Part I

Lessons from European Economic Integration

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Regional Exchange Rate Arrangements: Some Lessons From Europe[1]

Charles Wyplosz

1 Introduction

Regional arrangements are in vogue, at least on paper. The Western Hemisphere, already equipped with NAFTA and Mercosur, is discussing the Free Trade Area of the Americas (FTAA). With the Chiang Mai Initiative, East Asian countries are attempting to deepen financial cooperation. The Caribbean countries are also working on deepening their arrangements, and steps are being taken in Africa. Yet, regional efforts have rarely been successful over the last fifty years or so. This is partly explained by the official international emphasis on multilateralism, backed by such powerful institutions as the IMF and the World Bank. But another part of the explanation is that, to exist at all, regional arrangements must add to the fairly extensive web of already existing multilateral agreements. This, in turn, requires deeper integration, and, therefore, some sacrifices in terms of sovereignty – thus raising the costs of agreements whose benefits are typically marginal relative to existing multilateral arrangements.[2]

Europe provides the standard example of a successful regional arrangement. It is natural, therefore, to ask why it has succeeded and whether its experience reveals lessons that could be used elsewhere in the world. A vast literature explores various aspects of this question. This paper focuses on a particular aspect of regionalism, financial arrangements and the related choice of exchange rate and capital mobility regimes.

The attraction of regional exchange rate arrangements is in part stimulated by a new conventional wisdom, the hollowing-out view, which holds that there is no workable middle ground between floating and hard

[1] Paper presented at the conference on "The Role of Regional Financial Arrangements in Crisis Prevention and Management: The Experiences of Europe, Asia, Africa and Latin America", organised by the Forum on Debt and Development (FONDAD) in Prague on 21-22 June 2001. I have benefited from comments by conference participants, in particular my discussants Zdeněk Drábek and Bill White. This version draws on joint work with David Begg, Barry Eichengreen, Jürgen von Hagen and Lászlo Halpern. The opinions presented here are my own, however.

[2] For an analytical background on the politics of regional agreements, see Aggarwal and Dupont (1999).

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pegs. It predicts that traditional fixed exchange rate regimes, still in place in more than half of all countries, are doomed in a world of unfettered capital flows. According to this view, those countries that wish to limit exchange rate flexibility among themselves will have to go all the way to hard pegs. The relevant regional arrangement is a monetary union or joint dollarisation. In this discussion, full capital mobility is taken as a natural Darwinian step in mankind's evolution. Europe's experience emerges as a potential blueprint.

The thesis of this paper is that Europe's story is very different from the one suggested by the current conventional wisdom. I argue that the commitment to fixed exchange rates has all along taken precedence over capital mobility. Exchange rate stability has been seen as a pre-condition for trade integration, the only way of establishing a level-playing field for international competition. The decision to adopt a common currency has come very late, much as capital mobility has been restrained for decades, and established only after achieving a high degree of trade integration, along with powerful supporting institutions. Put differently, regional trade integration, exchange rate stability and institution building came first, capital mobility and monetary union came last.

The following section sets the stage; it describes the exchange rate regimes adopted in Europe over the last 50 years. Section 3 builds up the case that trade was a key concern behind the commitment to exchange rate stability. Having noted that fixed exchange rate regimes are inherently unstable, Section 4 looks at the various measures that were adopted in an effort to increase the chance of survival of the fixed exchange rate arrangements. These measures at times severely constrained the financial markets, both domestic and external. But is it not the case that such measures are costly and inefficient? Section 5 attempts to answer that question and, surprisingly perhaps, finds no such evidence. Quite to the contrary, in Europe at least, domestic financial repression seems to have supported growth. The last section attempts to distillate the lessons from Europe's experience. It argues that the choice of an exchange regime cannot be dissociated from the choice of a regime of capital mobility. Countries which are open, or country groupings which aim at deepening trade integration, may indeed opt for a fixed exchange rate regime. Hard pegs are an option, but not the only one once financial repression is not seen as sinful.

2 Exchange Rate Arrangements in Europe

This section briefly lists the different arrangements adopted in Europe since the end of World War II. It illustrates two key aspects of Europe's

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monetary integration: a constant quest for internal exchange rate stability and a succession of daring advances and setbacks.

Bretton Woods. The Bretton Woods agreements of 1944 provided indirectly for fixed exchange rates within Europe but it was not a joint undertaking, nor was it intended to further any specific European goals. The agreements matched European interests, but also those of the US equally preoccupied with the restoration of trade links. Faced with an acute shortage of dollar balances, European countries did not move to establish currency convertibility from the outset. As they concentrated on developing bilateral payment settlement agreements, both among themselves and with non-European countries, they started to work out their own arrangements.

The European Payments Union. The European Payments Union (EPU) was set up in 1950 to simplify the cumbersome web of some 200 bilateral payment agreements. It worked as a multilateral clearing system, focusing on the overall balances of payments of its member countries vis-à-vis the union. Generally considered as a success, the EPU is credited for having helped the resumption of intra-European trade. The EPU had some drawbacks, mainly its tendency to encourage trade amongst its members, discriminating against non-members.

Convertibility. The next major move, the restoration of currency convertibility in Europe in 1958, was decided collectively, alongside the adoption of the Treaty of Rome, the foundation of Europe's Common Market. Convertibility initially only concerned the current account. For many more years, the capital account remained subject to fairly draconian restrictions in most countries. The arrangement provided for a high degree of exchange rate stability, with few realignments. The first major depreciation, by the UK, did not occur until 1967. It was followed by a depreciation of the French franc and a revaluation of the Deutschemark, both in 1969.

The Snake. By the time the Bretton Woods system collapsed during 1971-73, further imbalances had accumulated inside Europe. After a series of realignments, most European countries undertook to maintain limited margins of fluctuations for their bilateral exchange rates while the other developed countries let their currencies float. The resulting arrangement, the Snake, was a mixed success; most countries were able to keep up with the arrangement, but speculative pressure forced others – mainly France, Italy, and Sweden – to exit the Snake. Outside of Britain, there was no serious questioning of the wisdom of keeping exchange rates pegged.

The Werner Plan. The main setback from European monetary integration during 1971-73 was the abandonment of the Werner Plan. Completed in 1970 and endorsed by the Council of Ministers in 1971, the

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Werner Report had recommended the rapid adoption of a common currency. It mapped out three stages, including the pooling of foreign exchange reserves for joint interventions. The turmoil surrounding the breakup of the Bretton Woods system led the larger countries to aim at more modest steps, partly out of pragmatism, partly as a pretext to escape a move that was clearly ahead of policymakers' thinking. The smaller countries, which were seeing their own policy autonomy decline, were frustrated by the failure of the Werner Plan but unable to shake the domination of the larger countries.

The European Monetary System. Monetary integration soon took another direction, though. The European Monetary System (EMS) was agreed upon in 1978 and launched in 1979. Eight of the then nine members of the European Community became active members of the exchange rate mechanism (ERM). When the euro was launched in January 1999, all members of the European Union were part of the ERM, with the exception of Sweden, the UK, and Greece. Greece joined the ERM later that year.[3]

The European Monetary Union. During its first ten years of existence, the ERM frequently underwent crises. By the early 1980s its survival was very much in doubt, especially as a series of attacks affected the French franc in the wake of the election of President Mitterrand. The political reaction turned out to be another show of support for fixed exchange rates. The authorities rededicated themselves to a new ERM, one where the DM would play the role of central currency. This "Greater DM area" gradually asserted its credibility and became seen as such a success that policymakers grew emboldened and resolved to move to the next logical step, monetary union.[4] But the ERM success was concealing a buildup of tensions. The combination of accumulated imbalances and of a major policy mistake – the denial that German unification would require a DM revaluation – triggered a round of violent speculative attacks. Two countries (Italy and the UK) left the ERM, many were forced to devalue, some of them several times. The ERM was radically changed when its margins of fluctuations were widened to the point of irrelevance. Yet, while the ERM currencies were officially quasi-floating, unofficially the monetary authorities endeavoured to keep them within narrow margins, in fact quietly mimicking the defunct ERM.

Summarising, since the early 1950s, with the notable exception of

3 Among European non-member of the EU, Switzerland has traditionally steered its own currency alongside the DM, even though it has always been very careful not to declare an official linkup, and has occasionally used the exchange rate as a tool of monetary policy.

4 A detailed review of this evolution is provided by Kenen (1995).

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Britain, the European countries have continuously sought to tie their exchange rates. The Bretton Woods system initially provided an adequate framework which did not require any additional explicitly European initiative. When it fell apart, Europeans promptly moved to develop their own arrangements, starting with the rather informal Snake, moving on to the more structured and cohesive EMS, and ending up with a full-blown monetary union. This history reveals a strong commitment to exchange rate fixity, even as most other developed countries, including the UK, were moving in the opposite direction of increased flexibility.

3 Why Exchange Rate Stability: Market Shallowness, Discipline or Trade?

There are several reasons for wanting to limit exchange rate variability. The most commonly cited reasons are a lack of sufficiently deep financial and exchange markets, a strategy of importing monetary discipline, and a quest for stability for trade purposes. This section argues that, in Europe, the key motivation was trade.

Financial and exchange markets were shallow in Europe in the 1950s. After the move to current account convertibility in 1958, capital account restrictions remained widespread, partly motivated by the belief that it would help to operate the fixed exchange rate system. By the late 1970s, Europe had deep enough markets to operate reasonably efficient exchange markets, yet capital restrictions remained widespread. The UK had liberalised in 1979 but was not part of the ERM; within the system, Germany was the first, and for a long while the only country, to make the move towards lifting capital controls in 1981 (see Table 1).

It is often claimed that most countries wanted to use the nominal exchange rate as an anchor to import the Bundesbank's discipline. This view is wholly revisionist. To start with, the discipline argument predicts that Europe's inflation rate should have remained close to that of the US during the Bretton Woods period, and then close to the German rate. It also predicts that Europe's inflation should have been lower than in the other industrialised countries which have been floating for most of the post-Bretton Woods era (Japan, the UK, Switzerland and Canada; and more recently Australia and New Zealand). Figure 1 does not bear out these predictions. On average, Europe (excluding the floaters, Switzerland and the UK) exhibits the worst inflation performance in the OECD area. If discipline was the motivation, it did not work. Most likely, it was not.

Next, the view that exchange rates can be used as an anchor is fairly recent, at least in European official thinking. Arguing that the inflation

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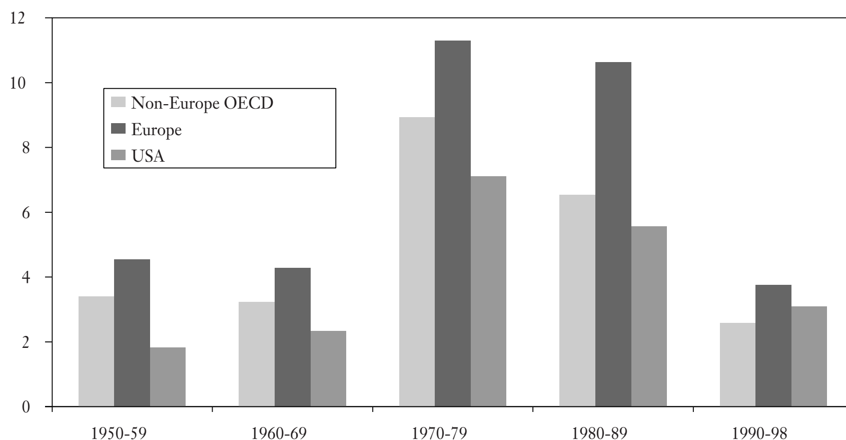
Figure 1 Inflation in the OECD Area



Non-Europe is Japan, Canada, Australia, New Zealand, Switzerland and the UK.
Source: IFS.

anchor argument lays as the motivation for the setting up of the EMS involves mixing up timing. It is only after the wave of currency crises of 1983, once France adopted the "Franc fort" strategy, that the EMS started to function asymmetrically with the DM as its recognised anchor. When the EMS was created, reference was explicitly made to nominal exchange rate stability, not to the desire of anchoring inflation to best practice in Germany. Realignments were not only possible but actively practiced and always justified as a "correction" of accumulated inflation differentials. In fact, the EMS was explicitly set up as a symmetric system, with no centre currency. Its rules carefully avoided adopting the Bretton Woods presumption that countries with high inflation and a weak currency would bear the burden of adjustment in case of misalignment and market pressure. Responsibility for exchange market interventions was strictly bilateral, with unlimited support from the strong to the weak currency country. Much to the discomfort of the Bundesbank,[5] the EMS was aiming at a "regression toward the mean", not attempting to build up pressure towards best practice.

The view that exchange rate stability promotes commerce has no theoretical support (uncertainty can either encourage or discourage international trade depending on assumptions) and limited empirical support.

5 As documented in Eichengreen and Wyplosz (1993), the Bundesbank had arranged for a private agreement with the German Treasury that would suspend the intervention clause if it determined that it was threatening price stability. This clause was invoked during the Italian lira crisis in September 1992.

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See for example Kenen and Rodrik (1986) for a sample of industrialised countries and de Grauwe (1988) for the European Union; a recent review and more weak evidence is provided by Flam and Persson (2000), with stronger evidence in Pozo (1992), Rose (2000) and in the recent literature on the border effect (Helliwell, 1998). Yet, this motivation has been crucial. Policymakers happened to believe that nominal exchange rate stability matters for trade, in spite of the theory and the evidence, and possibly for good reasons.

Most of the empirical evidence is based on high frequency (typically from one month to one year) fluctuations in the exchange rate. At such frequencies, there exist cheap hedging instruments, so that it is not surprising that the effect of high frequency exchange rate volatility is weak or non-existent. For technical reasons (chiefly the lack of enough observations), the literature does not deal with lower frequencies, in particular with the often deep multi-year currency cycles (e.g. vis-à-vis the dollar, the yen has depreciated by 47% between 1978 and 1985, then appreciated by 52% between 1985 and 1988, to depreciate again by 28% until 1990, and appreciate by 48% by 1995; similar fluctuations can be found for the DM, e.g. a 92% depreciation between 1979 and 1985, followed by a 52% appreciation by 1987). Such fluctuations cannot be insured against, at least not cheaply or conveniently.[6] They simply wipe out established competitive positions. It is difficult to believe that they do not hurt trade.

Evidence on the stability of intra-European exchange rates is presented in Figure 2 for the three most important intra-European exchange rates vis-à-vis the DM. The figure displays the actual and PPP exchange rates[7] of the French franc, the Italian lira and sterling pound relative to both the DM and the US dollar. For comparison purposes, they are all expressed as indices computed to average 1.0 over the sample period. While PPP is not necessarily a fact of life, it seems to act as a reliable anchor for most OECD countries. Intra-European rates have differed little from PPP, in sharp contrast with the other exchange rates, with the UK sitting in-between.

It is important to note that it is not the *nominal* exchange rate that was stabilised (another nail in the coffin of the discipline argument), but the *real* rate. Indeed, the ERM provisions for realignments and actual management relied heavily on PPP. Figure 2 also reports the monthly variance of

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6 In principle, firms can cover long-term trade exposure by acquiring matching positions but they do not seem to do so.

7 PPP exchange rates are computed using CPIs and take as a base the average exchange rate over the sample period. None of the conclusions drawn are sensitive to the use of a particular price index or to the choice of a base level.

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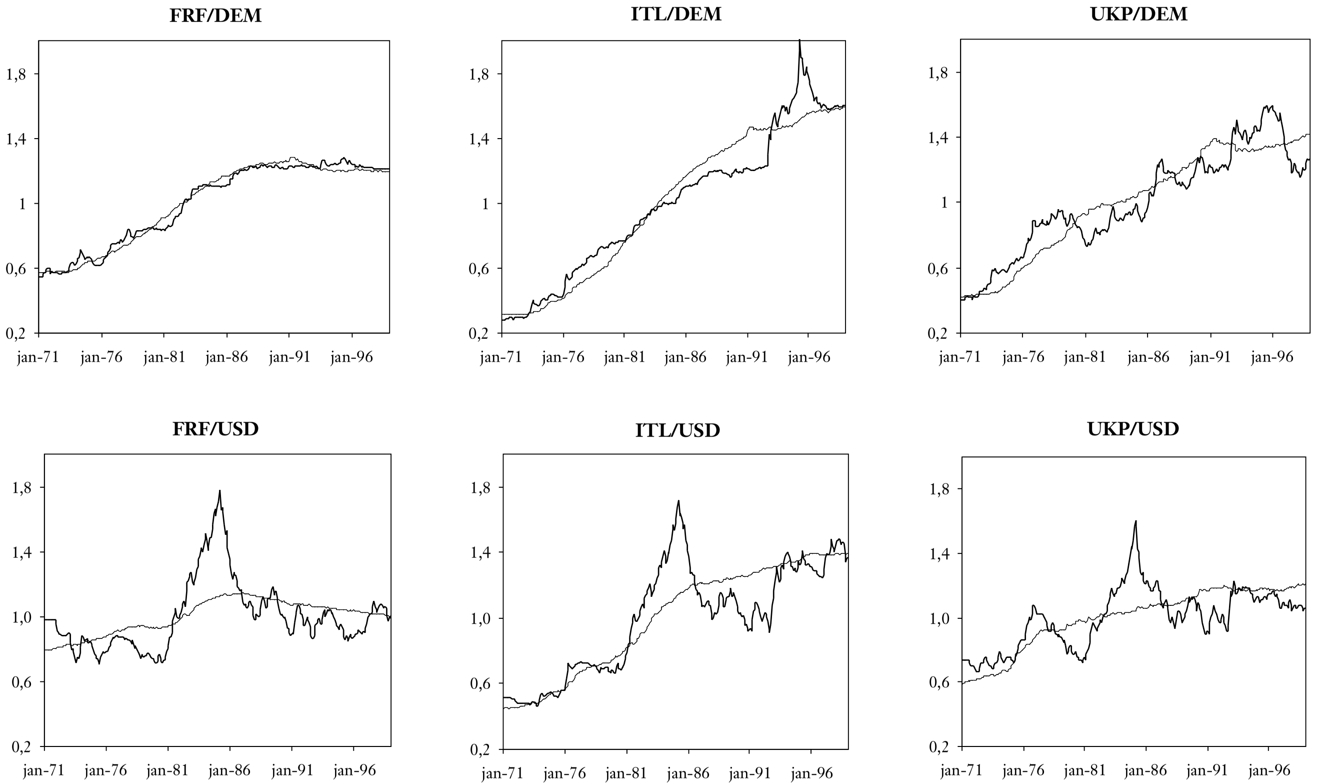
Figure 2 Exchange Rates: Actual and PPP



Source: IFS, CD-ROM.

log-deviations of the actual from the PPP exchange rate; for France and Italy this variance is much smaller vis-à-vis the DM than vis-à-vis the US dollar. For Britain, which did not share the continent's preoccupation with stabilising intra-European real exchange rates, the variances vis-à-vis the dollar and the DM are similar.

Summarising, this section argues that the European countries have identified real exchange rate stability as a key policy target. The discipline argument for exchange rate stability aims at the nominal, not the real exchange rate: nominal rates were anything but stable and Europe's inflation performance has been worse than in most other developed countries. The view that exchange rates were kept pegged because the markets were too shallow to be efficient is not convincing either. That may have been the case in the 1950s and the 1960s when the currencies were simply not convertible, but certainly not in the 1970s and beyond.

4 Exchange Rate Stability or Capital Mobility?

The emphasis on exchange rate stability should have implied a willingness to give up the use of monetary policy for domestic purposes. That has not been the case. Until the mid-1980s, most European countries fully intended to retain their monetary instrument. The first country to completely and explicitly give up monetary policy independence, the Netherlands, did so only after 1982. In fact, in a large number of countries, monetary policy was not only seen as a macroeconomic tool, but also as an instrument to support fiscal policy through the financing of budget deficits, and even as one of the means to conduct structural policies. Interest rates were kept low, often negative in real terms, and bank lending was often directed to favoured sectors and to firms identified as national champions.

The conflict between exchange rate stability and the active use of monetary policy was reconciled through internal and external financial repression, i.e. the use of widespread regulation designed to restrain financial markets. Domestic financial repression included quantitative limits on bank credit, ceilings on interest rates, directed lending, priority to budget financing, limits on the development of stock markets, etc. External financial repression took the form of capital controls, including administrative restrictions on inflows and outflows, the interdiction to lend to non-residents, the banning of forward transactions, the obligation for exporters to remit foreign currency earnings, etc. Domestic financial repression allowed the authorities to control the interest rate independently of credit and money supply growth. External financial repression was mainly designed to prevent international transactions from undercutting

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Table 1 Year of Liberalisation in Postwar Europe

	Internal	External
Austria	1981	N.A.
Belgium	1978	1990
Denmark	1980	1988
Finland	1970	
France	1985	1989
Germany	None	1981
Ireland	1969	1992
Italy	1983	1990
The Netherlands	1981	1986
Norway	1984	
Portugal	N.A.	1992
Spain	1966	1992
Sweden	1983	
Switzerland	1975	1980
United Kingdom	1971	1979

Sources:
Exchange controls from Bakker (1996), p. 220.
Credit ceilings from Cottarelli *et al.* (1986), unpublished appendix.

domestic repression. In some countries, external repression was also seen as a way of 'keeping domestic savings home', mercantilism applied to finance. Mostly as a by-product at first, restraints on capital movements also limited the ability of markets to attack the currency.

While Europe has been quite fast at deepening its internal trade, it has been notoriously slow at liberalising its financial markets, both internally and externally. Table 1 reports the final year of full liberalisation. Restrictions did not apply continuously, they were applied on and off according to perceived needs. Even in periods when restrictions were not enforced, the empowering legislation remained in place, no doubt reminding investors and citizens that the regime was *de jure* one of restraints. This section first documents and then interprets financial repression.

4.1 Domestic Financial markets

Internal restrictions mostly took the form of credit ceilings and other limits on credit availability. These restrictions were designed to control the money supply while interest rates could be kept at non-market clearing

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levels, typically lower. The outcome was a rationing of liquidity, with real interest rates remaining negative in real terms for extended periods of time.[8] Officially, interest rates were kept low to promote investment but the real motivation was to permit a cheap financing of budget deficits. In fact, the authorities were quite explicit on that point. For example, the French authorities had established a queuing system for bond issues by the private sector, in particular hollowing out periods when the Treasury was issuing its own debt.[9]

4.2 Capital Account Convertibility

External liberalisation occurred several years after internal liberalisation (Table 1). Various measures were in place to restrict capital movements. They mostly relied on direct administrative controls affecting citizens, firms and financial intermediaries. Belgium operated a dual exchange market separating commercial from financial transactions. Full, unconditional liberalisation was not mandatory until the Single Act of 1992, with accelerated effect on July 1990, except for Greece, Portugal and Spain which were granted grace periods.

The main aim was to keep domestic interest rates lower than implied by the interest parity condition. While it is often asserted that capital controls are ineffective, this has not been the case in Europe, as documented in Figure 3. The figure shows that the controls succeeded in creating long-lasting wedges between the two exchange rates (commercial and financial) in Belgium, and between the internal and external franc interest rates in France. Such deviations represent large profit opportunities. These unexploited opportunities are remarkable because they were riskless since they did not entail either exchange or maturity risk (the returns are in the domestic currency on identical assets). Of course, there was evasion and the measures never were 100% effective. Yet, the fact that the markets were unable to arbitrage away profit opportunities for significant periods of time – often more than one year – is clear evidence that the controls were effective. Despite widespread belief to the contrary, this should not come as a surprise. Evasion is always costly because it is illegal, which creates a rent that eats into arbitrage profits. The figure also indicates that, in quiet periods, the wedge disappeared. This corresponds to either temporary suspensions of the restrictions or to markets' ability to cheaply circumvent the capital controls given enough time.

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8 The only country where real interest rates have not been negative during the postwar period is Germany.
9 For a detailed discussion of this point, see Wyplosz (1999).

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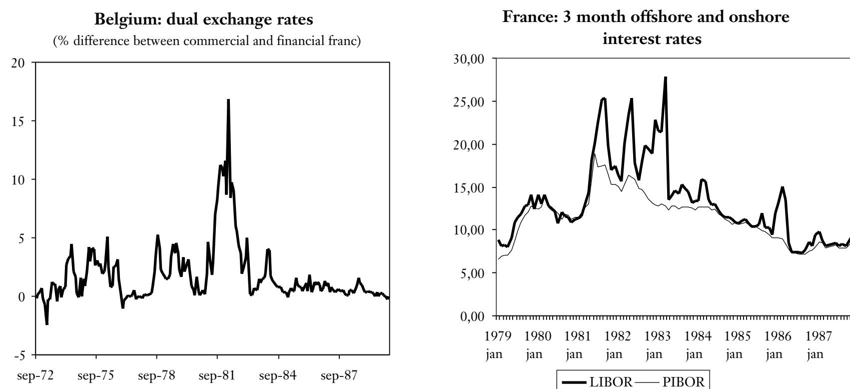
Figure 3 Effectiveness of Capital Controls



Sources: Belgium: Bakker (1996); France: Burda and Wyplosz (1997).

4.3 Impact on Domestic Financial Institutions

Almost by definition, financial repression looks bad. Is it not the case that it hampers both saving and borrowing, that it thwarts competition in financial markets with associated efficiency costs, possibly even breeding corruption and misuse of financial resources? The conventional answer (see e.g. Eichengreen, Tobin and Wyplosz, 1995; Furman and Stiglitz, 1998) is that financial markets are far from perfect. In the presence of information asymmetries, which leads to instability and occasional, catastrophic crises, second-best theory warns that first principles can be seriously misleading. This is not a proof that external financial restrictions are harmless, simply a reminder that their costs and benefits must be balanced before drawing policy prescriptions.[10] This section looks at the costs.

Beck *et al.* (1999) have developed a set of criteria of performance of financial systems. There is no clear indication that European financial systems have been seriously inefficient, at least as far as bank overhead costs and interest margins are concerned. However, the detailed analysis in Wyplosz (1999) suggests that this favourable assessment conceals rent extraction by governments: banks have long benefited from an implicit state subsidy through protection from internal (e.g. interest rates were

10 Until quite recently, there has been little research into the costs and benefits of capital controls. For recent papers, see Arteta et al. (2001), Edwards (2000), Grilli and Milesi-Ferretti (1995), Kraay (1998), Quinn (1997), Rodrik (1998) and Wyplosz (2001a).

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regulated) and external competition in exchange for deficit financing at attractive conditions. This is a clear case of crowding out of the private sector by the public sector.

The main conclusions that emerge from the overview of financial repression in Europe in Wyplosz (1999) are as follows. First, domestic financial repression affected financial intermediation, crowding out the private sector to the benefit of public sector financing. Domestic and external financial repression jointly allowed a segmentation of the domestic financial markets from world markets, delivering at times lower than market-clearing onshore interest rates. And more than a decade after full internal and external liberalisation, Europe's banking and financial markets are still undersized relatively to the US. Financial repression has long-lasting effects. Thus, the adverse effects have been far from trivial, and are lingering more than a decade after full liberalisation. But how harmful have they been to growth? This is the issue taken up in the next section.

5 Overall Assessment: How Bad Was It Really?

The macroeconomic development literature (see e.g. McKinnon, 1979), eventually enshrined as the 'Washington consensus', argues that financial repression hurts economic growth. This view is largely informed by the experience of developing countries, for example Latin America over 1950-1970. A possible problem with the conventional wisdom is that it is based on the experience of countries which simultaneously resorted to a wide array of extensive controls, often alongside serious political instability and many other potential impediments to growth, of which financial repression was just one component. In Europe instead, a quick look reveals that its best economic growth performance was achieved in the postwar period, fastest in the 1960s at the heyday of financial repression while goods markets and trade were being liberalised.[11]

Section 3 argues that financial repression was, partly at least, driven by the trade-related concern with real exchange rate stability. Section 4 documents the effects of repression on financial markets. An assessment of Europe's strategy then requires tracking the impact of trade integration and financial repression on the growth performance. It could be that trade integration buoyed growth while financial repression slowed it down, with an overall favourable impact. It could also be that fast growth was simply a catch-up process after the damages of the war, too powerful to be blocked

11 South-East Asia too offers another counter-example to the conventional wisdom, see Rodrik (1998).

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by financial repression. In that view, growth would have been even faster had financial markets be liberalised earlier.

Since Europe stands out among the developed countries for its commitment to exchange rate stability, but otherwise differs little, it is natural to compare its performance with that of the other OECD countries. This is done using the now standard approach developed by Barro and Sala-i-Martin (1992).[12] The approach accounts for catch-up by including the beginning-of-period GDP per capita. It then adds a variety of variables which, theory predicts and previous empirical investigations often confirm, affect growth performance: a measure of education (to proxy for investment in human capital), demography, health, trade openness, saving behaviour and infrastructure factors. The approach uses panel data for two reasons: it looks for general sources of growth, shunning national idiosyncrasies; and in order to eliminate shorter-run aspects, it uses low-frequency data which severely limit the number of observations per country hence the need to increase the sample size, which is achieved by pooling as many countries as possible.

As the aim is to study Europe's experience relatively to other similar developed countries, the sample includes the 14 OECD countries for which adequate data is available: Australia, Belgium, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Spain, Switzerland, United Kingdom, United States. The sample period is 1960-95 and, as is customary, cyclical effects are eliminated by using low-frequency, five-year, observations.

Given the similarity of OECD countries, several of the variables found significant in the empirical growth literature which includes both developed and developing countries, play no role here and are left out. On the other hand, the specificity of Europe and the issues at hand suggest adding two institutional aspects: the weight of government – measured as its share of total employment – and the independence of monetary authorities – approximated by the inflation rate.[13] The focus, however, is set on the role of financial repression. Internal and external repression is captured by two dummy variables developed in Wyplosz (1999) and extended here for the non-European OECD countries. A dummy measuring the exchange rate regime is also included.

The results are displayed in Table 2. Neither the fixed effects nor the time dummies (when used) are reported. The first four columns present

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12 For related work on samples including developing countries, see Rodrik (1998), Edwards (2000), and Arteta, Eichengreen and Wyplosz (2001b).

13 There is much evidence linking inflation and central bank independence, see e.g. Cukierman and Lippi (1999). For an opposite view, see Posen (1993).

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different estimations of the same model with country-specific fixed effects, depending on whether subperiod-specific intercepts are allowed or not, with and without cross-section weights (GLS estimation). The last two columns include additional variables as explained below. The estimates appear to be very robust to the choice of estimating procedure and generally in line with the literature. The credit constraint dummy is everywhere highly significant and precisely estimated to *raise* average annual growth by 1%. The capital controls dummy is also found to have a positive effect on growth but it is only significant at the 10% confidence level in columns (1) and (2), and not significant in columns (3) and (4). Operating a fixed exchange rate regime appears to reduce growth, but this effect is not systematically significant in column (3).

Although the catch-up effect is captured by the beginning-of-period level of GDP per capita, it can be argued that Europe's distinctive experience may be driven by the additional need to make up for World War II destruction, spuriously captured by the financial repression dummy variables. In order to check this possibility, two additional variables have been added: column (5) includes the gap in per capita GDP vis-à-vis the USA, and column (6) further adds the drop in GDP between 1938 and the trough year between 1940 and 1947.[14] The results remain largely unchanged, certainly for the variables of interest, while the additional variables are never significant at the 5% confidence level.

Thus, in contrast with conventional wisdom, internal financial repression – captured by the presence of credit constraints – is found to have a *positive* effect on growth, adding on average one percentage point to the annual performance (measured by growth in per capita GDP). The effect of capital controls is not well established, possibly not significant, but certainly not adverse. The adoption of a fixed exchange rate regime has a small, negative but hardly significant impact on growth. Importantly, trade openness raises growth: a 10% increase in the ratio of the average of exports and imports to GDP is found to raise annual economic growth by 0.2%. It may be that the survival of a fixed exchange rate regime requires financial repression, so we need to look at the overall package, financial repression *plus* fixed rate regime. The effect of such a package on growth is found to be positive. According to the estimates in column (4), the combination of a fixed exchange rate, credit ceilings and capital controls adds annually 0.9 percentage points to growth, without even taking account of the favourable effect of increased trade integration. This is a large number.

It is unclear what precisely lies behind these results. They certainly

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14 When there was no decline in GDP per capita over 1938-1947, the end-of-war year is conventionally set in 1945.

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Table 2 Financial Repression and Growth Performance

Dependent variable: average annual growth rate of GDP per capita

	OLS No time dummies (1)	GLS No time dummies (2)	OLS With time dummies (3)	GLS With time dummies (4)	GLS With time dummies (5)	GLS With time dummies (6)
GDP per capita	-0.050 **	-0.054 **	-0.043 **	-0.048 **	-0.139 *	-0.062
Beginning of sub-period	-4.172	-4.511	-3.372	-4.375	-2.539	-1.980
Capital controls	0.007	0.004	0.002	0.003	0.006 **	0.001
	1.760	1.839	0.699	1.532	4.708	0.304
Credit constraints	0.010 **	0.010 **	0.011 **	0.010 **	0.010 **	0.008 **
	2.977	3.409	4.280	5.175	6.369	2.964
Fixed rate regime	-0.007 *	-0.008 **	-0.006	-0.004 *	-0.004	-0.003
	-2.135	-3.593	-1.764	-2.375	-1.615	-1.235
Inflation	-0.207 **	-0.198 **	-0.179 **	-0.186 **	-0.187 **	-0.122 *
	-5.150	-7.585	-4.045	-5.588	-8.017	-2.377
Openness	0.021 *	0.019 *	0.025 **	0.023 **	0.021 **	-0.006
	2.067	2.343	2.713	3.943	3.545	-1.942
Size of government	-0.014	-0.009	-0.016	-0.018 **	-0.028 **	-0.009 *
	-1.038	-0.980	-1.589	-2.962	-5.256	-2.440
Higher education	0.004	0.003	0.001	0.002	0.009	0.008 **
	0.441	0.419	0.115	0.528	3.140	3.003
Fertility	-0.012	-0.014 *	-0.014	-0.009	-0.004	-0.002
	-1.419	-2.463	-1.080	-0.990	-0.372	-0.135
Saving ratio	-0.001	-0.004 *	-0.002	-0.007 **	-0.008 **	-0.001
	-0.259	-0.899	-0.564	-2.704	-3.339	-0.233
GDP/capita gap					0.251	0.052
(relative to US)					1.938	0.721
World War II						-0.003
						-0.747
Adjusted R^2	0.716	0.825	0.822	0.959	0.941	0.962
S.E.R.	0.009	0.009	0.007	0.007	0.006	0.009
N. observations	83 m	83	83	83	83	83

Sources: GDP, openness (exports plus imports of goods and services as a share of GDP), size of governments (ratio of public employment to total employment) and saving ratio: OECD *Economic Outlook*, December 1999; Capital controls and credit restraints: Wyplosz (1999); fertility and higher education: Barro-Lee data base from World Bank web site; inflation: IFS; World War II drop in GPD per capita from Appendix C in Angus Maddison, *Monitoring the World Economy, 1820-1992*, OECD Development Centre, Paris, 1995.

Notes: t-statisitics in second line, **(*) significant at the 1% (5%) confidence level; White heteroskedastic-consistent standard errors. Fixed effects allowed.
Estimation period: 1960-1995 with 7 five-year sub-periods. Not reported:country-specific (fixed effects) and period dummies. All variables in logs.
Unbalanced panel of 14 OECD countries: Australia, Belgium, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Spain, Switzerland, United Kingdom, United States.

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challenge conventional wisdom, but not accepted general economic principles. We know from second-best theory that there is no presumption that financial repression has negative effects in the presence of financial market imperfections, for example credit rationing or connected lending. More generally, other non-market distortions which often coexist with financial repression, may have strong adverse effects and contribute to the conventional wisdom. Europe indeed has long been characterised by widespread government intervention in the good and labour markets.[15] But the formal evidence presented here certainly does not support the view that financial repression *in and by itself* has hurt growth in postwar Europe.

6 Lessons From Europe

6.1 One Step at a Time

The main conclusion is that, in continental Europe, exchange rate stability has been considered as the lynchpin of efforts to achieve trade integration. Capital mobility has long been seen as of secondary importance and, when it rose to the top of the agenda, monetary policy independence was given up relatively easily. True, much independence had been given away to sustain the EMS. The only country that had retained monetary policy independence was Germany, due to its gradual emergence as the centre of the EMS. Why did Germany accept to give up the DM? This is a crucial question to draw lessons from Europe.

One view is that that the whole strategy was only possible because it was carried out with much wider objectives than just a common market. In that view, the required political will was steadied by an ambitious vision which included, from the start, a monetary union and eventually a federal union. This view is both correct and misleading. It is true that the underlying logic has been political reconciliation after centuries of wars. On the other side, there has never been any detailed master plan, nor any set deadline. For example, a German proposal has recently brought back to life the goal of a 'United States of Europe'. But opposition to this proposal runs equally deep, with profound national divergences and national public opinions equally divided. and indication that there is no master plan, and there never was any. A telling example is the monetary union. In 1971, the Werner Plan was deemed wholly unrealistic, and it was immediately scuttled. As late as 1988, when the idea of a monetary union resurfaced, it

15 Studying the French postwar experience, Sicsic and Wyplosz (1996) conclude that public subsidies and directed lending have had a sizeable negative impact on growth.

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was widely met with the same scepticism. It took an exceptional event, the collapse of the Berlin Wall, to trigger a deep reassessment that no political leader would have predicted just a few weeks before.[16] Even the celebrated countdown to monetary union, with a terminal date set in concrete, was only accepted at the last minute in Maastricht.

The more sober view is that Europe's integration has always been characterised by a process of muddling-through, two steps forward and one step backward, with deep and lingering divergences as to what the end objective is. But each integration step makes the next one more likely. The desirability of adopting a monetary union was being discussed, and staunchly opposed by Germany and a few others, before the Berlin wall fell. It was available on the shelf, and could be pulled out to form the basis of a historical political deal whereby Germany would give up its currency in return for support for its unification. Thus, integration can be seen as a dynamic process, but one that is not predetermined, at least in the policy-makers' eyes. It makes bold, unplanned moves possible when the occasion arises unexpectedly. Time is not of the essence, opportunities are.

Thus, Europe's lesson No. 1 is that what matters is a political will to seek closer economic and financial integration, but not tied to any precisely defined plan and schedule. Lesson No. 2 is that opportunities must be quickly seized when they arise.

6.2 Centre Country

The role of Germany is often seen as crucial in the adoption of a single currency. The message would be that regional integration needs at the centre of the process a champion, a leading country that provides the political and economic impetus. Here again, some caution is needed. There is no doubt that it was crucially important that Germany was both the largest economy and home to the anchor currency within the EMS. The anchor currency probably has to belong to a large country, but luck had it that the Bundesbank had many features of what has become the hallmark of modern central banks that could be used as a blueprint: a clear price stability objective and a monetary policy committee (the Direktorium) which was designed for a federal state.[17]

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16 Gros and Thygesen (1998) argue that one does not need to invoke a political deal to explain Germany's acceptance of EMU. Once the other countries had recognised the pre-eminence of price stability and central bank independence, they claim, Germany was willing to give up the DM. From an economic viewpoint, this makes sense, but the political costs were considerable and required a 'sweetener'.

17 Should the NAFTA countries consider a monetary union, the Fed model would be less ready-made for the task of building up a common central bank.

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Equally important was Germany's post-war approach to foreign policy. Its acceptance of a subdued role – the self-imposed price to pay for Nazism – largely removed suspicion that it wanted to exert leadership. Its professed desire to develop its influence only within the context of a united Europe has been, and will remain, crucial. The EMS would never have been created had it been built as an asymmetric arrangement based on the DM. It took several years before the DM organically emerged as the system's centre, and it did so because the other large countries had failed to develop responsible monetary policies, and were keenly aware that they had only themselves to blame for their demotion. In retrospect, it could be seen as clever strategy on the part of Germany but this would be, again, a revisionist view. Much of this evolution was unplanned and, most likely, unforeseen,

Lesson No. 3 is that, more than a leading country, deep integration requires confidence-building steps. This is a slow process.

6.3 Institutions

Another feature of Europe's integration is the early buildup of institutions. The European Commission was set up in 1958 by the Treaty of Rome when the Common Market was launched. Its powers and ambitions were initially quite limited. It has become the advocate of integration, binding together two opposite forces. On one hand, it embodies the collective interest and the gains from cooperation. On the other hand, it derives its powers from governments which represent national interests. This explains its often arcane decision process and many of its shortcomings. The Commission's inherent internal contradiction is not often appreciated: its role is to manage those elements of national sovereignty which have been given up by its member states while it needs approval from the member states which are instinctively loath of relinquishing politically sensitive decision powers. The fact that the Commission exists, and has seen the range of its responsibilities grow considerably since it was created, cannot be overestimated. Not only does the Commission act as the lobby for integration, it also undertakes the background work needed to study further steps. When the time is ripe, the project is readily available in the Commission's drawers.

Besides the Commission, Europe has built up a vast array of institutions, as it has gradually expanded the scope for cooperation beyond economics. Each step usually illustrates the same uneasy compromise between integrationist and nationalistic forces. A good example is the European Parliament. It has few powers, its most illustrious being the right to throw out the Commissioners. Its most recent formal task is to supervise the

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European Central Bank (ECB), even though supervision is limited to expressing its opinion. And, of course, the European System of Central Banks (ESCB) is a new institution which has been granted the authority of all member central banks. Note, however, that the ECB itself, the n+1th central bank, is under control of the ESCB which include the n other central banks.

Institution building lies at the heart of Europe's success at integration. Each institution cements the willingness of member states to devolve some of their powers. Each institution provides a forum where national differences must be reconciled. Eager to deepen integration, these institutions are often coming forward with new suggestions and, when they politely clash with member governments, the important points of disagreement are plainly visible to public opinion.

Lesson No. 4, therefore, is that integration is made considerably easier when backed by regional institutions. Europe's success is largely due to the early creation of a number of institutions, how imperfect they may be.

6.4 Exchange and Capital Flow Regimes

Europe's experience runs against the view that financial markets ought to be promptly liberalised and if that means giving up the exchange peg, so be it. The strategy adopted in Europe puts trade integration and exchange rate stability at centre stage and if that means delaying financial liberalisation, so be it. There is no evidence that Europe's strategy has had an adverse effect on its growth performance. Quite to the contrary, capital flow liberalisation has a tendency to be destabilising in the wake of rapid liberalisation, as Argentina, Chile, Mexico, Korea, Malaysia and many other emerging market countries have discovered much to their grief.[18] On the other hand, there is neither strong argument nor empirical evidence that trade integration may be welfare-reducing.

The choice of an exchange rate regime ought to be considered as part of a package that may include, if needed, some degree of financial repression. Indeed pegged exchange rate regimes are inherently unstable in a world where financial shocks eventually challenge the hardest commitment of the monetary authorities. Given enough time, pegged exchange rate regimes ultimately collapse. Financial repression is a useful backup to reduce the incidence of financial shocks and make fixed exchange rate regimes more manageable and longer lasting.

It is interesting to note the evolution of capital controls. They were initially designed to back domestic financial repression with mercantilistic

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18 For an overview, see Calvo, Leiderman Reinhart (1996). See also Wyplosz (2001a).

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undertones. The controls owe much of their bad reputation to this original sin. When domestic restrictions were lifted, external restrictions were gradually made more market-friendly, relying less on administrative interdictions. The motivation also shifted towards slowing down speculative capital to support the fixed exchange rate regimes.

Lesson No. 5 is that full capital mobility is not sacrosanct. It provides support for a strategy of regional integration that starts with trade opening and exchange rate stability, leaving capital mobility as distant goal.

7 Conclusion: What Does It Mean for Other Regions?

This section briefly sketches implications of Europe's experience for current debates on regional integration. It is important to recognise at the outset that Europe's way is not the only possible one. Nor is there any presumption that regional integration is always and everywhere desirable. The view taken here is that, *if* regional integration is deemed desirable, Europe's experience offers some useful lessons.

7.1 Central and Eastern Europe

The countries of Central and Eastern Europe are unique in many ways. They emerged a decade ago from 50 years of central planning and their natural fate is to join the European institutions. Regional integration within a greater Europe is at the forefront of their strategy, with strong popular support. The main surprise is that, even though at the outset of the transition process they shared the same recent history and the same ambitions regarding European Union membership, the countries of Central and Eastern Europe have rejected the narrower regional approach. They could have first sought to achieve economic integration among themselves and then collectively access to the European Union.[19] Their refusal to adopt such a strategy partly reflects older historical misgivings. It is also based on the suspicion that the strategy could have delayed accession. Given how slowly the accession negotiations have proceeded, they may have been right.

Lesson No. 3, the need for a benevolent leader, is essentially moot. The ready existence of a centre, and a relatively clearly defined accession path removes many of the stumbling blocks. Political will, which is Europe's lesson No. 1, exists in Central and Eastern Europe, but not to the same

19 In-depth discussions of sub-regional integration efforts in Central and Eastern Europe, see Teunissen (1997, 1998).

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extent within the European Union. The centre's wavering, explained by a conjunction of special interests, is sapping support for accession in the candidate countries. This is where the role of institutions (lesson No. 4) is crucial. A process has been formally launched, and it is masterminded by the Commission, which sees to it that it does not stall, despite many a government's desire to avoid confronting national interests which, rightly or wrongly, feel threatened.

On the other side, the ready-made nature of the accession process does not make things unambiguously easier. In fact, the Union's long history creates serious difficulties. The Copenhagen Council has adopted the principle that the *acquis communautaire* – eurospeak for the rules adopted over fifty years – must be taken on board by the newcomers. One clear case where this is problematic concerns the exchange regime. The Maastricht convergence criteria are considered a part of the *acquis*. This implies that EMU membership cannot occur until two years after the new member countries have joined the ERM in its second reincarnation, which itself must await until they have accessed the Union. Yet, the situation of Central and Eastern European countries differ considerably from the one that prevailed in western Europe in the early 1990s. For example, by 2004 Estonia will have operated for a decade a currency board – vis-à-vis the DM first, and the euro next. It makes little sense for that country to first dismantle its sturdy currency board, then adopt the fragile ERM2, and finally ditch its currency.

More generally, Lesson No. 5 is studiously ignored. Full capital mobility is an *acquis*. Combined with ERM2, the result is a potentially explosive mix, more so than ERM1 that was itself unable to withstand the pressure of capital liberalisation. To start with, in contrast with ERM1, ERM2 does not provide for the collective support of the pegs. Thus the Central and Eastern European countries will be alone when facing speculative pressure. Next, accession is likely to trigger large capital inflows. As has been the experience in many parts of the world, capital flows have a tendency to revert themselves for a variety of reasons, some of which are not understood. The likely financial instability, coupled with the application of *acquis* designed in other times for other countries, is a recipe for trouble.

7.2 *East Asia*

Interest in regional exchange rate arrangements has grown in East Asia following the crises of 1997-98. The countries of the region have discovered, through the contagion process, that their fates are linked in the eyes of international financial markets. They naturally think of ways of responding collectively to the previously unexpected challenge. Talks of a monetary

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union are taken seriously. The Chiang Mai Initiative can be seen as an attempt to build a collective defense against speculative attacks. How far can they go in this direction? The lessons from Europe send a sceptical message.

Lesson No. 1 emphasises political will, Lesson No. 3 calls for confidence-building steps. East Asia does not seem ready on either dimension. The region is clearly not at peace with itself. One of the two regional giants, Japan, remains seen with deep suspicion. The other giant, China, operates with a different political regime and is not really a market economy. While the latter may change as China becomes part of the WTO, the fact that national animosities remain virulent more than 50 years after World War II suggests that the appetite for deep integration is not there and that no country, or group of countries, is in a position to exercise leadership. Indeed, in spite of a higher degree of trade integration than within the European Common Market, the countries of the region have not been able to build any collective trade agreement. Numerous attempts have resulted in a myriad of bilateral agreements, but the big picture remains as elusive as ever.[20]

Europe's own sequencing is not necessarily the only possible. Having achieved *de facto* a high degree of trade integration, the Asian countries could proceed first with a collective exchange rate arrangement, possibly even a monetary union. Indeed, Lesson No. 2 says that every opportunity must be seized. The 1997-98 crisis has created a sense of commonality in the area of financial instability, and this realisation should not be discarded because it does not fit the standard approach to economic integration. Chiang Mai can thus be seen as a promising first, confidence-building step. But, in line with trade agreements, Chiang Mai only aims at bilateral arrangements. It clearly violates Lesson No. 4, which puts in centre stage the buildup of collective institutions.

Talks of an Asian Monetary Fund (AMF) were more promising in this respect. The abandonment of the project illustrates another reason for scepticism. The AMF idea clearly displeased the IMF and the US, and they had enough muscle to kill it. The project was not well thought through – another illustration of the crucial usefulness of institutions that can nurture blueprints and keep them ready for when the time is ripe – and probably ill introduced. Yet, Europe had agreed long ago to a European Monetary Cooperation Fund, and the ERM agreements provided for mutual financial assistance that clearly competed with the IMF's, and no one seriously objected. One could envision an AMF issuing guidelines and

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20 For a detailed presentation of past attempts, current arrangements and the current state of play, see Scollay and Gilbert (2001).

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exercising surveillance, providing resources and preparing the ground for more ambitious steps. The Asian countries have shown a lack of political will to stand up to external influence. Regionalism has taken the back seat.

This sensitivity to outside interests is also visible in several plans to limit exchange variability now that most of the (official or unofficial) dollar pegs have been abandoned. Talks often centre of establishing basket pegs, with baskets including the US dollar, the euro, and the yen. The use of baskets is meant to reduce the dependence on the dollar. Given the depth of regional trade integration, intra-regional currencies stability is desirable, a feature well in line with Europe's experience. This would logically call for a collective arrangement similar to the EMS, rather than the very roundabout attempt *via* basket pegs. Strangely enough, such an idea is not explored.

Lesson No. 5 seems today the hardest to apply. Capital liberalisation has happened in most countries and back-tracking is seen, especially in Washington, as a backward move. Yet, the use of pegs (multilateral or external baskets) calls for some restrictions on capital mobility.

The obvious solution, then, would be to aim directly at a monetary union. There are good reasons to think that the idea is premature. To start with, giving up monetary policy sovereignty is politically complicated, as Europe has found out. In the current mood, Asia seems far from being ready for such a radical step. In addition, from an economic viewpoint, real convergence is an important pre-requisite. Unless the Asian Monetary Union starts with a small number of countries which are at a similar stage of development, the construction could prove to be unsustainable.

7.3 Latin America

Much as in Asia, the Tequila contagion has brought home the perception of a commonality of interests throughout the continent. But the first reaction, Argentine's short-lived bid to dollarise, has been to seek individual protection in the North. The FTAA project further reinforces the impression that Latin America is not ready for a major collective step. Yet, in many ways, Latin America is more advanced towards regionalism than Asia. Regional trade agreements are in place, for example, and the idea of a common political house dates back to the 19th century. Yet, Europe's lessons suggest that little progress is likely to be achieved without deep rethinking.

Lesson No. 1 certainly applies. Argentine and Brazil are the two major players, and it is hard to envision any regional agreement which is not driven by these two countries. Yet their rivalry is crippling. Mercosur could be seen as a confidence-building step, in line with Lesson No. 3, which further suggests that trade is a good way to start. But Mercosur lacks

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the proper institutional backup, as required by Lesson No. 4, and the experience so far does not suggest that trust has been established. The rules of the game are not strictly adhered to. *Faits accomplis* abound and the active use of the exchange rate to achieve trade advantage sap the construction. Unsurprisingly, regional trade is not very deep, even though much progress has been achieved over the last decade. Unless Mercosur establishes an institution with features of the European Commission, including powers to nurture rules of the games and then enforce compliance, it will remain as much a source of conflict as an integrationist step.

Lesson No. 2 is that regional integration progresses when opportunities are promptly seized. The reaction to the Tequila effect is a good example of a missed opportunity. The current focus on the FTAA initiative also acts as a diversion from regional integrating efforts unless, of course, one is ready to consider the whole of America as a region. But that is not what history and trade patterns suggest. Sceptics already predict that the FTAA initiative will fail. A serious crisis in Argentina, which would spill over to much of the region, is seen as very likely. For regional integration, such events could provide the required trigger for new regional initiatives. But such initiatives cannot be invented on the spot, they require serious advance work, which in turn necessitates an institutional backup. It is not clear that any existing institution has the corresponding mandate.

Finally, Lesson No. 5 – capital movement liberalisation ought to come last – seems to be, as in East Asia, beyond the point. Most of the continent has now fully liberalised its capital flows. Barely a year ago, the view that Latin America has become an area of financial stability, complete with sound banks and lively stock markets, was popular in Washington. A more sober appraisal is that financial stability remains as elusive as ever in the region. The case of Argentine seems to remind us that extreme monetary discipline, meant to ban forever the shadow of financial instability, is delivering deflation and depression, not stability. Of course, fiscal discipline is also needed, but just how much all-around discipline can real-life politicians deliver? Backtracking on capital liberalisation may be less foolish than it currently seems.

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Comment on "Regional Exchange Rate Arrangements: Some Lessons from Europe," by Charles Wyplosz

Bill White

Growth in the global economy, and especially the United States, has recently been decelerating sharply. In this light, it is somewhat amusing to hear many previous advocates of New Era economics now say "Well, we always knew that the stock market was overvalued ..., we always knew that investment cycles were still possible ..." I think this kind of historical revisionism is too easy. We should rather be asking ourselves how we came to believe certain things at certain times, and what factors caused us to revise our views when we did.

Regarding Charles' paper, I like his overview of what went on in continental Europe, particularly in the post-war period until the mid-1990s. It has some very intriguing results, not least of which is that financial repression was good for Europe, as indicated by his statistical estimates. While I am more than a little suspicious about this, as I will argue later, I do agree with the associated proposition that governments should be very careful about how they go about financial liberalisation. Sequencing, particularly in so far as it affects external capital flows, can be very important. Moreover, the period of transition seems inherently to be a dangerous one. This applies even in cases where the target state of affairs is judged to be totally desirable.

My principal criticism of this paper, and perhaps I am actually inviting Charles to write another paper, reflects the fact that this is a conference on the role of regional financial arrangements in crisis prevention and management. Unfortunately, what I did not see in the paper was exactly how the analysis it contains actually relates to this topic. A related criticism about focus is that the second part of the paper, in which the lessons are drawn, seems to me to have very little to do with the first part, in which a rather straightforward historical description of European economic developments is presented.

Focusing then on the lessons themselves, Charles seems to be saying that continental Europeans have always valued fixed exchange rate systems. This is because the benefits have been thought to exceed the costs, even when these costs include a significant degree of financial repression to

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make the fixed rate systems functional. In effect, recognising the reality of the "impossible trinity", Europeans have opted for financial controls to square the circle.

The benefits of fixed exchange rates, as argued in the paper, seem to be of two sorts. First, they encourage trade, competition and growth. Second, the fixing of exchange rates can lead on to a single currency, which may be both economically and politically desirable. What about the costs of financial repression? Basically, the paper says that the costs are not large. Indeed, repression may even be good for you in its own right. While Charles does not say this explicitly, he seems to suggest that other regions might want to go down the European path. That is, they might wish to institute regional fixed exchange rate systems and then gradually evolve the institutions needed to foster the movement to a single currency. If this is the basic lesson for other regions to be drawn from this paper, based on European experience, I would argue that it may not be generally valid. Let me explain why. In effect, I question in turn the analysis of each of the benefits and costs just described.

I do not dispute the fact that continental Europeans have traditionally preferred fixed exchange systems. Where I do disagree with Charles is his suggestion that the principal reason for this was the belief (and I will return to this) that fixed exchange rates encourage trade and growth. Other reasons suggested by Charles for this preference could also be plausible. A first possibility is that fixed rate systems were chosen to foster stability given that financial markets were shallow. This could be historically true, but there is a logical problem with this argument. If Europeans consciously kept financial markets shallow in order to fix the exchange rate, there must have been some other more fundamental motivation than the absence of well-developed financial markets.

However, there remains a second and more plausible reason for this preference. It is that Europeans preferred fixed exchange rates in order to encourage discipline and price stability. With Germany as the European anchor, this view seems very much in accordance with conventional wisdom. Charles, however, disagrees with this conclusion on the following grounds. He argues that, if Europeans were after discipline via fixed exchange rates, they ought to have had lower inflation rates than other countries. I think this logic is incorrect. Fixing an exchange rate amongst themselves in no way provides an inflation anchor relative to some other group of countries. And, in any event, fixed exchange rates only give the participating countries similar rates of inflation over the long run. Nigel Lawson, it will be recalled, tried at the end of the 1980s to peg the pound to the Deutsche Mark. His experience was that, before you get to price convergence, it can be a very long run indeed.

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In spite of all these counterarguments, Charles continues to conclude that the real motive behind the decision of Europeans to fix the exchange rate was to promote trade. But this is where I have another problem. As even Charles himself says in the paper, there is absolutely no empirical evidence that fixed exchange rates encourage trade. I invite you to take a look at the broadest set of data. What happened after the collapse of Bretton Woods? The answer is that trade exploded when currencies started to float. And what has happened in recent years since many smaller countries have chosen to float their currencies? Again, the growth of trade volumes has been dramatic.

I also found unconvincing Charles' discussion of why the literature on this topic might be wrong. In the very short run, exchange rate volatility might make cross-border trade less attractive. However, this risk can be easily hedged in modern markets. In the medium term, exchange rate misalignments could conceivably hollow out the trading sector of the country with the overvalued currency. However, this effect would be only temporary and would be matched by the stimulus to trade given to others.

So to sum up, I simply do not believe that fixed exchange rates are needed to promote trade and growth. Nor do I accept that this belief, in fact, provided the principal motivation behind the revealed preference of continental Europeans for fixed exchange rate systems.

The second postulated benefit of fixed exchange rate systems, as argued in Charles' paper, is that they may lead on to a single currency. The question of course is whether such a single currency would be economically and politically desirable for regions other than Europe. As for economic desirability, one has to go back to the literature on optimum currency areas. In this context it is not so obvious that there are many such regions already out there, with the possible exception of those Gulf States already pegged to the dollar. As for the political desirability of a single currency, the impetus provided to the concept by the two world wars in Europe can hardly be underestimated. In contrast, were Canadians and Mexicans to be told that accepting a single currency with the United States would lead to political unity, I doubt there would be great popular enthusiasm.

Finally, let me turn to the costs of the financial repression which might be needed to make a fixed exchange system work properly. Charles recognises that internal financial repression does have costs in that it leads to a lower quality of financial services and inefficient resource allocation. In particular, such a system often leads to a wasteful government getting enhanced access to national savings. However, he argues (and I agree) that liberalised domestic financial systems also have costs associated with the booms and busts caused by alternating waves of optimism and pessimism in a credit-based economy. But the former set of costs seems to me, although

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perhaps not to Charles, to dominate the latter. If so, this makes internal repression broadly undesirable and explains why the vast majority of countries in the world are now moving towards financial liberalisation. As for financial repression with respect to the external accounts, I would again argue that there are significant costs, even if liberalisation also holds certain dangers. These latter concerns have been attested to by a number of recent crises in emerging market economies, which has led countries to be more careful about how and how quickly they go about removing capital controls. It has not, however, led to any kind of a significant move in the direction of reimposing controls.

What is the bottom line for me? Fixed rate systems in themselves need not enhance trade or growth, although in some cases they might do so. Nor do they necessarily lead on to the development of a single currency. And even if they did have this tendency, it is not clear that a single currency would be desirable on either economic or political grounds. As for the costs of financial repression, I believe they could be significant. For all these reasons, I conclude that the positive aspects of the post-war experience with fixed exchange rate systems in continental Europe may not be easily replicated elsewhere.

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Comment on "Regional Exchange Rate Arrangements: Some Lessons from Europe," by Charles Wyplosz

Zdeněk Drábek

The paper by Charles Wyplosz covers what is perhaps one of the most fascinating political and economic processes in Europe in modern times – the economic integration of European countries. From the integration of coal markets to the adoption of common currency – the euro – the West European countries have continuously defied the critics when they pushed for more and more markets to be integrated and for more and more countries to join in. This process of widening and deepening the integration process has been quite unique in the world.[1] The European Union has, therefore, a considerable experience in making its own regional arrangements work. Undoubtedly, the EU has also a great deal of experience to share with other countries attempting to create something similar, albeit perhaps less ambitious.[2]

I have been, therefore, very pleased to find in the paper a brief history of different monetary arrangements. Such a review is important especially when it comes to discussions of monetary issues. It is quite easy to forget what has happened in the past, and for this reason it is useful to remind ourselves that the process was slow and piecemeal, that it was not always smooth and that it required a considerable degree of coordination and foresight, and that it also required the fulfilment of certain conditions. The brief review of the exchange rate arrangements is particularly instructive in stressing the argument about the important role of the financial sector and reminding the reader of the long period during which financial markets were repressed. Similarly, and perhaps even more importantly, the paper reviews the speed and sequence of capital account convertibility in individual countries and shows how long it took the EU countries before they eliminated their restrictions on capital flows. Obviously, the central argument in promoting this course of policies was the emphasis on the stability of exchange rates.

With regard to Charles Wyplosz's review of European economic history

1 For more details see, for example, WTO (1995), chapter II.

2 There is a variety of lessons that a paper such the one of Charles Wyplosz could cover. For example, he could have looked at the effects of the EU on trade flows, investment, on trade policies or policy responses of third countries. See, for example, WTO (1995).

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I only have two minor criticisms. The first regards the alleged commitment of the EU authorities to fixed or stable exchange rates. While this statement may not sound controversial, it is not clear what is actually meant by the commitment to the stability of exchange rates. Do we really mean commitment to fixed exchange rates or do we mean commitment to a stable exchange rate fully recognising that stable exchange rates may involve some reasonable degree of flexibility and exchange rate movements? This issue is particularly relevant once we take into account the differences between nominal and real exchange rates, or on a more sophisticated level, when we talk about deviations of actual from equilibrium exchange rates. The paper does make a distinction between fixed exchange rates and the rates under the Bretton Woods system. Nevertheless, it seems to me that the author has primarily in mind the stability of exchange rates, an issue that is rather different from the more specific and narrow question of fixed exchange rates. This is a matter that can be easily sorted out.

My second minor criticism is that the author does not make a distinction between two types of financial restrictions. One type of financial restrictions involves domestic financial flows. Another type of restrictions are those that affect cross-border financial flows. It appears that the author is exclusively concerned about the latter – i.e. what he calls 'external convertibility' – and, in particular, about the speed with which the capital accounts in Europe have been opened. I am raising this because it is not evident from the paper to what extent the member countries used various monetary restrictions and regulations to channel resources into what they perceive to be their priority sectors. I am not an economic historian and have not studied the credit markets of the 1960s and 1970s, but I would be surprised to find in Europe in the 1970s highly regulated credit markets and interest rates. Nevertheless, some restrictions were undoubtedly in place with some credit regulation directing credit into priority uses. Moreover, the patterns must have differed from country to country. Some countries did more of these restrictions, others did less. In brief, it would be useful to make a clear distinction between the types of restrictions (internal/external) and to identify the main trends and differences among countries.

Let me now come to my main point. Charles' central idea is that the pattern of economic integration in Europe was entirely driven by the attempt to first integrate the goods markets and to promote trade. I very much agree with this statement.[3] I find it, therefore, also very plausible and

3 I am also painfully aware that the statement represents a gross simplification of what actually happened in the EU over time. There clearly was a continuous pressure within the EU for widening and deepening of the integration process, as I have already noted and as documented in WTO (1995).

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correct to argue that some notion of exchange rate stability was important for that process. In addition, I also find it quite plausible that this process was somehow linked to what Charles calls the "process of financial repression". Now, when we look at his econometrics, the empirical evidence seems to confirm these conclusions. But there is other empirical evidence that is provided in the paper but could be additionally used, and this comes from the historical experience of centrally planned economies. It seems to me that these countries provide by far the best case studies of repressed financial systems and the way in which these systems were used to suit the intent of government officials. These were countries in which financial markets were repressed *par excellence* and the system worked precisely to feed into some notion of growth and social priorities. One must obviously ask what kind of growth and social priorities, but the system worked, at least up to a certain point. Another example occurs to me from my experience of working in Asia, most notably in the Philippines and in countries such as Korea. The Philippines and Korea were always seen as two countries with rather different policies of financial liberalisation. The Philippines was a country that was pushing for financial liberalisation much faster than Korea, which had a long, and quite well history of financial restrictions and of directed credit.[4]

Charles argues that the integration process was built on two main pillars – exchange rate stability and financial repression. On the exchange rate stability, enough has already been said both in the paper and in my comments above, and I fully agree with the relevant comments of Bill White, my partner in this debate. Perhaps the only exception in this agreement is my preference for stable exchange which I offer here as a rhetorical footnote. I am convinced that a certain degree of exchange stability must have been extremely important even for the Asian countries that Bill has dismissed in his comments. After all, we know that the local currencies in South-East Asia have been linked to the US dollar for some 20-30 years and served them well. The conventional wisdom and prevailing argument of the time was that one reason why the countries have been growing so fast was precisely the fact that they had a clear notion of the advantages of stable exchange rates. Unfortunately, as we all now know, the policy eventually collapsed but hardly for reasons of stable exchange rates but for failing to recognise the divergent pattern of domestic inflation and productivity patterns vis-à-vis the rest of the world.

But the most interesting and unusual thrust of the paper is obviously the argument on financial repression. The critical notion for me, as it is

4 Wyplosz is fully aware of the peculiarities of the Korean policy which was well documented by, for example, Rodrik whose work on the subject he also quotes.

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for Bill White, is the question: what are the policy implications of his argument? One can look at this question from two different angles. First, what are the policy implications for countries with *open* financial regimes, the ones that have been already liberalised? Second, what are the policy implications for countries that are still managing various restrictions on the operations of their financial systems? I am personally finding it difficult to answer these questions, and would find it even more difficult to make a sensible recommendation to countries that have already liberalised. Such a recommendation would imply for the governments to reverse their policies, with serious implications for credibility of government policies and for the efficiency of financial markets.

Let me now raise two separate points that I would like to develop by asking the following questions. What are the merits of capital account liberalisation? Why would countries want to remove restrictions on capital account transactions? My responses are based on the experience of somebody who has worked in various countries in which governments have taken the liberal approach to transactions on the capital account for one key reason – these countries lacked domestic savings and needed to mobilise additional savings from abroad. It is quite well known that one argument for capital account liberalisation is the need to attract foreign capital, which obviously must be free not only to "come in but also to get out" when it is no longer profitable for it to stay in. How this is done is another matter. For example, countries could start with the liberalisation of long-term capital flows while retaining certain restrictions on short-term capital. In Europe and in the EU in particular, the low level of domestic savings was probably never a major issue, because European savings tend to be relatively high. The same holds for countries of East Asia, which also have high savings rates. This should be contrasted with developing countries such as those in Africa, some transition countries or countries in Latin America. This "savings argument" is clearly important for these countries.

Another important argument for capital account liberalisation is privatisation. This was clearly one of the driving motivations for the liberal attitude in the Czech Republic. Privatisation became a priority policy objective domestically, and as a result, it drove the argument on capital account liberalisation. How could the Czech government privatise if it had no access to foreign capital? After all, the only capital that was available at the time was either in the hands of the state or abroad. And how would the government attract foreign capital without allowing foreign investors to repatriate profits, dividends, and if they decided to liquidate their investment, their capital? On the other hand, arguments calling for capital account liberalisation on the grounds of balance of payments financing are

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far more dubious and less convincing. Countries in which capital accounts have been liberalised for BOP or fiscal deficit financing reasons – such as Mexico and Argentina – have tended to be exposed to great volatility of capital flows and vulnerability. I would, therefore, argue that the liberalisation of capital account driven primarily by the latter factors is very risky.

What these arguments suggest to me is the presence of linkages between the capital account and what government economic policy does domestically. In the above example of privatisation, for example, government officials should obviously be asking questions about the speed and the scope of the capital account liberalisation. If one is concerned about instability of the external account or fragility of external balances, one of the critical questions must also be how fast and how much does one want to privatise. Assuming that the government in question wants to privatise "a lot", it will have to assume that it may increase its exposure to instability of capital movements. In other words, it may overburden the system. Referring again to the Czech example, it is now easy to see in retrospect that that these questions were not asked, primarily because the privatisation was driven by fiscal considerations. To repeat, the point that I am making is that one of the lessons of capital account liberalisation must be that there are strong linkages between the elimination of restrictions on foreign currency transactions with domestic policies and objectives and that these linkages must be coordinated.

The final point with regard to regional financial arrangements which I would like to raise is the critical question about the relationship between foreign investments and the merits of regional financial arrangements. Is a free trade arrangement within a region enough to attract foreign investment, assuming that the RTA has as one of its objectives to attract foreign investment? The answer is probably 'yes, but up to a certain point only'. There are other policy issues that can play an important role. One of them is the question of exchange rates. There can be no doubt that a RTA with a fixed exchange rate regime or common currencies provide extra incentives for foreign investors, *ceteris paribus*. Another important issue concerns the operation of financial markets and in particular the role of public finance and their harmonisation. These issues are not discussed in Charles' paper. Given the limited objectives of his paper, this is not surprising but the issues are important. Take, for example, the case of financial harmonisation. Should it be a part of effective regional arrangements? Was financial and/or fiscal harmonisation important in the European experience? Without having the benefits of hard-core evidence, I would suggest that some degree of fiscal harmonisation is important. Otherwise, we would not be having as much debate about tax competition as we

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actually do. Thus, I would argue that some fiscal harmonisation is necessary especially because of the argument about tax competition. But I am aware that the evidence is not clear-cut. As Richard Baldwin and Paul Krugman argue in a recent paper, the case can be made for exactly the opposite to fiscal harmonisation.[5] They argue that harmonisation is not important. Still, I am convinced that it is an issue that should be addressed in the context of discussing regional arrangements.

Let me conclude with another rhetorical question, one that I trust could be of considerable interest to this audience and to anybody seeking the path of regional integration. Namely, what can regional arrangements do to help stabilise financial systems? Or, rather, what can they do to help reduce the countries' vulnerability against unstable capital flows? Do they possess the necessary instruments and pre-conditions to protect the member countries against capital surges and flights?[6] Again, that is a topic that was not discussed in Charles Wyplosz' paper. This is perhaps somewhat unfortunate. It seems to me that regional trading arrangements can operate in two different directions. They can be seen as instrument of economic policy to reduce these countries' vulnerability against unstable capital movements. For example, one can envisage a system of regional arrangements in which countries may cooperate in defending their currencies, and reducing their (excessive) levels of international reserves.[7] On the other hand, regional arrangements may also be origins of financial instability and of unstable capital movements given the fact that the member countries may be permitted to move along different inflation paths and pursue different monetary policies. Both of these differences are likely to affect the attractiveness of their capital markets and the attractiveness for foreign investments. But, as I have already noted, this a subject for another paper of Charles Wyplosz.

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5 For more details see Baldwin and Krugman (2000).

6 One could obviously ask other questions such as about the merits of regional arrangements as an instrument of trade liberalisation. But this would put us on a more familiar ground. See, for example, Panagariya (1999), pp. 477-511.

7 This could be particularly the case of countries in South-East Asia which have historically relied on building up their reserves.

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Comment on "Regional Exchange Rate Arrangements: Some Lessons from Europe," by Charles Wyplosz

Brian Kahn

The History of African Regional Integration

I will try to comment on Wyplosz' paper in the context of the African experience. I think the paper provides a very useful framework for looking at the African experience. His first lesson is that regional integration has an internal logic, that each step makes the next one more desirable. Unfortunately the opposite also applies to the African experience with integration – the experience has been one of numerous integration failures. I think the more failures you have the more suspicious countries become of getting involved in these regional integration initiatives.

Ironically, if we look at Africa, the most successful regional integration stories have been the ones that were imposed by colonialism. In those cases, the issue of reducing national sovereignty was not an issue, it was simply imposed. Whereas now national sovereignty comes to the fore and this becomes a problem. The one I am thinking of specifically is the French Franc Zone that has France as the agency of restraint. The future of that zone is now in question, given the new status of the French Franc. Other colonial legacies that worked successfully are the Southern African Custom Union (SACU) and the Common Monetary Area (which evolved from the Rand Monetary Area). Apart from these, most other African initiatives have been plagued by enormous numbers of problems. For example, the East African Economic Community (EAEC) collapsed in the early 1970s. In West Africa alone there are more than 30 regional integration treaties. According to the African Development Bank, "an overall assessment of Africa's experience with regional integration reveals…that regional integration and cooperation groupings have achieved limited success...(T)he consensus is that there has been no significant increase in intra-regional trade. While intra-regional trade remained stagnant, the continent also experienced marginalisation in international trade. Also evident is the failure of Africa's regional groupings to attract foreign direct investment."

An additional complication in Africa is that there have been numerous

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overlapping initiatives. For example the South African Customs Union (SACU) overlaps with the Common Market for Eastern and Southern Africa (COMESA) and the Southern African Development Community (SADC) and the recently signed Free Trade Protocol. These overlaps create their own problems. Then you have a number of different initiatives and a lot of them there are stronger on the rhetoric than on the actual implementation. So overall, within Southern Africa there is a very messy situation of regional integration.

At the continental level, we have the new African Union (AU) which is to replace the Organisation of African Unity (OAU). The Constitutive Act of the African Union has in some sense tried to go ahead of itself in terms of establishing institutions such as an African Monetary Fund, an African Central Bank and an African Investment Bank. In proposing an African Central Bank, the Constitutive Act has a view of a common monetary area for Africa, but there is no discussion on how this and the other institutions are going to work. Also it is interesting that in the Constitutive Act there is no view that the trade issues must come first. In the Act there is no provision for trade issues. So very broadly speaking, the history of African regional integration is very problematic. Although integration is seen as important, there is no clear view of how this should be achieved, nor is there any view as to the need for the sequencing of trade and monetary integration.

Political Will and Confidence Building

The second point, about the need for political will, is a critical one. Africa is a continent with its fair share of dictatorships. Even in some democratic countries, succession is provided for in the constitution. So if leaders are unwilling to give up sovereignty internally, it is hard to imagine these countries giving up sovereignty externally – which is part of the integration process. The experience of regional integration initiatives in sub-Saharan Africa provides ample evidence of political forces that have frustrated economic motives.

The political will to engage in regional integration also relates to the issue of stages of development. I think a lot of the regional integration attempts would require a change in labour mobility, particularly in areas of very high unemployment. This could create problems for countries that would attract labour but already have high unemployment, like South Africa.

With respect to confidence building, this also boils down to the centre country issue, specifically confidence in the centre country. Many of the debates in Southern Africa about regional integration, particularly

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monetary integration, focus on the 'problem' of South Africa being the dominant country. South Africa contributes 70 percent of total GDP of Southern Africa and is by far the most developed industrially. That does create a great deal of suspicion about South Africa's motives in the regional integration route. But you cannot get away from the fact that South Africa is dominant and it is difficult to think of a regional system not involving South Africa. In fact, there is no doubt that South Africa will have to take some leading role in any successful integration initiative, even though it is resistant to doing that. A further problem is that even though South Africa is the leading country, it is still a developing country.

Economic Convergence and Financial Integration

Another issue that Wyplosz raises in his paper is that one should start with trade and then move to financial integration. I think that is generally recognised in the Southern African region (although as mentioned above, not at the continental level). However, I find it difficult to think of no financial integration or no economic convergence at all when such diverse macroeconomic conditions prevail. In SADC for example, we have very divergent inflation rates, to the extent that some countries have single digit inflation while others are in triple digits. If there is no move towards regional financial integration, it is hard to see how intra-regional trade relations can actually be successfully developed. If you have highly divergent fiscal deficits, inflation rates, etc., it will make this first step of trade integration more difficult, particularly if inappropriate exchange rate policies are followed.

Finally, a comment on the issue of capital accounts and capital mobility: In Africa, generally, the move towards financial liberalisation has happened to some extent, but not to the same extent as in Europe. In South Africa, for example, we resisted a lot of pressure in the mid 1990s to liberalise very quickly. And I think the IMF agrees with us now that we got it right in that sense. However, there surely is a point at which financial repression does become dysfunctional to the whole system.

One only has to look at Zimbabwe, where we have a classic case of old-style financial repression, where they have an inflation rate of over 60 percent and an exchange rate that has been kept fixed for a few years (apart from a five percent devaluation last year). They have now reduced the interest rate to about 11 percent in order to reduce the cost of financing the fiscal deficit. The end result of that is predictable. There is simply no foreign exchange available in the country today. Exports are collapsing and companies are closing down. In the last month or so, five foreign companies suspended operations because they cannot import the

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necessary equipment.

Obviously, in the case of Zimbabwe we are talking about major financial repression. I think that we have to distinguish between the financial controls that are supportive of market-based, real exchange rate stability, and a system that exists now in Zimbabwe (and as existed previously in Zambia, where financial repression resulted in a major real exchange rate appreciation). I think it is important that that distinction is made.

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Floor Discussion of "Lessons from European Economic Integration"

Yung Chul Park raised the question of whether any of the European Union integration arrangements had not brought benefits to global integration. His own view was that they had been building blocks rather than stumbling blocks. He then observed that in the case of East Asia, trying to tie the currencies of the region tightly to one another would not be easy.

"We have two major currencies, one is the Japanese yen and the other the Chinese yuan. The yuan has become the currency to reckon with, especially because China's trade share in East Asia has increased so much over the last ten years. So somehow we have to incorporate these two diametrically opposed currencies in an East Asian monetary arrangement. That is why we are thinking about some sort of a basket of currencies. We don't know yet what currencies we are going to put in the basket, but nevertheless we are skirting around the critical issues. We do not talk about creating a 'yen bloc' and if we would start talking about it then there is no hope of moving forward any reasonable initiative at this stage."

Park raised a point about financial repression. "As a Korean, I should know something about it. It is our experience that it makes sense to distinguish between repression in a market-oriented financial system and in a bank-oriented system. Our experience with the bank-oriented system is that financial deregulation does not lead to free market activities or to the liberalisation of the financial system, at least in the short run. Because most of these bank-oriented systems are pretty much dominated and controlled by a few major financial institutions. So the authorities may deregulate their control, but then these major banks tend to continue the same financial repressive behaviour. In this case, you don't see much difference between the period in which financial markets and institutions were controlled and repressed and the period in which they are deregulated and liberalised."

Park also raised the issue of institution building. "In my view, institution building is very important. In East Asia we don't have the institutions that Europe has, but at the same time we have too many institutions right now: a regional bank, regional meetings of finance ministers, the Chiang Mai Initiative, the East Asian Summit, you name it, too many. My question to Charles Wyplosz is: What institutions are crucially important to get this kind of European arrangement on the drawing board in East Asia and push

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it forward? What institutions are important from your experience and how do you nourish these institutions?"

Daniel Heymann raised doubts about the usefulness of a blueprint. "In Latin America, there is a tension between two views. On the one hand, there is the view that financial arrangements and exchange rate agreements should be assessed from a historical perspective, stressing that there is no blueprint and that you sort of grope your way to some solution. On the other hand, there is the view that there should be a blueprint. Coming from a country like Argentina, in which at a time of capital controls people were getting their wages in the domestic currency and changing them into dollars the very same day and then spending their dollars to make their daily purchases, the impression that you have is that capital account liberalisation was thrown upon you from Washington instead of being decided by policymakers looking at cost and benefits. Some exchange rate choices sound strange when you look at them from far away, but when you see them from a day-by-day perspective they are quite obviously intuitive."

János Vincze stressed the importance of looking at the interdependence of various institutions in the financial and labour market spheres. "I have two points," he said. "One is the necessity to look at the interdependence between any of these institutions and how they determine each other and the second is that the whole set of institutions must be judged by how these institutions are able to respond to shocks. This latter point is not an easy test, because there is only one shock at a time and institutions are developing because people usually try to find answers to a problem in the long run. One of the main benefits of this disturbing experience of a shock is that you are motivated to try and devise economic structures that maybe are not optimal but may be able to respond properly to different kinds of shocks."

Amar Bhattacharya raised four sets of questions. "First, to what extent is regional financial market integration the same as regional financing arrangements for crisis prevention and crisis management? And what does this distinction imply in terms of differences in institutional arrangements? For example, if the two concepts are not the same, can we have regional financing arrangements for crisis prevention purposes without having regional financial integration? Second, if the pursuit of exchange rate stability is basically for trade integration purposes, what implications does that strategy have for crisis prevention and crisis management? Third, regarding Europe's experience with capital account liberalisation, why is it that countries starting with quite different initial points, not just in macroeconomic circumstances but in terms of microeconomic structures and prudential regulation and supervision systems, have come close in terms of improving their ability to withstand crisis? To what extent is this

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the result of convergence of national standards, and to what extent is it because of an implicit regional arrangement that has been in place? And fourth, to what extent have financial markets changed fundamentally making yesterday's prescriptions no longer valid for today? Is not the essential question we are grappling with today, that the world has changed and the implications that has in terms of crisis prevention and management?"

Leslie Lipschitz was struck by Wyplosz' emphasis on the choice of capital account liberalisation. "In the East Asian case, we have a fair amount of capital account liberalisation and I don't see how you could get the genie back into the bottle. I cannot imagine that you could impose successfully any kind of capital account restriction on the Philippines or on Indonesia, where a large part of the business community is very internationally integrated. The inter-corporate flows, the inter-family flows are extremely difficult to tackle. So I think this is totally improbable."

Reply by Charles Wyplosz

"Yung Chul asked many questions and I can't answer all of them. He asked, for instance, 'what institutions matter?' One is the European Commission. This is an institution that has broad powers, which is an active lobby for integration, and which has its own legislation for member countries. It is important that it was created from the outset, from day one of the Treaty of Rome. The second important institution is the European Monetary System (EMS). The big difference between the Chiang Mai Initiative and the EMS is that agreements within the Chiang Mai Initiative are supposed to be negotiated bilaterally, whereas the EMS is a very precise set of agreements that was negotiated multilaterally. The third important institution is the European Central Bank. These are examples of important institutions, but there are more.

The second point that Yung Chul brought out is, how do we deal with the fact that East Asia has two dominating currencies that are rather different, the Japanese yen and the Chinese yuan? He raised the political question of what currency one should peg to. One of the lessons of Europe is that by doing it collectively you remove some of these political problems. When the EMS was created it was created as a completely symmetric set of bilateral agreements and there was no presumption of who, which country would intervene when there would be a crisis. By doing it in a multilateral way, everybody is the same and you get away from the political sensitivities.

Daniel wondered whether one needs a blueprint or not. What I meant to say is that it is very dangerous to think, we first need to agree on how we

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go from A to Z before we move from A to B. That is why I said, you don't need a blueprint. But at the same time I was saying that it is very important to have a continuous debate on how to do things, if only for the sake of not having left out any options when the occasion arises. For example, in the case of Europe there has always been a discussion of the Treaty, of the vision of the future of European integration. And if there had been no previous thinking about that future, which many people considered a crazy idea which would never see the light of the day, European monetary integration would not have happened.

There was a recurrent theme: have financial markets changed to the point that there is no going back to financial repression? It would take several conferences to answer that question. So in two quick shorts. One thing that has changed is that our knowledge and competency in financial regulation and supervision has increased. The second thing is this view that we have all this wonderful technology and that there is just nothing economists can do to restrict capital movements. I think this is completely wrong. The effectiveness of the financial instruments at the same time increases the effectiveness of regulation, and if we wanted to restrict capital movements we could use all this technology for that. So I don't agree with the view that you can't put the genie back in the bottle because the genie has become so sophisticated. I think the bottle too has become much more sophisticated.

A different question is, once you have moved to liberalisation and liberalisation is followed by crisis, what do you do? Do you go back to restricting capital movements knowing that you may have to free them again and then open the door to another crisis? That is an argument for nonreversibility. On the other hand, if you want to have exchange rate stability you may decide that is has costs. It really is a question of cost-benefit analysis. There is no black-and-white answer.

Zdeněk said that the experience of the centrally planned economies showed that financial repression did not work. Maybe I did not make clear enough that I believe that for the goods market liberalisation is really crucial. But for financial markets liberalisation is less essential, because financial markets are prone to market failures. Goods markets are much less prone to market failures. So my view is that liberalising goods markets yields great efficiency gains, but I am not sure about that for financial markets."

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