

New Issues in Regional Monetary Coordination

**New Issues in Regional
Monetary Coordination**
Understanding North-South and
South-South Arrangements

Edited by

Barbara Fritz

and

Martina Metzger

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Notes on the Contributors

Peter Bofinger is Professor for Monetary Policy and International Economics at Julius-Maximilians-University Würzburg (from 1992) and a Member of the German Council of Economic Experts (from 2004). He was formerly Vice-President of the same University (2003–4). He has researched monetary theory and policy, European integration, currency theory and policy, transition economics, reform issues of the social security system, and coordination of monetary and fiscal policy. His current research interests are economic policy and reform issues, e.g. the social security system.

e-mail address: bofinger@t-online.de

Fernando J. Cardim de Carvalho is Professor of Economics at Institute of Economics, Federal University of Rio de Janeiro. His research areas and current research interests are macroeconomics, international finance, finance and development.

e-mail address: ficcarvalho@uol.com.br

Herbert Dieter is Senior Research Associate at the German Institute for International and Security Affairs, Berlin, and Associate Fellow at the Centre for the Study of Globalization and Regionalization, University of Warwick. His research areas are international economic relations, globalization and regionalization, financial crises and the reorganization of the international financial system. His current research interests are regional cooperation in Asia.

e-mail address: herbert.dieter@swp-berlin.org

Heiner Flassbeck is Officer-in-Charge, Division on Globalization and Development Strategies, UNCTAD, Geneva. He was State Secretary at the Federal Ministry of Finance, responsible for international affairs, the EU and the IMF; German Institute for Economic Research (DIW); Federal Ministry of Economics, Bonn; German Council of Economic Experts, Wiesbaden. Affiliation/institution: American Economic Association. His research areas and current research interests are macroeconomics and international finance.

e-mail address: heiner.flassbeck@unctad.org

Barbara Fritz is Senior Researcher at the Institute for Ibero-American Studies, Hamburg. Previously she was Assistant Professor at the Free University Berlin. Her research areas and current research interests are monetary issues and exchange rate regimes in developing countries, and economic development in Latin America.

e-mail address: fritz@ilk.duei.de

Dirk F. Kohnert is Deputy Director at the Institute of African Affairs, Hamburg. He was Senior Research Fellow at the University of Bielefeld (1981–4), Co-ordinator of the Regional Planning Department, Ministry of Planning, Bissau, Guinea-Bissau (1985–6), and Senior Development Expert GTZ, Cotonou, Benin, 1987–90. His research areas are the socio-cultural dimension of economic development in sub-Saharan Africa; participatory development planning, target-group analysis, poverty-assessment; agricultural extension, and the politics of decentralization and empowerment; project and programme evaluation in developing countries. His current research interests involve the comparative study of cultures of innovation in Africa and Latin America.

e-mail address: kohnert@jak.duei.de

Jan Kregel is Chief of the Policy Analysis and Development Branch of the United Nations Financing for Development Office. He previously served as a high-level expert in International Finance and Macroeconomics in the UNCTAD. Before joining the UN he was Professor of Economics at the Università degli Studi di Bologna as well as Professor of International Economics at the Johns Hopkins University, Paul Nitze School of Advanced International Studies, where he also served as Associate Director of its Bologna Centre from 1987 to 1990. He is a Life Fellow of the Royal Economic Society (UK), an elected member of the Società Italiana degli Economisti, and a *Membro Distinguido* of the Association of Cuban Economists. He has published widely on Keynesian economic theory and development issues.

e-mail address: kregel-ny@un.org

Martina Metzger is Senior Researcher for the Berlin Institute of Financial Market Research (BIF). Before joining BIF, she was Assistant Professor for Macroeconomics at the University of Applied Science in Berlin. She previously served as a research fellow and lecturer at the Department of Economics of the Free University of Berlin; her research areas are monetary theory and policy, exchange rate regimes and international finance; besides monetary coordination projects her recent

research interests lie in Basel II, funded social security systems and financial sector's implications of migration.

e-mail address: martina.metzger@bif-berlin.de

Manfred Nitsch is Professor Emeritus of Political Economy at the Latin American Institute, Free University Berlin. His research areas and current research interests are monetary aspects of development, microfinance, Amazonian studies.

e-mail address: manfred.nitsch@f-online.de

Peter Nunnenkamp is Senior Research Fellow at the Kiel Institute for World Economics. His current research interests are implications of globalization for industrial and developing countries; foreign direct investment; foreign aid; financial crises and reforms of the financial architecture.

e-mail address: nunnenkamp@ifw.uni-kiel.de

Ugo Panizza is an economist in the Research Department of the International Development Bank. Prior to joining the IDB he was an assistant professor in the Department of Economics at the University of Turin (Italy). He also held a visiting position in the Department of Economics at the American University of Beirut and worked as consultant for the World Bank. He holds a *Laurea* in political science and economics from the University of Turin and a PhD in economics from Johns Hopkins University. His research interests include political economy, international finance (with particular reference to the structure of external debt and the choice of the exchange rate regime in emerging market countries), and public sector labour markets.

e-mail address: UGOP@iadb.org

Beate Reszat is Senior Economist at the Hamburg Institute of International Economics. Her research areas and current research interests are European and international financial markets and monetary policy cooperation. She also serves as a lecturer on European and International Financial Market issues and on Macroeconomics at several universities and academies.

e-mail address: reszat@hwwa.de

Waltraud Schelkle is Lecturer in Political Economy at the European Institute of the London School of Economics (LSE) and Adjunct Professor at the Economics Department at the Free University Berlin. Previously she was Visiting Professor at the Economics Department, Free

University of Berlin, and Research Fellow at Johns Hopkins University (AIGGS). Her research areas are monetary integration and welfare state reforms. Her current research interests are fiscal policy co-ordination in EMU and social policy coordination in the EU.

e-mail address: w.schelkle@lse.ac.uk

Jan Suchanek is an economist and journalist. His research areas are currency problems in Africa, neo-colonialism, integration, media and development. His current research interests are cooperation between the European Union and the African Union, community radio and independent media in Africa.

e-mail address: janmaat@so36.net

Preface

The issue of regional monetary coordination has moved to the forefront of the policy and academic agenda, with a large number of developing countries involved in projects aimed at regional monetary coordination. This is due to three factors:

- The successful creation of the euro, and its international projection. Developing economies have paid particularly close attention to the eastern enlargement of the EU. If these countries join the euro zone in the medium term (or even if they choose other arrangements, with the euro as their key currency), the result will be a hitherto unknown model of international monetary coordination between countries with considerable differences in income levels.
- The increasing regionalization of international trade imposes new monetary restrictions on those countries that do not belong to either of the major trading blocs. For these reasons, the formation of regional currency arrangements is increasingly being considered.
- The series of financial crises in emerging markets in recent years has highlighted the difficulties of unilaterally defending a national currency under the present conditions of globalization, free capital movement and the absence of a single globally dominant key currency. The increased exchange-rate volatility between international key currencies due to intensified monetary block-building has underscored the crucial role of extra-regional shocks.

However, research has by-passed the question of the specific conditions and problems of monetary South-South coordination in which, unlike in North-South arrangements, none of the international key currencies, the dollar, the euro or the yen, is involved.

For that reason, we invited outstanding scholars to the Institute for Ibero-American Studies in Hamburg for an international workshop from 7-9 July 2004 to debate the issue of regional monetary coordination from this specific viewpoint.

The contributions of this book, based on the conference papers, seek to provide a fresh analytical perspective on the study of regional monetary cooperation, particularly emphasizing the differences between North-South and South-South arrangements. By bringing together new

theoretical approaches and substantial empirical findings from various world regions, our goal is to sketch a framework that will allow for an innovative interpretation and a convincing typology of regional monetary coordination initiatives in Africa, Asia, Eastern Europe and Latin America.

The term 'monetary coordination' as used here covers a broad spectrum of economic policy activities, ranging from *ad hoc* monetary and exchange-rate policy arrangements between neighbouring countries to the creation of a common supranational currency, and including such intermediate steps as the creation of regional liquidity funds, or the establishment of regional monetary systems with adjustable exchange-rate bands and mutual intervention agreements between central banks. The guiding perspective of the contributions of this book is toward the elaboration of macroeconomic constellations that may open up opportunities for stabilization and sustainable development.

In this context, the term 'South' is not entirely a geographical characterization. In accordance with the 'original-sin' argument, the assignment of a country to the typological categories of 'South' or 'North' is determined by its ability to accumulate debt in its own currency ('North'), or predominantly in a foreign currency ('South'). In this sense, many of the Eastern European transformation countries are as much 'southern' as the developing countries of Asia, Africa and Latin America – although a closer look leads to a further differentiation within this group of 'southern' economies and monetary coordination projects.

The articles in Part I of the book deal with qualitative differences between countries of the South and of the North and hence the different potentials of South–South coordination projects as compared with North–South coordination arrangements. They do this by drawing on the original-sin hypothesis, by resorting to historic examples of regional monetary coordination, and by analysing the exchange rate options for developing countries.

Barbara Fritz and Martina Metzger discuss the opportunities and limitations of South–South coordination projects, compared with North–South arrangements. They concentrate on the specific monetary restrictions to which developing countries are subject in stabilizing their exchange rates and initiating a sustainable development process, e.g. currency mismatch, restricted lender-of-last-resort functions, and the costs of original sin. Furthermore, they outline some features of a South–South coordination project which are not identical with conventional OCA criteria, e.g. similar vulnerability with regard to extra-regional factors, a clear hierarchical structure between member countries, and cooperation

between macro players both at the domestic and regional levels. They come to the conclusion that South–South coordination projects do indeed have the potential for limiting a mercantilist race to the bottom from the very outset, and can reduce original sin over the medium to long term. However, escaping original sin is not without its costs.

In the second chapter, Ugo Panizza presents a concise summary of the hypothesis and the empirical outcomes of the so-called original-sin hypothesis. The main lesson is that the inability to borrow abroad in domestic currency is the factor that, over the long run, most hampers growth. In the last section of the paper, dealing with monetary cooperation, he concludes that North–South monetary cooperation offers the obvious advantage of automatic redemption for the participating developing country marked by original sin. But even if South–South coordination does not bring with it that advantage, the author argues that at least for monetary unions that include large and well-diversified economies, the increased size of the currency area can raise the interest of international investors in holding this currency in their portfolios.

In her comment to Panizza's paper, Waltraud Schelkle highlights the policy relevance of the original-sin hypothesis for developing countries. She then identifies some 'hidden treasures', such as the importance of foreign direct investment that may strengthen the demand for domestic currency, concluding that one criterion for choosing one's partners for a common currency could be their attractiveness to foreign direct investors, since their demand for the common currency would then spill over to the other members, reducing the degree of foreign debt even in a case of South–South coordination. Schelkle concludes that some of the findings of original-sin research, such as the irrelevance of fiscal performance for the degree of original sin, the efficiency of financial markets, or the minor role given to monetary credibility, represent highly relevant questions for further research.

Historically, the idea of forming a monetary coordination project to reduce the dependence on foreign borrowing by member countries which are short of foreign exchange is not new. After giving an overview of different monetary coordination projects beginning with the former European Payments Union over current projects like ASEAN and the Mercosur, Jan Kregel identifies as major benefits of a monetary coordination project – be it North–North, South–South or North–South – efficiency gains caused by the use of net settlement systems or the pooling of reserves. However, he analyses crucial limitations of such projects, e.g. volatile autonomous capital inflows and the widespread lack of monetary sovereignty of developing countries. He proposes a

deepening of regional capital market integration with regard to commercial bank asset portfolios as an alternative to a South-South monetary coordination project.

In his comment, Peter Nunnenkamp states that the phenomenon 'original sin', and the tight external financing constraints under which developing countries suffer, might be caused by both domestic and international institutional deficiencies. Furthermore, he stresses that it is important to differentiate monetary coordination arrangements according to their objectives and the corresponding types, e.g. settlement of payments, agreements for balance of payments support, and monetary unions. He raises the question of what can reasonably be expected from a South-South monetary coordination project if exchange-rate volatility to hard-currency areas is the major problem, and if those hard-currency areas are not involved in the coordination projects.

Heiner Flassbeck focuses on the need for multilateral exchange-rate coordination, be it at the regional or at the global level. A key condition for successful economic performance is the ability to keep the domestic exchange rate at a competitive level. However, especially those developing economies which show higher inflation rates than the international level and have a liberalized capital account are not able to achieve competitive and stable exchange rates. Inflation stabilization requires higher interest rates that attract interest-rate-driven capital inflows, the appreciation of the exchange rate will lead to a loss in international competitiveness and the risk of costly financial crises. Since the exchange rate is by definition a multilateral phenomenon, attempts by many countries to undervalue their currency may end up in a globally harmful race to the bottom that could be prevented by multilateral arrangements. In a world without such multilateral solutions, the only way out, especially for smaller and less competitive developing countries that are not members of a regional monetary union, is to resort to capital import controls.

The articles of the Part II of the book give a detailed overview of selected regional case studies which include, on the one hand, such already-existing monetary arrangements as the CFA zone in Francophone Africa and the common currency zone of southern Africa and, on the other, regions which are striving on an implicit or even explicit basis for monetary integration over the medium term (NAFTA, Mercosur and ASEAN or ASEAN +3), or which will have to define such arrangements in the context of the future enlargement of key currency zones (the eastern European transformation countries).

Based on an analysis of the existing exchange rate regimes adopted by the new EU member countries, Peter Bofinger comes to the conclusion

that managed floating is better than expected, while the two corner solutions might be sub-optimal. Furthermore, he discusses the adequacy of ERM II for both the pre-convergence period and the two-year transition period prior to adoption of the euro by the new EU member countries. He identifies several flaws in the current ERM II mechanism, of which the mutual determination of exchange rates, the safeguard clause with regard to intra-marginal interventions with its ECB veto right, and the very limited financial support in case of speculative attacks, are the most damaging. Finally, proposals to overcome the asymmetry of rights and obligations inherent in the current ERM II mechanism are presented.

Before drawing on the case of the Mercosur, Fernando Cardim de Carvalho first discusses the arguments developed in the Optimum Currency Area (OCA) tradition, relates it to issues like price stabilization and exchange rate regimes, and then discusses the special case within OCA of dollarization; finally, he addresses the case of monetary unification of the Mercosur countries. Analysing then the OCA question for Argentina and Brazil, the two biggest economies within Mercosur, Carvalho concludes that the costs of a common currency are too high and offer too little, and argues instead for less far-reaching joint measures, such as the introduction of common protective policies like capital controls, to reduce vulnerability.

Manfred Nitsch comments on the Carvalho paper in the light of the non-neutrality theory of money that posits an international monetary hierarchy. Sketching the monetary options in Mercosur, he concludes that an intermediate solution for the exchange-rate regimes of all participants could help to increase regional convergence of policies and harden the currencies within the region.

Barbara Fritz argues in her paper that although Latin America forms part of the US dollar's 'sphere of influence', its countries and sub-regions are seeking rather divergent monetary strategies. Among them, she first analyses Mexico as a case of implicit monetary coordination within NAFTA. The second case treated in the chapter is Mercosur, with its perspectives for monetary coordination, where Fritz concludes that even if stabilization gains may be small, regional cooperation is worth the effort, because in a highly unstable global financial environment, common regional strategies offer advantages over the national option of defending one's currency.

In the African continent, a series of agreements on monetary coordination exist, two of which stand out. The Common Monetary Area in Southern Africa is regarded as an unusually longstanding monetary

coordination project between developing countries. In her paper, Martina Metzger analyses the functioning of the CMA, including issues of institutions, interdependence and convergence. She identifies considerable benefits for the smaller member countries, e.g. low real interest-rate spreads, participation in seigniorage, the existence of a lender of last resort in form of the South African Reserve Bank, and access to foreign borrowing on the South African capital market. Furthermore, the smaller members show a favourable currency mismatch, as they earn forex other than rand while paying for the majority of their imports in rand. Hence, from the point of view of the smaller member countries, the CMA is a North-South coordination project, whereas for South Africa, with its volatile rand exchange rate *vis-à-vis* hard currencies, the CMA is more of a South-South coordination arrangement.

The North-South arrangement of the Franc CFA Zone is another long-standing monetary coordination project in Africa which stabilizes exchange rates between the member countries, as the French treasury guarantees full convertibility with an unlimited supply of liquidity. Although the literature states that the Franc CFA Zone is not optimal according to traditional OCA criteria, Jan Suchanek identifies as major benefits of the monetary coordination arrangement lower inflation rates and higher growth rates for the African member countries of the CFA than for neighbouring countries. The benefit is clearly paid for by a considerable overvaluation of the nominal exchange rates *vis-à-vis* the rest of the world, due to the peg with the French franc – now the euro – which has appreciated enormously against the US dollar during recent years. For the future, he expects limited progress in the ambitious project of a single African currency, as many countries do not fulfill convergence criteria, and due also to unsolved political and military conflicts.

In his comment on the CMA and the Franc CFA Zone, Dirk Kohnert argues that both monetary coordination projects have been shaped by external politics and informal economics. While the CFA Zone is based on the colonial heritage, and is highly dependent on the monetary policy of the Euro zone, the CMA is dominated by the regional giant South Africa, and monetary integration involves the risk of deepened economic and political dependence of the smaller member countries. For the future, he proposes the establishment of specific monetary regimes based on the needs of their member countries, rather than the simple application of economic optimality criteria, which might ultimately be sub-optimal for all members.

Since the Asian crisis in 1997 Asian policy-makers are continuously searching mechanisms to combat volatility of exchange rates and to

reduce vulnerability of their countries at the regional level. In his paper Herbert Dieter juxtaposes the traditional understanding of regional economic integration to an alternative model of monetary regionalism, which takes into consideration the link between monetary policies and the financial sectors of the participating countries. Although, the deepening of central bank cooperation and the efforts for the creation of a regional bond market are important and indicate a break with the policies of the past, he also shows the piecemeal progress that is apparent in cooperation in East Asia. One obstacle to further progress constitutes the political context in which this new monetary regionalism is embedded and where the three big players (China, Japan, US) have a blocking power over each other. The author argues that successful regional policy coordination will be as much dependent on Sino-Japanese relations and leadership as on US relations with these two states.

In her comment to Dieter's paper, Beate Reszat asks about the effectiveness of a regional liquidity fund to cope with Asian-style financial crises. Instead, she points to the fact that currency crises could be limited by establishing new rules to the few players, most of them western banks, in the interbank market of the country whose currency is under pressure. The editors wish to express their sincere thanks to the German Thyssen Foundation for the generous financial support, without which the workshop and this book would not have been possible. Our heartfelt thanks also go to UNCTAD, not only for co-financing, but especially for contributing to the workshop as regards content and discussion. We are very grateful to Laurissa Mühlich for supporting us with the preparation of the workshop, and to Gabriele Neusser and her team for their excellent technical assistance before and during the workshop. We also wish to express our appreciation to Palgrave and especially to Katie Burton who was prepared to support us whenever help was needed. And, as always, the authors alone are responsible for the contents of their contributions; the articles do not necessarily express the opinion of the institutions with which they are affiliated.

Hamburg/Berlin

BARBARA FRITZ
MARTINA METZGER