Floor Discussion of the Griffith-Jones Paper

Stephany Griffith-Jones' paper and the subsequent comments by Mohamed El-Erian and Barbara Stallings provoked a lively discussion which seemed to be inspired more by the participants' differences in experiences and backgrounds than by their differences in opinion. Participants brought in the perspectives of their respective countries or regions and presented views which were clearly influenced by their working experience in either the official or private sector, or in policy-oriented academic research.

The Caribbean Experience

Fay Housty, programme manager at the Caribbean Community (Caricom) Secretariat, started off the discussion by supplementing some information on the Caribbean experience in financial integration. She briefly reviewed six public arrangements that were meant to foster financial integration but which, in most cases, had failed.

The first mechanism mentioned by Housty was the Caribbean Multilateral Clearing Facility (CMCF). "Stephany Griffith-Jones indicated that one of the reasons why the facility failed was because of the accumulation of debt by Guyana and the balance of payment problems of Jamaica. She also indicated that part of the failure might have been because of the lack of bilateral credit ceilings, but the formal structure of the CMCF did have bilateral credit ceilings. However, in the operationalisation of the facility these individual credit ceilings were waived. Countries were allowed not to settle their outstanding liabilities to the full. That was the major reason for the failure of the CMCF."

The second mechanism was the Caricom travellers cheques facility. "This facility – which was meant to facilitate the movement of goods and services in the region – had some initial success, but it has failed within the last two years mainly because of a lack of confidence by the purchasers due to the instability of the currency in which the traveller cheques were denominated." The lack of use of the Caricom traveller cheques was also caused by the liberalisation of certain economies and the more extensive use of the US dollar after the relaxation of exchange controls, Housty explained.

A third attempt at financial integration in the Caribbean – which did not meet with much success either – was the idea of establishing a Structural

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Adjustment Reserve Fund. "There was much discussion of this facility in the 1970s," Housty said, "but it was never established because it would have meant too much dependence on one country. There was only one country in surplus, while all the others were in deficit. And this overdependence on a single economy made it very difficult to introduce such a system."

A fourth instrument for monetary integration in the Caribbean was the establishment of an export credit facility. "Again, it was a non-starter," Housty explained, "because the proposal was that this facility should reside in the Caribbean Development Bank. The external member states of the Bank did not support the facility and considered that it should be established at the national level or that member countries should take advantage of the arrangements within BLADEX to support export credit."

A fifth mechanism for financial integration was a soft-loan window of the Caribbean Development Bank. "This Bank was established in the Caribbean not only to facilitate the development of infrastructure and give balance of payments support, but also to provide special assistance to the least developed countries of the region," Housty said. "In the Caribbean the countries are grouped into two types: the larger ones (Guyana, Trinidad and Tobago, Jamaica and Barbados) are considered more developed countries, while the countries of the OECS (Antigua, Grenada, Dominica, Saint Kitts-Nevis-Anguilla, Saint Lucia, Saint Vincent and Montserrat, as well as Belize) are considered less developed. The Caribbean Development Bank set up a soft-loan window to allow these countries to participate in the integration movement. Similarly, the Caribbean Development Bank accesses a channel for IDB funds for the small or less developed countries that are not permitted to join the IDB because of their size."

A sixth instrument for monetary integration was the Caribbean Investment Fund. "This Fund was set up to foster private investment by, for example, assisting in the financing of venture capital. At the beginning of last year the member countries, with the exception of Barbados and the Bahamas, also agreed to introduce a double taxation agreement. So far three countries have signed that agreement and it is operational among those three."

Another attempt at financial integration by the Caribbean countries was the decision to establish a monetary union, Housty stated. "The decision was based on what they called 'a two-stage three-tier system', in which criteria were set up for some convergence in macroeconomic policy; the countries were divided into two groups in terms of the pace at which monetary union could be achieved. In February 1995 there was a discussion in Belize on the progress made towards monetary union, and it was observed that macro-economic convergence has not been achieved nor some of the other criteria which had been identified. It was agreed that as a first step towards monetary

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union we would have currency convertibility from July 1995. Our central bank governors also agreed on closer collaboration to achieve a low level of inflation and exchange rate stability."

With respect to capital markets, Housty noted that the three countries that have stock exchanges recently decided to enable cross-listing and cross-trading of securities. "In the initial stages this cross-listing and cross-trading did stimulate some investment flows. However, again, because the base is too narrow and because the markets in these countries are unstable, the degree of stock exchange activity is rather low."

Fay Housty concluded her intervention with the observation that the Caribbean region – i.e. the Caricom as currently defined – may be too small or too dependent on one or two economies to make proposals such as the clearing facility and the long-term structural adjustment facility feasible. She therefore agreed with Griffith-Jones' suggestion that the Caribbean should link itself to the larger Latin American region. Similarly, with respect to the stock exchanges in the Caribbean, Housty thought it would be useful to link the Caribbean Stock Exchange with other stock exchanges in Latin America. She also endorsed Griffith-Jones' view that regional integration would need to be accompanied by some sort of compensatory mechanism. "The move towards hemispheric free trade is for us a great challenge and I was very stimulated by Stephany's remarks about the need for compensating arrangements, because we in the region see ourselves as needing special arrangements or some special consideration as we move into the wider level."

Investment and the Roles of the Public and Private Sectors

Various participants dwelled on the nature and implications of intra-Latin American investments.

Ricardo Ffrench-Davis, principal advisor on economic policy of ECLAC, corroborated Stephany Griffith-Jones' finding that a significant part of reciprocal investment in Latin America was not associated with the trade in goods. "That is very clear in the case of Chile. To a large extent Chilean investments were encouraged by capital gains offered by privatisation processes and by capital gains which could be obtained in the stock exchange when stocks were going up in most of the middle-sized and large-sized Latin American countries. Only a minor part of Chilean investment – but a very fast-growing part – was used to increase the trade in goods by, for example, establishing a producer or a marketing office in another country. However, the fact that growing reciprocal investment is accompanied by these more structural relations at the firm level is important, because if problems arise in the future, you have the structural relations that will enable trade to survive better in difficult circumstances."

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Augusto Aninat, president of a large Chilean export firm, emphasised that foreign direct investment and intra-regional trade are interlinked through the operations of private enterprises to which the Latin American markets in manufactured products are very important. "This intra-regional trade in manufactures is to a high degree intra-industrial and intra-firm trade, and intra-firm trade is operated largely by transnational corporations who came to Latin America during the import-substitution era of the 1960s and 1970s in order to have entrance to the nationally closed markets of the time." Aninat said that if Latin American countries wanted to obtain additional inflows of foreign direct investment, they should beware of creating conditions that might result in losing part of the already existing stock of foreign direct investment (of around 100 billion dollars) which has been provided by these transnational corporations.

According to Aninat the rise of manufactured trade between, for example, Argentina and Brazil is not only a consequence of the liberalisation of trade, but also of administered special trade regimes. "There are special protocols which give protection to transnational corporations' subsidiaries which are located in these countries. One well-established example is the automotive industry. Exports by these industries in Argentina and Brazil are one of the main explanations of the boom in the trade in manufactures between these countries. Another example is Maquila Automotive, an industry in Mexico which is connected with the United States. NAFTA is going to liberalise trade in a 10-year period, but for the moment there are special trade regimes that favour the exports of this kind of industry."

Aninat believed that these industries – the case of the automotive industry is a notable example – remain in Latin America because they enjoy some kind of protection. "A complete and sudden liberalisation would perhaps tempt many of them to go away and make offers to the Latin American markets from outside the region. This does not mean that it is good to have this kind of protective regime, but it does mean that liberalisation has to take into account the necessary competitive adjustments that these industries will have to make. The challenge for us is to try to get inflows of new foreign direct investment and at the same time retain the foreign direct investment already located in the area."

Claudia Schatan, economic affairs officer at ECLAC-Mexico, elaborated on the nature of intra-Latin American foreign direct investment. "Why doesn't foreign direct investment of Latin American countries within the region seem confident? It doesn't seem confident enough to make new investments, risky investments in the export-oriented areas. They concentrate on acquiring enterprises that have been privatised or private enterprises that already exist. In this sense something is wrong. Integration is not leading the region to a more competitive stance in the world economy, which is what one

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might expect from an additional effort at foreign direct investment. Take, for instance, the case of Costa Rica and Mexico. After they signed the free trade agreement, and Mexico had all the guarantees for foreign direct investment that NAFTA gives because that was Mexico's requirement from Costa Rica, many Mexican entrepreneurs came to Costa Rica to buy Costa Rican firms. Then the Costa Ricans were arguing that no new investments and no new projects were coming in. Why?"

Schatan also pointed to the speed at which investments are made and withdrawn in Central America. "You can see foreign direct investment moving very quickly from one country to another within the Central American region – perhaps also within the Caribbean – according to the conditions that each country offers. If El Salvador is offering lower wages, then Costa Rican capital and Guatemalan capital seem to be going to El Salvador. So while investment is going to areas that export and that can be competitive, there is the problem of a very foot-loose kind of investment, not from the US or the Koreans, but from the Latin American investors."

Renato Baumann, economic affairs officer at ECLAC-Brazil, referred to lessons to be learnt from the experience of Mercosur, and in particular from the evolution of the integration agreement between Brazil and Argentina. "There are some lessons that might be of interest. First of all, Stephany's paper tells us that there is a long-standing sort of tradition of bilateral investment flows in the region being concentrated in the tertiary sector. In particular in the Brazil-Argentina experience, I would stress that it is not the tertiary sector in general, but the commercial banks segment in particular. The integration process started with investments in the banks and then led to investment in the secondary sector, and, more recently, to the acquisition of land in the primary sector. Why was investment in the commercial banks so important for the whole process? What motivated it in the first instance? Another lesson to be learnt relates to what has happened with the compensatory mechanism that was originally designed to reduce bilateral trade deficits. If there was a trade deficit over a given percentage, an investment fund had to be created to compensate for structural deficiencies of the deficit country. This trigger mechanism was in the original Brazil-Argentinean agreement, but it disappeared in the Mercosur treaties. Why?"

Focusing on the role of financial flows in development, Baumann raised the question of the best way to finance long-term growth in the region. "Stephany's paper does not pay sufficient attention to one important aspect, which is credit guarantee. There is a multitude of institutions, as Mohamed El-Erian stressed, but exactly how do you configure a mechanism so that the smaller and medium firms can have access to credit? – not only institutional credit in BLADEX or some regional institution, but also credit that is available from all the pension funds around the world and all the liquidity we

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have. Why do medium and smaller firms have difficulties in gaining access to those resources?"

Baumann also wondered why the need for development bank financing is stressed time and again rather than following the Anglo-Saxon way of financing long-term investment via stock exchange. "Why is there no integration between the stock exchange markets in Latin America? Probably it is connected with the way the stock exchange markets function – they are heavily concentrated in a few stocks. Certainly it has to do with recent experiences of some countries. At least until last month, very frequent comments were made in Chile in terms of the migration of liquidity – ADRs being captured, resources being captured in Wall Street meaning that some liquidity was going abroad – as a result of difficulties with the local stock exchange."

Antonieta del Cid, vice-president of the Central Bank of Guatemala, thought that too much attention was focused on the importance of institutional arrangements: "Is it the institutional arrangements that facilitate or stimulate larger intra-regional trade, or is it the other way around, i.e. the intra-regional trade which stimulates these institutional arrangements? The failure of, for instance, the clearing and payment arrangements in the Central American region was due exactly to what Stephany points out in her paper. Even after the adjustments of 1991, only a small part of intra-regional trade was channelled via this mechanism (in 1992, around 15 per cent) because imbalances of trade between Central American countries remained high and thus a large proportion of the transactions had to be settled in hard currencies. However, last year some commercial banks of Guatemala, Costa Rica, and El Salvador virtually replaced this public clearing and payment arrangement by creating a Central American current account! An importer in Guatemala from El Salvador can now pay in local currency, and it is the same in El Salvador and Costa Rica. Other commercial banks are following the same mechanism. Although it may be too early to talk about a success story, I think this is an example of something that could not be accomplished by the government or the public sector and is now being accomplished by the private sector. Perhaps in the end the market is going to find the way to replace these institutional arrangements and create the adequate mechanisms."

The Asian Experience

Percy Mistry, an Indian economist engaged in both policy-oriented research and private sector activity (he owns a merchant bank in India), provided an Asian perspective. "As an Asian who was involved in the way in which Asia developed its intra-regional network in the 1970s and 1980s, I

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would like to share some elements of experience and their relevance and irrelevance for Latin America. I keep worrying that people look at Asia and have a tendency to draw rather simplistic and wrong lessons from the Asian experience.

The first thing which strikes me is that in all these discussions in Latin America, Africa, South Asia – where you have brilliant economists and very effective institutions in which economists work – the issues get confused because economists substitute their judgements for what and how business people think. The fact of the matter is that in any policy-driven and institution-driven regional integration process – including the European Union – whereas policymakers think that they are reducing costs for businesses, business people perceive it in exactly the opposite way. They see the transaction costs, the information costs, the cross-border risks and the familiarity premium problem as much easier to cope with when they are dealing directly with one other, than if they are dealing through bureaucracies. It is not just a question of bureaucratism or non-bureaucratism, but of how businesses react to bureaucracies. Very often when I talk to policymakers in Latin America and Africa they actually believe that they know how business people think, but they don't! They haven't a clue! Policymakers are naturally risk-averse, terribly intelligent, and awfully thoughtful, while business people are none of these things! They look at an opportunity and either they move or they don't.

Now I will say something that may strike you as a contradiction to what I just said, but really it isn't. It's of critical importance to understand the so-called 'cascade' or 'flying geese' effect – both by industry and by country – in Asia. People often wonder how intra-regional developments in Asia actually took place without anybody – at least, from the policy point of view – guiding them. But in fact, when you were involved in some of these things as I was, you saw that they were being guided very carefully by long-term planning by major corporations which had a 5, 10, 15 year horizon (which, by the way, I find completely lacking in the Western Hemisphere whether it is in the North or in the South). I was working with Japanese and Korean business people who were literally doing scenario-planning for 2000 and 2005, by industry, by country.

However, this notion that Asian integration is entirely market-driven is too simplistic. Indeed, it was driven by large firms, first by Japanese multinationals, then by Korean and Taiwanese multinationals, then by Hong-Kong/Singapore multinationals and now by Malaysian/Thai/Indonesian/-Philippine multinationals. But these multinationals have very effective relationships to their governments, so it is misleading to simply classify the Asian experience as market-driven integration! It is not. It is a very carefully planned, very thoroughly executed process. But it is a process in which

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business people have a driving role, not governments! They use governments, and governments let themselves be used. It is not the government's feeling that they should drive the process, and that again is very different in Latin America and in Africa, and even in South Asia.

Another aspect of this term 'market-driven' is that most of the intense integration in Asia has been cost-production driven. In the early phase it was 'competitive tax incentivation-driven' but that was very quickly abandoned. Within 5 or 6 years Asian countries decided not to compete with each other and offer favours and tax holidays in their tax regimes because they were cutting each other's throats. They cut that out and discovered the merits of a basically uniform, stable, low-cost macroeconomic regime very quickly.

The reason the Asian machine has kept going so long is because this cascade has been planned and at each stage of planning somebody else has entered into the game. It started off with the Japanese multinationals, but then involved the Koreans and all the others. The next phases are Indochina and South Asia. In fact, Asian businesses are looking now – and not only looking but they have been very effective investors – at Mauritius. They are also looking at South Africa and Madagascar.

So you have this full concept of regional integration based on the export of an entire production platform and everything that it entails: the technology, the finance, etc. One of the things that has been left out in Stephany's paper which I would suggest as a theme, is the role of intra-industry and intra-firm credit facilities to suppliers and buyers. In Asia this has played an incredibly powerful role. Not the banks, not the credit insurance companies, but the firms on their own account are providing the supplier and buyer credits – sometimes supported by governments, but in Asia there is very little of that; only in Japan is there major support. The other thing you see is that integration in the services industry, particularly in financial services, has often preceded integration in manufactured goods. In fact, the financial services industry has led integration in Asia.

Then there is the whole issue of ethnicity, which plays a very powerful role in Asia. If you look at the major driving forces of investment – apart from Japanese investment in Korea and Taiwan – you see that investment from Taiwan, Hong Kong and Singapore into all of the other Asian countries has been heavily concentrated within the overseas Chinese communities: intra-firm, intra-family, intra-well-known, and it is even broken down by ethnic type. The Shanghainese will invest with the Shanghainese, the Cantonese will invest with the Cantonese, the Fuchianese will invest with the Fuchianese. The peculiar thing is that Asian development is based on a view of exploiting the *world* market, but actually has facilitated *regionalisation* because of the premium it attaches to 'familiarity with the environment'.

Asia started out much poorer than Latin America and is now richer than

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Latin America. Asia started out with just as much American multinational presence as Latin America did in the 1960s and 1970s, and now the American multinational presence in Asia is minimal. There is virtually no European presence at all. And what has really characterised Asia is the emergence of very powerful regional corporations, which are now becoming transnational corporations. The rate at which people from Singapore, Hong Kong, China and Malaysia are buying up the UK is not funny. This year, I suspect people will realise that investment in the United Kingdom from Hong Kong, Singapore and Malaysia has exceeded investment from Japan.

A thing that came out strongly in Stephany's paper was the role of official finance in facilitating integration. When you look for the official role in Asia, there is none. If you abandon the Asian Development Bank tomorrow, Asia will develop without missing it. Perhaps the only country to which the ADB is making a significant difference is Bangladesh, but you could forget about regional institutions like that. There is no regional clearing facility, it is all done through commercial bank to commercial bank arrangements. There is no support whatsoever, no official agency underwriting exchange risk, no official agency underwriting commercial risk. When two firms decide to do something together, they get their banks to do something together.

In Asia there has also been a tremendous amount of industry-led backward and forward integration. When I said that there was a cascade by country, one should not forget the cascade by industry: first textiles, then footwear, then electronics; first consumer, then industrial; and then a tremendous boom in diversification. Automobiles are now beginning to play a very significant role in the development of backward integration in glass and steel and a forward integration role in terms of global marketing arrangements which are shared.

Stephany and others have raised the issue of capital markets. I agree that this perhaps needs to be looked at a bit more intensively in future research, but the funny thing in Asia is again that nobody has attempted to plan to integrate regional capital markets and yet, in a peculiar way, they integrate very well. Essentially regulatory harmonisation has come about through regulatory competition rather than through regulatory cooperation. Everybody in Asia has wanted to offer a better regulatory deal, only on certain kinds of issues regulators have cooperated."

The Mexican Crisis

Because of the importance of the Mexican peso crisis that erupted in December 1994, a long discussion took place on the implications of this crisis for the process of economic integration in Latin America.

In the view of Ricardo Ffrench-Davis there was a clear link between

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Mexico's currency crisis and its entering into NAFTA. "The appreciation of the exchange rate of the Mexican peso between 1991-94 – which increased imports from the US and contributed to the one digit inflation – enhanced very significantly the probability of being accepted as a member of NAFTA."

According to Ffrench-Davis, the Mexican government was so keen on entering into NAFTA that macroeconomic policies were subordinated to that goal. "What was happening in the process? The appreciation of the exchange rate – the real exchange rate, not the nominal one – was encouraging additional capital inflows. In a sense, you got a perverse dynamic. The aim of entering into NAFTA helped to keep up the exchange rate, the appreciation of the exchange rate encouraged the inflow of capital, the capital inflows allowed the exchange rate to lag more, and so on. You got a dynamic which could go for 1, 2, 3 or 4 years. It is very difficult to know when it ends, but one knows for sure that when this process is so massive – in the case of Mexico the stock of external liabilities was growing very fast: an additional 20 billion in 1991, 23 billion in 1992, 25 billion in 1993, 29 billion in 1994 – it will end, whether you are in NAFTA or not, whether you are in Mercosur or not, the European Union or not, when it is so massive, running at 8 or more per cent of GDP for three or four years."

Why did Mexico not try to stop the appreciation of its currency to avoid aggregate demand growing faster than the GDP? "That is not easy to do when you have free capital inflows and when world capital markets have a large supply of cheap funding. In 1992, 1993 and even in 1994 it was very cheap – in real terms – to get money from the US market or the international capital market. Mexico's entering into NAFTA raised expectations and made the country an attractive investment opportunity for capital markets. Mexico did not have the problem of a too large direct foreign investment – which was fairly small, 5 billion in 1993, maybe 8 billion in 1994, and could be absorbed quite well by Mexico – but of a too large inflow of short-term capital," Ffrench-Davis explained.

Mexican economist Jaime Ros stressed that the Mexican crisis was the result of both market failure and government failure. "It is this combination of markets and government failing together that made the crisis so acute and the present mess so big. The market failure has to do with foolish speculation, grossly misinformed and over-optimistic expectations about the profits of the Mexican economy which supported for too long – for about three and a half years – a currency that was very clearly overvalued since mid-1992. The government failure has to do with the policy of following a real appreciation of the peso at the time of a very radical process of trade liberalisation and a dramatic fall of the domestic savings rate – especially the private savings rate. According to the textbooks on international economics, you can implement a very radical process of trade liberalisation only if you

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compensate with the real depreciation of your currency, otherwise you get into trouble."

Jaime Ros pointed out some of the implications of the Mexican crisis, both for Mexico and for the process of economic integration in Latin America.

"One consequence is that the problem of capital inflows is over. We are unlikely to see bullish speculation in financial markets for years to come, partly because financial confidence is bound to remain very shaken, partly because of the high interest rates in the US. And as long as the present situation doesn't degenerate into a credit crunch 1982-style, I think this will have positive consequences for Mexico and Latin America. One positive consequence is that it will force exchange rate policies to focus on production and growth rather than leaving the exchange rates in the hands of the financial markets. As long as this is the case, we may see a change in the composition of investments from abroad in the right direction. One of the problems of the investment boom – financial investment boom and foreign direct investment boom – in Mexico in the years preceding the current crisis was not only that the composition of investment was very biased towards short-term financial flows with very little foreign direct investment, but another problem – and a serious one – was that the composition of foreign direct investments itself was increasingly biased towards the non-tradeable rather than to the tradeable sectors. Putting it in simple terms, we were getting McDonalds, Wallmart and Tacobell rather than Toyota and IBM, and it makes an enormous difference! Not only because of the kind of jobs and productivity gains that you may get from IBM and from McDonalds – that is not the major point – but also because the non-tradeable goods sector cannot become an engine of growth. It is only the tradeables sector that can become an engine of growth in an open economy.

The second implication for the process of economic integration is – and here we should recall the textbooks of 10, 15 years ago – that in processes of unilateral or bilateral trade liberalisations (that will proceed necessarily at an uneven pace and starting from different initial conditions), we are bound to produce currency realignments, precisely because the trade liberalisations proceed at an uneven pace and start from different initial conditions. The challenge is then how to manage these currency realignments, how to prevent them from degenerating into major exchange rate or even financial crisis."

Renato Baumann raised the question of whether the crisis in Mexico – which has been aiming so much at the US market – showed the need for diversifying trade and pegging the currency to a basket of currencies instead of the US dollar. "Most of the Latin American countries usually peg their currencies to the US dollar. One of the lessons of the Mexican crisis may be that you should peg to a basket of currencies, as Chile did a couple of years ago," Baumann said.

Jaime Ros observed that in the case of Mexico, the dollar is *the* currency in the relevant basket. "So the issue is not so much whether you peg against the dollar or you peg against the broader basket of currencies. The issue is whether you peg or not. I mean, you can either continue to peg the peso at say 4.50, 4.75 to the dollar (assuming that the currency situation stabilises) or follow a policy of real exchange rate targets. This is the important debate at the moment. I can see the advantages and disadvantages of both options, but I tend to be in favour of real exchange rate targets."

Shahen Abrahamian, officer-in-charge of the Global Interdependence Division of UNCTAD, argued that one should forget about the idea that private capital markets would ever produce the right amount of flows.

"I agree with almost everything Jaime Ros said, but he gave the impression that this Mexican crisis was a sort of salutary shock, and now the flow of capital would be right. I think that private capital flows will always be either too much or too little. If the right amount goes, that will increase confidence and more than the right amount will go. If less than the right amount goes, that will deter confidence and less than the right amount will go. The typical pattern will be either a glut or a shortage. And this is particularly worrying in a context like Latin America where short-term capital is taking the place of long-term capital.

There has been the notion that somehow Latin America has been getting itself into a kind of quasi-Asian type of development. I think this is completely wrong. In Asia, by and large, there has been a tremendous boost to the competitiveness of the developing countries in the region. This has not happened in Latin America. The capital flow from the United States to the South of the region is superficially like the Japanese capital flow to the rest of the region. But there has not been the relocation of production and the real structural changes that occurred in Asia. You haven't had the push from Japan or Korea under the impact of rising real wages. The situation in Latin America is much weaker than in Asia. Capital investment in Asia tends to be much more long-term. When a Japanese bank buys shares in a company, it is there for a long time. The pension fund managers in the States are just thinking of their quarterly earnings.

We really have to think more from the longer-term point of view, back to the old question: Where is long-term development finance going to come from? One of the legacies of the 1980s is to say: 'Government failure, forget about public flows, leave it to the market'. We left it to the market, you got market failure. We discussed this crisis actually two and a half years ago in another Fondad conference in The Hague. Then I said it was a very good place to meet because Holland had been the scene of one of the first crises of modern capitalism, the tulip mania, at a time when there was no welfare state, no import substitution and none of the other evils that have apparently beset

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private enterprise, and yet it happened. So this Mexican crisis is quite a serious turning point for Latin America, which gives us a lot to think about."

Compensatory Mechanism

Griffith-Jones' plea for the establishment of a compensatory mechanism provoked an interesting discussion about the nature and the targeting of such a mechanism if it were to be applied in Latin America's economic integration process.

Ricardo Ffrench-Davis observed that the crucial point of a compensatory mechanism would be at what exactly it should be directed. He thought it should mainly help to complete markets and increase the productivity of the poorer countries. "Trade within Latin America – of goods and services – is less than it ought to be given the geographical vicinity because we have incomplete markets. We have more complete markets between Latin America and the US or Latin America and Europe than, for example, between Bolivia and Paraguay, Peru and Chile, etc. The last two or three years we have been working on either completing or creating markets where they did not exist, and I would prefer the compensatory mechanism to be geared in that direction instead of being merely a mechanism to transfer money (which might just disappear in the deficit of the current account)."

Robert Devlin, a US national who heads the Integration, Trade and Hemispheric Issues Division of the Inter-American Development Bank, entirely agreed with Barbara Stallings that the US had shown no disposition to get involved in the establishment of a compensatory mechanism. However, Devlin thought the US ultimately was a very pragmatic place and might in future change its mind. "Just because there is a negative predisposition vis-à-vis compensation today does not mean it will always be like that. I think one has to – both at the political and the technical level – continue to talk about it and not just accept the status quo. My own personal belief is that if integration is going to succeed it will need compensatory mechanisms. Indeed, if it succeeds it will create demands for compensatory mechanisms. In fact we see that a little bit in Mexico today. The rescue of the Mexican peso came as a de facto result of the integration between the US and Mexico. The issue of compensation adjustment is a key one: it is both necessary to push integration forward and it becomes a necessary product of successful integration agreements as they move along."

Hector Assael noted that the case of Mexico was more like the kind of compensatory financing given by the IMF when a country faces balance of payments problems and had nothing to do with integration problems. "That is why the IMF could come in and put 17 billion dollars over there, not because of integration," Assael stressed. He therefore suggested that the

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concept of compensatory financing should be elaborated in more detail. "What are we really talking about? Both the IMF and the World Bank have compensatory financing mechanisms, but I don't think that's what we have in mind, because these are not related to resolving integration problems. The first approach which does relate to the resolving of these problems is the provision of compensatory financing to less developed *countries* that have trouble because of regional integration. For instance, you can give special treatment to Paraguay, or Bolivia, or Haiti. The second approach would be that we give a special compensatory treatment to less developed *regions* inside the member countries of the region – which is a little nearer to the European scheme. Third, we can think of – as Ricardo suggested – some specific sectors. For instance, if we have trouble with transport, with tourism or services, we give special support to those *sectors*. So, we need to explore what terms we are thinking in when we speak about compensatory financing for integration."

In this context, Percy Mistry suggested it might be useful to dwell for a moment on the unique range of regional compensatory arrangements established by the European Union (EU). According to Mistry, the EU has basically four categories of compensatory arrangements to remedy integration shocks.

- The first is to cover the costs of dislocation caused by integration. "Invariably, when you integrate you enlarge market size, you permit firms to operate across borders. Some firms will go under, some will survive, some will have to reinvest, some will have to develop new marketing capabilities. So you establish compensatory arrangements which can either benefit countries who make a case that their industries are being hit, or industries who make the case that they are going to be hit".
- The second category is directed at reducing regional imbalances. "This has become a boondoggle with the Mezzogiorno, Northern Ireland, Portugal and Spain. What was supposed to be a mechanism to reduce regional imbalances has become an effort on the part of the EU to buy support for the Community. Some of this has just confused the plain development financing, much of which the private sector could do. But the private sector is very happy to take government money especially when it is provided cheap. So I think one has to deal with this issue of regional imbalance reduction very carefully if one is contemplating these kinds of arrangements in Latin America. How much is really necessary? This is a damned difficult calculation to make".
- The third category is to compensate poorer outsiders (developing countries) for trade diversion effects. "This is what part of the ACP programme is all about, but the compensation is roughly 1 ECU for every 10 ECUs' worth of damage done. It is more a palliative than real compensation".

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- The fourth category is to support industries which are affected by integration. "Here you give compensation when it is clear that massive upgrading is needed to restore competitiveness in the steel industry or in the coal industry or in the textile industry, or you give compensation when a coal mine has to close down".

Augusto Aninat observed that the case of the European Community is very different from the Latin American experience, for while the member countries of the EU have resources in common and have the obligation to administer them, the Latin American countries do not have common resources and would first have to create them. Aninat thought that the first thing Latin America should do towards establishing an intelligent and efficient compensatory mechanism is to link the granting of such support to efforts at readjusting the economy or certain production sectors of the member country concerned.

Macroeconomic Policy Convergence

Most participants seemed to agree on the importance of policy convergence. Robert Devlin, however, added some critical remarks.

"I think there is an interesting dynamic developing. Mohamed El-Erian pointed out that there are criteria of convergence for entrance into the European Community and that these might have lessons for Latin America. Yet at the same time one has to take into account that the criteria of convergence have become strong when the European Community has reached the point where they do most of the trade among themselves. When they were integrating in the earlier stages, there were quite a few members in macroeconomic disequilibrium. France is probably a good example. It was not until the *franc forte* came along that France achieved macroeconomic equilibrium. Before that it had one macroeconomic problem after another. If we look at Europe, it is important not to look at Europe today, but to go back and look at Europe in its earlier stages and see what lessons can be drawn from that experience.

Second, perhaps Roberto Bouzas' comment remains valid that even with macroeconomic disequilibria there are a lot of things that you can do to promote integration. We have to remember that in Latin America intra-regional trade is still a relatively small part of total trade. The main trade partner for Latin American countries remains without any doubt the rest of the world. So it may not always be convenient to look for convergence with your Latin American partners when most of your trade is being done outside of your integration scheme.

I don't have any clear answer on this, but I think this is an area where we

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have to do more thinking. It is not a clear-cut black and white case of 'convergence, convergence, convergence', which you hear quite a bit. On the other hand, one doesn't want to be associated with promoting macroeconomic disequilibrium.

It seems to me that, in the initial stages of the integration that we have in Latin America, it is in the grey area where much of this falls.

There is another issue too: one has to be careful about how you converge. Part of what occurred in the Mexican case was because of convergence. There was a strong desire to converge with the US rates of inflation as quickly as possible. In order to achieve this, the exchange rate policy chosen was one of a nominal anchor, or semi-nominal anchor, and there were clearly problems with that. So again, it is not only a question of convergence but also a question of how you do it. Within our own profession there is a lot of disagreement on how you should go about it.

I don't have an answer, but I think there are a lot of questions which remain to be answered in this particular issue at these early stages of integration in Latin America."

Reply by Stephany Griffith-Jones

"I will try and address just some of the many issues that you all have raised and will concentrate on the comments made by the official discussants because I have had more time to think about them. Mohamed El-Erian and a number of people raised the issue of macroeconomic convergence. I think this is a very important issue today, particularly in the context of integration which includes such a strong element of financial integration and where you have short-term capital flows making macroeconomic coordination both more essential – because mistakes are punished very quickly – and much more difficult. Even in the case of the European Union, which is much more advanced in the integration process than anything we have in the Western Hemisphere, macroeconomic convergence has been very difficult, as we can – see from the break-up of the ERM and the need to broaden the bands both as a result of wrong macroeconomic policies in some countries – but not in others – and of massive surges of private capital flows. This is an issue which is even more difficult to handle in the Western Hemisphere.

The other issue that Mohamed raised is the issue of harmonisation of supervision and regulation. Indeed, this is a very important issue. And again, I think there are interesting lessons to be learned from the European experience, where there have been very long and very intense debates on how to integrate European financial markets, both in the banking sector and in the security sector. One of the lessons one can draw from the European debates is that the integration of supervisory regulation should be done as soon as

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possible, before the markets begin to be more developed. The more developed financial markets are and the more they have developed along different lines, the more difficult it becomes to harmonise them. There have been tremendous fights within Europe on apparently very technical issues like the level of transparency in stock exchanges, but they have to do a lot with harmonising financial sectors which are very different institutionally – you have, for example, universal banks versus banks which have more limited roles – and where you have very different philosophies of regulation. In the UK, for example, the emphasis is more on competitiveness of the financial sector and how to enhance that competitiveness, while the French and the Germans are much more concerned with market safety and avoiding financial distress and financial crisis. So you see from the European experience that there is an urgency to start soon with the harmonisation of supervision and regulation.

Next is the issue of compensatory mechanisms, to which I just devoted a little paragraph. It raised a number of issues. Barbara Stallings started the discussion by recollecting a session we had with Ron Brown here in Santiago. The question that she very clearly addressed to him, and which he very clearly answered, is that the US would be unwilling to do anything in this field. But the point I was trying to make is that it is not surprising that the US is unwilling because they would have to put either all of the money or 90 per cent of the money. The Germans were unwilling to put the money in 1956 too. But the point is that the Italians pressed them, saying they would only join if there was a European Investment Bank. And when the Spanish joined and the Portuguese joined, they also put almost as a condition of entry that compensatory mechanisms were created. There was a big fight, the Germans didn't just say 'OK, we'll sign the cheque'. In the end it was agreed that, as a condition of market access, some compensatory finance would be given to particularly the poorer areas that were affected by trade disruptions – but not just to the poorer areas, because the so-called 'senile' industries (for example, old steel plants), in the relatively richer countries like Britain or Luxembourg, also benefitted. If these industries were unable to adapt, they also received financial help to restructure.

All this is much more difficult in the context of Western Hemispheric integration because we have countries with very different levels of income and the majority of the countries are much poorer and so there are big issues of where the money would come from and go to. I think one possible way forward is to expand some of the compensatory mechanisms which – as was mentioned here – already exist in the context of the Caribbean Development Bank and on a much larger scale in the context of the Inter-American Development Bank. But to be realistic, we have to realise that these mechanisms, at least in the context of the IDB, have actually been decreasing.

The volume of flows going at a subsidised rate to the poorest countries has been decreasing in the IDB quite sharply, particularly because the IDB doesn't have resources to fund it. The money has been far better targeted: it really goes now to the poorest countries, but there is very little of it. One possible way forward could be, as there is already an institution which exists and a mechanism which exists, to perhaps expand that and perhaps broaden it to the effects of integration. I am just thinking aloud.

The idea of Ricardo Ffrench-Davis to complete markets is very powerful and is consistent with what has been done in the European Union where the argument was, 'there are market imperfections'. These imperfections are particularly strong in the poorest countries. It is much easier to fund infrastructure in German or in Britain than in Portugal. Therefore it is more justified to give a loan from the European Investment Bank – a public fund – or to give some kind of guarantee for building a road or for funding small or medium enterprises in Portugal than it is in Germany or the UK. That is the line that has been taken and I think it works relatively well.

That brings me to a fourth point, which is the link between private and public sector funding. Again, I think there are interesting experiments going on in the European Union to fund intra-national projects of a very large magnitude in integration, not just roads or railways which involve massive costs, but also telecommunications and so on, which are now so crucial. It is the preference of EU governments, and the preference in general today of governments, to do this through the private sector, but the problem is that the private sector is sometimes unwilling to go into risky projects. So there is a search within the European Union for an intermediate package through creating a sort of guarantee facility which protects mainly against the specific risks which are borne by the private sector when it is involved in an intra-national project. For instance, you have to harmonise environment regulation, safety regulation and you don't know how this will affect your future profitability. We don't know yet how this guarantee facility – a 3 billion ECU facility has just been created – will work, but it should involve much less public funding than either if the government fully funded the facility or provided completely blank guarantees. To be clear, this facility will not guarantee against conventional commercial risks, it will only guarantee against risks of integration.

Finally, I would like to say that you raised a number of interesting issues that were not in my paper, for example the integration of stock exchanges and so on. This will be useful for our next meetings when we look at regional integration in other parts of the world."

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