reciprocal Payments and Credits of the Latin American Integration Association
EMS	European Monetary System
EPU	European Payments Union
FLAR	Latin American Reserve Fund (Fondo Latinoamericano de Reservas)
FLAR	Regional reserve fund
GDP	Gross domestic product
GFCF	Gross fixed capital formation
IADB	Inter-American Development Bank
IMF	International Monetary Fund
LAIA	Latin American Integration Association (ALADI – Asociación Latinoamericana de Integración)
LCB	Local currency bond
LIBOR	London inter-bank offer rate
MERCOSUR	Common Market of the South (Mercado Comùn del Sur)
OCA	Optimum currency area
PPP	Purchasing power parity
REER	Real effective exchange rate
SML	System of Payment in Local Currency (Sistema de Pagos en Moneda Local)
SUCRE	Unified System for Regional Compensation (Sistema Unitario de Compensación Regional)
TDR	Trade and Development Report
UNASUR	South American Union (Unión de Naciones Suramericanas)
UNCTAD	United Nations Conference on Trade and Development



## **Chapter I**

# **WHAT WENT WRONG? AN ANALYSIS OF GROWTH AND MACROECONOMIC PRICES IN LATIN AMERICA**

## **A. Falling behind: Lack of dynamism in Latin America**

During the past few decades some regions in the developing world – particularly the so-called late industrializers in South-East and South Asia – have been successful in their efforts at “catching up” with developed countries. Latin America, on the other hand, has been “falling behind” in terms of economic growth and investment (UNCTAD, 2003; Palma 2010). Both regions started with a similar GDP per capita level in 1980, yet, unlike Latin America, the Asian economies found a sustainable way of narrowing the income gap (figure 1.1). During the 1980s and 1990s, the annual rate of real GDP growth in Latin America averaged 2–2.5 per cent – a growth rate only about half that of the 1960s and 1970s (UNCTAD, 2006). It started to pick up somewhat during the global boom period from 2003 to 2008, but nevertheless growth still remained much lower than in Asia.

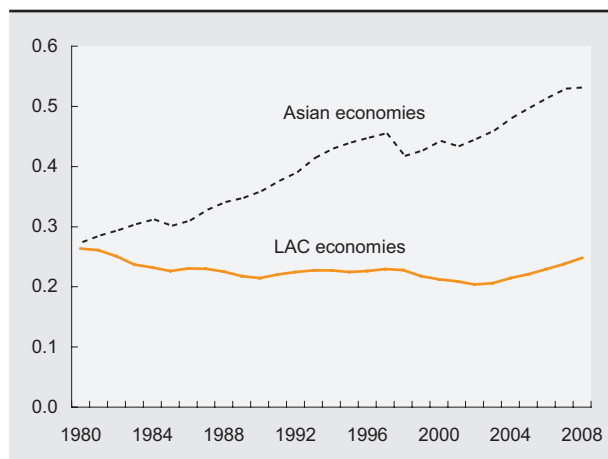
### **1. What went wrong?**

The strong differences in regional growth performance show that globalization does not guarantee uniform economic outcomes. Indeed, globalization – or integration into global markets under conditions of liberalized trade and capital flows and an international monetary system of flexible exchange rates – has delivered very uneven outcomes: it has enabled some countries to catch

up, but has not prevented others from falling behind (UNDESA, 2006). It is increasingly recognized that the adoption of alternative development strategies that deviate from the rapid liberalization of trade and financial flows explain some of the differences in the degree to which countries have reaped gains from globalization (Flassbeck and La Marca, 2007).

This explanation is not limited to structural policies alone; macroeconomic conditions, which are related to the strategic options and the policy space available, are also a significant part of the picture. Latin American countries have been important laboratories of the most liberal versions of structural reforms. They also provide outstanding examples of how long-term economic performance can be affected by misguided short-term macroeconomic policies, and of how shocks can be induced by “wrong” macroeconomic prices. Therefore, to understand what went wrong in the region, it is necessary to analyse the dynamics of the key macroeconomic variables that determine economic growth, particularly real exchange rates and real interest rates.

There is widespread agreement that growth cannot be sustained without an adequate level of investment. Empirical evidence confirms that strong and sustained growth of domestic investment, often from very low levels, has been a defining feature of successful development episodes in the post-war period. More specifically, in order to achieve

**Figure 1.1****COMPARISON OF THE RATIOS OF AVERAGE GDP OF SELECTED LATIN AMERICAN AND ASIAN ECONOMIES TO THAT OF G-7, 1980–2008***(Simple averages)*

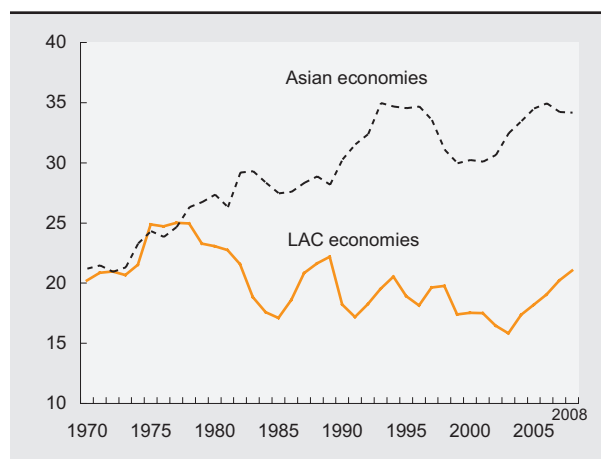
**Source:** UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database.

**Note:** LAC economies comprise in this figure: Antigua and Barbuda, Argentina, the Bolivarian Republic of Venezuela, Bolivia, Brazil, Chile, Colombia, Dominica, Ecuador, Guyana, Honduras, Nicaragua, Paraguay, Peru, St. Vincent and the Grenadines, Suriname and Uruguay. Asian economies comprise in this figure: China, Hong Kong (China), Indonesia, Malaysia, the Philippines, the Republic of Korea, Singapore and Thailand. G-7 comprises: Canada, France, Germany, Japan, Italy, the United Kingdom and the United States.

satisfactory growth performance, a minimum of 20 per cent of fixed investment in gross domestic product (GDP) has been suggested as a target threshold in poorer countries, rising to 25 per cent as countries' income levels increase (UNCTAD, 2006). However, in Latin America neither the levels nor the trends of investment – measured as gross fixed capital formation (GFCF) as a percentage of GDP – have reached this benchmark, in stark contrast to the Asian economies (figure 1.2 and figure 1.3). Some Asian economies have displayed a clear and fairly stable upward trend in investment ratios (only briefly interrupted during the period 1997–1999 as a consequence of the Asian financial crisis<sup>1</sup>), but there has been no such upward trend in Latin American economies. Both regions started at similar investment levels during the first half of the 1970s, but since 1977, their development paths began to diverge. In Latin America, the “recovery”, which began in the late 1980s, has never returned to earlier levels. The region has steadily fallen further and further behind the

G-7 and Asian economies (figure 1.1). The economies in the region rarely achieved the minimum threshold of 20 per cent of GDP during this period.

A variety of reasons have been mooted for the notable divergences between Asia and Latin America, but undoubtedly one event has been decisive: the impact of the so-called “debt crisis” of the early 1980s. This crisis marked a watershed in the investment regime by throwing many developing countries, including in Latin America, off their long-term growth path. The Latin American region felt the impact of the crisis much more strongly than did some other developing regions, particularly the emerging-market economies in Asia. However, the persistently weak investment performance should not be considered as simply the result of the debt crisis. With few exceptions, countries in the region have been unable to remove structural and institutional impediments to rapid and sustained accumulation, growth and diversification. This should be analysed in terms of the policies implemented to create a pro-growth environment.

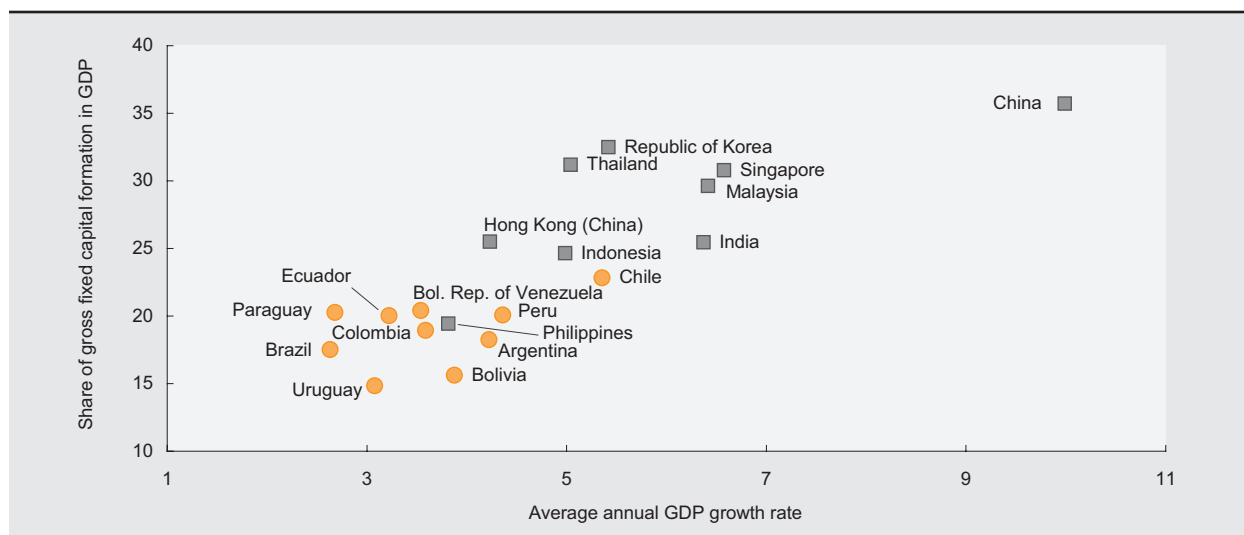
**Figure 1.2****SHARE OF GROSS FIXED CAPITAL FORMATION IN GDP, SELECTED ASIAN AND LATIN AMERICAN ECONOMIES, WEIGHTED REGIONAL AVERAGES, 1970–2008***(Per cent)*

**Source:** UNCTAD secretariat calculations, based on World Bank, *World Development Indicators* database.

**Note:** LAC economies comprise in this figure: Argentina, the Bolivarian Republic of Venezuela, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Honduras, Nicaragua, Paraguay, Peru and Uruguay. Asian economies comprise in this figure: China, Hong Kong (China), Indonesia, Malaysia, the Philippines, the Republic of Korea, Singapore and Thailand.

Figure 1.3

**CORRELATION BETWEEN GROSS FIXED CAPITAL FORMATION (AS A PERCENTAGE OF GDP)  
AND AVERAGE ANNUAL RATE OF GDP GROWTH, SELECTED ECONOMIES, 1990–2008**  
(Per cent)



**Source:** UNCTAD secretariat calculations, based on World Bank, World Development Indicators database.

**Note:** GDP refers to GDP at constant 2000 United States dollars.

The debt crisis was followed by a period of drastic policy changes for many countries in the region. Strategies adopted to induce capital accumulation and growth were based on a combination of attracting foreign direct investment (FDI), along with privatization, public spending cuts and reduced policy intervention. Since these measures were introduced, most countries in the region have made progress on some measures of macroeconomic performance. They have been able to overcome rapid inflation, in some cases hyperinflation, and establish a reasonable degree of monetary and fiscal discipline. However, macroeconomic stability is not just about stability of prices in goods markets. Even though inflation has been brought under control, overall macroeconomic conditions, including key prices such as real wages, exchange rates, interest rates and asset prices, that exert a strong influence on resource allocation and investment decisions, have been extremely unstable in most countries in the region. This has partly been due to external vulnerability associated with trade and financial shocks, and partly to a loss of macroeconomic policy autonomy resulting from rapid liberalization and close integration into the global economy. Furthermore, rather than “getting prices right”, as promised in the Washington Consensus, macroeconomic prices were kept at levels that have impeded rapid capital accumulation and economic

diversification. The disappointing results were indicated in the three figures presented above (figures 1.1 to 1.3).

In summary, the new macroeconomic policy orientation has failed to establish a virtuous circle between investment, productivity growth and wages which could encourage firms to expand at home and abroad. Neither has there been effective policy interventions at the sectoral and micro levels of the kind practiced in East Asia to support structural transformation and technological upgrading. In both respects, the Washington Consensus had its influence on economic policy in the region.

## 2. Getting the macroeconomic prices right

For developing countries with rather small and undiversified markets and fragile domestic financial systems, effective use of the instruments they have at their disposal for short- and medium-term macroeconomic management is extremely important. An overemphasis on resolving structural problems and on macroeconomic “soundness” for efficient resource allocation – as under the reform agenda of the so-called Washington Consensus – is

inadequate. Indeed, by focusing on static efficiency, the Washington Consensus neglected the advantages created by dynamic investment. If the interest rate and the exchange rate are understood as the key macroeconomic variables for creating an investment-stimulating macroeconomic environment, the conduct of short-term policies is critical because of its long-term structural consequences.

As discussed in the previous section, policies pursued to eliminate inflation in Latin America in the 1980s and 1990s served to undermine macroeconomic fundamentals and adjustment of the productive structure due to the evolution of the exchange rate, real interest rates, as well as both fiscal and external accounts. In particular, countries applying exchange-rate-based stabilization programmes and an opening up of their capital account experienced a great sacrifice in terms of growth and employment.

A growth-oriented macroeconomic regime should aim at an exchange rate that is:

- **Competitive in real terms**, in the sense of avoiding unsustainable current-account deficits;
- **Stable in real terms**, with the aim of reducing the investment risk; and
- **Nominally adjustable**, to be able to adapt to circumstantial shifts and correct for idiosyncratic shocks.

At the same time, this regime should aim at keeping real interest rates stable, low and below the real GDP growth rate:

- **Stable**, in order to reduce uncertainty in the investment-decision-making process, enabling stable profit expectations;
- **Low**, so as to ensure that real investment will be preferred to investment in financial assets, which as a rough rule implies that they are below the real GDP growth rate.

The exchange rate is one variable with visible and lasting positive effects on investment and growth

(Rodrik, 2008; Eichengreen, 2008). The appropriate variable to be observed and monitored for achieving economic competitiveness is not the nominal, but the real exchange rate. Indeed, the real effective exchange rate (REER) is the most important measure of competitiveness for the overall economy (box 1).

Preventing repeated boom-bust cycles and associated vulnerability by means of a competitive exchange rate also opens up space for countercyclical policies that have proved to be the key to pro-development macroeconomic management in general, and in the event of global shocks in particular. As for the interest rate, it not only represents the price of investment financing and the opportunity cost of not keeping wealth in purely financial assets; it is also the variable that is most directly determined by monetary policy and macroeconomic policies more generally.

In most cases of successful catching up, inflation has not been the sole target of monetary policy, but part of a broader set of macroeconomic targets, and often with non-monetary instruments that intervene more directly in goods and labour markets (Flassbeck et al., 2005). An incomes policy is one such measure which can be used to keep inflation at a low and stable level by linking real wage increases to expected productivity growth.

Hence, getting the macro prices right is an essential condition for successful economic development. Whether it can be achieved in a globalized economy still depends very much on the economic policy approach chosen by the national authorities but just as critically on support from appropriate multilateral rules and mechanisms in the context of global economic governance. The focus has to be on a short- and medium-term macroeconomic policy mix. At the heart of this policy orientation should be exchange rate and monetary policies that are favourable to investment, with a complementary role for fiscal and incomes policies and other structural tools. In this framework, controlling inflation is not the main goal, but rather one of a broader set of goals, on both the supply and demand sides, that are required to ensure rapid and balanced growth and development.



**Box 1****NOMINAL, REAL AND EFFECTIVE EXCHANGE RATES**

A simple way to explain the exchange rate is to view it as “the price of foreign currency”. For example, one dollar costs three pesos, and this rate can be used to compare the prices of goods and services across different countries. But this simple concept – the nominal exchange rate – is misleading, or at the very least it provides only a partial picture of international competitiveness.

To express the real purchasing power of a currency in international transactions – or in other words, to assess the real cost of the exports of a country in external markets – it is necessary to take into account the inflation differential between this country and the issuer of the reference currency – generally the United States. This constitutes the real exchange rate, expressed by the formula:

$$e = E \cdot \frac{\Pi^*}{\Pi}$$

where E is the nominal exchange rate,  $\Pi^*$  is the inflation rate in the reference country and  $\Pi$  is the domestic inflation rate.

The reason for finding out the real exchange rate this calculation is that variations in nominal rates can only reflect movements in domestic prices, and does not indicate the quantities of domestic goods that could be bought with the same amount of foreign currency. In other words, while the *nominal exchange rate* measures the value of the currency with respect to another currency, the *real exchange rate* is the crucial measure for assessing the value of a country’s goods against the value of goods from another country.

But this concept still gives an incomplete picture. Since exports and imports of a country will be affected by the changes of one currency against all other relevant currencies (and not only by exports and imports to and from the issuer of the reference currency), nominal exchange rate and inflation rate differentials relating to all the relevant trading partners matter, and thus need to be included in the calculations. This is the concept of the REER, which is the most appropriate measure of overall competitiveness of a country, as it includes the level of trade-weighted exchange rates with all trading partners of a country.

## B. A closer look at macro prices in Latin America

### 1. *Exchange rates: Growth-hindering trends among “peggers” and “floaters”*

Discussions about exchange rate policy often focus on formal or institutional aspects, especially where developing countries are concerned. Following the financial crises in emerging-market economies during the 1980s, a broad consensus emerged, that an efficient exchange rate regime lies in one of the so-called “corner solutions” of absolute fixing or free floating.

However, the idea that either of these “corners” offer an easy form of exchange rate management is

flawed. Indeed, the dismal experience of the past few decades highlights the problems with both solutions (UNCTAD, 2001). Floating regimes have proved to be highly unstable, leading to repeated boom and bust cycles and periods of high volatility. And in most cases the experience with unilateral hard pegs has not been satisfactory either, since inflation differential tends to persist, that leads to an overvaluation of the real exchange rate. Indeed, the danger exists of an *overvaluation trap*, where the nominal exchange rate cannot be corrected in the face of an external shock.

In Latin America, a variety of exchange rate regimes directed towards one or the other of the

“corner solutions” can be found (figure 1.4). There is, moreover, a certain geographical pattern in the preference for one corner rather than the other. Many of the economies comprising the Bolivarian Alliance for the Peoples of Our America (ALBA) adopted the extreme solution of fixing the exchange rate in varying degrees, through currency board arrangements (Antigua and Barbuda, Dominica, Saint Vincent and the Grenadines), other fixed peg arrangements (the Bolivarian Republic of Venezuela, Guyana and Honduras), a crawling peg (Bolivia, Nicaragua) or full dollarization (Ecuador). In contrast, the South American Union, UNASUR, in general opted for the form of managed floating (Argentina, Colombia, Peru, Paraguay and Uruguay) or independent floating (Brazil and Chile), again with marked differences among the countries.<sup>2</sup>

In the following, this classification by corner solution is used to highlight the distinct problems encountered by each of two groups: the “peggers” (corresponding to ALBA members) and the “floaters” (UNASUR economies that are not also ALBA members).

### 1.1 Flexible exchange rate regimes: The case of UNASUR members

Economic theory predicts that in flexible exchange rate regimes, market forces will smoothly adjust exchange rates to their “equilibrium” level. According to textbook modelling, changes in foreign currency prices are a response to temporary disequilibria between demand and supply. Such flexibility, would allow external accounts to balance automatically, leaving no room for permanent misalignments.

In practice, results for the Latin American economies that have adopted a flexible exchange rate regime are rather different: even considering a short-term horizon such as 2006–2009, nominal exchange rates have been highly volatile, with visible procyclical upward and downward trends among countries (figure 1.4.a). When considering the more relevant concept of the REER (box 1) over a longer period of analysis, similar problems are encountered (see figure 1.5.a). When analysing the dynamics of REERs in these cases, three common features are noticeable: visible shocks during the period 2001–2002, a clear trend towards appreciation from

2003 onwards (with the exception of Argentina), and a V-effect as a result of the recent global economic downturn. The strong trend of appreciation of most of the currencies during the global boom period from 2003 to 2008 is a main explanation for the lower average growth rate of the region, compared to other developing regions over the same period. After a steep depreciation in 2008, in 2009 there was again a strong trend towards appreciation, and with it the risk of a repetition of this pattern for the region. These results are far from the best-case scenario of competitive and stable real exchange rates discussed earlier.

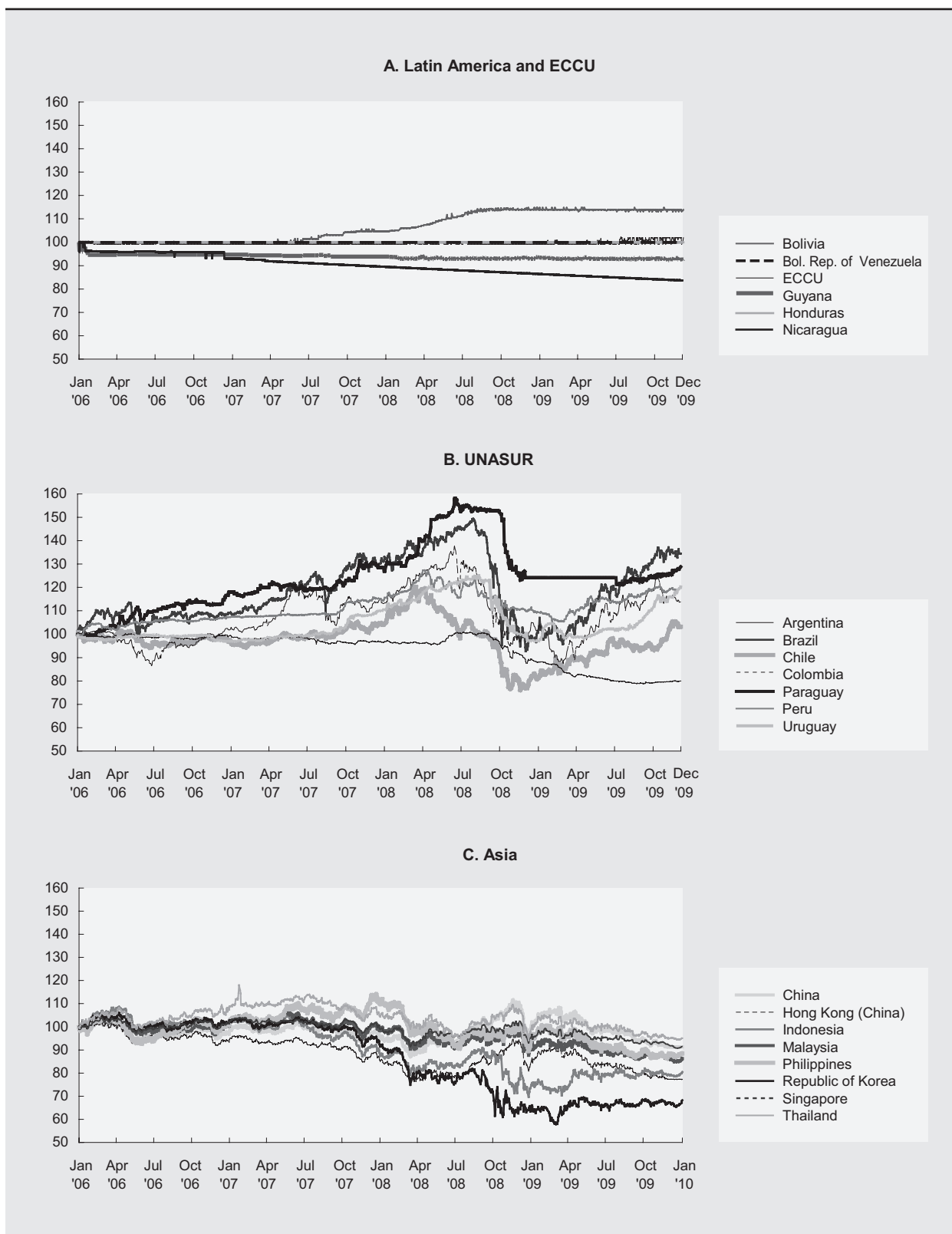
The V-effect in real exchange rates from July 2008 to mid-2009 was the result of nominal exchange rate fluctuations, given the moderate or low levels of inflation in these economies during the period covered. As figure 1.4 shows, during the recent global crisis, the currencies were moving in the same direction, although with wide differences, in an extreme episode of sudden change. How can this cyclical and volatility be explained?

A currency will tend to appreciate in nominal terms whenever demand for it is greater than its supply. In other words, this upward trend is the result of an excess of foreign currency in the foreign exchange market. An increase in demand for the national currency (or an excess of foreign currency) can be due to an increase in the demand for money either for transaction purposes or for speculative purposes. In other words, the movement of the nominal exchange rate can be driven by “real” or “financial” operations. For the countries presented in the figures above, both have played a significant role.

### 1.2 Speculative financial flows

An overvalued exchange rate has been closely linked to strong capital inflows, initially encouraged by the success of the Brady process, reinforced by the Washington Consensus reforms, and to the success in halting hyperinflation. For the economies with full access to international financial markets, part of the explanation for the appreciation (and volatility) of their currencies can be found in currency speculation – so-called currency *carry-trade* flows. This type of speculation is an “investment” strategy that is essentially based on arbitrage between interest rates.

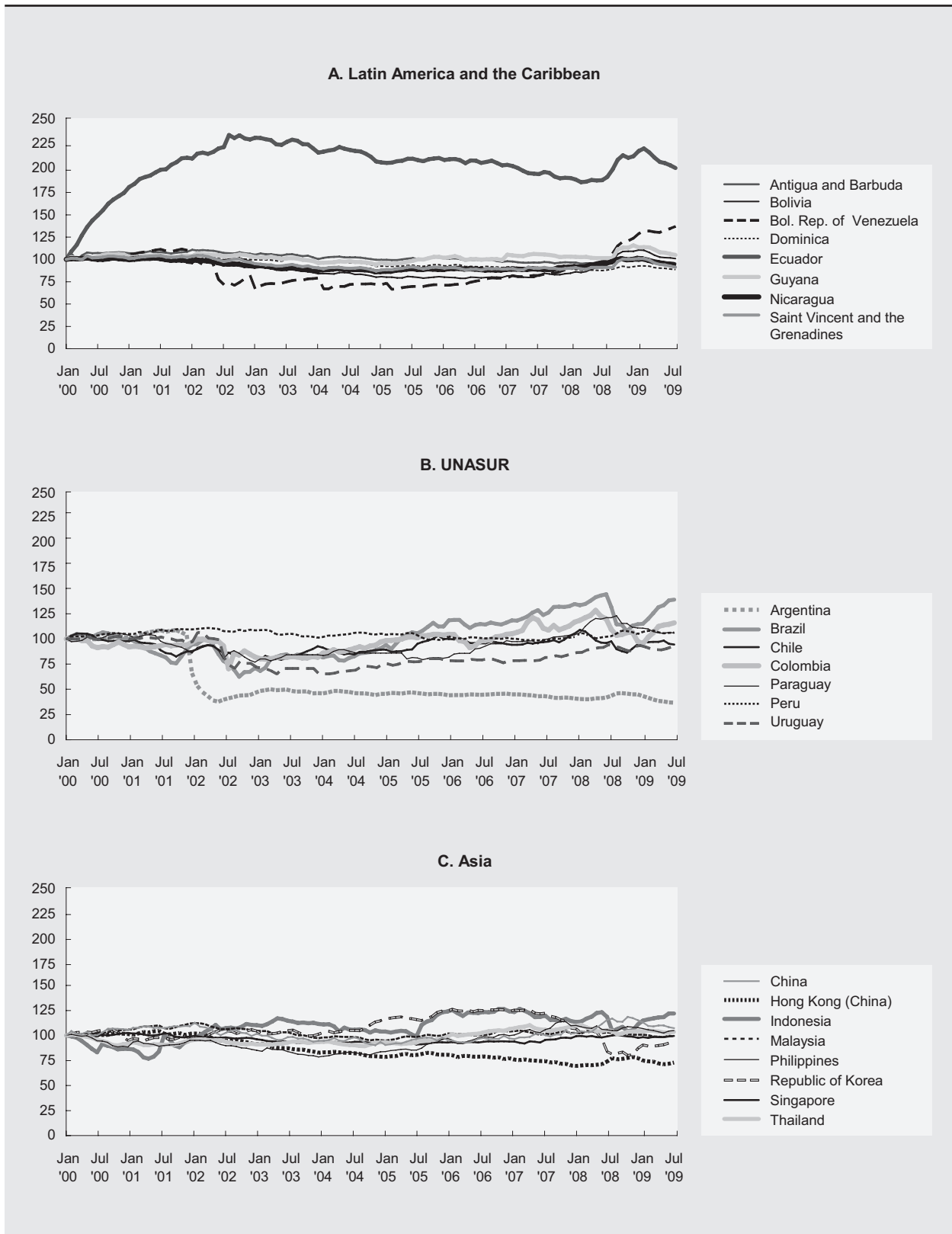
**Figure 1.4**  
**NOMINAL EXCHANGE RATES: SELECTED ECONOMIES, 2006–2009**  
*(Index numbers, 3 January 2006 = 100)*



**Source:** UNCTAD secretariat calculations, based on daily data from Bloomberg.

**Note:** The index has been constructed in the following manner:  $(1/x)/(1/x)^*100$ . Therefore, an increase in the index represents an appreciation of the selected currency against the United States dollar. The Eastern Caribbean Currency Union (ECCU) comprises: Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia and the Grenadines.

**Figure 1.5**  
**REAL EFFECTIVE EXCHANGE RATES, SELECTED ECONOMIES, 2000–2009**  
 (Index numbers, January 2000 = 100)



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

**Note:** The index has been constructed in the following manner:  $(1/x)/(1/x) \times 100$ . Therefore, an increase in the index represents an appreciation of the selected currency against the United States dollar.

It consists of borrowing in low-yielding currencies (the so-called funding currencies) and “investing” in currencies that provide a higher return (the so-called investment or target currencies). The carry-trade operation increases demand for the target currency in foreign exchange markets, and results in a nominal appreciation if the central bank of the targeted country does not intervene to sterilize this increased demand for domestic currency.

As a result of relatively high interest rates in most of the larger South American economies (see next section), the increase in this type of flow has undoubtedly been responsible for the exchange rate (mis-)alignments observed in figures 1.4 and 1.5. Brazil, as a top ranked carry-trade pair, is the best example, but not the only one.

Speculative inflows and their effect in pushing up the exchange rate have a major impact at the macroeconomic level. The resulting overvaluation creates an unsustainable situation that sooner or later has to be reversed. At a certain point in time, a nominal devaluation is unavoidable. This pattern was evident during the 2008–2009 crisis, when the global deleveraging process led to an unwinding of currency carry-trade flows and triggered a wave of depreciation of the region’s currencies (figure 1.5A).

### 1.3 Fixed exchange rate regimes and ALBA economies

Given the frequent nominal and real exchange rate misalignments observed in those Latin American economies that have adopted flexible exchange rate regimes, a fixed exchange rate might be considered a preferable growth- and investment-enhancing monetary policy option. Indeed, the majority of the ALBA members, along with other small economies of the region, have chosen this option.

Ranging from currency boards and crawling pegs to arrangements with no independent legal tender – as in Ecuador – the countries appear to have achieved better results than the selected UNASUR economies. In nominal terms, fluctuations have been considerably smaller (figure 1.4B). Even in the two outliers in the sample – Bolivia appreciating and Nicaragua depreciating – the variation has been much smaller than in the UNASUR countries shown in figure 1.4A.

However, this apparent success of ALBA members in maintaining a stable exchange rate is misleading. Of greater relevance for competitiveness and growth are the REERs (as discussed in box 1). From this perspective, the scenario seems less successful, especially for the three biggest economies in the sample: the Bolivarian Republic of Venezuela, Ecuador and, to a lesser extent, Bolivia (figure 1.5B). To varying degrees, they show higher exchange rate volatility and a clear trend towards real overvaluation. Thus their exchange rate regimes are driving them away from a development path which fosters investment and long-term growth – just as much as the UNASUR countries with flexible exchange rates.

What explains this continuous appreciation of the real exchange rate? To a large extent, it is due to these countries being in an overvaluation trap caused by the hidden dynamic of inflation. Fixed exchange rate regimes have often been used successfully to stabilize domestic inflation rates. However, while many countries have succeeded in reducing domestic inflation, it takes time to arrive at permanently lower inflation levels. Furthermore, even when stabilization is achieved, domestic inflation usually remains higher than the very low levels of the key anchor currency countries. Thus an economy’s competitiveness can be seriously undermined even with a fairly stable nominal exchange rate. In general, whenever inflation in the anchoring country (regardless of its sources) is higher than in the anchor country, the discrepancy between the internal and external value of money is reflected in the real exchange rate, which will continuously appreciate.<sup>3</sup>

The Ecuadorian and Venezuelan experiences are clear examples of this perverse dynamic. In 2000, the Government of Ecuador abandoned the Sucre and adopted the dollar<sup>4</sup> as that country’s official currency (so called *de jure* dollarization). Since then, the currency has experienced real appreciation. Similarly, the Bolivarian Republic of Venezuela experienced the most pronounced appreciation of the real exchange rate of all the countries in the region, which resulted from its adopting a fixed exchange rate vis-à-vis the dollar. In Bolivia, appreciation of the real exchange rate has been less pronounced, and started only recently, mainly due to an appreciation of the nominal exchange rate (figure 1.5A).

Currency appreciation under a fixed regime has serious adverse effects on the production and export performance of the anchoring country. It not only

causes trade distortions, but also renders countries more crisis prone as boom-bust cycles of capital flows and commodity prices eventually make sharp nominal devaluation unavoidable. Probably the most dramatic example occurred in Argentina under its currency board arrangement (1991–2002). Needless to say, the scope for countercyclical policies in such situations is strongly restricted, resulting in additional damaging effects to the real economy.

#### **1.4 Lack of exchange rate harmonization hinders regional integration**

Even if a certain common trend of procyclical exchange rate volatility can be observed in Latin America, a high degree of intraregional divergence exists, especially in real terms (figure 1.5). The absence of a common regional pattern of real exchange rates can be explained not only by the variety of formal regimes, or a lack of formal cooperation mechanisms, but also by the lack of regional agreement on an appropriate growth-enhancing macroeconomic regime (see annex 1).

In most countries of the region, inappropriate macroeconomic regimes for growth and employment creation are a major hindrance to regional monetary cooperation and economic integration. Divergence in their macroeconomic regimes translates into uncoordinated volatility of exchange rates, which is particularly harmful to the process of regional integration, as it disrupts intraregional trade and makes it difficult to agree on collective rules (see annex 1). For example, the establishment of a cooperation mechanism to prevent adjustment policies in individual countries from having negative spillover effects requires at least a common exchange rate regime and less exchange rate divergence (see chapter II).

All in all, the different exchange rate dynamics in Latin American economies is part of the overall diversity of the macroeconomic landscape of the region. This largely explains why Latin America's growth and investment performance has been falling behind. In contrast, the exchange rate dynamics in the East and South-East Asian economies (hereinafter, Asian economies) have contributed to that region's relative success in achieving a growth-oriented macroeconomic regime. Despite the variety of

institutional arrangements in the Asian economies,<sup>5</sup> there is a high level of exchange rate convergence and a consistent preference for external competitiveness (figures 1.4C and 1.5C), both key elements in the region's success.<sup>6</sup>

The co-movement of nominal and real exchange rates is a fairly strong demonstration of regional convergence of macroeconomic regimes. This feature, which also responds to long-term structural processes, and even without any formal mechanism to coordinate macroeconomic policies, is a major advantage for economic growth and investment in a region. In Asia, intraregional real exchange rate stability and trade integration have been mutually reinforcing (see also chapter II).

The two problems previously identified in Latin America in relation to exchange rate movements – carry-trade flows and the overvaluation trap – are less relevant for the determination of exchange rates in Asia. Regarding financial speculation, lower domestic interest rates and a more cautious approach to capital-account liberalization have been playing an important role. In the case of fixed exchange rate regimes, inflation differentials have been lower, thus avoiding an overvaluation trap.

## **2. Macroeconomic policies and interest rate management in Latin America**

Apart from exchange rate movements, the interest rate is the other key macroeconomic variable for understanding growth dynamics. On the one hand, it is closely connected with exchange rates and external financing – as mentioned in relation to carry-trade flows. More importantly, interest rates play a major role in any investment decision, and thus have implications for employment creation.

An optimal condition for investment and growth would be to keep the real interest rate stable and below the real GDP growth rate (section A.2). However, neither ALBA nor UNASUR members have managed to achieve this in recent times (figure 1.6A). Their extremely high and unstable rates represent a strong barrier to productive investment.

In the adjustment programmes adopted across much of Latin America in the 1980s and 1990s,

tight monetary policies were considered an integral part of the macroeconomic discipline necessary to bring inflation under control. However, the resulting high nominal (and real) interest rates, together with currency appreciations and gyrations, caused serious difficulties for domestic industry, choking off investment and leading to job losses. A monetary conditions index (combining the real exchange rate and the real interest rate) developed by UNCTAD was persistently much higher for Latin America than East Asia throughout the 1990s, suggesting that monetary conditions were much less conducive to investment and growth in the former region (UNCTAD, 2003, p.136). The fundamental flaw of this approach was its assumption that less active governments, independent central banks and the famous “flexibility” of the markets are sufficient to create investment and employment. But capital accumulation, productivity enhancement and more jobs do not automatically result from a better allocation of resources.

Not surprisingly, the experiences of financial crises have forced many developing countries to adopt economic policies that fundamentally differ from the traditional approach to “sound macroeconomic policy” as prescribed by the Washington Consensus. The most successful cases of economic catching up, notably in Asia, never adhered to the Washington Consensus despite the fact that price stabilization was a major objective of their economic policy. Indeed, the choice of policies to reach this target was in important respects just the opposite of the orthodox approach.

In the Asian stabilization model, monetary policy stimulated investment and growth, and various means were used to control inflation. An incomes policy and/or direct government intervention in the goods and labour markets were the preferred instruments to stabilize the price level. In an environment of rapid growth and despite the danger of overheating, this approach has proved its worth.

Since the Asian financial crisis, many Asian countries adopted accommodative monetary policies, maintaining very low interest rates. Fiscal policy was used pragmatically to stimulate demand when required in response to cyclical developments. The policy interest rate (in real terms) has been consistently lower than the growth rate (in real terms) over the past eight years, and for the past 20 years in Asia (figure 1.6(b)). The most striking example is China, where the real interest rate had been lower

than real GDP growth rates. No other country has managed to maintain such good macroeconomic conditions or been able to rival China in terms of growth and investment. The lesson is simple: low interest rates are the single most important monetary factor in promoting investment in fixed capital and catch-up growth.

By contrast, most countries in Latin America have not been able to combine low inflation with accommodative monetary conditions in a similar way. Only in Argentina have interest rates been consistently lower than the growth rate. Brazil is the most extreme example of prohibitive monetary conditions, and leads to the conclusion that the country is not fully exploiting its economic potential. But even in Chile, which has had a fairly stable growth performance, macroeconomic conditions are far from ideal. In Brazil and Chile the commodities’ bonanza of the past century could have yielded a much better performance if investment had not been hindered by high interest rate. Only recently, have some smaller countries markedly improved their macroeconomic conditions. Under the Latin American policy approach growth rates have remained subdued (and much below their growth potential), and the countries in this region are in danger of falling even further behind Asia and most of the industrialized countries.

This lesson is extremely important but not easy to digest by those who subscribe to the traditional macroeconomic policy approach. For sustained income and employment growth open economies need proactive and permanent management of the monetary regime to ensure that investment plans exceed savings plans in the long run. In such an environment, even if incentives for private “thrift” remain unchanged or low, the economy as a whole may expand rapidly. The *ex post* visible “savings” will correspond to the increased investment and will eventually be generated through profits. However, the original investment is “financed” by liquidity created through bank credit based on an expansionary central bank policy. Increased investment stimulates higher profits as temporary monopoly rents of the companies rise. These profits provide the macroeconomic savings required to “finance” the additional investment (or repay the bank credit).<sup>7</sup>

From another angle, if the monetary conditions (i.e. interest rates and exchange rates) are restricting growth and investment, no countermeasures exist to overcome that restriction, so those monetary

**Figure 1.6**  
**REAL GDP GROWTH RATES AND REAL INTEREST RATES IN SELECTED ECONOMIES IN**  
**LATIN AMERICA AND ASIA, 2002–2008**  
*(Per cent)*

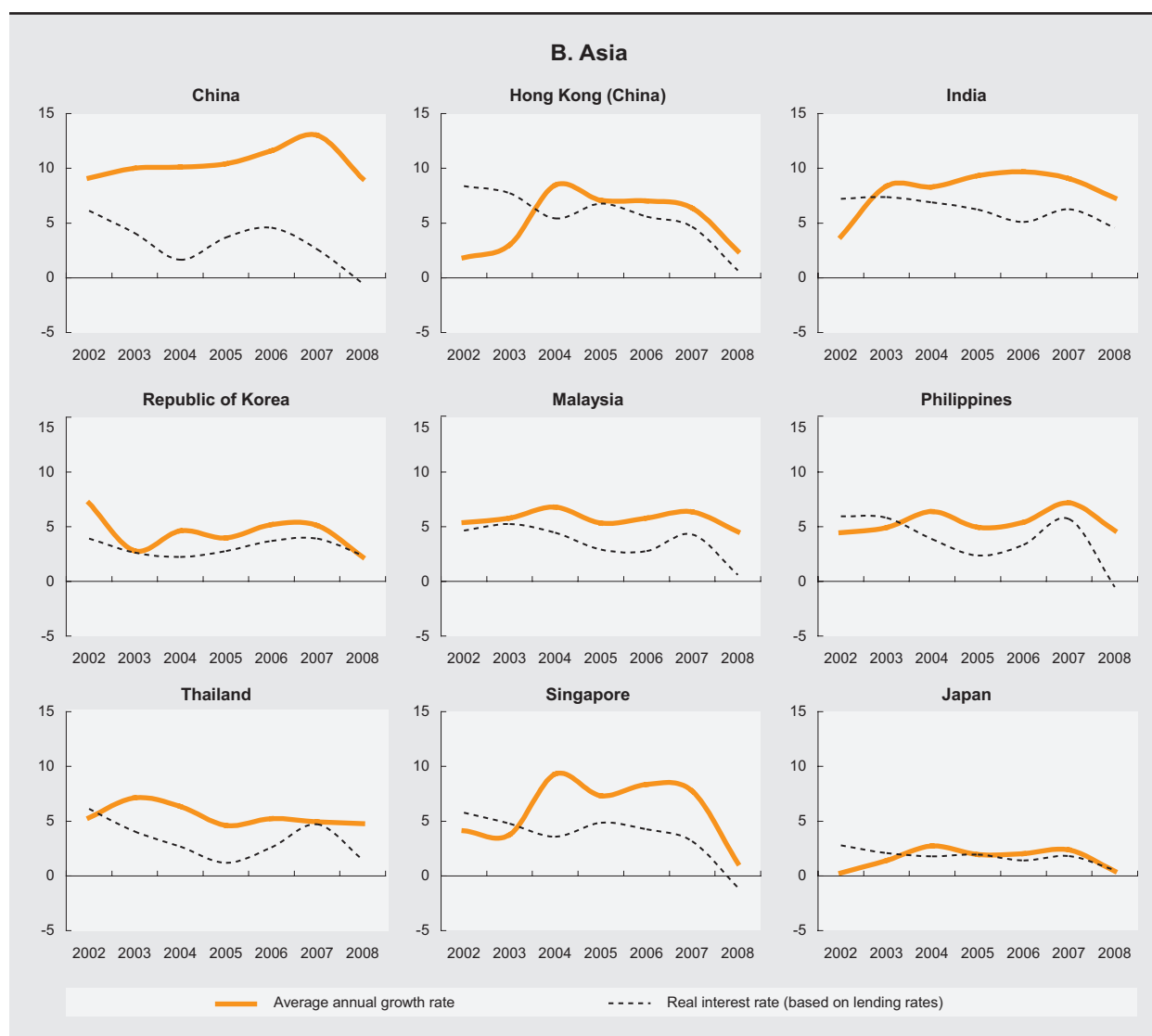




Figure 1.6 (concluded)

## REAL GDP GROWTH RATES AND REAL INTEREST RATES IN SELECTED ECONOMIES IN LATIN AMERICA AND ASIA, 2002–2008

(Per cent)



**Source:** Average annual growth rate, based on data from UNCTAD, *GLOBSTAT* database. Real interest rate: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; for LAC economies: UNCTAD secretariat calculations, based on ECLAC, *Statistics* database.

- a** A lower nominal interest rate is provided by the Brazilian Development Bank with the main purpose of support investments in the private sector through strengthen company's capital structures, as well as to develop capital markets, commercialization of machinery, equipment and financing of exportation.

conditions in fact inhibit development. In aiming at “getting the prices right” many countries that pursued the neo-liberal agenda in its extreme got the most important prices – the interest rate and the exchange rate – wrong, as these were too high to allow the economy to flourish.

The theoretical basis for a more pragmatic policy approach is the perception that higher fixed

investment is not the result of greater planned savings of private households, but rather the result of economic policy. This approach requires a monetary policy that provides cheap financing to entrepreneurs and enterprises for investment in new products or production techniques. Such a policy, in the orthodox view, is inflationary and should clearly be avoided. Successful experiences elsewhere, particularly in East Asia, suggest otherwise.

## C. Conclusions

A first and crucial step for assessing the potential benefits and challenges of monetary cooperation and integration in the Latin American region is to understand what went wrong. What many Latin American countries needed following the debt crisis, and still need today, is a transformation of their production structure through higher investment and technological change in a process of what Schumpeter called “creative destruction”. Instead, the rapid lowering of inflation resulted in an increase in incomes and wealth, before productive capacity was expanded and nationalized. Subsequently, the macroeconomic environment of high interest rates, strong exchange rates and volatile capital flows did little to support the new investment required for such a transformation.

The general picture in Latin America is still characterized by: (a) high volatility and significant periods of exchange rate appreciation/overvaluation; and (b) unstable and high real interest rates (higher than real economic growth). That these conditions resulted in disappointingly low rates of growth and investment in the region cannot be overemphasized. Indeed, the region’s macroeconomic conditions have been far from conducive (in terms of a competitive and stable real exchange rates and stable real interest rates, with rates below the real GDP growth rate) to achieving sustained economic growth.

It is clear that the poor economic performance of Latin America in the past few decades has been rooted in the macroeconomic regime chosen by the majority of the countries in the region. The comparative analysis of the key macroeconomic variables in Latin America and Asia reinforces the central argument,

that an emphasis on efficient macroeconomic management is an essential condition for sustainable growth and development.

In Asia, even though there is no formal coordination of exchange rates and the overall macroeconomic regime, a high degree of convergence of exchange rates and interest rates has been achieved through a common belief in the importance of having a macroeconomic regime that gives priority to the maintenance of stable and competitive real exchange rates combined with relatively low and stable interest rates. Such convergence in the conduct of macroeconomic policy can be an important starting point for a process of mutual reinforcement through regional economic integration and monetary cooperation.

Convergence of these key variables has been lacking in Latin America. High volatility of macroeconomic prices has been associated with differences in short- and medium-term macroeconomic management. As discussed in detail in subsequent chapters, diverging macroeconomic regimes of countries in the region distort intraregional trade and hinder the establishment of cooperation mechanisms to buffer external shocks and prevent the sort of individual adjustment policies that can have negative spillover effects on neighbouring countries.

Uncoordinated volatility of exchange rates can be a major stumbling block to regional monetary cooperation and successful economic integration and growth. It should therefore be taken into account in the efforts currently under way in Latin America to improve the exchange of goods, services and ideas.

## Notes

- 1 In recent years, the newly industrializing economies (NIEs), especially Malaysia, the Philippines and the Republic of Korea have seen their investment levels remain stable (or even decline). Following the Asian crisis of 1997-1998, the upward trend in the Asian region after 2000 is attributable almost exclusively to China and India.
- 2 IMF, De facto classification of exchange rate regimes and monetary policy frameworks; available at: <http://www.imf.org/external/np/mfd/er/index.asp> (data as on 31 April 2008; accessed January 2010).
- 3 This is another reason – in addition to those discussed in box 1 – why awareness of the need for a moderate level of inflation should be part of economic policy goals; the converse would require permanent nominal devaluations, which would trigger a devaluation-inflation spiral, thereby creating even stronger expectations of a devaluation. But this does not mean that it should be pursued relentlessly, in a manner that may seriously damage investment and growth.
- 4 Throughout this document, dollar refers to the United States dollar.
- 5 The International Monetary Fund (IMF) identifies the different exchange rate regimes of the most important Asian economies as follows: independently floating (the Philippines and the Republic of Korea), managed floating with no predetermined path for the exchange rate (Indonesia, Malaysia, Singapore and Thailand), crawling peg (China) and currency board (Hong Kong, Special Administrative Region of China). (See: <http://www.imf.org/external/np/mfd/er/index.asp>: De facto classification of exchange rate regimes and monetary policy frameworks.)
- 6 The major exceptions, in real effective terms, are the Philippines which has displayed a more marked appreciation trend, and China, which, under strong international pressure regarding its exchange rate management, allowed an appreciation of its currency that, apparently, was reversed in 2009. But neither of these economies is even close to resembling the kind of appreciation of Brazil's or Venezuela's currencies, discussed earlier, owing to the absence – or lower degree – of carry-trade operations and/or smaller domestic inflation rates.
- 7 The importance of a strong profit-investment nexus to the design of development strategies has been extensively discussed by UNCTAD, in its *Trade and Development Report* in 1994, 1997, 2003 and 2006.



## Chapter II

# REGIONAL MONETARY COOPERATION FOR GROWTH-ENHANCING POLICIES

## A. The need for regional monetary cooperation

Growth and development prospects through regional monetary cooperation and integration are generally examined in terms of the costs and benefits of giving up the exchange rate as a policy instrument. This chapter outlines the dynamic connections between regional monetary coordination, cooperation and integration, and a growth-oriented macroeconomic regime that gives priority to increased investment and growth.

In part A, the traditional approach to regional monetary integration, the so-called optimal currency area (OCA) theory is reviewed. The theory's main shortcomings with regard to regional monetary cooperation and integration involving developing countries are summarized. In part B, potential connections between regional monetary cooperation and the macroeconomic goal of achieving sustained stable and competitive exchange rates together with low and stable interest rates are analysed based on different regional monetary coordination, cooperation and integration arrangements. Here, the focus is on differentiating *necessary* conditions from *sufficient* conditions for a growth-oriented macroeconomic, and in particular, monetary policy. Necessary conditions, which can be supported by regional monetary cooperation arrangements, include reducing volatility and vulnerability in developing countries. Sufficient conditions involve linking regional monetary cooperation and integration arrangements with growth-enhancing policies that seek to establish and

maintain competitive exchange rates together with low interest rates in the long term.

It is important to note here that any form of regional monetary cooperation requires a strong commitment to jointly enforce regional binding arrangements, be they in the form of regional agreements or supranational institutions. Hence, any form of regional monetary coordination or integration depends on member countries' political will to cooperate. There is often a reluctance to give up national sovereignty over monetary policies. However, the transfer of national sovereignty in the management of macroeconomic policy instruments to the regional level does not result in a reduction of de facto economic sovereignty. On the contrary, regional cooperation, as understood here, aims to increase, rather than reduce, the policy space for domestically and regionally oriented policies within globalization.

A clear and commonly agreed concept of regional monetary coordination, cooperation or integration does not exist. Regional monetary cooperation aims at the establishment of institutionalized and formal forms of regular policy dialogue at the regional level between representatives of monetary authorities and governments. These first steps towards developing regional monetary policy networks provide the basis for joint decision-making on monetary and exchange rate policy. The main aim of regional monetary

cooperation is to create favourable conditions for investment and growth by stabilizing exchange rates and coordinating monetary policy, and also to enable a better response to external shocks to the region. Regional monetary cooperation can include a variety of arrangements, from formally pegged bilateral exchange rates to a regional currency basket peg. Any form of regional monetary cooperation thus involves a growing commitment not only to conducting monetary policy adjustments at the national level, but also to jointly accommodating shocks at the regional level (Bénassy-Quéré and Coeuré, 2005). Full regional monetary integration occurs once a common authority for monetary policy is established, together with the creation and issuance of a single regional currency.

### 1. *Limitations of the optimal currency area theory*

The conventional approach to analysing the costs and benefits of regional monetary integration is based on the so-called optimum currency area (OCA) theory. Even though the OCA theory has been widely criticized (Tavlas, 1994; and Goodhart, 1995), it is still frequently used to analyse monetary cooperation and integration in all regions of the world (Salvatore, Dean and Willett, 2003). For this reason, a brief introduction to OCA theory and the main criticisms directed against it, revealing flaws that render it irrelevant for this study, are presented here.

In the first generation literature (Mundell, 1961; McKinnon, 1963; and Kenen, 1969), OCA theory focused on the trade-offs between the benefits of regional monetary integration – including reduced transaction costs for regional economic transactions – and the costs of regional economic integration and adjustment that would result from abandoning flexible exchange rates and sovereignty over monetary policymaking.

The major conclusion of OCA theory is that integrating countries need to react symmetrically to external shocks in order to lower the cost of regionally coordinated monetary policy. Hence, according to this view, the success of regional monetary integration depends on a high level of economic convergence. In line with this argument, OCA theory identifies three main optimality criteria for regional monetary integration:

- Liberalized factor markets, to allow free movement of labour as an alternative adjustment mechanism to exchange rates in the event of asymmetric shocks (Mundell, 1961);
- A certain degree of openness, to allow integrating countries to abandon the exchange rate as an adjustment mechanism (McKinnon, 1963); and
- A diversified production structure in the integrating economies, in order to reduce the impact of external shocks on individual economies (Kenen, 1969).

While the OCA theory provides an understanding of the factors that affect the costs and benefits of monetary integration, it has at least four major flaws. First, it ignores the dynamic effects of cooperation on economic integration; second, it is based on a highly static view of the potential gains of cooperation and integration; third, it overstates the ability of countries to manage their exchange rate by themselves by advocating flexible exchange rate regimes as an alternative to cooperation. Last, but not least, by not sufficiently taking into account the need for mutual support, especially for small and open economies, it ignores the problems associated with unilateral currency arrangements. These flaws in the OCA theory are discussed in greater detail below.

#### (i) *Dynamic effects of regional monetary cooperation*

The OCA theory takes a highly static perspective, based on the belief that close economic integration and convergence of the relevant macroeconomic variables are needed to enable smooth monetary cooperation and integration. Even if the OCA theory does not prescribe clear convergence thresholds, it implies the need for fairly high levels of trade integration. It suggests that intraregional trade in the majority of developing regions is too low for them to start engaging in monetary cooperation.

However, more recent approaches argue that economic convergence and trade integration should not be considered exogenous determinants (Frankel and Rose 1997; Rose and Stanley, 2005). They suggest that monetary cooperation could even give an impetus to further trade integration, thus meeting the OCA criteria endogenously during the integration

process. According to DeGrauwe and Mongelli (2005), not only trade but also financial and labour market integration would be fostered by monetary integration.

This argument against the OCA theory is relevant for the majority of developing countries. Indeed, in the developing world a series of efforts towards regional monetary cooperation are under way, despite comparatively low levels of trade integration at the regional level so far. Even though overall South-South trade has grown significantly, from 11 per cent of world trade in 1995 to 15 per cent in 2007, this increase is highly concentrated within the Asian region, while Africa and Latin America show only moderate increases in intraregional trade (UNCTAD, 2009a).

A brief analysis of the sequencing of trade integration and monetary cooperation in Asia, Europe and Latin America also shows that the reality is much more complex than what is assumed in theory (see annex 2).

*(ii) Growth-oriented macroeconomic regimes should take priority over efficient resource allocation*

Theoretically, the OCA approach focuses on efficient resource allocation for economic development. However, this is a very static interpretation of the functioning of an economy, based mainly on the idea that enlargement of markets or greater flexibility of prices in existing markets will automatically improve the welfare of the society. In reality, more important for development and welfare than these static gains are the dynamic gains to be had from investment in fixed capital. Thus investment is the key variable in fostering long-term growth and employment creation (see chapter I).

Therefore in order to be growth-enhancing, efforts at regional monetary cooperation and integration need to take a different approach. It is necessary to establish a road map, from the initial steps of regional monetary cooperation, such as trade-related initiatives, towards deeper forms like regional exchange rate cooperation that focuses on the overall goals of supporting competitive exchange rates and low real interest rates. This more ambitious approach, aimed at reaping dynamic gains from regional monetary cooperation and integration,

aims at tackling the real effects of global monetary shocks (e.g. exchange rate shocks or long-lasting overvaluation). From this perspective, agreement on an overall and coherent economic policy strategy and on the final objectives of monetary cooperation is necessary. Indeed, the most important step to be taken at the beginning of any coordination process would be to reach agreement on the role of regional monetary and fiscal policies as well as the role of labour market institutions. However, the current crisis in the countries of Southern Europe that are members of the euro zone also shows that cooperation within a currency union should go well beyond monetary policy and fiscal targets (discussed below).

*(iii) The OCA view on independent monetary policy with flexible exchange rates is flawed*

The main flaw in OCA theory is that it views abandoning a floating exchange rate as a major price paid for monetary cooperation and integration. However, in the case of developing countries, and small open economies in general, floating exchange rates are a major source of instability and produce major shocks, mainly due to overvaluation.

Recent debates on carry trade (see chapter I) and capital-account liberalization (UNCTAD, 2004 and 2007) point to the fact that short-term capital flows are mainly driven by interest rate differentials bringing about exactly the opposite of the effect expected by purchasing power parity (PPP) over the short and medium term. Countries with relatively high inflation rates and interest rates are often swamped by short-term funds that drive up their currencies in real terms, undermine absolute and comparative advantages and distort the production structure of tradable and non-tradable goods. If this happens, formal monetary autonomy becomes meaningless.

In this sense, even if a free-floating exchange rate provides formal autonomy to monetary policy, as the central bank need not intervene in foreign exchange markets, this does not result in effective policy autonomy. In the same way as formal freedom does not imply material freedom, formal autonomy does not imply material autonomy. Material economic autonomy would be warranted only if the market determined exchange rates strictly on a PPP basis – that is, changes in exchange rates between two countries would always equal the inflation differentials of those countries. However, due to short-term

speculation in financial markets, the PPP rule, as the International Monetary Fund (IMF) and many others have shown empirically, is not valid over extremely long periods. As such, both corner solutions turn out to provide much less monetary policy autonomy than is conventionally assumed (UNCTAD, 2007). This holds true especially in the context of a global financial architecture that is characterized by uncoordinated exchange rates, liberalized and volatile international capital flows and inadequate provision of short-term liquidity. The debate on the right choice of the exchange rate regime is far from conclusive. Especially since the global financial crisis, even mainstream economists (see, for instance, Blanchard et al., 2010: 13) focus increasingly on the need for appropriate exchange rate management beyond the corner solution.

The forming of regional economic blocs is a possible response to a highly unstable global economic environment. The European integration process that culminated in the creation of the euro can be viewed in this light. Not least, it has encouraged many developing countries to consider regional monetary and financial initiatives of their own.

Closer macroeconomic cooperation may sound utopian to many realistically thinking policymakers, especially in developing countries, but movement in this direction must take place if a region as a whole – and each of its countries – is to achieve lasting economic gains from closer integration. To avoid adverse effects on trade and a smooth functioning of common regional markets, there is no viable alternative to some form of managed exchange rate. This implies that some form of monetary cooperation at the regional level, or even beyond, is highly desirable, especially when it aims at fostering a low interest rate and a competitive and stable real exchange rate.

Finally, even the European experience – on which most of the OCA theory is built – reveals the weakness of the theory's approach at several stages of the integration process. Increasingly close monetary cooperation was made possible by the fact that governments were aware that there was no easy alternative. Similarly, for developing countries today, the simple alternative of leaving it all to market forces is not viable when establishing or maintaining a growth-oriented macroeconomic regime. Hence this is one of the rare cases of a valid TINA principle: There Is No Alternative to monetary cooperation.

(iv) *Full dollarization does not achieve exchange rate stabilization*

The argument that flexible exchange rates are not an option for the majority of developing countries is sometimes used to defend unilateral currency unions, including full dollarization.<sup>1</sup> The main reason put forward is that *de jure* dollarization eliminates the need to defend the exchange rate, thus reducing the exchange rate risk to zero. This should result in a significant reduction of real interest rates. Key to this reasoning is that there is no longer a need to rely on a discredited domestic institution to apply discretionary economic policy, as this is replaced by a credible external anchor institution such as the United States Federal Reserve (Alesina and Barro, 2002).

However, the main problem with full dollarization is that countries are no longer able to pursue their own monetary policy and are therefore unable to use the key macroeconomic instruments for growth-enhancing policies, the interest rate and the exchange rate (see chapter I). If an economy is unable to generate a permanent current-account surplus, for example due to higher inflation than that in the anchor-currency country, capital flows have to be maintained either by setting high real interest rates – which depress domestic growth and increase vulnerability to external shocks – or by adopting a policy of deflation, which will deepen the problems for the domestic economy.

Thus the advantage of eliminating currency risk through unilateral currency unions may be more than offset by the loss of key instruments for growth-oriented economic development (Acosta, 2001). The decision to abandon the national currency demonstrates better than anything else the desperate situation of small open economies in their struggle to cope with unreliable global capital flows. In a sense, it may be a policy instrument for countries that already suffer from very high *de facto* dollarization and that are at the same time highly integrated economically with the country that issues the currency they are taking over, but it is not a solution for growth-oriented economic development.<sup>2</sup>

Once a country has adopted full dollarization, re-establishing its own sovereign currency, or creating a new currency at the regional level that would require that member countries abolish full dollarization, entails a strong and clear policy shift to a growth-enhancing macroeconomic policy (see chapter I,



section B). A necessary condition for (re)establishing a domestic or regional currency following *de jure* dollarization is to gain the confidence of market participants in the new currency, and, in the case of the establishment of a regional currency, to gain confidence also in its potential precursor – a currency unit or currency basket. In order to prevent *de facto* re-dollarization, it is especially relevant to prevent devaluation expectations over a longer period of time. Permanent devaluation expectations have been identified as one of the main reasons for *de facto* dollarization in many countries in the past.

In order to avoid the problems associated with unilateral monetary integration, regional monetary cooperation and integration need to be established in a multilateral manner, that is based on joint agreement among the participating sovereign States. It is only through a commonly agreed regional monetary and exchange rate policy based on an equal commitment by all the member countries that regional cooperation and integration mutually reinforce a growth-oriented macroeconomic development path, despite the possible costs entailed in cooperation and economic adjustment.

## **2. Conditions for growth-enhancing effects of regional monetary cooperation**

Our analysis of regional monetary cooperation and integration specifically draws attention to the need to reduce macroeconomic volatility and buffer exogenous shocks. Such cooperation must also have the capacity to sustain a competitive level of the exchange rates of the countries within a region. This study highlights the crucial distinction between *necessary* and *sufficient* conditions for realizing growth-enhancing effects of regional monetary and financial cooperation and integration. As a necessary condition for growth, deep economic integration needs to shield a region from global shocks. This can be done through the creation of regional institutions to provide short-term liquidity as a form of self-insurance. In addition, economic integration can help increase investment financing in domestic currencies thereby avoiding the destabilizing effects of external capital inflows. Finally, it helps to prevent distorting competition of individual countries, which can have deflationary consequences for all the economies of the region. All this requires harmonization

of exchange rates, which is the key to preventing a slide backwards in the process of regional integration and overall growth. Furthermore, achieving and maintaining a competitive exchange rate through regional monetary cooperation is a necessary condition for growth.

### **(i) Self-insurance against global shocks: a role for regional payment systems**

Regional monetary cooperation can play an important role in increasing intraregional trade and financial linkages, thereby significantly reducing the vulnerability of regional economies to global shocks (see annex 1). It can also be a valuable instrument for reducing volatility of investment and growth, and increasing the space for macroeconomic management oriented towards meeting domestic needs for growth and employment creation. Similarly, it can allow flexibility for pursuing countercyclical policies.

If a global shock affects the group of cooperating economies in a homogeneous manner, the higher the degree of intraregional economic integration the less the region will be affected by the external shock. However, this applies only if individual countries do not adjust their exchange rates and interest rates unilaterally rather than in a regionally coordinated way. Coordinated responses to shocks enable a region to avoid distorting intraregional trade, financial flows and investment.<sup>3</sup> On the other hand, if individual countries react to exogenous shocks with policies that result in significant and lasting shifts in intraregional exchange rates, this will create disincentives for regional economic integration. This will not only reduce the buffering effect of integration to global shocks, but will also result in countries reorienting their trade and monetary policies from an intraregional to an extraregional direction.

Besides trade integration schemes such as customs unions, the mechanism that focuses most directly on intraregional trade is a regional payment system. The overall objective of such a system is to foster trade among member countries by reducing the transaction costs of foreign exchange market operations through the use of domestic currencies. The effectiveness of a regional payment system, at least in the short run, depends on the level of intraregional trade even before starting formal regional cooperation. Since trade integration and monetary cooperation have been shown to mutually

reinforce each other (see box 1), a regional payment system can be implemented at any level of regional trade intensity through agreement among the participating countries.

The additional option of establishing a unit of account within a regional payment system aims at avoiding a complex system of binational exchange rates in settling regional trade transactions. At the same time it can be an instrument for embarking on the establishment of a common currency within the region at a later time. At least technically, in the beginning, a regional payment system does not require any kind of exchange rate coordination. But in order to create incentives for importers and exporters to make use of the scheme of intraregional clearance, any changes in the exchange rate of a single country vis-à-vis external currencies have to be smoothly reflected in an adjustment of intraregional exchange rates and the composition of the regional unit of account.

For a regional payment system to be effective, there should be exchange rate coordination, at least in the medium term, for two reasons. First, to strengthen regional economic integration as a means of shielding the region from global instabilities, intraregional exchange stability is necessary, at least to a certain extent, in order to prevent severe setbacks in regional economic integration. Second, the long-term goal of establishing a regional currency as a means of reaping the full gains of regional monetary cooperation is not possible without increasing exchange rate and overall macroeconomic cooperation.<sup>4</sup>

While European regional integration may at least initially be a point of reference for traditional sequencing, with trade integration first, the debate shows that from a theoretical point of view there is no clear reason for introducing trade integration ahead of monetary integration. The lack of regional monetary cooperation, especially the lack of coordination of exchange rates and policies aimed at responding to external shocks, may cause stagnation, and even a reversal of regional trade integration, if it is not simultaneously accompanied by regional monetary cooperation (Fernández-Arias, Stein and Panizza, 2002). The volatility of unilaterally managed monetary and exchange rate policies may itself become a source of asymmetric shocks. In such a situation, disruptive exchange rate movements may easily reverse any previous efforts at regional economic integration, particularly if the participating countries

are net debtor economies and highly dependent on external financing, as mentioned earlier.

### *(ii) Self-insurance against a shortage of international currency*

In addition to increasing regional trade in order to minimize economic vulnerability induced by international financial volatility, preventing short-term liquidity shortage is another necessary condition for a growth-oriented macroeconomic policy. Developing countries have recently exerted considerable efforts to accumulate foreign exchange reserves, partly as a means of self-insurance against shocks. The cost in terms of foregone interest earnings on less liquid investments opportunities is much debated (Eichengreen 2006; Machinea and Titelman, 2006). However, the cost involved in accumulating foreign currency reserves cannot be seen in isolation from a country's broader macroeconomic strategy. In particular, to prevent a currency appreciation – that may occur as a consequence of an external surplus in the trade balance, or due to large capital inflows as a consequence of portfolio investment decisions by foreign investors – it becomes important for the central bank to intervene in the foreign exchange market to help maintain the international competitiveness of domestic firms (UNCTAD, 2009b: 123).

Given the aforementioned limitations of national and global insurance mechanisms, regionally coordinated self-insurance (which turns into co-insurance at the regional level) mechanisms such as the Latin American Reserve Fund (FLAR) and the Chiang Mai Initiative Multilateralisation Agreement (CMIM) have recently gained attention as potentially more efficient and sustainable options for protection against external shocks.<sup>5</sup>

The recent upswing in the accumulation of reserves by developing countries is closely linked to the widespread discontent with international short-term assistance provided by the IMF (UNCTAD, 2009b). Traditional assistance packages or swap agreements, combined with restrictive policy prescriptions – or at least an expectation by donors that belt-tightening exercises will be applied by recipient countries – are clearly counterproductive. Indeed, countries that have been exposed to carry-trade speculation need a real domestic currency devaluation in order to restore their international competitiveness. They also need assistance to avoid a

downward overshooting of the exchange rate, which would not only hamper their ability to check inflation, but also unnecessarily distort international trade. However, they do not need belt-tightening. Rising interest rates and reduced government spending will only lead to speculation and worsen conditions in the real economy. In such situations, countries need expansionary fiscal and monetary policies to compensate for the fall in domestic demand, as long as the expansionary effects of devaluation have failed to materialize in a contracting global economy (UNCTAD, 2009b).

Therefore, regional self-insurance mechanisms, such as swap arrangements or regional liquidity pooling, have strong appeal as efficient ways of self-insurance against short-term liquidity shortages (Imbs and Mauro, 2007). A regional swap arrangement usually consists of bilateral liquidity swap arrangements between the participating central banks of a region. Generally, central bank swap arrangements are temporary and reciprocal in nature: in times of liquidity shortage, the national central bank that draws on a previously established swap line with a foreign central bank sells a specified amount of its currency to that foreign bank in return for either foreign- or local-currency-denominated liquidity at the market exchange rate. This transaction is usually followed by a second transaction that requires the national central bank to buy back its currency on a specified future date at the same exchange rate plus interest rates at market rate. Bilateral swap arrangements can be established as a regional network of swap arrangements designed according to the participating country's needs in terms of volume, maturity and prolongation rules, denomination of the swap or currencies swapped against, interest rates, reciprocity arrangements and conditions (e.g. concerning threshold amounts for funds that may be withdrawn immediately and amounts that require approval of a regional or international institutionalized control mechanism).

Regional reserve pooling constitutes a more efficient way of reserve accumulation than nationally stocking up on foreign exchange, since each participating country may reduce its overall volume of reserve accumulation. Pooling national foreign exchange reserves requires a collective commitment on the part of participating countries to a joint regional contract to provide liquidity to member countries in times of crisis. Once agreement is reached on the volume, maturity, fees, interest rate payments and

conditionality of the financing, member countries gain access to immediate, short-term or medium-term financing, depending on the volume and structure of the fund. As such, regional reserve funds may constitute a flexible tool for reserve provision that is easier and more rapidly accessible than international mechanisms of assistance. However, it requires stronger commitment by the participating countries to cooperate regionally, as a mutual regional surveillance mechanism is likely to be needed to oversee macroeconomic development at the domestic level. This necessitates transparent information-sharing and monitoring of the macroeconomic policy implemented in the participating countries.

Depending on its design and volume, a regional reserve pool offers a number of possibilities for expansion according to the commitment and objectives of the member countries; for example, the regional fund may also be established as a regional financial development fund that accesses international financial markets to issue securities at different maturities and denominated in different currencies (Eichengreen, 2006), as discussed in greater detail below.

Taking a short- and long-term perspective and these various additional functions that regional liquidity funds may serve, Ocampo and Titelman (2009) point out that regional ownership by the cooperating countries facilitates enforcement of conditionality criteria. Given the heterogeneity of the international community, international and regional multilateral financial institutions, such as regional funds, may thus play complementary roles in providing assistance. For instance, regional institutions may provide credit to smaller countries, while the IMF may concentrate more on larger economies (Culpeper, 2006).

Obviously, regional self-insurance mechanisms only work as true insurance mechanisms if the pooled resources – whether in bilateral or multilateral regional agreements – are not drawn on by all the member countries at the same time. While exchange rate regimes need to be harmonized in order to achieve deeper economic integration at the regional level, regional co-insurance mechanisms provide a form of self-insurance that does not necessarily require a convergence of real exchange rates among regional partners. This means that this kind of mechanism may be adopted even at a low level of regional macroeconomic coordination.

(iii) *Financial development as a regional public good*

For developing countries in particular, regional cooperation may play a role in promoting the development of a sound domestic financial system as a condition for growth-enhancing macroeconomic policy.

In most developing countries, net foreign currency debt and the lack of long-term financial instruments causes exposure to balance-sheet effects increasing the risk of currency, debt and financial crises. This risk is exacerbated by the fragility of their financial markets, due to their lack of sufficient size, diversification, capitalization and liquidity compared with the more advanced financial systems of industrialized countries. Such weaknesses threaten to undermine a growth-oriented macroeconomic development policy, since financial crises are associated with short-term disruptions to economic growth and long-term loss of economic output (see, for example, Bordo, Meissner and Stuckler, 2009). In this context, preventing financial crises is understood as ensuring financial stability. And since a financial crisis may include contagious elements that imply economic costs even for countries that are not responsible for the underlying causes of the crisis, financial stability can be considered a public good.

Usually small developing countries lack sufficient scale to enable the development of mature, diversified and liquid financial markets by increasing lending maturity and reducing foreign currency borrowing. At the same time, international financial markets tend to have a low level of confidence in the domestic currencies of developing countries compared with key currency countries. Hence, for the majority of developing countries, external borrowing is costly. There are many underlying causes, but in the orthodox view on macroeconomic policy the main cause is inflation stabilization. But even in a situation of low inflation and stable real exchange rates, the domestic banking system may fail to provide long-term financing for real investment at low real interest rates (*TDR 2008*, box 4.1), thereby pushing firms to seek financing in international markets.

One option for developing countries is to avoid dependence on foreign finance by trying to achieve a current-account surplus (*TDR 2008*, chapter IV). Joining a multilateral currency union – as opposed to the unilateral choice of full dollarization involving

one of the world's key currencies – sharing a regionally diversified and large financial market is another. However, the first option is not always possible for all countries, and the second is not readily available for most regions. This applies especially to Latin American countries, where the possibility of creating a multilateral currency union with the country that emits the regionally dominant currency is not foreseeable in the near future. Nevertheless, even in the absence of this option, regional monetary cooperation without a major key currency can still enhance financial development.

Bond market development, as part of financial development for emerging markets, has been widely discussed recently. Even if bond markets are seen as an organic part of the domestic financial system whose development cannot be isolated from the establishment of an efficient and sound banking system, they have received more attention within regional cooperation mechanisms. Creating regional financial markets through a regional expansion of issuance and demand for local currency bonds (LCBs) and further innovative financial instruments represents a more demanding, but at the same time highly promising, strategy for enhancing financial development and providing financial stability.

Regional financial markets can be developed in two main ways that complement each other. First, through a regional financial institution that is in a position to take on a strong market-maker role. At the very outset, a regional financial institution can channel regionwide technical assistance and initiate regional information sharing. More importantly, based on country or regional agreements, the regional financial institution can issue LCBs and others in international markets. Additionally, such an institution would be in a better position than individual countries to attract international investments, and thus not only facilitate the issuance of LCBs but also the demand for them. As such, these institutions may play a strong market-maker role by bridging the gap between international and regional financial markets – with particular emphasis on smaller countries.

Second, regional financial markets can be developed by the member countries jointly creating a regional market for LCBs through the provision of the necessary infrastructure and funding at a regional level. Initially, on the supply side this may involve promoting and authorizing the issuance of LCBs by regional or international financial institutions. While

this can be approached countrywise, a regionally created basket currency unit bond is another possibility for promoting regional financial markets, but it requires a higher degree of commitment on the part of the participating countries. In addition to the supply side, demand for LCBs and additional investment instruments can be created by setting up a regional reserve fund (discussed above). Such a fund can be used to invest in bonds issued in regional markets using different approaches: bonds may be issued by public, quasi-public institutional or private entities, depending on the level of sophistication and development of the regional financial markets. They may also be issued as regional bond indices or in individual markets. Moreover, they may be denominated in dollars, a regional currency unit, or in local currencies of the participating countries (see also section B above).

For any of these options, establishing regional financial institutions is of crucial importance (UNCTAD, *TDR 2007*) for three reasons: first, as they are much better equipped for risk pooling or diversifying their portfolio than their individual member countries, regional multilateral financial institutions are better able to provide self-insurance mechanisms at the regional level. Second, as mentioned before, member countries are likely to have a strong sense of ownership of regional multilateral financial institutions, and as such, lending conditions can be enforced more effectively. Third, as a result, provided they are managed professionally, regional multilateral financial institutions generally enjoy a preferred creditor status, easier access to international financial markets and a higher credit rating, which makes them a valuable tool for enhancing regional financial development by bridging the gap between regional and international financial markets.

Summing up, regional approaches are required in order to provide financial stability, understood as a regional public good, which needs to be jointly promoted by countries within a region in order to support growth-oriented economic development. Financial market development at the regional level offers several advantages, in particular for smaller developing countries. The larger the size and more diversified the nature of regional financial markets, the easier it will be to create primary and secondary markets for LCBs, provided that regional financial regulations are established along with enforcement mechanisms. Furthermore, regional markets may provide an opportunity to introduce additional

innovative financial instruments that involve less risk of balance-sheet mismatches and financing costs for the issuing countries. Most importantly, regional financial development initiatives can be tailored towards the participating countries' requirements for financial stability and to suit their level of market sophistication (UNCTAD, 2009b). In particular, for the majority of smaller developing economies, creating financial markets at the regional level is much more likely to succeed than if they were to individually try to establish a market for local currency debt instruments or other financing mechanisms.

However, any effort at developing regional financial markets is likely to fail if countries' exchange rates are moving in different directions. In other words, the less volatile and the less divergent the regional exchange rates, the less costly and more effective will be any initiative for the development of a regional financial market, regardless of its level of sophistication. Varying movements of nominal and real exchange rates among regional partners have disruptive effects on intraregional trade and financial flows (Férrandez-Arias, Stein and Panizza, 2002). As such, any attempt to increase market shares of local-currency-denominated debt instruments, not only regionally but also internationally, quickly loses market confidence, depending on the predictability of prices. Moreover, it increases the cost both of intraregional financial transactions and of regional cooperation.

#### *(iv) Avoiding distorting competition among neighbouring countries*

Regional cooperation needs to give particular attention to the prevention of regional contagion and to internalizing the external effects of domestic macroeconomic policies on regional partners (UNCTAD, 2009b; Akyüz, 2009; Ocampo, 2006).

Unilateral efforts at currency devaluation and deflationist policies trigger contagion effects to other countries of the region. First, due to hoarding behaviour based on insufficient information of investors, devaluation of one currency within a region increases expectations of devaluation of other currencies in the region, thus triggering sudden stops of capital inflows and outflows and the spreading of a financial crisis in the region. Second, contractionary domestic policies following currency devaluation

produce contractionary effects also on regional partners through direct trade and financial links in the region: falling demand and changes in the direction of financial flows due to higher yields in the adjusting economy create a deflationary effect on other countries within the region. For example, in the Southern Common Market (MERCOSUR) unilateral currency devaluations first in Brazil and later in Argentina sharply disrupted trade integration efforts at the end of the 1990s. Deleterious effects of beggar-thy-neighbour policies increase with the level of regional economic integration already achieved if the much-needed monetary (including exchange rates) and overall macroeconomic cooperation are not enforced sufficiently to protect economic integration. Even in regional blocs that have rather low levels of economic integration, but whose members have similar production structures, currency devaluation in one country will give rise to competition for export earnings and for foreign direct investment, and hinder deeper economic integration.

Macroeconomic dialogue or stronger forms of regional surveillance, ranging from policy consultation to explicit coordination of exchange rates and other monetary policy, are necessary in order to internalize, at least partially, the externalities of national macroeconomic policies on regional partners.

Regional monetary cooperation can take on a range of intermediate coordination of exchange rate regimes, growing increasingly into a regime of intraregionally fixed exchange rates. Regional exchange rate coordination can begin by agreeing on a defined band width (wide or narrow) for a network of fixed intraregional nominal exchange rates. More binding forms involve the fixing of intraregional nominal exchange rates at par rates. The latter may be adjusted by a joint decision of the participating countries, if adjustment becomes necessary in the event of an external shock hitting the region. Coordination can progress with the member countries agreeing to peg their currencies to

a common virtual currency unit that is defined on the basis of an internal currency basket, which broadly unifies the participating currencies with weighted shares determined by their economic weight. The form or extent of coordination of exchange rate policies can thus be adapted to the requirements of the participating countries.

Exchange rate coordination provides the grounds for further regional monetary cooperation efforts. A regionally coordinated exchange rate policy can considerably reinforce efforts to enhance transparency and exchange of information, as well as intraregional trade and financial transactions, through the introduction of a regional payment system, the setting up of a liquidity fund and/or initiating the development of a financial market. At the same time, regional exchange rate policy coordination gains further strength as it becomes increasingly embedded in supranational institutional structures for the conduct of monetary policy, which eventually leads to full monetary integration.

In essence, the crucial role of regional monetary cooperation in the form of a coordinated exchange rate policy is to mutually enforce an end to beggar-thy-neighbour policies, on the one hand, and to shock-induced large nominal exchange rate depreciations on the other. If the member countries reliably commit themselves to taking on the adjustment cost involved in regional cooperation as well as to coordinating monetary policy decisions, including those relating to exchange rates, regional monetary cooperation can become a forceful instrument in support of growth-oriented macroeconomic regimes.

Such mechanisms are not expected to evolve independently of other schemes of regional cooperation, and may take a long time to evolve. By cooperating in specific fields, such as regional trade or liquidity provision, the degree of macroeconomic cooperation and coordination is expected to increase through a process of mutual reinforcement.

## B. The need for a growth-oriented regional monetary regime

The crucial question at the regional level is how regional monetary cooperation can facilitate the achievement and maintenance of a pro-growth interest rate and a competitive real exchange rate. A preliminary answer is presented here, as the recent turmoil in Europe has raised questions about the effectiveness of regional integration (chapter IV addresses this issue in greater detail.)

Developing-country regional arrangements are well advised not to follow slavishly the example of the euro zone, where a rather orthodox policy was adopted. From the very beginning it focused almost exclusively on price-level stabilization on the monetary side, thereby disregarding the interdependence of monetary and other macroeconomic policies (e.g. fiscal and wage policies) to sustain low inflation, together with low and stable interest rates and competitive exchange rates vis-à-vis the rest of the world (Arestis and de Paula, 2003). Uncoordinated internal competition among the euro-zone countries in terms of wage setting and external accounts resulted in a situation where some member countries, especially Germany, pursued wage deflation and subsequently gained high intraregional trade surpluses. In contrast, those countries that allowed their unit labour costs to grow in line with, or even higher than, the European inflation level suffered from a loss of competitiveness and intraregional trade deficits (Flassbeck and Spieker, 2010).

Without the possibility to use the exchange rate as an instrument for correcting intraregional misalignments, deficit countries are forced to adopt painful deflationary policies that are highly damaging to growth, income and public revenues. This can create a downward spiral that may take the economies a long period of time to recover. Therefore, in order to avoid the kind of severe imbalances experienced by countries like Greece and Spain in 2010, regional monetary cooperation should also include wage and incomes policy coordination, and at the same time prevent intraregional imbalances as a result of large

current-account surpluses of some countries and deficits of others.

In all stages before full monetary union, regional swap arrangements or regional liquidity funds may help contain uncontrolled devaluations. Such regional monetary cooperation would increase the credibility of regionally coordinated macroeconomic policies, especially when supported by macroeconomic surveillance of national systems of regulation. In this sense, any form of regional monetary cooperation – from regional liquidity funds to exchange rate cooperation – that shields the member countries against external shocks and prevents capital flow reversals and a financial crisis supports the maintenance of competitive real exchange rates. The Plaza Accord of 1985 is a rare but outstanding example of monetary policy cooperation in support of competitive real exchange rates at the international level. At that time, the G-5 countries (France, Germany, Japan, the United Kingdom and the United States) agreed to devalue the dollar over the course of the subsequent two years through joint foreign-exchange-market intervention by the central banks of the other four member countries of the accord with the objective of reducing the United States' current-account deficit and increasing the competitiveness of that country's exports in order to prevent a recession.

Finally, introducing selective regional capital controls in order to jointly avoid disruptive effects of carry-trade-related capital inflows and/or sudden stops in capital flows may constitute another means of supporting the competitiveness and stability of real exchange rates. Doing this at the regional level may be more effective for preventing a race to the bottom to attract external financing in the process of liberalization. Capital controls are much more likely to be implemented under full monetary integration, where there is a high degree of harmonization of monetary policy among member countries, and a jointly designed regional monetary policy with a common currency. While temporary and specific regional

capital-account regulation could be highly supportive in maintaining a competitive real exchange rate, it seems to be difficult to achieve at the regional level in non-harmonized systems of financial regulation and surveillance of multiple currencies due to multiple possibilities of circumventing controls. Within the Common Monetary Area (CMA) in Southern Africa, capital flows are fully liberalized, while 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. However, CMA is an exceptional case (UNCTAD, 2007: 132), as South Africa dominates regional financial and banking markets, and provides the regional anchor currency for the smaller CMA member countries.

Those regions with a regional monetary anchor, and which pursue the kind of growth-enhancing macroeconomic policies outlined in chapter I, are the most likely to be able to reap the benefits of regional monetary cooperation and integration. But for this to occur, a regional anchor-currency country needs to be willing and in a position to share its strength, in terms of growth-oriented macroeconomic management, with the remaining weak currency countries (see annex 3). If a core regional anchor currency exists, and its monetary policy authorities aim at realizing a pro-growth monetary policy, the usually smaller non-core countries will find it easier to conform to the necessary and sufficient conditions for a growth-oriented macroeconomic policy by orienting their monetary policies towards the anchor-currency country's monetary policy.

In contrast to the limited liquidity a regional reserve fund is able to provide, a regional monetary anchor with a central bank can issue a currency that is at least partially accepted as an international means of payment. Therefore, the best means for establishing a competitive exchange rate level would be through a widely accepted regional anchor currency. The regional anchor country should be sufficiently large

in terms of economic size to play a leading role in the region, with a currency that is strong enough to support other currencies in the region. At the same time, it should pursue a macroeconomic policy of competitive exchange rates and low interest rates, together with moderate inflation rates. In this best-case scenario, smaller, weak currency countries could adjust to the policy of the anchor country, thus importing its stability and growth orientation. Despite the economic adjustment costs entailed for follower countries, this is likely to represent a favourable macroeconomic condition for them. Being part of a regionally enforced liquidity provision or exchange rate stabilizing mechanism, or even adopting a joint regional currency provides a more effective, because less costly and more binding, means of realizing a growth-oriented macroeconomic regime.

However, most developing regions lack a currency that is able to play the role of an adequate regional anchor (see annex 3). In this case, it is more difficult to envisage gains from regional monetary cooperation and integration, at least at the initial stages of a regional monetary cooperation arrangement. However, a regional monetary anchor may emerge in the medium or long term. Alternatively, a regional anchor may be substituted, at least partially, by regional multilateral financial institutions.<sup>6</sup> But in the absence of a regional anchor, the chances of creating favourable macroeconomic conditions for enhancing productivity and investment seem weaker, as they depend entirely on the effectiveness and strength of the regional enforcement mechanism for a joint monetary policy regime. In this case, any level of regional monetary cooperation – from mutual agreements on liquidity support to deeper forms of regional exchange rate arrangements – may benefit from the creation of a strong regional multilateral financial institution. Thus the success of regional efforts to provide long-term support to a growth-oriented monetary policy will depend on the level of institutional sophistication and transparency and enforcement capacity at the regional level.



## Notes

- 1 The term “dollarization” is commonly used also for other forms of fixing a country’s currency firmly and unilaterally to a convertible currency such as the Euro, or allowing a foreign currency to circulate as a parallel currency. For a systematic overview of the differences between unilateral and bilateral currency unions and the greater stability provided by the latter, see also Angeloni, 2004.
- 2 For a more detailed view on the applicability of de facto dollarization to specific countries, see Panizza, Stein and Talvi, 2003.
- 3 In fact, one of the motivations for deepening economic integration within Europe was to shield the European economies from shifts in the value of the dollar following the end of coordinated exchange rates within the Bretton Woods system (Thomasberger, 1992).
- 4 If anything, the European experience shows that it may take decades to achieve a level of exchange rate and overall macroeconomic coordination that provides the foundation for a sustainable new regional currency to be established.
- 5 For a comprehensive analysis, see Eichengreen, 2006.
- 6 In South-East Asia, the Asian Development Bank is playing a major role in fostering and monitoring regional financial cooperation initiatives (see also chapter III). In the various subregions of Latin America, however, so far there is no clear indication of monetary cooperation, either in the form of an equally strong regional multilateral institution or a clear regional anchor currency. It would be difficult for Brazil, as the “natural” regional monetary leader due to its sheer economic weight in the region, to serve as a regional anchor in terms of broader monetary policy. This is because of its high real interest rate levels and the strong revaluation tendency of its currency caused by intensive carry trade (see also chapter I).



## **Chapter III**

# **REGIONAL PAYMENT SYSTEMS AND THE SUCRE INITIATIVE**

## **Introduction**

This chapter analyses regional trade-related payment systems as an initial step towards deeper regional monetary and economic cooperation (see chapter II). The focus is on evaluating the potential benefits of the Unified System for Regional Compensation – the SUCRE initiative – as a regional payment system.

Broadly, the analysis in this chapter finds that regional payment systems have a positive but small beneficial effect on intraregional trade volumes by

reducing transactions costs related to the use of foreign currencies in regional trade. To maximize gains in real terms from regional payment systems, they need to be carefully constructed, but also there should be a clear idea of how such systems should evolve beyond sustaining regional trade in the context of regional efforts at broader monetary cooperation. This especially applies to the idea of future exchange rate coordination at the regional level, for which the introduction of a regional unit of account for the invoicing of regional trade can be used as a reference value.

## **A. General framework**

Regional payment systems are international mechanisms designed to facilitate payments between residents of the participating countries. The advantage of this kind of mechanism is easy to understand: if a resident of country A, say Bolivia, wishes to buy a good produced in country B, say Nicaragua, the Bolivian resident has to find a way to pay for this good with a currency that is accepted by the Nicaraguan resident. This may be the Nicaraguan cordoba, or a major international reserve currency like the dollar. In either case, the Bolivian importer has to assume the cost of obtaining a currency different from his/her own currency in order to pay for the Nicaraguan good. While the cost for the individual importer may

be small, it increases at the aggregate level, due to the high number of international trade transactions that characterize a modern economy.

Regional payment systems basically aim at reducing transaction costs related to the involvement of third currencies in regional trade. The primary function is the establishment of a clearing mechanism among the central banks of the participating countries, where trade-related payments are registered. While payments to their residents are realized immediately, at the core of a regional trade-related payment system is an agreement between the member countries' central banks to temporarily extend credit to each

other by settling the accumulated net differences periodically.

Following Chang (2000: 3f) the reduction in currency flows and the associated transactions costs are realized mainly in two ways. First, the number of transactions is reduced to net final settlement at the end of the period, while transactions of equal value cancel out. Second, it provides temporary liquidity to the member countries' central banks, as they allow each other to cancel mutual obligations not immediately, but only at the end of the clearing period. In effect, an efficiently run regional payment system in this simple version may slightly improve the terms of trade for intraregional trade transactions. This in turn may create incentives to increase the share of intraregional trade.

A closer look at past and present regional payment systems shows that there are a variety of arrangements that address the problem of transaction costs in regional trade and they choose different instruments. Thus the effects of such systems in terms of reducing transaction costs have to be differentiated further. Since the economic literature so far lacks a systematic definition and discussion of regional payment systems, this chapter first develops a typology of such systems in order to evaluate the effectiveness of different arrangements in reducing transactions costs (part B) and to apply it to various past and present systems (part C). This provides the basis for assessing the planned design of the SUCRE initiative in part D, followed by general conclusions about the design and effectiveness of regional payment systems in general.

## B. A typology of regional payment systems

By definition, a regional payment system aims at reducing transaction costs at the level of individual transactions, by allowing firms in each of the participating countries to settle their transactions with firms in other member countries in their domestic currency.<sup>1</sup> The amount of the cost reduction depends first on the costs of the currency exchange transactions in the foreign exchange market, and these may vary for firms and banks depending on their size, their share in international trade and other criteria. The degree to which regional payments systems can contribute to reducing transaction costs at the aggregate level depends on three main criteria and the institutionalized mechanisms established among the central banks involved:

(a) *The difference between the gross and net values of trade transactions, and the length of the clearance period.* As a general rule, the greater the difference between the number and volume of gross and net transactions, and the longer the clearance period for net surpluses and deficits, the more effective a regional payment system can be in terms of reducing transactions costs (Chang, 2000). Additionally, temporary liquidity may rise through the provision of credit by central banks over the agreed clearance period.

(b) *The currency denomination of the final clearance, and settlement of surpluses and deficits among the central banks.* When final clearance and settlement among the central banks are allowed, not only in international currencies but also (at least partially) in national currencies of the member countries, this helps to reduce the transaction costs, because the central banks do not need to obtain the equivalent volume of the foreign currencies for this purpose.

(c) *Provision of credit beyond the clearance period.* Additional credit can be provided to deficit member countries through credit lines or swap arrangements on terms agreed among the member countries' central banks. Depending on the interest rate charged for these mutual credit lines, this can be more advantageous than financing conditions in financial markets.

Beyond the specific features of clearance, regional payment systems may also include coordinated mechanisms for adjustment among deficit and surplus countries at the regional level. Strongly unbalanced intraregional trade within a regional payment system rewards debtor countries with greater gains in terms of reduced transaction costs, especially when final

net clearance in domestic currencies is allowed and/or the provision of credit beyond the clearance period is provided. The higher the intraregional cumulative deficits, the smaller is the incentive for surplus countries to continue trading within the system. In this manner, regional payment systems themselves create incentives to balance trade at the regional level. The main benefit expected from regional adjustment mechanisms that help balance the deficits and surpluses is the prevention of beggar-thy-neighbour policies, especially in periods of balance-of-payments stress of individual member countries.<sup>2</sup>

Regional payment systems can also introduce a unit of account, which has two main functions:

- (a) The simple function is that it reduces transactions costs in multilateral clearing at the macroeconomic level, as it reduces the number of intraregional exchange rates to the bilateral exchange rates of each of the currencies towards the regional unit of account. The latter is usually fixed to an external key or reference currency. Nominal changes in the exchange rate of individual members' currencies should be reflected precisely in the adjustment towards the unit of account in order to prevent misalignments against market-based intraregional exchange rates and avoid trade distortion.
- (b) In a more sophisticated arrangement, the unit of account may emerge as an instrument for intraregional exchange rate cooperation, as it provides a point of reference for regional coordination of the exchange rate. It already delivers a common denominator against external currencies that can be used as a target for increasing harmonization of real exchange rate fluctuations against an external currency or currency basket. Here, more significant gains in terms of increased intraregional trade may be expected as a result of shielding intraregional exchange rates from global currency instability through coordinated adjustment. Moreover, it prepares the ground for deeper regional monetary cooperation (see chapter II).

In conclusion, most types of regional payment systems may provide rather modest results by reducing specific transaction costs of intraregional trade. However, the extent of reduction of transaction costs depends not only on the difference between gross and net trade transactions at the regional level and the length of the clearance period (for provision of temporary liquidity), but also on the costs of this provision of liquidity during, and eventually, also beyond the period of settlement.

The potential benefits of regional payment systems associated with the provision of temporary liquidity are greater the higher a region's costs of securing and maintaining foreign exchange liquidity. Thus the incentive for using these mechanisms may increase during periods marked by high interest rates at the global level, as much as when one or more of the countries involved in the regional payment mechanism are experiencing balance-of-payments stress.

Additional gains beyond transaction costs can only be expected if the inclusion of adjustment mechanisms reduces the risk of beggar-thy-neighbour policies at the regional level, and especially if the payment system is designed as a first step towards deeper regional monetary cooperation and coordination. This link could be established by increasingly using the regional unit of account as a reference for intraregional exchange rate harmonization.

By creating confidence in cooperation among member States, regional payment systems could also provide the basis for further steps towards greater institutional integration. However, more ambitious objectives related to regional trade-related payment systems can be met only if the countries sustain the arrangement through increasing macroeconomic policy convergence oriented towards economic growth, and if they have a medium- to long-term strategy for regional monetary cooperation. Otherwise, even small steps, such as a regional unit of account for reducing transaction costs of intraregional trade may well serve only short-term objectives of increasing intraregional trade and slowly improving terms of trade of the member countries on a very small scale.

## C. Lessons from past and present experiences

This section describes the experiences of four regional trade-related payment systems, including a comparison of those systems (table 3.1), in order to gain a better understanding of the instruments and potential outcomes of the SUCRE initiative. The four examples selected, in chronological order, are: the European Payments Union (EPU), the Agreement on Reciprocal Payments and Credits of the Latin American Integration Association (CPCR-LAIA/ALADI), the Asian Clearing Union (ACU), and the System of Payment in Local Currency (SML) between Argentina and Brazil.

A comparative analysis of these schemes shows that, beyond their specific context, due to regional differences and varying conditions, they represent different degrees of sophistication in their objectives and related instruments. To compare these schemes, we use (as also used by some of these arrangements) the “Keynes Plan” for a global payment system as a reference.<sup>3</sup> However, it is important to state that the Keynes Plan did not focus primarily on the reduction of transaction costs, but rather on the establishment of an international lender of last resort. It envisaged an arrangement that would be equipped with powerful weapons to force not only deficit countries but also surplus countries into adjustment, with the aim of avoiding large trade imbalances that may trigger economic crises or provoke protectionist measures. In contrast, regional (as opposed to global) payment systems need to take into account extraregional trade and financial conditions.

Depending on whether their objective is to reduce transaction costs in intraregional trade or whether their long-term vision is some form of deeper regional monetary cooperation, the regional arrangements analysed here differ widely in terms of their purpose with reference to the comprehensive Keynes Plan.

In the following sections, these schemes are presented based on table 3.1. Each analysis also includes a brief empirical assessment of the use of

the schemes in intraregional trade transactions in comparison with regional trade conducted outside each scheme, depending on available data.

### 1. The European Payments Union

The European Payments Union (EPU), which was created in 1950 and was replaced by the European Monetary Agreement in 1958, is held up as a role model for fostering regional trade. It performed the full range of functions of regional payment systems as shown in table 3.1, including reduction of transaction costs in regional trade by enabling trade payments to be settled in domestic currency (item 1 in table 3.1): where foreign exchange requirements were limited to the minimum amount necessary through multilateral clearing with a short-term liquidity provision (2a), during the settlement period of one month, (2b) and where credit provision exceeded the payment system’s internal clearance periods (2c). In addition, it had strong trade adjustment incentives through gold quotas (3) and a regional unit of account that was used for accounting purposes only (4a). Though explicitly not designed to provide a common European currency, this unit of account can be regarded as the first stage of what 30 years later became the European Currency Unit (ECU) in 1981 (4b).

Although it is widely believed that regional payment systems modelled on the EPU would solve problems of regional trade creation in a similar way, it should be pointed out that the design of the EPU was strongly linked to the unique conditions and historical context prevailing at the time of its foundation, when the Bretton Woods system provided very stable international monetary conditions. It is therefore probably the only regional payment system that did not need to create adjustment mechanisms for extraregional exchange rate adjustments. It was set up in a world of fixed exchange rates, non-convertibility of all currencies other than the dollar and strictly limited private capital flows. In addition, it is important to note that EPU was not established

**Table 3.1**  
**COMPARISON OF OBJECTIVES OF SELECTED REGIONAL PAYMENT SYSTEMS AND THE KEYNES PLAN**

<i>Objectives</i>	<i>Keynes Plan for a global payment system</i>	<i>EPU</i>	<i>CPCR-LAIA</i>	<i>ACU</i>	<i>SML</i>	<i>SUCRE</i>
1. Reduction of transaction costs (use of domestic currency at firm level)	X	X	X	X	X	X
2. Saving of foreign reserves by:						
(a) Temporary liquidity (clearance period)	X	X	X	X	-	X
(b) Final settlement in national currencies	X	partially	-	optional	-	optional
(c) Credit lines beyond clearance	X	X	-	X	-	planned
3. Coordinated adjustment among deficit and surplus countries	X	X	-	-	-	planned
4. Unit of account						
(a) For accounting purposes	X	X	-	X	-	X
(b) Instrument of exchange rate coordination	X	-	-	-	-	-

**Source:** UNCTAD.

without difficulties: negotiations to reach agreement on the incentive structure to reduce intraregional trade imbalances took a long time, and the EPU underwent a series of modifications during its existence.<sup>4</sup>

The European Payments Union (EPU) was founded in 1950. An important incentive for its creation was pressure from the United States for trade liberalization in Europe, aimed at rapidly restoring Europe's economic strength after the Second World War. In this context, the EPU's objectives were to: develop convertibility of the European currencies at the regional level, liberalize intra-European trade, and multilateralize existing bilateral trade arrangements. The founding members were: Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.

The main benefit of the EPU was that it ended bilateralism in intraregional trade by introducing a multilateral clearing system: a regional unit of account was set up at par to 1/35 ounces of gold (equal to the gold conversion rate of the dollar but independent of it). The EPU's unit of account was used only for multilateral clearance of regional transactions, and each country set a parity of its own currency with this unit of account.

The EPU's accounts were held at the Bank for International Settlement (BIS), which acted as its financial agent and also its clearing house. Each country had to hold only one account with the clearing house, denominated in the unit of account. The settlement period was one month, after which the participating countries reported their balances with each of the other countries to the BIS. Remaining balances were merged to represent balances of the EPU as a whole, so that it made no difference what balance was held by each member country.

The EPU had a limited mechanism to balance trade.<sup>5</sup> Following its inception, each country received a quota of 15 per cent of its total trade with the EPU. As long as a country's net debt was less than 20 per cent of its quota, it was financed by credit, so that the country did not need to pay. If a country's debt reached 20 per cent of the quota, that country had to settle 20 per cent of the quota in gold. Debts amounting to 40, 60 and 80 per cent of quota were required to settle in an equal percentage of shares in gold or dollars. If a country exceeded its entire quota, it was required to make its payments entirely in gold.<sup>6</sup> Cumulative surpluses were settled in a similar way as deficits but at different percentage shares. Until its quota was exceeded, a surplus country would receive gold, but amounting to only a maximum of 50 per cent of its cumulative net surplus position. In

addition, claims were converted into commodities or hard currency only partially and with a delay.

Despite inherent incentives to avoid excessively large surpluses, countries with a net export surplus to the region benefited from the EPU in three ways (Eichengreen and de Macedo). First, surplus countries had access to gold, rather than having to use internationally unconvertible neighbour countries' currencies in return for their exports. Creditors were given more gold than debtor countries from a pool of \$350 million, which was initially financed by the Marshall Plan. Second, financial assistance was provided, conditional upon economic adjustment by the debtor countries, thus limiting any potential misuse of the system. Third, trade liberalization was a requirement for EPU membership. Reducing trade barriers by up to 75 per cent was required over the course of EPU's existence, which resulted in trade gains, particularly for the internationally more competitive surplus countries.

The strong orientation towards trade liberalization within Europe was a crucial additional element of the EPU's success in increasing trade, as it prevented the countries from reverting to trade-related beggar-thy-neighbour policies in order to enhance economic growth. The importance of the quest for intraregional trade liberalization came into sharp focus when EPU found itself on the edge of collapse in its initial years of existence (for details, see Bühner, 1997: 206; and Eichengreen, 2007: 83). Germany's quick shift to a net trade surplus in 1951 would not have been possible without the existence of the EPU. Despite a surge in demand for German industrial goods due to the Korean war in 1950, German import demand exceeded its export production so that its current-account deficit increased and it exceeded its EPU quota. To prevent a return to trade restrictions by Germany, the EPU made an exception and granted it a credit.<sup>7</sup>

The volume of European trade increased considerably during the existence of the EPU, partly as a result of trade liberalization agreements. According to Eichengreen and de Macedo, 2001, "Although both intra-European trade and trade with the rest of the world expanded more quickly than European production in the EPU years, the spurt in European trade was coincident with the inauguration of the EPU." This is evident from the fact that intra-European trade increased from \$10 billion in 1950

to \$23 billion in 1959, while imports from North America grew more slowly, from \$4 billion to \$6 billion. At the same time, credit expansion under the EPU fuelled intraregional trade by reducing specific trade-related transaction costs through the use of extraregional currencies in intraregional trade (ibid.): "Participating countries had \$46 billion of surpluses and deficits against one another during the EPU years. Nearly half (\$20 billion) was cancelled multilaterally. Another quarter (\$12.6 billion) was cancelled inter-temporally, as countries ran deficits in one month, financing them wholly or partially with credit, and ran offsetting surpluses in subsequent months, cancelling their previous position. Settlement in gold and dollars was limited to most of the remaining quarter (\$10.7 billion). Thus, EPU reduced settlement in gold and dollars by more than 75 per cent compared to what would have been required under strict bilateralism."

Apart from increasing intra-European trade, the EPU contributed significantly to improving Europe's terms of trade. It functioned like a common external tariff scheme: demand for extra-regional goods declined as the prices of intra-European goods became more favourable due to the intraregional convertibility scheme and the credits provided. While this rapid expansion of intra-European trade fuelled productivity and rising income levels, it was crucial for the economic development of Europe to be able to build on several elements for economic growth. At the national level, the EPU counted on a strong commitment to an agreement on income distribution. Labour and management in the member countries bargained real wages below or at the level of productivity increases in return for productive reinvestment of profits (Eichengreen, 1993: 121). At the regional level, the EPU was built upon trust in members' commitments to contribute to the mutually agreed rules.

Ultimately, the EPU's exit barriers were too high to not commit strongly to the intra-European payment system. However, it is important to note that during its existence, the EPU had to contend with a number of challenging crisis periods, which was only possible due to its highly favourable incentive structure. "What helped to overcome these was the fact that the EPU proved to be very useful to its members as it not only provided credits for importing but in this way also allowed members to export." (Dickmann, 1997: 195).



## 2. *The Agreement on Reciprocal Payments and Credits (CPCR-LAIA)*

The Agreement on Reciprocal Payments and Credits (CPCR – *Convenio de Pagos y Créditos Recíprocos*), which was established in 1966, was the first mechanism of its kind in Latin America. It was the result of a long process of negotiations and studies, at least since the 1950s, under the aegis of the Economic Commission for Latin America and Caribbean (ECLAC).<sup>8</sup> This agreement, under the auspices of the Latin American Integration Association (LAIA/ALADI – *Asociación Latinoamericana de Integración*),<sup>9</sup> has 12 of LAIA's 13 member countries as signatories: Argentina, the Bolivarian Republic of Venezuela, Bolivia, Brazil, Chile, Colombia, the Dominican Republic, Ecuador, Mexico, Paraguay, Peru and Uruguay.<sup>10</sup>

This payment system serves to reduce transaction costs (item 1 in table 3.1) and provides temporary liquidity during a clearance period of four months (2a). The central banks agree on the amounts and conditions of the temporarily provided credit lines, register the operations and assume the risks of delayed payments during the clearance period (see below). At the end of that period, the net amount of all credits is settled multilaterally in dollars. The CPCR does not provide credit mechanisms beyond this period, maintains the hard currency for final clearing among central banks, and does not include a common unit of account.

Even without replacing the dollar as the currency for final clearance (2b), the CPCR mechanism has been able to reduce transaction costs in intraregional trade. In particular, it was able to help overcome the obstacles to trade expansion resulting from the high costs of financing in dollars during the so-called debt crisis in Latin America in the 1980s.

However, since the 1990s the use and effectiveness of the CPCR has declined significantly, for two main reasons. First, the CPCR has not been able to keep up with the expansion of intraregional trade since the mid-1990s as a result of MERCOSUR. Since then, the value of operations channelled through the CPCR has steadily declined, reaching its lowest level in 2003, at \$700 million. While the share of intraregional trade channelled through this mechanism amounted to an average of almost 90 per cent of total regional trade transactions in the 1980s, it has remained below 10 per cent since

the mid-1990s. Second, there has been a significant increase in pre-payments (i.e. voluntary settlement of claims before the maturity date of four months). These operations rose from less than 10 per cent of the total at the end of the 1980s to more than 90 per cent in the mid-1990s, with only a short reduction in the period 2001–2004.

As a consequence of these developments, the CPCR's usefulness and its contribution to intraregional trade creation, has continuously declined. Based on the LAIA's calculations<sup>11</sup> of the benefits derived from CPCR (i.e. the percentage difference between the total value of operations channelled in each year and the amount of dollars effectively disbursed), the high values of the 1980s (of 70–80 per cent) fell to around 25 per cent in 2003. Since 2006, this share has been lower than 5 per cent.

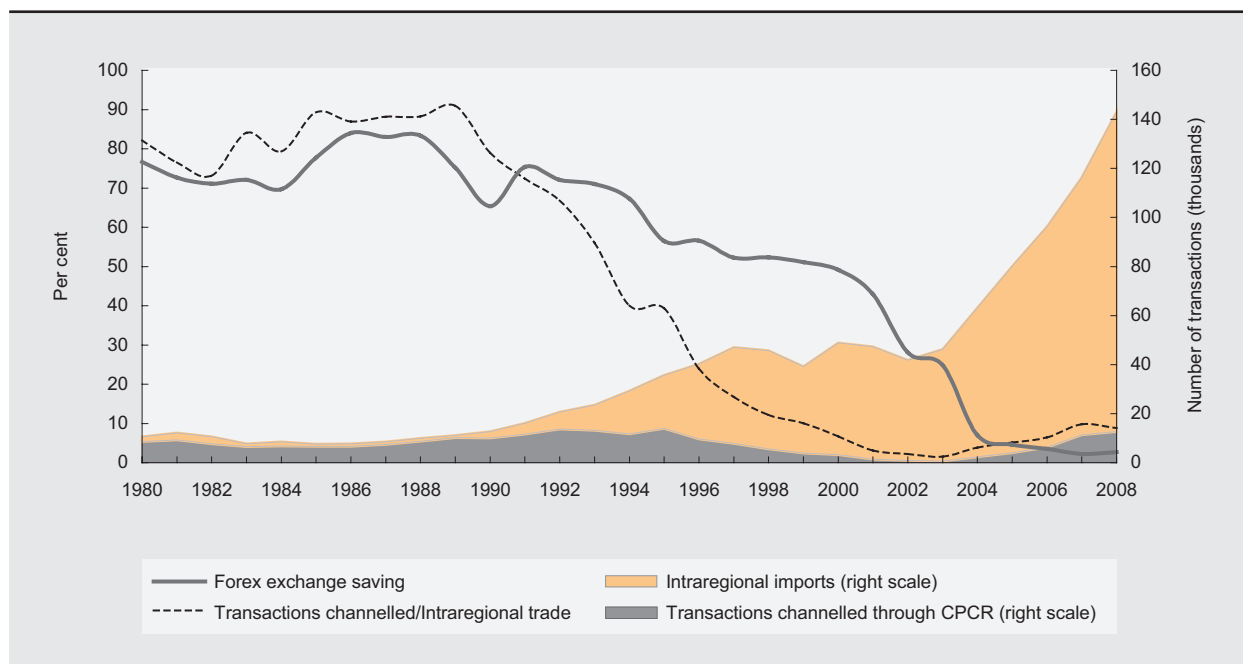
Other underlying reasons for the declining use of the CPCR relate to some specific problems with the system that should be taken into account in the design of a new payment system in Latin America.

The first reason explaining the decline in CPCR utilization involves the possibilities and conditions for choosing the mechanism to channel payments. During the 1980s, faced with severe balance-of-payments problems, the majority of CPCR-member central banks made it mandatory to channel payments for intraregional trade transactions through the CPCR, until 1992. Since then, however, while still in accordance with the general rules of the Agreement, the countries started to bypass the CPCR through their own domestic regulations.

Among the reasons for this increasingly cautious stance, was the reluctance of the central banks to assume risks associated with intraregional trade transactions arising from the set of guarantees assumed under the Agreement by the central banks for convertibility, transferability and reimbursement for transactions provided by the system.<sup>12</sup> As the LAIA secretariat itself has stated: "... the fact that the Central Banks assume the credit risks involved in intra-regional trade transactions by granting a reimbursement guarantee to each transaction greatly stimulated the use of the system by exporters and by commercial banks since its initiation in 1968. From the 1990s onwards, institutional changes with respect to objectives and aims of the members' central banks turned out to be 'problematic' for the majority of the Central Banks, due to their

Figure 3.1

## AGREEMENT ON RECIPROCAL PAYMENTS AND CREDITS: KEY OPERATIONAL RESULTS, 1980–2008



Source: LAIA, at : <http://www.aladi.org/nsfaladi/convenio.nsf/Pcompensacionsaldos>.

duty to provide reimbursement guarantees” (LAIA, 2009: 11).

Another reason was that the increase in pre-payments caused a steady decline in the comparative advantage of the CPR in the settlement of intraregional trade transactions in terms of its providing temporary liquidity by central banks. A claim is settled in advance only if there are no better alternatives available for one or both sides of the contract. The interest rate on the bilateral credits of the agreement is fixed as the average of the four-month daily values of the London inter-bank offer rate (LIBOR) plus one percentage point during the first three months and half a percentage point for each compensation period. If this rate is lower than what a creditor country may earn in alternative investments of its foreign exchange reserves, it is interested in receiving payment in advance, thus creating a potential disincentive for net exporting countries. If, at the same time, this interest rate is higher than that offered by other financing sources, it too provides a greater incentive for pre-payment by a debtor country.

Thus advance payments within the CPR started to increase at the beginning of the 1990s, when Latin

America once again became an increasingly attractive destination for private capital inflows (figure 3.1). Later, between 1999 and 2003, when external financing conditions deteriorated once more, the percentage of pre-payments fell slightly, but increased again with the resurgence of capital flows during the global boom period. These trends suggest a correlation between the attractiveness of payments through the CPR and the absence of private external financing.

Beyond this, the incentives to use the CPR developed asymmetrically among the members, since increasingly diverging creditor and debtor positions developed between the largest member countries. The bulk of the operations have involved Venezuelan imports and Brazilian exports of engineering services associated with big infrastructure projects, thus involving only a small number of transactions. This too has had the effect of diminishing the CPR’s role in reducing transactions costs, beyond unequal distribution of its use by members. Thus there seems to be room to improve the incentive mechanisms and institutional arrangement within this LAIA payment system. Certainly a payment system better suited to the regional context could have helped the expansion of intraregional trade since the 1990s.<sup>13</sup>

### 3. The Asian Clearing Union

The Asian Clearing Union (ACU), founded in 1974, offers a clearance period with provision of short-term liquidity (table 3.1, item 2a) and the provision of swap lines for deficit countries beyond clearance (2c). It also provides a unit of account for the factoring of transactions channelled through the system (3a).

ACU was the outcome of an initiative of the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) in order to foster regional cooperation between the countries concerned, namely Bangladesh, Bhutan (since 1999), India, the Islamic Republic of Iran, Maldives (since 2009), Myanmar, Nepal, Pakistan and Sri Lanka. ACU itself describes its objectives as follows: “To facilitate settlement, on a multilateral basis, of payments for current international transactions; to promote the use of participants’ currencies in current transactions; to promote monetary cooperation among the participants and closer relations among the banking systems so as to expand trade and economic activity among the countries of the ESCAP region; and to provide for currency swap arrangement among the participants.”<sup>14</sup> Use of the ACU clearing facility by member countries is optional.

A regional unit of account, the Asian Monetary Unit (AMU), has been created for the settlement of ACU transactions. For many years market participants invoiced and settled intraregional payments in local currencies, but since the beginning of 1996, ACU is implemented as a multi-currency settlement system through which participants may also settle their accounts in dollars or euros, and AMU is referred to as ACU dollar or ACU euro. As the main purpose of the ACU is to provide a common unit of account, the term ACU dollar is specifically used to identify the use of ACU transactions as distinct from transactions in dollars. Otherwise there is no distinction value-wise between the ACU dollar and the dollar. The same applies to the ACU euro. AMU is kept equivalent to one dollar and one euro respectively. Intraregional exchange rates with the ACU dollar/ACU euro are calculated based on daily SDR cross rates as published by the IMF. The Board of Directors may change the denomination and/or the value of the AMU at any time by a unanimous vote of the Board of Directors.<sup>15</sup>

Provision of liquidity by mutual central bank credits during the settlement period is realized in

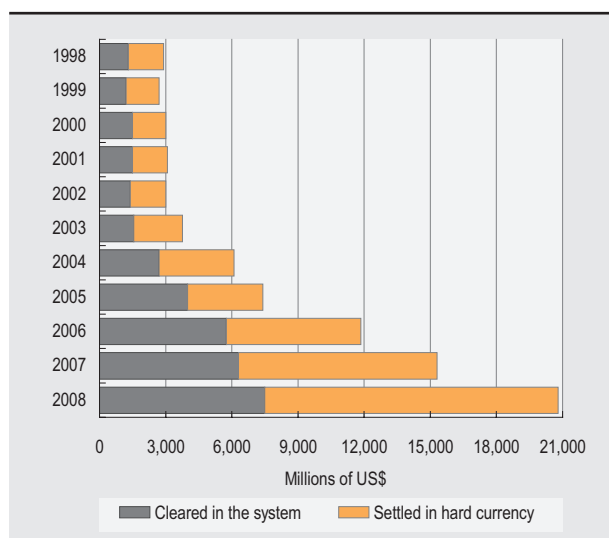
ACU. The settlement period is two months, after which interest payments and debtor and creditor positions are netted out. Within that period, trade between ACU member countries does not require any payment and there are no restrictions on volumes, or kinds of goods and services traded. The basis of the ACU operating mechanism is the ACU dollar and ACU euro accounts of the participating countries’ banks with the correspondent banks in other participating countries (ACU, 2009: 6). Out of these accounts, only the net surpluses and deficits are required to be settled by the central banks in the countries concerned. Authorized banks settle commercial and other eligible transactions similar to usual foreign exchange transactions; they are responsible for maintaining their AMU-related accounts commensurate with the requirements of their foreign exchange business. The participating central banks commit to making their payments within four working days of notification, either in international reserve assets or in the debtor countries’ currency, as specified by their boards of directors. In case of payments in other currencies than dollars or euros, the settling member countries have to agree on the appropriate exchange rate.

The mechanism for inducing timely payments is through penalty fees or the threat of possible expulsion from the ACU. Delayed payments are subject to fines amounting to the higher of either the interest of 1 per cent per annum above the rate for the relevant settlement period(s) or 1 per cent per annum over the rate applicable on the day of default. In case a participant fails to pay within 15 days upon notification and no agreement can be reached between the partners involved in the pending transaction within seven days, the respective country is expelled from ACU until payments have been made. According to the ACU, no partner country has ever defaulted so far, probably due to its strong enforcement mechanism.

The ACU contains a swap facility for debtor countries beyond the clearing period: any participant in net deficit at the end of a settlement period is eligible for this swap facility. An eligible participant is entitled to the swap facility from every other participant up to 20 per cent of the average gross payments made by it through ACU to other participants during the three previous calendar years. The interest rate charged on drawing on the swap facility is derived from the dollar or euro two-month LIBOR declared by the British Bankers’ Association.

Figure 3.2

## TRANSACTIONS CLEARED/SETTLED THROUGH THE ACU MECHANISM DURING 1998–2008



Source: ACU, *Annual Report of 2008*. Available at: <http://www.asianclearingunion.org/Portals/0/Annual-Report/ACU%20Annual%20Report%202008.pdf>.

According to ACU, the regional payment and clearing system has contributed to a rapid expansion of trade, particularly in recent years: In 2007, transactions amounted to \$15,830.5 million, 31.4 per cent more than the preceding year (figure 3.2). On a monthly basis, the average transactions stood at \$1,319.2 million compared to \$1,004.2 million in the preceding year. India, the Islamic Republic of Iran, Sri Lanka, Bangladesh and Pakistan account for the bulk of transactions (export+import+interest).<sup>16</sup> Although comparable data on total net intraregional trade volumes are not available, approximate measures suggest that payment of a large share of intraregional trade is being channelled through the ACU.

#### 4. The system of payment in local currencies

The System of Payment in Local Currencies (SML – Sistema de Pagos en Moneda Local) between Argentina and Brazil began operations in October 2008. With reference to table 3.1, this is a simple payment system that uses the national currency for trade factorizing and clearing of bilateral trade operations between an importer, and exporter and commercial banks (item 1 in table 3.1). It is designed to overcome only one of the problems presented in table 3.1, namely transactions costs associated with

international trade operations. Use of the SML is voluntary by both member countries.

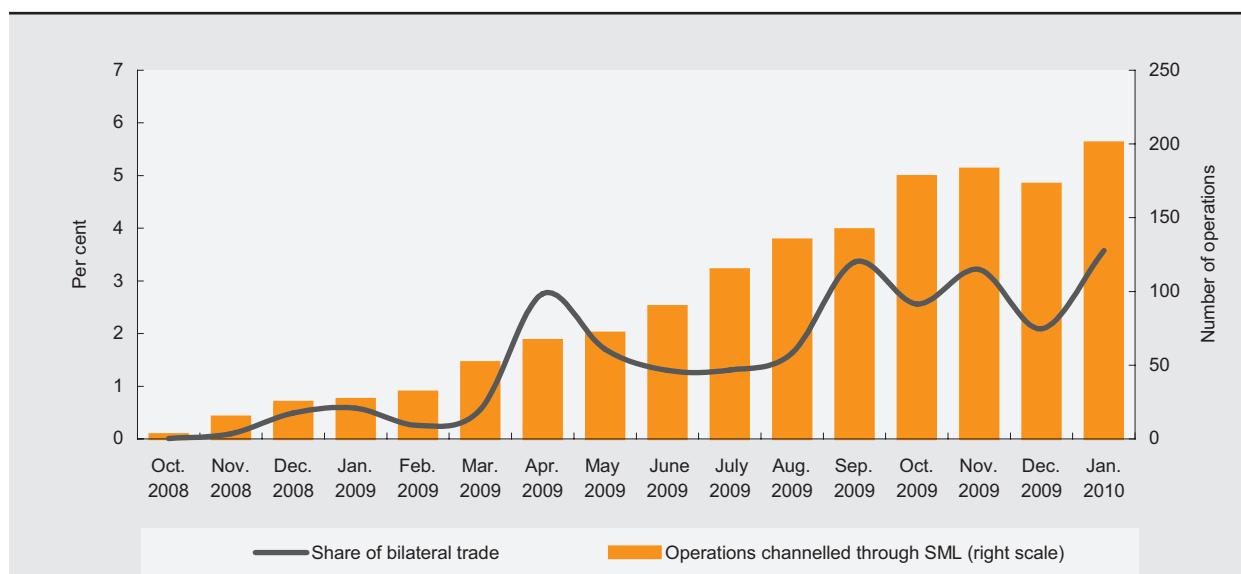
An explicit goal of the mechanism is to develop the foreign exchange market between these two countries. Thus, the exchange rate between the Argentinean peso and the Brazilian real is determined on a daily basis. This is triangulated through the respective dollar exchange rates.<sup>17</sup> Based on this daily rate, the values of export and import transactions in the two countries are converted into national currencies, to be paid by importers to their central banks and received by exporters from their central banks. These payments are made like any other international transactions, by local banks previously authorized to transfer the operations,<sup>18</sup> which means that credits can be granted in local currencies. Each operation between the central banks via the SML is cleared through the international banking system in New York. The maximum period for this clearing is three days, but it usually takes just 24 hours. Thus there is no clearing period which would enable a saving of foreign exchange reserves by accumulating and final clearing of net positions between the central banks.

As the mechanism has been established only recently, an evaluation of its use and effectiveness can only be very preliminary. The mechanism started operating with a limited number of operations and trade volume. In the 16 months until January 2010, a total of 1,510 transactions were channelled through the SML, of which 94 per cent were Brazilian exports. The amount channelled was equivalent to 1.63 per cent of bilateral trade: 538 million real (of which 99 per cent were Brazilian sales). This is equal to 3 per cent of total shipments from Brazil to Argentina and less than 0.05 per cent of transactions in the opposite direction.<sup>19</sup> However, the SML is being used more and more, with a continuous increase in the number of operations and share in bilateral trade (even if concentrated on one side of the balance). In January 2010, already 7 per cent of the total trade between the two countries was channelled through the SML (figure 3.3). In addition, satisfaction with the use of the system seems to be high: 65 per cent of companies have used it more than once, and the number of complaints seems to be low.<sup>20</sup>

Another explicit goal of the SML is related to the kind of enterprises using the mechanism. Being voluntary, by definition should offer advantages over traditional payment settlement in international

Figure 3.3

**SYSTEM OF PAYMENT IN LOCAL CURRENCY: EVOLUTION OF USE AND SHARES OF BILATERAL TRADE, OCTOBER 2008–JANUARY 2010**



**Source:** Central Bank of Brazil (<http://www.bcb.gov.br/?SMLESTAT>); and Brazilian Ministry for Development, Industry and International Trade (<http://www.desenvolvimento.gov.br/sitio/interna/index.php?area=5>).

transactions. The SML is specially designed to cater to the specific needs of small and medium-sized enterprises (SMEs), for which access to the foreign exchange market is restricted due to high transactions costs relative to their small size. Unlike the larger companies in both countries, for these smaller firms the option to pay and receive in local currency represents significant cost reductions.

At the same time, the SML could gain importance by expanding regionally, especially to include other members of MERCOSUR. Indeed, Uruguay is expected to enter into a test phase with the mechanism, at least for bilateral trade operations with Brazil in 2010. Regarding Paraguay, some technical challenges persist, mainly involving computerization of the domestic payment system. Once the difficulties

of initial implementation between Argentina and Brazil are overcome, extending the SML to other economies should become easier.

In terms of lessons in the design of payment systems, probably the main contribution of this new initiative is its effectiveness in addressing specific transaction costs in foreign exchange for smaller firms. The system has a simple and transparent structure with a clear set of rules and incentives. In its short period of implementation, SML has shown that a step-by-step approach may be beneficial as long as it is continuously and transparently adapted to international financial conditions and addresses specific problems linked to the transaction costs inherent to accessing non-domestic currency for intraregional trade.

## D. The SUCRE initiative

### 1. *An initial appraisal of the SUCRE initiative*

In recent years, Latin America and the Caribbean have shown a strong inclination for fostering regional integration. In 2007, a regional development bank, the Banco del Sur was established, and more recently there has been much debate about creating a common reserve fund, Fondo del Sur, among others. With respect to enhancing regional efforts in monetary cooperation, importance has been given to the role of payment systems. Current initiatives in the region are seeking an alternative to the traditional use of the dollar as the invoice currency for regional trade transactions.

In November 2008, during the third Extraordinary Summit of Heads of State and Government of the Bolivarian Alliance for the Peoples of Our America (ALBA), ALBA members discussed the idea of creating a virtual currency to be used among central banks as an invoice currency for intraregional trade transactions. This was followed up by the presidential commissions of the Bolivarian Republic of Venezuela, Bolivia, Cuba, Ecuador, Honduras and Nicaragua working together on the creation of such a system. The final outcome was the so-called Unified System for Regional Compensation (Sistema Unitario de Compensación Regional) – or SUCRE initiative – which was approved in April 2009<sup>21</sup> and used for the first time in a trade transaction between the Bolivarian Republic of Venezuela and Cuba in February 2010.

#### (a) *Functioning of the initiative*

In traditional payment systems, compensation and liquidation of commercial balances between central banks is done in dollar or another internationally accepted currency. The SUCRE initiative aims at offering ALBA members an alternative system that offers the option to invoice intraregional trade transactions using a virtual unit of account,

the SUCRE, and permitting the use of domestic currencies of the member countries for final clearing and settlement.

Following the items presented in table 3.1, the SUCRE initiative aims at reducing transaction costs in intraregional trade (item 1 in table 3.1), and is linked to the saving of foreign exchange by allowing the delayed settlement of trade transactions (2a). The mechanism offers the option of settling final net payments of net trade surpluses and deficits in a domestic or international currency (2b as option). The establishment of a regional credit fund (2c) and adjustment mechanisms to balance intraregional trade channelled through the system (3) are envisaged, but not yet operational.

A key feature of the SUCRE proposal is that it involves the creation of a regional unit of account, the SUCRE, to replace the dollar for invoicing regional transactions. The creation of a virtual currency unit is a unique feature of the SUCRE proposal, which distinguishes it from other existing regional payment systems in Latin America, such as the SML between Argentina and Brazil. Its use does not involve physical emission of SUCREs, and is restricted to invoicing operations relative to intraregional trade payments only at the central bank level.

The SUCRE is designed to be a common unit of account the value of which is derived from a basket of currencies of the member countries weighted according to the relative economic size of their economies (see section 2(a) below for the formula used for determining the value of the SUCRE). It is intended to be used by selected ALBA members (the Bolivarian Republic of Venezuela, Bolivia, Cuba, Ecuador, Honduras and Nicaragua), with the exception of three CARICOM-ALBA members: Antigua and Barbuda, Dominica and Saint Vincent and the Grenadines. For these latter economies, the use of the SUCRE might pose a problem, as they are already members of the Eastern Caribbean Currency Union (ECCU) which uses the East Caribbean dollar.

The SUCRE has been designed as an alternative and modular system of regional payments. Central banks can decide whether to use the SUCRE mechanism and unit of account for invoicing trade transactions, or the traditional international system for invoicing exports and imports in dollars. An additional feature of the system, atypical for payment systems, is that, in its preliminary form, countries can select which products will be traded using this system of payments.

If a country decides to use the SUCRE as a unit of account for intraregional trade, the Central Unit of Compensation (CCC – Camara Central de Compensacion,) will assign it an initial amount of SUCREs. The assignment will be registered as a liability for the CCC and will be adjusted periodically according to that country's trade levels with other members. The CCC is also the entity responsible for the periodic compensation and liquidation of payments in SUCREs among the central banks of the member countries.<sup>22</sup>

Apart from the CCC, the dynamics of the system include interactions among importers/exporters, commercial banks and central banks. However, as is usual in regional payment systems that provide a unit of account, the clearance of transactions in SUCREs takes place only at the central bank level; meanwhile importers/exporters cancel/receive the amount of the respective trade transaction in their local currencies. Importers in country A pay for their orders in their local currency through their commercial bank and exporters in country B receive the payments through their commercial bank in their local currency.<sup>23</sup> As a second step, the central bank of country A registers the operation by reducing the amount of SUCREs, thus showing a deficit position in its SUCRE account, and country B shows a trade surplus in SUCREs. The clearance of the SUCRE position has, as a counterpart, a SUCRE account at the Central Unit of Compensation.

The SUCRE scheme is characterized by the existence of two payment circuits operating at different levels: one is clearance at the *intraregional level* (among central banks, carried out in SUCREs) and the other is at the *national level* (between the commercial bank and central bank of the same country, where payments are made in the national currency. Regarding payments at the *national level*, the SUCRE scheme also offers the possibility for making the final payment to the exporter in dollars.<sup>24</sup>

In this case, the exporter's central bank pays the converted amount in dollars to the exporter's commercial bank. This practice does not imply any changes in the use of the SUCRE as a unit of account in the *intraregional* payment circuit.

### (b) Objectives of the SUCRE initiative

The SUCRE initiative has two objectives. First, it aims to reduce the high transaction costs involved in using a third currency – the dollar – by progressively replacing the dollar as the invoicing currency in intraregional trade. Second, by providing liquidity during the clearance period, it will enable the participating countries to expand their volume of imports even in times of scarce foreign exchange reserves.<sup>25</sup> This is because, through such a regional payment system, countries require less foreign exchange over the clearing period until the final settlement of each period is made for the remaining amounts of multilateral trade surpluses and deficits in the region. Therefore, the SUCRE initiative aims to maintain or even increase trade among member countries, especially in periods when foreign exchange reserves are low. It is also intended to be a tool not only for the strengthening regional commercial ties, but also for moving forward in the building of a new regional financial architecture.

## 2. An evaluation of the SUCRE as a virtual currency

### (a) The SUCRE formula

The value of the virtual currency, the SUCRE, is determined by the following formula:

$$sucr^t = F + \left[ (1 - \alpha) \sum_{i=1}^n \frac{\bar{N}_i}{Tc_i^t} \right] + \left[ (\alpha) \sum_{j=1}^m \frac{\bar{N}_j}{Tc_j^t} \right]$$

$Sucr^t$  = Value of the SUCRE at time t

$F$  = Level factor

$\alpha$  = Weight of the currency basket

$N_j$  = Number of units of the currency J in the basket

$Tc_j^t$  = Nominal Exchange rate currency J to US dollar.

This value is constructed using two currency baskets: (i) an *intraregional currency basket*, which comprises the exchange rates of the national currencies of the SUCRE member States in relation to the dollar, and (ii) an *extraregional currency basket*, which comprises the exchange rates of the major currencies of non-member States in relation to the dollar.<sup>26</sup> Fluctuations in both currency baskets have an impact on the value of the SUCRE. According to available information,<sup>27</sup> the *extraregional currency basket* has been included in order to take account of changes in the exchange rates of the major foreign currencies against the dollar. The final weight of each basket in the value of the SUCRE is determined by the value assigned to the parameter *Alfa* ( $\alpha$ ).

Apart from the two currency baskets, the SUCRE formula also includes an ad hoc parameter F – the so-called “level factor”. This parameter is used to adjust the value of the SUCRE vis-à-vis the dollar in two ways: (i) The *initial valuation* process, which revises the value of the SUCRE at least once a year,<sup>28</sup> and (ii) the so-called *mechanism of adjustment*, which deals with sharp nominal exchange rate fluctuations of one or more members’ currencies vis-à-vis the dollar.<sup>29</sup>

The mechanism of adjustment is automatically applied in cases of sharp devaluations/appreciations of national currencies of member States, or of large fluctuations of major foreign currencies, vis-à-vis the dollar.<sup>30</sup> In each of these cases, the technical procedure to keep the SUCRE/United States dollar exchange rate practically unchanged is activated. The parameter F has the same function, namely to avoid sharp fluctuations in the SUCRE/dollar exchange rate.

The initial value of the SUCRE – currently 1.25 to 1 dollar –<sup>31</sup> has been calculated using the SUCRE formula, but with two modifications: (i) the *extraregional currency basket* has not yet been activated (*alfa*, representing the weight of the currency basket, is equal to zero), and (ii) the incorporation of SUCRE exchange rates in the *intraregional currency basket* will be done upon *ratification* of the SUCRE agreement. The latter implies that since only the Bolivarian Republic of Venezuela and Cuba have ratified the Treaty so far (in January 2010), the *intraregional currency basket* at present consists of only the nominal exchange

rates of these two countries’ currencies in relation to the dollar.

### (b) *Stability of the SUCRE*

The construction of the formula shows that maintaining a stable SUCRE/dollar exchange rate is the overarching target. However, under what conditions is the intertemporal stability of that exchange rate a reasonable target? This depends on what was intended with the creation of the SUCRE. Following the typology presented earlier in this chapter (table 3.1), the SUCRE is either a mere unit of account (4.a) or a currency basket that aims at more ambitious regional currency cooperation (4.c).

### (c) *The SUCRE as a unit of account for a regional payment system*

As an optional payment system, the SUCRE initiative gives central banks the choice to use either the SUCRE or the dollar for invoicing trade transactions. If the exchange rates of national currencies to the SUCRE differ from their exchange rates to the dollar, the incentive to use SUCREs may differ between net importer and net exporter economies. For example, supposing there is a 15 per cent depreciation of the Venezuelan bolivar vis-à-vis the dollar, in the *intraregional currency basket* this would cause a depreciation of the SUCRE to the dollar (but by a smaller amount, i.e. 10 per cent<sup>32</sup>). If the exchange rate of other SUCRE members’ national currencies to the dollar remains unchanged, the value of the SUCRE would depreciate by 10 per cent in relation to those other national currencies. If the net exporter and the net importer countries can choose between using the SUCRE or the dollar, the net importing country has an advantage in using the SUCRE, since the depreciation of the SUCRE vis-à-vis the national currency allows that country to pay less for its imports. The net exporting economy faces the opposite situation: there is a strong disadvantage in its using the SUCRE, since, in term of its national currency, that country will receive a smaller amount for its exports.

To avoid an arbitrage of this type, the mechanism of adjustment is applied if the shock stems from a change in the extraregional or the intraregional currency basket. Using the same example, the mechanism works in the following manner:



- (i) By adding the new exchange rate of the Venezuelan bolivar/dollar to the intraregional currency basket and recalculating its value, the 15 per cent depreciation of the Venezuelan bolivar leads to a depreciation of the intraregional currency basket by a smaller amount of 12 per cent.
- (ii) Recalculating the value of the SUCRE using the new value of the intraregional currency basket results in a depreciation of the SUCRE vis-à-vis the dollar.
- (iii) The value of F changes to an amount that fully compensates for the depreciation of the SUCRE against the dollar as a result of the depreciation of the Venezuelan bolivar.

This reduces the incentive for exchange rate arbitrage. This mechanism is not the only instrument aimed at keeping the value of the SUCRE constant vis-à-vis the dollar. The *initial valuation* has a similar purpose, although the revision of the value of the SUCRE under this procedure takes place once a year (or when the CCC considers it necessary). The modification of the weight of the basket ( $\alpha$ ) adds a third instrument for managing the value of the SUCRE.

For a SUCRE aimed at being solely a unit of account for payment systems, a more direct and clear method of assessing and adjusting the unit of account is feasible by setting a starting SUCRE/dollar exchange rate value and allowing each country to adjust their exchange rates to the SUCRE following changes in the exchange rate of the national currency to the dollar.

The experience of the ACU offers a good example, where the common unit of account is fixed at 1:1 to the dollar. The countries are able to invoice trade transactions in the unit of account instead of in dollars, but the value of the currency vis-à-vis the unit of account is exactly the same as the rate of exchange of that currency with the dollar. This amply demonstrates that there is no need to create complex formulas to avoid exchange rate arbitrage. If one or more countries devalue, there is no impact on the value of the unit of account, and the adjustment process only requires the country to adjust its unit of account according to the change in the exchange rate of the national currency to the dollar. As far as the unit of account is concerned, there is no need to construct a complicated currency basket.

(d) *From a currency basket to a regional currency*

If the final objective of the SUCRE is to progress beyond being more than a mere unit of account, to becoming a vehicle of improved monetary cooperation, or even to serve as a regional currency unit, then keeping a stable nominal SUCRE/dollar exchange rate is not an advisable strategy. By assuring such nominal stability, the external value of the money – the exchange rate – may become dissociated from the domestic movements of the value of money or the inflation rates.<sup>33</sup> If one member country has a higher inflation rate than the others and the SUCRE/dollar exchange rate remains constant, the currency of the country with the higher inflation rate appreciates in real SUCRE terms, which means it loses competitiveness in relation to other members and to the dollar area if calculated in SUCRE. Thus, sharp real exchange rate fluctuations pose a dilemma for the nominal stability of the SUCRE. Unstable real exchange rates may be much worse than unstable nominal exchange rates, but to compensate for the inflation differentials, the nominal value of the SUCRE has to be adjusted and cannot remain stable vis-à-vis the dollar.

Therefore, what is the right approach to deal with intraregional real exchange rate fluctuations? Member countries would need to engage in a joint effort to conduct policies aimed at adjusting the nominal exchange rate according to inflation differentials. In such an approach, the artificial unit of account will turn into a currency basket that has a clearly defined relationship with fundamentals (mainly inflation differentials). As it cannot be expected that the market-determined exchange rates of national currencies of member States to the dollar would reflect the inflation differentials in the same way (except in the very long term) as the government-determined exchange rates of national currencies to the SUCRE, the appreciation or depreciation of the SUCRE/dollar rate would have to reflect any deviations of the dollar from its long-running, “true” value. Such an approach would allow the member countries to use the SUCRE as an anchor to assess the real value of their currency. However, this approach implies a certain degree of coordination and agreement among SUCRE members. But only this approach offers the chance of a real decoupling from the monetary policy of the United States and other foreign powers in the long run. It also offers a SUCRE that has the potential to be used progressively as a monetary unit for transactions or as a store of value

in the SUCRE initiative's member countries. In this manner, the SUCRE would gradually be more than

a mere accounting unit; it would turn into an anchor for the whole system.

## E. Conclusions

A comparative analysis of past and present trade-related regional payment systems shows a variety of schemes in different parts of the world. The general reference or model for most of the initiatives is the International Clearing Union, proposed by Keynes during the negotiations leading up to the Bretton Woods system. The Keynes proposal sought to overcome a number of problems with the international monetary system at that time, such as the prevention of global imbalances due to asymmetric adjustment costs assigned to debtor economies in case of a shortage of international reserves, and the problems for international trade associated with misaligned exchange rates. As is well known, only the latter problems were addressed by the Bretton Woods system from 1948 onwards.

### (a) Options for intraregional payments

The payment systems established at the regional and subregional levels in Europe, Asia and Latin America seek to address a small part of these problems through regional (instead of bilateral) clearance of intraregional trade transactions. A comparison of various regional payment systems shows that two elements are common to most of them: first, they offer the possibility of making transactions in local instead of international currencies, at least at the microeconomic level between importers and exporters and correspondent banks; and second, at the macroeconomic level, they provide temporary liquidity during a clearance period under an arrangement whereby the participating central banks mutually offer credit by delaying final settlement of net deficits and net surpluses to the end of that period.

### (b) Lessons learned from past and present experiences

The European Payments Union is an example of a system that placed great emphasis on saving foreign exchange reserves in response to the specific circumstances prevailing in the post-war period when it was founded. There was no intention of creating a regional currency, but rather of providing an accounting mechanism, at least during the EPU's existence. This is because the system was created in the context of a system of globally fixed exchange rates, where additional intraregional fixing of currencies was not needed. However, the EPU served as the first step in a process that ultimately led to the creation of the euro and to European monetary integration after the breakdown of the Bretton Woods system of fixed exchange rates.

In Latin America, the CPR payment mechanism of the LAIA witnessed its most active period during the so-called debt crisis, when it became imperative for countries to save their foreign exchange. Indeed it was very effective in terms of channelling most of the intraregional trade-related payments during that period. Yet, probably due to intense competition among the member countries that were all net debtors vis-à-vis the rest of the world, even intraregional surplus economies faced payment pressures from international creditors. Thus, within the CPR mechanism no solution for additional provision of credits beyond the clearing period, or final settlement in local instead of international currencies, could be developed.

Payment systems have adapted to changing circumstances and preferences over time. The Asian

Clearing Union adapted to changes in its member countries' stocks of foreign exchange reserves and international trade with the introduction of a multi-currency standard and by offering members the possibility to invoice and settle payments in domestic or international currency. This increased the effectiveness of the mechanism in terms of the volume of transactions channelled through it over the past few years.

*(c) The SUCRE initiative: drawing on a rich variety of experiences*

Drawing from these experiences, the SUCRE initiative provides mechanisms that take into account the manifold interests of the countries of the region. It offers member countries the possibility not only of reducing the transaction costs related to intraregional trade, but also of saving foreign exchange by using domestic currencies for settlement of trade transactions both at the firm and the central bank level.

The SUCRE initiative is set up as an optional mechanism (i) for general use by regional importers and exporters; (ii) with regard to the economic sectors and products that shall be included in the system; and (iii) with regard to the choice of the currency for settlement of transactions. In addition, the initiative is designed as a modular mechanism, with plans for additional elements in the future.

The flexibility of the SUCRE system, particularly allowing final clearance of net deficits and surpluses among central banks in domestic or in international currency, seems to be an adequate arrangement for the time being. The Asian Clearing Union introduced such an option around a decade ago. In the SUCRE system, the option to choose the settlement currency provides the member countries with the possibility to first gain experience with the mechanism itself and then with the common unit of account, the SUCRE, which will determine the final amount of transfers – in domestic and in international currencies – to be made from the deficit to the surplus countries. Either

way, the provision of a unit of account, together with the agreed clearance period, increases the deficit country's liquidity position if the surplus countries also accept the mechanism.

At the same time, the threefold flexibility – that is, the option to use or not to use the SUCRE system, the option to decide which economic sectors shall be part of it and the option to decide which settlement currency to use for net claims and debts – needs to be designed with great care in order to provide appropriate incentive structures. If the SUCRE is intended to form the basis for increasing intraregional trade, it needs to offer advantages over the traditional way of trading and invoicing in dollars. This requires careful construction of the unit of account in order to constantly reflect the exact reference values of intraregional exchange rates as traded in foreign exchange markets, and prevent the creation of opportunities or incentives for arbitrage under the system. As such, it needs to reflect member countries' currency exchange rates in relation to the currencies of the main trading partners outside the region, as much as their respective cross-rates with each other. This requires rules for continuous and timely adjustment.

Apart from the design of the SUCRE unit of account, stronger incentives to use the system require a regional mechanism to balance intraregional trade. As the ongoing crisis of the euro zone shows, preventing regional imbalances requires even deeper macroeconomic cooperation than what currently exists among the euro-zone countries. This is especially true with regard to wage policies and other mechanisms to force surplus countries to adjust their positions by increasing domestic demand.

Summing up, it is important to note that the SUCRE mechanism has the potential to be a first and important step on the long and sometimes winding road towards deeper monetary and overall macroeconomic coordination and a common macroeconomic regime oriented towards economic growth and employment.

## Notes

- 1 The transaction is realized as follows: when there is agreement (between the exporter in country A and importer in country B) to channel a trade transaction through a payment system, the importer in country B will pay in currency B to central bank B while the exporter in country A will be paid in currency A by central bank A. These payments are frequently made through commercial banks, at the time of the goods' boarding, and the buyer and producer pay and are paid, respectively, in their own currencies, using their own domestic banking systems.
- 2 As the ongoing crisis of the euro zone shows, to effectively prevent unsustainable imbalances at the regional level, even deeper macroeconomic cooperation is required than currently prevails among the euro zone countries. This is especially true with regard to wage policies and additional mechanisms to force surplus countries to adjust their positions to boost domestic demand.
- 3 The Keynes Plan proposed the creation of an institution, the international clearing union (ICU), for registering and settling all international payments, using a virtual common unit of account – the bancor – for invoicing all these operations. The most important feature of this planned new international currency was its uniquely fiduciary nature: it was not related to the quantity of gold or another good. Moreover, it was to be used only in international transactions among central banks. An important part of the proposal was a mechanism for both deficit and surplus countries to adjust in order to prevent global imbalances. The idea was for the deficit and surplus countries to share the burden of adjustment, through some sort of tax on the bancors in excess (i.e. in the form of reduced interest earnings for the bancor claims, which would result in reduced interest on the credit lines to deficit countries). If a country accumulated surpluses with the ICU, thereby accumulating bancors, and refused to adjust to greater import demand, it would be penalized.
- 4 For an extensive overview of regional negotiations of the EPU and its reforms, see, for example, Bühner, 1997: 189.
- 5 For a detailed description, see Braga de Macedo and Eichengreen, 2001; Bühner, 1997: 195; and Eichengreen, 1993.
- 6 Additional credits were also approved by EPU's Managing Board if a country exceeded its quota, the Managing Board met to advise that country on adopting corrective policies. The Board comprised a group of financial experts who advised EPU and reported to the Council of the Organisation for Economic Co-operation.
- 7 This and other crises during this period gave rise to the first steps towards full convertibility of the European currencies that was finally achieved with the creation of the European Monetary Agreement (EMA) in 1958, including a European Fund. EMA was designed to foster multilateral trade and currency convertibility as the first step in mutual consultation and regional cooperation. Its core institution was the European Fund, which provided non-automatic short-term liquidity to member countries in times of balance-of-payments crises in order to prevent them from implementing trade-distorting measures. The European fund led to the creation of the European Monetary System and finally to the euro.
- 8 Probably the first reference to this subject was the report entitled *Compensación Multilateral de Pagos Internacionales en America Latina* (CEPAL, 1949), prepared by the IMF. On these debates and the funding Agreement, see also Aragão, 1984; and Ocampo, 1984.
- 9 For the official source of data and documents, see: <http://www.aladi.org>.
- 10 Cuba is the only member of ALADI which does not participate in the CPR, due to legal restrictions involved in the compensation mechanisms which are not only denominated in dollars, but also operated by the United States Federal Reserve System.
- 11 The difference in terms of total and net value of transactions channelled through the system is labelled by the LAIA as foreign exchange currency savings. It is defined in the following manner: in a certain period of time, all transactions channelled through the CPR have a value of \$X. During the same period, \$Y are used to pay/receive for these transactions. The foreign currency saving is  $(X-Y)/X$ , which represents the total amount of dollars that the member countries could "save" in this sense by using the system.
- 12 The guarantee mechanism for convertibility requires the immediate conversion to dollars of payments made in local currency through the mechanism. Transferability means the transfer (to the other central bank) of the corresponding amount of dollars from the deficit country to the surplus country at the end of the clearance period. And reimbursement means the irrevocable acceptance of obligations resulting from operations conducted under the Agreement.
- 13 Recently, a series of studies and discussions have been undertaken by the LAIA in order to "relaunch" the CPR, including a meeting in Montevideo in April 2009 for this purpose. Documents and presentations are available at: <http://www.aladi.org/nsfaladi/reuniones.nsf/PConvenio>.
- 14 See: [www.asianclearingunion.org](http://www.asianclearingunion.org).
- 15 ACU's main decision-making body is the Board of Directors, which consists of one director nominated by each participating country who has one vote in the Board. The Board elects a Chairperson from among its members for one year. Directors are remunerated by their nominating countries. Apart from the directors, a secretary-general is elected every three years, who is responsible for the

- daily business of the ACU, and represents the Board of Directors.
- 16 See: [www.asianclearingunion.org](http://www.asianclearingunion.org) (access February 2010).
- 17 The bilateral exchange rate are available at: <http://www.bcb.gov.br/?PROCEDTAXA>.
- 18 At present, 22 banking institutions in Brazil and 24 in Argentina are authorized to use the mechanism (for the list of banks, see: <http://www.bcb.gov.br/?PROCEDINST>).
- 19 There is no information available to explain the concentration of the movement in one direction. One reason may be the strong appreciation of the Brazilian real (against the dollar) during this period, which increased incentives for Brazilian exporters to accept export earnings in domestic currency.
- 20 Information provided by experts involved in the operation of the SML.
- 21 It has been approved by ALBA member States, but ratification is still pending. So far, only the Bolivarian Republic of Venezuela and Cuba have ratified the initiative.
- 22 The CCC, as an administrative body, also has the function of assigning the initial value of SUCREs to member economies. A department for economic and trade analysis within the CCC is under consideration, which would carry out technical studies necessary for full implementation of the SUCRE scheme.
- 23 It is planned that, instead of using commercial banks, this process should be administrated by special banks created for this purpose.
- 24 The option of paying the exporter in dollars is an alternative payment channel in the SUCRE proposal, with the clear exception of Ecuador, which uses the dollar as its national currency.
- 25 Due to the fiduciary nature of the virtual currency, the SUCRE may not need to be fully backed by the holding of foreign reserves. This would be particularly useful for those countries whose limited foreign exchange reserves have so far constrained their ability to import.
- 26 Intended as currencies that are used for holding foreign exchange reserves internationally.
- 27 The information available has been provided by the Ecuadorian Commission for the New Financial Architecture in the document entitled “Consideraciones técnicas de la operación del Sistema Unitario de Compensación Regional (SUCRE)” received in March 2010.
- 28 The initial valuation could be reviewed more frequently if the CCC considered it necessary.
- 29 Modifications in the weight of each currency basket, the so-called parameter *Alfa* ( $\alpha$ ) could lead to a similar outcome.
- 30 The adjustment procedure starts whenever the divergence of an internal or external exchange rate in relation to the dollar is equal to or greater than 5 per cent. This band of 5 per cent can be modified with the Consejo Monetario Regional del SUCRE.
- 31 This was the current value at the time of this study (March 2010).
- 32 The impact of the value of the SUCRE depends on: (a) the weight of the country in the extraregional currency basket, and (b) the weight of the extraregional currency basket in the SUCRE formula. Therefore, it is unlikely that a unilateral devaluation of 15 per cent of the Venezuelan bolivar against the dollar will cause a devaluation of the SUCRE against the dollar by exactly the same amount.
- 33 Even in the case of SUCRE economies, since the empirical evidence presented in chapter 1 shows that even if fixed exchange rate regimes predominate among SUCRE members, fluctuations in nominal exchange rates can take place.



## **Chapter IV**

# **POLICY CONCLUSIONS**

### **A. The relevance of money and currencies for economic development**

Why are money and currencies relevant for economic policy if the overall goal of governments is welfare for the majority of the population? This is the first of some difficult and profound questions that have to be answered before economic policy conclusions can be drawn from this analysis. Without a clear theoretical background, experiences and empirical findings alone cannot lead to policy recommendations.

Broadly, economic theory offers two contradictory views on whether and how money affects economic development. In the neoclassical paradigm, money is understood purely as a medium of exchange that enables transactions in the real economy but is neutral to economic development. Thus the real economy, including investment, production and employment, is not particularly affected by monetary policy decisions. Investment is considered to be the direct result of the propensity to save, and the influence of policies on the decisions of private households to save or to consume is believed to be rather small. Price stabilization is seen as necessary in order to avoid distortions in the optimal allocation of resources.

According to the kind of heterodox perspective favoured by UNCTAD, money is not neutral but is a powerful instrument to create or destroy wealth. Creation of money “*ex nihilo*” through central bank policy is believed to be the most important mechanism for the creation of credit that is needed for

investment, leading to the creation of income for workers, employment and company profits that can be reinvested. From this perspective, sustained income and employment growth need proactive management of the economy through macroeconomic policy to achieve investment plans that exceed saving plans. Here, the role of stable monetary values should not be underestimated. With labour being the determinant of the level of overall costs, an incomes policy has an important role to play. Countries that are prone to high and accelerating inflation may find it more difficult to start and sustain a process of development and catching up triggered by the creation of money and credit. In other words, without an incomes policy that can be used to effectively dampen inflationary pressures, the attempt to spur development by means of an expansionary macroeconomic policy is likely to fail as it rapidly causes inflation. Conversely, in countries or regions that have cultivated a highly disciplined attitude towards price stability by means of heterodox instruments, monetary and fiscal policy can push hard for an investment-led development process (*TDRs 2006 and 2007*).

The role of currencies and exchange rates in international transactions mirrors the two contrasting standpoints. According to the neoclassical view, where exchange rates simply reflect countries’ price levels, it is assumed that the purchasing power parity theory holds. In the non-orthodox view, currencies are understood as assets that are determined by the composition of market participants’ portfolio

preferences. Shifts in nominal wealth reflect market expectations, and short-term speculation may trigger movements in the exchange rate far beyond the fundamentals, namely the inflation differentials.

The external and internal values of money are of considerable importance to economic development because they define the level of international competitiveness of the whole economy. In a Keynesian world, the relevance of monetary policy for overall economic growth is reflected in its aim of maintaining a competitive level of the exchange rate in real terms and low interest rates. If monetary conditions, including the exchange rate, restrict growth and fixed investment, all the other ingredients of good governance or market flexibility are insufficient to overcome this restriction. Thus the right monetary conditions are crucial for development. That was the main mistake of the past: in following the Washington Consensus slavishly to “get the prices right”, many countries pursued an agenda of “market flexibility”, which got the most important prices – the exchange rate and the interest rate – wrong.

In view of the monetary chaos of the post-Bretton Woods era, developing countries need to find adequate instruments to introduce and/or maintain

pro-growth monetary conditions. This means, *inter alia*, avoiding frequent currency overvaluations and crises as well as excessively high real interest rates. Exchange rate levels need to be supportive of export growth, and interest rates kept at low and positive levels to encourage investment in fixed capital. In addition, reducing the risks of currency and financial crises by self-insuring against global shocks is essential. These conditions are required not only for economic growth but also to gain space for countercyclical policies. However, for developing countries, the monetary policy options available for achieving these conditions are very limited. On the one hand, flexible exchange rate regimes that are traditionally assumed to give greater space to monetary policy (as central banks are free to refrain from intervention in the foreign exchange market) do not provide effective policy autonomy. Rather, for developing countries that are very often additionally exposed to negative balance sheet effects, exchange rate fluctuations increase the risk of a financial crisis that counteracts any effort of growth-enhancing policies. On the other hand, rigidly pegged exchange rate regimes, including unilateral monetary integration such as *de jure* dollarization, deny the ability to initiate a growth-enhancing money-profit-investment cycle.

## B. Diminished importance of savings

The prevailing thinking shaping the economic advice extended to developing countries in general is based on the assumption that investment is financed from a savings pool formed mainly by private household savings. Based on this view, entrepreneurial investment is encouraged by policies aimed primarily at increasing household savings rates and capital imports (“foreign savings”), and at improving the efficiency of financial intermediation by developing a competitive financial system and creating securities markets. This approach, although widely shared in the development community, has to be taken with a considerable dose of caution. The assumptions of this model are heroic and in many respects far from realistic. Its predictions have been repeatedly refuted by empirical evidence. For

example, many developing countries, particularly in Latin America, failed to achieve higher productive investment despite monetary and financial policies that attracted waves of capital inflows. On the other hand, Asia is the most important global investor with an unprecedented catching-up performance and is able to export capital.

A view that better reflects the complexity and imperfections of the real world emphasizes that strong domestic demand and stable profits simultaneously increase the incentive of firms to invest and their capacity to finance new investments from retained earnings. Thus a fall in the savings ratio does not lead to a fall in investment; since it implies an increase in consumer demand, it will increase



profits and stimulate investment. By the same token, an improvement in the current account as a result of changes in relative prices in favour of domestic producers does not necessarily lead to a reduction in foreign savings inflows that cause a fall in investment; on the contrary, it reflects an increase in aggregate demand and in the profits of domestic producers, and tends to lead to higher investment. Therefore, a fall in consumption or in exports is not a prerequisite for higher investment. Rather, the causality works in the opposite direction: changes in the current account towards lower deficits or higher surpluses lead to greater investment in fixed capital.

The consequences of this latter approach for economic policy are substantial. When investment, output growth and employment are determined largely by company profits, economic policies have an important role to play in absorbing shocks and providing a stable environment for investment. By contrast, in the neoclassical model there is little room for economic policy, and where it offers economic policy options, they often point in the opposite direction. Where the neoclassical model sees the need for private households “to put aside more money” or for developing countries to attract more “foreign savings” to raise investment in fixed capital, the alternative model emphasizes positive demand and profit expectations as incentives for domestic entrepreneurs, and the need for reliable and affordable financing for enterprises.

The upshot of the analysis is straightforward: the decisive factor for catching up is domestic accumulation of capital, which will normally be the result of simultaneous investment and consumption growth in a process of rising real incomes among all groups of society. A major obstacle to the realization of such a process is high interest rates and/or an overvalued currency. In real terms, interest rates should be close to the real growth rate of the economy or below. A vicious circle of excessively high interest rates and a high risk of default call for more proactive financial policies. Governments can directly restrict the size of bank spreads through the kind of legislation that is used to stop usury in many developed countries. Moreover, public banks offering reasonable rates for private savers as well as for smaller private companies could directly compete with a non-competitive private banking system.

Monetary instability, periods of hyperinflation and frequent financial crises have often forced many developing countries to adopt economic policies that generate the exact opposite of what would be favourable investment conditions. “Sound macroeconomic policies” as prescribed by the Washington Consensus, combined with financial liberalization, have seldom led to the desired result of higher investment and faster growth, whereas the alternative policy approaches helped the newly industrializing economies of East and South-East Asia to accelerate their efforts to catch up.

### **C. New economic policies for growth and employment**

New economic policies require a reconsidering of the roles of all the actors of economic policy. As mentioned, most important is monetary policy because it controls the short-term interest rate, which is significant for the determination of investment. In a world without an automatic adjustment of investments to savings or an automatic increase of investments in cases of underutilized labour and capital, economic policy has to act. Monetary policy in all systems of fiat money (i.e. non-convertible paper money made legal tender by a government decree) is able to do that simply by the provision

of liquidity by the central bank, because the central bank directly determines the short-term interest rate (and the long-term rate, at least indirectly) based on its evaluation of the economic situation.

In any case, more than anything else, macroeconomic policies determine employment creation through their effect on investment in fixed capital. With macroeconomic policies – and monetary policy in particular – strongly affecting employment, policy choices based on the Washington Consensus and the advocacy of an independent central bank to stabilize

the price level by all means possible seem dubious. If monetary policy is permanently used to fight protracted or inertial inflation, employment creation and sustainable income growth are made impossible a priori.

If monetary policy is responsible for stabilizing investment, growth and employment, the traditional instrument for controlling inflation is occupied and has to be replaced. Since wages are the crucial determinant of overall costs, their importance in the stabilization of the inflation rate cannot be overestimated. Indeed, it can be shown that for developed and developing economies alike, growth rates of unit labour costs, are extremely closely correlated with price movements.

Nominal wages rising in line with the national or regional inflation target and the productivity growth trend in the overall economy constitute an institutional arrangement that serves several goals of economic policy at the same time. First, it opens the gate to a growth-oriented monetary policy as it warrants price stability (with respect to the inflation target set by the government or the central bank) in the medium term. By excluding cost-push inflation, monetary policy can avoid restrictive measures such as interest rate hikes during times of overutilized labour and capital capacities where the need to stimulate growth anyway does not exist. Central bankers frequently use the term “anchoring the inflation target” to describe a regime where all the economic agents have rational expectations concerning the reaction of a central bank. Indeed, by far the most important variable to be anchored is the growth of nominal wages in relation to productivity.

Second, nominal wages rising on a stable growth path (where the productivity trend is fairly stable and the inflation target is set) constitutes a regime of fairly flexible real wages if prices are more flexible than nominal wages. Such a regime is extremely important for the smooth absorption of negative supply-side shocks. For example, in the aftermath of the oil price hikes, countries where the trade unions did not seek quick compensation for the negative real income effect of the falling terms of trade were much better off. In these cases with nominal wages sticking to the inflation target and not to the actual, much higher, inflation rate, the fall in real wages was larger in the first round. But if the country succeeded in avoiding higher long-running or accelerating inflation, the

overall effect of the original stickiness of nominal wages was definitively positive.

By contrast, countries with flexible nominal wages, very often taking the form of so-called backward-looking indexation schemes, ended up with permanently higher inflation rates and a long and costly struggle against this kind of inflation inertia. Companies in all these countries suffered mainly from an unavoidable loss of real income (*vis-à-vis* the oil producers), and their attempt to pass this on to prices resulted in a new round of a distributional struggle.

Third, and most importantly, nominal wages that rise in line with the inflation target and productivity growth are the most important stabilizer of demand. This is the only way a country can consistently create the demand necessary to absorb the “productivity shocks” that stem from the use of new technology, or technology that is meant to reduce the “disutility” of labour but would lead to unemployment if labour was not able to demand new goods as soon as the old ones are produced more efficiently than before.

If nominal wages rise in line with the national or regional inflation target and the productivity growth trend in the overall economy, it implies that real wages grow steadily in line with productivity growth, excluding supply shocks. Productivity growth, like wage growth, has a dual character. On the one hand, it is a source of income, in fact the most important one for all economies that lack a rich endowment of natural resources; on the other hand, it destroys traditional work and is a potential source of permanent unemployment. However, the destructive part of it can be tamed if the higher proceeds from the new technologies (assuming that the new technologies are more productive than the old ones) find their way to those agents whose needs are unlimited but whose means are limited by the old technology.

In this way, the productivity growth, distributed equally between labour and capital (for example, a 5 per cent growth of productivity increases the real income of labour by 5 per cent and the real income of the capital side by 5 per cent), will – with unchanged savings behaviours of private households and companies – produce exactly the additional demand that is needed to induce the additional production and the additional demand for labour that, from the point of view of the overall economy, can compensate

for the laid-off labour in those firms that were at the origin of the productivity increase.

Beyond the very short term, the outcome is much more conclusive. If real wages rise less than productivity, producers are in the comfortable position to make higher profits, but over the longer term they will not be able to fully employ their production capacities. Under conditions of competition in the goods markets, this will lead to increasing pressure on prices up to the point where prices fall to the full extent of the growth in productivity. That is why the growth rate of unit labour costs is highly correlated with the inflation rate. If nominal wages rise by 10 per cent (assuming a wage share of 50 per cent), companies will try to raise prices more than before, as unit labour costs will have increased. If the whole productivity growth is passed on to falling prices, the price level will be constant and a positive inflation target will be missed. Only with real wages rising in line with productivity, which means a constant wage share, can the inflation target be met (i.e. unit labour costs rising in line with the inflation target) and the risks for overall demand growth minimized. Anchoring the inflation target in wages thus takes on a new and more important meaning.

In developing countries in particular, a policy of maintaining wage growth consistent with the inflation target may be an important instrument for stabilizing the economy in real and nominal terms. Many developing countries have a history of very high inflation, or even hyperinflation, due to bouts of inflation spilling over into nominal wage increases through indexation mechanisms. This has proved to be extremely costly, because for central banks to bring inflation down to their target level against a permanent cost push means applying a shock to the economy repeatedly through interest hikes, and implies sacrificing real investment for the sake of nominal stabilization. In these cases, the anchoring of nominal wage demand is extremely important. However, as is often forgotten by the advocates of such anchoring by central banks, it is only consistent with the overall targets of growth, full employment and inflation if

nominal wages not only reflect the inflation target but also the productivity growth trend.

Arguments such as those presented in this chapter will be subject to fierce criticism from the advocates of traditional neoclassical employment theory. For them real wages have to fulfil only one task in a market economy, namely to equalize demand and supply in the labour market. They would argue that whenever unemployment is high or rises, real wages must be too high or rising too much. And whenever a country has persistent and high unemployment – an excess of labour supply – its unions must be so strong that they prevent the equilibrating mechanism which is based on the “fact” that flexible prices (falling wages) will remove the excess supply. However, the simple application of such microeconomic supply/demand logic to the overall economy is unfounded. For prices to equal supply and demand consistently and exclusively at the micro level, the supply and demand functions have to be independent, which is not the case in the labour market.

Supply and demand in the labour market is without any doubt dependent on the overall economy, thus the simplistic rule of supply and demand does not apply and more sophisticated analysis has to be used to understand the effects of falling or rising wages. But it is obvious, and in particular for developing countries, that the idea that the existence of unemployment forbids the application of the wage rules elaborated above is flawed. It may even be just the opposite: the fact that unemployment has prevailed in developing countries for many decades may directly result from this flawed idea. If the power of employers and their ability to dictate low wages is regarded as the “natural” outcome of a market with high unemployment, the high unemployment rate may be locked in by the faulty approach. Additionally, if “trade” is viewed as being the only force that can move the economy to higher income levels in a sustainable manner, as is the case in many emerging-market economies, the flawed argument is perpetuated.

## **D. No automatic gains from regional cooperation**

Countries can normally open their borders to trade and capital flows if they are assured that their companies will have a fair opportunity in the global division of labour and that they are not in danger of permanently losing against the rest of the world. This is the simple proposition underlying all international arrangements about trade in the World Trade Organization (WTO) and elsewhere. If, at the level of the overall economy, the nominal remuneration of the immobile factor – labour – in one country consistently exceeds the effectiveness of its use (labour productivity) by a wider margin than in competing countries, the country is in deep trouble because most of its companies are in trouble. They have to ask for higher prices and accept a permanent loss of market shares, or accept lower profits to prevent the loss of market shares.

Regional monetary cooperation can take many forms, ranging from simple clearing arrangements for trade balances or payment mechanisms to more sophisticated forms of collaboration on, for example exchange rate regimes, or monetary policy coordination or full monetary union with a unified currency. In general, benefits are expected from different forms of cooperation, but they are neither automatic nor

automatically large. For example, to smooth bilateral payment mechanisms is a reasonable endeavour, irrespective of the degree of regional integration. However, it is very difficult, or even impossible, to determine the concrete gains resulting from such measures in terms of growth and employment. Most probably, they are rather small.

Most of the studies that find positive results from integration suffer from following the neoclassical theoretical approach with its focus on improving the “allocation of resources”. However, this only means improving the functioning of the economy in a very static sense, mainly based on the idea that enlargement of markets or greater price flexibility in existing markets will automatically improve the welfare of the society. According to the alternative view presented in this chapter, more important for development and welfare than these static gains are the dynamic gains to be had from investment in fixed capital, as investment is the key variable for long-term growth and employment creation. And stimulating investment in fixed capital is much more dependent on the interaction of supply with effective demand than on a perfect allocation of resources and flexible prices.

## **E. Macro prices and the SUCRE initiative**

Seen from this point of view, there are very few variables that have visible and lasting positive effects on growth and employment. If permanent government intervention – as opposed to temporary intervention – is excluded as a viable instrument in market economies, only two major variables remain that have to be controlled to maximize the chances of dynamic growth and catching up of developing countries. These variables are the real exchange rate and the real interest rate. The main objectives of the

SUCRE initiative, namely to foster trade expansion, to balance trade among member countries and to decouple their currencies from the dollar are of some importance. But in the longer term, in order to reap the expected gains, it will be necessary to go beyond these targets by establishing a roadmap – from trade-related initiatives to the overall goals of supporting competitive exchange rates and low real interest rates – through monetary cooperation in the region.

In this case, agreement on an overall and coherent economic policy strategy and on the final target of monetary cooperation is unavoidable. Thus the most important step to be taken at the beginning of the cooperation process would be to agree on the approach the region should take in terms of monetary and fiscal policies and the role of labour market institutions. Exchange rate shocks and persistent overvaluation of the currencies of developing countries are among the major hindrances to development and to reaping gains from international integration. High real interest rates (higher than real growth rates, in particular) are, more than anything else, associated with a combination of a lack of investment dynamics, weak productivity and weak employment performance.

Closer cooperation in the field of macroeconomics may sound utopian for many realistically thinking

politicians, but there is little alternative if the region as a whole and each of its countries is to succeed in job creation and economic growth. Hence regional performance can be improved, first, if cooperation is able to buffer global monetary shocks better than national policies and, second, if it allows countries to conduct monetary policies conducive to growth without running the danger of an acceleration of inflation as soon as a recovery in real activity gathers pace. However, the ability to buffer shocks is the necessary condition for success. Even if a group of countries succeeded perfectly well in reducing the vulnerability of their currencies and smoothening the adjustment of the nominal exchange rate to the inflation differentials (which means stabilizing the real exchange rate over time), only the right choice of the overall monetary regime, applied to the group as a whole, would be sufficient for successful growth and job creation.

## **F. The SUCRE initiative and the way towards a new common economic policy**

The chance of achieving this overall success rises dramatically if a new economic policy approach is applied. In such an approach, monetary policy cooperation is accompanied by cooperation or agreement on a wage or incomes policy. A step in this direction would be if the SUCRE initiative were to aim at achieving common economic policies with a road map towards monetary cooperation or even monetary union.

However, the major benefits of monetary cooperation will only accrue at the end of the convergence process. As long as the regional group uses only an anchor system, such monetary cooperation short of a fully-fledged monetary union has one major drawback due to the fact that monetary cooperation means replacing national monetary policies by the monetary policy of one member. In the Bretton Woods system the leading role was played by United States monetary policy, and in the EMS by the policy of the German Central Bank. Clearly, the policy of one member is not necessarily the right policy for the other members at the same time, even if the monetary policy approach of the anchor country is reasonable. This problem can only be overcome by

moving sooner or later to full monetary union using one currency, where the central bank conducts its policy based on the conditions of all members, and where all members are involved in jointly determining this policy, as was done in the creation of the euro area.

Overall, monetary cooperation can have huge positive effects for growth and development. However, the political target should be clear, as moves towards more cooperation and coordination can be steps in the right direction or steps to nowhere. Paradoxically, we know little about the effects of small steps in any direction. We know a bit more when it comes to influencing the crucial variables – the interest rate and the exchange rate – that determine growth and employment. However, it is clear that the hoped for benefits will only be realized if the political will and the political leadership are strong enough to reach consensus on the really big questions. Those big questions concern a reasonable economic policy, an inflation target and the consequences of the latter in terms of wage developments in relation to national productivity performance, and the role of fiscal policy in such a setting.



## **Annex 1**

# **Why homogeneity of macroeconomic regimes can bolster regional cooperation: Latin America and South-East Asia compared**

During the 1990s, Latin America was a laboratory for radical policy shifts towards market liberalization. Since then, strong appreciation of real exchange rates – mainly due to exchange-rate-based stabilization programmes and liberalization of trade and financial flows – have produced low growth rates and triggered a series of severe financial crises.

Policy responses to these crises in Latin America have varied widely. One group of countries opted for maintaining highly orthodox macroeconomic policies. Brazil, for example, sought to re-establish international investors' confidence by opting for a regime of rather strict inflation targeting in 1999, with a free-floating exchange rate that required a strongly restrictive monetary policy. This led to low inflation rates together with strong appreciation of the exchange rates of this group of countries, especially during the global boom period of high capital inflows due to carry trade (see also figure 1.5). However, growth rates remained fairly low in comparison with other major emerging-market economies during this period, even though their monetary policy was combined with a rather development-oriented approach to social and industrial policies, similar to the second group of countries.

The second group of countries opted for a shift away from orthodox policies, and gave priority to exchange rate competitiveness. The most outstanding example of this was Argentina, despite letting inflation run at higher levels than the regional and international levels of inflation. Another policy variant was chosen by countries like the Bolivarian Republic of Venezuela, which adopted a clearly anti-liberal stance on global economic integration. Priority was given to

income redistribution, based mainly on large earnings from commodity exports, while somewhat neglecting exchange rate competitiveness.

This divergence of macroeconomic policies undermines the strength and effectiveness of regional monetary cooperation efforts in the region. Latin America has a long history of attempts at regional integration, but with mixed results. Particularly recently, intensive efforts at new regional initiatives can be observed. Even though these efforts are commonly referred to as “post-liberal regionalism” that goes beyond trade integration (Viega and Ríos, 2007), their aims and focus vary as much as the participating countries' macroeconomic policy choices, resulting in a mosaic of multiple and divergent approaches to regional integration (Viega and Rios, 2007).

Some of the existing monetary cooperation schemes in Latin America were originally established in the context of import-substituting industrialization. Regional cooperation gained strength following experiences with the debt crises of the 1980s in a bid to overcome the problem of the lack of external liquidity. Although the then large regional payment system, the Latin American Integration Association (LAIA), established in 1980, no longer plays a vital role (see chapter III), the Latin American Reserve Fund (FLAR – Fondo Latinoamericano de Reservas) established among the Andean countries at that time, is still used effectively for providing foreign exchange liquidity during periods of balance-of-payments stress (Ocampo and Titelman, 2009). Its provision of liquidity has sometimes exceeded that extended by the IMF in terms of volume, and so far there has been

no default on loan repayments. It has the advantage of a high degree of contract enforcement as a result of a strong sense of ownership by the member countries (Ocampo and Titelmann, 2009).

Later, during the 1990s, attempts at strengthening regional trade integration as part of the conventional approach of “open regionalism” were made through MERCOSUR. However, so far, monetary cooperation has not gone beyond political declarations. A major hindrance is the divergence of exchange rates and the absence of monetary cooperation mechanisms in the two major member countries, Argentina and Brazil (Bresser Pereira, 2009).

Related to the macroeconomic policy shifts in the region in the aftermath of the emerging-market crises of the 1990s, efforts to build “post-liberal” integration schemes intensified. Within UNASUR, the Bank of the South (Banco del Sur) was established to serve as a development bank with a focus on financing regional infrastructure projects. However, a broader role for this institution within a new regional financial architecture, as envisaged for example in an Ecuadorian proposal (Páez, 2009), is yet to be decided, as is its operationalization. The System of Payment in Local Currency (SML) is another recent initiative in South America, which so far involves only Argentina and Brazil. It is a simple mechanism reflecting the traditional belief in the benign effects of free trade.

The SUCRE initiative, on the other hand, has multiple objectives that go beyond fostering regional investment and free trade (see chapter III). It aims at a socially inclusive form of economic development at the regional level and, starting with a regional payment system with the Sucre as its unit of account, it aims to eventually make this a regional currency. However, these efforts overlap with the existing schemes of cooperation: the Eastern Caribbean Currency Union (ECCU)<sup>1</sup> and FLAR.

In contrast to Latin America, macroeconomic policy orientation in East and South-East Asia has been more homogeneous. First, as demonstrated by the relatively high degree of convergence of real exchange rates and interest rates (see chapter I), most countries in this region have adopted similar macroeconomic approaches guided by pragmatic, growth-oriented macroeconomic policies. The 1997 Asian financial crisis, as much as the 2008 global financial crisis, deepened these countries’

commitment to maintaining a competitive exchange rate regime and to accumulating foreign currency reserves as a self-insurance mechanism.

Two major initiatives for monetary cooperation in the region represent a coherent and collective effort to strengthen their common macroeconomic policy orientation. First, the Chiang Mai Initiative (CMI) was established as a bundle of bilateral swap agreements among the ASEAN+3 member countries (see table A.1 for the list of members), with swap amounts increasing gradually from \$1 billion in 2000 to \$80 billion in 2008 through the creation of a regional liquidity fund in 2005. Partly in response to the 2008 global financial crisis, the ASEAN+3 members signed an agreement in March 2010 to convert the CMI into the Chiang Mai Initiative Multilateralization (CMIM), which will constitute a regional reserve fund totalling \$150 billion formed from the foreign exchange reserves of the member countries.

Second, together with the Asian Development Bank (ADB), the countries are jointly focusing on regional financial market development, in particular bond market development. The ADB will help in setting up the market infrastructure and creating demand for local-currency-denominated debt instruments. The countries themselves will be responsible for creating bond funds to provide liquidity for disseminating local- and foreign-currency denominated bonds.

A major objective of both these initiatives is overall macroeconomic policy coherence with the aim of achieving stable and competitive exchange rates, and cushioning the economies of the region against global shocks. First, by being able to provide large amounts of liquidity to the members when they experience balance-of-payments difficulties, they can limit large downswings of exchange rates at times of sudden stops of capital or capital flow reversals. Second, although increasing the market for domestic-currency-denominated public and private bonds at the regional level prevents a better use of high domestic savings within the region, it nevertheless reduces exposure to net balance-sheet effects by increasing market shares of local-currency-denominated bonds. Thus, even if the region does not engage in formal exchange rate coordination, these South-East Asian regional initiatives should enable the members to pull together with a common focus on strengthening similarly growth-oriented macroeconomic policies.



**Table A.1**  
**REGIONAL MONETARY COOPERATION INITIATIVES IN SOUTH-EAST ASIA AND LATIN AMERICA**

<i>Context</i>	<i>ASEAN +3</i>	<i>Latin America</i>
1980s: Debt crisis	–	ALADI: regional payments system FLAR: regional reserve fund
1990s: Liberalization of trade and financial flows	–	MERCOSUR: trade integration with intended, but not realized regional monetary cooperation
Series of emerging-market crises	ASEAN + 3: Chiang Mai Initiative (2000): from bilateral swap arrangements to reserve fund ASEAN Bond Fund; Asian Bond Market Initiative (involving the ADB) (2003)	SML (2009): bi-national payment system (Argentina and Brazil) Banco del Sur (UNASUR; 2009): regional development bank SUCRE (2010): regional payments system with a virtual currency unit

**Note:** ASEAN+3 comprises: Cambodia, Brunei Darussalam, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam + China, Japan and the Republic of Korea.  
LAIA comprises: Argentina, the Bolivarian Republic of Venezuela, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru and Uruguay.  
FLAR comprises: the Bolivarian Republic of Venezuela, Bolivia, Colombia, Costa Rica, Ecuador, Peru and Uruguay.  
MERCOSUR comprises: Argentina, Brazil, Paraguay and Uruguay.  
SUCRE participants are: the Bolivarian Republic of Venezuela, Bolivia, Cuba, Ecuador, Honduras and Nicaragua.  
UNASUR comprises: Argentina, the Bolivarian Republic of Venezuela, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Surinam and Uruguay.

## Notes

- 1 ECCU is a common currency area comprising the following countries: Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines. The East Caribbean dollar is unilaterally pegged to the dollar. The ECCU dates back to the 1950s when there was a monetary arrangement with the former British Commonwealth.



## Annex 2

### Sequencing of trade and monetary cooperation: Experiences in Europe, South-East Asia and Latin America compared

Regional monetary integration in Europe is seen as being grounded in the so-called “trade first” approach, based on the belief that regional economic convergence through close trade links is a prerequisite for regional monetary integration. However, looking at the European experience – on which most of the optimal currency area (OCA) theory is built – the weakness of this approach is evident at several stages of the process leading to monetary union.

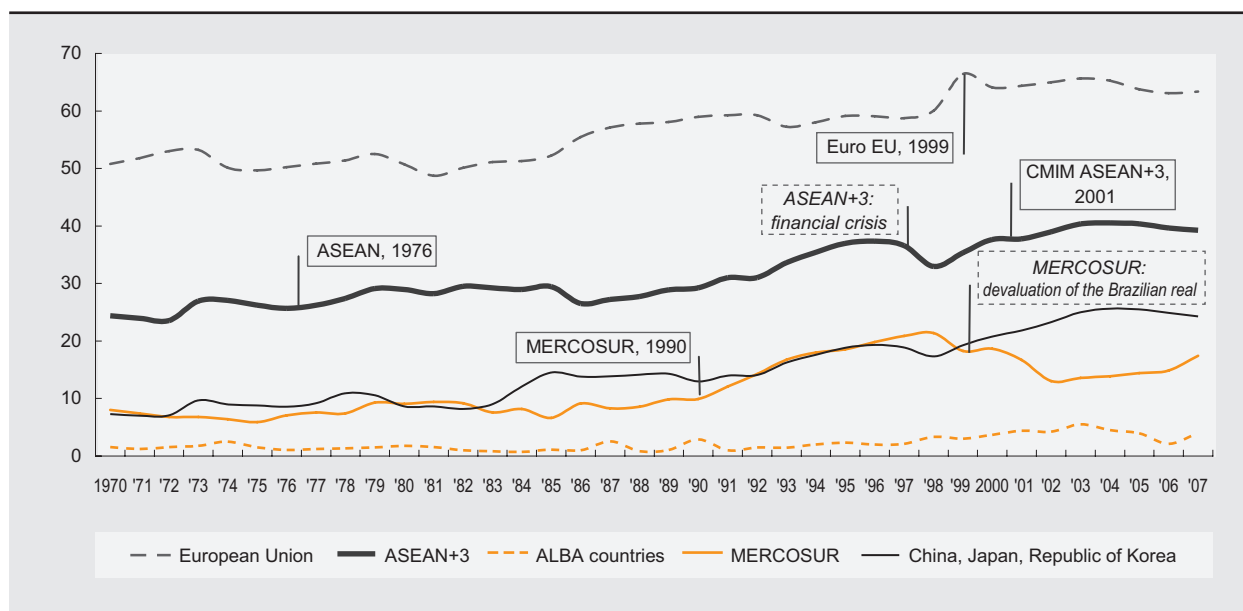
First, trade integration gained impetus under the Bretton Woods’ fixed exchange rate system. Thus, monetary cooperation in the first phase of European integration (from the end of the 1940s to the beginning of the 1970s, until the collapse of Bretton Woods) took place under the specifically favourable conditions of stable intraregional exchange rates. As a result of this and other initiatives to create a common European market, intraregional trade increased, accounting for 50 per cent or more of the region’s total trade during the 1970s and 1980s (figure A.1).

Second, the collapse of the Bretton Woods system and the subsequent destabilization of exchange rates internationally prompted European policymakers to seek a system of cooperation on exchange rates that finally took the form of the European Monetary System (EMS) towards the end of the 1970s. Thus, based on the experience of fully coordinated and fixed exchange rate regimes in post-war Europe, free-floating exchange rates have no longer been considered a viable alternative to monetary cooperation because of the perceived trade distortions of a financial-market-based system (UNCTAD, 2007).

The East and South-East Asia region provides another example of the oversimplicity of the “trade first” argument. Here, even without any kind of formal regional exchange rate cooperation, the level of intraregional trade achieved has been significant, especially if China is included. Yet these strongly growing intraregional trade linkages have not been pushed as part of a “trade first” approach. Rather, the region embarked on promoting financial and monetary cooperation along with trade. As such, sequencing of regional integration has involved the simultaneous and mutually reinforcing processes of trade integration and macroeconomic convergence (Bird and Rajan, 2006). Regional trade integration has increased steadily since the 1970s, only briefly interrupted by the Asian financial crisis in 1997-1998. It has been strongly influenced by the production integration patterns of the countries of the region with the Chinese economy, whereby the former participate in intraregional production networks as producers of intermediate goods for the latter. These production networks are facilitated, among others, by the de facto convergence of real exchange rates at the regional level, as exchange rate co-movement creates stable conditions for overall economic integration (see chapter I).

In South America, in contrast, the case of MERCOSUR, is a clear example of how a focus on “trade first” is unfeasible in the context of volatile exchange rates. Here, trade integration increased following the creation of the MERCOSUR customs union in 1994. However, growing debt and balance-of-payments problems in the two larger member

**Figure A.1**  
**INTRAREGIONAL TRADE SHARES BY REGIONAL COOPERATION ARRANGEMENT, 1970–2007**  
 (Per cent)



**Source:** United Nations University-World Institute for Development Economics Research (UNU-WIDER); Regional Integration Knowledge System's calculations based on *UN-COMTRADE* data.

**Note:** The year against each regional arrangement indicates when it took effect or the date of its inception.

economies, Argentina and Brazil, and unilateral currency devaluations caused intraregional trade to decline from 21.4 per cent in 1998 to 13 per cent in 2002. The sharp devaluation of the Brazilian real at the beginning of 1999 in the context of a major financial crisis and as part of IMF conditionality attached to its financial assistance provoked severe economic crises in countries throughout the region and caused a sharp fall in intraregional trade, particularly in neighbouring countries' exports to Brazil. The beggar-thy-neighbour effect of unilateral devaluation was harsh. As all member countries were suffering from current-account problems, primarily due to an accelerated appreciation of their currencies in the context of exchange-rate-based stabilization programmes, they began competing for foreign exchange earnings through exports and provoked a race to the bottom in their bid to attract foreign direct investment and financial flows. The beggar-thy-neighbour effects of uncoordinated large swings in exchange rates finally triggered a series of trade conflicts among the member countries over the subsequent

years (Férrnandez-Arias, Stein and Panizza, 2002). This caused serious and long-term damage to trade cooperation mechanisms within MERCOSUR. Even after the temporary re-establishment of intraregional exchange rate levels following the devaluation of the Argentinean currency in 2002, trade integration has not returned to its pre-crisis level.

As the "trade first" argument does not hold based on empirical evidence, the point of departure for monetary cooperation does not appear to depend on the level of intraregional trade already achieved. This observation may be relevant for initiatives such as ALBA, where the comparatively low level of intraregional trade should therefore not be considered an impediment to engaging in monetary cooperation. Indeed, as the experience of MERCOSUR shows, regional cooperation with a focus on trade alone is ineffective, as these efforts may easily be disrupted by strong intraregional exchange rate volatility and the subsequent negative spillover effects to neighbouring countries.

### **Annex 3**

## **Monetary anchors in regional monetary cooperation and integration: Experiences in Europe and South-East Asia**

Currency anchors are of considerable importance for regional monetary cooperation and integration. The literature recognizes their role from a political economy point of view (Cohen, 2000; Tavlas, 1993) as well as in the context of regional political power relations of hegemonic stabilizers (Kindleberger, 1981; Keohane, 1984; Eichengreen, 2000). However, intraregional hierarchies and the role of regional anchor currencies have not been systematically analysed from an economic point of view. Instead, traditional OCA theory gives priority to economic convergence among integrating countries and their common reaction to external shocks. This is related to the fact that the theory adheres to the neoclassical belief in the neutrality of money, with exchange rates being just another price to be adjusted in order to achieve perfect resource allocation.

What are the characteristics of regional monetary anchors and why do they play a special role in regional monetary cooperation? While an economy whose currency provides the regional monetary anchor is usually the largest in the region in terms of economic size and trade volume, these features are of minor importance for its role as an anchor (see Bofinger and Flassbeck, 2000). Rather, in order to become an anchor, the economy needs to have a strong external position and favourable structural conditions such as financial depth. This adds up to the regional monetary anchor's core function – to be able to step in when there are temporary balance-of-payments problems and act as a lender of last resort for the region by stabilizing intraregional exchange rates. This holds true even in the initial steps towards regional monetary cooperation.

A regional monetary anchor catalyses regional economic convergence by providing the common policy orientation for the region: the anchor country sets the reference values of key macroeconomic prices for the region to enable such convergence.

If a region lacks a regional monetary anchor, alternative quasi-lender-of-last-resort functions need to be created in order to prevent the regional arrangement from falling apart. This is the case even if cooperation through regional arrangements is rather limited, such as regional reserve pooling or other means of providing liquidity. While not being able to set a similarly strong target for the convergence of macroeconomic regimes as a regional anchor, regional financial institutions may have the advantage of inculcating a sense of regional ownership and regional risk-sharing. In addition, where a regional anchor is lacking, a regional bloc should focus more on jointly developing a regional financial market as an alternative source of financing, giving priority to the development of local-currency-denominated bonds as a means of financing that carries less exposure to exchange rate changes.

Looking at Europe, East and South-East Asia and Latin America, it can be observed that a regional monetary anchor does not exist in all the regional blocs, and that the strategies used to cope with this absence differ.

In Europe, regional monetary cooperation was designed around the monetary anchor provided by the German deutschmark, with a credible price stabilizing monetary policy. Although not formally designated as

the regional monetary anchor, the German deutschmark stood at the centre of the EMS, with the German central bank, the Bundesbank, successfully managing to keep inflation low. An empirical analysis of European interest rates shows that the monetary policies of the other EMS member countries were strongly directed towards aligning with German interest rates (Fratzcher, 2002). During the 1970s and 1980s, high-inflation, oil-importing EMS member countries used the stable deutschmark's nominal exchange rate as an external anchor to bring down domestic inflationary pressure expectations in the context of several oil price hikes. And European inflation levels converged to the level in Germany.<sup>1</sup>

For the smaller European countries, having the German deutschmark as the de facto regional monetary anchor brought the benefit of stabilizing internal prices and external exchange rates in the region, which provided the basis for sustained economic growth, at least until the beginning of the 1980s. In exchange, they gave up their independence in monetary policymaking. Not that the smaller European countries had much to give up by tying their monetary policy to that of the anchor country; even without a formal regional arrangement they would have oriented their monetary policy decisions to converge with the policies of the regionally dominant economies, primarily Germany. Indeed, they gained from a formal arrangement that supported limited nominal devaluations and provided reserves in case of balance-of-payments difficulties. The fact that the Deutsche Bundesbank, and later the European Central Bank, followed a highly orthodox monetary policy, pushing the euro area into a long period of low growth, does not necessarily mean that this is one of the criteria for a currency to serve as a regional anchor or a common currency. Rather, the most recent crisis that has hit countries at the periphery of the euro area, such as Greece, Portugal and Spain, shows that a jointly agreed regional macroeconomic regime which includes coordination of unit labour costs and the balancing of intraregional surplus and deficit positions would be preferable to a regime that focuses primarily on public debt levels.

In East and South-East Asia, regional monetary cooperation is based on an extraregional "shadow anchor" – the dollar – since the region itself lacks an undisputed regional monetary anchor. Rather, there has been deep rivalry between the two dominant economic powers – China and Japan – to serve as the regional anchor country. Seen from the outside, Japan constitutes the natural choice for a monetary

anchor for the region: the Japanese yen is one of the international reserve currencies, its financial markets are highly developed, and it is widely connected with other countries in the region through both trade and financial linkages. While Japan's involvement in providing financial support during the Asian crisis in 1997-1998 was acknowledged by the region, China's decision not to suspend its long-standing exchange rate peg to the dollar, as well as that country's contribution to restoring regional macroeconomic stability, has boosted its reputation from the regional perspective (Schnabl, 2005; Volz and Fujimura 2008). In addition, China plays a central role in the regional economy, not only due to its economic size but also to its deep trade linkages throughout the region. However, it lacks well-developed, liquid and well-capitalized financial markets and a convertible currency, which are prerequisites for a regional monetary anchor country. Thus, while Japan and China are rivals for regional economic leadership, neither of them stands out as the obvious, unquestionable regional monetary anchor country.

Despite the East and South-East Asian countries recently taking more diverse approaches in terms of formal exchange rate regimes with de facto real exchange rate fluctuations, they are clearly following the strong Chinese orientation towards the dollar. The lack of a formal arrangement opens the door to beggar-thy-neighbour policies, macroeconomic instability due to revaluations of the "shadow" anchor currency (the dollar) which is external to the region, and higher transaction costs of intraregional trade and financial transactions (McKinnon, 2005; Akyüz, 2009). There have been several studies on potential scenarios for monetary policy harmonization as a further step towards regional monetary cooperation in this region. With regard to its extraregional exchange rate orientation, McKinnon (2005) advocates the introduction of a collective de facto peg of the regional currencies to a major reserve currency such as the dollar, which he calls the "East Asian dollar standard". Such a proposal is disputed by Akyüz (2009), who emphasizes the increasingly diverse approaches to exchange rate policy in the region reflected in recent widely varying exchange rate movements. He therefore suggests that a regional peg to a basket of reserve currencies, rather than to the dollar alone, would be more suitable for maintaining competitive real exchange rates vis-à-vis extraregional currencies. There have been several other proposals as to how the countries in the region could flexibly move on from adopting a reserve currency basket as an extraregional exchange rate

anchor to an intraregional currency basket as the unit of account, or finally to a regional currency (see, for instance, Kawai, 2007; Akyüz, 2009).<sup>2</sup>

In view of the current absence of a regional monetary anchor, the region has been pursuing an alternative strategy of strongly pushing for developing regional financial markets. It is involving the ADB in the creation of regional financial, and in particular, bond markets with a special focus on local currency bonds as a safer form of external financing. In addition, the region embarked on the first step towards monetary cooperation by setting up a mechanism for liquidity provision, the CMIM (described in annex I), as well as a number of further bilateral swap arrangements.

The example of South-East Asia shows that developing strong regional multilateral financial institutions may be an alternative means to supporting regional monetary cooperation and integration and for stabilizing regional macroeconomic development in the absence of a strong regional monetary anchor. Regional financial institutions, if designed in an appropriately sustainable manner, managed professionally and jointly enforced by member countries, could be capable of intervening when countries encounter balance-of-payment problems by providing ad hoc liquidity, and they could also stabilize exchange rates. Regional financial institutions may therefore constitute a viable alternative to a regional monetary anchor if the latter is not in place to support regional monetary cooperation (Cohen, 2000).

In Latin America, neither a strong regional anchor nor a regionally supported multilateral financial institution exists so far. While the dollar dominates as the nominal reference value for monetary policy intervention in most of the region's exchange rate regimes, and serves as a major reserve currency for the region (IMF, 2008), it is not considered a viable option as an extraregional monetary anchor as in East and South-East Asia.

With regard to a regional monetary anchor, Brazil would be the natural choice owing to its large

economic size and trade volume. However, despite its recent turnaround, the country has a history of high inflation and high levels of external debt, and is currently following a very orthodox monetary policy that has resulted in an unstable and uncompetitive exchange rate. Brazil's macroeconomic record of the past few decades thus prevents it from being able to serve as a regional monetary anchor or as a regional lender of last resort to provide pro-growth macroeconomic stability.

With regard to regional multilateral financial institutions, Latin America has several options (for a comprehensive overview, see Ocampo and Titelmann, 2009). However, so far none of them has materialized, since each has its own drawbacks. At the national level, Brazil's National Development Bank, BNDES, is one of the largest development banks in the world, but with no mandate for regional operations, its regional expansion is not foreseeable. At the regional level, the Inter-American Development Bank (IADB) would be the natural choice as a regional multilateral financial institution. However, owing to its shareholder structure, which gives the United States and other donor countries a strong say in its activities, the region is hesitant to deepen its involvement in a similar way as the ADB in South-East Asia. Even though the IADB assists in the development of capital markets in local currencies in the region, it is playing a less important role than another regional financial institution, the Andean Development Corporation (CAF). In fact, CAF represents one of the most efficient regional financial institutions (Ocampo and Titelmann, 2009). However, while being the closest form of a regional institution, CAF ownership is still limited to the Andean Community, its volume is comparatively small, and its operations are mainly focused on funding investment in infrastructure projects in the region. While CAF would be the natural choice for a regional financial institution, so far member countries have not been able to agree on proceeding with its regionalization for providing short-term liquidity or for enabling monetary policy cooperation. An alternative proposal is the Banco del Sur, although its full role is yet to be finalized.

## Notes

- 1 For an extensive discussion of the European case, see *TDR 2007*: 137. The crisis of the EMS in 1992-1993 was triggered largely by a shift in Germany's monetary policy towards very high nominal interest rates in order to prevent an overheating of its economy after German reunification. Disregarding its role as the de facto regional anchor in setting Europe's monetary policy, this policy shift had disruptive effects on the anchoring countries, leading to the British pound sterling opting out of the system and the devaluation of the Italian lira and the French franc, together with a widening of the EMS band.
- 2 In order to maintain intraregionally stable exchange rates without a regional monetary anchor, two different approaches are proposed. As a first step, the ADB advocates the introduction of an Asian Currency Unit (ACU), which could exist as a parallel currency to the regional currencies (see also Eichengreen, 2007). Akyüz (2009: 32), on the other hand, believes that moving directly towards a more sophisticated form of an intraregional exchange rate basket as a regional anchor is politically no more demanding, since the acceptance and use of an ACU would depend equally strongly on the support of member-country governments if it were to be used for closer regional monetary cooperation (see also Kawai, 2007; Park Wyplosz, 2007).



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