Strengthening *regional financial* cooperation

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

I

Introduction

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

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

Strengthening the regional financial institutions would have the following objectives:

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

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

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

II

The latest generation of financial crises

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TABLE 1

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

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

Source: IMF (2000).

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

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

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

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

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

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

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

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

III

The role of regional funds in coping with financial crises

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

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

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

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

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

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

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

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

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

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

IV

The role of regional funds in furthering integration

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

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

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

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

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

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

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

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

Generalized financial crises are particularly harmful to integration. When a country begins to suffer from contagion from other crises in the region, its currency is devalued and its producers recover the competitiveness they lost during the capital inflow boom that preceded the crisis. The positive effects of this currency devaluation are obtained at the expense of its regional partners, however. Furthermore, it cannot take full advantage of the situation because its regional partners are suffering recessions on account of the crisis. The abrupt changes in the competitiveness of Brazilian producers compared with those of Argentina during the recent financial crisis are a copybook example of this.

There can be no doubt, then, that in order to achieve greater integration of trade and investments, greater exchange stability is needed among the countries seeking to integrate. Without this, it is unlikely that much more progress can be made in the region towards greater integration. This does not mean that we should hasten to adopt a common currency. Integration processes take place gradually, and in Latin America they are still at an early stage. It is essential, however, to take the first steps towards financial integration, for which bilateral exchange rates must be much more stable than they have been so far.

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

The stormy moments that the exchange rate mechanism had to weather during the financial crises of 1992-1993 did not prevent final progress towards the irrevocable fixing of exchange rates and the adoption of the Euro by 11 European countries. There can be no doubt that the exchange rate stability which exists among the European countries, to which they are politically committed, has been a powerful impulse in favour of trade integration and real investment flows in Europe.

The existence of Community monetary institutions and concerted intervention in exchange markets have helped the European countries to attain the high degree of exchange rate stability they have enjoyed since the collapse of the Bretton Woods system.

One of the crucial differences between the member countries of the European Union and the Latin

American nations is that the European countries have convertible currencies and can carry out interventions in the exchange markets in their own currency. Furthermore, their central banks (and now likewise the European Central Bank) have lines of credit from the United States Federal Reserve and the Bank of Japan for intervening in exchange markets.

The Latin American countries are at a serious disadvantage in this respect, because as the currency for intervention is the U.S. dollar, they must use their reserves for this; furthermore, the possibility of coordinated intervention by their central banks to prevent sharp fluctuations and misalignments in bilateral exchange rates is much weaker, and they do not enjoy lines of credit from the Federal Reserve. Only at times of crisis, and even then only in the case of the biggest countries, can they have a chance of obtaining emergency financial resources from that source. Moreover, this only occurs when a crisis has already broken out, and only under an adjustment programme agreed with the IMF.

All this suggests that monetary and exchange support for integration will only be available from a much fuller system of regional financial institutions than that which currently exists. In order for Latin America to achieve greater trade integration, it is important to attain greater exchange rate stability among the countries of the region, which would also promote the growth of mutual investments. This process, which has already begun, is essential for achieving fuller economic integration.

The objectives of ensuring financial resources for limiting contagion phenomena at the regional and subregional levels and securing greater bilateral exchange rate stability are of course interrelated. Financial crises have an almost immediate effect on exchange rates, so if a regional financial institution fulfils the objective of preventing financial crises among its member countries it will likewise contribute to greater exchange stability among them.

Exchange rates are also sensitive to economic policy mismatches. Consequently, by promoting greater macroeconomic policy convergence, the existence of a regional financial institution would check exchange rate volatility among its member countries.

As already noted, financial crises are gestated during booms in foreign capital inflows. In order to avoid such crises, it is essential that countries should take measures to moderate capital inflows when these threaten to become excessive and to cause a deterioration in their macroeconomic balances. One of the missions of a regional financial institution would be to facilitate the exchange of information and thus promote common standards for bank regulation and prudential regulation of capital flows.[4] As destabilizing capital inflows also include flows which do not pass through the banks (such as direct loans to local companies and inflows of portfolio investments), these prudential regulations are not only limited to adequate bank supervision, although of course this is essential.

V

A brief review of some existing regional external payments support institutions

Latin America already has financial and monetary institutions which carry out to some extent some of the functions that we consider a regional fund should have. They are the Latin American Reserve Fund (FLAR), the Mutual Payments and Credit Agreement (CPCR) of the Latin American Integration Association (ALADI), the Central American Clearing House of the Central American Common Market (CACM), the Latin American Monetary Stabilization Fund of the CACM, and the Caribbean Multilateral Clearing Facility of CARICOM.[5] An analysis of their activities and the amounts of finance these bodies provide would therefore be a good starting point for our study. We will concentrate our attention in particular on two of these institutions: FLAR and CPCR.

[4] The recent experience of Chile and Colombia in this field has been analysed in Agosin and Ffrench-Davis (1997), Le Fort and Lehmann (2000), Barrera and Cárdenas (1997) and Ocampo and Tovar (1999).

[5] For a description of other financial cooperation mechanisms in the region, see ECLAC (1990).

1. The Latin American Reserve Fund (FLAR)

FLAR was originally set up in 1978 by the Andean Community as the Andean Reserve Fund. In 1991 its then members (Bolivia, Colombia, Ecuador, Peru and Venezuela) decided to throw it open to participation by other Latin American countries, so that it became in effect a regional financial institution. At the end of June 1998, FLAR had assets of some US$ 1,032 million, made up of the quotas of its member countries and its capitalized net profits (FLAR, 1998). With the incorporation of Costa Rica in mid-2000, FLAR began a process of expansion to bring in Latin American countries which are not members of the Andean Community, in order to increase the Fund's scope (FLAR, 2000).

The stated objectives of FLAR are:

– To provide member countries with support when they suffer from balance of payments problems.
– To help in the harmonization of macroeconomic and exchange policies in order to give countries support in complying with the commitments entered into under the Cartagena Agreement, which set up the Andean Community, and the Treaty of Montevideo, which set up ALADI.
– To improve the conditions for investment of member countries' international reserves.

FLAR is financed primarily from the quotas paid by the central banks of its member countries. Another way of securing funds is to accept time deposits by central banks and other authorized bodies. During the 1997/1998 financial year (1 July 1997 to 30 June 1998) central banks and the Andean Parliament made deposits amounting to US$ 1,837 million, with the balance at 30 June 1998 standing at US$ 237 million (FLAR, 1998).

FLAR's main activity is the provision of support services for its members' balances of payments. Thus, FLAR is a form of credit union along the lines of the IMF. The central banks of member countries can draw loans up to 2½ times their paid-up contribution of capital, in the case of Colombia, Peru and Venezuela, and up to 3 times that amount in the case of Bolivia and Ecuador.

FLAR provides the following services for the central banks of its member countries:

– Balance of payments support credits: these are granted for up to four years, including one year's grace, subject to macroeconomic performance commitments.
– Credits for restructuring the external public debt: these are granted under co-financing with other multilateral bodies, with a term of up to four years, including one year's grace.
– Liquidity credits: these are designed to help countries to cover transitory liquidity needs through credits with a term of up to one year.
– Contingency Financing Facility: this facility, set up in 1998, is designed to help member countries to finance temporary balance of payments imbalances of external origin not due to fundamental inconsistencies in the balance of payments equilibrium conditions. This finance is for a term of six months, non-renewable. Loans granted by this facility must be guaranteed by the debtors with securities acceptable to FLAR.
– "Andean Peso": this was created in order to facilitate payments between central banks and other authorized holders. It has not been used much so far.

Thus, FLAR covers almost the whole range of activities that a strengthened regional fund should have. But how important, in quantitative terms, is the finance provided to the central banks of member countries in order to prevent or relieve balance of payments crises, particularly those due to exogenous causes, and how much does it contribute to the stability of bilateral exchange rates?

FLAR's importance as a supplier of finance depends on its quotas, which are its only stable source of finance. As may be seen from table 2, the quotas FLAR receives from its member countries (except in the case of Venezuela) are significant with respect to their IMF quotas. Furthermore, access to FLAR resources multiplies the value of those quotas by a factor of up to 3.5 for the less developed members (Bolivia and Ecuador) and 2.5 in the case of the other three members. This means that Bolivia and Ecuador have access to FLAR loans worth US$ 437.5 million, which is considerably more than they could obtain from the IMF, which rarely grants loans larger than the borrower's quota, and when it does, grants them in tranches which are disbursed only slowly, and against proof that the borrower is complying with the conditions laid down in the Letter of Intent. The FLAR loans are not devoid of conditions, but these tend to be less strict. Disbursements are usually quite rapid, with only a meeting of the Board of Directors being needed to examine requests for loans greater than the respective quota, which, if approved, are disbursed forthwith.

For the smaller member countries, FLAR credits represent a substantial addition to their reserves and to their capacity to cope with an international financial crisis.

TABLE 2

Latin American Reserve Fund (FLAR): Relative size of quotas at end of 1997

(Amounts in millions of dollars; ratios in percentages)

	Bolivia	Colombia	Ecuador	Peru	Venezuela
FLAR quotas	125	250	125	250	250
IMF quotas	170	757	296	628	2 633
International reserves	1 359	9 611	2 213	11 306	17 704
Short-term debt	374	5 759	2 069	6 832	4 395
Debt/reserves[a]	27.5	59.9	93.5	60.4	24.8
Debt/reserves as augmented by FLAR[b]	20.8	56.3	78.1	57.3	24.0

Source: IMF (1998); World Bank (1999); FLAR (1998).

[a] Ratio of short-term debt to reserves.
[b] Ratio of short-term debt to reserves as augmented by maximum indebtedness with FLAR.

This is not so in the case of the three largest members, since their international reserves are a high multiple of their quotas in FLAR.

The ratio between a country's short-term debt and its international reserves may be considered as a reliable indicator of that country's vulnerability to a run on its currency. Table 2 gives two different calculations of this ratio: between the short-term debt and the reserves as at the end of 1997, and between that debt and the reserves plus the maximum credit available from FLAR. As may be seen from the table, access to FLAR's resources significantly reduces the external vulnerability of Bolivia and Ecuador, but not that of the three biggest members.

Thus, in spite of its modest resources, FLAR is already playing an important role in the international finances of the Andean Community members. If FLAR or a successor with expanded capacity is to become an institution capable of providing the finance needed by its member countries, however, it will need considerably larger resources. Various ways of securing these are put forward in section VI below.

2. The ALADI Mutual Payments and Credits Agreement (CPCR)

CPCR began to operate in 1969, its aim being to minimize the use of the ALADI member countries' international reserves in the settlement of external trade transactions among them. The system has two components: a clearing house, with the Central Reserve Bank of Peru acting as banking agent, and mutual lines of credit with terms of four months. The banking agent carries out settlements between creditors and debtors every four months. The central banks have given each other bilateral lines of credit in dollars which must likewise be settled every four months. The system has been a success, because a high and growing percentage of intra-regional trade has been covered by its operations (ECLAC, 1990). In 1990, the coverage of operations handled by the Agreement compared with the total value of intra-regional trade was almost 100%. At the same time, the foreign exchange transferred by the banking agent amounted to less than 20% of the total value of the transactions. The existence of the CPCR has thus meant a substantial saving of foreign exchange by the central banks of the ALADI member countries.

The system was put to the test during the 1980s crisis. Because of that crisis, some central banks had difficulty in covering their debit balances and had to leave the system temporarily, negotiating bilateral terms of payment with the creditor central banks. As the financial crisis eased, however, the central banks returned to the system, which had recovered all its members by 1988.

The 1981 Santo Domingo Agreement established arrangements for granting credit to central banks which were unable to settle their debit balances within the four-month term. These arrangements provide credit for an additional four months, renewable for up to one year. The Agreement established a special credit programme for countries with general balance of payments deficits and those suffering from natural disasters. In the first case, the term of the credit is for two years, renewable for a further year, while in the second case the term is for two years, renewable on a

bilateral basis with the creditor central banks for five years.

Unlike the FLAR, the CPCR does not have resources of its own, but simply brings into effect the lines of credit that the central banks agreed to previously. When the crisis spread over the whole region, however, those banks were not in a position to make the contributions they had promised. This is why it is essential that such a system of payments should operate in conjunction with a larger regional institution with greater resources.

VI
Options for strengthening the regional payments bodies

FLAR is undoubtedly an excellent starting point for measures to strengthen the regional financial institutions: it already operates on a significant scale, and the functions its member countries have assigned it are exactly those that a regional financial mechanism should have. In this section we will deal with various aspects that must be taken into account in considering a possible agreement by the countries of the region to set up a Latin American financial institution.[6]

1. Membership

The regional fund would be open to all the countries of Latin America and the Caribbean. Participation in a regional fund along the lines of FLAR could be an attractive proposition. The reserves deposited in it are multiplied at times of crisis, and moreover the fund could gain access to resources not available to the individual countries.

2. Resources

The resources available to a regional fund must be commensurate with its responsibilities. There are various options in this respect:

a) *Increases in the paid-up capital of the fund*

The fund's resources would increase with the entry of new members. Consideration could also be given to an increase in the level of the quotas, which currently represent between 9% and 1.5% of the FLAR member countries' reserves.

b) *Contingency credit commitments*

The central banks of the member countries could provide the fund with lines of credit that would only be activated in the event of financial emergencies of a predetermined nature. This solution would be similar to the General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB) between the International Monetary Fund and the central banks of the Group of Ten and Switzerland. The IMF also has a parallel agreement with Saudi Arabia. Under the GAB, 11 industrialized countries or their central banks have agreed to lend the Fund certain volumes of resources at market interest rates in situations of financial crisis which cannot be tackled with the IMF's regular resources. The NAB, which were approved in November 1994 as a result of the Mexican crisis, are similar to the GAB, except that they involve 25 countries. The resources available to the IMF under both arrangements can be loaned to both participating and non-participating countries. A mechanism of this type would provide the Latin American fund with resources that are much greater than its capital, for coping with financial emergencies in its member countries.

c) *Indebtedness on international capital markets*

The IMF is not authorized to assume indebtedness in order to finance its rescue operations for countries suffering from financial crises. There is no impediment to a Latin American institution doing this, however. A Latin American fund could imitate the World Bank and have two classes of capital: one would consist of the quotas of the central banks, while the other would serve

[6] We are not necessarily suggesting that FLAR should become the strengthened regional monetary body referred to in this article. The exact way in which the region should progress from the present institutions to one with greater resources and capacity for action is a political question which goes beyond the scope of this article. The aim of this section is simply to outline the features that a future continental-scale financial body should have.

as a guarantee for the fund to take out debt directly on the market. This option would still be conservative, as even under this system the gearing ratio of the fund would still be less than 1.

Would the international financial markets be willing to accept long-term bonds from a Latin American fund, and would the spread for the fund's securities be less than for those of its member countries? The answer to both questions is probably affirmative: the joint guarantee of all the fund members would necessarily be better than in the case of each of them individually, since the financial capacity of a group of countries acting together is greater than that of the countries individually.[7]

By increasing the availability of financial resources, this option would endow the fund with great capacity to help member countries with financial problems.

d) *Contingency credits with the private banking system*

The fund could negotiate lines of credit with the international private banking system, to be activated in the event of financial crises threatening member countries. The central banks of Argentina and Mexico have already done this on an individual basis. The intervention of a regional body could undoubtedly help to obtain larger amounts of resources on better terms, however, as it would be backed up by all the central banks or governments of its member countries. This option, together with that discussed in the previous sub-section, could make the fund attractive even for big countries needing finance at times of crisis on a scale that could exceed the fund's capacity.

e) *Creation of "Latin American Special Drawing Rights"*

FLAR already has an instrument of this nature: the "Andean Peso", but a Latin American peso that could be used in payments among the central banks of the region would undoubtedly have more uses. A unit of account of this nature could strengthen the CPCR and help to minimize the use of international reserves.

As in the IMF, the member countries of the fund and the CPCR would receive allocations of Latin American pesos, which could be used in payments among central banks to settle their debts in the CPCR. Countries which registered a net absorption of Latin American pesos would undertake to pay off their net debit balances when their balance of payments situation improved or within maximum terms to be determined by the Board of Directors of FLAR. This option would obviously call for close relations between CPCR and the fund. CPCR could even become a direct dependency of the fund.

f) *Access to IMF resources*

If the regional institutions were strengthened within the context of a reform of the international financial architecture providing for the establishment of a network of regional funds to complement the IMF in the event of a crisis affecting a number of countries of the region, the Latin American fund, like other funds, could serve as an intermediary for the availability of resources between the IMF and the countries in question (Ocampo, 1999, p. 70). Likewise, the Latin American fund could be designated as a recipient of special drawing rights (SDRS), to which it could resort at times of crisis.[8]

3. Possible facilities of the fund and their conditions

It would be necessary to lay down quite clearly the occasions on which a country with balance of payments problems could seek assistance from the fund. Thus, four types of balance of payments problems should be distinguished: (a) temporary shortage of international liquidity; b) balance of payments crises due to fundamental imbalances in the member country's economic policy; c) balance of payments crises by contagion, and d) balance of payments problems due to a transitory deterioration in the terms of trade.

a) *Liquidity credits facility*

FLAR already has a facility for tackling transitory liquidity problems, under which countries can make use of a certain proportion of their quotas (75% in the

[7] It could be argued that the spread payable by the fund would be a weighted average of the spreads for the sovereign debt of its members. We are assuming that the fund would enjoy substantial synergies because it is an institution with the simultaneous guarantees of a group of countries. In this sense, the existence of the fund could be seen as the solution to a problem of collective action.

[8] In another study (Agosin, 1999) the present author argued that in order to tackle acute crises in the international financial system the IMF could resort to extraordinary issues of SDRs, which would be annulled when the system returned to normal. The mere existence of such a possibility would make systemic crises less likely.

case of the two less developed member countries and 50% in the case of the other three) for a period of up to one year. A Latin American monetary institution could incorporate this facility without much alteration.

b) *Balance of payments support facility*

This facility would be available to countries suffering from balance of payments problems due to fundamental imbalances in their exchange, monetary or fiscal policies. Such credits should be granted subject to strict conditions, along the lines of the IMF. The regional fund could even conceivably act in a concerted manner with the IMF in these cases.

c) *Contingency credit facility*

This facility would have two objectives: to discourage potential speculators and to persuade member countries to coordinate their economic policies more effectively.

If well designed, this facility would be used only infrequently. It would be activated when a country suffered from a balance of payments crisis associated with capital flight that had nothing to do with fundamental macroeconomic imbalances. FLAR already has a contingency credit facility, approved quite recently. However, the term it allows for repaying the loans (six months) is too short, and the resources it has available for this purpose are too scanty.

In order to avoid moral hazard problems, member countries would have to satisfy some minimum prior requirements in order to have access to this facility. These could include progress in bank regulation, especially with regard to potential currency mismatches between assets and liabilities; financial fragility indicators (ratios between short-term debt and reserves and between reserves and M2), and current account deficit targets.

It is important not to add too many dimensions to these prior requisites. The mere fact of a country losing access to the facility could set off capital flight. Therefore, although it is impossible to do without some degree of prior conditionality, the fund should be free to manage this flexibly and constructively.

In order for the facility to be of use in halting herd effects on international markets, its disbursements should be quick and timely. If the interest rates charged were higher than for other operations of the fund, this would encourage user countries to repay the resources loaned as quickly as possible.

d) *Compensatory financing facility*

This facility would be activated when a country was facing balance of payments problems due to a transitory and reversible deterioration in its terms of trade. Consequently, as soon as those terms improved, countries would be under the obligation to repay the balance owed and/or loan resources to the fund, which could maintain a special account for this purpose. Debtor countries would pay interest, while creditors would receive it. A further option would be to include in this facility, as in the case of the IMF, the possibility of granting credits to cover needs connected with international interest rate rises.

As almost all Latin American countries suffer pronounced fluctuations in their terms of trade, either because the prices of their exports are volatile or because this is true of the prices of some specific imports (especially oil and grains). Terms-of-trade cycles are not synchronized between countries. Indeed, the movements of some key prices (such as those of oil, for example) simultaneously improve the terms of trade of some countries but depress those of others.[9]

It is therefore both possible and desirable that there should be a regional fund to help countries to cope with balance of payments problems due to this structural condition of their economies. As there is a trade-off between the countries whose terms of trade deteriorate and those whose terms improve, a regional fund could make much better use of foreign exchange than the stabilization funds that some countries maintain for this purpose. Countries which already have such funds could contribute part of the resources deposited in them to the regional fund. As already mentioned, these contributions would be suitably remunerated.

There is generally no correlation between movements in the terms of trade of the countries of the region, so that it would be financially viable for a regional body to operate a scheme like that suggested here. For the period from 1981 to 1999, 55 coefficients of correlation between the annual variations in the terms of trade of the pairs of countries were studied, but of

[9] This is not only because some countries are exporters of oil while others are net importers. There is also an indirect effect on the prices of other industrial inputs. When oil prices rise, exports of other commodities such as copper, iron ore or wood may go down if the oil price rises generate expectations that the economic activity of the industrialized countries will be adversely affected.

these only 18 were significantly different from zero.[10] Four of the 18 coefficients were negative; all of them involved a gas or oil exporting and an importing country (Bolivia-Brazil, Brazil-Ecuador, Brazil-Venezuela and Costa Rica-Venezuela). Three of the coefficients of correlation which were positive and significantly different from zero were between gas or oil exporters (Bolivia-Venezuela, Ecuador-Venezuela and Bolivia-Ecuador), and one of them was between copper exporters (Chile-Peru). The results are shown in table 3, with the coefficients which are significantly different from zero in bold type.

A regional compensatory financing facility could coordinate its activities with the corresponding facility of the IMF. If this were possible, the regional fund could mobilize more resources and help the countries of the region to make more use of the IMF facility.

4. Coordination of economic policy and bank supervision

A regional monetary institution could become a suitable and probably very effective forum for coordination of the economic policies of the countries of the region in order to encourage member countries to maintain the fundamental macroeconomic balances and thus minimize the possibility of financial crises. Coordination of policies, including those on capital flows, is easier and more acceptable among peers than when it is imposed by a far-off institution which may be seen as hostile. A strengthened Latin American financial system would therefore strengthen the macroeconomic balances of its members and hence make them less vulnerable to contagion.

Greater convergence of economic policies, together with the existence of a regional financial fund with access to substantial resources, would favour regional exchange stability and make it possible to advance towards greater integration of the Latin American economies.

The weakness of domestic banking supervision has been one of the causes (although certainly not the only one) of national financial crises. Among other shortcomings, regulatory bodies have omitted –or been unable– to prevent local banks from taking out excessive debts in foreign currency and then lending those resources to bodies which do not have foreign currency incomes. A regional financial body could help to substantially raise the standards of prudential supervision of its members. As already noted, having suitable standards (and ensuring that they are respected)

[10] At 10% significance. The stadigraph $z = \frac{\hat{\rho}\sqrt{n-2}}{\sqrt{1-\hat{\rho}^2}}$, which has a distribution t with n–2 degrees of freedom, was used. $\hat{\rho}$ is the estimated value of the coefficient of correlation.

TABLE 3

Latin America (10 countries): Coefficients of correlation between variations in terms of trade, 1981-1999[a]

	Argentina	Bolivia	Brazil	Chile	Colombia
Bolivia	**0.62**				
Brazil	–0.14	**–0.55**			
Chile	0.01	–0.21	**0.46**		
Colombia	0.44	0.40	0.05	–0.01	
Costa Rica	–0.22	–0.39	**0.51**	0.17	**0.46**
Ecuador	**0.70**	**0.89**	**–0.67**	–0.21	0.31
Paraguay	0.22	0.05	**0.72**	0.26	0.17
Peru	0.15	–0.22	**0.47**	**0.82**	–0.21
Uruguay	0.10	–0.10	0.16	**0.70**	–0.25
Venezuela	**0.61**	**0.84**	**–0.60**	–0.10	0.08
	Costa Rica	**Ecuador**	**Paraguay**	**Peru**	**Uruguay**
Ecuador	–0.44				
Paraguay	0.10	–0.28			
Peru	–0.02	–0.15	0.25		
Uruguay	–0.13	0.17	0.16	**0.53**	
Venezuela	**–0.67**	**0.91**	–0.20	0.02	0.04

Source: ECLAC, 1999.

[a] Coefficients significantly different from zero are shown in bold type.

could be made one of the prior conditions for having access to the contingency credit facility. The regional body could also institute periodic appraisals of national banking supervision and establish standards that could be adopted by all its members.

The existence of a regional fund would also make possible a fluid exchange of information about the various countries' experience regarding policies for the prudential regulation of capital movements. This would facilitate progress towards regionally concerted policies on this important and delicate subject, which would help to ease the financial crises which, as already noted, tend to result from excessive inflows of foreign capital.

VII
The feasibility and size of an expanded regional fund

Is it feasible to expand regional financial cooperation in the way we have been suggesting in this study? Whether this is so or not will depend on the magnitude of national crises and the degree of co-variance between them. If all the countries of the region suffer balance of payments crises simultaneously through financial contagion (or through deterioration of the terms of trade), a regional fund could be non-viable from the financial point of view.

In order to answer the queries about the co-variance of national crises, an analysis was made, for pairs of countries, of the correlation between changes in capital flows (less foreign direct investment and official flows) in the period from 1978 to 1998 (table 4). The period was divided into two sub-periods, 1978-1987 and 1988-1998, in order to see how far co-variance has increased between capital flows to different countries. In table 4, the bilateral correlation coefficients which are significantly different from zero at 10% significance are shown in bold type.

This analysis showed that there is indeed considerable co-variance between capital flows to different Latin American countries, but this is not large enough to make a regional fund financially inviable. In 1988-1998, only 22 out of 55 coefficients of correlation were positive and significantly different from zero. Another conclusion which could back up the need for a regional fund is the increase over time in the number of high bilateral correlations: thus, positive correlations significantly different from zero increased from 11 to 22 between 1978-1987 and 1988-1998, whereas the number of negative and significant correlations remained unchanged at two.

In order to determine how big a regional fund should be, an analysis was also made of the annual changes in private capital flows (excluding foreign direct investment) to the six largest countries of the region, except Mexico, over the period from 1991 to 1998. If there are annual outflows from all the countries simultaneously, it is unlikely that a regional fund would be able to cope with them. Table 5 shows that there is a tendency for both increases and decreases in foreign private capital to be correlated among the countries, but there is sufficient divergence among the individual situations to make a regional fund viable. Thus, for example, whereas in 1994 Argentina had a great need of finance due to the "tequila crisis", Brazil registered heavy inflows of capital. Exactly the opposite occurred in 1997-1998. The maximum amount of resources needed may be estimated as the sum of the negative figures in table 5. In those crisis years, that amount was between US$ 25 and 30 billion, which a regional fund could certainly handle.

It is important to bear in mind that the existence of a regional fund with the capacity to deal with crises could result in a change of climate: stopping a crisis in one country could considerably reduce the probability that it would spread to other countries. In other words, the existence of the fund would reduce the co-variance of capital flows to the countries of the region.

If it is true that crises are sequential and that the existence of a big enough fund would reduce the probability of contagion for other countries of the region, then the fund should have sufficient resources to ensure that a vulnerable member country capable of giving rise to contagion should be able to cope with the non-renewal of its short-term debt. A fund that had, say, 15% of the reserves of the 11 countries shown in table 6 (some US$ 20 billion in 1997, which was the

TABLE 4

Latin America (10 countries): Coefficients of correlation between net inflows of capital, 1978-1998[ab]

			1978-1998		
	Argentina	Bolivia	Brazil	Chile	Colombia
Bolivia	0.02				
Brazil	0.30	–0.20			
Chile	0.22	**–0.49**	**0.41**		
Colombia	**0.50**	–0.07	**0.61**	0.29	
Costa Rica	**0.54**	–0.07	**0.38**	0.17	0.13
Ecuador	0.27	–0.19	**0.66**	**0.38**	0.09
Paraguay	**0.58**	–0.01	**0.51**	0.34	**0.37**
Peru	**0.58**	**–0.43**	**0.62**	**0.61**	**0.40**
Uruguay	0.29	0.05	0.26	**0.45**	0.03
Venezuela	0.04	0.13	–0.09	0.16	**–0.39**
	Costa Rica	Ecuador	Paraguay	Peru	Uruguay
Ecuador	**0.66**				
Paraguay	**0.47**	**0.45**			
Peru	**0.52**	**0.42**	**0.76**		
Uruguay	0.27	**0.32**	**0.38**	0.30	
Venezuela	0.15	**0.37**	0.25	0.00	0.08
			1978-1987		
	Argentina	Bolivia	Brazil	Chile	Colombia
Bolivia	–0.20				
Brazil	0.27	–0.23			
Chile	0.41	**–0.57**	0.39		
Colombia	–0.19	–0.29	0.42	0.46	
Costa Rica	**0.67**	0.26	0.42	0.11	–0.11
Ecuador	**0.65**	–0.05	**0.75**	0.35	0.07
Paraguay	0.36	0.00	0.42	**0.58**	0.19
Peru	0.32	**–0.76**	**0.55**	**0.75**	0.43
Uruguay	0.38	0.06	0.11	0.45	–0.37
Venezuela	**0.71**	0.29	0.13	0.17	–0.38
	Costa Rica	Ecuador	Paraguay	Peru	Uruguay
Ecuador	**0.83**				
Paraguay	0.30	0.44			
Peru	0.05	0.33	**0.56**		
Uruguay	0.13	0.30	0.36	0.04	
Venezuela	**0.88**	**0.62**	0.22	–0.08	0.43
			1988-1998		
	Argentina	Bolivia	Brazil	Chile	Colombia
Bolivia	**0.51**				
Brazil	0.36	0.33			
Chile	0.33	0.47	0.44		
Colombia	**0.60**	0.18	**0.88**	0.33	
Costa Rica	**0.65**	0.06	0.13	–0.01	0.33
Ecuador	0.36	0.07	0.33	0.27	0.39
Paraguay	**0.62**	**0.82**	**0.57**	0.15	**0.51**
Peru	**0.71**	**0.80**	**0.63**	**0.52**	**0.52**
Uruguay	**0.60**	**0.55**	**0.73**	0.33	**0.60**
Venezuela	–0.10	0.38	–0.43	0.14	–0.41
	Costa Rica	Ecuador	Paraguay	Peru	Uruguay
Ecuador	–0.24				
Paraguay	0.13	0.30			
Peru	**0.51**	0.12	**0.76**		
Uruguay	**0.57**	0.17	**0.67**	**0.92**	
Venezuela	**–0.56**	–0.06	0.10	–0.22	**–0.56**

Source: IMF, 1999.

[a] Excluding flows of foreign direct investment and official flows.

[b] Bilateral coefficients of correlation significantly different from zero at 10% are shown in bold type.

TABLE 5

Latin America: Changes in private capital flows[a] to six countries of the region, 1991-1998
(Billions of dollars)

	Argentina	Brazil	Chile	Colombia	Peru	Venezuela	Total[b]
1991	5.6	0.7	–2.3	–0.6	–0.2	–12.8	–15.8
1992	3.9	9.0	1.6	0.6	1.1	1.4	0.0
1993	26.2	2.7	0.2	2.9	–0.5	–0.9	–1.4
1994	–21.6	31.5	0.1	0.2	0.5	–5.3	–26.9
1995	–11.6	–15.3	–1.6	1.1	0.1	1.3	–28.5
1996	8.7	1.7	1.2	0.0	–0.5	0.4	–0.5
1997	1.4	–18.4	–1.0	–3.2	2.3	–1.0	–23.6
1998	4.0	–20.9	–4.6	0.6	–2.7	0.8	28.2

Source: IMF, 1999.

[a] Excluding foreign direct investment.
[b] Total reduction in private finance.

TABLE 6

Latin America (11 countries): International reserves, short-term debt and money supply, 1997
(Billions of dollars)

	International reserves	Short-term debt	Money supply (M1)	Money supply (M2)
Argentina	22.8	18.0	21.5	77.6
Bolivia	1.2	0.4	0.7	3.8
Brazil	52.0	36.2	47.3	236.5
Chile	17.7	9.9	7.7	33.6
Colombia	9.7	5.7	10.3	24.9
Costa Rica	1.3	0.5	1.5	4.0
Ecuador	2.2	2.1	1.7	6.7
Paraguay	0.7	0.5	0.9	2.9
Peru	11.3	6.8	5.7	16.8
Uruguay	1.7	1.9	1.1	8.6
Venezuela	15.2	4.4	11.4	19.0
Total	135.8	86.3		

Source: World Bank (1999) and IMF (1999).

last “normal” year for the region as a whole) could comfortably cover capital flight equal to the entire short-term debt of each country in the group in question except Brazil. In order to cover the possibility of simultaneous capital flight from more than one country, contingency credit lines like those suggested earlier in this article would give the fund even greater financial capacity.

The first line of defence against capital flight is a country’s own reserves. As may be seen from table 6, the Latin American countries are quite prudent in this respect, since in all of them the 1997 reserves more than covered their total short-term debt, which was not the case in the Asian countries in the last crisis. It must be borne in mind, however, that in a crisis capital flight includes other components, such as the liquidation of foreign portfolio investments and the replacement, by domestic investors, of their local-currency assets with others in foreign currency.

In crisis situations, the maximum dimension of pressures on the balance of payments is determined by the amount of money. If the agents lose all confidence in an economy, they will try to convert a large proportion of their liquid assets into foreign exchange. Those liquid assets are determined by the stocks of local currency, which could be measured for this purpose as M1 (currency in circulation plus demand deposits) or M2 (M1 plus term deposits and savings accounts). The corresponding figures are shown in table 6, which

indicates that 15% of the reserves of the 11 countries in question would come to US$ 20.4 billion. This means that all those countries, except Brazil and Argentina, could cope with capital flight equal to the whole of their M2 by using their own reserves (85% of the figures shown in table 6 under "international reserves" plus those of a fund set up with 15% of the reserves of the countries as a whole. Argentina, for its part, could finance capital outflows equal to the whole of its M1 or over half of its M2. In other words, a fund with 15% of the reserves represents an important potential for discouraging speculative attacks against the currencies of the region. If, in addition, it could have other sources of finance like those suggested earlier, the proposed fund could play an important role in promoting the stability of the Latin American economies.

VIII
Conclusions

This article has argued in favour of the establishment of a regional fund which would help to fill a gap in the international financial architecture. Such a fund would be extremely useful for the countries of the region as an additional line of defense against international financial crises, which have become increasingly exogenous to national policies and will probably continue to affect the region even though its countries continue to improve the quality of their macroeconomic policies.

A regional fund is no substitute for macroeconomic prudence, of course. Its existence would rather be a means of helping the countries of the region to continue improving the quality of their macroeconomic policies. A fund with substantial resources for lending to countries that apply good policies would be a powerful incentive in that direction.

A regional fund could be conceived either as part of a thorough-going reform of the present financial structure or as a body that would fit into a system that would not undergo fundamental changes. Although the first scenario is the most favourable from the point of view of the new body's efficiency in protecting the countries of the region from the adverse effects of international financial disturbances, such a fund would in fact be even more necessary in the second scenario. In any case, as we have argued in the preceding section, a regional fund of the type described is not outside the financial capabilities of the Latin American countries in the present circumstances.

A regional fund like that proposed would have the additional mission -of great importance for the future development of the region- of helping to integrate the regional economy through the promotion of exchange stability and the coordination of macroeconomic policies. In their policies to promote regional integration, so far the countries have given priority to progress in the harmonization of trade policies. The trade barriers between them have tended to go down significantly in the last decade, and the setbacks observed have almost always been related with financial disturbances. In some cases, governments have had to resort to trade protection in order to defend themselves from the effects of capital inflows which cause exchange rate appreciation and threaten internationally tradeable domestic activities. In others, capital flight has caused balance of payments crises which leave no alternative but to restrict trade flows. The biggest menace to the progress of regional integration is undoubtedly international financial instability, which has significantly increased exchange rate volatility and domestic instability in the countries of the region.

The institutional mechanism proposed here could soften the adverse effects of international financial instability on the national economies and also help the countries to progress towards economic integration. With each financial crisis that periodically hits the countries of the region, the advances in integration which have been obtained with so much effort are usually succeeded by partial setbacks. Greater stability of exchange rates and of the domestic economies would allow the Latin American countries to converge towards the long-desired trade integration: a dream that began four decades ago but has still not been realized.

(Original: Spanish)

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