

Fostering economic policy coordination in Latin America

**The REDIMA approach
to escaping the
prisoner's dilemma**

Christian Ghymers



UNITED NATIONS



Economic Commission for Latin
America and the Caribbean (ECLAC)

Santiago, Chile, April 2005

While writing this book, the author was on secondment to the Economic Development Division of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), where he headed up the Macroeconomic Dialogue Network (REDIMA) project. Mr. Ghymers is an adviser responsible for multilateral surveillance for the economy of the euro area and the European Union with the Directorate-General for Economic and Financial Affairs of the European Commission. The views expressed herein are those of the author and do not necessarily reflect the views of the above-mentioned institutions.

Cover design: Andrés Hannach

United Nations Publication

ISBN: 92-1-121544-7

LC/G. 2270-P

Sales No. E.05.II.G.42

Copyright © United Nations, April 2005. All rights reserved

Printed in United Nations, Santiago, Chile

This document has been produced with the financial assistance of the European Union. The views expressed herein can in no way be taken to reflect the official opinion of the European Union.

<http://europa.eu.int/>

Requests for authorization to reproduce this work in whole or in part should be addressed to the Secretary of the Publications Board, United Nations Headquarters, New York, N.Y. 10017, United States of America. Member States and their government institutions may reproduce this work without prior authorization, but are requested to mention the source and to inform the United Nations of such reproduction.

Contents

Acknowledgements.....	9
To Francisco de Miranda and Robert Triffin.....	11
Foreword.....	13
Overview.....	19
I. <i>“The Remains of the Day”</i> , in terms of theory.....	23
II. <i>“Gone with the Wind”</i> , in attempts at international coordination.....	31
1. The Bretton Woods system, or hegemonic asymmetry (1945-1965).....	31
2. Limits to the Bretton Woods system, or the lack of a common anchor and consensus (1965-1973).....	33
3. The illusion of floating rates without cooperation, or a return to the prisoner’s dilemma (1973-1984).....	37
4. Managed floating through the “collegial” coordination of the G-7 under United States leadership (1985-1990).....	39
5. Lessons of “G-7-style” hegemonic coordination.....	44
III. History of the emergence of the European monetary pole through economic policy coordination.....	47
1. The forgotten roots and the basic principles of the European regional integration.....	48
2. The European response: economic and monetary integration through coordination.....	52
3. First coordination attempt in the 1960s and early 1970s: discretionary coordination.....	56
4. The second coordination experiment (1979-1987): rules for collegial management of the EMS.....	58
5. First multilateral surveillance exercises (1987-1989).....	60

6.	Maastricht: surveillance in Stage II of the EMU (1994-1998).....	63
7.	The macroeconomic regime of the euro: Stage III of EMU since 1999.....	69
IV.	General philosophy of the European coordination model.....	79
V.	General principles derived from coordination experiences.....	83
VI.	Applicability to Latin America: The REDIMA approach.....	87
1.	Identifying the method rather than the model.....	88
2.	Macroeconomic coordination and regional integration: a political-economy view.....	90
3.	Macroeconomic coordination and exchange-rate regimes.....	101
4.	The REDIMA approach and the debate about policy coordination.....	108
5.	Policy-oriented conclusions.....	109
VII.	Three major obstacles to regional macroeconomic cooperation in Latin America.....	111
1.	First obstacle: the traditional prisoner's dilemma, or the unbalanced incentives for cooperating.....	112
2.	Second obstacle: the Latin centralization syndrome.....	113
3.	Third obstacle: the lack of institutional reputation and credibility.....	115
4.	A comparison of Europe and Latin America with eradicating a view to these obstacles.....	115
VIII.	Some key guidelines for escaping the prisoner's dilemma in Latin America: political economy at REDIMA.....	119
1.	Using the coordination paradox, or how to gain more autonomy through coordination.....	120
2.	Encouraging mutual knowledge and direct communication among national administrations through the creation of technical networks.....	121
3.	Developing incentives for national decision makers the to use regional level to promote their own interests...	123
IX.	Operational conclusions: applying the cooperative REDIMA guidelines for facing Latin American macroeconomic instability.....	129
1.	The first priority: including exchange-rate development in regular peer monitoring at the regional level.....	129

2.	Emerging economies' ERRs share a common character....	131
3.	Why regional monitoring of exchange-rate evolution and national policies could spur institution-building.....	134
4.	An example of a specific REDIMA proposal for organizing dynamic macroeconomic regional cooperation.....	137
X.	The REDIMA I experiment (2000-2003).....	145
1.	Origin and definition of the REDIMA project.....	145
2.	Purpose, method and expected results.....	146
3.	Implementation.....	146
4.	Comparison of expected and effective results and activities.....	147
5.	Principal specific positive results.....	148
6.	Conclusions and proposed actions.....	153
Appendix		
	Main publications on REDIMA's work.....	157
	Acronyms used.....	159
Bibliography.....		
		161

Box and figures

Box I.1	The Prisoner's Dilemma.....	28
Figure III.1	Economic policy coordination mechanism in the European Union.....	72
Figure III.2	The European Union convergence process: Annual inflation rates in 15 member states.....	76
Figure III.3	The European Union convergence process: Net public lending in 15 member states.....	76
Figure III.4	The European Union convergence process: Long-term interest rates.....	77
Figure III.5	The European Union convergence process: Short-term interest rates.....	77
Figure VI.1	Comparison of intraregional trade as a percentage of regional gdp of the main regions having preferential trade agreements.....	91
Figure VI.2	Cyclical correlation among partners of the main regions having preferential trade agreements.....	92
Figure VI.3	Interest rate differentials, Southern cone: Mercosur and Chile.....	98
Figure VI.4	Interest rate differentials: Mexico and members of the Andean community.....	99

Acknowledgements

Heartfelt thanks to all of the ECLAC staff for their excellent cooperation during my mission in Santiago and in the region. Particular thanks to José Antonio Ocampo, Executive Secretary of ECLAC, and Raynaldo Bajraj, Deputy Executive Secretary, for the assistance and enthusiastic support they have shown throughout, as well as to the former and current Director of the Economic Development Division, Hubert Escaith and Manuel Marfán, during the time REDIMA was being implemented, for the excellent contributions to REDIMA provided by them and their entire staff at the Economic Development Division.

Special thanks also to Giovanni Ravasio and Hervé Carré, the former Director General for Economic and Financial Affairs and Director for the Economy of the euro area, respectively, for authorizing my secondment by the European Commission to the United Nations in order to launch the REDIMA networks, thereby affording me the valuable opportunity to directly implement some of my ideas on regional integration.

Thanks to the Latin American macroeconomists and, especially, my colleagues from the finance ministries and central banks of the 18 countries of the region that are part of REDIMA for the exceptional opportunities they kindly provided, allowing me to participate in in-depth exchanges on sensitive topics and to be present with them at crucial moments in their work and during important events in their economies.

The final version benefited from valuable comments from my colleagues at the Economic Development Division of ECLAC, in particular those of Rodrigo Cárcamo and two anonymous referees. Naturally, I am solely responsible for the final result and for the flaws of this work, whose only aim is to kindle debate and encourage exchanges among Latin American and European experts.

*To Francisco de Miranda (Caracas 1750 - Cadiz 1816)
and Robert Triffin (Belgium 1911-1983)*

Two inspiring pioneers of the regional integration process to whom the author is indebted and whose ideas indirectly influenced the REDIMA project.

Miranda was the precursor of Latin American emancipation, and he provided the inspiration for the region's identity and integration. He considered a constitutionally based formula for regional integration a necessary condition for ensuring genuine sustainable political emancipation and a significant socio-economic modernization of Latin American societies. His visionary constitutional projects for a confederation announced the kind of governance the European Union eventually set up two centuries later.

Triffin is the founder of the European Payments Union (EPU; 1949) and one of the main architects of the European Monetary System (EMS; 1979) and the euro (1999), the single currency of the European Union, which he described as "a modest step in what I see as the most promising direction for a reordering of the present worldwide monetary chaos". Like Miranda, he saw that "any innovating proposal will be criticized as premature, but... one must be premature to have any impact... I prefer to be wrong nine times out of ten, if I can contribute once in ten times to divert us from catastrophe, and help build a better future".

Their thinking provides universal contributions to modern governance in a globalizing world.

Foreword

This book is one result of the REDIMA experiment and it is dedicated to the memory of two exceptional cosmopolitan citizens who are insufficiently well known but whose visionary thinking remains useful today for making progress on the road to regional cooperation and integration: Francisco de Miranda, the “most universal of Latin American citizens”,¹ born in Caracas, a soldier in and hero of the three main revolutions that shaped the Western World—the United States independence, the French Revolution and the Spanish American emancipation—and Robert Triffin, the internationally renowned Belgian economist whom President John Kennedy described as “our first Atlantic citizen”.² Triffin was a key player in the European integration process, through his inspiration for the European Payments Union, the European Monetary System and the single European currency, the euro, and through the advice he gave to many governments and central bankers. Although they lived in very different times and acted in very different ways, these two precursors share fundamental ideas on regional integration and international cooperation as ways to improve national governance and ensure higher levels of sustainable development. They devoted their entire lives to “trying to make possible tomorrow what appears impossible today”.

¹ On Miranda, see Bohórquez Morán, C. *Francisco de Miranda, Precursor de las Independencias de la América Latina*, Universidad Católica Andrés Bello, Caracas, 2002. (A first edition, in French, was published by L'Harmattan, Paris, 1998).

² In a meeting at the White House to assess Triffin's plan for reforming the Bretton Woods system, Secretary of Treasury Douglas Dillon, who had noticed that Triffin was a member of the European Community Delegation at an IMF meeting as well as member of the President's Council of Economic Advisers, asked Kennedy if Triffin was an American or a European. Kennedy replied, “relax Doug, he is our first Atlantic citizen and we need more of them”. *Robert Triffin San Paolo Prize for Economics 1987*, Instituto Bancario San Paolo di Torino, p. 120.

Looking back at Miranda is not done out of mere intellectual curiosity regarding the numerous federalist utopias. Miranda's visionary constitutional proposals for Spanish America, written from 1790 to 1801 (Ghymers, 2003), presage with impressive accuracy the kind of government that emerged from the long process of Darwinian natural selection among political systems and now in practice under the European Union's Treaty of Maastricht (Ghymers and Grisanti), after two centuries of nationalist conflicts and criminal wars: This is a union in diversity, feasible thanks to the pragmatic principle of "*subsidiarity*"; that is, a generally decentralized government structure, respectful of national or local sovereignties, except when federal centralization is proven beneficial for governance at all levels. Miranda believed, as does the European Union today, that very few policies should be determined at a federal level: (i) the general institutional framework (such as principles of representative democracy, with a genuine separation of powers and, specifically, an independent judiciary to defend human rights and guarantee the rule of law; (ii) defence and diplomacy; (iii) trade; and (iv) a single currency. The people's interests are better served when all these policy areas are managed at the federal level. It is worth salvaging from the selective poor memory of history that what has emerged recently and so painfully from the long trial-and-error process of European integration had been clearly formulated two centuries before by an exceptional Latin American traveller who studied the enlightened courts of Europe in search of "the best of the republics" to institute in Colombia (i.e., in Spanish America). Unfortunately for the region, Miranda's coherent plan for emancipation through democratic integration was snuffed out by Latin American *caudillos* and rent-seeking local oligarchies, which led to poor institutional frameworks unable to warrant good government or to bring about regional integration.

The revolutionary Miranda accurately foresaw that without genuine integration to unite the viceroyalties of the former Spanish Empire,³ the political and economic emancipation of the former colonies would be illusive or untenable. Furthermore, integration was also essential for the region to join, from a position of strength, the democratic camp of England and the United States and to form with them a comprehensive "tripolar" alliance on issues ranging from the political and military to the commercial and monetary. A strategic alliance among the only democracies at that time was perceived by Miranda as necessary to coordinate economic development through free trade and democratic government, thus allowing the countries in question to gain new allies and protect

³ The "Colombian federation" proposed in Miranda's constitutions would have integrated people and territories from Louisiana to Patagonia.

themselves from non-democratic absolutist regimes, or, after the French Revolution, from radical mercantilism and its totalitarian threats.

To remember Robert Triffin is an obligation of any economist dealing with economic-policy coordination, and all the more for the author of this book, who worked closely with him when Triffin returned from Yale University and rejoined his alma mater, the Catholic University of Louvain, in 1977. With a small group of Louvain economists, Triffin drafted a proposal for a European monetary system that was submitted to Roy Jenkins, President of the European Commission.⁴

More generally, as noted by Paolo Baffi, Triffin was *“the first thinker ever to emphasize that recurring crisis and unrest in external economic relations stem from a fundamental dilemma between national sovereignty in economic policy decisions and the measure of international incompatibility inherent in such ‘atomistic’ decisions”* (Baffi, 1987). Triffin is recognized as the specialist who identified the need for economic cooperation among nations and regional groups and the ways to achieve such cooperation.

Like Miranda in previous times, Triffin was convinced of the need for a transatlantic strategic alliance among Europe, the United States and Latin America, which would be easier to achieve if Europe and Latin America formed integrated regional entities without foregoing their national sovereignties. How far-sighted still is his 1957 recommendation to set up a mechanism of incentives for national authorities to commit to economic coordination: *“[I]n many cases, the centralization of negotiations and decisions ... would constitute a handicap, an element of paralysis, and a source of international friction rather than an effective contribution to the solution of our problems”* (Triffin, 1957, p. 258). He also noted that *“sovereign countries should not be expected to undertake and respect international commitments which come into conflict —real or even imaginary— with powerful national pressures or interests. Barring the use of coercion, the efficacy of international commitments depends primarily on the provisions that make their implementation both feasible and attractive, and their breach unnecessary and damaging for the countries concerned. National interests should be made to coincide, through a double mechanism of deterrents and incentives, with the collective interests of the group. Reciprocity and mutual help are the keystones of such a construction”* (Triffin, 1957, p. 246).

Miranda would have agreed with Triffin’s courageous conviction that *“any innovating proposal will be correctly criticized as premature”*, although *“one must be premature to have any impact”*.⁵ Thus, Triffin wrote — and Miranda would also have agreed with him on this point: *“I prefer to be*

⁴ The proposal inspired the October 1977 “Discourse of Florence”.

⁵ Triffin, Robert, San Paolo Prize, 1987, pg. 126.

wrong nine times out of ten, if I can contribute once in ten times ... to help build a better future".⁶ On the possibility of fulfilling such an objective, they both were profoundly realistic. Triffin expressed this realism as follows: "Innovation is essential, but we must build with the materials at hand".

Miranda's and Triffin's pragmatic contributions to the principle of subsidiarity are the foundation of sound regional integration, which in turn is a prerequisite for reforming the international economic order and shaping a more regulated globalization, along the lines of the proposals currently supported by the Economic Commission for Latin American and the Caribbean (ECLAC).

Although the content of this book was not determined by the two international institutions —the United Nations and the European Commission— that have supported its publication and REDIMA, the book clearly makes a contribution to ECLAC efforts to design suitable strategies for improving governance in a globalizing world. In particular, the book intends to identify and systematize the possibilities of suitable regional cooperation for improving policy-making in Latin America in the context of globalization (ECLAC, 2002).

As is well known, globalization diminishes the traditional importance of national frontiers, or the power of the "nation state". It translates into a weakening—for better or worse—of national authorities' capacity for discretionary actions, as well as that of local monopolies or national vested interests. Consequently, one can observe a clear consensus among economists and political scientists on the need to face this new reality through strengthening the institutional underpinnings of long-term growth, mainly at the national level but also at the global level. Nonetheless, the role that regions might play in responding to globalization does not focus their attention much on collective, or regional, responses. On the contrary, national authorities tend to react in isolation, using national instruments and generally without specific consideration for explicit regional cooperation or for grouping neighbouring partners to respond collectively. Theoretic academic models do not generally consider the increasing significance of the regional context, despite the contagion visibly affecting Latin America. Mainstream economic thinking still considers countries and their national economies as autonomous entities, without asymmetries or externalities among them, in which the growth rate depends on domestically determined advantages and policies.

This paradigm leaves no room for a regional strategy with which to respond to the common institutional failures that are a major determinant of poor growth performance or to structure reforms able to make Latin

⁶ Ibid., 122.

American economies resilient to shocks induced by globalization. This is an inexplicable contradiction between the undeniable internationalization of the economic sphere and the rigid concept of economic governance, which remains squarely in the national realm.

However, resolving this dilemma is not simple and raises fundamental issues for governance. Consequently, this book, following the practices of the REDIMA experiment, attempts to put forth the following theses related to this issue:

- Macroeconomic subregional cooperation is an important factor for progress towards regional integration; and regional integration could, in turn, enable economies to benefit from the globalization process and to have a stronger say in international affairs.
- The regional dimension is a powerful tool with which to make up for institutional failures, insofar as it provides tangible net gains to national policy makers; this holds to the extent that the chosen formula strikes the right balance between cooperation and competition among national administrations, breaking the prisoner's dilemma specifically at the level of national macroeconomic policy makers in the context of a strictly subsidiary conception of regional cooperation and integration. Such a balance can easily be struck through mutual monitoring of macroeconomic policies at the subregional level that focuses on their compatibility and acts as a catalyst for cooperative attitudes among national policy makers as well as for strengthening the institutional underpinnings of economies (which, in turn, leads to a higher rate of sustainable growth).
- Subregions, defined by Triffin as a "*group established among geographically neighbouring countries sharing cultural and economic affinities*", are suitable entities for macroeconomic cooperation between national administrations, but also for building a broader consensus at a higher level, through subregional dialogue (and in Latin America, among the three main subregions) as well as for interregional dialogue (between the subregions and outside regions, like the European Union, the North American Free Trade Area countries, or the Association of South Asian Nations (ASEAN)). Subregions are indeed an efficient intermediate stepping stone to the more ambitious and difficult goal of reshaping the global economic system and controlling the unruly globalization process.

Christian Ghymers
October 2003
ECLAC, Santiago, Chile

Overview

This work attempts to assemble and synthesize some results of the first phase (2000-2003) of the REDIMA project implemented in Latin America by ECLAC in cooperation with the European Commission, which provided technical support as well as co-financing for the project. REDIMA is the acronym of the Spanish and Portuguese name of the Macroeconomic Dialogue Network (Red de Diálogo Macroeconómico), which was conceived and implemented in the three main subregions of Latin America between the end of 2000 and end of 2003 by the ECLAC—United Nations headquarters in Santiago, Chile.

This volume is intended mainly for Latin American experts involved in setting the macroeconomic policies of their respective countries, but it should also be of interest to a broader public concerned with regional-integration options and strategies. It aims to provide some useful elements for addressing specific issues related to coordinating policies among sovereign nations in a world undergoing globalization and subject to increasing uncertainty. It is not constructed as an analytic treatise. The book has a twofold objective: to provide clear positions regarding and options for Latin American integration (on the basis of the author's personal analysis, which, in turn, stems from his own professional experience both at the European Union and in Latin America), and to publicize the REDIMA experiment, as well as the momentum behind it and the proposals issued through it. In addition, the book hopes to elicit reactions from readers and promote an exchange of ideas among policy makers, experts and citizens,

and thus encourage the formulation of feasible courses of action in Latin America. More than arriving at normative conclusions, my purpose in staking out positions and debating issues is to encourage endogenous processes appropriate to each subregion and use the experience gained by REDIMA.

The book is structured as follows: given the theoretical results and the indisputable fact that the greatest obstacle to policy coordination lies in the lack of appropriate consensus-based models for understanding reality (“underlying models”) —a problem which has no short-run solution— attention is focused on practical examples and on the attempts frequently made in this direction (the Bretton Woods system, the Group of Seven [G-7], the European Monetary System [EMS] and the European Economic and Monetary Union [EMU], in which the euro is the common currency) to draw some initial lessons (chapter I). This effort also examines the prisoner’s dilemma situation that hinders cooperation (chapters II and III). The examples given in these chapters make it possible to pinpoint the specific elements behind the success of the European experiment of encouraging national decision makers to welcome cooperative strategies (chapter IV). The European Union case shows that escaping planned “centralist coordination” through successive “trials and errors” —a pragmatic scheme based on a dialogue between autonomous actors gradually creating mutual trust— and recognizing that each government legitimately tends to act in its own interest made it possible to arrive at a minimum consensus regarding the content of policies and at an acceptance of some basic common rules. In the European process, this kind of dialogue stimulated self-discipline to protect countries’ own legitimate national interests (market-based rewards for or sanctions against national political decision makers).

Next, the book attempts to identify the essential principles allowing the prisoner’s dilemma to be overcome (chapter V). In the European case, rather than being devised according to a broad institutional plan, the solution emerged from the development of personal contacts among policy makers within a collective effort to monitor each economy from a regional perspective, thereby allowing it to be viewed as a continuous game, which, it was hoped, would enhance the credibility of domestic policies. This multi-faceted approach created specific incentives for individual participants to cooperate at the regional level, thereby creating a positive-sum game in which the positive outcome increased with the iteration of the game. Hence, the prisoner’s dilemma was resolved through the dynamics of the game: that players had to meet over a long and undefined period, that they could not escape the consequences their decisions had on fellow participants, that the incentives to defect diminished over time and were commensurate with the strengthening of

integration, that players learned more and more about each other, that rewards and sanctions were administered progressively and allowed the balance of benefits and costs to be identified, reducing uncertainty regarding the results of cooperation—all these factors implied that the cost of non-cooperation rose rapidly with time, and positive outcomes increased with the iteration of the game.

Next, the applicability of these general principles to Latin America is examined, allowing the REDIMA political-economy approach to be introduced (chapter VI). In particular, the contextual differences between the European and Latin American integration processes are examined. This leads to an identification of the three essential obstacles to regional cooperation in Latin America (chapter VII).

The book builds on these elements to present the key guidelines stemming from the REDIMA political-economy approach for escaping the prisoner's dilemma (chapter VIII).

To conclude on a practical note, the preceding analysis is summarized through an examination of exchange-rate regimes (ERRs) and policies, in order to formulate some concrete proposals for debate (chapter IX). In particular, since "corner solutions" for the choice of exchange-rate regime imply either a lack of flexibility or a lack of robustness, a regional cooperation scheme could, under specific conditions, provide the countervailing powers, or "checks and balances", that would lend credibility without a loss of flexibility. To complement this information, Phase 1 of the REDIMA project and its implementation are briefly evaluated (chapter X).

Chapter I

***“The Remains of the Day”*, in terms of theory**

The coordination of economic policies (both international policies and instruments) is a longstanding political-economy problem that has become a traditional theme of debates among economists, although no clear conclusion has emerged. Despite considerable development of the theory since the 1980s, with an impressive growth in complexity, the empirical results have been disappointing and it has been impossible to devise clear practical recommendations for policy makers.

This chapter presents a very schematic overview of the results of some theoretical and empirical studies, although without attempting to survey the very abundant technical literature on this subject. For readability and to focus on operational aspects, Box I.1 presents, from a layman’s standpoint, the key concept of the “Prisoner’s Dilemma” used in the REDIMA approach. This discussion makes clear that an analysis of policy interactions between countries is not limited to the overly simplistic one-shot games associated with the prisoner’s dilemma. REDIMA will present future works and additional developments that will allow this case to be inserted into a more comprehensive and analytical framework.

Because of closer international ties, policy decisions in one country have a stronger impact on that country’s partners. Nevertheless, policy-making generally continues to overlook these cross-border “spillovers” of domestic policies.

What does theory tell about such a contradiction in a globalizing world? It has been possible to establish, based almost solely on evidence,

that cooperative behaviour among national policy makers whose economies are linked leads to a “better” equilibrium for the group of countries involved. Nevertheless, it has not been possible to solve the (theoretical and real) problem by which, in practice, the asymmetry among economies, as well as the different perceptions of the way the economy works (that is, the underlying model and the evaluation of cyclical position) and the differences in political objectives (the “weighting” of the objective functions of national policy makers), makes it very difficult to identify the individual distribution of gains from coordination. The combination of these factors of risk and uncertainty greatly limits the concrete applicability of the cooperation principle.

In fact, it serves no purpose to show that a group of countries can arrive at a better overall outcome when —according to the definition of sovereignty— policy makers’ priorities are determined and approved solely based on their results at a national level. Indeed, at the regional level (that is, in the case of a group of neighbouring countries) the distribution of gains from coordination is uncertain, unknown beforehand or skewed through the domestic political game. Moreover, game theory has demonstrated very clearly through the famous prisoner’s dilemma (see Box I.1) the case in which individual rationality leads to collective irrationality: each risk-averse player is rational in refusing to cooperate, either because by adopting free-riding behaviour when the other party is playing fair maximizes one’s individual reward or because such behaviour minimizes loss when the other party defects.⁷

The mere probability of a partner’s defection strongly biases individual behaviour against cooperation in a game where players are sovereign powers —i.e., where the opportunity for collusion among them is, by definition, very limited. In this case, the potential for individual losses created by the risk of partner’s defection necessarily leads them to choose non-cooperative strategies, with highly negative consequences for all players. In an economic region, because players are decentralized and sovereign —that is, because they lack the normal possibility for feasible collusion— domestic economic-policy decisions whose mutual external effects are significant are destined to be harmful at the regional level (leading to suboptimal equilibrium). Furthermore, theoretical “bargaining” models show that it is possible to arrive at practicable cooperative solutions solely under restrictive hypotheses, with a precise weighting of policy objectives (or in the case of complete symmetries among players).

⁷ Strictly, a prisoner’s dilemma is considered to exist when individual gains from not cooperating are perceived ex-ante as higher than the individual reward for doing so, or the perceived individual loss from cooperating is higher than the expected cost of not cooperating (see Box I.1 in this chapter).

A path to a less pessimistic theoretical conclusion can be charted, however, by considering international cooperation within a more dynamic framework. The introduction of a dynamic dimension that takes into account linkages between decisions made through a succession of negotiations or contacts established over time (“multi-period”, or “dynamic”, games) makes it possible to consider an important aspect of reality: the interplay of expectations built on mutual learning experience among policy makers. Given that in a continuum of successive decisions, response strategies are developed among players and are included in the behaviour of each (“tit-for-tat” conduct), schemes of evolving cooperation can emerge (Axelrod, 1984). This means that players’ individual incentives can evolve to favour cooperation, making it possible to overcome the individual impasse to the prisoner’s dilemma inherent to the hypothesis of rejection of cooperative behaviour. This important insight—which does not appear to have been explicitly explored—will be the focus of attention for examining what produced successful results in the case of the European Union (chapter III), as well as for formulating specific propositions, in chapters VIII and IX.

By contrast, studies using macroeconomic models allowing for simulations generally showed empirical results of little impact (Bryant and others, 1988; Canzoneri and Edison, 1990): gains resulting from the coordination of monetary or fiscal policies—although documented—are relatively modest: on the order of 1% of the industrialized countries’ GDP over the medium term. This seems poor in the light of the margins of uncertainty in the models. Moreover, an analysis of noteworthy cases of international initiatives (such as those of the G-7 resulting from the 1978 Bonn Summit, the 1985 Plaza Agreement, or the 1987 Louvre Agreement) leads to the conclusion that, whether or not effective, these initiatives had a negative impact on several partners as well as on the global economy, through a destabilizing amplification of the international economic cycle.

For several *methodological* reasons, however, these initiatives are not useful for arriving at conclusions on the potential validity or merit of the international coordination principle. Here again, these objections are rooted in the difficulty of understanding and measuring the underlying model, which in itself tends to reduce the perceived gains of coordination and also represents a serious obstacle to its implementation. In fact, the results vary widely, depending on the model and the simulations used.

Although this volume will not survey the existing empirical literature, some basic methodological premises point to a deeper identification problem when an attempt is made to simulate coordination

or quantify its gains. The main arguments, in highly condensed form, are as follows:

First, coordination *per se* does not necessarily generate positive outcomes. Coordination is positive only when it allows for implementing better national policies. In the case of coordination leading to the imposition of inadequate measures, negative impacts tend to accumulate and to exacerbate growth difficulties. This is the case of past attempts to coordinate actions (for example, the 1978 Bonn Summit with the locomotive theory or the 1987 Louvre agreement with its huge exchange-rate interventions). Although these cases are unquestionably examples of coordination, they had a negative effect on the observed outcomes, on which parameters for potential simulations are estimated. The real problem, as mentioned, is not coordination itself but the uncertainty of or conflict with understanding the real world (referred to as the “underlying model”).

Second, in the real world, on which model parameters are estimated, there also are cases of implicit or “tacit” coordination (i.e., coordination regarding which no agreement is made or announcement is given). In such cases, the calculated parameters of the models would also be skewed and a simulation of formal coordination would fail to register part of its potential positive impact. This undetected part of the potential impact would already be included in the baseline case, which is considered to represent non-coordinated policies.

Third, formally agreed coordinated actions could, conversely, be imperfectly implemented, or offset by other measures not covered in the agreement. In this case, the estimated parameters might include a lack of effective coordination, making it impossible for a simulation to account for the change of regime that true coordination would involve (the dynamic aspects).

Lastly, an important argument regarding the lack of clear conclusions of theoretical works on coordination appears to be the endogenous reactions produced by the fact that the cooperative scheme comprises only some parameters or macroeconomic-policy instruments. Hence, this would tend to generate free-riding behaviour and introduce distortions or reactions that create moral hazard; national policy makers could take advantage of this situation to change their objectives or blame their neighbours, or simply shift the burden to favour themselves. Due to its partial and limited nature, the commitment to coordinate does not generally involve an objective distribution of the respective roles, and the costs of actions are generally not shared in an altogether transparent manner. It seems very likely that conflicts would arise and, by and large, that certain social or political actors would try to take advantage of the

agreement to maximize their individual gains. For example, certain actors (trade unions or vested interests consisting of sheltered producers) could keep the gains for themselves or offset them by asking for supplementary income once they become aware that the partners in the agreement are able to indirectly assume or make up for part of the costs. This important weakness is systemic and inherent to the existence of frontiers.

Although this simplified overview does not purport to fully summarize the sophisticated theory of coordination, it does underscore the difficulty of finding a satisfactory theoretical framework, that is, a general formula capable of encompassing such a complex reality and able to lead to concrete proposals or practical recommendations. In the light of this lack of solid facts and appropriate methods to guide economic policy decisions, I propose adopting a basically pragmatic focus —first, by drawing on analogies from elementary game theory to break the complex issue of coordination down into more manageable components; applying the prisoner's dilemma to regional cooperation will provide insight on elementary mechanisms that explain the lack of cooperative behaviour and make it intuitively clear that cooperation is possible only if it is in the best interest of each partner. The second way to follow a pragmatic approach is to refer to known experiences of cooperation while keeping in mind the elementary mechanisms shown by the prisoner's dilemma analogy.

Box I.1
THE PRISONER'S DILEMMA

In the past decade, the popularity of traditional game theory —defined, for our purposes, as interactive decision theory— as a tool of economic analysis has been rising with the development of a set of techniques and tools for analyzing non-cooperative behaviour. Within this promising literature, one of the basic concepts that gained prominence for policy-making analysis was the prisoner's dilemma (Kreps, 1990).

Like any other modelling, game theory simplifies reality to shed light on situations in which autonomous decision makers have interconnected interests and behaviours. National macroeconomic and trade policies —and, hence, regional integration issues— are, a priori, excellent candidates for applying a method that explicitly tries to include interactions between sovereign states in order to examine the possibility of reconciling opposing or competing interests. Moreover, the progress of human societies and their economic development seem intimately linked to the ability to transform conflicts of interests through institutions that allow for sufficient cooperation among economic agents, thereby changing zero-sum games to positive-sum games, or “win-win situations”, by reducing the gap between individual and collective returns. Macroeconomic-policy coordination in the context of regional integration should therefore be analyzed in terms of the game-theory approach used at REDIMA and described in its publications.^a

Regional integration succeeds when a minimum degree of cooperation among sovereign nations emerges. This kind of cooperative behaviour is sustainable and successful only if the participants' cooperative attitude is perceived to be in the best interests of each of them acting alone. The metaphor of the prisoner's dilemma helps us understand why such behaviour is not the general rule in the real world, thus opening the way for possible solutions.

The prisoner's dilemma is the most prevalent example of a basic game that recurs in many political, social and economic contexts in which the general rationality of conflicting preferences prevents cooperative actions and inflicts losses on all players.

The name is taken from the pedagogical story first used to illustrate it by A.W. Tucker. Two individuals commit a crime together. The police apprehend them under strong suspicions but no solid proof of their guilt. The suspects are placed in separate cells and cannot communicate with one other. A proposal is made to each of them to confess and incriminate the other. (i) If they both confess, they will both receive the same reduced penalty for pleading guilty (for example, a five-year jail sentence); (ii) If only one of them accuses the other, the accuser will be set free, while the recalcitrant partner will receive the maximum penalty, a twelve-year sentence; (iii) if neither confesses, they will both be convicted of a minor offence and receive a one-year sentence.

Hence, both individuals receive a better deal (a shorter sentence) when they both refuse to cooperate and accuse their partner (that is, defect): for each of them, the best individual outcome is obtained by accusing the partner, regardless of what the latter does. If one partner cooperates (i.e., does not accuse the other), while the other defects (by accusing his accomplice), the defecting party goes free; but if his partner accuses him, the cost is still lower for him than if he cooperated (by not accusing the partner). The worst outcome is obtained when one cooperates while the other defects. The structure of the relative incentives makes it impossible to cooperate. Rational, isolated, individual decisions (that minimize one's risks or maximize the gains from acting in isolation) do not lead either defendant to cooperate. Indeed, each is guided by the rational fear that if he does not implicate the other (that is, if he cooperates with his accomplice) and his partner defects

^a See, especially, Escaith, and Paunovic (2003).

and implicates him (that is, chooses to not cooperate), he risks receiving the most severe sentence. In this example, the defendant receives a twelve-year sentence if he chooses to cooperate by not accusing his partner. If, however, his partner cooperates (fails to defect), the partner also receives a one-year sentence, thereby forfeiting the opportunity to obtain the best option by acting in isolation (release, or no jail sentence). In either case, defecting gives each individual a comparatively better outcome, although collectively the outcome is not Pareto-optimum, and, clearly, both defendants would be better off by cooperating and refusing either to confess or to accuse the other. In game-theory terminology, this is known as the prisoner's dilemma: each player, in pursuing his rational, individual interest, has a "dominant strategy" that precludes him from cooperating and locks both of them into a suboptimal equilibrium, from a collective standpoint.

Therefore, decisions that are rational from the standpoint of a single decision maker become irrational from a collective standpoint. This simplistic case of a clear divergence between individual and collective rationality leading to an effective loss of welfare has drawn much attention to the conditions for making cooperative outcomes feasible, which, in turn, has popularized the prisoner's dilemma model. Obviously, this (static) case, with a one-shot interaction between players, is the simplest, and it is clear that the dilemma is over as soon as the players are able to bargain a credibly binding agreement that prevents the emergence of a damaging "dominant strategy". In our simplistic case of two defendants, merely being able to communicate would suffice to make them "cooperate".

However, in the real (dynamic) world of international relations, communication is far from sufficient or possible, specifically because of uncertainty about the future (especially about potential gains and losses from cooperation that depend on partners' behaviour), about the genuine underlying model, and about the credibility of international commitments to binding national decisions; moreover, partners face a "continuously repeated game", that is, they do not meet only once for a specific matter but have to play forever (or for an indeterminate length of time) regarding several concurrent, important issues. As developed by Robert Axelrod (1984), this dynamic dimension changes behaviour, insofar as the weight of a future outcome in present decisions is sufficient. Indeed, in a repeated game, by learning about each other's behaviour, players acquire the ability to create and develop their own incentives (or disincentives) for cooperating (or refusing to cooperate). Reputation effects can develop, making spontaneous cooperation attractive for reasons of credibility and political economy, which affords opportunities to create additional incentives resulting from cooperation itself. This means that cooperative gains become endogenous— i.e., they increase with time (as will be shown with the REDIMA proposals for financial spreads in chapter IX) and could be encouraged by "commitment technology" like tying a government's hands with regional institutional agreements that increase the cost of defecting (as this concept is defined by Persson and Tabellini, 1990) and create significant incentives for individual players (in line with the REDIMA approach to market rewards and sanctions). In the base case (the static example of two prisoners), the endogenous nature of the potential gains from cooperation could unlock the dilemma, insofar as the dynamic (potential) gains to be reaped in the future clearly exceed the immediate gains from defecting. Here, the dominant strategy is no longer to defect but to cooperate, and at this point, the prisoner's dilemma is, by definition, solved.

It is clear that the prisoner's dilemma does not prove anything in itself, but it does provide economists and policy makers with general categories of assumptions that break a complex issue down into simpler components and allow fundamental relations and their intrinsic mechanics to be identified such that insights and intuitions can be arranged to find a probable way out of the non-cooperative status quo. This approach to international economics promises to yield many more results, and further developments are expected from phase II of REDIMA.

Chapter II

***“Gone with the Wind”*, in attempts at international coordination**

Although this volume does not provide a systematized summary of the numerous attempts at and experiences with coordination in the world, it considers the two most important and clearly related cases, the G-7 and the European Union’s EMS. First, it will re-examine the starting point, the Bretton Woods cooperation system.

1. The Bretton Woods system, or hegemonic asymmetry (1945-1965)

It is well known that much of the disaster of the 1930s (and of the totalitarian regimes that thrived from it) can be explained by the non-cooperative or nationalistic policies of the industrialized nations. At the end of World War II, the catastrophic consequences of these policies led the United States, the hegemonic Western power, to attempt to reorganize the world economic system by imposing certain basic cooperation principles, which the war had made possible.

Without giving a detailed presentation, it is useful to recall that the initial logic for cooperation rested on three complementary institutional pillars: the General Agreement on Tariffs and Trade (GATT), which allowed for the establishment of clear rules on coordinating a progressive liberalization of market economies; the International Monetary Fund (IMF), a monetary agreement imposing a minimum of common discipline for ensuring monetary stability and making balance-of-payments adjustments less conflictual while avoiding distortions; and the International Bank for

Reconstruction and Development (IBRD), designed to compensate for the “market failures” of international capital movements and especially to further European reconstruction and support least developed countries (LDCs). Although each of these three pillars pertains to a cooperation-based institutional construct that attempts to coordinate national policies through rules and direct incentives to the actors involved, it is an indisputable historical fact that the creation and acceptance of each of them was the result of unilateral action by the United States “hegemon”, which not only launched these initiatives but also voluntarily offered the incentives and/or adjustment mechanisms that would allow for almost automatic coordination and, consequently, the successive functioning and acceptance of the system.

The examples given below illustrate that a single country’s political and economic hegemony allowed it to impose a growth-oriented system on the remaining players. The functioning of this system hinged on certain simple rules whose observance was made attractive to the other countries. Coordination with the other countries thus became automatic: it was in the individual interest of the participating policy makers to adhere to the system proposed by the “hegemon”. The prisoner’s dilemma situation, in which the partners were trapped because of a lack of hegemony among themselves, was thus resolved. Let us examine this in greater detail in the commercial and monetary spheres.

1. In trade, only the largest economy could impose non-discriminatory access to markets by making compliance with multilateral principles by its small, divided interlocutors a condition for access to its big internal market. This unilateral advantage made it possible to unlock the prisoner’s dilemma among the other countries. The United States thus achieved its objectives of political security and trade-regime and longer-term economic stability at the expense of the shorter-term interests of some of its lobbies, while the other countries also achieved most of their goals at the expense of the interests of some “rent-seeking” sectors. This hegemonic asymmetry permitted systemic progress, which, in turn, allowed the dynamics of progressive and coordinated globalization to be triggered through *two key principles of political economy*. First, an international conflict between foreign exporters and domestic producers (which is more difficult to rationalize and is prone to be used by simplistic, xenophobic populists) was transformed into a merely “domestic” conflict between national exporters and protectionist lobbies of the same country. The acceptance of such a transformation is probably easier in representative democracies, given that, in the end, trade opening essentially benefits more voters than does protectionism). Second, the economic interdependence that develops with mutual

trade liberalization gradually imposes greater discipline and restrictions on discretionary national policies, while the growing need for organization and security—which cannot be achieved merely in the domestic sphere—has, increasingly, to be sought through the acceptance of supranational or multilateral regulations and institutions.

2. In the monetary sphere, because of the failure to establish a supranational solution right from the start through the creation of an international standard (the Keynes-Triffin proposal), the only currency that could act as an international standard at that time was the United States dollar, given that it was the only national currency that had all the attributes required internationally. Moreover, as a reaction to the aggressive depreciations of the preceding period (“beggar-my-neighbour” policies) and in the presence of the generalized control of international capital movements, a fixed-parity system was imposed on the $n-1$ other currencies *vis-à-vis* the dollar. This meant that the $n-1$ central banks of the rest of the world had to commit to buy or sell dollars (the “ n ” currency) at an agreed and fixed (but adjustable) parity, while the United States adopted a passive attitude of functional “benign neglect” (inescapable for the “ n th” countries, since there are only “ $n-1$ ” degrees of freedom) in the currency market. This monetary asymmetry implied a spontaneous coordination of the $n-1$ national policies, while the “ n th” economy had to renounce its monetary policy and foreign-exchange autonomy and was obliged to offer to serve as the adjustment instrument for the world system. For the $n-1$ other countries, the automatic coordination of internal policies resulted from the “external” discipline imposed by the obligation to maintain a stable exchange rate: the external restriction (loss of dollar reserves in the event of excessive local money issuance or of an excessively expansionist fiscal policy) provided an incentive for national authorities to progress towards macroeconomic convergence and politically punished any “inflationary” policy stance (overvaluation and devaluation or need to resort to the conditioned funding from the IMF).

2. Limits to the Bretton Woods system, or the lack of a common anchor and consensus (1965-1973)

The flipside of this asymmetry, however, was an intrinsic weakness: the absence of any external constraint on the United States (excluding the more formal, rather than real, anchoring represented by the convertibility of the dollar to gold at a price determined with other central banks). In such a system, for the external stability of the $n-1$ other countries to translate

into internal stability, it was also necessary for the internal policy of the nth country—the anchor of the system—to be spontaneously disciplined and on target. Otherwise, the obligatory interventions (dollar purchases against national currencies—i.e., issuing monetary base) by the n-1 other countries to maintain exchange-rate stability would become a channel for increasing the transmission of the anchor country's lack of monetary discipline. In other words, the system was based on the assumption that the hegemon would always be lucid and benevolent, renouncing its own short-run interests to protect those of the rest of the world, and that it would always be in a political position to do so. That meant that three difficult conditions had to be permanently met: (1) United States' macroeconomic policy makers had to be willing to impose the necessary discipline on themselves; (2) this would have to be accepted and supported politically by the United States' electorate and lobbies, and (3) even if the goodwill of the hegemon was guaranteed, the system needed to have effective knowledge of the real model behind the United States economy and that of the rest of the world. If this was closer to being respected in trade matters (GATT), the inevitable errors of judgement (legitimate lack of knowledge regarding the real model) by macroeconomic policy makers in both the United States and other countries were fatal to the Bretton Woods system.

The system worked provided the United States willingly accepted not to pursue balance-of-payments objectives, all while addressing global pricing stability. Nonetheless, as was vocally denounced at that time in the Triffin dilemma, this double commitment contained a logical impossibility: if the United States averted global deflation (resulting from the global scarcity of liquidity), thereby fulfilling its stabilizing role, it did so by meeting the rest of the world's demand for reserves through the United States balance-of-payments deficits, that is, by accepting an accumulation of liquid external liabilities with the potential for an eventual crisis of confidence in the dollar. Hence, the amount of reserves that the rest of the world could accumulate was constrained by the progressively waning confidence in its main reserve currency: either the world would be supplied sufficient international reserves and the dollar would be condemned to a crisis of confidence, or the United States would be tempted to defend the dollar's credibility through a balance-of-payments adjustment, which would put a chokehold on the needed international liquidity, giving rise to global deflation and the consequent mercantilist trade wars. In fact, since the first course was chosen, the worldwide system—lacking an effective anchor—became inflationary. Since the fixed-parity mechanism automatically amplified any Keynesian impulse (excess money creation or fiscal expenditure) by the United States and since the international multiplier of expenditures was greatly enhanced

by the role of the dollar standard itself (Ghymers, 1986), the world system was predisposed to inflation.

This was a *direct consequence of the monetary asymmetry* created by the dollar's international role: the exodus of dollars from the United States created a monetary base abroad without reducing the monetary base inside the country, because the dollar reserves acquired by other central banks were placed not in liquid deposits at the Federal Reserve (creating a monetary liability) but in income-producing instruments, like U.S. T-bills or certificates of deposit (CDs) with United States commercial banks (creating financial liabilities), as a result of the dollar's international role (Swoboda, 1978; Mc Kinnon, 1982a). This investment of external monetary reserves by the n-1 central banks into the United States financial market represented an inflow of financial capital into the United States, contrary to the normal logic of the gold standard or of any other symmetric fixed-parity mechanism. The reason for this was the monetary asymmetry of the dollar standard, which worked as follows:

1. As a peg system, under the dollar standard, excessive dollar liquidity led to compulsory purchases abroad by n-1 central banks (the United States did not intervene in the foreign-exchange market).
2. This increased these central banks' assets (i.e., their accumulated foreign-currency reserves in dollars) as well as their corresponding liabilities (non-dollar monetary bases), equivalent to a transfer of excess monetary stocks from the United States to the rest of the world.
3. N-1 central banks —rather than depositing their dollar reserves in their accounts with the Federal Reserve System (or “Fed”), in which case these reserves would have represented a symmetric destruction of the United States monetary base, by increasing the Fed's liabilities— placed (or “recycled”) them in the more attractive, income-producing United States Treasury Bonds or in United States bank CDs (that is, liabilities of non-monetary authorities).
4. These automatic loans from the rest of the world to the United States Treasury or banking system impeded an equivalent reduction in the United States' monetary base, instead of allowing the normal logic (symmetry) of a corresponding reduction in the monetary base of the country with a balance-of-payments deficit.
5. In such an asymmetric monetary system, the initial excess of money creation in the United States economy led to monetary expansion in the rest of the world; the international currency did not behave as did other national currencies: its monetary multiplier was bigger, allowing the United States to act as the world's banker.

Thus, *the macroeconomic world of Bretton Woods provided automatic coordination*, with an amplification of the Keynesian impulses originated in the United States, *which resulted historically in proclivity toward international inflation*.

Moreover, this proclivity was progressively intensified, insofar as the development of private capital movements undermined the fixed-parity discipline. Without free flows of capital, the excess internal demand of the n-1 countries could not easily be financed and the external constraint entered into full force. With the progressive but overwhelming combined forces of financial innovation and deregulation, the emergence of international capital movements that were increasingly attracted by interest-rate differentials rendered national fiscal policies even more effective through the inducement of domestic monetary creation. This meant an automatic accommodation of the money supply towards the highest levels of overall demand and prices (through the compulsory central-bank purchase of the excess inflow of dollars). The purported automatic discipline generated by the fixed rates thus gave way to destabilizing *international money waves* (a wide fluctuation in international liquidity conditions). In fact, automatic coordination continued, though rather than disciplining the United States' policy mistakes, it merely went hand in hand and amplified them in the rest of the world (*perverse coordination*). Without an anchor capable of objectively disciplining the dominant country, not only was the source of external stability unable to guarantee internal stability but it became a vector for the transmission of generalized instability.

Under these conditions, *free-floating exchange rates* appeared as a necessary response and saving grace. Abandoning the fixed rate of exchange vis-à-vis the dollar was the only way to break the disruptive link and opt for domestic anchoring through the discipline of a self-imposed monetary policy (control of the domestic money supply through objective indicators) in order to return to domestic price stability or to have self-imposed objectives. External stability could thus result from each participant's individual achievement of internal stability —the opposite of what was expected from the Bretton Woods system, in which internal stability was supposed to result from each participant's external stability. Flotation was supposed to protect each economy from the negative impacts of policies chosen by others and in any case to absorb the divergences resulting from differences in national policies or from idiosyncratic economic cycles.

After nearly thirty years of fixed rates, exchange-rate flexibility appeared as an “anti-spillover panacea” by which the autonomy of national macroeconomic policies would be re-established while the

external impacts of the internal policies would be directly internalized in the form of national exchange-rate development. In theory, at least, a flexible exchange rate should thwart the external spread of erroneous domestic policies thereby transmitting them directly to the external value of the national currency. Exchange-rate flexibility then has more visible and stronger effects internally and makes it possible to react or to establish domestic political sanctions to correct such errors in case of misguided domestic choices.

Bearing in mind these features of the Bretton Woods system and its limits allows us to draw some conclusions and establish three universal principles:

1. The mere existence of coordination is insufficient since policies must also be appropriate; in the event of mistakes in the dominant country, coordination can even worsen the outcome for everyone. This, in turn, justifies non-cooperative attitudes and a return to the prisoner's dilemma situation, in which all players react to more powerful incentives to protect their own interests.
2. Fixed exchange-rate regimes enhance the importance of fiscal policies, which are no longer capable of self-discipline and therefore require a system of rules for imposing discipline.
3. Anchoring to a currency means adopting the monetary policy of the anchor country. Therefore, the abandonment of any autonomous monetary policy requires that other economic-policy instruments be readily available to deal with each economy's external or cyclical shocks.

3. The illusion of floating rates without cooperation, or a return to the prisoner's dilemma (1973-1984)

A generalized float of the main currencies was inevitable. In an increasingly globalized world, with the anchor country exporting inflation rather than the expected stability, there was no other course. This option, however, led to major fluctuations in the real exchange rates, accompanied by "misalignments", i.e., exchange rates that were not only misaligned regarding (distant from) the fundamental equilibria of the economies (in terms of competitiveness) but also subject to wide cyclical swings with alternating periods of under- and overvaluation.

From the very beginning of the flotation policy, the IMF and national authorities tried to maintain the principle of coordination, adjusting the rules of the system to the new circumstances imposed by flotation. First, a posteriori negotiations were necessary to formalize what the

industrialized countries had put into practice when they broke off from the fixed-parity system. Moreover, these negotiations sought to maintain a cooperation-based system with rules and thus pave the way to a more complete subsequent reform of the international monetary system (IMS).

The negotiations to give official consent to the de facto generalized float led to the **Jamaica Agreement** (January 1976) on the second amendment to the Fund's statutes, which, after ratification by IMF members, took effect on 1 April 1978. The revision of Article IV called for abandoning the gold standard as a monetary benchmark, allowed members to choose an exchange regime provided they accept a Fund surveillance formula, and promoted the principle of cooperation between members and the Fund, as well as among members themselves, to ensure *"a stable system of exchange rates through domestic [macroeconomic] stability policies"*.

However, profound disagreements on the specifics of the stability policies, which the general terms of the agreement in principle had managed to disguise, made it impossible for the expected cooperation to materialize. Moreover, the widespread dissemination of academic views on the advantages of flexible exchange rates supported a backlash of "domesticism" in the United States, as a political reaction to the previous "internationalist" approach (pitting the first Reagan economic team against its Democratic predecessors). This, in turn, led to the belief that any aspiration towards international coordination was ineffectual and counterproductive. Although criticism of the previous coordination system was well founded, the reaction against it was ideological, in its assumption that flexible and freely determined exchange rates and the application of sound national policies would automatically eradicate the need for international coordination. This strong hypothesis rested on the assumption that the economies in question would spontaneously internalize sound policies because of the effect on their exchange rates.

Although this "domesticist" reaction correctly emphasized the need to first have domestic stability policies in place, expectations for the internalization allowed by exchange-rate flexibility were overly optimistic. This is confirmed by observing exchange-rate fluctuations between 1973 and 1985 and by the widespread disappointment in the flexible exchange-rate regime. Currency markets did not achieve the theoretically expected degree of efficiency (as a result of "bubbles", "overshooting", "herding" and a lack of stabilizing speculation), and the major international currencies failed to place themselves on the same footing as the dollar. The dollar remained the international standard, and its de facto status as the only completely international currency continued to be a source of asymmetries. In practice, it was not possible to apply a policy of

generalized “benign neglect” regarding the value of the dollar, which the flexible exchange-rate policy assumed would occur. These unrecognized and uncontrolled externalities harmed all concerned, giving rise once again to prisoner’s dilemma conditions.

The self-anchoring-through-domestic-monetary-policies strategies were more complex to manage and costlier to implement. The massive substitution of assets between different currencies created new disturbances in domestic-currency demands that counteracted the application of targets to domestic-monetary aggregates.⁸ Moreover, the lack of consensus regarding a model of how economies really work and what policies should be applied, combined with greater than expected exchange-rate variations, hindered a spontaneous convergence of domestic policies among industrialized economies.

4. Managed floating through the “collegial” coordination of the G-7 under United States leadership (1985-1990)

These difficulties, added to the growing awareness of the interdependencies among the main economies, and, above all, to the perception that the dollar’s overvaluation in 1984-1985 had triggered a massive wave of protectionism in the United States, seriously undermining freedom of trade (as evidenced by complaints from the protectionist lobbies in the United States and the introduction in Congress of a large number of bills to restrict trade), led to a **radical change in economic doctrine** in the United States starting in 1985. This about-face was seen both in the exchange rate and in the renewed policy coordination with the other G-7 nations, and it was characterized by an unmistakable demand for coordination through international negotiation as a way of internalizing the new international linkages in an increasingly multipolar world.

Circumstances were now very different from in the past. The idea this time was for the major industrialized countries to jointly correct the accumulated macroeconomic imbalances among them without “crash-landing” the dollar, which could have triggered world recession. The macroeconomic imbalances had resulted in a vicious circle of domination of exchange rates by financial flows, which in turn caused further imbalances. The economic team in President Reagan’s second term, with James Baker as Secretary of the Treasury, considered, with reason, that neither the United States alone nor the operation of free markets could correct the imbalances at an acceptable cost. **Coordinated action and**

⁸ See McKinnon’s argument in McKinnon (1982a and 1982b).

the establishment of a macroeconomic directorate among the major economies were viewed as a better option.

This turnaround in the United States' position thus bore out the August 1985 report of the Group of 24 (non-aligned developing countries) and partly refuted the Group of Ten report, prepared and approved at the Bonn Summit in May of that year. The need for exchange-rate intervention and for a more "voluntaristic" coordination of macroeconomic policies was officially recognized.

This change in economic thinking imposed by the new challenges of globalization allowed Secretary Baker to build a macroeconomic monetary coalition. Initially, in 1985, the coalition was formed by the G-5 countries (on whose currencies Special Drawing Rights [SDRs] are based,⁹ that is, the United States, Germany, Japan, France and the United Kingdom). The group was subsequently joined by Italy and Canada at the 1986 G-7 Summit in Tokyo. It took up the principle of multilateral surveillance through objective indicators and set up "G-7 Finance", with the technical expertise of the IMF. Policy coordination was to be submitted to the authority of the G-7 heads of state. The main reason for enlarging the membership and formalizing policy was the need to intervene not only in the (more technical) exchange-rate and interest-rate policies but also in the (more political) budgetary policies. The United States hoped to achieve effective coordination of national macroeconomic policies to support the established exchange-rate objectives (keeping exchange rates within "target zones"). The idea, then, was to correct both the lack of coordination among domestic policies and the lack of orientation regarding exchange rates that by definition characterized the floating-rate monetary system.

Since exchange-rate target zones were not compulsory, the collegial determination of target ranges necessarily involved a collegial definition of macroeconomic policy to allow exchange rates to remain within the intended range. Thus, policies had to be brought into line with each other through negotiation, unlike the automatic mechanisms imposed under Bretton Woods.

With G-7 "collegial management", the IMS went from a floating exchange rate to target zones, with fluctuation margins intended to

⁹ Special Drawing Rights, or SDRs, are an international reserve currency issued (belatedly) by the IMF starting in 1969 to solve the Triffin dilemma. They are a basket averaging the five major international currencies (United States dollar, Deutsch mark, Japanese yen, French franc, and British pound). They also serve as the IMF's currency unit. A total of 21.4 billion SDRs were issued by IMF in two different periods (1970-1972 and 1979-1981). A third allocation, called for in 1997 by the IMF Board of Governors, is still awaiting ratification by the United States Congress.

serve only as guidelines. Still, these guidelines were supported by policy coordination through peer pressure, which was set up by regular “multilateral surveillance” exercises. This pragmatic solution recognized the crucial link between external and internal stability but avoided a predetermined causal direction (unlike Bretton Woods parities, which were predominantly “external to internal”, or free-floating rates, which were predominantly “internal to external”). This made it possible to act simultaneously in both directions in search of an international equilibrium that would favour global growth. The challenge of this attempt at coordination consisted of **introducing greater symmetry** into the adjustment effort between countries with current account deficits and those with surpluses, and thus **avoiding the traditional deflationary bias inherent to such an external adjustment** in the still-dominant United States economy.

Specifically, the following agreements were reached:

1. In the **Plaza Agreement** (New York, September 1985), the G-5 resolved to correct the overvaluation of the dollar by bringing influence to bear on currency markets through coordinated actions, exchange-rate and monetary intervention and signals in communiqués. Although mentioned, fiscal matters were not specifically addressed and, in fact, could not have been given the lack of consensus: the United States favoured a Keynesian budgetary expansion led by the two major economies —Germany and Japan— in order to force them to cut their growing current account surpluses, while these two countries feared inflationary risks and were wary of the United States’ intentions.
2. The **Tokyo Summit** institutionalized coordination through the monitoring of nine macroeconomic indicators, enlarged the G-5 to seven members and placed it under the technical oversight of the IMF staff, with the intermediation of G-7 finance meetings. The purpose was to strengthen the credibility of the Plaza Agreement and organize the transition from exchange-rate adjustment to a macroeconomic “policy mix” adjustment, particularly in the budgetary sphere. IMF participation was used to give to this exercise a more neutral and multilateral quality.
3. Through the **Louvre Agreement** (Paris, February 1987), the G-7 finance ministers resolved to stabilize the dollar (halt its depreciation) through interventions to keep it within the exchange-rate reference zones and to adjust monetary and fiscal policies to ensure the consistency and sustainability of exchange-rate objectives while promoting growth through a Keynesian stimulus of the global demand.

The idea was that exchange-rate stability with growth could only result from a compatibilization of domestic policies through an explicit sharing of the burden of adjustment between countries with current account deficits and those with surpluses in order to sustain global demand. Even the United States—perfectly coherent in its wish to provide better symmetry—tried to achieve a genuine system of coordination with *normative indicators*. This meant going from mere cooperation through the search for consensus by negotiation and peer pressure to a more formal, automatic “binding system” that would include commitments from the G-7 members, whether the arrangement was minimalistic, under a “trigger mechanism” formula with compulsory consultation in the event of deviation from the agreed-upon desirable goals, or more ambitious, with compulsory policy-correcting actions by any country whose performance diverged from the objectives that the group considered necessary for preserving policy compatibility. The different assessment of world inflation risks by the United States and the countries with current account surpluses (Germany and Japan) prevented an effective regulatory coordination agreement. Hence, Secretary Baker proposed an alternative course in September 1987 to ensure fair symmetry, a **global anchoring** of G-7 monetary policies according to the price movements of a basket of goods especially sensitive to inflationary pressure. This would have made it possible to guarantee that policy-adjustment coordination would not lead to inflation. The purpose of this proposal was to introduce a price indicator sensitive to inflationary pressures and establish a mechanism for non-sterilized foreign-exchange interventions by each country (i.e., through automatic modifications in countries’ monetary base) as a way to stabilize this indicator in each domestic currency, thereby providing a transparent domestic target and commitment. In the event of a rise in the domestic-currency indicator, all G-7 members would buy up their own currencies against reserves to appreciate their respective exchange rates until the rise of the indicator measured in their own domestic-currency was neutralized, thus absorbing imported inflation and inducing an automatic contraction of the global money supply. This mechanism would have provided an objective guarantee against any international inflationary consequences of G-7 coordination.

However, this ingenious plan was rejected by the other G-7 members. Although all the G-7 members were somewhat interested in a system with objective rules on sharing the burden of correcting imbalances, the lack of consensus on inflationary risks and on the content of possible policies, the fear of being obliged to waive certain domestic objectives so as to meet the agreed exchange-rate targets, and, above all, governments’ inability to make credible international commitments regarding fiscal policies without national legislative support thwarted the credibility of effective

coordination of budgetary policies. This combination of exchange-rate agreements and excessive rigidity of national fiscal policies led to an **unbalanced coordination** detrimental to global monetary stability. The burden of the agreements fell excessively on exchange-rate interventions and monetary policies. Consequently, **global anchoring was the real key to the problem of coordination.**

Assessments of the chosen policies continue to diverge.¹⁰ Stretching the limits of the purpose of this generic document, I would venture to say that this experience was important for both its achievements and its failures, because:

1. It offered a concrete opportunity to analyze the implications, challenges and risks of international coordination.
2. Regarding the G-7's macroeconomic impact, G-7 coordination achieved positive short-term results and had negative longer-term effects. One positive result was that it permitted the "soft landing" of the dollar and avoided a serious crisis in the world economic order at that moment. Although the G-7's action did achieve an orderly depreciation of the dollar —i.e., with no major financial mishaps, serious recession or worldwide deflation— it failed to bring about the promised stability and —as feared by the current-account-surplus countries— led to greater inflation and less fiscal adjustment, as well as to a financial bubble in the United States and especially in Japan.
3. Regarding its more systemic impact, the positive outcome was a transition towards a more multipolar monetary world in which macroeconomic decisions were more "collegial" than in the past. The negative aspect was the "(ab)use" by the United States of the deflationary risk to build a complacent "Keynesian" coalition among the G-7 members capable of isolating the "monetarist" Bundesbank (the only autonomous actor at that time) and imposing a global policy mix more consistent with United States' and French preferences, thereby postponing sorely needed budgetary adjustments by industrialized countries through excessive money creation.
4. In conjunction, these results led to another "international money wave" (i.e., an excess in the global monetary supply) and to overheating (1989), intensifying stock market speculation in general and foreign-exchange speculation in particular (the EMS crisis). This,

¹⁰ At the time, very few economists were aware of the inflationary risks. One clear example was the manifest issued by a group of prominent economists from various countries in 1988 asking for additional measures to spark global demand, precisely when an upturn was already underway.

in turn, resulted in a deepening of the European and worldwide recession of the early 1990s. Regarding international cooperation, the result was a certain loss of credibility of international agreements. Still, this negative experience had the positive effect of contributing eventually to unifying a European monetary bloc in search of its own stability. That four members of the G-7 also belonged to the European Union and three of them belonged to the EMS and abided by its exchange-rate mechanism expedited the organization of a common response as an original regional system of macroeconomic monitoring.

5. Lessons of “G-7-style” hegemonic coordination

An examination of the G-7 attempt reveals the operation of some logical forces, from which more general principles can be drawn. Despite its success at short-term crisis management, the United States—which no longer had the same relative economic weight it once had and whose currency was increasingly being substituted with competing emerging currencies—was unable to establish a sustainable scheme for macroeconomic-policy coordination through the G-7.

The basic problem was how to achieve effective progress towards greater symmetry in the IMS. This could not be done simply through a closed club holding a few meetings, mainly due to a **lack of effective fiscal policy coordination**. With the G-7, Secretary Baker’s intention was for fiscal policy to be subordinate to international negotiations, which would have highlighted common interests and thus achieved agreed-on and more balanced adjustments. Although this was a meritorious step in the right direction in both its method and its goals, Baker’s plan was predicated on two overdrawn hypotheses:

1. Baker’s assumption that, through negotiations, this closed and non-transparent club could reach decisions and implement timely, significant adjustments in national fiscal policies that would be democratically approved by the respective legislative bodies (hence, there was an institutional problem), and
2. His assumption that assessments of global inflation risks would not differ greatly among the G-7 members, and therefore that the cost for any one of them to relinquish part of its monetary autonomy would not be high.

The fundamental asymmetry introduced by the dollar’s monopoly as an international monetary standard made the simultaneous fulfilment of these two key conditions impossible. First, the United States enjoyed an

absence of an effective external constraint because it was able to assume debt in its own currency and transfer the exchange risk to its creditors (the “*exorbitant privilege*” famously decried in the 1960s by General Charles De Gaulle). Hence, the United States’ incentive to reduce its fiscal deficits was much lower than that of the other partners, causing an asymmetrical coordination to the detriment of the more fiscally rigorous countries. Second, this risk reinforced concern for global stability because the greater burden fell on monetary and exchange intervention policies, threatening the credibility of monetary policies (especially for the Bundesbank). Consequently, *the less feasible the fiscal coordination, the more difficult it was to reach an agreement regarding inflationary risks and on appropriate monetary policy stances and the greater the need for objective global anchoring, making the internal political costs of coordination that much higher*. Nevertheless, it remains difficult to understand why Baker’s anchoring proposal was so quickly and overwhelmingly dismissed, since it provided a concrete and objective solution to the differences in assessing the risk of inflation.

Bear in mind that the Bretton Woods system was abandoned due to a lack of anchoring, and the other major countries opted for a safer domestic anchoring system. Hence, any attempt to return to more rigid exchange-rate regimes would have involved replacing the individual internal anchoring systems with a credible global one. The coherent proposals put forth by Baker (and the IMF) were not enough to make a convincing argument that anchoring should stem from the discretionary coordination of the G-7 (Tokyo 1986 and Louvre February 1987) or from an automatic piloting mechanism through monetary rule (Baker’s September 1987 proposal). The fundamental reason for this was that the asymmetry of the dollar, by reducing the likelihood of balanced action vis-à-vis national budgets, entailed a greater risk of conflict between external and internal objectives and increased coordination costs, especially regarding the credibility of the central banks. The G-7 thus became ensnared in a logical contradiction: asymmetry hindered the valuation of common interests and tended to perpetuate distrust, which, in turn, undermined efforts to escape from the prisoner’s dilemma situation. Coordination was not effective, except in emergency situations, in which a shared fear bonded the G-7 members together in the short term.

In general, this review of the G-7 experiment allows us to arrive at some **initial, basic principles of coordination**:

1. No coordination is feasible without a minimum consensus regarding the underlying model and in particular regarding the evaluation of the risk of global inflation as well as how to anchor the global system (the problem of assessing the output gap, as well as of aggregating it at a global level).

2. There is an important linkage between exchange stability and national budget policies; hence, coordination of these policies is a key issue in any attempt at international coordination.
3. It is illusory and dangerous to think that a closed international club can make timely decisions regarding, and implement significant adjustments to, national fiscal policies, which by definition have to be democratically approved by the respective legislatures and public opinion.
4. International coordination requires checks and balances and the autonomy of central banks to avoid asymmetries that favour the dominant countries or that are created through collusion regarding short-term interests by political policy makers who answer to domestic public opinion. Asymmetry of information favours the members of any "international policy makers' club" and allows them to be complacent regarding the policies they implement and to impose their own view regarding the general interest (growth) and how to achieve national goals.

Chapter III

History of the emergence of the European monetary pole through economic policy coordination

The preceding chapter gave an overview of some important experiments in coordination and the steps taken by industrialized economies to manage coordination. It showed that the main difficulty of G-7 coordination was linked to the lack of progress in the regulation of global liquidity within a context of an asymmetric dollar. Such externalities provoked a European response, in the form of the development of regional coordination, as shown in section 2 of this chapter. Before spelling out this European reaction to the IMS caveats, section 1 raises the broader issue of determining the optimal level of governance and the kind of regulation a global market economy needs to operate smoothly and efficiently. The issue is deep-rooted and goes well beyond technical or economic domains since it involves fundamental philosophical choices about the kind of society citizens would like to live in, not to mention the contradiction between the “interventionist centralism” of Latin culture and the “individualistic decentralism” of Anglo-Saxon societies.

As is known, institution-building by the European Union represents an original, challenging blending of different cultures. (Roughly speaking, the European Union has brought together, for the first time in history, the three major cultural heritages that the Western World comprises: Latin, Anglo-Saxon and German.) This might be an experience of special interest for other regions, especially for Latin America and the Caribbean, when deliberating the optimal level of government needed to cope with ascendant economic globalization. This is all the more so

given the precedent of the ongoing implementation of the EMU and its single currency, the euro, since regional integration appears more clearly a possible option for a more regulated and stable globalization. Further, recent trends towards uncoordinated dollarization in Latin America, and the Argentine crisis, call for a deeper reflection on practical regional alternatives.

Hence, any consideration of the need for reforms should take account of the possible contributions of a regional approach of the IMS. The most concrete way to deal with this is to examine the euro experience and its potential impact on the IMS, which will also entail examining the relationship between globalization and regionalization.

Before addressing this aspect of European monetary unification and its possible lessons for Latin America, we need, however, to go back to the beginning of European integration, in order to assess some longer-run aspects of governance in a globalizing world as well as the close interaction between the development of European integration and the international economic system.

Hence, this chapter begins by looking back to some fundamental aspects at work in the European experience, underscoring some basic principles that still seem valid and useful for LDCs and, more specifically, for Latin American countries. Following the section devoted to recalling these important antecedents, the emergence of the euro is presented as a reaction to the externalities of the dollar and the weaknesses of the IMS. The following sections build on these two foundational sections to review in detail the main steps in the construction of the European Union's coordination scheme and put forth some practical conclusions.

1. The forgotten roots and the basic principles of the European regional integration

From the outset, the European process of integration was closely linked to macroeconomic considerations and to the external context, especially to the IMS. This is best demonstrated by focusing on the decisive contributor to the regional integration approach, who is also famous as an important analyst of international monetary problems: Robert Triffin (1911-1993). A Belgian economist trained at the universities of Louvain and Harvard before World War II, Triffin became a United States citizen and served as an adviser both in that country (to the Federal Reserve, the White House and others) and to European institutions, namely, the Organisation for European Economic Cooperation (OEEC) and the EPU, during the Marshall plan, and later for the European Commission, where he was the driving force behind the EMS and the euro. Triffin's thought provides the

best insight to understand the European concept of integration and the model on which the entire process of regional integration has been built. This understanding is a key not just for domestic reasons but also for the sake of the international order.

Triffin perceived very early, and expressed better than others, the most fundamental issue of a globalized economy. His work decisively shaped the emerging European integration and the promotion of a regional approach as a way to stabilize the international economic and monetary system. He was the first to diagnose and propose a concrete solution to the fundamental issue of the proper level of economic governance (later named the “subsidiarity principle”).

Next, the way the international economy works (or, rather, how it does *not* work very well) must be analyzed, in line with two fundamental but simple observations: First, there is a need to provide an institutional framework for international trade and payments limiting the instability inevitably resulting from a clash of national sovereignties. Since independent national policy decisions in an interdependent world cannot be optimal in themselves, there is a **need for economic cooperation** among sovereign policy makers and especially for a strengthening of the institutional framework of international convertibility, to ensure monetary and financial stability. Second, **regional cooperation** might be a useful tool to construct such an international coordination scheme, since it is an intermediate step and an efficient way to launch the required institution-building and practices that a workable global coordination scheme ultimately needs. Triffin’s conception of a stable international economic order and especially of the IMS (the convertibility issue) is based on the interconnectedness of global institutions, regional cooperation and national policies. In fact, and before the concepts were properly named, this was the “subsidiarity” issue in a “globalizing” world.

The basic issue of what is now called “globalization”, with which we are increasingly forced to grapple, was observed by Triffin as far back as 1957 when he said, “*the fundamental dilemma of international economic relations in the 20th century lies in the inadequacy of national sovereignty as a framework for policy decisions and their administrative implementation in an interdependent world*” (Triffin, 1957, p. 303). All Triffin’s work was influenced by this menacing gap, which traps national policy makers and their voters into a typical prisoner’s dilemma. Most of Triffin’s contributions to international monetary issues resulted from this systemic question, which he attempted to tackle by designing workable schemes for reducing its costly consequences for the world economy and policy-making.

Although he had “greater faith in market convertibility than in intergovernmental agreements and organizations for world trade and payments” (Triffin, 1957, p. xiii), Triffin considered that the only stable solution was the creation of an institutional framework that could introduce some degree of coordination, reducing national discretionary autonomy for the sake of preserving external stability. The Belgian economist’s solid realism, together with his cosmopolitan idealism, made him perfectly aware that this was easier to apply first among like-minded neighbouring countries sharing common cultures and similar economic conditions.

The most famous contribution he made in that direction —the so-called **Triffin dilemma**— was to warn the Bretton Woods institutions that the dollar standard, under which a national currency was used for international purposes, was a logical incongruity preventing an optimal level of international liquidity. Since the very emergence of the dollar standard, and thus well before his 1957 book, Triffin had already argued that restoring a worldwide multilateral trading and payments system through the establishment of the IMF and the reinstatement of the sterling as a key currency was doomed to fail and that new methods of regional cooperation were required, at least for Europe at that time. Thus, Triffin’s transparent bias in favour of regional rather than global agreements led him to become one of the earliest proponents of, most active negotiators for and most ardent defenders of the EPU, which filled the vacuum left by the failure of the sterling’s convertibility in 1947 and the weakness of the IMF in those early days. Indeed, in 1947-1948, the IMF dollar-denominated resources had already been exhausted and the cost of the Marshall Plan was twenty times greater than Europe’s borrowing rights from the IMF. Drawing on the success of the EPU, Triffin advanced the theory that “regional arrangements of this character, while admittedly discriminatory in some respects, can accelerate and consolidate progress towards global currency convertibility, introduce elements of stability in international economic relations, and help limit the international spread of recessions and restrictions” (Triffin, 1957, p.x).

During the 1950s, his analyses showed that the obstacles to restoring currency convertibility in Europe no longer lay “in the weakness of its economy, in its inflationary proclivities or in the shortage of dollars, but in fears and uncertainties regarding the future harmonization of nationalistic trade and monetary policies in an interdependent world” (Triffin, 1957, p.86).

I will leave it to the reader to determine to what extent this sentence, nearly a half-century old, remains crucially true regarding current-day Latin America. Further, in the light of a full decade of successive crises, starting with the ERM in 1992-1993 and the Tequila Crisis in 1994, followed by crises in Asia in 1997, Russia in 1998, Brazil in 1999, Argentina

in 2001-2002, with its repercussions in Uruguay, Brazil and Paraguay in 2002-2003, as well as ... the next crisis, it is worth recalling that for Triffin maintaining the ideal of full convertibility was impossible among fully sovereign national states without triggering a crisis.

Although, for the most part, this seems reminiscent of the propositions put forth in the 1960s in "*Mundell's triangle theorem of impossibility*", i.e., the impossibility of simultaneously maintaining autonomous national monetary policies, fixed exchange rates and free capital movements, Triffin's position goes further.

For Mundell, market efficiency is equivalent to opting for flexible rates as a way of solving the monetary dilemma through the markets. As the events after the collapse of the fixed-exchange-rate system tended to show, Mundell's position relied on the implicit hypothesis that all currencies are equivalent substitutes of each other, allowing the markets to respond efficiently to the international demand for money. It is now clear that this hypothesis did not hold in the real world. Much earlier, Triffin had already perceived the same impossibility but without presuming any triangular equivalence. History will increasingly show how right he was, and events have already demonstrated the validity of the European approach. Historians of European reconstruction and integration acknowledge that the solution finally devised for bilateralism,¹¹ thanks to the design of the EPU (with Marshall's money carrot)¹² and its consequent success, was the keystone for the post-war recovery and the creation of European Community.

Less well known but even more important is that Triffin also contributed to shaping the European approach to and method of integration. First, through the **subsidiarity principle**, although he did not use that term, by explaining the need for cooperation on and limitation of some aspects of national sovereignty over economic policies. Still, he insisted that, "*in many cases, the centralization of negotiations and decisions ... would constitute*

¹¹ This was not only regarding monetary issues (convertibility) but also trade policy. One of Triffin's important contributions was to link the two sides. He also wanted the IMF jurisdiction to be closely associated with that of the planned International Trade Organization, to ensure cohesiveness between the two.

¹² Here I must acknowledge the farsightedness and political talent of some United States leaders of the time who were eventually able to resist short-term vested interests in the United States and other industrial lobbies and adopt a strategic long-run vision of a globalizing multilateral world. They saw this as better for the United States than exploiting the country's power in bilateral schemes. They also agreed to allow Europe to temporarily derogate the non-discriminatory principle, giving Europeans both the time and the wherewithal to rebuild their competitiveness and postpone a faster sustainable opening.

*a handicap, an element of paralysis, and a source of international friction rather than an effective contribution to the solution of our problems” (Triffin, 1957, p.258). Second, with the definition of the **coordination principle** based on market sanctions, which would be finally selected through the “trial and error” process, leading to the European Union’s present surveillance and coordination of economic policies, “sovereign countries should not be expected to undertake and respect international commitments which come into conflict—real or even imaginary—with powerful national pressures or interests. Barring the use of coercion, the efficacy of international commitments depends primarily on the provisions that make their implementation both feasible and attractive and their breach unnecessary and damaging from the point of view of the countries concerned. National interests should be made to coincide, through a double mechanism of deterrents and incentives, with the collective interests of the group. Reciprocity and mutual help are the keystones of such a construction” (Triffin, 1957, pg. 246). The successes in the recent development of the European Union stem precisely from the application of these two basic principles, demonstrating once again the validity of the precursor Triffin’s approach to regional integration.*

Hence, the history of the basic principles of and successive attempts at coordination in Europe goes back fifty years. It began—at the behest of the United States (through the Marshall Plan), and in keeping with the lessons learned from the failure of cooperation during the interwar period—with the EPU and the OEEC in 1947-1948.

However, the success of European reconstruction and the speedy return to convertibility in the framework of Bretton Woods notably diminished efforts to design specific coordination arrangements, as discussed in section 3 of this chapter. Later, the collapse of the Bretton Woods regime and the failures of the successive formulas examined in chapter 2 (floating, G-7 coordination) caused by the asymmetry of the dollar contributed significantly to a European reaction. In each instance, it appears that the external context, and especially the IMS, played an important role in the development of a regional approach and European integration.

2. The European response: economic and monetary integration through coordination

Although, as described in the following sections, the formation and design of a veritable European pole of macroeconomic policies was very slow and painful, it can be viewed as a response to the externalities generated by the asymmetry of the dollar and as an operational modality for the construction of a multipolar monetary world. At the very least, the

shortcomings of the IMS played a significant role in the European process, first by creating obstacles but also by gradually giving rise to the will and the means to overcome them. This does not mean that the European integration process would have been either slower or faster without these occurrences but simply that regional integration must be analyzed in the light of the external context in general and that of the IMS in particular.

Both the floating-currency regime and the hegemonic-cooperative G-7 regime (which systematically ignored the EMS) were initially a source of divergence and internal conflict within the European Community. The general dissatisfaction with and reaction against the asymmetry imposed by the dollar and the use of the G-7, however, served as a catalyst for the EMS and regional integration. A series of forces was mutually strengthened, leading to a regional response of greater import for the IMS.

1. Flexible exchange rates among the currencies of the Common Market were perceived from the beginning as a source of conflict and divergence inconsistent with the Community's objectives.
2. In addition, flexible exchange rates were perceived as unattractive or much less attractive to the small or even medium-sized countries, whose exchange rates were used as an intermediary instrument of monetary policy in their search for stability. This explains the progressive development of a regional European system anchored to the deutsche mark (DM), with the latter anchored to an internal monetary principle, the "M3" monetary aggregate. This regional regrouping via parities with the DM (the "snake") and subsequently via a more symmetrical basket system (the EMS and the ECU) was a significant step towards a multipolar monetary system.
3. Another step (or at least an additional force) arose from the need to overcome the external effects that the increasingly frequent but unstable substitution between the dollar and the two emerging key currencies (the DM and the yen) generated both inside the EMS and for the German anchor. The emergence of the international role of the German mark, combined with the wide fluctuations in the value of the dollar, caused asymmetrical shocks to European economies beset by speculative capital movements, intensifying tensions among the Community's currencies and requiring countervailing national monetary policy reactions pulling in conflicting directions and generally inappropriate for domestic objectives. These speculative capital movements jeopardized the EMS and disrupted the management of the M3 aggregate itself, threatening the credibility of the Bundesbank's monetary policy as well as weakening members' sense of belonging to a community.

4. Moreover, in the light of the need for a more collegial management of exchange rates and of the policy mixes that sustained them, not only did the membership of four of the seven G-7 members in the European Community undermine Europe's leading role but their divergences impeded the Europeans from speaking in a single voice. Nor was the existence of the EMS, to which three members of the G-7 belonged, recognized. The United States managed to build alliances within the G-7 that divided the Europeans. The effects of the G-7 agreements at the Louvre and in late 1987 demonstrated the need for the European Community to achieve greater macroeconomic cohesion to correct the asymmetry of the respective impacts: whereas the United States exerted much macroeconomic influence on each European country, none of these countries could have sufficient impact by acting alone. Even in the monetary sphere, Baker's collaborative strategy pressured the Bundesbank from 1986 to 1988. The German central bank's legal autonomy found its limits when the bank became aware that its economic base (the German economy) was much weaker than was its de facto monetary role (as the anchor of the EMS and partial substitute for the dollar). By continuing to go it alone, Germany was exposed to overvaluation shocks and to arousing hostile reactions to its autonomous monetary policy. What was needed to achieve German monetary stability was progress beyond the coordination of European positions in the G-7; this, in turn, required establishing a more effective intra-European coordination mechanism capable of consolidating the EMS and reducing or overcoming European monetary segmentation.

These arguments converged to prompt the different European actors to search for a formula for effective coordination among themselves, and mainly to improve management of the EMS. Both sides—the German government and the independent Bundesbank, and the less-stable countries or those requiring major policy adjustments—gradually discovered the costs that monetary segmentation imposed on their respective policy mixes. There was an increasing awareness that all were on board the same ship, that it had sprung a leak, and that those on the bridge and in the first-class cabins could not survive without joining forces with those on the lower decks.

To counteract the effects of the dollar's asymmetry and the G-7 on the EMS, Germany needed more stable monetary policies throughout Europe, while its less-stable European partners were interested in leveraging German credibility to escape from speculative shocks and reduce their punishing interest-rate differentials (which exacted a high cost for growth, jobs and public finance). Germany could accept sharing its monetary power in exchange for a system of coordination that guaranteed common

discipline in both the monetary and budgetary spheres. This **disguised promotion of the role of the Bundesbank to the European level** was the main function of the Euro Project and one of its driving forces, insofar as it created a win-win game for all partners.

However, to fully understand how it was possible in the European case to design an effective coordination device with the aim of reducing European vulnerability to external shocks and consolidate its regional integration, we must review, step-by-step and from the beginning, the long historical process of its implementation.

The Bretton Woods regime provided a strong boost to European reconstruction, by bringing a return to monetary stability and convertibility, thereby ensuring a system of automatic coordination, as described in chapter II, section 1. It should be stressed that trade integration in Europe was possible because the countries put their macroeconomic systems in order prior to establishing preferential trade-liberalization agreements. **The return to macro-monetary stability was thus a prerequisite to trade integration**, which is often overlooked when monetary unification via the euro is viewed as merely the crowning moment of the single market (see chapter VI, section 2, below).

In the late 1960s, when global inflation was accelerating and a period of exchange and monetary instability had begun, Europe perceived increasing risks to the continuation of its regional integration. The need for the Continent to consolidate its own stability through greater regional cooperation became more apparent than it had been during the years of external stability. The Common Market was threatened by members' floating their currencies. Even the December 1971 Smithsonian Agreement decision to broaden the fluctuation bands regarding the dollar from 1% to 2.25% risked potential extremes on the order of 9%, if one European currency sank to the floor of the band and another one rose to upper limit (thereby doubling the 4.5% band). In this period of fixed exchange regimes, but with a broadened band, the management of a single agricultural market was already proving extremely difficult and costly.

This need to react to external shocks and to the asymmetry of the dollar explains the existence of a European monetary agreement and the subsequent need to strengthen it through a system of coordination of other policies.

Let us now examine in more detail the basic principles and the successive steps that were followed in the European case, chronologically and with a view to drawing some general lessons.

3. First coordination attempt in the 1960s and early 1970s: discretionary coordination

The Treaty of Rome (1957), which created the European Common Market (a customs union with the addition of some common policies), envisioned neither the transfer of sovereignty and institutional devices nor coordination rules in the macro-monetary sphere. The initial Treaty simply established a general principle of coordination of national economic policies by the Council of Ministers (former Article 104), and this only to the extent necessary to achieve the Treaty's objectives. Member States were allowed to decide the scope and limits of this coordination (former Article 6).

The business-cycle policies of the Member States were considered "matters of common concern" (Article 103). In the monetary sphere, the Treaty stipulated only that the foreign-exchange policy was a "matter of common concern". To supervise this, however, the Treaty created a consultative body—the Monetary Committee—made up of representatives of the central banks, ministries of finance and the European Commission (former Article 104), entrusted with coordinating relevant policies. The Committee played a key role in coordination.

In this context of "subsidiarity", the European Commission proposed giving operational substance to the rather vague principles of the Treaty, through the adoption of "secondary legislation" by the Council. These Council decisions settled practical modalities of cooperation among national administrations under a coordination mandate given to the Commission. Through these centralized procedures, the Commission organized several macroeconomic committees (the business-cycle policy committee, in 1960; the medium-term policy committee and the Central Bank Governors Committee, in 1964; the budgetary policy committee, in 1965) in a centralized framework, with a view to unifying and preparing a future federal power in Brussels.

With the emergence of macroeconomic imbalances in the Bretton Woods system and the resulting inflationary pressures, national policies started to show significant divergences, giving rise to monetary instability in the Community. In response to this threat to the Common Market, the coordination procedures were consolidated:

- 1969: obligatory prior consultation for any economic-policy decision at a national level; Barre plan for policy coordination and monetary unification; The Hague Summit.
- 1970: Werner Plan for monetary union.
- 1971 and 1972: resolutions on economic policy.

- 1974: directive on stability; decision on economic convergence; merger of the three non-monetary committees into an Economic Policy Committee; establishment of an Annual Economic Report on the Community economy.

All these measures contributed to the establishment of a rather sophisticated system, with quantitative objectives and formal procedures to coordinate national economic policies through a process centralized at the Commission, and as a first step towards the transfer of macroeconomic sovereignty. This centralist system leaned towards budgetary activism and the fine-tuning typical of the intensified Keynesian stance of the times.

These actions, however, resulted in a serious failure of coordination: despite their juridical sophistication and centralist nature, the formal procedures were utterly incapable of ensuring a minimum degree of convergence within the Community. The reason for this failure lay simply in each national administration's different economic-policy proposals, i.e., the lack of consensus on the specific economic policies. Combined with some asymmetries of external shocks, these policy differences led to varying economic results and lower growth in the Community.

The failure of this first European coordination experiment provides two major lessons (Ghymers, 1995) that make it possible to formulate **two basic principles for economic-policy coordination**:

1. No centralized policy-coordinating procedure among a group of sovereign countries can succeed if national decisions on their concrete content diverge. Stated in the affirmative, this negative lesson can be formulated as a general principle: *when economic policies continue to be the responsibility of national governments, the effectiveness of any coordination system depends fundamentally on its ability to contribute positively to a consensus among national political policy makers*. That is, content takes precedence over procedure; what is important is not so much the institutional aspect—the establishment of obligatory formal procedures—but the ability to narrow down the differences in economic analyses and choices through the development of appropriate incentives likely to interest national authorities in exchanging opinions and information.
2. In this context of decentralized economic policies, and given that national governments cannot sacrifice their own goals for the sake of others', coordination stumbles into a prisoner's dilemma: national governments tend to act individually even though doing so may harm not only their neighbours but also their own country. This observation can serve to devise a second affirmative principle and escape the dilemma: *Priority should be given to cooperative systems*

capable of further internalizing the effects of national policy or making them more visible in order to stimulate self-discipline and protect countries' own interests (market-based rewards or sanctions to national political leaders).

4. The second coordination experiment (1979-1987): rules for collegial management of the EMS

Towards the end of the 1970s, macroeconomic divergences and the associated poor economic results, disappointment in flexible exchange rates and a soaring dollar all encouraged political consensus on the need to restore cohesion and stability within the Community through some kind of common discipline. The negative experience of exchange-rate instability encouraged making a top priority of the search for greater external stability, considered the most pragmatic way of indirectly imposing the minimum discipline required to achieve internal stability.

The 1978 creation of the EMS¹³ came in response to this change both in macroeconomic strategy (towards favouring policies stability policies) and in the approach to European coordination (towards a self-imposed discipline through exchange-rate stability). Simply stated, the EMS constituted a transition from *a discretionary form of coordination to a rules-based system*. A major innovation of the EMS was the shared nature of any decision on parities between participating currencies, because these parities were defined in reference to a common basket (the ecu). Formally, the EMS was a set of bilateral agreements among national central banks, which were given greater responsibility and functions in a process that would lead to a notable increase in their role in setting European policies. This institutionalized participation thus made it necessary to hold ongoing collegial discussions on the national policies that were causing foreign-exchange pressures, and particularly to change discourse between the central banks and the ministries of finance at a national level. Specifically, political coordination among countries and between monetary and fiscal authorities was no longer a discretionary administrative procedure but the result of a self-motivated discipline,

¹³ The President of the Commission, Sir Roy Jenkins, launched the EMS process in October 1977 through his "Florence speech", based on papers prepared by the DG for Economy and Finance (formerly, the DGII) and by Triffin, with a small consultative group from the University of Louvain-la-Neuve. Not until 5 December 1978 did the Council publish a resolution to this effect and did the central banks establish operational bilateral arrangements, for entry into force 1 March 1979. The EMS was in fact the belated materialization of some of Triffin's early proposals issued in the framework of the EPU and its transformation into an EMU, in November and December 1957 (Memorandas sur la création d'un Fonds Européen de Réserve).

because it was the only way to ensure that the rules of the game would be respected and that the EMS stability objectives would be attained, in the interest not only of each Member Country but also of each individual authority (central bank and finance ministry). The EMS, with its emphasis on exchange-rate performance and the factors that determine it, permitted **an authentic internalization of the external effects of national policies**: any divergence in monetary and/or fiscal policy had even stronger consequences on exchange rates, and the institutionalized commitment to parities increased the visibility and political cost of non-compliance. This internalization helped solve the fundamental problem of coordination—how to impose a common discipline—because, with its “hands tied”, each political authority was more motivated to adjust its own behaviour. Thus, coordination progressively became the automatic result of an optimal combination of national policies under compulsory rules and *vis-à-vis* some markets, capable of genuinely sanctioning national authorities.

During this learning process, the **Bundesbank’s credibility and anchoring were crucial**. The fixed exchange-rate option (ERM) made it possible to disseminate the German monetary standard of stability to the benefit of all participants: Germany reduced its risk of being harmed by the instability of its main partners (and particularly the risk of overvaluing its own currency) while its partners were able to diminish their disinflation costs by “borrowing credibility” from the DM, thanks to the EMS and under the threat of the visible political cost of non-compliance. In effect, after a difficult start in the middle of the second oil crisis, the strong recession of 1981-1982 and some last attempts at divergent policies, macroeconomic strategy was adjusted in the direction of stability—both external and internal—throughout Europe. The resulting convergence restored growth and employment and paved the way to stronger integration, especially through European currency unification.

These successes, based on the intelligent coordination of “market-conforming” principles, confirm the two negative lessons of the failed attempts of the 1960s and early 1970s, which were based on centralized modalities, making it possible to more explicitly formulate the two previously mentioned **basic principles of coordination**:

1. *Consensus on economic policies is a necessary condition to ensure the success of coordination*. It requires that countries have a similar vision of the workings of the economy, i.e., a minimum degree of agreement on “underlying economic model”.
2. Institutional or practical modalities of coordination play two primary roles: first, in progressively *building a cooperative culture and a climate of trust through personal contacts among technical decision makers in order to encourage emulation and cooperation among national authorities*; and

second, in establishing, through rules and procedures, some *visible signals to inform public opinion and the markets* of the advantages of their policies. This makes it possible to accelerate the rewards or sanctions given to national authorities. In the EMS, the most important linkage was established between a commitment on parities and the credibility of national economic policies, with rewards or sanctions being determined by the reaction of the financial markets.

5. First multilateral surveillance exercises (1987-1989)

Based on this experience, the Commission submitted a proposal to the Council to consolidate, through legal channels, the established practices and collaborative work of the national experts in the ERM management. By early 1987, a confidential regional-surveillance exercise between national experts and the Commission was established in the Monetary Committee (based on a technical evaluation presented by the Commission) to improve the stability of the parity grid. This initiative responded to, and took advantage of, the Baker initiatives in the G-7, within the context of the dollar crisis. Macroeconomic surveillance, based on indicators and implemented at the Tokyo Summit (1986), would have been impossible without the collegial management of the EMS. In effect, the Community had to make the ERM operation compatible with the commitments acquired by three of its G-7 members—in particular, the exchange-rate and intervention objectives.

The positive result of this informal but explicit surveillance of the ERM operation, as well as the Council's decision to carry out the first stage of the EMU process in July 1990,¹⁴ led the Council to establish formal surveillance of the convergence required in preparation for the EMU during this first stage: a new "convergence decision" was issued to create a regional system of mutual surveillance.¹⁵ This institutionalized the confidential exercise already in place, and its implementation served as preparation for the provisions set forth in the Maastricht Treaty regarding economic-policy coordination. In 1991, a complementary element was

¹⁴ The Madrid European Council, in June 1989, endorsed the Delors Report (commissioned by the Hannover European Council one year before) and called for an intergovernmental conference to revise the Treaty with a view to establishing an Economic and Monetary Union. However, the Delors Report concluded that the first stage of this EMU did not require any amendment of the Treaty. Therefore, 1 July 1990 was chosen as the starting date for the EMU in order for it to coincide with the complete liberalization of capital movements decided on in the context of the single market.

¹⁵ Council Decision of 12 March 1990, EEC 90/141.

introduced: multiannual “convergence plans” that the Member States undertook to abide by and to submit as their own commitments to the Council for approval.

At the end of the 1980s and during the first stage of the EMU, an a posteriori evaluation of this first surveillance exercise was critical of the results. Because the system was excessively based on peer pressure among decision makers, it relied too much on understandings among Member State authorities. The “behind-closed-doors” work gave the exercise an overly “intergovernmental” character rather than an authentically shared approach capable of imposing a common discipline. The system only worked during the “good times” and with the implicit understanding that it had an anchor (the asymmetrical role of the German DM). In fact, when a succession of external shocks (the decline in the dollar and the reflationary pressure exerted by the United States in the Louvre Agreement, the crisis meeting of the G-7 after the October 1987 stock-market crash, the financial consequences of the fall of the Berlin Wall) weakened the EMS anchoring, the provisional surveillance system that should have been triggered to impose the required discipline went unused. The loss of ERM asymmetry gave the false illusion of easy convergence, while the “institutionalization” of regional surveillance gave the markets the even more misleading illusion that progress was being made towards coordination and macroeconomic management in Europe. The result, in a certain sense, was biased free riding and moral hazard.¹⁶ The markets overreacted (out of “Eurooptimism”, or pro-convergence speculation or in response to “convergence trade”), mitigating the pressure on public-finance consolidation and relaxing monetary policies through the “ERM paradox” (The traditionally weak currencies rose to the upper limit of the ERM band, forcing authorities to relax their monetary policies beyond what had been agreed). Hence, the blind use of coordination through automatic rules resulted in a macroeconomic imbalance that led to poor results in convergence and, finally, to a combination of unbalanced policies throughout the European Union that prolonged and deepened the 1991-1993 recession.

Paradoxically, the conclusion is that this failure was caused more by a lack of coordination than by shortcomings in the existing system, inasmuch as the system was misused for political reasons.

These errors stemmed mainly from a conjunction of rare events, including that the 1990 convergence decision was designed only for a

¹⁶ Ghymers, C., 1991.

brief, transitory period until a new, more powerful instrument could be introduced through the new Treaty, whereas the political negotiations on the new Treaty hindered the full use of available instruments: for instance, the possibility of making the surveillance documents public and publishing the recommendations directed at certain Member States in a timely fashion (Aglietta and Ghymers, 1993). Despite these understandable mistakes, this experience shows that one of the two basic principles taken from the past was disregarded. In not publishing the surveillance results and the specific recommendations to the countries, national authorities, in a certain sense, colluded to “cheat the markets” and delay their negative reactions, thus attempting to reap only the benefits of the positive reactions.

This leads to the formulation of a **third universal principle of coordination**, which explains the difficulty during this period in applying the second principle. Since, just as does any other organization, governments and authorities have their own interests, which do not necessarily coincide with the general interest, there is a **risk that national authorities will collude and become complacent**, using any coordination system as a tool to enhance their manoeuvring room. This risk is a permanent feature of any governmental behaviour, but it is also one of the main incentives for national administrations to accept entering into coordination systems. Although not necessarily harmful, collusion can be a “perverse deviation from coordination” that takes place when coordination is badly designed or poorly balanced. *The challenge is to design a set of arrangements that allows certain countervailing forces to be developed to prevent national political authorities from being the sole arbiters of their actions.* Governments reach agreements to gain time and increase their discretionary powers, protecting themselves against market sanctions by monitoring the issuing of signals to the public, as occurred in Europe with the first surveillance mechanism in the 1990-1993 period, in which the Council of Ministers acted as judge and jury and encroached on the Commission’s role. At other times, governments naturally tend to reach agreements to obviate the usual political or macroeconomic obstacles—for example, by setting up smokescreens to shift priorities and juggle certain rules, strengthening their positions so as to make unpopular decisions, or even blaming others for their failure to act. Experience, in Europe and in the G-7, shows, however, that this type of damaging collusion occurs when there is insufficient competitive pressure among the different national governments and/or between fiscal and monetary authorities (specifically, when central bank autonomy is insufficient).

6. Maastricht: surveillance in Stage II of the EMU (1994-1998)

Contrary to the predictions of many macroeconomists, the serious recession of 1991-1993, aggravated by poor macroeconomic management and insufficient coordination during Stage I (see preceding section), produced a favourable reaction. It consolidated the consensus on the strategy for macroeconomic stability and the need for more effective coordination, which was in the interest of each government and central bank. The ERM rules had to be changed in August 1993 when exchange-rate turbulence necessitated broadening the band to restore a two-way bidding in the markets and increase each authority's individual responsibility for exchange-rate performance (one of the Treaty's criteria for joining the euro). And, in effect, national authorities did not use this broader band to relax the agreed-upon discipline and change macroeconomic strategy. In general, they managed their policies to adjust voluntarily to a narrower flotation band and submitted "*multiannual convergence programmes*" to their parliaments and partners for approval by the Council. The governments intended to tie their own hands by committing to visible and detailed goals. In exchange for demonstrating their determination through these self-imposed commitments verified by the Council (and financial markets), they hoped to gain credibility in their efforts to meet the conditions for entering into the single currency pursuant to the criteria and schedule set out in the Treaty.

Towards the end of 1993, once the Maastricht Treaty had been ratified, the **new regional surveillance system** immediately entered into force and was implemented. This gave way to a new range of experiences in consolidating economic policy coordination to prepare for the single currency regime. Maastricht surveillance, in fact, institutionalized practical procedures that had emerged from a process of "natural selection" among different attempts over more than thirty years. The Treaty's articles on economic policy (102-A-104-C) formalize pragmatic experiences to create an economic-governance system among decentralized political authorities.

In Stage II of preparation for the single currency, economic policy was designed as follows:

1. Economic policy continues to be the responsibility of the Member States, but they are to conduct their policies with a view to achieving Community objectives and respecting the guidelines established by the Council (Article 98).
2. National economic policies are a matter of common concern and must be coordinated within the Council (Article 99.1). The main tools

are “the broad guidelines of the economic policies of the Member States and of the Community”, the preparation of which follows a detailed procedure. (As set forth in Article 99.2, the draft recommendations of the Commission are sent to the Monetary Committee, which discusses them and from there issues its own draft recommendation to the European Council of Economic and Finance Ministers [Ecofin].) The Ecofin Council, acting by a “qualified majority”, issues a report and submits it to the European Council. The European Council discusses a conclusion based on which Ecofin, by qualified majority, publishes a recommendation for broad guidelines and informs the European Parliament. These guidelines are the reference point for *multilateral surveillance*, a collegial process of monitoring, analyzing and assessing the economic situation and policies through periodic reports submitted by the Commission, by way of the Expert Committees, to Ecofin (Article 99.3). Where national policies are found to be inconsistent with the broad outlines or with the proper functioning of the EMU, the Council may, acting by a qualified majority and on recommendation from the Commission, make the necessary recommendations to the Member State concerned and may, for dissuasive purposes, decide to make its recommendations public (Article 99.4). These procedures may be further specified or improved through derivative legislation (Article 99.5).

3. As a complement to the general principle of coordination and to the multilateral surveillance provisions that the system applies to any economic policy (whether macroeconomic or structural), a set of rules has been established to guarantee a minimum degree of *budgetary discipline* in all Member States (and not only in those that wish to join the euro). Given that budgetary policies continue to fall under the full responsibility of the Member States, the Treaty contains strict mechanisms to avoid conflicts between budgetary and monetary policies and any imbalance from policy mix (i.e., budgetary policies that overburden monetary policy and have negative effects for the EMU and the Community). Articles 101, 102 and 103 prohibit monetary financing of budgetary deficits, privileged access by the public sector to financial institutions and support to commitments made by governments or public authorities, respectively. Excessive government deficits are prohibited under Article 104, but this provision is not fully applicable during Stage II, and thus Article 116.4 establishes that prior to Stage III, Member States will attempt to avoid such deficits. To allow the Commission and the Council to assess these efforts, Member States are to submit *multiannual convergence programmes* aimed at consolidating public finances and through which they commit to achieving quantified goals.

This transitory period was difficult, because it focused entirely on achieving nominal convergence. Nevertheless, the application of the new coordination system was effective and in the end very positive. It was largely based on the same kind of market pressures as those in Stage I, although the new forms of pressure were much more effective. In fact, budgetary conditions had deteriorated notably as a result of a combination of unbalanced policies (high deficits and rigorous monetary policies), leaving governments no choice but to apply stability policies and reap the benefits of belonging to an institutionalized regional system to enhance their credibility, in view of the prospect of adopting the euro. The last exchange crisis of Stage I, which arose in 1995 because of market concern over the credibility of some Member States' budgetary policies, showed the impossibility of deceiving the markets and that compliance with the convergence criteria was, in any event, a necessary condition for returning to sustainable growth, even without a single currency. When credible efforts were made, market expectations contributed significantly to feed a virtuous circle of convergence through the reduction of the high risk premiums on interest rates. Budgetary consolidation was thus self-validated by "positive market sanctions" that radically diminished adjustment costs for all concerned (lower interest payments on the budget as well as to private agents, improving the prospects for future demand and activity).

This period offers **three major lessons**:

1. "*Non-Keynesian effects*" of credible budgetary consolidation, which made it possible for private demand to overcome the negative effects of deficit reduction. Growth cannot be inhibited by measures intended to improve "the fundamentals" of an economy, because it depends more on the prospects for future demand than on the present situation. The positive effects on expectations can mitigate the direct effect of fiscal-deficit reduction, especially if such a reduction is the result of lowering expenditures and not increasing taxes.
2. The markets perceived the systemic improvement of the European Union's policy formulation through the EMU and its institutional regional surveillance. This contributed appreciably to reducing the adjustment cost in most Member States, making their policies more credible and less revocable. *Coherent regional integration can make a major contribution to institutional progress necessary to improve conditions for growth.* Establishing a pragmatic mechanism of mutual surveillance over national policies at a regional level is particularly useful for improving national policy credibility.
3. One important aspect of European cooperation on economic policies is its "*learning by doing*" component, essentially based on the

interaction of two principles: the exchange of best practices among parties (not only among ministers, but, especially, among national experts), and market pressures that permanently test and question the credibility of the authorities and their policies. These dynamics seem to be underestimated by some economists when evaluating European policy formulation, because they overlook that this is an “intrinsic” mechanism resulting from the broad collegial efforts of the experts from the different agencies involved.

Although the European coordination system was left incomplete and was biased in favour of the discretionary power of the Council (for example, during Stage II, Ecofin did not issue specific recommendations to any country), the race to the euro during Stage II was sufficient for national policies to converge to an impressive degree. Moreover, this successful application of new approaches to policy formulation in the Community led to successive improvements and pragmatic corrections with an eye to Stage III—hence confirming the learning-by-doing character of European economic governance (application of lesson no. 3).

In effect, the end of Stage II introduced new elements that helped to perfect the operating modalities of the coordination process:

1. First, the awareness of the need to progressively consolidate coordination in Stage III, in particular with a view to compensating for the disappearance of market sanctions on euro-area members, led to agreement on the Pact for Stability and Growth at the Amsterdam European Council in June 1997.¹⁷ The pact was intended to ensure, through formal, binding procedures, an effective budgetary discipline in Stage III: nearly balanced or surplus budgets under normal economic conditions (see following section).
2. The broad guidelines had favoured nominal convergence on the path to the EMU; nevertheless, macroeconomic issues such as growth and employment, and structural problems with, for example, the goods and labour markets, have gradually gained ground during the last two years. According to the rationale of the Treaty, the broad guidelines not only define the combination of overall macroeconomic policies pursued within the framework of the EMU's common monetary-stability policy but also must indicate the contribution that other economic policies, including fiscal and structural policies, should make towards the objectives of the Community (in particular, a high employment rate, as set forth in Article 2). The broad

¹⁷ European Council Resolution of 17 June 1997, Council Regulation of 7 July 1997 EC no. 1466/97, and Council Regulation of 7 July 1997 EC no. 1467/97.

guidelines are, then, an expression of the requirement that economic policies be considered “*a matter of common concern*”. Similarly, the Amsterdam European Council issued a **Resolution on Growth and Employment** that proposes coordinating structural policies having a strong potential to stimulate the economy. The Resolution sets forth the firm commitment of the Member States, the Council and the Commission to expand economic-policy coordination and enhance its effectiveness through the broad guidelines, with a special focus on employment policies. To this end, the European Council outlined different problems and issues to be addressed through the broad guidelines in order to make specific recommendations to the Member States. In conformance with the principle of subsidiarity (Article 3b), the broad guidelines are to take account of the national multiannual employment programmes (or national action plans) that the Member States commit to submit, inasmuch as employment measures are their responsibility. The Council also requests the **social partners** to live up to their own responsibilities and recommends full use of consultation and social dialogue in the coordination process. To improve coordination, the European Council, in the Presidency’s conclusions, urges Ecofin and the Commission to examine how to improve coordination procedures.

3. In addition, the European Council requested the Council to try to immediately carry out the relevant provisions of the new Treaty’s section on employment, so that the **Employment Guidelines** —a new procedure to coordinate labour-market policies among the Member States that should be consistent with the broad guidelines— could thereafter be applied to improve job creation. This was put into effect at an Extraordinary European Council on Employment in Luxembourg on 20 and 21 November 1997, which, in practice, made it possible to move up to 1998 the application of future Article 128 of the new Treaty, on Member State coordination of employment policies. Based on this, the Council (Labour and Social Affairs) adopted the first employment guidelines on 15 December 1997. In keeping with these guidelines, in April 1998 the Member States submitted their national action plans regarding employment in the agreed-upon form and structure.
4. In December 1997, the Luxembourg European Council adopted a **Resolution on the Coordination of Economic Policy** reiterating that Ecofin is the only decision-making body in the coordination process, in particular regarding the adoption of broad guidelines, the main instrument for economic coordination. To exercise multilateral surveillance, Ecofin was to meet in restricted sessions (ministers plus one) in order to stimulate open and frank debate. However,

the Resolution explicitly sets forth that such coordination should “respect the competencies and responsibilities of the social partners in the wage formation process”. It also calls attention to the crucial importance of “an ongoing and fruitful *dialogue between the Council and the European Central Bank*, with the participation of the *Commission*”. To this end, the recently created Economic and Financial Committee (formerly, the Monetary Committee), which comprises the ECB, the central banks, national Finance and Commission officials, provides the framework for preparing the dialogue. Moreover, the Council requested supervision of the Member States’ structural policies in the labour, goods and services markets, which are part of the overall economic-policy framework covered by the broad guidelines. In its report to the European Council, Ecofin requested the consolidation of the role of the Economic Policy Committee (with composition similar to that of the Economic and Financial Committee) in the preparation of Ecofin meetings, in particular when structural policies are to be discussed.

5. The same Luxembourg European Council created the **Euro-Council**.¹⁸ The Council is informal and allows euro-area members to discuss problems related to their shared responsibilities in the presence of the Commission and, when applicable, of the European Central Bank. This new forum was inaugurated immediately after the May decision on Member States that met the criteria for joining the euro, and it was decided that it would meet prior to each Ecofin meeting. The Council regularly addresses coordination issues and closely examines budgetary issues. Although not a decision-making body, it has already proved its usefulness and effectiveness in reaching and improving consensus on the policy mix in the Euro Zone. The shared interest in the common currency is a strong incentive for Member States to intensify their dialogue and search for the best combination of policies through genuine debate, thereby improving the results of Ecofin. The Commission plays a central role in the laying the groundwork for these meetings, ensuring their continuity and “communal”, non-intergovernmental character. The European Central Bank’s president usually attends, which permits an exchange of views on monetary and budgetary policies.
6. In May 1998, at the European Council meeting to decide which Member States were eligible to join in order to move to Stage III of

¹⁸ The Euro Council became Euro-11 once 11 countries met the requirements for joining the Euro Zone, and Euro-12 in 2001, when Greece was accepted and became part of the single currency.

EMU, Ecofin published a Declaration on the EMU and decided that the Pact for Stability and Growth would enter into effect on 1 July 1998 and not 1 January 1999 as mandated by the regulation.

7. After the informal Ecofin meeting at York on 21 March 1998, the declaration of 1 May and the Ecofin of 19 May, the Cardiff European Council met on 15 and 16 June and welcomed the Ecofin involvement in the work on economic reforms in the labour, goods and capital markets, which established a streamlined procedure for goods and capital. This involvement —named the **Cardiff Process**— was to consist of multilateral surveillance of structural reforms in the European Union economies and translate into political recommendations based on the broad guidelines and a system to monitor the recommended reforms. The conclusions of the Cardiff Council Presidency called for Member States and the Commission to submit, before the end of the year, brief reports on their spheres of competence related to the goods and capital markets. On the basis of the reports, the Commission was to draft a brief report on structural issues and policies, to be discussed at the Economic Policy Committee and other Council forums in the context of surveillance and the preparation of the broad guidelines.
8. The European Council underlined that economic reform must go hand-in-hand with **social dialogue** and be based on specific studies of comparable progress indicators, to ensure the effective contribution of the social partners.

7. The macroeconomic regime of the euro: Stage III of EMU since 1999

As described in preceding chapters, the pace of the experimentation process and of the progressive improvements in coordination increased greatly with the introduction of the euro. Aside from the well known, traditional argument that greater integration increases the need for coordination, a specific element of political economy was added through sharing this common good —the single currency. By definition, the disappearance of national currencies also eradicated the main source of accountability for (or identification and internalization of) the effects of national policies, via market sanctions, on exchange rates and national exchanges. This, in turn, undermined (strengthened) the currencies of countries that implemented divergent (convergent) policies. It was therefore essential to compensate for these **new free-riding and moral-hazard risks**, through an adequate reinforcement of the institutional monitoring and coordinating mechanism among the countries that shared

the single currency. The Treaty had prepared for this with the regional “surveillance” mechanism (Art. 99) and the principle of progressive sanctions against countries failing to abide by the budgetary-discipline criteria (Art. 104). It was the role of the **Pact for Stability and Growth** of 1997 to give more credibility to these principles by specifying the operating modalities for their application, and this was complemented by a specific **macroeconomic dialogue** for gathering the social partners with all the other actors of the policy mix in closed-doors meetings twice a year (**Cologne process** of 1999).

Indeed, the European coordination mechanism designed to manage Stage III of the EMU institutionalizes the practical procedures that, through various attempts, had withstood a “natural-selection” process lasting over 30 years. The Treaty’s articles on economic policy (98 through 104) are a formal expression of pragmatic experiences to create an economic governance system among decentralized political authorities. Each authority faces a single monetary policy, which imposes an overarching objective of pricing stability on all actors.

European economic governance is characterized by a combination of three basic principles: subsidiarity, autonomy and regional coordination through mutual surveillance. These principles are applied to three main categories of independent actors operating at very different levels of sovereignty but whose responsibilities are clearly identified:

1. There is a single, autonomous supranational (i.e., of a federal nature) monetary policy with an imposed, formal objective: to ensure domestic price stability in the euro area.
2. At the national level, budget and structural policies remain decentralized (the Member States are sovereign) but are a common concern and are therefore subject to mutual monitoring and formal coordination procedures.
3. The mechanisms to establish labour conditions (mainly wages) are left in the hands of autonomous social partners (workers unions and employer organizations) and operate without any unified or common framework at the Community level—that is, they conform to very different types of national practices (whether centralized at the national or sectoral level, regulated or informal, geographically decentralized, or even determined by individual companies).

This combination of practices is modelled on an experimentally tested combination of coordination provisions that clearly define economic policy and the responsibilities of the three main autonomous groups of actors, with a view to achieving the Community’s objectives. Within this framework of ongoing dialogue and monitoring, the interactions among

these three autonomous poles create the euro area's macroeconomic policy mix and lead to an authentically agreed-on stance *vis-à-vis* economic governance. The driving force behind this coordination formula is the growing mutual interest that the European Union members find in their economic achievements.

A brief recapitulation of the **architecture of the mechanism**, with its procedures and instruments, follows.

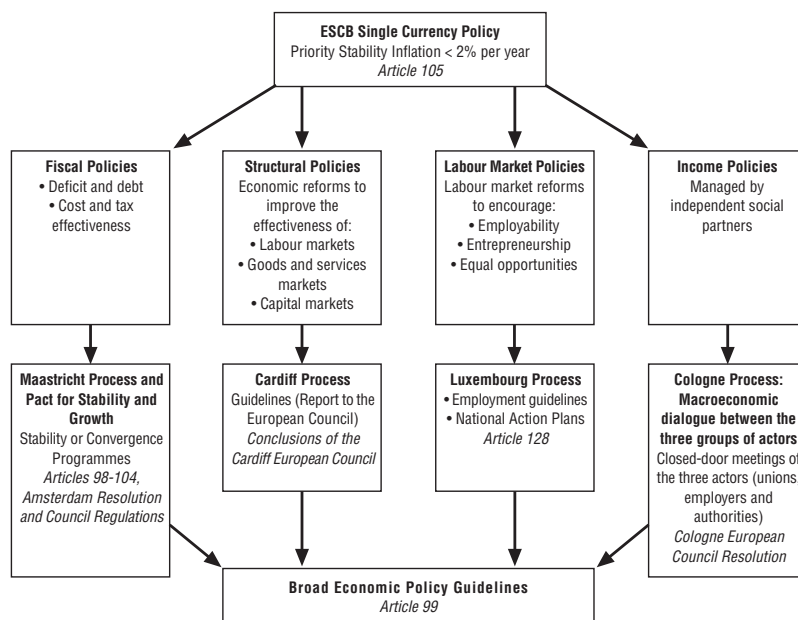
1. Member States are still responsible for economic policy, but they are required to carry out their policies with a view to achieving the Community's objectives and adhering to the Council's guidelines (Article 98).
2. National economic policies are a matter of common concern and Member States are to coordinate them within the Council (Article 99.1); the main tools are the broad economic-policy guidelines of the Member States and the Community, which are prepared according to a detailed procedure (Article 99.2: the draft recommendations of the Commission are submitted to the Economic and Financial Committee [formerly, the Monetary Committee], are then sent to Ecofin, which issues a report by qualified majority and submits it to the European Council [heads of state]. The European Council discusses a conclusion based on which Ecofin, by qualified majority, publishes a recommendation setting out these broad guidelines and informs the European Parliament). These guidelines are a reference point for "multilateral surveillance", a peer process of regional monitoring that assesses the economic situation and policies by means of periodical reports presented by the Commission to Committees of Experts (the Economic and Financial Committee [EFC] and the Economic Policy Committee [EPC]) for discussion and for the drafting of a report that is submitted to Ecofin (Article 99.3). When national policies are found inconsistent with the broad guidelines or with the proper functioning of the EMU, the Council may, acting by a qualified majority and on a recommendation from the Commission, make specific recommendations to the Member State concerned, and, for dissuasive purposes, make its recommendations public (Article 99.4). These procedures may be further specified or improved through derivative legislation enacted at the Community level (Article 99.5).

The general coordination principle and the regional mutual surveillance provisions applied to any economic policy (whether macroeconomic or structural) are complemented by more specific provisions for certain fields, when more precise coordination is deemed necessary. This takes place in four special areas: (a) budget matters,

through the articles of the Treaty and the Pact for Stability and Growth; (b) structural reforms, through the Cardiff Process; (c) labour-market policies, through the Luxembourg Process, and (d) wage policies, through the Cologne Process and its “macroeconomic dialogue”.

Most important among these are the regulations guaranteeing minimum budgetary discipline in all Member States, and not only in those that belong to the euro area. (Most of these provisions were explained in the preceding section, since they were applied in preparation for the single currency by ensuring budgetary convergence to a sustainable position.) With the move to Stage III and the participation in the single currency, excessive governmental deficits are prohibited pursuant to the provisions of Article 104, which sets forth a precise procedure for defining and supervising compliance with the required budgetary discipline. A mechanism to sanction a euro-area Member State’s non-compliance with this minimum discipline completes this arrangement. The modalities and periods of application of this discipline were specified in the Pact for Stability and Growth that the European Council enacted with a view to launching the single currency, although it is applied to all European Union members, with the exception of financial penalties in the event of infringement of budgetary discipline.

Figure III.1
ECONOMIC POLICY COORDINATION MECHANISM
IN THE EUROPEAN UNION



This binding pact consolidates and accelerates budgetary surveillance pursuant to Articles 99 and 104, provides the operating modalities for that surveillance and makes the application of the common budgetary discipline fully credible. The pact is reflected in two new Council Regulations under the guidance of a European Council Resolution directed at the Council and the Commission. The intention is to achieve and maintain a combination of pro-growth policies that the Member States need to ensure that the EMU is sustainable and creates employment. The provisions of the pact—especially the objective of approaching budgetary balance in the medium term—ratify the budgetary policies previously recommended in successive European Council broad guidelines since December 1993. The pact has three aims:

1. To prevent pressure on monetary policy that would lead to a suboptimal and excessively restrictive policy mix and thus impair growth.
2. To support the accumulation of investments that the European economy requires to increase its potential output, making greater growth feasible: budgetary consolidation makes it possible to generate the savings needed to increase investment and put downward pressure on interest rates.
3. To restore the manoeuvring room required by budgetary and fiscal authorities to optimize economic management in a full-fledged EMU (automatic stabilizers and discretionary action in the event of asymmetrical shocks):
 - (i) Countries with a sound structural budgetary balance will have considerable budgetary flexibility during normal cyclical recessions without needing to exceed the limits of the Treaty in their budgetary deficits (since the “automatic stabilizers” can fully perform their role as a buffer in the economic cycle).
 - (ii) The achievement of a medium-term budgetary balance in normal cyclical conditions (structural equilibrium) requires a rapid reduction of the debt/GDP ratio. Thus, the combined effect of smaller deficits and lower interest rates lessens the heavy burden of national debt servicing, making it possible to lower taxes and/or establish other spending priorities, especially if necessary because of specific shocks in a country. This contributes to creating a virtuous circle, buttressed by market expectations, allowing governments to take sound stabilizing measures such as cutting taxes and producing collective goods, thus increasing supply and consolidating stability and internal sources of growth.

The secondary legislation introduced by the Pact is structured by two Council regulations. The first, based on Article 99.5, has a warning function. It is a *preventive measure* establishing national “*stability programmes*” (or “*convergence programmes*”, for non-euro countries) and setting forth the modalities for their application and surveillance. Through these programmes, national authorities announce their detailed budgets according to a common guideline for at least three years, including all measures that might be needed to meet these goals, and they commit to make supplementary adjustments should they deviate from the course outlined in the programme. In the event of divergence, the adjustment measures must be specified so that they can be monitored each step of the way. The second regulation, based on Article 104.14, sets forth a *dissuasive measure* to ensure Member States’ full compliance with budgetary criteria and ensure full enforcement of sanctions in the event of non-compliance. More detailed provisions were needed to speed up and clarify the application of the Treaty’s procedure for addressing excessive deficits, in particular by establishing clear definitions and precise deadlines for each stage and by providing quantitative definitions for the foreseen exceptions.

These complementary provisions to the Treaty clarify the intent of the principle of subsidiarity. In the European Union, coordination remains in the hands of the States and not those of a higher central power, as long as sovereign states are able to adjust their budgets on their own. The Community authorities (Ecofin and the European Commission) are empowered only to implement specific supranational procedures that allow them to gradually pressure national authorities, initially confidentially among peers in the expert committees and at the ministerial level, and progressing to a level of public debate, through the use of market and public-opinion pressure, with the potential reinforcement of financial penalties. In essence, sovereign governments and parliaments are solely responsible for designing stability programmes and deciding which adjustments they require to meet those programmes on schedule, but the other Member States, the Commission, the Council, the European Parliament, as well as other stakeholders (the European Central Bank, national central banks, social partners) provide input and conduct monitoring in an ongoing, dynamic debate that constitutes a comprehensive formula for “macroeconomic dialogue”.

Macroeconomic dialogue allows the macroeconomic policy mix to favour growth and employment as long as the national budgetary policies and the wage trends do not counteract the essential objective of ensuring the stability of the common monetary policy. This is the **basic theorem of**

the EMU's macroeconomic policies formulated in the broad guidelines:¹⁹ *the more the budgets of the Member States and the wage negotiations of the social partners contribute to the common objective of stability, the more favourable the monetary stance will be to growth and employment.*

In other spheres that provide for explicit coordination, procedures are even more subsidiary—that is, Community power is even more discrete and is reduced to a mere system of monitoring that allows for dialogue through the issuance of specific reports. For structural policies, before the launch of the euro, two dialogue mechanisms were put in place: the Cardiff Process, for market reforms and other microeconomic measures, and the Luxembourg Process, for labour markets and policies. The first process only entails issuing a common report, which presupposes a review and mutual monitoring of the situation of each national economy. The second process consists of two more precise instruments that are part of the Treaty of Amsterdam's section on employment: an annual document titled "**Employment Guidelines**" is issued by the Council based on a Commission proposal and national documents, called "**National Action Plans**" (NAPs), which describe how each Member State intends to apply the Council's Employment Guidelines.

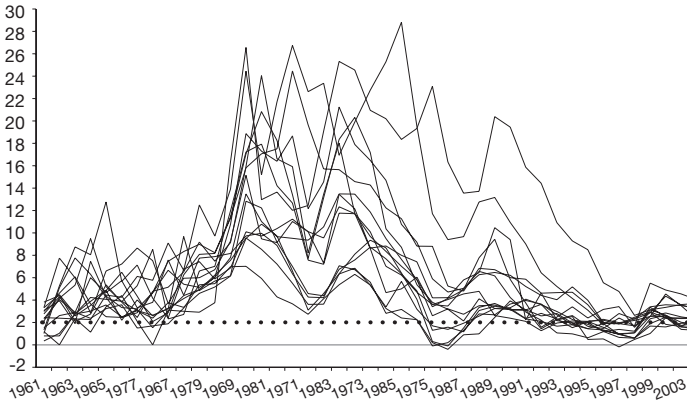
After the launch of the euro, structural and supply-side policies were addressed through a more general method: the "**Lisbon Strategy**" (European Council, March 2000), which is the generalized application of the dialogue method (also known as the "**Open Method of Coordination**") to all national economic-policy areas relevant for reconciling competitiveness with social and environmental objectives. This method involves "periodic monitoring, evaluation and peer review organized as mutual learning processes"²⁰ of the guidelines that each Member State is to carry out through specific action plans, in accordance with its particular circumstances, and without formal constraints. The generalization of the method is a de facto solution to externalities and the need for coordination in areas where the Treaty does not envision specific harmonization, common policies or common actions, or where domestic governance remains adequate. This method also seeks greater involvement of economic agents, social partners and civil society.

The European Union and its euro area (which comprised 11 of the 15 European Union members as of 1 Jan 1999, and 12 two years later) have transformed the system of *economic governance into a unique experience* in world history.

¹⁹ Council Recommendation of 7 July 1997.

²⁰ Lisbon European Council, 2000: paragraph 37.

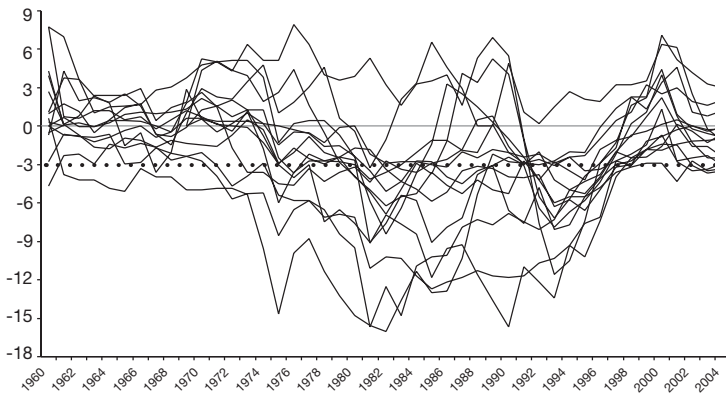
Figure III.2
THE EUROPEAN UNION CONVERGENCE PROCESS:
ANNUAL INFLATION RATES IN 15 MEMBER STATES
(Private consumption price deflator / Percentage change)



Source: European Commission Services.

Dotted line = ECB inflation ceiling

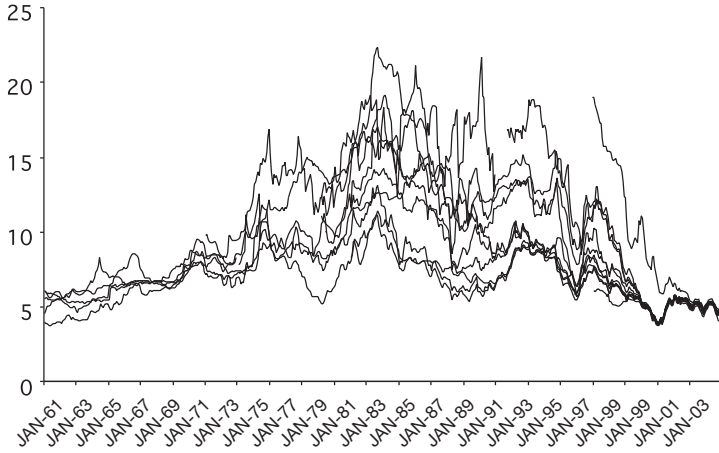
Figure III.3
THE EUROPEAN UNION CONVERGENCE PROCESS:
NET PUBLIC LENDING IN 15 MEMBER STATES
(Percentage of GDF)



Source: European Commission Services.

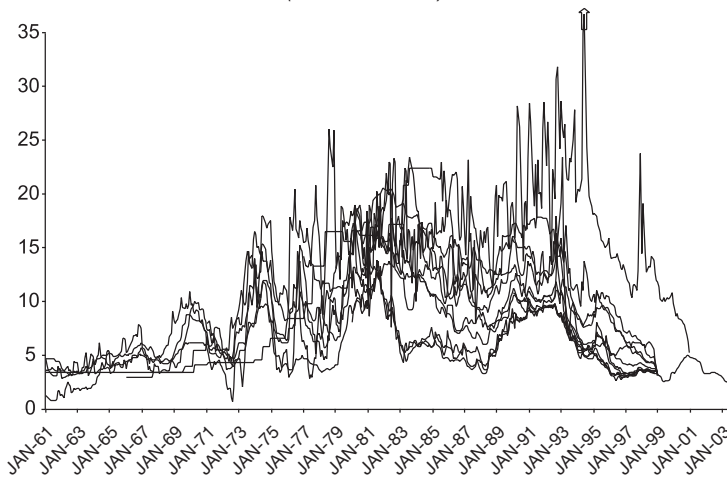
Dotted line = Maastricht criterion

Figure III.4
 THE EUROPEAN UNION CONVERGENCE PROCESS:
 LONG-TERM INTEREST RATES
 (10-year bonds)



Source: European Commission Services.

Figure III.5
 THE EUROPEAN UNION CONVERGENCE PROCESS:
 SHORT-TERM INTEREST RATES
 (3-month notes)



Source: European Commission Services.

Chapter IV

General philosophy of the European coordination model

Despite the sophistication of the regional surveillance scheme and the disciplinary measures and sanctions set forth in the Treaty and in the Pact for Stability and Growth, it should be stressed that —apart from the monetary sphere, now entirely governed at the supranational level in the euro area— economic policy decisions, including coordination, were left totally in the Member States' hands. The Treaty sets forth that "*the States shall coordinate within the Council*", applying the *subsidiarity* principle.

Since this book is intended for Latin American decision makers who wish to assess the European experience, it will focus on what is essential and dispel the myths regarding both coordination and the reality of the European Union. Although the achievements made over so many years in Europe are very important, they might appear negligible compared to initial expectations or to theory: the "only" thing achieved was the creation of a "communal" culture and a "collegial" spirit regarding national economic-policy decisions, albeit one that is able to enact common rules and formal procedures for monitoring their application in each member's self-interest. This framework helps authorities to meet their responsibilities and become more aware of the external impacts of national policies, but does not significantly affect their nation's individual sovereignty. The Community has imposed very few limits on national policies. Those limits that exist are intended solely to prevent "*gross errors*"²¹ by national authorities in a very narrow field (the budget)

²¹ To use the wording of the Treaty; see Article 104 (2).

through rigorous procedures based on previously agreed-on criteria in the framework of the supranational Treaty. For all other policies, even those considered “*matters of common concern*”²² and monitored by “collegial” instruments, the Council of Ministers may issue only broad guidelines and, on occasion, recommendations to individual countries.

The European coordination scheme thus appears to be rather “minimalist”, insofar as it merely places each Member State under the surveillance of its regional partners to avoid jeopardizing the EMU common interest. In fact, the operational modalities of this surveillance come down to ensuring that each government does what is best for its own economy. This situation is a far cry from the illusory coordination expounded in economic-theory texts, which envision the search for regional optimization through formal commitments imposed on members.

What has been achieved, however, is essential and works because it benefits the Community’s members and because this is a “learning-by-doing” process open to iterated improvements. The system is akin to a natural selection of successive attempts and reflects the European peoples’ political and cultural reality. With this observation—which from the outside might appear to illustrate a collective lack of ambition or institutional mediocrity—one reaches the crucial point for understanding the challenge of coordination and its difficult equilibrium.

Our shared Latin culture often exposes us to dangerous illusions: we expect too much from so-called coordination, seen as an effort imposed top-down that ignores the subsidiarity principle. That is, we forget that doing more would involve greater changes in constitutional systems, requiring conditions that do not exist in Europe (and are nowhere near materializing). *National governments cannot sacrifice their own aims for the sake of others’*. By definition, the decisions of sovereign national authorities cannot be overridden without a change in the institutional system and the imposition of a federal regime—a centralized decision-making authority. Nor can Member State governments be asked to embrace or abide by commitments that entail changing decisions made by autonomous parliaments, except within the framework of specific procedures adopted by a supranational treaty in restricted areas and with the acceptance of the sovereign national authorities.

This confusion arises from the “Jacobin” illusion that centralized (“enlightened”) decisions are superior to those of short-sighted local authorities. This type of authoritarian coordination is inconsistent not only with existing democratic institutions but, on the whole, with current globalized markets. It presupposes perfect regional integration and strong

²² Ibid.; see Article 99 (1).

consensus on the underlying economic model. The reality, however, is another matter: with economic uncertainty, a diversity of nations and a lack of regional cohesion, there still must be multiple (national or subnational) intermediary states that, in a certain sense, compete both with one another and with centralized decision-making. In this context, “strong” formal coordination would expose the Union to a high risk of losing legitimacy (since certain nations could perceive themselves as being exploited or marginalized by their partners). Such strong coordination could also lead to conflicts among authority levels stemming from situations of moral hazard caused by the mere existence of authoritarian coordination: national authorities exposed to the pressure of domestic “policy demands” might attempt to blame their neighbours or the coordination scheme itself. This inevitable bias tends to favour free-riding behaviour and discourage domestic efforts, causing a loss of effectiveness of national policies and confusion regarding responsibilities.

The economic governance that the European Union’s EMU has recently attained, based on coordination between sovereign states and an autonomous central bank, constitutes a unique experiment. It results from a natural selection based on successive attempts leading to a pragmatic method for developing cooperation among sovereign states whose interdependence and common interests are being strengthened. In monetary matters, the European Union decided that the best way to address the high level of mutual spillovers in a single market was to transfer national monetary sovereignty to the Community (with the two exceptions set forth in the “opting-out” clause for the United Kingdom and Denmark). For all other economic policies, centralization is formally excluded, with coordination among decentralized authorities being the norm. Such coordination is in fact limited to a formal set of dialogues, in which all the authorities meet and organize mutual monitoring. The exchange-of-best-practices method leads to agreement on common guidelines based on benchmarking against the best. Stability programmes and national action plans translate these common guidelines into national policies. Emulation among national administrations results from peer pressure and market sanctions brought about by enhanced transparency. Since the Lisbon European Council (March 2000), this evolving practice of economic dialogue has been extended to all supply-side policies (including social policies and social exclusion, corporate governance, education, research, the environment, etc.). The practice was formally instituted as the Open Method of Coordination. In budget matters, however, the Treaty and the Stability Pact put in place stricter procedures to enforce a common discipline based on quantitative rules and sanctions but still contingent on a final political determination, without any mechanistic interpretation.

The basic philosophy of the European Union method allows the key players (policy makers and social partners) to identify the strengths and weaknesses of their action plans by comparing their results with those of their peers, in the knowledge that at some stages they will be accountable for the observed performance. This emulation among authorities is more effective than other controls. In addition, as noted by Rose (1993) and Olsen and Peters (1996) and quoted in Dehousse “*governmental structures are often prisoners of tradition anchored in their history and, except for during periods of crisis, rarely seek to learn from the experience of other actors*” (Dehousse, 2003).

In conclusion, where “federative” conditions do not (yet) exist (as in Europe and, currently, in the subregions of Latin American), centralist coordination would be counterproductive; and coordination—trapped in the prisoner’s dilemma— would lead to a conflict that would undermine the community’s goals. Conversely, a more pragmatic scheme based on **dialogue among autonomous actors**, gradually creating mutual trust to escape the dilemma and recognizing that each government legitimately tends to act in a way that is most advantageous for itself, makes it possible to arrive at a minimum consensus on policies and an acceptance of some basic common rules. In such a process, *dialogue stimulates self-discipline* to protect a nation’s own legitimate interests (rewards for or sanctions against national political decision makers through markets). This is one of the lessons of the prisoner’s dilemma: *if sovereign partners happen to engage in cooperative behaviour, they do so because it is in the best interests of each country.*

Chapter V

General principles derived from coordination experiences

The analyses and elements set forth in the preceding chapters make it possible to formulate some general principles that synthesize the experiments of the IMS and the G-7 as well as those of the European Union and the EMS, or EMU.

Coordination presupposes autonomous actors and it protects their autonomy. I call this fundamental principle the “**coordination paradox**”. As the etymology of the word indicates, coordination is the opposite of centralization: it serves to limit centralization and to defend the sovereignty and interests of individual actors when they interact. Coordination is inherently related to autonomy, and not its opposite, as often believed by those who use the term with an authoritarian or hierarchical connotation and depict it as a situation with “one coordinator” imposing his rule over the other players.

A necessary (but insufficient) condition for coordination is that there be a minimum capacity for dialogue and consensus among autonomous actors, allowing them to agree to act according to certain common rules or goals (a common order). Actions remain the sole responsibility of the autonomous actors, who, nonetheless, collectively establish a frame of reference allowing for a common and transparent evaluation of each other and of the interactions among them. This, then, presupposes a modicum of institutionalization, without which a common framework or a transparent order would be impossible.

The greatest problem of coordination is the *prisoner's dilemma* — the risk that, because of either asymmetry or uncertainty about their partners' behaviour, actors will try to act on their own to minimize the risks to their national authorities. This problem is inherent to actors being politically but not economically independent.

In the Bretton Woods world, the United States' hegemonic power provided a way out of the dilemma and made it possible to impose a system of automatic coordination through parities pegged to the dollar (a form of dollarization). The system, however, was asymmetrical and sought only to prevent divergence from United States policy. In the event of an error by the United States as the anchor country, and failing any means of objectively disciplining it, coordination became perverse by forcing everyone else to follow its lead. This amplified the Keynesian stimuli created by the United States, which resulted in a global inflationary bias. This bias not only made it impossible for external stability to guarantee internal stability but also made the system a vector for the transmission of generalized instability.

A float of the major currencies, which was imposed as an alternative, led to a return to the prisoner's dilemma. Internalization, which was expected to result from the divergence of policies on exchange-rate performance, was unsatisfactory, and the asymmetry of the dollar persisted. The result was disappointing and unfortunate.

The United States was compelled to react in favour of negotiated coordination through the G-7 and exchange-rate management. Struck by the common fear of crash-landing the dollar, G-7 members overcame their mutual mistrust and tried to correct both the lack of coordination among domestic policies and the lack of guidelines on exchange rates that, by definition, characterized the monetary-flotation system. The G-7 attempted a consensual definition of "*reference zones*" for the exchange rates that also entailed a collegial scrutiny and the setting of macroeconomic policies compatible with such zones, in particular regarding budget policies. But this was not possible in the real world of national politicians and further complicated the problem of global anchoring and the difficulty of assessing global inflationary risks. Exchange-rate agreements, combined with the excessive rigidity of national fiscal policies, led to **unbalanced coordination**, which caused a serious deterioration of global monetary stability and a return to mutual mistrust (a prisoner's dilemma situation).

In both its successes and its failures, this G-7 experience illustrates the principles that determine whether a coordination scheme is effective:

1. The need for consensus on policy content, and the evaluation of inflationary risks, which implies collective analysis;
2. Budget policies' key role in determining exchange stability, with these policies necessarily remaining in the hands of sovereign institutions, which will not consent to closed-doors agreements reached by technocrats or politicians;
3. The need for transparency and countervailing powers in international coordination.

The European experience shows that acting at the regional level is an effective means for consolidating institutional progress and designing a common response to the asymmetries or external shocks that may affect national economies. More to the point, regional cohesion can provide a way out of the prisoner's dilemma through the combination of two elements:

1. The gradual development of *personal contacts and collaborative efforts* between decision makers and experts of a region's countries, to encourage a common culture, build a basic consensus and create a climate of collegial trust. Since the prisoner's dilemma hinges on uncertainty about other players' behaviour, increasing communication among them and asking them to issue collegial opinions clearly improves their chances of finding a way out of the regional suboptimal situation through cooperation.
2. Regionally implemented rules and objective **mutual surveillance** procedures, making it possible to generate individual incentives for the players by focusing the markets' and the public's attention on each government's individual performance. Coordination thus becomes a directly useful and desirable instrument for national decision makers by enhancing the credibility of their policies and directly helping them carry out their tasks. This ensures consistency between national and regional interests: cooperation is based on self-interest. To use game-theory terminology, the probability increases that all games will have dominant strategies that coincide with the social optimum. In particular, an important component of any successful macroeconomic-monitoring scheme is the incorporation of fiscal rules with numerical benchmarks and precise procedural commitments able to attract public attention and trigger political incentives.

In the European case, this combination effectively led to the spontaneous development of individual incentives for participants

to cooperate (as recommended by Triffin and described in chapter III, section 4), creating a positive-sum game in which the positive outcome increased as the game was repeated. Hence, the prisoner's dilemma was resolved through the dynamics of the game: that players had to meet over a long and undefined period, that they could not escape the consequences their decisions had on fellow participants, that the incentives to defect diminished over time in inverse proportion to the strengthening of integration, that players learned more and more about each other, that rewards and sanctions were administered progressively and allowed the balance of benefits and costs to be identified, reducing uncertainty regarding the results of cooperation—all these factors implied that the cost of non-cooperation rose rapidly with time, and positive outcomes increased with the iteration of the game.

The important lesson is that, because of the endogenous nature of the gains from cooperation (and integration), the more time goes by and the more countries interact (and the more interdependencies emerge), the higher the gain from coordination and the lower the interest in defecting (Escaith and Paunovic, 2003). Furthermore, as explained by Axelrod (1984), *“the most promising finding is that, if the rules of cooperation theory are known by the participants in advance, the evolution of cooperation can be speeded up”*. Hence, given the dynamic dimension of cooperation, the incentives to play cooperatively emerge insofar as cooperation is effective, visible and credible, and they displace the incentives to act non-cooperatively in a static analysis.

This is the key to the guidelines resulting from REDIMA's approach for Latin America in chapter VIII and in their concrete expression in the proposal made in chapter IX.

Chapter VI

Applicability to Latin America: The REDIMA approach

Although the principles set forth in the preceding chapters appear to be universally applicable, only in Europe has it been possible to implement them on a long-term basis and in a concrete and formal manner. Europe has thus piloted the case for a successful policy-coordination scheme. However, since the differences between Latin America and Europe are substantial, the first question should be: to what extent is it possible for Latin America to think of importing the European model? And, of this model, what is valid for the countries of Latin America?

ECLAC, Santiago, attempted to answer to these questions, in close cooperation with the European Commission of the European Union (Directorate General for Economic and Financial Affairs, Brussels). This joint experiment was implemented in Latin America through the creation of Macroeconomic Dialogue Network (known as REDIMA, the Spanish/Portuguese acronym of Red de Diálogo Macroeconómico) at the subregional level.²³ Because it comprises informal networks of experts in charge of national policy, to whom it offers a space for open and confidential technical exchanges, REDIMA is already, by its nature, an instrument for diminishing the prisoner's dilemma that inhibits macroeconomic cooperation among the countries of Latin America. REDIMA circumvents the traditional logic of formal negotiations through its informal nature.

²³ See Chapter X for more details. Also see the REDIMA Internet (WebBoard) site at www.eclac.cl/REDIMA, or enter through the ECLAC site (www.eclac.cl), click on "Divisions", then "Economic Development", and then, on the left, select "Macroeconomic Dialog Network".

No negotiations are undertaken at REDIMA, in that no government or institution commits itself to anything other than to participate in technical workshops, and no official positions or conclusions on policy choices are taken or made. Nor does REDIMA create or replace any regional agency or institution, given that its results serve as inputs for official negotiations, pursuant to due procedures through existing institutions.

Moreover, REDIMA does not espouse any precise economic doctrine or policy, except its specific focus on the potential advantages of cooperative regional strategies for the subregions of Latin America, which is the working hypothesis by which REDIMA is guided. Even in this specific area, REDIMA does not seek to propose or select any a priori institutional options but only to provide a collegial mechanism for the progressive selection of ideas, policies and institutions that might match local realities.

Notwithstanding these reservations, the following chapters draw directly on the work of REDIMA and the exchanges of views among its participants, although none of its members could be seen as responsible for the views and positions expressed in this book.

1. Identifying the method rather than the model

Not everything done during the integration process in Europe is universally applicable or should be replicated in other regions. Although the **European experience is not transferable** as such to Latin America, important lessons can be derived from this series of experiments to avoid unnecessary delays or a repetition of the mistakes made during the learning process. The European process has been very slow and imperfect and developed in a very different international context. In launching other regional-coordination or integration processes, policy makers have a duty to try to compare their own process with other cases. This was the point of departure for REDIMA.

Although I do not claim that the European process is the only or best course, other regions wishing to develop coordination mechanisms and advance on the path to regional integration might profit by gaining more insight into the European case and its methods.

The European experiment illustrates a trial-and-error process that allows for pragmatic methods while recognizing that other approaches have been illusory in economic governance. European integration is still being implemented, especially regarding policy coordination in the euro area, which as yet has not proven its effectiveness. This has been and continues to be a lengthy and painful process, and not always a glorious

or very successful one, and progress has frequently resulted from crisis. It has been a useful experience for economists, political scientists and, above all, policy makers. Moreover, despite the significant differences between Latin America's subregions and Europe, European respect for national sovereignties might be, a priori, a feasible model for emulation by Latin American countries that have no wish to form federal states at this time but that share common values and goals.

In particular, the European Union's fiscal-policy coordination—based on rules that pursue higher budgetary discipline while maintaining flexibility—provides interesting lessons for Latin America, as explained in more technical terms by the European Commission in a paper by M. Buti and G. Giudice for the 2002 IMF/WB Conference titled "Rules-based Macroeconomic Policies in Emerging Market Economies".²⁴

Although an outcome cannot be imported, it is possible to import a method for *launching a process* to be tailored to the needs of a group of countries. Regional achievements necessarily result from each subregion's endogenous processes, and, although Latin American subregions are very different from one another, they all require the collective efforts of Latin American policy makers and technical experts. Only these policy makers and experts can launch an exercise in mutual exchange that might determine the appropriate formulas for each subregion and tailor them to their economies' specific features.

This analysis of the applicability or inapplicability of the European model is a specific and useful starting point. In particular, it underscores three very important methodological lessons of the European Union experiences but also of Latin America's failed integration attempts:

1. The highest priority must be given to **including the macroeconomic domain** into Latin American subregional integration schemes, inasmuch as they condition the success and continued viability of the region's commercial (and even political) integration. This is illustrated, for example, by MERCOSUR's difficulties stemming from the major divergences and crises from 1999 to 2002. For economic operators (external as well as domestic), an attempt only to forge trade agreements among the partners of a subregion has no credibility, when the results of such agreements can be offset by a lack of convergence and can give rise to macroeconomic imbalances and concomitant financial or exchange crises. Such imbalances entail

²⁴ Buti, M. and Giudice, G. EMU's fiscal rules: what can and cannot be exported, ECFIN working paper, April 2002

costly contagion risks and reactions contrary to regional integration, hindering the application of the agreements and undermining their credibility.

2. **Exchange rate** policies and fluctuations are a key to both the consequences of regional agreements and the credibility of any attempt at macroeconomic cooperation or coordination. Since they become “matters of common concern” for a region, they signal the convergence or compatibility of national macroeconomic policies and thus offer a tangible opportunity to undertake a technical dialogue on each country’s internal policies at the regional level. European experience, accumulated mainly during this process of exchange-rate monitoring (through the EMS and subsequently in the run-up to the EMU), leads to certain operational conclusions on the limits and scope of coordination among sovereign authorities, as well as on the fundamental need for a modicum of dialogue and macroeconomic monitoring if regional integration is to prove successful. This lesson is confirmed by recent events in Latin America, showing that a lack of dialogue and cooperation on exchange-rate policies significantly contributes to the failure of integration.
3. As discussed in section 2 below, the European Union case also shows that regional integration is much more than trade integration based on preferential agreements. With globalization, the institutional-capacity building inherent to integration is becoming an essential component for ensuring growth and stability. Consequently, regional integration could become a driving force for offsetting some institutional weaknesses by speeding up the creation of the checks and balances most countries of the region urgently need —or by or strengthening existing check and balances. The importance of this “political-economy” aspect of regionalism is overlooked.

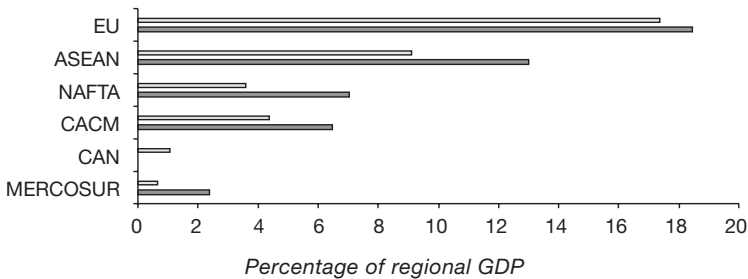
2. **Macroeconomic coordination and regional integration: a political-economy view**

It is generally considered that coordination among sovereign authorities only makes sense once regional integration reaches a significant level of intraregional exchanges, creating clear interdependencies among a region’s countries. The conventional view is that Latin American economies are still far from meeting the conditions for an endogenous development of coordination schemes moved by national individual interests. Indeed, many articles written from a traditional perspective have pointed out that neither the region as a whole nor its subregions constitute an optimal currency area.

This consideration is obvious a priori and is not discussed. Moreover, the European Union is often held up as a model in reference to the apparent historical progression from trade to macroeconomic cooperation and finally to monetary issues. Indeed, European integration is generally presented as a progressive succession of integration steps, starting with the customs union, followed by economic-policy coordination within a single market and an economic union, and finally, with a single currency to complete the first pillar of the European Union.

That intraregional trade is not even one-third as advanced in Latin America as it is in Europe is an argument against making it a high priority in the region. At the very least, this type of argument makes regional coordination of national policies or exchange rates seem like a distant or premature ideal requiring prior steps still far from implementation.

Figure VI.1
COMPARISON OF INTRAREGIONAL TRADE AS A PERCENTAGE OF REGIONAL GDP OF THE MAIN REGIONS HAVING PREFERENTIAL TRADE AGREEMENTS



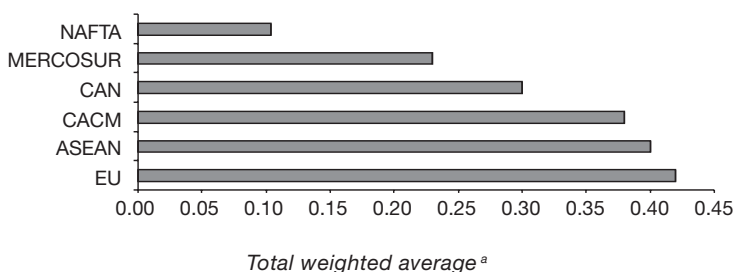
Source: José Luis Machinea, "Mercosur: en busca de una nueva agenda. La inestabilidad cambiaria en el Mercosur: causas, problemas y posibles soluciones", *Documento de trabajo IECI series*, N° 06, Washington, D.C., Inter-American Development Bank (IDB)/Institute for the Integration of Latin America and the Caribbean (INTAL), December 2003.

However, recent research shows that such arguments are an incomplete vision of recent developments. While this book does not intend to undertake a technical analysis of previous research articles, one article, which evidences significant and growing interdependencies among MERCOSUR economies, is worth mentioning: an article by the Centro de Economía Internacional (CEI, an agency of Argentina's Ministry

of Foreign Affairs) examining not only trade but capital movements and exchange-rate regimes shows that shocks affecting MERCOSUR members are common and that the countries' business cycles share the same dynamics (Lacunza and Carrera, 2003). An analysis of the covariations among these economies shows an increasing correlation with their cyclical component. Using a computed-general-equilibrium-model, the CEI article demonstrates that a shock affecting one member generates significant spillovers on that country's trading partners.

Moreover, J.L. Machinea, merely using a cyclical-correlation indicator, shows that interdependencies in Latin America's subregions are not negligible, although lower than in Asia and, naturally, than in the European Union.

Figure VI.2
CYCLICAL CORRELATION AMONG PARTNERS OF THE MAIN
REGIONS HAVING PREFERENTIAL TRADE AGREEMENTS



Source: José Luis Machinea, "Mercosur: en busca de una nueva agenda. La inestabilidad cambiaria en el Mercosur: causas, problemas y posibles soluciones", *Documento de trabajo IECI series*, N° 06, Washington, D.C., Inter-American Development Bank (IDB)/Institute for the Integration of Latin America and the Caribbean (INTAL), December 2003.

^a The average correlation coefficient of economic cycles in each regional area's members, weighted by their share of average regional GDP for 1971-1999.

In addition to the issues raised in this counterargument, the conventional view appears outdated or biased because it relies on a misreading of the history of the integration process: the argument positing a sequential progression from trade integration that climaxed with macroeconomic cooperation is largely erroneous, for three reasons:

1. It is a superficial and incomplete historical interpretation of European integration, because it fails to take account of the high priority placed on macro-monetary stabilization at a much earlier date (1947) than

the signing of trade agreements through the Treaty of Rome (1957), which was a precondition for the implementation of effective trade integration.

2. European integration is part of a past that will not return. A more economics-oriented interpretation that considers the major trends in globalization—including monetary and financial issues—that simultaneously unfolded and that have completely transformed the global economy would recognize that the path followed in Europe was partly context-based. This contingent process cannot be replicated as such in other regions because the world has changed significantly in the past decades.
3. In this globalized world, financial markets mete out rewards or sanctions—with regional contagion—according to the expected results of macroeconomic policies or to conditions in emerging countries. This imprints a regional dimension on national macroeconomic policies, greatly magnifying the externalities of national policies among neighbours, that is, creating regional linkages in addition to already existing commercial linkages.

Let us examine these three related reasons in greater detail:

1. From a longer-run perspective and as an overall process, the European path shows that restoring macroeconomic stability and monetary convertibility was a prerequisite for the Continent's economic reconstruction. The EPU mechanism (1949), established with the assistance of the United States-backed Marshall Plan (1947) and bound by strict conditionality, underscored the need for **macroeconomic and commercial complementarity** in the building of regional integration. This mirror image of the same basic premise was demonstrated when, after the failure of Bretton Woods, a loss of external discipline led to macroeconomic divergence and the resegmentation of the Common Market. In sum, the European success stems from a combination of the two elements: trade agreements and macroeconomic cooperation. However, this success story began in the special context of post-war reconstruction, followed by the outbreak of the cold war and the emerging Soviet threat. Additional contributing elements included the United States military protection and its huge conditional financial assistance (Marshall Plan, OECE and EPU). This might, however, be replicated in some respects through a large North-South agreement to provide strictly conditional assistance to LDCs emerging from severe crises. In Europe, this external stimulus of regional integration was especially important as a way to break out of the prisoner's dilemma, which trapped national authorities into non-cooperative behaviour. As

a result of the stringent conditions imposed by the United States, monetary reconstruction was intimately linked to trade integration. In fact, as Triffin insisted at the time, European bilateralism was deprived overnight of its major underpinning with the creation of the cooperation-based EPU. Hence, the cooperation scheme for returning to convertibility was the first step on the path to gradual trade integration in Europe.

2. However, the **international economic context** in which European integration took place during the 1950s and 1960s was radically different from the environment that Latin America faces today. European integration through the tariff union was established in the 1960s, a period of high growth with solid monetary and financial stability and low capital movements, and during a process of strong institutional consolidation (community institutions and legislation; common policies). National currencies' return to the convertibility according to a common fixed-exchange-rate system with low capital movements (Bretton Woods) ensured compulsory convergence and an automatic disciplining of macroeconomic policies (see chapter II, section 1). Hence, the progressive building of integration starting with trade and evolving towards finance and currencies was set in motion before the more political areas were addressed, with the placing of the second and third pillars of the European Union. In Europe, one "obvious" pattern prevailed, with integration appearing to begin "naturally" in trade long before invading the macro-monetary field. Institutional competencies were, then, inevitably and progressively transferred from the national to the supranational level, as if according to a natural law of history. The result is an "institutionalist view" of regional integration (which continues to be the "official" interpretation in Europe) as a legal process that begins, first and overall, through preferential trade agreements allowing for the progressive construction of a single market and moving slowly towards financial and monetary integration to which a political step would eventually be added. This conventional view is less a misreading of European history and its integration model than a largely misleading understanding of how today's world works. The globalized world has significantly changed the issue of regional integration and its sequencing.
 - In the 1950s and 1960s, global exchange rates and monetary stability explain why trade was crucial and the driving force behind European integration. The Bretton Woods framework of current-account convertibility and fixed exchange rates (a quasi-monetary union or dollarization, except for capital transactions) ensured predictability. This means that the customs union drew

most of the political attention while the remaining policies were either automatically coordinated through the exchange-rate constraint or allowed to diverge through capital controls and the complexities of the different national regulations.

- Today, capital liberalization and the GATT achievements impose a new dynamics, reducing the attractiveness and efficiency of the customs-union model for economies whose currencies are not yet fully convertible and/or are exposed to wild capital movements. Contagion acts directly on international capital flows and credit ratings, and indirectly, through a geographical area's business climate. Other fields of regional cooperation are also becoming crucial. Even more than for Europe in the 1950s, macroeconomic and monetary stability are today essential prerequisites for trade integration. Economic agents would be very reluctant to have confidence in a trade agreement in any region if the exchange rate among the main partners were to go from 1-to-1 to 2-to-1 in a few weeks.
- With globalization, financial integration has become fundamentally important for a region's competitiveness, which was less the case in the past and in Europe. The monetary and financial field has become a key to the success of regional integration anywhere.
- Market sanctions and power have increased everywhere, putting a premium on the efficiency and resilience of the regulatory and prudential framework as well as the quality of the policies and of governance overall, including the transparency of public decisions and the degree of effective democracy. National authorities and institutions compete for credibility in non-cooperative situations.

In conclusion: The globalization process has reversed the importance of the advantages of regional integration: **the static advantages of preferential trade have become less important than the dynamic advantages of institution-building and of improving the decision-making process.** The advantages of regional integration are not limited —as generally believed— to preferential access to a single market but also include guaranteeing a more stable, credible and transparent framework for economic agents, i.e., improving the “institutional factor”, which is the key to economic and social progress and to benefiting from globalized markets. This does not mean that regional trade agreements are unimportant but that they lose credibility and efficiency if the macroeconomic and regulatory framework is not reliable (as seen in MERCOSUR recently). Nor does

this mean that regional integration is the only way to improve the institution-building process or that such a process warrants a regional approach in lieu of other economic tools. Rather, it means only that these aspects —the political economy of regionalism— are crucial in the real world but are not properly addressed by most economics textbooks, LDC authorities, international financial institutions (IFIs) or the international community.

Latin American integration is taking place in a radically different context than that seen in Europe. Financial and exchange-rate stability is not guaranteed, there are significant divergences in macroeconomic policy, and institutional efforts remain weak, without strong agencies capable of taking the initiative for the subregional groups and representing regional interests. What little motivation there is to “integrate” stems exclusively from commercial issues —and, hence, we see customs unions or free trade areas with no supranational authority— and practical efforts or mechanisms to coordinate other policies are still very weak (although they are beginning to emerge). In fact, the difficulties tend to increase individual countries’ incentives to differentiate themselves from neighbouring countries in crisis, while the absence of a credible common project or regional strategy dampens the incentive to cooperate with one’s neighbours. The likelihood of becoming locked into a prisoner’s dilemma is stronger than in the European Union. Thus, Latin America finds itself embarking on new integration attempts using obsolete instruments: its institutional modalities do not fit the current global context, which requires consolidating decision-making at the macroeconomic level with the progress made in trade issues.

This disadvantage is further compounded by strong asymmetries stemming from differences in the relative importance of participating countries, mainly because of the presence of one huge economy, by far larger than its neighbours (which is not the case in Europe). Hence, intraregional exchange-rate fluctuations —always crucial for regional integration— become an even more fundamental issue for the success of integration based on rapidly growing intraregional trade flows.

3. Globalization has decreased the importance of “nation state” frontiers, weakening—for better or for worse—the possibilities for discretionary action by both national authorities and domestic monopolies. One consequence of globalization during the past decade was the re-emergence of regional integration in Latin America. The increasing proximity of the outside world has logically favoured closer linkages

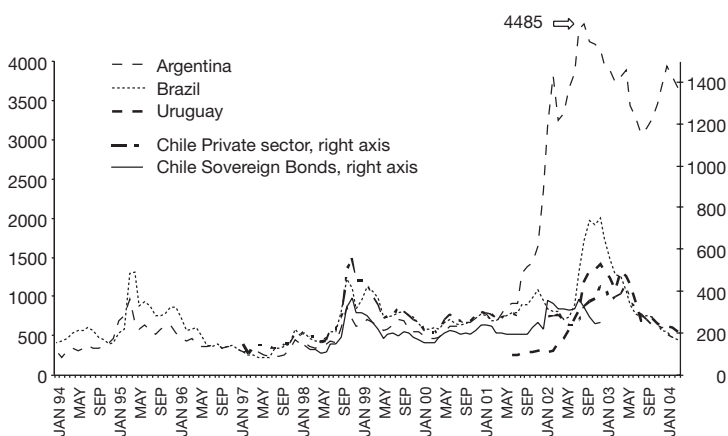
among neighbouring economies. The strategies of multinational companies as well as local exporters tend to take account of the regional context (suppliers, market size, macro-financial conditions and socio-political developments). Note that this phenomenon was not only a response to the changeover from protectionist policies to greater trade opening; it was also the effect of the convergence imposed by globalization in the macroeconomic sphere: external-funding restrictions and market pressure imposed under the “Washington Consensus” established the same type of priorities for and placed the same type of restrictions on macroeconomic policies. The achievement of a minimum convergence on macroeconomic parameters and, thus, the attainment of a certain stability greatly facilitated the negotiation of preferential trade agreements, both in the subregions and at the hemispheric level.

In a certain sense, globalization has imposed temporary macroeconomic stability or a form of implicit coordination by restricting options and making the common interests among neighbouring countries more obvious. However, not only do these interdependencies among economies result from increased intraregional trade; globalization also increases externalities from national macroeconomic policy decisions through the impact of external financial flows. Hence, these growing interdependencies tend to reduce the effectiveness of national policies (thus diminishing each country’s possibilities for independent action); moreover, a country’s macroeconomic conditions depends increasingly on policies applied by neighbouring economies. The stronger the external dependencies on capital flows, the greater the reciprocal effects of the guidelines of the neighbouring countries’ macroeconomic policy mixes, in addition to the well known impact of reciprocal trade exchanges.

Given psychological factors and the “herd” behaviour and massive nature of globalized financial markets, the perception of an economy’s financial sustainability has come to depend on the macro-financial conditions of its immediate neighbours, substantially intensifying externalities from independent macroeconomic policies. Immediate proof of this new reality is provided by the establishment of a common “risk premium” for the region in financial-market ratings. Fluctuations in the spreads on bonds issued in the various countries in a single region correlate strongly, irrespective of each country’s macroeconomic decisions and conditions. This correlation constitutes clear evidence that globalization reinforces regional importance by putting a common label—whether favourable or unfavourable—on groups of countries. This occurred during the period of huge capital inflows in the early 1990s, which were

portrayed in a favourable light. It was also the case during the financial crises that adversely affected emerging economies. The correlation is stronger when its visible effects are negative, i.e., in the downturn of the regional economic cycle, such as in 2001 and 2002. The deterioration of macroeconomic conditions in the MERCOSUR countries and their associated members and the rise in their risk premiums in 2000 and 2001 are convincing evidence of the forced macroeconomic “convergence” wrought by globalization. However, during a downturn, forced convergence, rather than contributing to regional integration, tends to exacerbate conflicts of interest among countries and among sectors or groups within them. Moreover, national authorities appear to think only in terms of individual reactions and decision-making processes without envisioning explicit cooperation at the regional level or utilizing existing mechanisms. The depreciation of floating currencies is a logical response to worsening financial conditions in countries with fixed exchange rates, locking them in an intense vicious circle that may undermine the regional cohesion achieved in the previous phase.

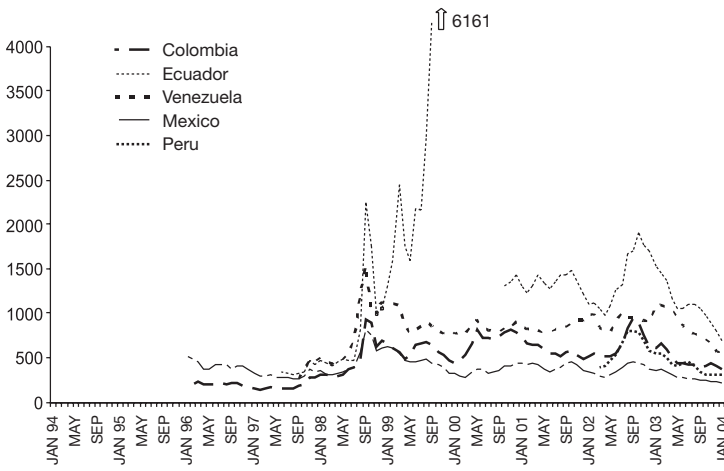
Figure VI.3
 INTEREST RATE DIFFERENTIALS (OR SPREADS)^a
 WITH RESPECT TO THE U.S. TREASURY BONDS
 MONTHLY AVERAGES, 1994-2002
 SOUTHERN CONE: MERCOSUR AND CHILE
(Measured in basic points of yields)



Source: ECLAC and JPMorgan.

^a Chile: Shown on a different scale (right axis).
 Argentina: 4485 was the maximum reached in July 2002.

Figure VI.4
 INTEREST RATE DIFFERENTIALS (OR SPREADS)
 WITH RESPECT TO THE U.S. TREASURY BONDS
 MONTHLY AVERAGES, 1994-2002
 MEXICO AND MEMBERS OF THE ANDEAN COMMUNITY
 (Measured in basic points of yields)



Source: ECLAC and JPMorgan.

Ecuador: 6161 was the maximum reached in February 2000.

This interpretation of globalization, which takes account of the regional context, emphasizes the need to explicitly analyze regional integration as an institutionalized construct, and from a broader perspective than merely examining trade issues by including the domain of macroeconomic management. Such interpretations, however, continue to be eschewed by national decision makers. In addition, theoretical textbook models also neglect the growing importance of the regional context and its possible use as a buffer against the destabilizing effect of globalization.

This analytical shortcoming brings us to the case of the European Union, the sole example of regional construction successful over a suitably long period and in which national sovereignty has been respected. Pressure from external competitors and the increasing instability of financial flows in the early days of globalization created the conditions for a drive for integration. Regional institutionalization channelled reactions to the pressure from globalization into a methodical, progressive regional response. The European Union was thus able to embark on a path that

consolidated its integration. The increased external competition generated by globalization stimulated internal demands for further integration by both economic and political actors. This translated into a search to reduce the transaction costs caused by frontiers, through the creation of a single market, while external financial shocks —by provoking costly speculative attacks among the currencies of its Member States and thus jeopardizing the single market's growth and viability— encouraged a search for a lasting monetary unification (a single currency). This process rested on institutionalizing macroeconomic convergence through policy coordination, which focused the attention of the financial markets and public opinion, thereby prompting market “sanctions” and “rewards”.

Consequently, the need for a similar push for regionalization in Latin America, through articles by academics, cooperative attitudes among national authorities and initiatives by IFI economists, is abundantly clear.

However, regionalization is not a panacea and its usefulness should not be overstated. No initiative guarantees success solely because of its regional orientation. Nevertheless, in macroeconomics, there are spillovers to address as long as the regional option is not properly used. Economists should therefore pay closer attention to the powerful regional dynamics and the forces of political economy behind European convergence. Latin American countries could find in the as-yet-unexplored regional (or subregional) dimension the tool needed to compensate for most of their intrinsic lack of monetary and fiscal credibility. To deliver both credibility and flexibility at the national level, a regional arrangement must, in essence, be based on a strong and transparent scheme for mutual monitoring of national monetary, exchange-rate and fiscal policies, backed by appropriate incentives and sanctions. Such a scheme implies fully abiding by the subsidiarity principle, regarding not only State sovereignty but also constitutionally autonomous public entities such as central banks and even auditors courts.

As discussed in chapter IX, regionalization is a realistic option for Latin America and the Caribbean, since the region does not require major changes but rather a progressive reinforcement of policies already in place in the different subregional groups (MERCOSUR, CAN, CACM, and the Caribbean Community and Common Market [CARICOM]). Under very strict conditions (transparency, technical coherency, institutional resiliency) —which have not yet been fulfilled— some forms of cautious macroeconomic cooperation among neighbouring economies (that is, in subregions) could serve as a vehicle for building credibility and instituting sound national policies. Indeed, as proposed in the REDIMA approach, the regional level could be an alternative instrument to spur

institution-building or to compensate for the lack of credible checks and balances of national policies. Although not a substitute for strong national institutions (which, in any event, are needed), regionalization could catalyze or even accelerate reforms of national governance, helping to solve the institutional shortcomings. Specifically, as proposed in chapter IX, subregional macroeconomic monitoring could even add credibility to already sound national policies, through the added value of more stringent scrutiny by competing administrations. Also, for countries with questionable credibility or policies, regional monitoring could help bypass intermediate steps, shortening the painful process of gaining credibility on their own. The basic principle here is that —when such efforts are seriously managed— regional competing peers tend to bring about more autonomous assessment. As a result, the credibility of regional monitoring is not determined by the credibility of any individual country; rather, it tends to surpass the highest level of credibility of even the best performer in the group.

This is why, under certain narrow conditions, subregional macroeconomic cooperation could even be much more credible than purely national rules such as “fiscal-responsibility” or “monetary-independence” laws or dollarization (such as currency boards), while also offering the advantages of flexible exchange rates (chapter IX). By imposing an institutional discipline from the outside —a supranational subregional set of transparent rules for meeting monetary and fiscal objectives— subregional macroeconomic monitoring could accelerate and generalize the institution-building required for both sustainable growth and reliable integration. Of course, current regional and subregional agreements do not yet meet these conditions. However, this does not imply that existing regional agreements cannot be improved along the path for dialogue proposed by REDIMA.

3. Macroeconomic coordination and exchange-rate regimes

The ERR is the key tool of macroeconomic coordination. It is also potentially the key instrument for triggering and organizing macroeconomic cooperation.

Chapters II and III explained that mutual monitoring of exchange-rate evolution was the operative method that emerged in past experiences for developing cooperation in industrial countries. More precisely, the European Union’s coordination scheme was constructed progressively, based on the attempt to reduce exchange-rate volatility among Community partners to sustain regional integration. The European experience,

accumulated mainly during this process of intense exchange-rate monitoring (through the EMS and subsequently on the path to the EMU), points to a realistic approach: ensuring that the evolution of exchange rates leads to the needed convergence and compatibility of national macroeconomic policies, creating a specific opportunity for instituting a collegial technical dialogue to discuss each country's domestic policies, leading policy makers to further formalize their commitments by first introducing binding rules for organizing a cooperative, managed float, and, as a consequence, for progressively disciplining monetary and fiscal policies. The validity of this principle is negatively confirmed by recent Latin American crises, which make clear that insufficient dialogue and a lack of cooperation on exchange-rate policies contributed significantly to the failures of integration.

Of course, this does not mean that Latin America is required to apply precisely the same formula as was used either in Europe's exchange-rate system (the EMS and its peculiar exchange-rate mechanism of adjustable mutual pegged parities within bands) or in Europe's method of surveillance of budgetary policies, through Maastricht criteria for fiscal discipline. As noted in detail above, the European Union model is not importable to Latin America, even though significant methodological aspects of the European experiment are especially useful for Latin American economies.

In particular, as in Europe and elsewhere, exchange rates are the key to macroeconomic cooperation and coordination, which is why exchange-rate monitoring could potentially be the key to triggering and organizing macroeconomic cooperation in Latin America. The need for greater compatibility among the policies of autonomous partners in a subregion attempting to integrate is unrelated to whether they share the same ERR or whether they have plans for a single currency. *Regional cooperation and coordination result from a quest for credibility when an attempt is made to build an equitable single market and become competitive in a globalized world.* This is an essential lesson to be drawn from the European Union. The European-coordination experience simultaneously covers the whole range of possible exchange-rate regimes: while 12 currencies have merged into the floating euro, the United Kingdom's and Sweden's currencies have remained purely floating, and Denmark's is narrowly pegged to the euro through the ERM II. **Regional cooperation or coordination is perfectly compatible with different exchange-rate regimes but not with macroeconomic divergence and exchange-rate instability.** Hence, precise schemes for regional cooperation and mutual surveillance were put in place to prevent such divergences and exchange-rate instability. In these efforts, any exchange-rate movement is analyzed with respect to the relative policy mix, which determines the currency position. Even when exogenous shocks are the main cause of fluctuations, domestic

reactions through the policy mix are crucial for the cost of adjustment and the potential stability of newly adjusted exchange rates. These policies could profit from cooperative monitoring to increase their credibility and transparency.

Academic and conventional views of macroeconomic policy usually present the ERR options in globalized markets as being limited by a fatal attraction towards “*corner-solutions*” —polarized between either a free float or a peg that should be as irrevocable as possible (Fischer, 2001). Thus, they portray intermediate formulas as being exposed to systemic instability under the pressure of globalized capital flows. In fact, all ERRs with relatively free capital movements are exposed to the same systemic instability when institutions are insufficiently resilient or when the underlying policies lack credibility, and choosing the right ERR is not a panacea. Although a large majority (92%) of Latin American countries currently have flexible (or very flexible) regimes, there are still partisans of fixed exchange rates, and even plans to introduce a single currency in some subregions. Meanwhile, ECLAC economists such as R. Ffrench-Davis and Larraín (2003) and J.A. Ocampo, together with some non-ECLAC economists, including John Williamson (2002), advocate a return to cautious intermediate options, such as “BBC” (basket, band and crawl) regimes, to determine the real exchange-rate level most conducive to sustainable development (Williamson, 2003).

Although I will not take a position on this debate here,²⁵ REDIMA provides an opportunity to look for a more consensual approach. The large diversity of ERRs might be simplified into three broad groups of regimes, or three basic categories of policy options, covering several subgroups,²⁶ whose fundamental features might be briefly summarized as follows:

- **Fixed parities, or pegs**, ranging from “*hard pegs*”, such as with full dollarization or monetary unions, to *traditional pegs*, which can be adjusted and provide significant advantages when stability is a priority as well as for political-economy reasons. However, this regime intends to abandon all or part of national monetary autonomy. The major risk of fixed parities comes from exposure to external shocks, which may turn stability into a fatal rigidity with negative impacts on growth. As recent experiences show, fixed pegs cannot supplant deeper reforms to guarantee the kind of fiscal discipline and market flexibility that are prerequisites for safely abandoning effective national monetary policy. Another important drawback is

²⁵ For more explicit considerations, see Escaith, Ghymers, and Studart (2002).

²⁶ For a more precise description, see the standard classification proposed by Ghosh, Gulde and Wolf (2002).

that, although these regimes may import stability and even credibility (through dollarization), they cannot, in themselves, solve the deep-rooted causes of a lack of credibility. With dollarization, this illusion of easy credibility could tempt authorities to postpone needed reforms in the rest of the economy and decision-making bodies, while putting a tight straightjacket on monetary authorities. If this occurred, the ensuing crisis would be stronger and the exchange-rate adjustment would be more severe. In emerging economies with episodes of a “sudden stop” of capital flows, all cases of de facto dollarization with fixed exchange rates ended in a severe banking crisis.

- **Free-floating regimes** (the near-total or total absence of central-bank interventions), which can provide an important stimulus for growth by cushioning external shocks, sudden stops and real instability but which also require strong and resilient national institutions. For most Latin American countries, such regimes require very harsh and deep reforms, to allow technical inflation targeting by a credible, independent central bank. The main disadvantage of floating regimes is their potential instability for LDCs and small economies and the difficulty of rationalizing many exchange-rate movements in terms of changes in the fundamentals. (This applies even to large industrial economies.) In particular, strong capital inflows often threaten to overvalue the exchange rate and make nascent, non-traditional export sectors uncompetitive, which leads to risks of further excessive fluctuations along with pro-cyclical capital movements and policy mix, all of which are detrimental to regional integration and sustainable growth.
- **Intermediate regimes**, which comprise a large number of systems with varying degrees of flexibility that try to channel market forces in an orderly manner. These regimes range from rule-based interventions, like cooperative regional interventions to ensure that bilateral rates among a group of economies remain stable (e.g., the EMS), crawling pegs (parity adjustments to make up for inflation differentials), target zones (binding or indicative), to discretionary interventions (“dirty”, or managed, floats). This broad spectrum of pragmatic options for countries tries to use real exchange rates for development purposes (Williamson, 2003), and includes the cautious, managed float proposed by Williamson’s BBC regime. This system seeks to avoid adjustments in response to what need not be shocks (movements among third currencies, which are neutralized at the macro level by the basket, and relative inflation, which can be neutralized by the crawl) and to ensure adjustments in response to shocks that cannot be neutralized (changes in terms-of-trade, or in

underlying capital flows) by small parity changes, as recommended by the Real Targets Approach. The disadvantages of such regimes are their endemic lack of credibility; the difficulty in distinguishing between real shocks, which should lead to changes in parity, and the expectational froth, which the Exchange Rate Stability Approach seeks to eliminate; the costs of sterilized interventions; and the difficulty in managing durable, efficient capital controls.

Whatever the textbook ideal system for LACs, there is neither a perfect ERR nor a one-size-fits-all model capable of accommodating all partners simultaneously. Some options are merely better (or less damaging) than others, depending on the specific characteristics of each economy, and especially regarding the trade-off between stability and growth faced by policy makers. No obvious common solution has emerged. However, *all three main categories share a single characteristic* (with the probable exception of Chile): they all run the risk of being undermined by a lack of institutional capacity and suffer to varying degrees from a lack of credibility. This is precisely the common malady that a regional approach could help tackle, not necessarily as an alternative to an ERR but as a complement to it. The REDIMA fundamental argument is that whatever ERR a given country chooses, national policy makers (including Chile's which is also affected by spillovers from its neighbours) could reap substantial gains by participating in regular dialogues with their counterparts from neighbouring countries, as recommended in the REDIMA method.

Indeed, regional cooperation might provide an opportunity to **compensate for the lack of credibility and institutional resilience that needs to be resolved for any ERR to be sustainable**. Under some conditions (see chapters VIII and IX), a cautious, cooperative regional scheme might provide the missing component —i.e., a common solution, irrespective of the ERR option chosen— by enhancing credibility through the powerful checks and balances that mutual monitoring and the consequent regional peer pressure would trigger. Checks and balances are very much needed to ensure greater accountability to public opinion, economic operators and financial markets. Public and market reactions provide incentives and sanctions for policy makers able to internalize spillovers. In a regional soft arrangement for progressive monetary and fiscal cooperation, LACs could find the needed catalyst of national institution-building efforts to compensate for most of the intrinsic lack of monetary and fiscal credibility.

Thus, the regional option is not an alternative to a rigorous ERR, even if it affords greater opportunities to evolve progressively towards intermediate formulas (see chapter IX, section 3).

Coordination is indispensable both for countries that maintain a floating currency—to allow exchange-rate fluctuations to perform their fundamental role without hindering integration and the single market—and for those that peg their currency or share a common currency. In the latter case, coordination has to be stronger and supported institutionally because the risk of free riding is higher and less severely punished by the markets, as demonstrated by the euro area case.

In both cases, the countries of a subregion have a direct interest in joining forces to build a regional-coordination scheme to improve the transparency of their macroeconomic efforts and ensure the credibility of chosen policies.

One special case is **dollarization**. Like any monetary union, dollarization requires a more active fiscal policy than do other exchange-rate regimes. For dollarized countries, it is essential to complement dollarization with an institutional framework that guarantees budget discipline and transparency to ensure the availability of a flexible instrument to compensate for the loss of autonomy in monetary and exchange policies. This framework would, obviously, be more effective and credible if decided on regionally than if left to domestic institutions and the discretionary political game. Again, this does not necessarily mean the imposition of a supranational power on national authorities, but rather an opportunity to take advantage of the countervailing powers easily provided by peer scrutiny among interdependent neighbours.

Having different exchange regimes within a subregion poses a serious complication but not an insurmountable obstacle to policy coordination among members, since cooperative behaviour is needed on all sides, even more than in regions with more similar regimes.

Among **MERCOSUR** countries, the degree of macroeconomic instability—on average, very high—varied greatly, such that the extent of dollarization has also varied among the economies of the region, leading to marked structural differences in the financial sectors. These differences determined both private and public behaviour and thus affected the entire range of policy instruments available. In particular, the role of the exchange rate divided Latin American countries into two camps, according to the macroeconomic-management scheme applied. In one camp was the highly dollarized Argentina, where dollar parity became so crucial that authorities found it expedient to tie their own hands, forsaking the use of monetary policy for internal purposes and opting for a radical fixed-exchange-rate scheme. In the other was Brazil, where monetary and exchange tools continued to be used very actively. This difference between the two macroeconomic regimes dictates the type of coordination that is feasible, by effectively reducing the number of instruments potentially

available for regional coordination. Although this difference does not impede coordination, it is a potential source of intraregional conflict, which makes the need to overcome these differences even more urgent. *Regional integration is compatible with divergent exchange-rate regimes but not with macroeconomic divergence.* For this reason, it is imperative that national policies converge towards common goals for internal price stability and balanced budgets. With such a convergence, exchange-rate fluctuations among MERCOSUR partners would be softer and tend to accomplish their basic tasks without hindering trade integration.

Regardless of the exchange-rate regimes chosen by authorities in the region, economic operators and financial markets would have little confidence in continued attempts at a Southern Cone regional-integration project in the absence of tangible progress towards better macroeconomic cooperation. MERCOSUR would find it difficult to ignore the explicit attention beginning to be given to these issues. Conversely, for exercises in macroeconomic coordination to begin, no matter how gradual and lenient the requirements for firm commitments, the countries need to adopt a long-term perspective on the importance of growth and structural reforms in their economies to begin implementing regional projects, especially regarding financial markets.

Any cooperation attempt of this type will lead to a consideration of exchange rates, which play a key role for trade partners on the path to integration. This consideration led Europe to the EMU and the euro, with an institutionalized mechanism for national-policy coordination. In MERCOSUR, the differences between the two main exchange-rate regimes, exacerbated by the floating of the Brazilian currency in January 1999, served as the basis for initiating closer macroeconomic dialogue focused on a convergence towards macroeconomic stability. Such convergence was indeed attempted with the establishment of the Macroeconomic Monitoring Group (GMM; “Grupo de Monitoreo Macroeconómico”), created by the MERCOSUR Council of Ministers in June 2000; however, the divergences were already too great, and the GMM, despite the impressive progress made up until the Florianopolis Agreement in December 2000 (which included convergence criteria), was too informal, too lax and came too late.

In each of the other two Latin American subregions, one member state had formally adopted the dollar as its currency: Ecuador, in the Andean Community, and El Salvador, in Central America. However, the issue is broader than the formal exchange-rate regimes since the banking systems of the other members are highly dollarized (that is, they have a very high proportion of dollar deposits). This structural feature, although an additional constraint for macroeconomic policy, also constitutes a

major reason for a common approach. It should therefore be dealt with by each subregion, and offers an opportunity for organizing cooperation and macroeconomic dialogue.

4. The REDIMA approach and the debate about policy coordination

To answer the initial question about the applicability in Latin America of the general lessons drawn from historical experiences, the arguments and facts presented above need to be understood within the larger framework of the policy-cooperation debate in economics. This was, in fact, one of the outcomes of the REDIMA work. In particular, some external contributions discussed within the groups make clear that a large segment of professional economists are rather cautious or even reluctant regarding the need or usefulness of regional policy coordination for Latin America. Their negative opinion is based on the following reasoning.²⁷

- Regional integration in the European Union has required about a half century of hard work involving countries that shared a high degree of political will, mutual trade and institutional capacity.
- Latin American countries are still far from meeting those same economic, institutional and political conditions.
- Therefore, the region must first improve national governance and consolidate domestic macroeconomic conditions, including the implementation of structural balanced-budget rules or some form of anticyclical fiscal policies.

Additionally, a number of economists and policy practitioners, especially at IFIs, adhere to what can be called “**the sceptical view**”, concluding that preferential regional integration does not seem very relevant as a policy priority and could even be of dubious value inasmuch as it provides opportunities to delay unavoidable measures or reforms.

The REDIMA project, by contrast, not only makes clear the benefits of regional integration; it also focuses on the notion that uncoordinated domestic policies can be deleterious to subregional integration by causing negative spillovers among the countries involved. Still, REDIMA acknowledges the significant differences between Europe and the Latin American subregions and believes that countries should recover a

²⁷ For a rigorous and clear presentation of the current conventional view see, for example, the address by Klaus Smidt-Hebbel, from Chile’s Central Bank, to the third annual plenary meeting of REDIMA participants: “Lecciones del Euro para America Latina y para Chile”, Santiago, Chile, October 2003.

significant degree of credibility and autonomy in domestic macroeconomic policies (monetary, fiscal, etc) before attempting to coordinate those policies with other countries. In fact, REDIMA goes further, supporting the view that cooperation and some cautious forms of coordination could also have significant positive effects on credibility and institution-building and thereby spur needed improvements in national governance.

This positive view of the scope of and opportunity for a regional approach has characterized the **REDIMA project**, which was created in keeping with the following tenets:

- Globalization strengthens the role and the importance of institutions and the quality of governance, creating or ensuring the conditions for high sustainable growth.
- Open regional integration can be an efficient tool for aligning the incentives of the different national governments to improve national governance and accelerate institution-building within countries.
- These steps forward allow for further opening and deeper integration.
- Fiscal discipline and structural reforms can gain greater credibility, sustainability and efficiency from a common framework and rules agreed on collectively and at the regional level, as shown by the European Union experiences.

These reasons make it all the more important for Latin American countries to use the regional level and the dynamics of integration to find the political will for and popular acceptance of crucial reforms and convergence policies as quickly as possible. This is a precondition for successful regional integration and for taking advantage of the opportunities offered by globalization.

5. Policy-oriented conclusions

From both the European Union and the Latin American experiences, it appears that macroeconomic convergence and some degree of exchange-rate stability are important conditions for the success of a regional-integration progress.

The European Union experience appears to show that: (1) at the beginning (1947 to 1957), macroeconomic stability and currency convertibility were preconditions for trade integration with a customs union; (2) later (1972 to 1979), policy divergence and the failure to coordinate dampened adherence to trade-integration policies; and (3)

more recently, convergence has been successful because of a regional scheme of surveillance and coordination of economic policies.

The Latin American experiences suggest that sharp macroeconomic-policy divergences (including exchange-rate regimes) are a major source of regional disputes and obstacles to integration, the most famous case being the MERCOSUR crisis: disequilibria in Brazil led to a strong currency adjustment in 1999 with negative spillovers for the overvalued Argentine peso. Recent and current difficulties in the Andean Community reflect, among other factors, the rising overvaluation of Ecuador's currency and sharp fluctuations in the exchange rate between the Venezuelan and Colombian currencies. On the positive side, the period of progress in trade integration—the better part of the 1990s—coincides with the period of macroeconomic convergence resulting from the adjustment policies imposed.

The working hypothesis adopted by REDIMA goes as follows: (1) improving convergence and exchange-rate stability is crucial for facilitating regional integration; (2) regional cooperation among neighbouring economies is a tool for enhancing or accelerating convergence, since a cooperative game could lead to a superior outcome for participants overall; (3) thus, regional macroeconomic dialogue is mainly intended to become a lever to seek a consensual, operative mechanism to improve and accelerate regional convergence and integration, i.e., to attain a superior outcome for the region; and (4) rigorous monitoring among peers could quickly trigger emulation, accelerating the credibility building of national governance.

This does not mean that economic-policy coordination is the only possible path to regional integration. Indeed, national authorities should, ideally, be able to reach such an objective on their own, if desirable for the growth of their own economies. However, the real world is not the textbook one, and, as mentioned, despite significant spillovers among regional partners, there are political-economy reasons that explain non-optimal decision-making. That is why I start from the hypothesis that not only could economic-policy coordination be, under precise conditions, an advantage, but that it is also a precondition for spurring integration and development in Latin America's subregions. That even Europe's advanced economies, with stronger institutionalization, found it necessary to resort to regional mechanisms to make progress in convergence and restore the conditions for sustainable growth indicates that this hypothesis deserves careful consideration and further discussion in Latin America.

Chapter VII

Three major obstacles to regional macroeconomic cooperation in Latin America

In Latin America, obstacles to regional cooperation continue to be strong for several reasons, which merit an open and frank discussion. As the subject is complex and sensitive, some comments are made below, from the author's comfortable position as an outside observer, to elicit reactions from readers.

The countries of the region are generally trapped in a typical suboptimal situation of a non-cooperative strategy as a result of uncertainty (or mistrust) regarding their partners' behaviour, including the possibility of defection. Security reasons provide more individual incentives for each country to remain uncooperative. In game-theory terminology, each player is led to apply a dominant strategy against cooperation to maximize its welfare (minimize its losses). However, this strategy can be analyzed in three different facets, all of which support the global dilemma. These can be seen as three different obstacles to regional cooperation.

Two facets also affected European integration: the strict logic of the prisoner's dilemma, and the erroneous belief in a power struggle between national governments and regional agencies. The third one, more specific to Latin America, is the lack of credibility and the poor reputation that adversely affects most countries in the region, and which includes their regional agreements and the laxity in enforcing those agreements. This also buttresses the traditional prisoner's dilemma.

1. First obstacle: the traditional prisoner's dilemma, or the unbalanced incentives for cooperating

Latin American countries are not immune from the traditional prisoner's dilemma that undermines international cooperation in general. Hence, although all parties may realize that certain collective actions would lead to better economic outcomes for the entire group, a series of reservations —perfectly rational from the standpoint of each country at the national level— translates into the failure of cooperation and to less desirable results for the group (but not necessarily for each individual country).

As explained in chapter V, each player perceives the identifiable gains from cooperation as clearly inferior to the tangible costs, especially in the relatively short period that matters to politicians. Hence, this is a problem of probability assessment. This suggests that the solution is to be found in changing perceptions on overall risks through an organizational initiative. Such a **change in perceptions is the objective of the REDIMA approach**, which is keyed to the supposition that an adequate regional mechanism might reverse the relative importance of cumulative gains from and costs of macroeconomic cooperation.

In addition to more technical issues (structural differences, disparate income levels), the nationalist and protectionist past continues to exert considerable influence on economic policy, despite the cultural and linguistic similarities that tend to favour strategic rapprochements. This explains the persistence of the dilemma. Political decision makers dare not take new initiatives because of a series of uncertainties: the difficulties countries have in evaluating the distribution of effects beforehand; wariness of other countries' reactions; lack of consensus on the situation and the best measures to take; lack of continuity among policy makers as a result of high turnover in economic teams; fear of having one's hands tied vis-à-vis one's neighbours and being the target of populist criticism from one's own constituency (sovereignty cult); institutional weakness, lack of authority and poor reputation (credibility problems); or even the absence of credible regional or arbitration institutions.

However, global and local changes, fallout from the foreign-debt crisis, deregulation and structural adjustment policies created strong pressure that imposed greater consensus and parallelism in Latin America, reducing obstacles and facilitating cooperation in the past decade. In fact, Latin American integration schemes progressed significantly. They now need to advance towards the more crucial macro-monetary stage to consolidate and take advantage of this progress and be better poised to face globalization.

A factor favouring a way out of the dilemma comes from the growing awareness of the interdependencies among neighbouring economies, combined with a recognition of the costs resulting from the lack of true regional markets and the divisions vis-à-vis large countries, other blocs or globalized financial markets. Precisely this type of consideration and external pressure allowed Europe to escape its own prisoner's dilemma. As set forth in greater detail below, the solution to the Latin American dilemma consists in improving mutual knowledge and encouraging communication and joint undertakings among national administrations to set in motion the dynamic gains each participant could reap from cooperative regional behaviour. The risk of higher turnover in economic teams could be addressed by establishing more contacts among the technical services themselves and less among ministers' political appointees.

2. Second obstacle: the Latin centralization syndrome

The prisoner's dilemma is not the only obstacle, however. The public often voices concern over a "lack of political will" in countries, which, in a vague and resigned way, conveys the perception that the authorities would not be willing (or would not be supported by constituencies) to surrender prerogatives or powers to regional agencies they do not control. Although this perception also reflects a manifestation of the prisoner's dilemma, it is useful to focus our attention on a more precise argument, which strengthens the perception: the general notion of regional agencies as competitors of national governments or administrations. This worsens the prisoner's dilemma with a moral-hazard situation, which leads decision makers to show no interest in taking regional commitments seriously or effecting integration. Under such circumstances, it is not possible to advance the regional integration agenda very successfully, because of a deeper logical flaw.

This obstacle arises from a perception — both outdated and erroneous— of integration as a centralizing factor. Although regional integration requires the transfer of certain specific powers from a national to a regional level (for example, when a tariff union or an economic and monetary union are being set up), recent European experience shows how limited and infrequent these instances are. Indeed, consensus on the importance of subsidiarity made it possible to clarify the nature of integration among sovereign states.

This is another example of how essential it is for Latin American decision makers to carefully consider the European case and its past errors. The tendency in every integrationist scheme in history to centralize

decision-making has resulted in a series of resounding failures, not only in Europe but also in Africa and Latin America (for example, in the initial version of the Andean Pact). As analyzed above, the same occurs with economic-policy coordination, which is generally confused with requiring nations to subordinate their responsibilities to supranational agencies or to more powerful neighbours.

This issue needs to be clarified in Latin America, especially in the macroeconomic and monetary fields. If macroeconomic coordination clearly does not purport to impose decisions but to improve national decision-making in each country's self-interest, the conflict of interest not only disappears but is transformed into a force favouring cooperation, by directly benefiting national decision makers, as will be underlined at the end of section 4 and developed in chapter VIII.

This second obstacle needs to be stressed, because it tends to reinforce the first by causing mistrust of regional agencies and excessive formality in contacts among national governments and administrations, which are perceived as negotiations. This inhibits exchanges of information and knowledge among countries, thus intensifying the prisoner's dilemma situation. There is a notable lack of regular communication among economic experts, except when viewed as "diplomatic negotiation". Despite several official channels of communication and institutional negotiations among the countries of the Latin American subregions, there is a need for true technical exchange, without any negotiating edge, to reduce uncertainty and mistrust and thus work towards the development of a communal culture and collegiate work. In Europe, the same shortcoming explains the long wait for a communal culture and cooperation spurred by the individual interest of each national administration.

European Union and Latin American experiences (but also those of other regions) should lead to a recognition that some aspects of the organization of diplomatic relationships seem obsolete and might, in themselves, constitute obstacles to regional integration. Ministries of foreign affairs, as the term conveys, generally put integration with immediate neighbours in the same category as formal diplomatic interactions with genuine "foreigners". While, by definition, an integration process implies rendering domestic what used to be seen as foreign, the nature of such integration and the procedures used to achieve it depend on the specific development of common goals and interests regarding economics, finance and currency. According to the principle of comparative advantage, it would be more rational and coherent (but perhaps "diplomatically incorrect") to transfer regional-integration affairs, or at least their technical aspects, to ministries of economy and finance before they are forwarded to the foreign ministry for a final decision.

This is not a secondary issue. Regional integration cannot be triggered in an intergovernmental framework, as the recurrent European attempts in the non-Communitarian fields (like the second and third pillars of the European Union) have demonstrated. Regional integration requires a Community-based context and procedures. Without further sharing of responsibilities among ministerial departments allowing economic integration to become a domestic issue, the prisoner's dilemma will continue to thwart or even to quash any genuine initiative for addressing common concerns.

3. Third obstacle: the lack of institutional reputation and credibility

This handicap reflects the institutional weaknesses of most countries of the region as well as of most of its national and regional institutions. Although this was also partially the case in some European countries, Latin America suffers more from the negative legacy of the past; in addition, in contrast with Europe, where the major economy was also the most credible one, no large Latin American economy is positioned to immediately serve as an anchor. Further, Latin America has no strong regional institutions capable of lending immediate credibility to supranational commitments; on the contrary, regional commitments suffer from weak institutional enforcement procedures and a poor reputation.

This lack of credibility poses an additional obstacle to the dynamic gains essential for providing incentives needed for the cooperative game to function, as explained in chapter V.

4. A comparison of Europe and Latin America with a view to eradicating these obstacles

As described in detail in chapter III, the European Union went through a long process in surmounting the obstacles to feasible coordination. In this lengthy history, numerous forces came together in a context radically different from present-day Latin America. A comparison of the European Union and Latin America should take into account that Europe had both advantages and disadvantages vis-à-vis Latin America:

Europe's advantages were that, from the beginning, there was greater economic interdependency, a relative balance of power between several big Member States, greater institutional credibility and a well-established monetary anchor with sufficient international weight (based on the German Bundesbank's reputation for stability and independence).

Inter alia, the European Union had three fundamentally important instruments in place:

1. An autonomous regional driving force, the Commission, whose main function was to take initiatives based on previously defined procedures. This made it possible to experiment successively with different formulas and to carry out tasks enabling national administrations to meet regularly and to gradually forge a common culture.
2. A Monetary Committee, or group of macroeconomic officials created by the Treaty of Rome (1957), which held closed-door meetings at least monthly with experts responsible for national macroeconomic policy. These meetings of top-level officials —appointed directly and not subject to removal, as they came from the civil service administrations and not from ministers' cabinets— enabled mutual trust and a communal culture to gradually take hold. The Monetary Committee (now named the Economic and Financial Committee) comprised two members per country —the director of the treasury and a high-ranking official from the currency-exchange markets at the national central bank— plus two macroeconomists from the European Commission's Directorate General for Economics and Finance and a third who acted as a permanent support secretary, responsible for the organization and distribution of studies and exchanges among members. Importantly, this specialized committee and its members do not depend on national chancelleries or on the European Union's foreign affairs procedures.
3. A *de facto* leader in monetary policy, based on its historical low inflation record and institutional independence. This essential factor allowed for a profitable trade-off: the other economies benefited from German monetary credibility inasmuch as they were able to apply some macroeconomic discipline, and the German economy benefited from more domestic stability (see chapter III). However, the German leadership was limited to this monetary area, since its economic weight was not very different from that of the other main European Union partners.

The disadvantages *vis-à-vis* Latin America were the greater cultural and institutional differences among the European Union Member States, as well as the broader spectrum of national policy options; less obvious costs of not integrating at that time; and a lower degree of social urgency because of higher income levels and greater social protection.

The Old Continent could also afford to take its time and make many mistakes, while maintaining the status quo apparently represented

a feasible option. The lower degree of globalization at that time meant that the pressure of necessity took longer to become evident than is the case today. In the end, however, the Europeans succeeded in pressing forward towards solutions on a gradually prepared terrain. For this reason, the resulting long process of “groping in the dark” provides the observer with two specific lessons on how Europe escaped the prisoner’s dilemma:

1. **Successful coordination is based on the individual interests of autonomous participants**, and coordination is successful only insofar as it is directly useful to the participants—a necessary condition—and truly protects their sovereignty. The European Union countries have effective coordination and accept formal procedures because doing so serves their own interests; i.e., national administrations take advantage of coordination as an instrument directly useful to their decision-making and the credibility of their policies. They obtain information and contributions from their partners, reducing the uncertainties that characterize the economics issues. The willingness to disclose their policies and even their future intentions turns into a win-win game when there is a minimum of trust. Participants benefit from the critical comments of their peers, who, in a continuing game, have no interest in creating problems for or disturbing their neighbours. Instead, countries share an interest in helping each other’s economies be sound and thrive to the greatest extent possible. In such a game, each participant’s involvement in monitoring the others and ensuring that they abide by the common rules reduces conflicts. There is no policeman or supreme authority; each actor simply maintains a strict surveillance of its partners. Achieving the common good depends on all parties observing the effective rules.
2. **Personal ties among high-ranking experts normally play a significant role** in European Union coordination building. Officials responsible for macroeconomic policy who participate in associative tasks at the regional level and responsible for the technical aspects of national policy mixes are the key actors in the coordination game and in setting down the conditions for its emergence and orientation. The communal culture, the minimum trust required and the successful cumulative participation arise from personal ties created and developed among the macroeconomists in charge of technical exchange. It is these macroeconomists who, by working together regularly, build consensus on policies. The role of national experts is dual and “evaluative”: (i) they must become well acquainted with their counterparts, understand their difficulties and ensure a direct channel of communication to avoid misunderstanding or mistrust, and (ii) they must convey their counterparts’ assessments to their

own ministers or superiors. In this dual mission, experts have certain manoeuvring room that enhances the value of their role: access to privileged information lessens their daily workload and allows them to defuse potential conflicts and provide that information to help their superiors (either cabinet ministers or central bank presidents) devise strategies. As macroeconomists share a common educational background and face similar restrictions and challenges, they speak the same technical jargon and quickly form a homogenous group with a sense of belonging and community. Of course, continuity in this task is crucial and depends on the relative permanence of policy makers.

Chapter VIII

Some key guidelines for escaping the prisoner's dilemma in Latin America: political economy at REDIMA

From the analysis given in preceding chapters and especially from the general principles drawn from coordination experiences (chapter V), a significant conclusion emerges for Latin America: the prisoner's dilemma—which reflects incentives for non-cooperative behaviour—can only be broken through a regional triggering of dynamic gains, which creates countervailing incentives for national policy makers to cooperate with one another. To launch such a dynamic process, it is necessary to simultaneously reverse the three major obstacles identified in the preceding section. The following political-economy guidelines are organized in line with these three obstacles.

The first two obstacles to coordination—one that stems from uncertainty (the prisoner's dilemma) and the other that stems from the formal nature of contacts among the administrations of countries, generally through foreign affairs ministries, in a single region (the sovereignty dilemma)—can be overcome through the implementation of two main guidelines: (1) making clear that feasible and realistic coordination for Latin American countries entails not a loss of sovereignty but an improvement in each participant's long-term autonomy (the coordination paradox, see chapter V); (2) allowing national macroeconomic experts to create their own direct network to share information, expertise and technical assessments, in which they do not negotiate for their respective authorities, so that they will have greater mutual trust when working together behind closed doors. This reduces uncertainty and leads to identifying differences and raising awareness of the common interests shared by all participants. Another advantage of this specific type of

network is the greater continuity of technicians compared with political teams or officials directly linked to the cabinet.

The third obstacle—the initial absence of a sound reputation and strong credibility—could be overcome through a third guideline, discussed below, which consists in accelerating the endogenous development of incentives for policy makers. Since at the beginning, the individual advantages of playing the cooperative game are still uncertain and credibility has not yet been established, temporary external intervention from creditors could be useful and would probably be needed to focus on the results of the regional commitments made by participants before endogenous incentives become sufficiently strong. In addition, there is a need to stimulate market rewards and sanctions by designing a system of adequate procedures. Such a system relies on explicitly gaining the attention of financial markets and agents.

The following subsections develop these three guidelines in detail.

1. Using the coordination paradox, or how to gain more autonomy through coordination

Paradoxically, coordination provides sovereign actors with a *de facto* higher degree of autonomy regarding their economic policies. From a legal or an institutional standpoint, coordination implies a formal limitation of sovereignty since national authorities accept restraint of their discretionary actions in specific areas and situations. However, the economic purpose of accepting this constraint is to reap benefits from greater credibility and consequently to enjoy greater manoeuvring room, as well as to avoid the future costs on partners of negative spillovers or policy mistakes. Accepting self-discipline to prevent errors or negative spillovers cannot, then, reduce effective national autonomy regarding economic policy, since effective coordination brings benefits that directly or indirectly increase the manoeuvrability of national policies.

It is necessary to overcome the erroneous perception that coordination is synonymous with a loss of national autonomy by making clear from the outset that the purpose of coordination is not to submit national decisions to foreign or supranational authorities. Specifically, this can be achieved in several ways—depending on the sensitivities of each subregion—starting with merely replacing the word “dialogue” for “coordination”, until specific operative content can be given to institutionalized coordination through common rules. The essential objective is to make clear that coordination is not about transferring responsibilities or decision-making, both of which will always remain under national control, but about taking advantage of regional synergies

to gain margins of autonomy by preventing gross errors, improving the efficiency of national decision-making and furthering understanding among neighbours and regional partners.

We can illustrate this with an analogy comparing national sovereignty with individuals' autonomy in driving. Individuals collectively agree to submit to a minimum set of common rules contained in a traffic code. Although in principle this limits their absolute freedom, all participants recognize that by applying the code, each individual broadens his/her potential freedom of movement. For instance, respect for traffic lights, rather than restricting freedom, increases individual driving speed when the light is green, given real traffic conditions (e.g., externalities and traffic jams). Without traffic lights, all drivers would have to stop, which would curtail each individual's freedom compared with driving according to a regulated traffic system. It is therefore legitimate to conclude that this type of coordination among individuals, through common rules, does not diminish their autonomy, but rather restores margins of freedom that would otherwise be forfeited. The explanation of this paradox resides in the reciprocal impact of individual decisions: absolute autonomy does not really exist, since there are always interdependencies and interactions. Hence, effective individual sovereignty is greater when the effects of interactions are taken into account by a qualified system of accepted rules.

The purpose of this analogy is solely to illustrate the paradox of coordination formulas that strengthen autonomy instead of restricting it. Naturally, this holds true only for coordination formulas that operate according to common, agreed-on rules and that include participant monitoring. In addition, only these formulas are practicable without major institutional changes. They are also the most feasible, given that they offer incentives to national decision makers—that is, they are directly useful for allowing national participants to attain their goals.

2. Encouraging mutual knowledge and direct communication among national administrations through the creation of technical networks

To escape the prisoner's dilemma it is by definition necessary—irrespective of the times, culture and circumstances—to advance in the following three directions:

1. Intensifying communication among the parties involved, thereby reducing risks of misunderstandings and uncertainty and building trust;

2. Ensuring sufficient continuity or regularity, in the sense of instituting an ongoing game that will oblige actors to maximize their longer-term gains and thus internalize the effects common to the group of countries. This requires establishing regular contacts among officials with more continuity—rather than only among staff members with a high turnover—and utilizing their technical services;
3. Ensuring that this communication is multilevel, rather than limited, as it usually is, to preparing for or making decisions. Contacts should be increased and lead to common tasks and joint, simultaneous reflections at several hierarchical levels, depending on their purpose, with official channels being reserved for official agendas and negotiations (among ministers) or for decision-making pursuant to formal procedures. Experts need to work together collaboratively without aiming to reach policy decisions but simply to improve mutual understanding and thus relieve technical exchanges and tasks of the encumbrance of specific purposes and official agendas, and above all to allow networking among staff members. An additional reason for increasing the number and the raising the level of meetings is to respond to the high turnover in economic teams that sometimes results from political instability or from shorter missions for decision makers.

Moreover, the recommendation that these contacts not be limited solely to diplomatic processes or official contacts among ministers is not intended as a criticism of existing mechanisms or institutions, which are essential, but as a recognition that these processes and contacts are insufficient to overcome the constraints on cooperation. The groundwork for these processes needs to be laid through joint efforts by national administrations. This is the key to spurring new cooperative efforts and avoiding unnecessary stages for Latin American integration, which will allow the region to make up for lost time. This author's strong conviction of the merits of this approach lies in the personal experience he accumulated, mainly during his in-house role, in the construction, from the ground up, of the mechanism currently in place in the European Union as well as his work in other regions and cases.

This aspect of direct contact at several levels might seem ingenuous or simplistic, but it allows for a response to the second obstacle that exacerbates the prisoner's dilemma, namely, excessive prudence resulting from official negotiations among administrations or institutions from different countries. When international communication is funnelled through this mechanism, it validates the rationale of the prisoner's dilemma, inasmuch as communication is kept within the hierarchical logic of domestic policy. Interlocutors lose opportunities to improve

their shared perception of reality. Since everything is reduced to the official negotiating agenda, participants can only go as fast as the slowest member, and the logic of cooperation is overridden by the particular ups and downs of domestic policies, the high risk of confrontation among neighbours and a mistaken fear of power being transferred from the national to the regional level.

When contacts are regular and less formal, networking occurs more quickly and technical experts can embark on effective cooperation initiatives in their own fields. A *group dynamic* is created, through which participants compete to enhance their roles, their management skills and their expertise, and to demonstrate the professionalism of their own administration. This induces an “upward-levelling” process and creative effort. With the use of new information, important tasks can be implemented that could not have been planned—even at a national level—if they had to go through a lengthy official agenda before formal regional negotiations could be held. Thus, sharing analyses and information on difficulties encourages gradually building an esprit de corps among macroeconomic experts. This unique group identity acts as a catalyst of cooperation among participants, because the group helps each participant in his/her daily work. Macroeconomists thus gain manoeuvring room and contribute more effectively to decision-making. This allows them to increase their effective say over internal economic policy-making. Increased external contacts and greater participation in collegial tasks also improve internal contacts within each country’s technical administrative team. The end beneficiaries are the authorities (ministers), who benefit both from the information they receive and from the motivation of their experts, and their experts, in turn, experience personal growth through their role in the regional group. This results in a dynamic process that, by improving each country’s governance, also expedites the formation of a regional consensus on needed measures.

In Latin America this can—a priori—be easier and speedier than it was in Europe if more opportunities for regular technical contacts among the macroeconomists who set policy are created.

3. Developing incentives for national decision makers to use the regional level to promote their own interests

As explained regarding the prisoner’s dilemma, the challenge is to make tangible the dynamic gains each participant expects to reap from taking advantage of the regional level, its rules and collective scrutiny. The key channel for giving incentives is the credibility-building process, which can be created through organized regional monitoring of national

policies. The mere existence of an effective system of rules and scrutiny should provide individual advantages to participants who try to play the game. Indeed, such a system allows them to enhance the credibility of their policies and therefore more easily attain their own goals at a national level. The credibility factor also acts directly on investment and savings, and more generally on growth, by reducing uncertainty and raising the expected returns of economic agents' decisions.

For example, the most representative of these incentives is the risk premium included in the interest rate on an economy's external financing (country risk premium, or what in Latin America is currently called a "spread"). A successful cooperation strategy that enhances the credibility of national policies also reduces their costs, especially by significantly reducing the spread between sovereign bonds issued by that country and United States T-bills. Hence, the purpose of regional peer monitoring must be to accelerate the lowering of spreads. To the extent that regional rules and criteria are technically consistent, are effectively enforced and are guaranteed by the critical scrutiny of the other countries, each subregion could receive the needed incentives and each country could reap important benefits much more easily than by acting alone.

Globalization means that each administration (and each country) competes with others for credibility in the eyes of international markets; however, the legacy of the past is a strong handicap. The purpose of creating a regional monitoring with specific incentives is for the regional level to be used as a more transparent and powerful institutional mechanism to create the countervailing forces or the checks and balances that developing economies find difficult to establish on their own. Thus, traditional institutional weaknesses at the national level could be circumvented (or offset) by more effectively channelling natural competition among countries, through an organized mutual monitoring at the regional level, thereby creating the checks and balances these countries cannot easily or quickly establish on their own. Indeed, the collegial monitoring system relies on a certain degree of competition, but within a previously agreed-on, regulated framework.

If this regional framework is transparent and competently managed, such critical peer scrutiny could have an impact on public opinion in each country and on financial markets and external creditors through an automatic system of rewards and sanctions (and especially through risk premiums). It is in the interest of each competing peer to oblige the others to respect the common rules (i) for it to benefit from the credibility afforded by the regional device, and also (ii) to protect itself from the behaviour of its neighbours, which are also interdependent (that is, to preclude contagion). **This combination of competition and cooperation**

among autonomous national administrations allows the reactions of national public opinion and international financial markets to be used as **an incentive system of rewards and sanctions *vis-à-vis* national policy and governance**. This approach for ensuring more accountable economic policies enables the countries of the region to internalize their spillover. The result is a win-win game for the different national actors as well as for their countries overall and for the entire region because regional coordination benefits national participants who are motivated to use such efforts to become more competitive.

The analysis of past experiences (chapter III) shows that a practicable scheme benefits the participants and is moved by the competition among them to respect the agreed-on rules and monitor their neighbours' enforcement of those rules. In this vein, consensus may be reached among national administrations to develop common rules and criteria and to decide to enforce them at the appropriate regional (or subregional) level, e.g., through peer monitoring under the scrutiny of economists and the markets. Such a transparent approach would become a powerful catalyst for reforms and an appropriate mechanism for institutional-capacity building. Most of the urgent reforms needed by each economy could be designed, promoted and monitored through this regional cooperation-based method, allowing for economies of scale, trustworthy accountability and genuine regional alignment, triggering endogenous incentives and garnering social support from a sceptical public. In particular, exchange-rate and macroeconomic stability could more easily and sensibly become a common subregional issue, contributing both to democratic participation and to shaping a regional identity. Of course, as mentioned initially, this entire dynamic supposes a non-centralist, non-bureaucratic regionalism (strict subsidiarity and transparency) and the permanent possibility of opting out, to preclude free riding or moral hazard.

Nevertheless, the most difficult aspect of this mechanism is the beginning. Clearly, incentives cannot appear automatically at the onset of any regional-monitoring system. In addition to the need for transparency and professionalism, opinions and markets have to be convinced that regionalism can effectively work and bring something new and credible to a region where the record of institutional enforcement is not stellar. Hence, **a specific organization is needed to ensure such a "regime change"**.

As shown by European integration, and drawing inspiration from Triffin's method applied for the EPU (that is, the Marshall plan with specific conditionality imposed by the United States on European countries at the end of the 1940s), the easiest way to create effective incentives from the very beginning would be through temporary external

assistance, —e.g., through a comprehensive North-South cooperation agreement to provide specific rewards to policy makers for cooperating at the regional level. Indeed, it is in a creditor's interest to cooperate with the development of credible regional integration capable of leading to better macroeconomic policies and governance. An effective formula to encourage such an institution-building process is to establish a formal and visible link between Northern external financial assistance and trade negotiations and the effective use of regional macroeconomic monitoring by Southern partners.

One proposal would be, for example, to create positive discrimination favouring subregions able to institute cooperative monitoring of their members' macroeconomic policies. New North-South trade and financial agreements would reward countries for implementing an effective two-tier system of macroeconomic dialogue: the first tier would be collegial monitoring of any macroeconomic policies among peer authorities in each Southern subregional entity (whether or not this monitoring is formal); the second tier would ensure that each North-South agreement incorporate the same kind of dialogue and monitoring between Northern authorities and their Southern counterparts organized into subregional groups. This second step would be the complementary incentive, since North-South cooperation agreements could provide the opportunity for accelerating the implementation of the basic cooperation proposal and could reward countries that do so. The content of all North-South agreements should not necessarily be identical, since each case is unique. However, the purpose would be to provide either equitable pressure (offering priority negotiations or additional, unrestricted access to Northern markets for subregional groups of economies introducing macroeconomic cooperation formulas among their members) or more indirect incentives —such as offering Latin American countries an effective mechanism to build the credibility of their own macroeconomic monitoring (financial assistance or support to promote credibility through the issuance of joint communiqués on consensual views on policy positions between Southern and Northern authorities during their dialogue). In either case, effective (and very economical) macroeconomic technical cooperation should be established and would constitute the main engine of cooperative behaviour among sovereign authorities and favour cooperative policies.

The ideal formula would be “comprehensive North-South-South regionalism”. This would mean obtaining conditional support from the North (positive trade discrimination, technical assistance) and creditor countries or IFIs (technical and financial assistance) to give incentives for regional macroeconomic cooperation among Southern partners. Since such financial assistance must respect the Bretton Woods rules, an interesting combination of supports would result, and the progressive

decentralization of IMF interventions could be envisioned. At a minimum, the IMF might be interested in using subregional and North-South dialogue to better its own recommendations and conditionality. For example, IMF programmes and vigilance could be combined with or even incorporate subregional schemes insofar as they contribute to IMF targets.

The overall formula could be a powerful vehicle for eliciting the interest of Southern authorities and strengthening the credibility of South-South vigilance schemes. It could also help Latin American countries set better priorities. In any case, and irrespective of linked financial assistance or market access, by bringing together the decision makers of neighbouring and like-minded Latin American countries, the “collegial” dimension might have a catalyst effect as a result of peer pressure, which already reduces the likelihood of a prisoner’s dilemma. In the proposal presented in the following chapter, additional modalities could expedite credibility building.

Chapter IX

Operational conclusions: applying the cooperative REDIMA guidelines for facing Latin American macroeconomic instability

This chapter summarizes the principles and guidelines set forth above in order to translate them into specific options for possible cooperation-based modalities that drawn on the issues and proposals discussed during this first stage of the REDIMA approach.

REDIMA does not seek to bypass existing institutions by becoming a negotiating group but only to build consensual dialogue among national experts. Hence, the options presented are an opportunity for technical debates and for fine-tuning the principles set out in preceding chapters. For the same reason, such a dialogue process cannot exclude any topic in advance. Indeed, no subject is a priori taboo in an informal technical network of peers whose main purpose is to build trust by improving mutual understanding and analyses of mutual spillovers. Consequently, there is a case for setting priorities and venturing to discuss exchange rates.

1. The first priority: including exchange-rate development in regular peer monitoring at the regional level

Exchange-rate regimes and policies are the most visible externality of national choices. Hence, mutual monitoring is also the best mechanism to catalyze regional technical dialogue and further cooperation among the policy makers of interdependent economies. Of course, it must be made clear from the beginning that the purpose of such monitoring (or of

REDIMA) is not to propose a precise EER but to analyze and shed light on the technical implications of existing or alternative EERs and exchange-rate policies for each economy and each regional context, taking into account the best interests of each participant. Therefore, in the application of what we have called the *coordination paradox* (chapters V and VIII), the technical discussion of exchange-rate policies and options among peers should be viewed not as a cumbersome constraint on national autonomy or sovereignty but as a helpful and needed step towards the full legitimacy of and respect for requiring responsible, efficient political accountability from national authorities. More precisely, this step is the most rational way of giving meaning to the fundamental reality that the “*exchange rate is a matter of common concern*” for regional partners.

Chapters II and III described the emergence, in past experiences with industrial countries, of mutual monitoring of exchange-rate evolution as an effective mechanism for envisioning a cooperative approach. More precisely, the European Union’s coordination scheme was gradually built on attempts to reduce exchange-rate volatility among Community partners, as a pillar of regional integration. The European experience, accumulated mainly during this intense exchange-rate monitoring (through the EMS and subsequently during the two first Stages of the EMU), suggests the possibility of envisioning a realistic process in Latin American subregions. The starting point is to focus solely on the exchange-rate evolution of partners’ currencies. This inevitably leads to technical discussions about the needed convergence and compatibility of national macroeconomic policies, providing an opportunity to institute technical dialogue to discuss each country’s domestic policies. The dialogue process will progressively bring important advantages to the participants and lead policy makers to envision further the formalization of their exercises. In this subsequent process, several options emerge. If a strong consensus is built, they could consider introducing binding rules, first on organizing a cooperative managed float and subsequently on progressively disciplining monetary and fiscal policies. The validity of this principle is negatively confirmed by Latin America’s recent crises, in which insufficient dialogue and a lack of cooperation on exchange-rate policies significantly contributed to the breakdown of integration.

As stressed in chapter VI, this does not, of course, mean that Latin America must apply precisely the same formula either for an exchange-rate system, like the EMS and its peculiar exchange-rate mechanism of adjustable, mutually pegged parities within bands, or for the surveillance of other policies, like the Maastricht fiscal-discipline policy. As explained in detail in chapter VI, the European Union model is not importable to Latin America, although important methodological aspects of the

European experiment continue to be especially useful for Latin American economies.

In particular, as in Europe and elsewhere, exchange-rate evolution is the key for macroeconomic cooperation and coordination. This is why in Latin America exchange-rate monitoring could also potentially be the key to triggering and systematizing macroeconomic cooperation. The need to further the convergence and compatibility of the policies of autonomous partners in a subregion attempting to integrate is unrelated to whether they share the same ERR or have a single currency project. Regional cooperation or coordination results from a quest for credibility when the common intention is to build an equitable single market so as to be competitive in a globalized world.

As also shown by the European Union experience, which covers the whole range of possible exchange-rate regimes —while 12 currencies have merged into the floating euro, the United Kingdom's and Sweden's currencies have remained purely floating, and Denmark's is narrowly pegged to the euro through the ERM II— *regional cooperation or coordination is perfectly compatible with different exchange-rate regimes but not with macroeconomic divergence and exchange-rate instability*. Hence, precise schemes for regional cooperation and mutual surveillance were put in place to prevent such divergences and exchange-rate instability.

Hence, the purpose of presenting our conclusions in this chapter is not to foster a debate on the optimum exchange-rate regime for Latin America or its subregions but to focus on a pragmatic way to leverage this crucial (for both national interests and regional integration) common issue as a trigger for cooperative behaviour among national authorities and thus avoid unnecessary costs or instability. Indeed, ERR optimality is relative and depends on the time horizon, circumstances and national structures. Usually conflicting academic models and prescriptions are either relevant or inappropriate, depending on the circumstances and kind of shock besetting the economy in question. In fact, there is an element of truth in all the leading academic approaches that focus on the partial determinants at work. Here the devil is not in the details but in the real-life and practical conditions of implementation. Our purpose is to step back from the type of thinking that stems from academic debates to provide policy makers methods to escape doctrinal rigidity or paradigmatic dominance.

2. Emerging economies' ERRs share a common character

Chapter VI stated that all ERRs with relatively free capital movements are exposed to the same systemic instability when institutions are insufficiently resilient or when the underlying policies lack credibility.

Furthermore, choosing the right ERR is not a panacea since there is neither a perfect ERR nor a one-size-fits-all model capable of accommodating all partners simultaneously.

Inasmuch as the region shares this ERR issue and in the light of the consequent risks of exchange-rate crisis and disruption, REDIMA has tried to institute a method that will get at the genuine roots of the problem—the lack of adequate checks and balances at national levels. This method consists merely of using the regional level to compensate for the lack of credibility and institutional resilience that needs to be resolved for any ERR to work. In a regional soft arrangement for progressive monetary and fiscal cooperation, LACs could find the needed catalyst of national institution-building efforts to compensate for most of the intrinsic lack of monetary and fiscal credibility which explains most of exchange-rate turbulences.

If we assume that any ERR option from the three available categories (synthesized in chapter VI, section 3) remains potentially attractive, depending on specific national traits and circumstances, its actual performance would still depend on the degree to which complementary institutional conditions were observed: under dollarization, fiscal discipline and banking supervision would be crucial; under a floating regime, the credibility of the monetary policy would be decisive; and under intermediate regimes, the transparency and coherence of the whole decision-making process would be fundamental. *The common feature of any efficient ERR is strong and credible institutions, with suitable, visible checks and balances able to convince markets and national economic agents of the policy orientation. The common weaknesses of most countries of the region are precisely the difficulties in meeting these conditions, basically because of a lack of checks and balances within a credible institutional framework.*

The stronger the exogenous shocks and the other structural difficulties to which the region is exposed, the more damaging these institutional weaknesses are and therefore the more attractive a regional contribution to the institutional capacity should be. The historical record of the numerous ERR experiments in Latin America indicates that, with very few exceptions, national policy makers have not convincingly shown themselves able to guarantee respect for the institutional conditions required by each regime. This is why the REDIMA approach proposes support at the regional level to strengthen supervision of the intrinsic coherence of these sensitive national choices.

That even in the European Union—with fewer structural and institutional problems—most countries were historically obliged to resort to the regional level to start to overcome their monetary laxity,

their procyclical fiscal policy and the excessive rigidity of their economies demonstrates the potential power of such an approach. European countries were long aware of the need to treat their *“exchange-rate policies as a matter of common concern”* but could not agree on how precisely to apply this consensual principle. As described in chapter III, mutual exchange-rate monitoring allowed them to be more successful than domestic policy makers at analyzing these required conditions as well as all the effects that national policy makers must deal with in their own interest.

Similarly, REDIMA provides, on the whole, a method for LACs to give operational content to the fact that their exchange-rate fluctuations or disruptions (like their economic policies) are also a matter of common concern for all, including those very few, like Chile, that have already attained satisfactory credibility. Indeed, LACs cannot escape the regional realities that also cause them to be adversely affected by their neighbours' behaviour. However, the same interdependence could also be turned into a positive spillover once a more resilient economy (like Chile's) actively contributes to spreading stability by *“lending”* (under strict unilateral conditions) its credibility to the regional dialogue. By triggering or accelerating the institution-building necessary for any sustainable EER for Latin American countries, this regional macroeconomic dialogue would decisively contribute to the advancement of regional integration and the move towards higher sustainable growth beneficial to all —and especially to Chile.

More specifically, where macroeconomic stability is a crucial regional public good but is difficult to achieve through spontaneous cooperation in the light of the prisoner's dilemma, an appropriate macroeconomic and exchange-rate mutual-monitoring scheme at the subregional level could provide an opportunity to identify these common interests as well as divergent ones, and both the common and the divergent interests could be better managed cooperatively to the advantage of all participants, even of countries that continue to opt for corner solutions. Indeed, this scheme creates immediate mutual checks and balances capable of rapidly emulating institution-building at the national level and irreversibly improving the quality of governance and the resilience to crisis.

Consequently, due to increased commercial integration and financial interdependency and the new environment of international finance, simultaneously achieving external and internal equilibrium requires something more than a nationally determined ERR. Thus, the *“regional option”* is to be viewed at this stage not as an alternative to any ERR or to any policy adjustment but as a complement to advantageously exploiting existing mutual spillovers. The formula for giving explicit significance to

the regional dimension, tentatively proposed in phase 1 of the REDIMA experiment, is developed after the main principles at work are recalled.

3. Why regional monitoring of exchange-rate evolution and national policies could spur institution-building

It could be argued that if institutional weaknesses are already a major handicap at the national level for numerous LACs, they could be an even greater obstacle at the regional level, which has an even lower reputation asset. The REDIMA answer to this logical objection is the positive counter-experiment that in Europe demonstrates that the institutionally weaker regional level has been able to bring considerable improvements to the already relatively good institutional workings at a national level. Among countries facing more governance difficulties, the incentive mechanisms that have worked in Europe should be all the more powerful. This argument hinges on the possibility of —under strict conditions— exploiting the dynamic added value of the regional level to solve certain domestic problems.

The basic principles that make exploiting this added value of regional monitoring a realistic possibility must be presented more explicitly, to show that there is no a priori logical objection that might impede their implementation by LACs. On the contrary, the less credible the national policy, the greater will be the net potential gains for a country that plays the monitoring game with its regional peers and the more powerful will be the “group dynamics” among peers.

Hence, this section describes the creation and exploitation of **regional added value** by referring to the series of arguments set forth in preceding chapters.

- Because of interdependencies among regional partners, a potential regional added value is generally not exploited as a result of the prisoner’s dilemma created by the uncertainty of identifiable gains for each partner (see box in chapter 1, and chapters V and VII).
- Regular regional mutual monitoring of exchange rates and macroeconomic policies makes a common added value more tangible through greater credibility and stronger checks and balances while creating self-rewarding mutual acquaintance, better communication and trust among autonomous participants (chapters V and VIII, section 3). This first step is needed to reduce uncertainty regarding the existence and the individual identification of potential gains.
- The temptation for each player to capture these gains in its own self-interest means that an endogenous, cooperation-based game tends

to emerge and lead to self-discipline, insofar as there is an adequate combination of competition and cooperation among players (chapter VIII section 3). This emulation among peers ensures an upward leveling towards the highest standards (chapter VIII, section 2), creating a net gain of credibility, even for the best, which benefit from their partners' improvement.

- By gradually focusing the attention of national public opinion, creditors and markets on national policy performance and commitments, the monitoring exercises indirectly generate market sanctions/rewards (effects on credibility, chapter VIII, section 3) that make the added value of regional cooperation identifiable and cause it to be internalized; this changes the importance of future gains in regional macro cooperation with respect to individual, unilateral actions. From the standpoint of game theory, this process leads to dominant strategies for each actor, improving the convergence between the national and regional optimum. Dynamic gains from regional monitoring reverse the incentives structure for national policy makers, leading to progressive cooperation based on self-interest (chapter V).
- This corresponds to a win-win game in which the positive outcome increases and incentives to defect tend to diminish with time, as effective cooperation develops and as the game is repeated and is seen as becoming an ongoing process (the endogenous nature of gains at the regional level in an ongoing game).
- This endogenous positive-sum game is even sped up through the effect of expectations (as noted by Axelrod; see chapter V), which creates a need for cooperative actions, thereby pointing to the definitive escape from the prisoner's dilemma.

The core of the REDIMA argument for enabling LACs to resort to the regional level to improve their national governance is the aforementioned emulation process among players, which emerges from peer pressure backed by market sanctions. This emulation is driven by a peculiar *combination of competition and cooperation* resulting from mutual monitoring: participants vie for credibility in the eyes of international financial markets or creditors but they cooperate not only to contribute to an increase in the common pool of credibility generated by monitoring but also to capture a part of that credibility, proportional to their individual efforts to present and meet individual commitments (adjustment and convergence plans). It is in the interest of each competing peer to be rigorous with its partners, obliging them to respect the cooperative rules of the monitoring game (to ensure regional added value and protect its own interests). However, an important condition for enabling such a

combination is the proper implementation of the subsidiarity principle in both its dimensions, not only to ensure that sovereign national authorities are exclusively responsible for national policies (since they compete to apply the rules of the game and to perform better under peer scrutiny and the potential of market sanctions) but also to allow regular regional monitoring (since they cooperate to allow the exploitation of a net added value that they try to capture or to protect, in competition with the others). Although national administrations cannot be asked to sacrifice their own national goals for the sake of their neighbours or the region, the driving force of their legitimate self-interest could be channelled to protect them from their neighbours' mistakes in order to create sound competition with which to enforce respect for some shared rules of the regional game.

To set this value-added process in motion it is not necessary to wait for the emergence of mature institutions with good credibility. In fact, the opposite is true, since individual gains are directly proportional to the initial lack of credibility of the weakest. This is also valid for the initially best performers, since they also benefit from the systemic consolidation resulting from their neighbours' progress. There is thus genuine added value for all participants, or a net creation of wealth resulting from the transformation of better governance into higher sustainable growth (through lower risk premiums). Contrary to the zero-sum game of the prisoner's dilemma, the credibility of regional monitoring is not determined by the average reputation for credibility of the individual countries, but tends to rise to a level higher even than that of the best performer of the group, thereby generating positive spillovers in growth and regional integration (a positive-sum game).

Furthermore, the incentive mechanism is very simple since it relies solely on the universal principle of the self-interest of policy makers, which depends not on the initial quality of governance but on the stringency of monitoring. In the light of the growing importance of the teams of top-level macroeconomists preparing the technical aspects of national policy mixes, the incentive mechanism activated through regional cooperation could be particularly forceful regarding the less effective incentives and means available to these macroeconomists for having an impact within their countries.

This section leads to two important outcomes:

- (1) For LACs to distil from the European Union experience their own regional approach aimed at accelerating their institution-building capacities through a suitable combination of competition and cooperation among national administrations and policies appears attractive and feasible: some forms of regional subsidiary monitoring could compensate for national institutional weaknesses insofar

as they provide tangible gains to all participating national policy makers, reversing the cooperation-adverse incentive structure.

- (2) REDIMA assumes that it would be easier and faster to establish such a regional monitoring scheme than to leave each country to its own devices when it tries, on its own, to reach the equivalent results in credibility and governance improvement. This approach is not a substitute for good national institutions and policies; on the contrary, its aim is to catalyze or even accelerate improved national policies and the reform of national governance.

However, the regional option is not a panacea and should not be overworked, not only because past experiences in the region were not very successful but also because regional institutions generally expose policy-making to an additional risk of moral hazard. This means that the regional option requires a cautious and progressive approach, which should be precisely one of the outcomes of the learning-by-doing process that would trigger the kind of regular macroeconomic dialogue proposed by REDIMA. Properly managing this still-insufficiently explored regional dimension could open a new dynamic approach for LACs.

Nevertheless, this option is inherently based on assumptions that can be verified only by experimenting with the self-validating process of quickly enhancing the credibility of national policies to break out of the prisoner's dilemma.

What are the conditions for and precise forms of such cooperation driven by participants' self-interests? The answer lies in devising operational formulas to organize regular monitoring or activate existing mechanisms. This is the task of Latin American macroeconomists, but it is useful to provide a starting point by offering an example, open to criticism, such as that proposed in the next section.

4. An example of a specific REDIMA proposal for organizing dynamic macroeconomic regional cooperation

This proposal relies on transparency, on a deliberately organized consensus-building mechanism and on simplicity in the determination and enforcing of rules. Contrary to the a priori approach, this does not entail revolutionary changes or sweeping institutional transformations, but rather introducing a radically inexpensive, new method for instituting the required checks and balances, countervailing powers and open public debates that could enhance the accountability and credibility of policy makers to their own benefit.

This step, discussed below, entails only a minor institutional change—the creation by subregions of small independent technical-assessment bodies as complements to each subregion’s groups or committees. All the subregions of Latin America already have the technical and institutional foundations to monitor national policies with a collegial group of peers: MERCOSUR created the Macroeconomic Monitoring Group (GMM)²⁸ in June 2000, and in June 2001 the Andean Community created the Permanent Technical Group (GTP).²⁹ These are the specialized teams of policy makers in charge of policy convergence and coordination. The two trade blocs also have regional decision-making levels through their respective ministerial councils and joint meetings with the central bank governors. The Central American states also have a regional decision-making level, the Council of Ministers of Economic Integration, which includes their central bank governors, while at the technical level they benefit from the experience of the Central American Monetary Council, a specialized group composed solely of central bank macroeconomists. Central America only needs to formally establish a specialized group allowing central bank macroeconomists and their colleagues from the ministries of finance to meet regularly.³⁰

The basic idea for strengthening and quickly guaranteeing policy credibility is to buttress the subregional level with a new, independent tool able to focus public attention on, and to spur technical monitoring and collegial assessment of, national exchange rates and macroeconomic policies. For macroeconomic policies, the deficit of credibility and transparency points to the need for a radical, “fresh” approach, giving priority to open debates among professionals, independent assessments and local ownership and sensitivity. This is similar to Eichengreen, Haussmann and von Hagen’s proposal (1999) to create independent national fiscal councils, but with two significant improvements: making such councils not only national but also regional and broadening their scope by extending the formula so as to also monitor monetary and exchange-rate policies.

Specifically, this means the creation of a *two-tier subregional system* to enhance credibility by triggering a positive dynamic of open debates

²⁸ In MERCOSUR, the GMM is composed of top officials from the ministries of finance and economy and from central banks.

²⁹ In the CAN, the GTP comprises top officials from similar institutions plus macroeconomists from the CAN’s General Secretariat in charge of preparing the meetings of the Consejo Asesor (Council of Ministers of Finance and Economy and central bank governors).

³⁰ The CAMC has the option of inviting officials from finance ministries to working groups or meetings with central bankers, but this option is not used on a regular or permanent basis.

capable of creating rewards or sanctions for national policies, through the markets and public opinion.

1. At the official level, national policy makers meeting as a collegial policy group: first the preparatory and advisory group of official “experts” i.e., the Group of Official Macroeconomic Monitoring (GOMM), which consists of macroeconomists from the national policy agencies, generally top-ranking experts from national finance ministries and central banks; second, the decision-making body or the ministerial and central-bank president level, for decisions on technical proposals or advice;
2. At the technical countervailing power level: a subregional, technical Group of Autonomous Macroeconomists (GAM), composed of a few prominent independent macroeconomists in charge of regularly monitoring regional exchange rates and national macroeconomic policies; rather than merely “shadowing” the GOMM, this group actively cooperates with it.

The independent GAM would be responsible for proposing subregional methods, criteria and targets, and for producing regular assessment reports on the evolution of subregional exchange rates and macroeconomic indicators and the corresponding national components and policy measures. It would submit all its results first to the GOMM, which would debate the proposals and assessments and prepare, in the presence of the GAM, its own recommendations for the decision-making body, the Council of Ministers and Central Bankers (CMCB), which would issue the policy recommendations.

To ensure a fair balance of power, the GAM would be guaranteed the option of issuing an annex (or parallel document) with its own recommendations and comments on the Council’s recommendations and of independently organizing public hearings with the media and the international macroeconomic and financial community.

In such an institutional framework, the interplay between government and independent macroeconomists would allow for more systematic checks and balances and automatic, credible surveillance. This regional approach could be expected to lend a high degree of credibility, flexibility and stability to decision-making in the eyes of national economic stakeholders and the public at large, as well as regional neighbours, IFIs and creditors.

I propose suggesting to each subregion that it adapt this two-tier regional system of mutual surveillance by carrying out *two basic, interrelated activities*:

- (1) Designing and implementing a rules-based subregional scheme for macroeconomic convergence with a view to reaching a **Regional Monitoring Arrangement (RMA)**, which would gradually establish the supranational rules and quantitative convergence criteria (priority fiscal rules for sustainability keyed to each economy but following common principles); and
- (2) Supervising and assessing exchange rates with a view to establishing a common framework to monitor, discuss and, when possible, agree on each participating country's rates at the subregional level, according to the general regional principle of mutual concern for exchange-rate credibility and stability known as **Regional Exchange-Rate Monitoring (REM)**.

As the RMA and the REM are mutually supportive, each subregional macroeconomic monitoring scheme would depend strongly on the exchange-rate regimes in the considered subregions, and the dynamics of the monitoring process would depend on the accumulated learning-by-doing resulting from the collegial concern with the mutual exchange rates or the implementation of the REM. As explained above, understanding exchange-rate movements requires close scrutiny of each national policy mix; hence, the activities would inevitably be mutually supportive.

Therefore, the initial stage of this "monitoring" would merely be a common framework for initiating a technical dialogue on exchange rates and policies. This would be the **basic scheme for bringing about an operational macroeconomic dialogue**, which could lead to an alignment towards the best of all the dynamic improvements expected from the creation of powerful checks and balances and peer pressure, with better mutual knowledge, the exchange of best practices and a more useful consensus on economic governance.

Since the proposal is based on gradually building mutual confidence and associated benefits, it would not require either intense previous negotiation or any formal commitment, but would merely need to be launched as a **progressive self-validating process**, which would fully safeguard national sovereignty. It is thus more realistic and politically acceptable than other formulas.

Viewing this example not as a required outcome but only as a possible future scenario, one could also imagine that such a process could **open the door to more extensive cooperation** in subsequent stages.

To the extent that consensus emerges within the REDIMA network, policy makers might envision stepping up cooperation. Of course, REDIMA would not be responsible for any such decision, although

its participants would raise the issue to regional negotiation bodies or institutions after following existing procedures.

- (1) In some subregions, the next step beyond REDIMA might be to use the REM to reach a **common position on sustainable exchange-rate targets** or on bands between partners, to enhance their mutual stability. Authorities would contribute to shaping market expectations by providing collegially agreed signals about the targetted exchange rates. The purpose at this stage would not be to fix bilateral parities but to prevent gross misalignments inside the subregion. Of course, this is feasible only where there is the political will to move towards this kind of implicit monetary cooperation. In such cases, the process of building a consensus on each exchange rate would come first from the GOMM level, with the technical opinion and possible support of the GAM. At the end of this first technical step, if the GOMM and the GAM reached a common position on sustainable exchange-rate targets, the CMCB would ideally announce *recommended bands* for exchange rates compatible with stated and expected national policies.³¹ This concept of recommended bands does not imply a system of fixed bilateral parities or compulsory limits since it would also be applicable to floating rates. Initially these bands would be broad and non-binding, and would merely alert the markets to the existence of a consensual orientation of national policies.
- (2) A complementary tool for influencing market expectations would be to commission the REM to set up an arrangement for **triggering formal (obligatory) consultations** of the GOMM and, eventually, the CMCB, when the limits of the consensual broad bands were being approached. These compulsory consultations could encourage designing and implementing the rules and procedures set forth in the surveillance scheme (the RMA). The consultations would work by consensus; thus, veto power would be given to each member, even to a single national central bank, in an attempt to reach consensus on the policy adjustments to be submitted to national authorities. The most obvious tool for this second step is a "*joint communiqué*" publicly expressing the degree of consensus on the region's fundamental indicators.
- (3) The next degree of cooperation would be to decide on **common actions** beyond national policy adjustments and joint communiqués. Such common actions and tools include a broad range of options,

³¹ Theoretical background data on the recommended-band approach can be found, for example, in Williamson (2003) and Krugman (1991).

from launching convergence criteria and implementing compulsory rules of the game with rewards or sanctions to ad hoc cooperative actions, such joint interventions in favour of specific currencies or announcing new consensual bands or ad hoc coordinated policy adjustments to support observance of the bands. After a trial period, the system would likely be able to design a common procedure for exchange-rate orientation by anchoring market expectations through precise criteria and formal procedures, thereby providing transparent information on the respective policy stances behind the bands and the required adjustment path.

- (4) Gradually, the option of trying a real or a nominal band around a parity grid would be discussed if the participating members were able to achieve an effective degree of consensus and cohesion, as demonstrated by respecting the common criteria and rules established by the RMA. With the continued strengthening of the consensus in the context of a consolidation of real integration (increased mutual trade and nominal convergence), successive additional steps could transform the REM into a *Regional Monetary System* (RMS) and eventually into a *Subregional Exchange rate Mechanism* (SERM). Of course, this kind of rules-based managed float requires a firm agreement between central banks and other national authorities. Such an agreement could be reached once the RMA and its convergence rules were sufficiently developed and their credibility demonstrated.

The example of the possible orientation of this approach tries to illustrate that national administrations could reach a consensus to develop common rules and criteria and to enforce them at the appropriate subregional level, i.e., through peer monitoring under the scrutiny of economists and markets. Such a transparent approach would become a powerful catalyst for reforms and an appropriate mechanism for institutional-capacity building. Most of the urgent reforms needed by each economy could be designed, promoted and monitored through this regional cooperation-based method, allowing for economies of scale, trustworthy accountability and genuine regional alignment, triggering endogenous incentives and garnering social support from a sceptical public. In particular, exchange-rate and macroeconomic stability could more easily and sensibly become a common subregional issue, contributing both to democratic participation and to shaping a regional identity. Of course, as mentioned initially, this entire dynamic supposes a non-centralist, non-bureaucratic regionalism (strict subsidiarity and transparency) and the permanent possibility of opting out, to preclude free riding or moral hazard.

Thus, it should be clear that the REDIMA proposal to build an RMS calls for neither the creation of a single currency nor the use of fixed subregional bilateral parities but a system for increasing macroeconomic stability through an acceptance to deal explicitly and collegially with national exchange-rate policies and to explicitly consider their role in the policy mix as well as in development strategy.

Hence, the method described above is much more comprehensive than are present IFI approaches, which only deal with individual national authorities on a bilateral basis. In particular, an effective monitoring system with rules and a capacity for enforcement would acquire the ability to act as a genuine subregional anchor. In such a situation, we can envision important consequences for the debate on the optimal ERR.

The following aspects might be considered for further debates, although such a suggestion is merely speculative.

An ideal macroeconomic-cooperation scheme at the subregional level is able to provide more credibility than purely national rules (such as fiscal responsibility or monetary independence laws) or dollarization (as through a currency board), while also being able to tailor rules and policy stances to each country-specific situation or to cyclical positions. With subregional macroeconomic cooperation, **the ERR issue changes radically**: the subregional monitoring system (RMA and REM) can activate the same kind of mechanism of tying politicians' hands as does dollarization but for both monetary and fiscal policies, although without necessarily limiting their flexibility (unlike a peg, which imposes an inappropriate external monetary policy), while this system would be expected to stabilize the real exchange rate and to prevent wild fluctuations.

This combination of advantages means that it would be possible to keep the benefits of dollarization without its rigidity and exogenous nature, in addition to gaining the flexibility provided by floating without exposure to the same risk of instability and overshooting.

Hence, such a regional scheme could:

- (1) simultaneously provide the advantages of both polar ERRs — flexibility and credibility,
- (2) without imposing its costs (rigidity or instability),
- (3) while internalizing the spillover effects of national policies and allowing a common, coherent policy answer to the challenges of globalization to be devised and
- (4) actively promoting regional integration and identity.

More specifically, this means that the regional option would have the “alchemist’s power” of combining the advantages of both corner solutions without imposing their costs. This would give national policy makers significantly more freedom.

Is such a simpler and more rational world really beyond the reach of policy makers?

Chapter X

The REDIMA I experiment (2000-2003)

The preceding chapters reflect on some results of the work undertaken through the implementation, from late 2000 to late 2003, of this joint United Nations-European Union experiment named REDIMA. This final chapter gives a short presentation of this promising experiment.

1. Origin and definition of the REDIMA project

As a result of successive contacts between ECLAC and the European Commission starting in 1997, in May 2000 the two institutions decided to cooperate to promote regional macroeconomic convergence in Latin America. In particular, since 1997 ECLAC had been requesting that analyses of the European Union experience in macroeconomic convergence and economic policy coordination be disseminated with a view to progressively incorporating macroeconomic convergence into the priorities for regional integration among Latin American countries. The cooperation that was finally agreed upon included the secondment of a senior expert from the European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN) to the ECLAC macroeconomic team in Santiago, together with a small operations budget from the Commission to design, discuss and implement, by consensus with national administrations, a new method to promote economic-policy coordination among regional partners. Specifically, the challenge was to build a technical-dialogue network among senior officials responsible for the main macroeconomic policy issues within a "peer-pressure system" and thereby fill a vacuum in Latin America. The project was named REDIMA.

2. Purpose, method and expected results

The REDIMA network's main objective was to gradually break the prisoner's dilemma that traps Latin American authorities into non-cooperative attitudes. To this end, the project sought to encourage technical dialogue and subregional initiatives capable of contributing to macroeconomic convergence by influencing the national policy mix, the choice of exchange-rate regimes and the awareness of the advantages of, and the need for, a cooperative approach to macroeconomic problems so as to attain sustainable regional integration. The method, specially designed by ECFIN with ECLAC macroeconomists and other macroeconomists from the region, called for creating confidential protected forums (networks) in each official integration area (that is, in each of the three subregions) to bring together macroeconomists in charge of the technical aspects of each economy's policy mix (i.e., senior officials from finance ministries, central banks and regional institutions). Moreover, REDIMA was conceived as a two-tier system: the three subregional networks, although autonomous, are also interconnected through an annual seminar and a permanent United Nations electronic conference (WebBoard). The basic aim is to allow officials to become acquainted by freely exchanging their views without a need to make formal commitments on behalf of their institutions or governments; this explains why they are allowed to bypass formal diplomatic channels. The main advantage of the forum's informal nature is that it instils trust and a regional culture among influential senior "experts". This, in turn, ensures the continuity of technical contacts and a collegial approach, unconstrained by diplomatic negotiation agendas, subregional political vagaries and/or recurrent financial/political crises.

The resulting work was expected to create a climate of trust among different experts, generating a community-based culture and synergies through better communication and understanding among policy makers. On this basis, one could expect the emergence and development of endogenous initiatives, since these regional networks prefigure the institutional bodies that might later be formally created as a result of positive cooperative experiments. The two-tier system should allow each subregion to take advantage of its own peculiarities or institutions and find its own speed, while the results of each experiment are made available to the others. It was hoped that this would create a positive emulation mechanism through a "benchmarking effect".

3. Implementation

The design, presentation, discussion, testing and implementation for eighteen countries and three subregions were initially scheduled to

take two years. However, a third year was necessary as a result of the crises in the region and because of the self-managed nature of the three networks. Work started in earnest in October 2000, with a total operations budget initially estimated at € 653,850 (equivalent, at the September 2000 exchange rate, to US\$ 616,840) of which the Commission offered to contribute € 200,000 (although only about € 180,000 was effectively paid out, for procedural reasons).

REDIMA was launched, and it succeeded in working efficiently and reaching the most ambitious of its targets for the three subregions, despite an exceptionally difficult environment (financial and political crises in most of the participating countries).

4. Comparison of expected and effective results and activities

Expected results: According to its July 2000 Terms of Reference, *“the project is expected to build consensus on the desirability of policy coordination, and demonstrate by concrete experience the usefulness of a regular process of close exchanges of views among national macroeconomic authorities and experts, whatever the degree of formality or commitment that may be reached.*

“Ideally, the best result which could emerge from the project would be the formal establishment of a two-tier system of macroeconomic dialogue and cooperation within and between the existing subregions (MERCOSUR, CAN, MCCA) and their member countries, which would establish their own macroeconomic cooperation schemes (which could be different as the subregions are at very different level of effective regional integration).

“More realistically, the project should produce concrete results in preparing for regional integration by improving the tools for decision-making: statistical harmonization, direct exchanges of views creating closer links between groups of national experts within and between subregions, building up a consensual view on common issues that would allow the preparation of studies published in the framework of the network and contribute to making progress towards genuine coordination schemes. The purpose of the network will be to create a concrete opportunity for creating such operational schemes as well as ensuring the diffusion to the whole region of the progress made (inter alia in the MERCOSUR area) in coordinating macroeconomic policies. The groups included into the network would also participate in promoting a formal dialogue for the whole region under the umbrella of the official ECLAC activities”.

Scheduled activities: These targets had to be met through four main activities: (1) the creation and operation of a network of Latin American officials and experts; (2) the organization of at least two internal workshops

per year for each subregion; (3) the organization of one annual regional seminar bringing the three subregions together; (4) the publication of working papers and policy blueprints.

Effective Results: Through these four categories of activities, co-financed by the European Community and ECLAC, the REDIMA project attained its two central objectives, i.e., (1) demonstrating the need for policy coordination so as to make regional integration sustainable, and (2) providing convincing evidence of the usefulness of regular, close exchanges of views among national macroeconomic authorities and experts. Furthermore, the “first-best target” (considered, ex-ante, the maximum proof of success) was also clearly met in two of the three subregions (Andean Community and MERCOSUR), and partially in the third (Central America), since REDIMA provided an opportunity to launch organizational initiatives, whether or not formal (since each subregion behaves according to different models and institutions), but with an impact on regional cooperation among sovereign states or entities. REDIMA has created genuine momentum towards regional integration through a realistic new approach to cooperation between national administrations and central banks, thereby contributing to build a climate of confidence and, progressively, a common culture.

5. Principal specific positive results

- (1) The operation of fully interconnected regional networks covering the three subregions (MERCOSUR, the Andean Community and Central America) and comprising some 50 senior macroeconomists from 17 countries and central banks and 10 regional institutions, despite the severe crisis.³² These three informal networks operate independently and according to their own rules; they are self-managed by their members, with ECLAC acting as the technical secretariat and providing financial support. All told, four hemisphere-wide meetings were held in Santiago (three plenary annual REDIMA meetings, in November 2001, November 2002 and October 2003, plus a special conference on exchange-rate regimes, in March 2002), compared with the two meetings initially planned. Likewise, 22 subregional workshops were held in different places, compared with a minimum of six that was expected. The resulting documents published by

³² The eighteenth country, Mexico, was not included at this stage by decision of the Monetary Council of Central America and the network's members, who wanted to enhance their internal cohesion as a subregion and to address their common problems before broadening the cooperation area.

REDIMA, in addition to the numerous working documents circulated on the electronic WebBoard, are listed in the appendix.

(2) Impact on the integration strategy and institutional workings:

- In the Southern Cone network (REDIMA-SUR, i.e., MERCOSUR plus Chile), the early creation (before the launch of REDIMA) of a technical GMM was a joint initiative of Argentina and Brazil. However, it was indirectly inspired in previous bilateral discussions on the REDIMA project (in 1999 and early 2000³³) and implemented starting in June 2000.³⁴ Its objective was to prepare the statistical basis for convergence monitoring. After a few months, a “MERCOSUR Mini-Maastricht” agreement was reached, with quantitative criteria, at the December 2000 Florianopolis Summit. After this quick progress, implementation of the Florianopolis Agreement and the GMM work were severely undermined by Argentina’s economic and political crisis, in which there were changes of the entire economic team in March and April 2001, and its impact on Brazil and the two smaller members. Growing tension between Argentina’s Minister of the Economy Domingo Cavallo and the administration of Brazilian President Fernando Henrique Cardoso led to the suspension of the formal GMM meetings. Hence, the GMM members conducted their efforts through the informal REDIMA-SUR, which shows the network’s effective function and the success of the formula by which it operates. It became the Southern Cone’s only confidential channel for macroeconomic dialogue on crisis management. Three special technical workshops were held during the financial turbulence of 2002 for dealing with the successive financial crises and the macroeconomic aspects of the political transition in Brazil. One of the important outcomes of REDIMA-SUR was that it paved the way for resuming the GMM meetings in preparation for the December 2002 MERCOSUR Summit and the re-establishment of the Buenos Aires-Brasilia axis in 2003.

³³ See Ghymers (1999). The proposals given in the conclusion were followed up on with bilateral contacts and special information requests by some administrations. Decision 6/99 of the MERCOSUR Council (June 1999) created a High Level Macroeconomic Policy Coordination Group, but it was only after the Buenos Aires Ministerial Declaration of April 2000 that the political will gave way to the creation of an informal technical group led by Machinea’s team.

³⁴ At the Buenos Aires Summit, June 2000, in which the GMM was created by the Common Market Council of Ministers (CMC decision of 30 June 2000).

- In the Andean Community, launching “REDIMA-CAN”, comprising five Andean countries, and its work directly led to significant institutional initiatives:
 - (i) the introduction of two macro-fiscal criteria for convergence and the launching of a work programme to ensure the sustainability of public finances;³⁵
 - (ii) the creation of a new official body, the “*Grupo Técnico Permanente*” (GTP), decided on in June 2001, pursuant to a proposal from the Andean Community General Secretariat, which was based on the result of the work of the REDIMA-CAN group.³⁶ The purpose was to give this informal network an official ad hoc nature when necessary to transform REDIMA-CAN consensual conclusions on convergence and the follow-up work on them into formal initiatives or decisions, especially for enacting community legislation;
 - (iii) the regular work of GTP through REDIMA-CAN workshops (or electronic conferences), despite serious political crises or changes in most of the Andean Community member states.³⁷ One example is the enactment of the “*Programmes for Convergence Actions*” (PACs), despite the cancellation of the Advisory Council of Finance Ministers and Central Bank Presidents in June 2002, because of the change of government in Colombia. A formal proposal was drafted and introduced by REDIMA, through the GTP, to take advantage of two REDIMA-CAN meetings (Caracas, May 2002, and Santiago, November 2002) to prepare and agree on Community legislation. The formal decision, Commission Decision 543, was made on 14 April 2003.³⁸

³⁵ Decision of the Fifth Advisory Council of Finance Ministers and Central Bank Presidents (Consejo Asesor de Ministros de Hacienda o Finanzas, Bancos Centrales y Responsables de Planeación Económica de la Comunidad), taken on 21 June 2001 in Caracas. See Acta Final, §4, de la V Reunión del Consejo Asesor.

³⁶ Decision of the same Fifth Advisory Council, Caracas; see Acta Final, §5.

³⁷ The GTPs were held in tandem with REDIMA-CAN workshops and were attended by same officials. The only differences between the two were that the REDIMA meeting had an informal agenda while the GTP meeting had an official one, with clear mandates to the representatives, and meetings were chaired by the country holding the Andean Community Presidency. Neither ECLAC nor the EC attended GTP meetings. The GTP met four times outside REDIMA-CAN workshops (Caracas in May 2002, Santiago in November 2002, Quito in September 2003 and Santiago in October 2003).

³⁸ Decision of the Andean Community, 14 April 2003, session no. 85 of the Commission, Lima, Peru.

It defines and unifies the PAC format and establishes a follow-up procedure for convergence surveillance in the Andean Community. Another important success of REDIMA-CAN was the June 2003 approval by the VI Advisory Council of the REDIMA recommendation to set up a “group of independent economists” to critically monitor GTP surveillance of the convergence process.³⁹ In the same package of decisions, the Advisory Council asked for a revision of the common convergence criteria on inflation in the Andean Community economies;⁴⁰ REDIMA-CAN and the GTP undertook studies and held discussions in August, September and October 2003 (the Quito workshop, a meeting in Bogotá at the offices of the Fondo Latinoamericano de Reservas (Latin American Reserve Fund; FLAR], and the Santiago workshop). One result of the REDIMA-CAN and GTP meetings was the cooperation agreed on by the central banks and the FLAR on inflation forecasting, bringing their econometric models into line with each other. Another example is the management of the October 2003 Bolivian crisis and its financial consequences on the budget. The REDIMA-CAN network was used intensively to organize collegial monitoring, which also expressed Andean solidarity for bargaining with some creditors.

- (iv) a proposal by Peruvian representatives at the September 2003 Quito workshop, that REDIMA be used to manage a project to create a South American initiative for regional infrastructure (*“Iniciativa de Infraestructura Regional de Sudamérica”*; IIRSA), which would be responsible for selecting and financing infrastructure for regional integration. Under the proposal, REDIMA-CAN would merge with REDIMA-SUR to streamline the management of large regional investments through a regional institution.
- In the CACM, the Monetary Council used the REDIMA-CA network to include finance ministries in its group of central bankers responsible for revising and improving the convergence criteria. Although the Monetary Council has not yet decided on a definitive institutional formula for creating a formal group like the GMM or the GTP for the two other subregions, some

³⁹ Acta Final del Consejo Asesor § 5, Bogotá , 26 June 2003.

⁴⁰ Ibid., § 2 of Acta Final.

initiatives could emerge in the context of the 40th anniversary of the Monetary Council, in 2005. Although very supportive of the REDIMA method and formula, the Monetary Council considers that permanent technical assistance is needed in its region, without going through ECLAC, Santiago. The Council asked for additional assistance from the European Union, while ECLAC decided to commission its regional office in Mexico to cooperate closely and directly with REDIMA-CA.

- (3) An incipient, yet significant, influence on debates on policy mix and on the method of peer monitoring. In all subregions, significant progress was made in raising awareness of, and in the quality of the technical analysis on, fiscal sustainability (except for Chile, all countries have a common sustainability problem), exchange-rate regimes and regional interdependencies.

In 2002, REDIMA participants expressed an interest in establishing a closer association between statistical and quantitative issues and the network's activities. They also voiced a need for simulation models to analyze the spread of shocks from a regional perspective and to quantify the benefits of policy cooperation. In response, the project received assistance from the Division of Statistics and Economic Projections of ECLAC (in addition to the current support received from the Development Division, which manages REDIMA). In this context, the Statistical Division conducted a series of activities in 2003 focusing on two major objectives: the unification of subregional economic statistics and the development of econometrics models to simulate economic integration and macroeconomic coordination. ECLAC presented the first objective at the Second Statistical Conference of the Americas, in Santiago, from 18 to 20 June 2003. REDIMA objectives and the related collaboration between ECLAC and the European Commission were discussed, and the Conference endorsed the REDIMA proposal as one of its priorities for its 2003-2005 international work programme. Several institutions offered to cooperate with ECLAC on this issue. The second objective calls for developing interconnected subregional macroeconomic models able to synthesize trade and macroeconomic interrelations among countries participating in a regional integration scheme and to analyze the sustainability of growth scenarios under balance-of-payments constraints. The related activities were organized by subregion.

- REDIMA-Sur, in addition to preparing convergence criteria and continuing with the statistical-harmonization efforts undertaken by the GMM, decided to analyze spillovers among

partners by pooling the efforts of the main research centres that conduct econometric modelling. However, this programme, partially supported by the ECLAC Statistical and Forecasting Division, will require the resources from a second phase of REDIMA announced by the Commission.

- In the CAN, and within a context of growing political tensions and changes in the economic teams of the five member countries, the continuity and flexibility of the REDIMA-CAN network enabled a consensual approach to be introduced and long-run work programmes to be launched on: (i) fiscal sustainability through the enactment of regional fiscal rules, a study of the fiscal impact of the Free Trade Area of the Americas (FTAA), and the need for fiscal harmonization; (ii) statistical harmonization and the definition of macro-fiscal criteria within the framework of specific, common PACs; (iii) a monitoring system to make peer pressure effective; (iv) building harmonized econometric models for addressing integration issues (two technical workshops were already held by ECLAC in Santiago), particularly given that, in the context of the review of inflation criteria, central banks exchanged their own forecasting models and launched bilateral cooperation (REDIMA-CAN in Quito and the FLAR seminar in Bogota); (v) ways to improve financial integration inside the Andean Community.
 - Also in the CACM, REDIMA-CA produced concrete results by raising awareness on a potential fiscal problem, and a common method for analyzing sustainability was prepared and the official convergence criteria were revised. The econometric work is being launched by ECLAC-Mexico (one workshop has already been held there), and it will require additional assistance in the second stage.
- (4) The confirmation of the suitability of the REDIMA approach, as follows: informal networks with key officials from fiscal and monetary authorities, based on a neutral entity, ECLAC, which offers the most convenient vehicle for utilizing and internalizing the European experience to ensure efficient, simultaneous access to 18 countries and for managing the three networks in a manner consistent with the three different integration schemes.

6. Conclusions and proposed actions

In this first stage of REDIMA, a new, self-managed instrument was implemented and successfully tested, and made available to Latin

American policy makers. This important experiment demonstrated the need for the further development of such a technical forum in each subregion as well as at the regional level.

In sum, the main lessons drawn from the REDIMA philosophy are that:

1. The regional dimension is a powerful tool with which to make up for institutional failures, insofar as it provides tangible net gains to national policy makers; this holds to the extent that the chosen formula strikes the right balance between cooperation and competition among national administrations; this means that the prisoner's dilemma has to be solved at the level of national policy makers.
2. REDIMA has proven to be a feasible way out of this suboptimal status quo that locks Latin America into a low level of cooperation, since it offers ways to change the perception of the balance of risks by creating operational incentives at the level of the active player.
3. Although macroeconomic coordination relies on a few universal principles (chapter V), these higher-order rules do not translate into unique institutional arrangements and they must match local capabilities and existing institutional opportunities.
4. Consequently, it is up to Latin American experts to "do the hard work at home" by collectively conceiving and designing their own cooperative paths in each subregion, without ideological lock-in or a priori institutional formula.
5. The subregional level is the main building block for macroeconomic cooperation among national administrations but also for dissemination and discussion among the different subregions of Latin America and with other regions (the European Union, NAFTA, ASEAN). In addition, this intermediate level provides an attractive ambit both for IFIs and for national governments in their financial and policy negotiations. Indeed, individual countries would find regional support and strategy advice, while for IFIs and creditors, the positive effects on national governance and transparency of the regional monitoring and peer pressure would represent a significant advantage.
6. In this first phase of the REDIMA experiment, participants expressed an interest in potential areas of development for subsequent stages, mainly regarding technical works on convergence, including indicators and econometric simulations, as well as ways to establish carrot-and-stick mechanisms for cooperation. In addition,

encouraging, alongside closed-door workshops, an open public debate and fostering an appropriate internalization by selectively extending networks to professional macroeconomists and to civil society would appear to be a suitable course of action. Another possibility, mentioned in REDIMA, would be the establishment of closer ties between statisticians and econometricians in subsequent stages, as a way to bypass some limitations of tools and measurement by closing the gap between demand (policy makers) and supply (statisticians and academicians) in order for the technical priorities on creating appropriate tools for addressing national policy debates to be jointly determined.

Appendix

Main publications on REDIMA's work

Documents published by the Economic Commission for Latin America and the Caribbean (ECLAC) in the series *Macroeconomía del desarrollo*:

- C. Ghymers, "La problemática de la coordinación de políticas económicas", *Macroeconomía del desarrollo series*, No. 10 (LC/L.1674-P), Santiago, Chile, December 2001. United Nations publication, Sales No. S.01.II.G.209.
- Luis Miotti, Dominique Plihon and Carlos Quenan, "Euro and the Financial Relations between Latin America and Europe: medium- and long-term implications", *Macroeconomía del desarrollo series*, No. 13 (LC/L.1716-P), Santiago, Chile, March 2002. United Nations publication, Sales No. E.02.II.G.27.
- Hubert Escaith, Christian Ghymers and Rogerio Studart, "Regional integration and the issue of choosing an appropriate exchange-rate regime in Latin America", *Macroeconomía del desarrollo series*, No. 13 (LC/L.1732-P), Santiago, Chile, August 2002. United Nations publication, Sales No. E.02.II.G.86.
- Hubert Escaith and Carlos Quenan (coords.), "Emergencia del Euro y sus implicaciones para América Latina y el Caribe", *Macroeconomía del desarrollo series*, No. 20 (LC/L.1842-P), Santiago, Chile, January 2003. United Nations publication, Sales No. S.03.II.G.7.
- Hubert Escaith and Igor Paunovic, "Regional integration in Latin America and dynamic gains from macroeconomic cooperation", *Macroeconomía del desarrollo series*, No. 24 (LC/L.1933-P), Santiago, Chile, July 2003. United Nations publication, Sales No. E.03.II.G.92.

Publications in external reviews:

- C. Ghymers, "Macroeconomics and Regionalization", document presented at the XIII Regional Seminar on Fiscal Policy, Santiago, Chile, ECLAC/IMF/IDB/World Bank, 2001, unpublished.
- C. Ghymers, "Monitoreo macroeconomico regional y sostenibilidad fiscal: algunos aspectos pragmaticos para los paises andinos", *Boletín FLAR*, March 2002.
- C. Ghymers, "America Latina y la coordinación de políticas económicas: hacia un Maastricht Latinoamericano?", *Estudios internacionales*, Santiago, Chile, University of Chile, July-September 2002.
- C. Ghymers, "The Euro and the IMS", Papers and Proceedings of the Third International Conference on Finance, London, 2004, unpublished.
- C. Ghymers, "Una repuesta regional a la globalización", document prepared for the fifth international meeting on globalization, La Habana, Cuba, February 2003.
- C. Ghymers, "Macroeconomic coordination and regional integration", document presented at the Seminar RINOS (Réseau Intégration Nord Sud), Paris, May 2003.
- C. Ghymers, "Metodología para estimar indicadores de sostenibilidad fiscal", San José, Central American Monetary Council, July 2002.

Acronyms used

ASEAN	Association of South-East Asian Nations
CARICOM	Caribbean Community
CDs	Certificates of Deposit
CEI	Centro de Economía Internacional
CMCB	Council of Ministers and Central Bankers,
ECLAC	Economic Commission for Latin American and the Caribbean
ECOFIN	European Council of Economic and Finance Ministers
EMS	European Monetary System, EMS
EMU	Economic and Monetary Union
FLAR	Latin American Reserve Fund
FTAA	Free Trade Area of the Americas
G-7	Group of Seven
GAM	Group of Autonomous Macroeconomists
GATT	General Agreement on Tariffs and Trade
GMM	Macroeconomic Monitoring Group
GOMM	Group of Official Macroeconomic Monitoring
GTP	Permanent Technical Group
IBRD	International Bank for Reconstruction and Development
IFIs	International Financial Institutions
IMF	International Monetary Fund
IMS	International Monetary System
LDCs	Least Developed Countries
OEEC	Organisation for European Economic Co-operation
PACs	Programmes for Convergence Actions
REM	Regional Exchange-rate Monitoring
RMA	Regional Monitoring Arrangement
RMS	Regional Monetary System
SERM	Subregional Exchange Rate Mechanism

Bibliography

- Aglietta, M. and C. Ghymers (1993), "Monetary integration in Europe", *Recherches économiques de Louvain*, vol. 59, special issue, No.1-2, Louvain-La-Neuve.
- Axelrod, R. (1984), *The Evolution of Cooperation*, New York, Basic Books.
- Baffi, P. (1987), Foregoing address read at the awarding of the San Paolo Prize for Economics: *Robert Triffin San Paolo Prize for Economics 1987*, Instituto Bancario San Paolo di Torino, p.16.
- Bryant, R.C. and others (1988), *Empirical Macroeconomics for Interdependent Economies*, Washington, D.C., Brookings.
- Canzoneri, M.B. and H. Edison (1990), "A new interpretation of the coordination problem and its empirical significance", *Monetary Aggregates and Financial Sector Behaviour in Interdependent Economies*, P. Hooper and others, Washington D.C, Federal Reserve Board.
- Dehousse, R. (2003), "The open method of coordination: a new policy paradigm. Paper presented at the Symposium "The Politics of European Integration: Academic Aquis and Future Challenges (Bordeaux, 26-28 September 2002)", *Cahiers européens de sciences politiques*, Paris, Institut d'Etudes Politiques de Paris 3, p. 4.
- ECLAC (Economic Commission for Latin America and the Caribbean) (2002), *Globalization and Development* (LC/G.2157(SES.29/3)), Santiago, Chile.
- Escaith, H. and I. Paunovic (2003), "Regional integration in Latin America and dynamic gains from macroeconomic cooperation", *Macroeconomía del desarrollo series*, No.24 (LC/L.1933-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), July. United Nations publication, Sales, No. E.03.II.G.92.
- Escaith, H., C. Ghymers and R. Studart (2002), "Regional integration and the issue of choosing an appropriate exchange-rate regime in Latin America", *Macroeconomía del desarrollo series*, N°14 (LC/L.1732-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), August. United Nations publication, Sales No. E.02.II.G.86.
- Ffrench-Davis, R. and G. Larrain (2003), "How optimal are the extremes? Latin American exchange rate policies during the Asian Crisis", *Informes y estudios especiales series*, No. 10 (LC/L.1824-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC). United Nations publications, Sales No.E.03.II.G.29.
- Fisher, S. (2001), "Exchange rate regimes: is the bipolar view correct?", Distinguished Lecture on Economics in Government, delivered at the Meetings of the American Economic Association, New Orleans, January.
- Ghymers, C. (2003), "Miranda y el Federalismo en América Latina: gobernabilidad, integración regional y subsidiaridad", paper presented at the 51th Congreso Internacional de Americanistas, Santiago, Chile, July.
- _____ (1999), "The Macroeconomic Policy Coordination in the Euro-Area: Origins, Development and Present Challenge, with Some Possible Conclusions for Latin America", document presented at the ECLAC Regional Seminar on Fiscal Policy in Brasilia, January.

- _____ (1995), "La coordination des politiques économiques dans la Communauté Européenne: une évaluation en vue de la conférence intergouvernementale", *Revue du Marché Commun et de l'Union Européenne*, No. 385.
- _____ (1991), "Convergence et transition vers l'UEM", *De Pecunia*, vol. 3, No. 1, Brussels.
- _____ (1986), "Réagir à l'emprise du dollar", *L'écu et la vieille dame. Un levier pour l'Europe*, Michel Aglietta (ed.), Paris, Economica.
- Ghymers, C. and L. X. Grisanti (2001), *Francisco de Miranda : L'Europe et l'Intégration latino-Américaine*, Louvain-la-Neuve, Versant-Sud.
- Ghosh, A., A.M. Gulde and H. Wolf (2002), *Exchange Rate Regimes: Choices and Consequences*, Cambridge, MA, MIT Press.
- Kreps, David (1990), *Game Theory and Economic Modelling*, New York, Oxford University Press.
- Krugman, P. (1991), "Target zones and exchange rate dynamics", *Quarterly Journal of Economics*, vol. 106, No. 3, August.
- Lacunza, H. and J. Carrera (2003), "Cooperación macroeconómica en el Mercosur. Un análisis de la interdependencia y una propuesta de coordinación", *Estudios del CEI series*, No. 4, Buenos Aires, April.
- Machinea, J. L. (2003), "Mercosur: en busca de una nueva agenda. La inestabilidad cambiaria en el Mercosur: causas, problemas y posibles soluciones", *Documento de trabajo IECE series*, N° 06, Washington, D.C., Inter-American Development Bank (IDB)/Institute for the Integration of Latin America and the Caribbean (INTAL), December.
- Mc Kinnon, Ronald (1982a), "Currency substitution and instability in the world dollar standard", *American Economic Review*, June.
- _____ (1982b), *Monnaie et finance dans l'échange international*, Paris, Bonnel Editions.
- Olsen, J. and B.G. Peters (1996), "Learning from experience?", *Lessons from Experience, Experiential Learning in Administrative Reforms in Eight Democracies*, Oslo, Scandinavian University Press,
- Persson, T. and G. Tabellini (1990), *Macroeconomic Policy, Credibility and Politics*, Harwood Academic Publishers, Switzerland.
- Rose, R. (1993), *Lesson-Drawing in Public Policy*, Chatham, NJ.
- Swoboda, Alexander (1978), "Gold, dollars, eurodollars and the world money stock under fixed exchange rates", *American Economic Review*, September.
- Triffin, Robert (1957), *Europe and the Money Muddle*, New Haven, Yale University Press.
- Williamson, J. (2003), "Exchange Rate Policy and Development", Working Paper, Washington, D.C., August.
- _____ (2002), "Exchange rate regimes for emerging markets: Reviving the intermediate option", *Policy Analyses in International Economics*, No. 60, Washington, D.C., Institute for International Economics, September.