REGIONAL INTEGRATION IN THE AMERICAS:
THE IMPACT OF THE GLOBAL ECONOMIC CRISIS

A Role for Regional Integration Agreements in the Architecture of International Finance?

José María Fanelli

CEDES & MERCOSUR Research Network

Woodrow Wilson International Center for Scholars

November 23, 2009

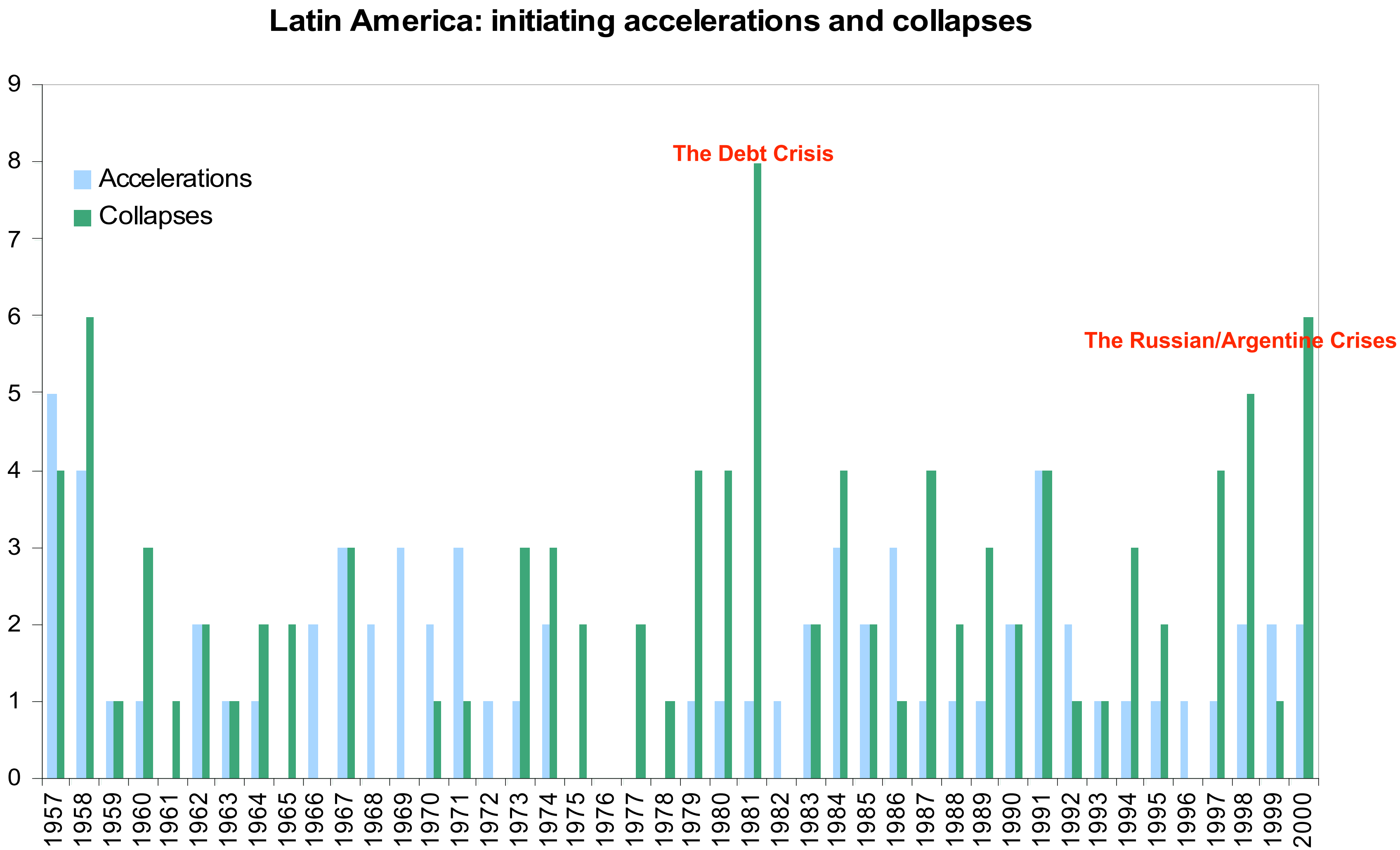
(I)

Volatility and Crises Matter in LA and the pre-crisis IFA was not effective at reducing volatility

Excess volatility in Latin America: some stylized facts

- ✓ ***Aggregate volatility is substantially higher than in developed countries***
- ✓ ***Consumption is usually more volatile than income, and investment volatility is high as compared to international standards***
- ✓ ***Crises have been frequent. Several countries experienced at least one important crisis in the "Second Globalization" period but the frequency of these crisis occurrences differs***
- ✓ ***The simultaneous occurrence of financial and real shocks (for example, interest rate and terms of trade shocks) compounds the size of growth collapses***

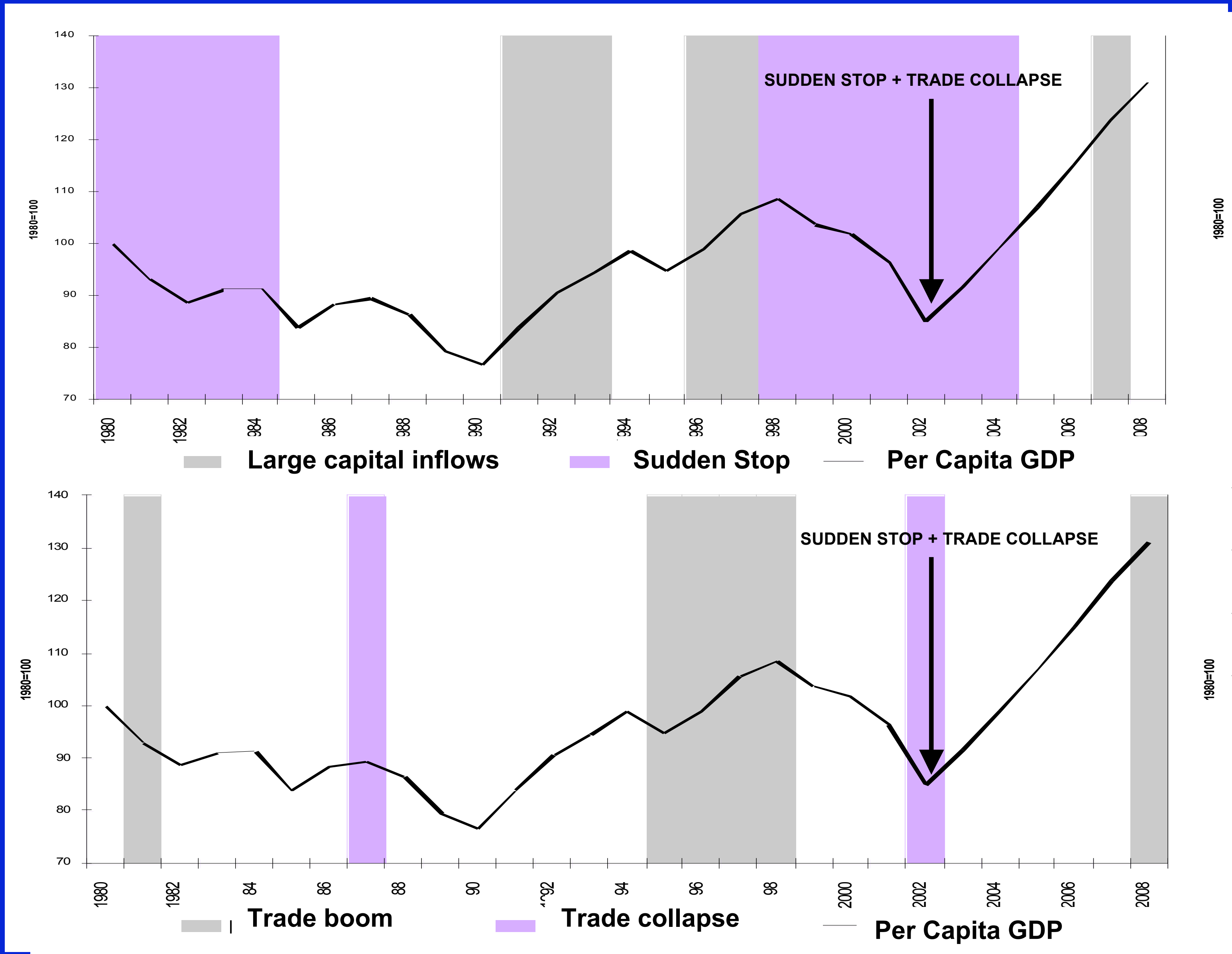
The Latin American region is particularly sensitive to financial shocks: more frequent collapses in 1981, 1998-2000



Sudden stops and large trade shocks occur frequently. Example, LAC-7

	Trade Shocks	Sudden Stops
Argentina	1986-87; 1993; 2002-03	1980-84;1994-96; 1998-2004
Brazil	1986;1999-2003	1981-85
Chile	1985-86; 2002-03	1981-86; 1998-2000
Mexico	1986;1992-94; 2003	1982-85; 1994-97
Colombia	1983;1985; 2002-04	1998-2002
Peru	2001-04	1981-86; 1997-99
Venezuela	1986-88;1998; 2002-03	1980-86

A simultaneous sudden stop and trade collapse. Example: Argentina



Weaknesses of the pre-crisis IFA from the LA point of view

- ✓ ***Financial stress, associated with sudden changes in risk aversion and domestic de-leveraging, causes strong output losses and has long-lasting deleterious effects on the aggregate investment rate***

- ✓ ***Currency and term mismatches play a role in nurturing financial disequilibria***

- ✓ ***The government acts as insurer of last resort and the fiscal imbalances provoked by the bailout of the banking system tends to erode public debt sustainability and affects political legitimacy***

- ✓ ***The authorities are unable to implement appropriate anti-cyclical policies in a context in which capital flows behave pro-cyclically***

- ✓ ***The resources that international financial institutions (IFIs) provided to counterbalance capital outflows and ease the credit crunch in the past did not suffice to significantly smooth aggregate fluctuations***

- ✓ ***More often than not, the conditionality attached to the funds did not help, either***

(II)

Volatility and a weak IFA provided incentives for

self-insurance in the 2000s

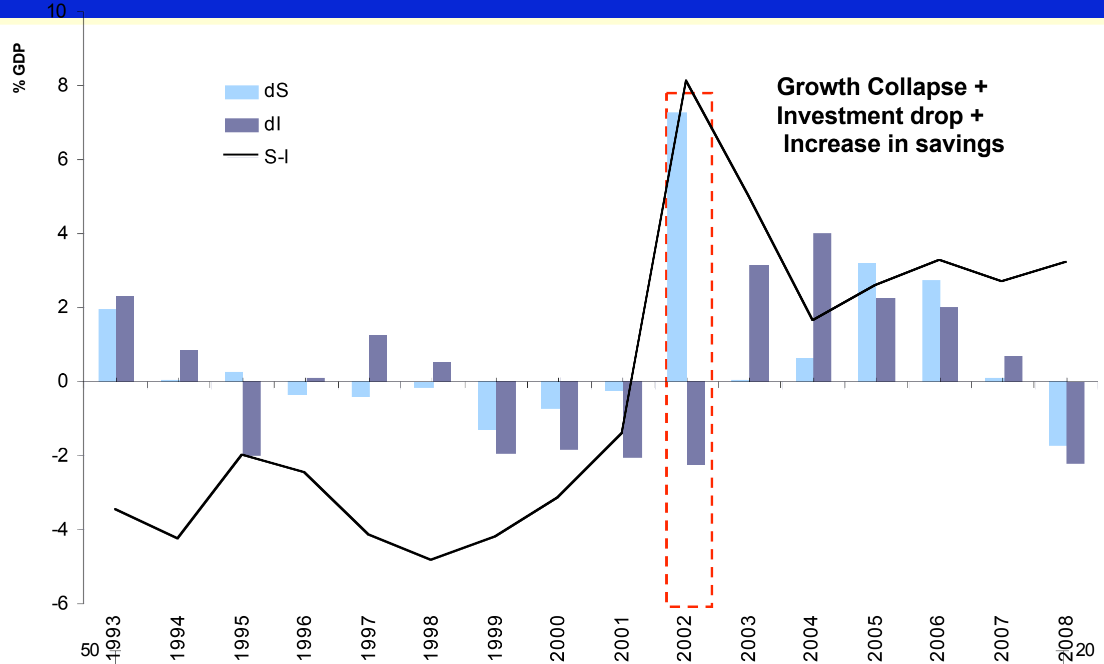
Self-Insurance in the Emerging Economies

- ✓ *A number of emerging countries that experienced episodes of financial stress and sudden stops in the 1980s and 1990s adopted a self-insurance strategy in the period prior to the international crisis*

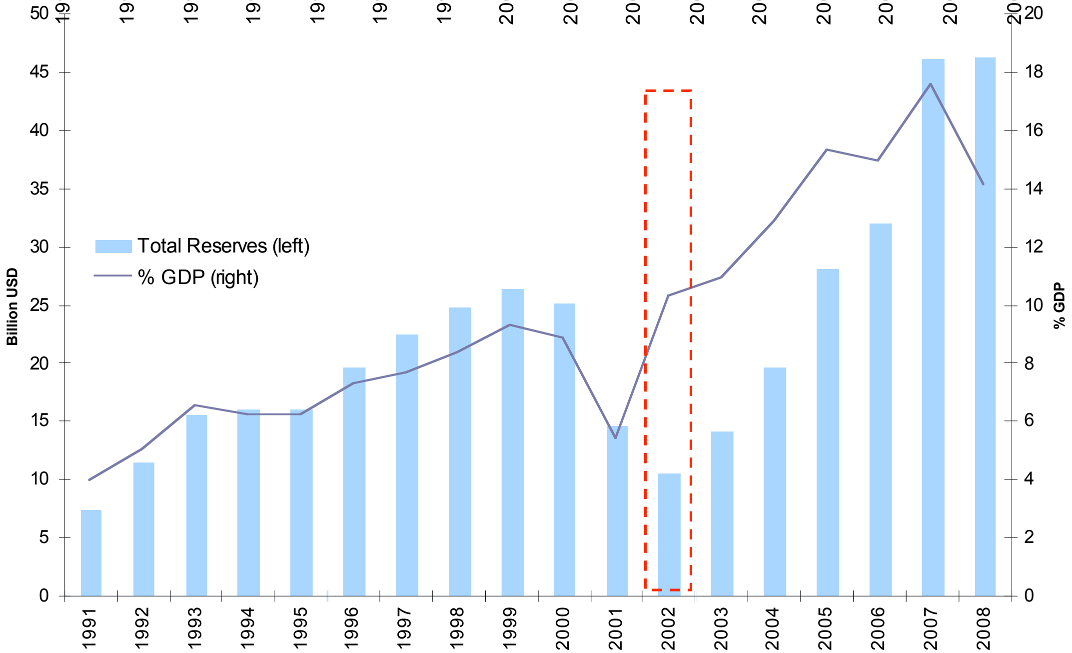
- ✓ *The widespread use of self-insurance strategies has fed global imbalances*

- ✓ *Some examples:*
  - *Argentina*
  - *Chile*
  - *Brazil*
  - *Korea*
  - *Indonesia*
  - *Thailand*
  - *Russia*

Argentina

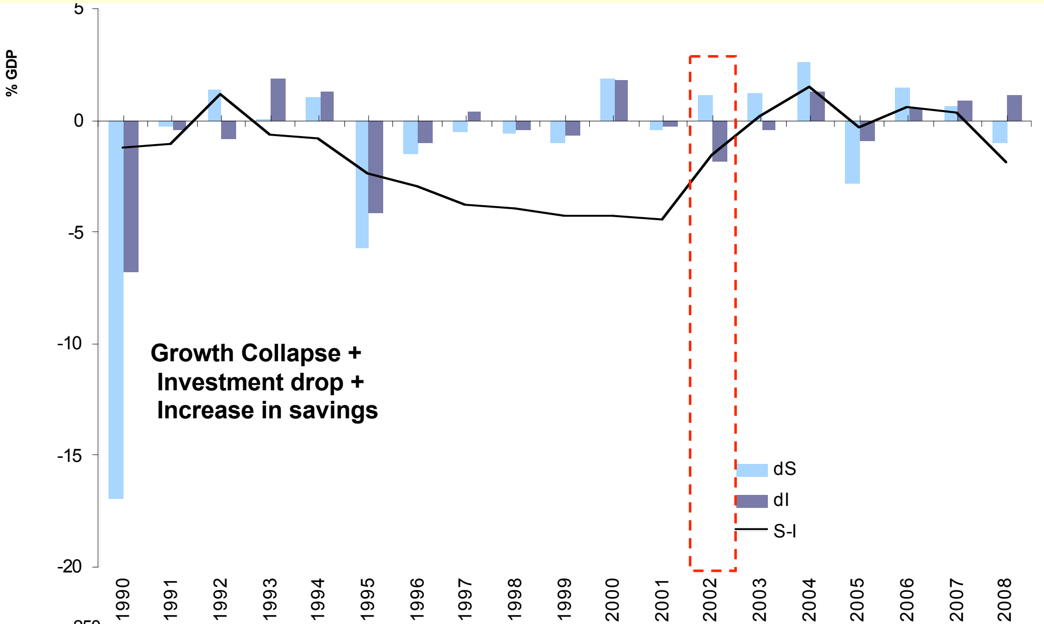


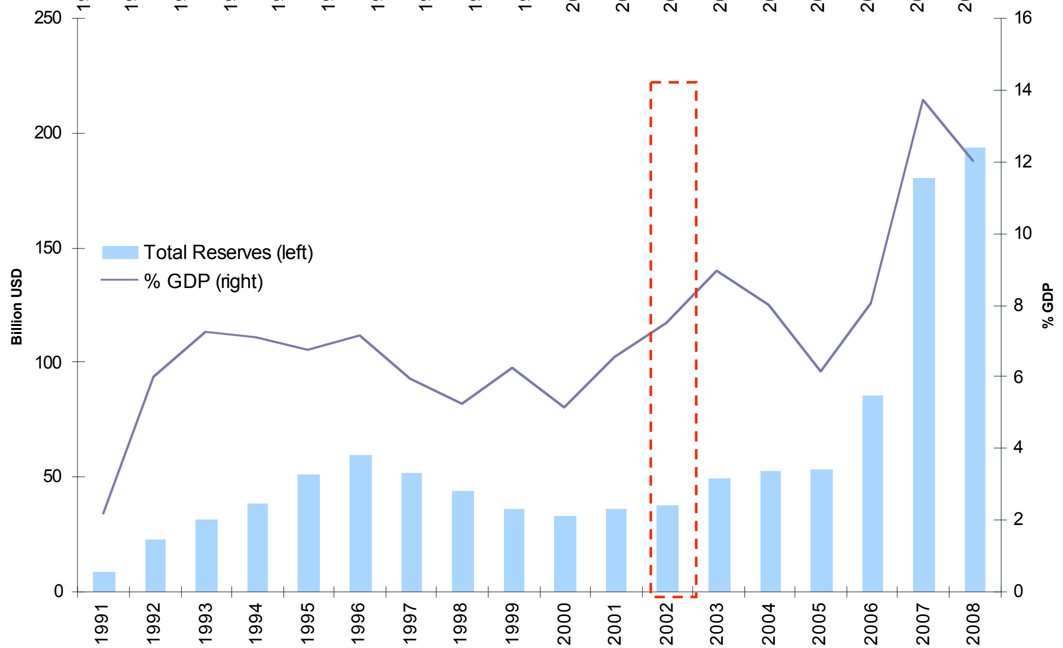
% GDP
dS
dI
S-I
Growth Collapse +
Investment drop +
Increase in savings
10
8
6
4
2
0
-2
-4
-6
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008



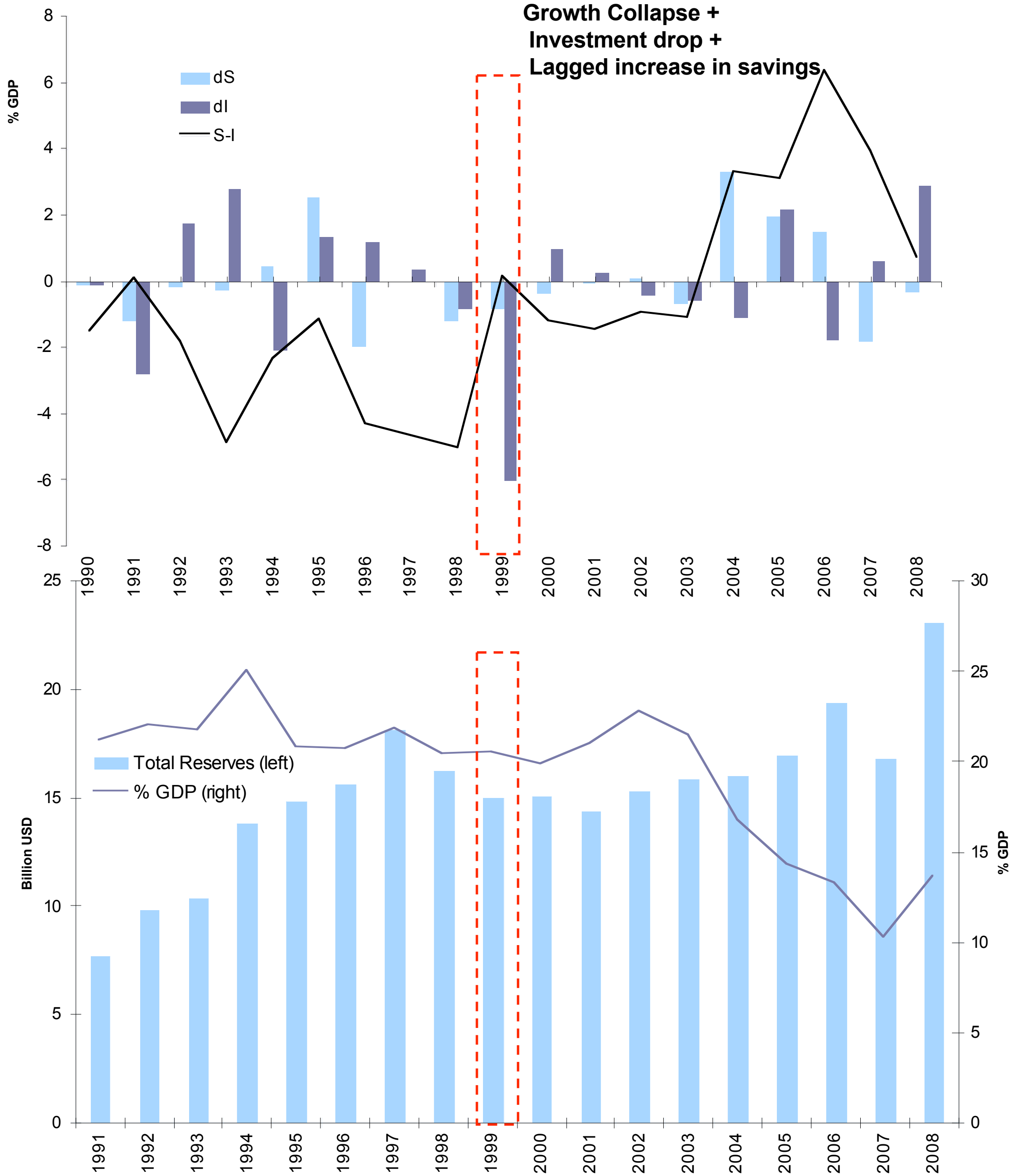
Billion USD
% GDP
Total Reserves (left)
% GDP (right)
50
45
40
35
30
25
20
15
10
5
0
20
18
16
14
12
10
8
6
4
2
0
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

Brazil


% GDP
5
0
-5
-10
-15
-20
Growth Collapse +
Investment drop +
Increase in savings
dS
dI
S-I
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

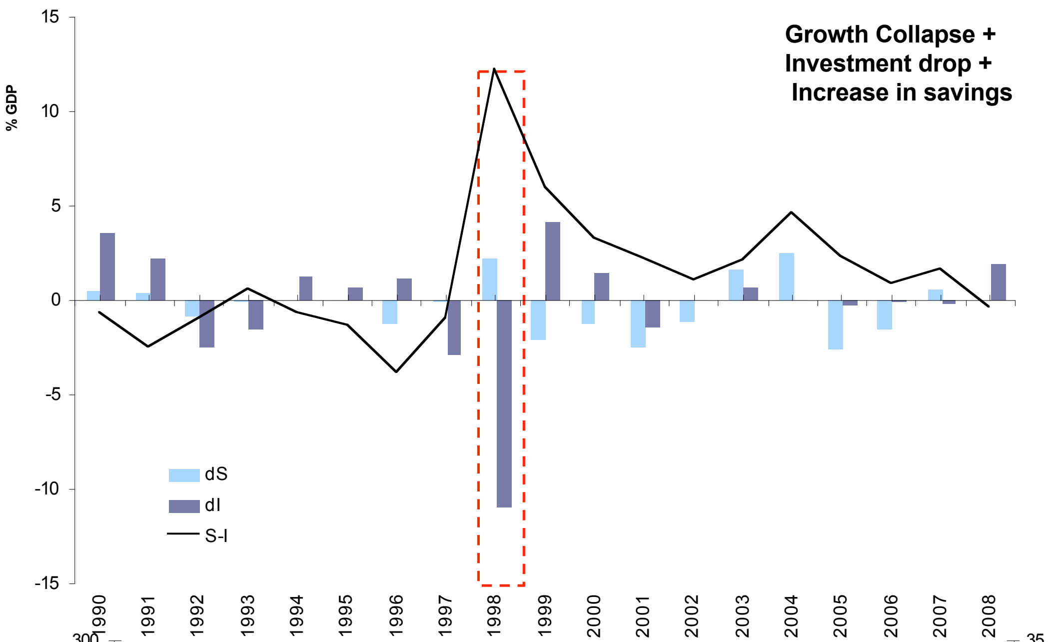

Billion USD
250
200
150
100
50
0
Total Reserves (left)
% GDP (right)
16
14
12
10
8
6
4
2
0
% GDP
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

Chile

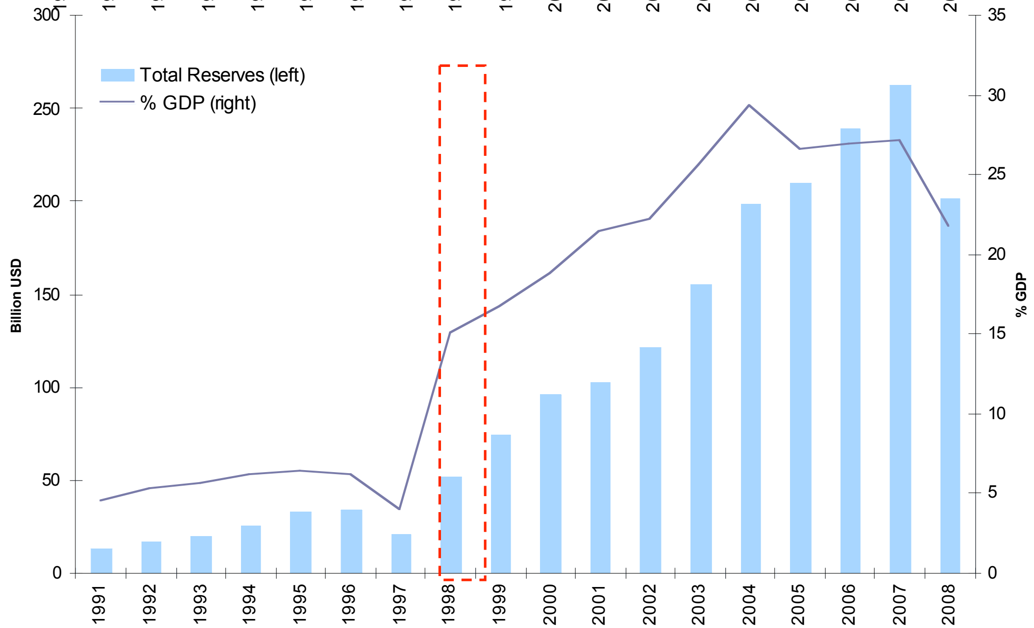


Growth Collapse +
Investment drop +
Lagged increase in savings
dS
dI
S-I
% GDP
8
6
4
2
0
-2
-4
-6
-8
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
Total Reserves (left)
% GDP (right)
Billion USD
% GDP
25
20
15
10
5
0
30
25
20
15
10
5
0
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

Korea

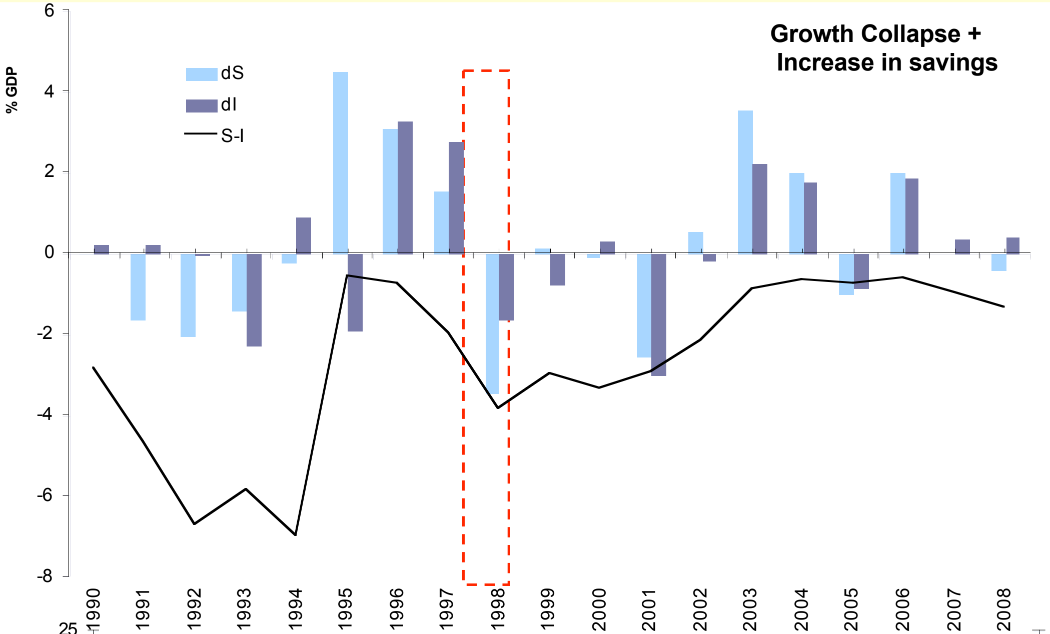


Growth Collapse +
Investment drop +
Increase in savings
% GDP
dS
dI
S-I

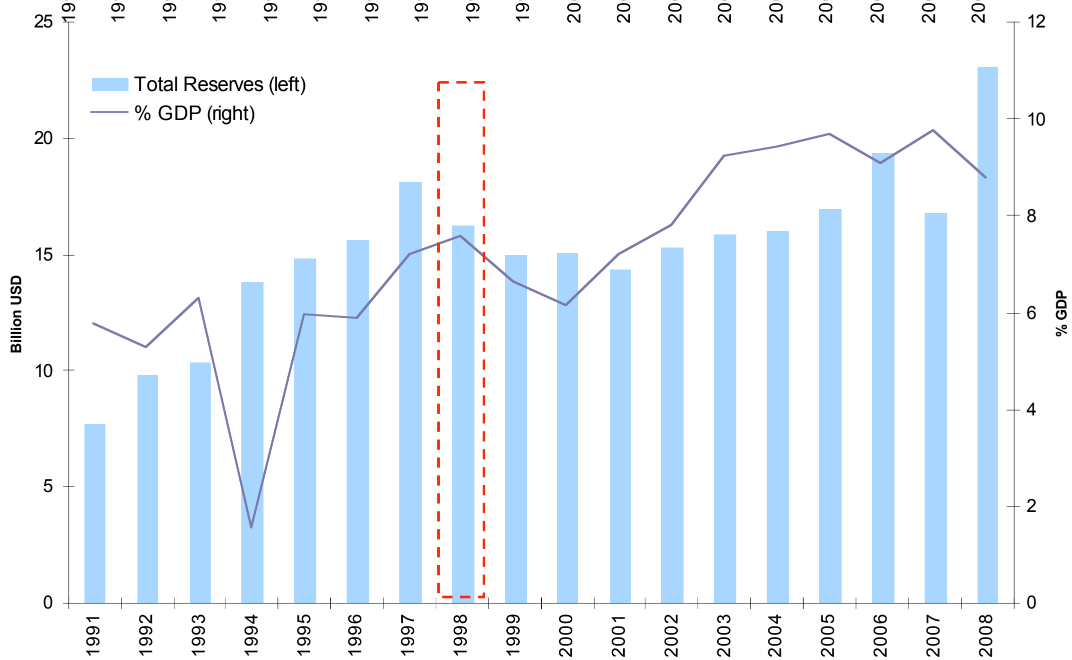


Total Reserves (left)
% GDP (right)
Billion USD
% GDP

Mexico

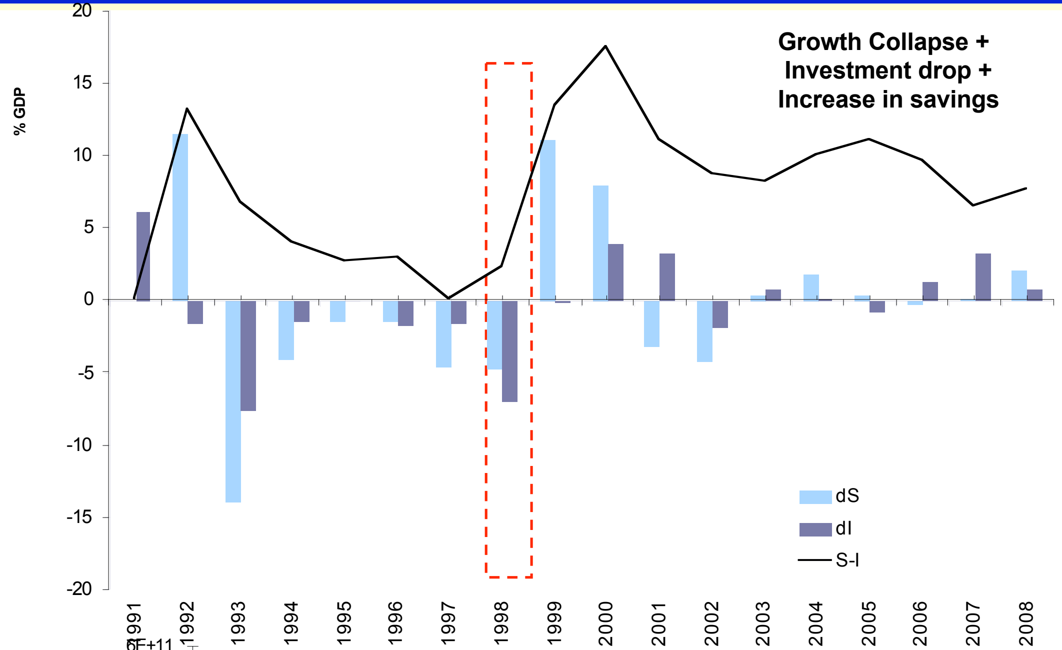


Growth Collapse + Increase in savings
% GDP
dS
dI
S-I
6
4
2
0
-2
-4
-6
-8
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

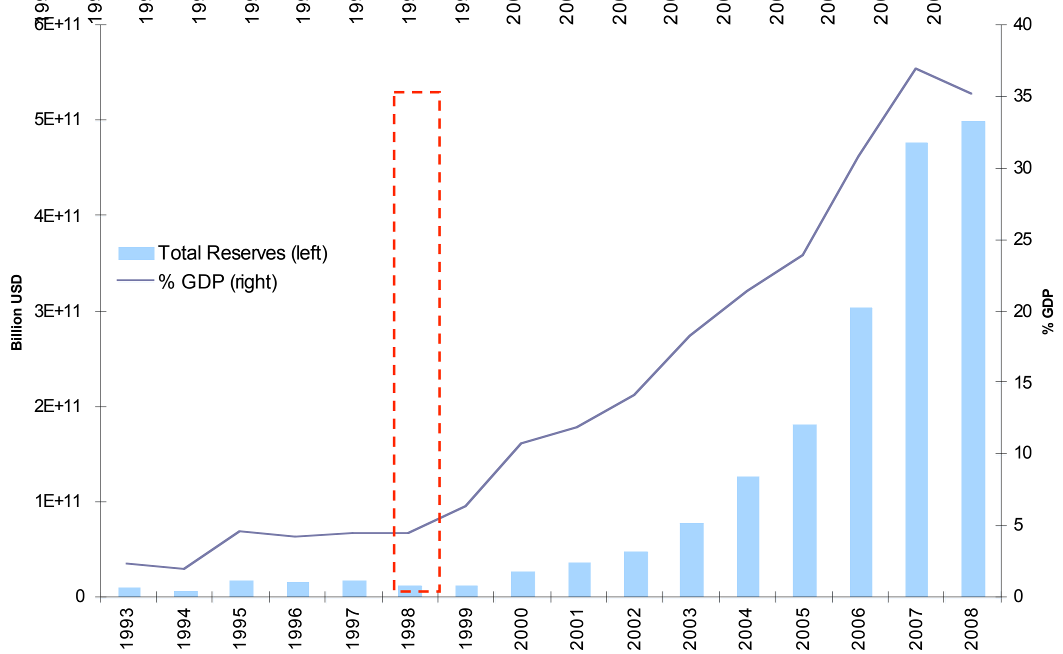


Total Reserves (left)
% GDP (right)
Billion USD
% GDP
25
20
15
10
5
0
12
10
8
6
4
2
0
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

Russia



Growth Collapse + Investment drop + Increase in savings
% GDP
20
15
10
5
0
-5
-10
-15
-20
dS
dI
S-I
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008



6E+11
5E+11
4E+11
3E+11
2E+11
1E+11
0
Billion USD
Total Reserves (left)
% GDP (right)
40
35
30
25
20
15
10
5
0
% GDP
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

Global failures and the reform of the IFA

✓ Self-insurance might <u>hinder global recovery</u>. The continuous generation of trade surpluses contributes to the preservation of the existing global imbalances:

Δ Trade Surplus ➔ - Δ Imports

✓ Self-insurance is a sub-optimal response from the national economy point of view: valuable savings are diverted from productive investment:

- Δ investment ➔ - Δ Imports

✓Excess volatility and crises create incentives for self-insurance; hence, mechanisms to smooth the cycle and reduce vulnerability should be placed at center stage

✓ The role of the IFA is to prevent the occurrence of global coordination failures associated with liquidity provision, pro-cyclical capital flows, and flawed regulations

✓The reform should be conceived as an institution-building exercise to be undertaken at the national, regional, and multilateral levels

✓Regional agreements can be instrumental at facilitating the reform of the IFA.

The role of Regional Agreements in the mitigation of global imbalances

✓ ***Regional Agreements can play a significant role in sustaining and promoting <u>international trade</u> in a world in which trade is not dynamic and beggar-thy-neighbor policies are a threat***

✓ ***Regional Agreements can provide the framework for coordination and <u>institution building</u>, in particular with regard to:***

- The design of mechanisms to manage international liquidity, reducing the costs of and incentives for <u>self-insurance</u>

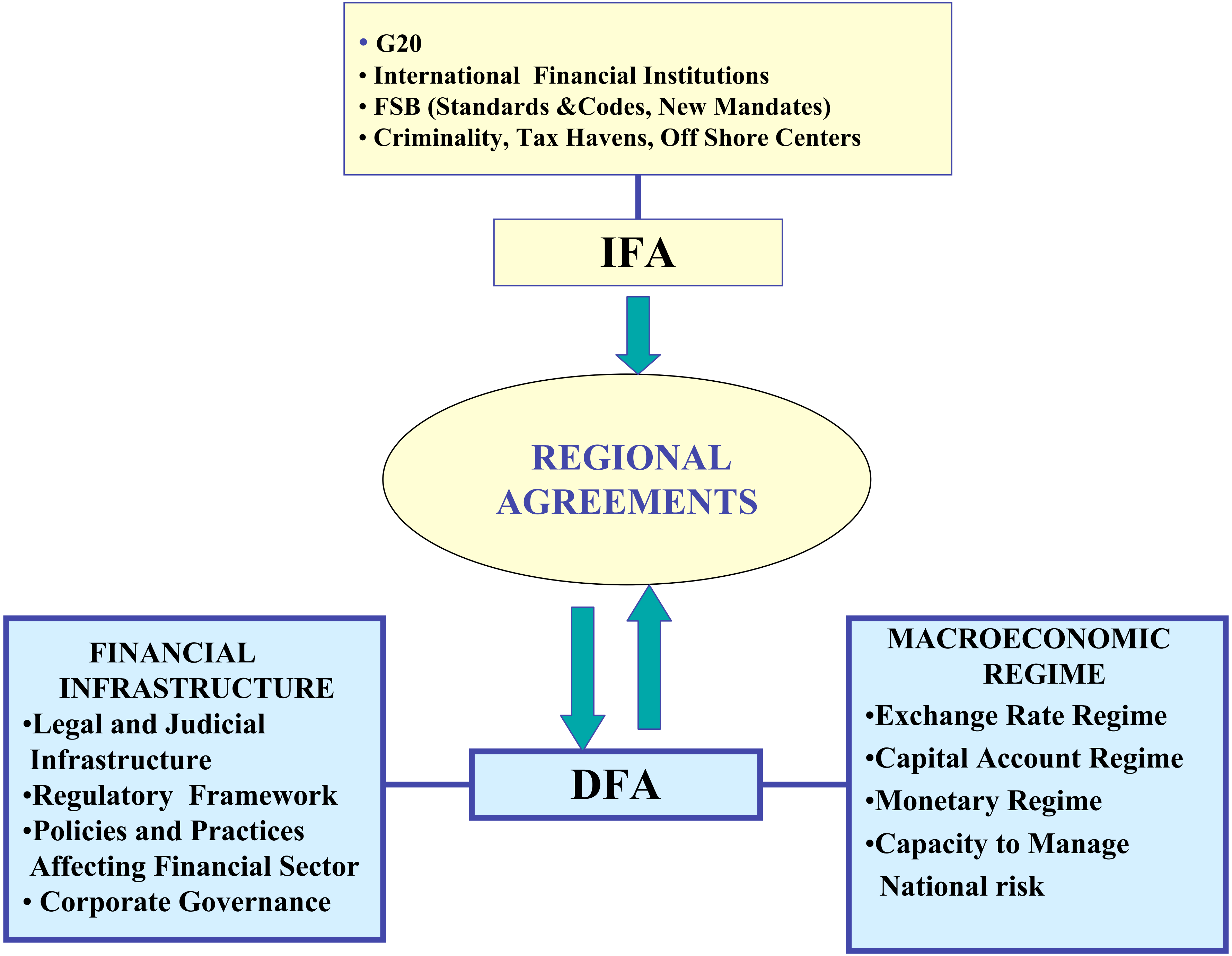
- The cooperation concerning the design and implementation of <u>standards and codes</u>

- The reduction of <u>macro volatility</u> via the coordination of macroeconomic policies

(III)

A stability-friendly IFA and the possible contribution of Regional Agreements:

An Exercise in Institution Building


• G20
• International Financial Institutions
• FSB (Standards &Codes, New Mandates)
• Criminality, Tax Havens, Off Shore Centers
IFA
REGIONAL AGREEMENTS
FINANCIAL INFRASTRUCTURE
•Legal and Judicial Infrastructure
•Regulatory Framework
•Policies and Practices Affecting Financial Sector
• Corporate Governance
DFA
MACROECONOMIC REGIME
•Exchange Rate Regime
•Capital Account Regime
•Monetary Regime
•Capacity to Manage National risk

Building the rules of the game after the crisis: the regional dimension

- ✓ ***Institution building** is difficult in LA economies and recommendations about standards and codes produced by the FSB or policies pushed by IFIs will not be enough*

- ✓ *The regional level can act as an intermediate step to articulate national and multilateral efforts: Three LA countries are members of the G20, two of them also belong to MERCOSUR*

- ✓ *Regional arrangements can supply key regional public goods. Lack of success in providing these public goods will result in suboptimal, probably unstable, unilateral solutions*

- ✓ *A blueprint and appropriate context-dependent strategies for institution building and enforcement are needed and regional arrangements can contribute to "internalizing" FSB and G20 recommendations, building a sense of policy ownership*

Building the rules of the game after the crisis: the regional dimension

- ✓ ***Regional Agreements can provide the framework for institution building concerning three pillars: Liquidity assistance + Monitoring and surveillance + Exchange rate coordination.***

- ✓ ***The emphasis should be on:***

  - The design of mechanisms to manage international liquidity, reducing the costs of and incentives for self-insurance; example: the Chiang Mai Initiative, the FLAR
  - The reduction of macro volatility via the coordination of macroeconomic policies

- ✓ ***Regional partners should cooperate concerning:***

  - The implementation of instruments that encourage more stable private flows (counter-cyclical guarantees); explicit introduction of counter-cyclical criteria in the design of prudential regulatory and supervisory frameworks;
  - Market-mechanisms that can better distribute the risk throughout the business cycle in the member countries (GDP-indexed and local currency bonds?)

- ✓ ***An evolutionary approach to institution building can help (Swap Arrangements, Bonds Markets)***

Building the rules of the game after the crisis: the regional dimension

✓ ***Regional Agreements can play a significant role in sustaining and promoting international trade in a world in which:***

- Trade is not dynamic and beggar-thy-neighbor policies are a threat
- Unilateral initiatives, such as aggressive exchange rate policies can harm intra-regional trade in existing regional agreements

✓***Political legitimacy matters for institution building: The goal of mobilizing resources for development must be part and parcel of the strategies to strengthen the banking sector and capital markets. Example: strengthening regional development banks***

✓***Institutional mechanisms should be designed at the regional level to mobilize the resources of countries that are generating a structural surplus. Example: initiatives to increase regional financial integration***

Thank you!

José María Fanelli