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New Financial Architecture and Regional Monetary Integration in Latin America¹

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Abstract:

Reducing transaction costs and the need for international reserves is a primary objective to the establishment of regional payment agreements. Another objective, especially in the case of Latin America where the Ecuadorian promoters of the Bank of the South and the New Architecture are planning the implement of a regional clearing system, is to reduce member countries dependence on the US dollar as an international standard and reserve currency. To help improving the design of such agreements this paper refers to the plan Keynes designed for the Bretton Woods Conference. First, it observes that cases were made against this plan from which useful lessons may still be drawn. Second, it shows that Keynes defined a system for exchanging domestic currencies for each other that can be improved and help design currency unions in accordance with their promoters' objectives.

Key words: regional monetary arrangements, foreign exchange, currency union, Keynes's plan, dollar standard, payment systems

JEL codes: E42, F31, F32, F33, F53

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1. Introduction

Ecuadorian promoters of the Bank of the South and the New Financial Architecture in Latin America are proposing to implement a regional clearing system designed to allow a multilateral offsetting of the liabilities and assets generated in the reciprocal transactions of member countries (Government of Ecuador, 2008). In order to think up this system, they refer to previous experiments of international settlement systems and regional currencies / units of account in Latin America but also in other areas – the former Sovietic Ruble and the European Monetary System and the current CFA Franc Zone arrangements. They also mainly refer to the ‘Proposals for an International Clearing Union’ that Keynes presented at the Bretton Woods Conference (Keynes, 1942, pp. 33-40). In words that the British economist certainly would not have denied, they advocate the creation of a Central Clearing Union (Unidad Central de Compensación - UCC) endowed with a currency unit they call “sucre” (Sistema Único de Compensación Regional de Pagos). This currency unit would be designed to keep member countries’ accounts with the UCC. Each of them, operating through its central bank, would be credited or debited with amounts labelled in sucre in accordance with its transactions with other member countries. The resulting assets and liabilities in sucres would be offset by the UCC, and then imbalances should be settled in domestic currencies through accounts held with the Bank of the South.

The reference to Keynes’s proposals is no doubt relevant when one comes to consider schemes relating to international payments and new monetary and financial architecture (cf Davidson 1991, 2002; Cartapanis and Herland 2002, Gnos 2006, Gnos and Rochon 2005). However, these proposals have been subject to objections that still deserve consideration. This paper aims at drawing lessons from the main cases made against Keynes’s plan, in order to help improving the design of regional monetary agreements. It is also intended to show that as part of his proposals Keynes drafted a system for exchanging currencies that, if it had been completed, would have allowed him to deal more convincingly than he did with the main objections arisen. Section 2 will present, as a starting point, the regional payments and unit of accounts agreements in Latin America: the Reciprocal Payments and

Credits Agreement of the Latin American Integration Association or ALADI, the ‘Peso Andino’ set up by the Latin American Reserve Fund (FLAR) and the Payment System on Local Currency agreement (SML) recently launched by Brazil and Argentina. Section 3 will examine the objections arisen against Keynes’s plan. It will also emphasise their relevance to the sucre plan or to any similar plan. Section 4 will focus on the exchange scheme drafted by Keynes and on how to supplement it in order to get over the objections under examination. Section 5 will conclude.

2. Regional Payment Agreements in Latin America

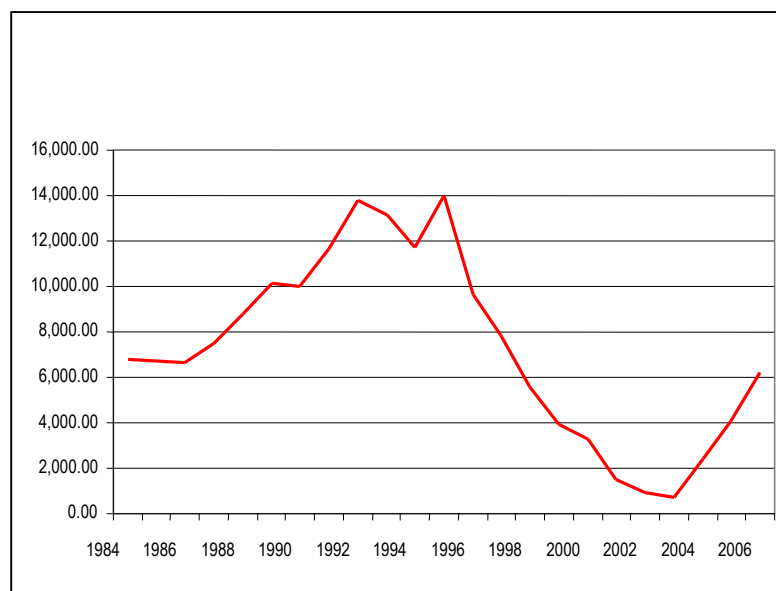
Regional payment agreements are international systems set up to facilitate payments between countries. Why are such agreements needed? To answer this question, we can give an example inspired from Chang (2000). If a resident of Bolivia wants to purchase goods from a resident of Colombia, the Bolivian has to find a way to pay for the goods with a currency that the Colombian is willing to accept. Such a currency can be the Colombian one, or some international currency such as the US dollar. However, in both cases, the Bolivian is confronted with the cost of obtaining a currency different from his own in order to pay for the Colombian goods. While the cost may be small for an individual transaction, it may be large for the country, since in a modern economy there will typically be a need for large numbers of similar payments. Given such a situation, two countries may reduce “transaction costs” by having their central banks act as clearing houses for payments between them. Both central banks may agree to record and pay their own residents for eligible purchases from residents of the other country, thus extending credit to each other, and settle the accumulated net differences periodically, at the end of each quarter for example (cf. Rossi, 2009).

Currency flows, and the associated transaction costs, are actually saved on at least two ways. First, if the periodic settlement of the two accounts is done in a net basis, the amount of each settlement would only reflect the difference between accumulated sales and purchases during the settlement period. In contrast, if all transactions are paid individually, as would happen in a decentralized system, all sales and purchases would involve an international currency flow. Second, in order to

pay for the bilateral trade between the two countries, the central bank of the country in deficit only needs to transfer a reserve currency at the end of the settlement period. In comparison, in a decentralized system each central bank would need to maintain enough international reserves to finance bilateral payments continuously during the period. Coupled with net settlement, this feature implies that each central bank can safely reduce its holdings of reserve assets. Reducing the need to hold international reserves was the primary motivation for the establishment of a number of regional payments systems, starting with the European Payments Union in the 1950s.

A first example of a similar system for a group of developing countries is the Reciprocal Payments and Credits Agreement of the Latin American Integration Association or ALADI. While the ALADI payments agreement was subscribed in 1982, ALADI itself dates back to the Montevideo Treaty of 1960, which set the agenda for creating a Latin American Free Trade area. This means, in particular, that the payment agreement was created to support the wider agenda for increased economic integration between Latin American economies, and consequently the payments agreement was assigned a somewhat subsidiary role. In terms of its functioning, the member central banks agreed to act as clearing houses for trade related payments of each member country vis-à-vis the others, settling the balances only every four months. Hence, the ALADI payment system worked essentially as we described above. Whether or not an eligible transaction goes through the ALADI payment system is voluntary and left to decide to the parties involved. A distinctive and noteworthy feature is that the ALADI system includes a system of guarantees for payments. In particular, there is a guarantee (the Reimbursement Guarantee) to exporters that the system will pay them the monies owed for their eligible exports, even if the importers eventually default on what they owe to the system. The system, after improving up to 1990, has decreased sharply since, before a new increase took place since 2003 (see figure 1)

Figure 1
Usage of ALADI's Payments Systems (Millions of US dollar)



Source: ALADI

In a number of cases, a group of countries have set up a common pool of international reserves and, at the same time, granted each individual country the right to borrow from the pool under specified circumstances. Such circumstances have been mostly related to temporary balance of payments problems, although it is conceivable for an agreement of this kind to allow members to borrow for longer term purposes.

We can now give the example of the Latin American Reserve Fund (FLAR). FLAR evolved from the Andean Reserve Fund, which operated between 1978 and 1991. Its current members are Bolivia, Colombia, Ecuador, Peru, and Venezuela; in addition, Costa Rica's parliament is currently considering formal incorporation into FLAR. FLAR's capital is coming from members' contributions. A second source of FLAR's funds is given by demand deposits and time deposits of member central banks. FLAR has used the resources thus obtained to grant loans to financial institutions of member countries in order to support trade and, in some circumstances, to assist member central banks experiencing a need for international liquidity.

While the preceding discussion suggests that FLAR may have played a stabilizing role, the question remains of whether FLAR can play such a role effectively given the size of its resources. And it seems that the answer, at least so far, has been negative. Indeed FLAR member central banks cannot produce convertible currencies on demand. Under such circumstances, it is not surprising that FLAR economists have argued that FLAR should aim to become a “Latin American Monetary Fund” (FLAR 2000).

The most important aspect of this new regional payment system is the creation of a common unit of account, the Andean Peso. Indeed, since 1983, Andean countries recognised the importance of a common unit of account used for regional commercial transactions. There are, nonetheless, important challenges. Indeed, for those who first proposed this initiative, the most challenging of hurdles was to determine how this new unit of account would be defined. At first, some suggested the use of SDR issues by the IMF. But it quickly became evident that the regional unit of account could not be based on a basket of local currencies, largely because of the inherent instability of these currencies. As such, the solution was to have this new regional unit of account be based on a basket of goods, that is the value of the regional staples.

In the end, the solution that was retained, on December 17, 1984, was the emission of regional assets denominated in Andean Pesos, which would be distributed by those central banks that signed the Cartagena Accord (Government of Ecuador, 2008). The objective was to encourage regional trade and to accelerate regional integration. Only the FLAR had the responsibility of emitting this new regional unit of payment. At first, more than 80 million Andean Pesos were distributed to the central banks of regional member-countries.

Yet, we believe that as appealing as is the idea of the Andean Peso, it remains nevertheless a partial solution. Its major drawback is its dependence on the US dollar. First, the value of the Andean Peso is defined as on par with the US dollar. Second, when regional central banks use the Andean Peso for the purpose of regional payments, they must reimburse the FLAR in US dollars, within 180 days. At its end, FLAR is committed to supply US dollars to any central bank wishing to convert its Andean Peso-denominated assets into US dollars. Therefore, the Andean Peso is a double-edge sword: on the one hand, we introduce a new unit of account in

which to carry out regional trade, but on the other, the Andean Peso remains fundamentally tied to the US dollar.

More recently, Brazil and Argentina launched a new payment system of bilateral transaction with their local currencies, aimed at eliminating the U.S. dollar as an intermedium. The Payment System on Local Currency (SML) was agreed in October 2008 to end decades of mandated trade in dollars. Under this system, exporters and importers from both countries can settle their exchanges with Brazilian (real) and Argentine (peso) currencies. According to the Central Bank of Argentina, the trade between Brazil and Argentina is about 25 billion U.S. dollars per year. Although this new system seeks to gradually eliminate the dollar from the bilateral trade, the dollar will continue at the exchange. Indeed, the central banks of Brazil and Argentina will set the exchange rate between the reais and pesos with respect to the dollar. If the mechanism works out without incidents between Brazil and Argentina, it could be adopted by other countries of the Mercosur, like Paraguay and Uruguay. Once again, the dependence on the dollar as an international standard and reserve currency is preserved. The hegemonic status of the US dollar is still effective (Ponsot, 2006).

3. Lessons from the cases made against Keynes's plan

In section 2, we have emphasised that a main asset to the regional agreements already implemented in Latin America and to the regional clearing system that Ecuadorian have in mind, is that it would help member-countries to economize on currency flows and the associated transactions costs. We have also noticed that these agreements do not break free from the dollar as an international standard and reserve currency. The case of the FLAR agreement just mentioned is quite symbolic of this situation. Could these agreements work another way? This is where the reference to Keynes's plan may prove useful. Actually, the relevance of the reference we can make to the latter plan is twofold. In the present section we propose to show that cases were made against it from which useful lessons may still be drawn. In section 4 below, we show that Keynes defined a system for exchanging domestic currencies for each other that can be improved and help get over the objections we are now going to examine.

To make our point, let us consider the stylized case of an international (regional) clearing union endowed with its own currency that will be an international common currency for member countries. This common currency would be designed to keep member countries' accounts with the clearing union. Beforehand, member countries would be endowed with drawing rights on the union. Of course, there is no chance that accounts would clear on a regular time basis. To settle their debts, member countries would then have to draw on their foreign currency reserves. And to help member countries to meet their commitments, promoters of clearing unions usually plan to build up a common pool of international reserves. The FLAR we have mentioned comprises this type of arrangements. In the Ecuadorian proposal, the Bank of the South would play a similar role. As for him, Keynes did not consider the building up of a common pool of reserves as a necessity (cf. Keynes 1943a). In his scheme, any country holding drawing rights or creditor accounts in the international currency (he named "bancor") would be simply entitled to ask any other member country to exchange bancors for the latter's currency. Anyhow, whether reserves assets are gathered together in a common pool or supplied on demand by creditor countries, the creation of drawing rights raises cases that commentators did not fail to make against Keynes's plan.

Let us consider a first case that US negotiators brought up at the Bretton Woods conference. The latter were namely concerned about the difficulty creditor countries, and specifically their country, would likely have in limiting and controlling their commitment to supply their currencies against the international currency. Allied to this, they also feared '[...] that the open-ended obligation to provide credit, involved in the Clearing Union, might have an inflationary effect in the United States, with adverse results on the dollar' (Horsefield, 1969, p. 49).

Keynes's response was that the US would not become a creditor to the Union, and therefore supply finance in dollars to deficit countries, except if she shows a trade surplus. He added that far from being a burden, becoming a creditor to the Union would be a facility: it would allow countries to keep balances in the international currency they earn when exporting goods and assets, until they spend them on foreign goods and assets (Keynes, 1943b, p. 276). He concluded that if the US were to accumulate excessive balances in bancors, it would mean that 'she has failed to solve her own problems' (p. 277).

Keynes did not convince the US negotiators, and the latter actually had good reasons for remaining sceptical. On the one hand, there is no doubt that in making drawing rights available to countries the clearing union grant credit to deficit countries and allow them to buy goods and assets from other member countries. To the deficit of some countries there necessarily corresponds a surplus in other countries. Then, contrary to Keynes's argument, it is not up to creditor countries to reduce their surplus. On the other hand, the funding of deficit countries would result in inflation in creditor countries and, moreover, in deflation in debtor countries. According to Keynes's proposal, amounts in the international money would be credited to surplus countries' central banks that would in turn, through commercial banks, credit exporters in the domestic currency. This means that domestic money would be created as a counterpart to the amounts of the international currency credited to the account of exporters' countries. Then, while the output available is reduced by exports, the quantity of money available in the economy is increased. Symetrically, deficit countries' central banks would meet a debit in the international currency, the counterpart of which would be made up of the sums of domestic currency spent by the importers and that in this way would be no more available in the economy for funding purchases on the goods available. In the latter case, the quantity of goods is increased by imports while the quantity of money is reduced.

In the 1970s, after the collapse of the Bretton Woods system, the International Monetary Fund member countries began thinking about reshaping the international monetary system. One of their objectives was to ensure short-run stability in exchange rates whereas the latter would be allowed to change in the long run. But, as McKinnon emphasised, the existence of 'hot' money made long-term flexibility in exchange rates incompatible with their short-run stability, except if foreign exchange controls were introduced, which was not considered acceptable at that time:

As long as world financial markets remained (modestly) open, speculative hot money flows would tend to anticipate any discrete change in official par values. And, certainly by 1973–74, the negotiators did not want a return to the draconian exchange controls that Keynes had in mind in 1943. (McKinnon, 1993, p. 25)

It is true that in order to ensure exchange rate stability Keynes recommended implementing strict exchange controls, especially in the early versions of his plan. In subsequent versions, he was more moderate but there is no doubt that foreign

exchange controls were part of his plan: “[...] the universal establishment of a control of capital movements cannot be regarded as essential to the operation of the Clearing Union; and the method and degree of such control should therefore be left to the decision of each member state” (Keynes, 1942, pp. 185–86).

These cases are all still relevant with reference to regional clearing unions. On the one hand, drawing rights would be allotted to member countries that would worsen balance of payments disequilibria in the region and induce inflation and deflation pressures on creditor and debtor countries respectively. On the other hand, the system would prove unable to stabilize member countries exchange rates and in this way it would enforce the use of the dollar or any other key-currency as a standard and an ever convertible asset among member countries. As for foreign exchange controls, if applied, they would run counter to a major goal of regional unions, to wit, to enhance the economic and financial integration of member countries.

4. The need for a novel system for exchanging currencies: Keynes’s scheme and how to supplement it.

In this section we argue that Keynes defined a system for exchanging domestic currencies for each other that can be improved and help get over the objections we have just examined.

As Keynes puts it in preamble to his plan, the bancor would have been a currency used by countries operating through their central banks or Treasuries while private individuals and companies would continue to use their domestic currencies:

We need an instrument of international currency having general acceptability between nations, so that blocked balances and bilateral clearings are unnecessary; that is to say, an instrument of currency used by each nation in its transactions with other nations, operating through whatever national organ, such as a Treasury or a central bank, is most appropriate, private individuals, businesses and banks other than central banks, each continuing to use their own national currency as heretofore. (Keynes, p. 168)

He also made it clear that

Within any member-country [...] the provision of foreign exchange to be concentrated in the hands of its central bank which would deal with the public through the usual banks. That is to say, a member of the public here desiring

to obtain dollars for a specified purpose would instruct his bank to make application to the Bank of England. [...] Central banks would buy and sell their own currencies amongst themselves only against debits and credits to their accounts at the Clearing Bank (Keynes, pp. 33-34).

Unfortunately, this scheme does not counter the objection relating to the funding of deficit countries and its inflationist and deflationist effects. Central banks in creditor countries would supply their own currencies against credits in bancors while central banks in debtor countries would buy their own currencies against debits in bancors. This scheme, as well, would not be able to ensure exchange rates stability. Since foreign exchange would be concentrated in the hands of central banks, we may expect that the latter would be in a position to apply fixed exchange rates between their own currencies and the international currency. The difficulty, actually, would be to maintain exchange rates that would be less and less in accordance with inflation differentials, the system inducing inflation in creditor countries and deflation in debtor countries. Maintaining exchange rates stable would be all the more difficult that allocations of drawing rights would worsen payment imbalances. Then, just as McKinnon emphasised, speculative money flows would tend to anticipate any discrete change in official par values.

How are we to solve the problem? The analysis we are developing suggests that the issue lies in the way domestic currencies are managed per contra debits and credits in the international currency. Therefore, we may think along the same line as some Post Keynesian economists who have suggested that the national organs through which countries would operate should borrow or lend in the financial markets of the countries they are trading with, the very sums of foreign currency they spend or receive as a consequence of their residents' foreign transactions. In other words, an importing country A should borrow in the exporting country B the very sums of money B that is needed in country B to pay for the goods it is importing. The exporting country B, on its part, should lend in country A the sums of money A it earns.

This latter proposal is actually in accordance with the logic of international payments, by which a country pays for its imports of goods and securities by means of the export of goods and securities (cf. Rossi 2007). As a consequence, the clearing of debits and credits in the international currency could take place on a very short term basis and would not result in an accumulation of imbalances. This would be so

because any country importing or exporting goods would, as a counterpart, export or import securities. Deflation and inflation resulting from trade imbalances would be avoided and consequently exchange rates of domestic currencies against the common currency could be maintained fixed by the central banks without any need to implement capital controls.

A further issue to be considered relates to payments between member countries and non-member countries. How should the proposed system be connected to the international monetary system? In order to maintain the benefits of it, particularly the fixity of local currencies' exchange rates against the common currency and thus against each other, the member countries should behave as a whole vis-à-vis third countries. This means that the union should hold member countries' reserves in non-member countries' currencies (notably the US dollar). The union would then act as an interface in payments involving member and non-member countries, just as it would in member countries' mutual transactions. In this way member countries' currencies would never happen to be directly exchanged against other currencies and their fixity against the common currency could not be challenged. It is the common currency that would be exchanged for non-member countries and it would be up to the union to fix its exchange rate against, say, the US dollar, with reference to the balance of its member countries' payments, that is, with reference to a criterion that ensures the solvency of the union.

5. Conclusion

In the context of the present financial and economic crises, the need for a new Bretton Woods Conference has more often than not been evoked at the global level. There is no doubt, however, that the time for implementing a renewed international monetary system along the lines designed by Keynes, has not yet come, to wit, the US dismissal of a recent proposal by Chinese authorities to consider the creation of an international currency. Then, the implementation of regional currency unions appears more than ever as a solution to rule regional payments on a sound basis despite the asymmetries in the international monetary system.

In this paper, we have laid focus onto a key element of Keynes's plan, the system proposed for exchanging currencies for each other. We have seen that as it stood, this system was unsatisfactory since it would have allowed the aggravation of disequilibria and imposed foreign exchange controls within the regional union. With reference to a Keynesian framework we have endeavoured to show that this issue admits a solution that confirms the feasibility of a clearing union intended to rule regional payments in a sound way.

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